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Fiscal Imbalances and Economic Growth in Nigeria: Causes, Consequences, and Remedies

Olisah, Remigius Chinedu
Department of Economics
University of Calabar, Nigeria

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Abstract

Maintaining a sound and stable fiscal policy is desirable for maintaining macroeconomic stability and achieving sustainable national development. This is because fiscal imbalance and deficit pose serious challenges to governance and economic management. In augmenting these fiscal imbalances, the government applies several policies toward financing them. Such financing can in Nigeria emanate from domestic debt, foreign debt, and the banking system (including the central bank, deposit money banks, nonbank public, and privatization proceeds). The continuous cycle of fiscal imbalance affects national growth and economic development. This paper interrogates secondary literature on the causes, consequences, and remedies to fiscal imbalances and economic growth in Nigeria. It examines trends in other countries and provides evidence for policy adjustment as a remedy to the existing challenges. The paper concludes and recommends the need for financial discipline by public officers, which can be achieved through an independent fiscal institution to monitor fiscal activities in Nigeria.

Keywords: *Fiscal imbalances, Fiscal deficit, Economic growth, Financial discipline*

Corresponding Author: Olisah, Remigius Chinedu

Background to the Study

The role of government spending in the economy cannot be overemphasized. The government spends for the development of the economy at all levels. Ubong and Supper (2001) disclosed that "the government takes responsibility for the provision of economic and social overheads, such as roads, hospitals, water, electricity, sanitation, etc. as well as being directly involved in the production of goods and services. These expenditures are crucial to put the economy on the path of sustainable growth and development". In the middle stage of development, they said, "public expenditure will be much lower because public investment is complementary to private sector investment (Ubong and Supper, 2001).

A core tenet of macroeconomics is to put in place an effective fiscal policy for achieving macroeconomic targets and ensuring stability in the economy (Karagoz and Keskin, 2016). This policy is implemented towards achieving desired and targeted levels of macroeconomic variables like inflation, employment rate, GDP, interest rate, stock market prices, exchange rate, and external debt. In achieving these targets, the government applies varying fiscal policy tools in terms of revenue (tax and non-tax) and expenditures, which have over the years created a fiscal imbalance as expenditures overshoot revenue in several economies. The fiscal imbalance problem was specifically exacerbated after the oil crises in the 1970s and it affected both the developed and developing economies of the world (Karagoz and Keskin, 2016).

When expenditure exceeds her budget or funds available, it leads to fiscal imbalances, which negatively affects economic growth. Ubong and Supper (2001) explained that "Over the past two decades, the combined overall fiscal balance of the state governments has, more often than not resulted in deficits". The fiscal deficits of the state governments averaged N176.20 billion during the period between 2008 and 2013. It increased from N86.80 billion in 2008 to N272.50 billion in 2012, dropped to N141.40 billion in 2013, and thereafter rose to N311.0 billion in 2014, because of the drastic drop in international crude oil prices, which affected the share from the Federation account. It is an issue that many countries of the world are experiencing. The most dominant is the issue of fiscal deficit which has been on a rising trend as many countries try to embark on an expansionary fiscal policy. As pointed out by Friedman (1963), the quest to offset fiscal deficit can also create undesired consequences in the economy (Tung, 2018).

Fiscal imbalance became prominent in Nigeria after the civil war in early 1970, when the three R's (Rehabilitation, Reconstruction, and Re-integration) policy was introduced to reduce the negative consequence of the civil war. Deficit financing history in Nigeria began in 1978 when the country obtained a $ 1 billion loan which was presumed to be required for the reconstruction, rehabilitation, and development of the Nigerian economy which had been damaged by the war (Akinmulegun, 2014). He admitted that "The policy implication of the findings is that fiscal policy actions (whether surplus or deficit) can have a serious macroeconomic implication on the stability of the economy and national development" (Akinmulegun, 2014). Therefore, the concern is beyond reducing government expenditure or increasing government expenditure rather, "it is a matter of striking a balance on the appropriate fiscal imbalance that can be beneficial to the economy" (Akinmulegun, 2014).

This, therefore, calls for the need to sustainably manage the excesses in government spending and to have a proper mix of monetary and fiscal policy to achieve the desired macroeconomic stability and to ensure sustainable national development. This paper aims to evaluate secondary literature on the causes, consequences, and remedies to fiscal imbalances and economic growth in Nigeria.

Theoretical Framework

There are three schools of thought on deficit financing: The Classical, the Keynesian, and the Ricardian schools. This study will leverage the classical theory to explain the variables of the study. According to the classical theory of deficit, the budget deficit (fiscal deficit) has the effect of increasing current consumption by the government or consumers, but this is counterbalanced by a fall in investment. Perry (2014) opined that, by definition, if consumption rises, savings must fall. A fall in savings raises interest rates, which then reduces investment. Thus, crowding-out occurs when the budget deficit brings about to increase in interest rates and a reduction in investment. Savings is represented by the supply curve, while demand for investment funds is captured by the demand curve, which is downward sloping. As interest rates rise, individuals are more likely to save, but businesses tend to invest less, all things being equal, provided all other economic factors are held constant.

The Concept of Fiscal Imbalances

In an ideal economic situation, expenditure is a function of income. In other words, we spend what we earn and the same goes for governments. A fiscal imbalance is when government expenditures are unequal with the revenue the government is bringing in. put it simply, the government spends more than its budgetary allocation. *The resulting difference between expenditure and revenue of different levels of government* is called fiscal imbalance (Richard and Andrey, 2002). Also, Tom (2008) added, "fiscal imbalance as occurring when all of a government's future debt obligations are different from its future streams of income".

According to Will (2022), "Fiscal imbalance occurs when a government's future debt obligations are not in balance with its future income streams". An imbalance generally occurs when a government's spending (and resulting debt) outstrips its long-term ability to raise revenue to finance its spending and debt. "This often occurs when a government takes on long-term spending obligations based on overly optimistic estimates of the cost of the obligations, or the ability or willingness of taxpayers to finance them" (Will, 2022). He added that "One common example is when governments commit to expensive defined-benefit pensions for public employees without considering the possibility of future economic downturns that might impact tax revenue and the value of pension fund investments" (Will, 2022). There are two types of imbalances that can impact a government's expenditures and revenue:

a. Vertical fiscal imbalance: A vertical fiscal imbalance describes a situation in which revenues do not match expenditures for different levels of government. A vertical fiscal imbalance is a structural issue that can be resolved if revenue and expenditure responsibilities can be reassigned.

b. Horizontal fiscal imbalance: A horizontal fiscal imbalance occurs when sub-national governments do not have the same capabilities in terms of raising funds from their tax bases to provide public services. This type of fiscal imbalance creates differences in net fiscal benefits, which are a combination of levels of taxation and public services. These benefits are also often used as part of the justification to require transfer payments and redistribution of wealth from some regions to others (Will, 2022).

Traditionally, fiscal policy performs three key functions: allocation, distribution, and stability. Allocation entails sharing of aggregate resources among public and private goods, distribution focuses on the appropriateness in the dispersal of societal income and wealth, while the stabilization function entails the use of fiscal instruments for achieving core macroeconomic goals like sustainable economic growth, price stability, and favorable external balance. Stability in the fiscal environment is indeed an essential condition for sustainable economic growth and is therefore a primary goal of the government (Simsek, 2010; Sharma and Jha 2012). The central authority in Nigeria employs fiscal and monetary policies. While monetary policy has gained more prominence over fiscal policy, the role and pertinence of fiscal policy in terms of generation and disbursement of revenue cum expenditure cannot be relegated to the background. The fiscal policy simply connotes control of taxes, and public spending on goods and services in addition to transfer payment (Kargoz and Keskkin, 2016).

Consequences of Fiscal Imbalances on Economic Growth

The effects of fiscal imbalances are far-reaching. According to Ubong and Supper (2001), "traditionalists believe that an increased budget deficit poses serious harm to the economy while the Ricardians believe that public debt does not exert any harm on the economy". Such problems, as pointed out by Nayab (2015), include an increased level of inflation, increased public debts in the economy, a deficit in the current account, and reduced economic growth. As pointed out by Boariu and Bilan (2007), inflation can also be seen as the outcome of debt bankrolling of the fiscal imbalance, when it incidentally embroils the proliferation in the quantity of money obtainable in the economy beyond what is essential".

In some studies, the concept of fiscal imbalance has been regarded as an important variable that fuels inflation in an economy (Ljunqvist and Sargent, 2000; Fisher, Sahay, and Vegh, 2002). The fiscal view also recognizes that less effective tax collection, political uncertainty, and reduced access to borrowing threaten to lower the relative cost of seignior age and increase reliance on the "inflation tax," as Catao and Terrones (2003) point out (Calvo and Vegh, 1999). A counter-argument on this has been that "a common criticism of this stress on the budget deficit is that the data rarely shows a strong positive association between the size of the budget deficit and the rate of inflation" (Blanchard and Fisher, 1989). Ubong and Supper (2001), argued further that "the financing of the fiscal imbalance can be either monetary financing or debt financing". Monetary financing entails issuing new money to finance the surplus of public expenditures generating budget deficits (Boariu and Bilan, 2007). Ubong and Supper (2001) added that fiscal imbalance may lead to macroeconomic instability such as fluctuations in output growth, rise in the price level, crowding out of the private investment, and possibly tantamount to declining employment.

In Canada, the case for the fiscal imbalance was given impetus in 2002 with the publication of the Quebec government's Séguin Report. The Report argued for a major re-division of resources between the federal government and the provinces (Oubliez le rapport, 2006). It demands federal action to redress the fiscal imbalance. In reply to those who contend there is a fiscal imbalance, the federal government has advanced four main arguments, either to deny the existence of a fiscal imbalance or to claim the problem of fiscal balance arising from the 1995 cuts is being addressed.

a. First, the federal government argues that since the provinces have access to all the same sources of tax revenue as the federal government, they are free to raise taxes to pay for the social and infrastructure costs within their respective jurisdictions.

b. Second, they suggest that, since 2000, federal transfers to the provinces across a wide range of program areas, including health care, Equalization, cities, and early childhood learning, have arguably helped considerably in restoring the cuts made in 1995, and that indexed transfers to the provinces for health care– transfers that increase each year by a fixed percent – exceed the inflation rate.

c. Third, they posit that federal tax cuts that have reduced the Government of Canada's share of taxes – from 17 percent of GDP in 2000-01 to less than 15 percent in 2005-06 – have presumably made it easier for the provinces to raise their taxes, even in a competitive tax environment.

d. Fourth, the federal government argues that its spending responsibilities are substantial and growing. Further, it is argued the federal government's debt reduction initiatives, made possible since the budget deficit was first eliminated in 1998, have had a positive impact on its own – and provincial – budgets and competitiveness by keeping interest rates low and reducing debt-servicing costs (Canada Department of Finance, 2007).

Over the years, the federal government has also suggested that proponents of the fiscal imbalance sometimes exaggerate their claims by focusing primarily on cash transfers for health, post-secondary education, and welfare, rather than the dollar value of the tax points transferred to the provinces in 1977, or of direct federal transfers to individuals and institutions. Changes to the Equalization program were not arbitrary; it is argued but purportedly made necessary by provincial tax cuts – which in turn reduced the provinces' average tax revenues used to calculate the payments – and success in reducing regional disparities (Canada Council of the Federation, 2006).

The Canadian experience supports previous literature on the linkages between inflation and fiscal imbalances (Ahking and Miller, 1985; Dwyer, 1982; Hondroyiannis and Papapetrou, 1997), and inflation may lead to a budget deficit. The money supply rises for a long time if fiscal policy is accommodating to a budget deficit. As a result of the deficit funding, aggregate demand rises, allowing production to rise past its normal level (Ubong and Supper, 2001). Growing labour demand raises wages, which leads to a downward change in overall

production. For a while, the economy returns to its normal productivity level. This, however, comes at the cost of ever-increasing inflation (Solomon and de Wet, 2004).

Citing Ubong and Supper (2001), Solomon and de Wet (2004) studied how the budget deficit affects inflation in Tanzania. The paper reported that the country has experienced a limited high rate of inflation in the face of a high fiscal deficit. As such, the study was geared towards investigating the deficit-inflation linkages in the economy of Tanzania for the period 1967 to 2001. From their empirical findings through dynamic simulations, they reported a significant inflationary effect of the budget deficit when it is being monetized (Ubong and Supper (2001).

In a related experience, Cebula (1995), examined the effect of budget deficits on the economic growth of the US economy. Cebula utilized quarterly data that covered the period 1955 – 1992. In his study, he realized that both budget deficits and personal income tax impede growth. Also, Hassan, Nassar, and Liu (2014) examined the linkages between deficit spending and economic growth in the United States. Using time series data for the economy, the study also revealed that deficit spending had a detrimental effect on economic growth, but generated the desired negative effect on unemployment.

Similarly, the same was conducted by Ghura (1995), on 33 Sub-Saharan African countries for the period 1970 – 1987. The study also affirmed that budget deficits had a devastating effect on the economic growth of the countries under consideration. Meanwhile, Augustt, Adu, and Frimpong (2015) conducted a similar study in Ghana using data from 1960 – 2012. In their study, they concentrated on tracing the direction of causality between fiscal deficit and economic growth. Their findings showcased that a bidirectional causality flows between fiscal deficit and the economic growth of the country (Ubong and Supper, 2001). In Pakistan, Fattima, Ahmed, and Rehman (2012), conducted a similar study using time series data for the period 1978 to 2009. A similar negative effect of budget deficit on economic growth was recorded. In Japan, Kameda (2014) examined the linkages between budget deficits and some macroeconomic variables in the economy as of 2008. The finding was that the budget deficit generated about 0.39% - 0.63% decline in the economic growth of the country

In Nigeria, a study on the effect of fiscal deficit on inflation was carried out by Ezeabasili, Mojekwu, and Herbert (2012). The study was conducted using time series data for the period 1970-2006. The technique of analysis was the cointegration approach. From the result, it was discovered that fiscal deficit exerted a positive, but insignificant, effect on the rate of inflation in Nigeria. Similar evidence was reported by Anayochukwu (2012) while attempting to examine if fiscal deficit triggers inflation in Nigeria. Similarly, Awe and Shina (2012) conducted a study to investigate the linkages between fiscal deficit and inflation in Nigeria. The study covered the period from 1980 to 2009. With the Vector Error Correction Mechanism in use, it was reported that significant unidirectional causation flows from budget deficits to inflationary pressures in the Nigerian economy (Ubong and Supper, 2001).

The increase in fiscal imbalance is a global phenomenon. Following the difficult economic situation in different countries, the government has opted for borrowing to finance budget

deficits and increased their debt to gross domestic product ratio above one hundred percent (Karagoz and Keskin 2016). Recently, some developed countries displayed a high level of fiscal deficit. For example, Lopez-Claros (2014) observed that out of one hundred and thirty countries with ninety-seven percent of the global GDP, a total of one hundred and twenty countries including the United Kingdom and the United States of America experienced a high budget deficit in 2009. Most of these countries still maintained the deficit till 2016. The case of Nigeria was not exceptional.

Nigeria has witnessed a plethora of fiscal reviews as evidenced by various committees and commissions instituted in that regard (Okeke, 2004). These include Philipson Commission (1946), Hicks-Philipson Commission (1950), Lenis-chick Commission (1954), Raisman – Tress Commission (1958). However, even though each tried to resolve the controversy surrounding true fiscal federalism in Nigeria, the issue persisted. This culminated in the series of other post-independence commissions that were equally set up to provide the needed panacea on fiscal federalism arrangement for the country. These included: Bins Commission (1964), Interim Revenue Allocation Review Committee (1969), Obigh Commission (1979), Danjuma Commission (1988), etc. Given the scenario, when the country reverted to democratic rule in 1999, the 1989 constitution was made operational with several attempts to address the plethora of problems associated with the country's fiscal federalism.

Nigeria has experienced a series of fiscal imbalances due to debt overhang, fiscal mismanagement, and specifically the vulnerability of her economy to fluctuations in the global oil price. The fiscal deficit has remained a predominant occurrence at both the Federal and state government levels, and this has become a source of concern for economic managers. At the individual state level, a quarter of the state governments consistently ran a deficit for more than six consecutive years, from the period 2007 to 2014. More importantly, the combined overall fiscal balance of the state governments has resulted frequently in deficits in the past two decades. A fiscal deficit is not bad in itself, but most state governments are running a fiscal deficit to sustain recurrent expenses, rather than infrastructure development.

Apart from these, the consistent fiscal imbalance is traceable to an increase in recurrent expenditures of the government, particularly in terms of the national assembly spending since 1999 during which there was a regime shift from military rule to a civilian regime. For example, the share of the Nigerian national assembly's expenses increased from more than six billion naira in 1999 to almost seventy billion naira in 2008 representing 1.3 and 3.2 percent respectively of the federal government's recurrent expenditure (CBN 2009). Meanwhile, it has been established in the macroeconomic literature that an economy on persistent fiscal deficit is prone to economic challenges like inflation (Awe and Olalere 2012 and Okpara and Odionye 2013).

Conclusion and Remedies

Fiscal stability is one of the key drivers of economic growth and national development. To achieve this there is a need for financial discipline by public officers: The Nigerian fiscal responsibility bill, due process should be adhered to by public officers. More so, effort should

be made to ensure that all tiers and institutions of government adhere to fiscal transparency, accountability, and constitutional provisions on fiscal relations. There is a need to establish an independent institution to monitor fiscal activities in Nigeria; National Fiscal Commission. The Commission will establish a policy framework for financial activities in the country. This may include varying fiscal policy tools in terms of revenue (tax and non-tax) and expenditures, which have over the years created a fiscal imbalance as expenditures overshoot revenue in several economies.

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