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Implementing the Fiscal Responsibility Act at the State Level in Nigeria¹

Vanessa Ushie²

Fiscal responsibility acts have become increasingly common tools to enhance fiscal prudence and public expenditure transparency in many countries. In Nigeria, fiscal profligacy at the sub-national level has emerged as a major contributor to state corruption and macroeconomic instability. While the federal government has enacted the Fiscal Responsibility Act (2007), the major challenge is reconciling the economic rationale for fiscal responsibility with the political demands of fiscal federalism. Although several states have recently ratified the FRA, this has not been matched with concrete policy reforms that enhance fiscal discipline and public expenditure transparency. Likewise, the federal government has been unable to persuade state governments to rein in public spending and centrally co-ordinate macroeconomic policies, contrary to the provisions of the national FRA. The paper explores the policy framework for implementing the FRA across the 36 states, and identifies the underlying macroeconomic principles required for the FRA to be effective at the state level, and the political economy challenges facing the states in entrenching fiscal discipline in Nigeria.

I. Introduction

Nigeria exists as a federal republic - there are three tiers of government; the federal government, 36 states and a federally administered capital territory, and 774 local government councils, which all receive allocations from a pooled revenue fund according to an agreed formula. The 1999 constitution provides for separation of powers between the three arms of government; the executive, legislature and judiciary at all levels. Since 1999, democratisation in Nigeria has thrown up a paradox of decentralisation without improved accountability; while states enjoy fiscal autonomy, and states' spending constitutes 50% of consolidated government expenditure, the national government has no oversight over their fiscal affairs.

Corruption and mismanagement of public finances are problematic at all levels of government in Nigeria. Various forms of corruption such as theft, fraud, bribery, extortion, requests for kickbacks, nepotism, and political patronage exist in Nigeria. At the sub-national level, however, the major driver of corruption is the discretionary use of funds by the Executive (i.e.

¹ This paper has emerged from extensive discussions with leading donor institutions and policymakers on the need for improved fiscal transparency in Nigeria. I am grateful to Menachem Katz, Ebere Uneze and an anonymous constitutional law expert, for comments and constructive criticism.

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Governors and Local Government Chairmen), and the lack of transparency and accountability in the utilisation of expenditures.³ State governors routinely utilize public funds without proper stated budgets. State legislatures are unable to exercise any control, and tend to be stooges. Local government leaders often owe political allegiance to their governors and tend to be complicit in mismanagement of public funds rather than challenge their Governors. Power is therefore concentrated largely in the hands of the governor and a few political accomplices, resulting in discretionary and arbitrary use of state and local government resources. The high level of fiscal profligacy at the sub-national level poses immense challenges for overall macroeconomic stability, debt management and public financial management.

With the introduction of a reform programme under the second Obasanjo administration (2003–7), progress has been made in improving fiscal policy management in the country, particularly with the adoption of an oil-price based fiscal rule as well as the introduction of a medium-term expenditure framework and medium-term sector strategies to guide the planning of government budgets. These fiscal policy developments constitute a subset of a larger reform programme, the National Economic Empowerment and Development Strategy (NEEDS), adopted since 2003. The adoption of NEEDS at the federal level was also complemented by individual State Economic Empowerment and Development Strategies (SEEDS), which were prepared by all 36 Nigerian states and the Federal Capital Territory (FCT).⁴

As a counterpart to these fiscal reforms, there have been concerted efforts at the national level to introduce a Fiscal Responsibility Act (FRA), which gives legislative backing to prudent fiscal policies, transparent public finances, and sets parameters for the accumulation of public debt. The campaigns mounted by Civil Society Organisations (CSOs), members of the donor community and reform-minded elements in the Executive and Legislature culminated in the passage of the Act by the National Assembly and its ratification by President Umaru Yar'Adua

³ A vivid illustration of sub-national corruption in a key oil-producing state in Nigeria is provided by Human Rights Watch (2007). In the states and local governments, there is a practice of setting aside public funds for the purpose of maintaining peace and security. These funds are the so-called 'security votes'. However, in practice, security votes amount to a pool of off-budget funds available to the executive for discretionary expenditures, or distributive patronage. The size of security votes for Governors or Local Government Chairmen can be very significant: for example, in 2006, the Khana Local Government Chairman in Rivers State (in the Niger Delta Region) allegedly received about N60 million (\$461,000) for his security vote.

⁴ Okogu B. and P. Osafo-Kwaako (2008), 'Issues in Fiscal Policy Management under the Recent Economic Reforms', CSEA Working Paper WP/08/001, April 2008.

in 2007.⁵ The Fiscal Responsibility Act (2007) ensures that the Federal Government carries out expenditure within formally specified and reasonable limits, given a sound revenue base. The new law also places strict limits on the accumulation of public debts. The FRA is designed to institutionalise transparency in the budgeting process in Nigeria, provide guidelines for public expenditure management and revenue forecasting, and limit the level of national debt. Collectively, these reforms should improve fiscal transparency on one hand, and the efficiency of public expenditure, on the other. Given the scale of state corruption in Nigeria, the introduction of the FRA is a laudable step. However, the institutional and policy environment presents constraints for the effectiveness of the legislation, and there is the knotty issue of the fiscal and political privileges enjoyed by sub-national units in the Nigerian federation, and how the national political economy influences fiscal discipline.

Reforms that target fiscal prudence and effective public financial management in the Federation would be incomplete without an extension to the sub-national levels of government, given their substantial claims on the public exchequer, and the explosion in corruption and mismanagement of public finances that has accompanied fiscal federalism in Nigeria. However, while there is widespread awareness of the need to adopt the FRA at the sub-national level, and several states have ratified FRAs, due to the challenges of fiscal federalism in Nigeria, public financial management by the states and federal government is not synchronized, and states still retain independence in setting expenditure priorities and accumulating debt. This rush to adopt FRAs has also not translated into substantial policy gains, by way of a reduction in public corruption, better fiscal prudence and macroeconomic stability.

This paper seeks to examine the issues surrounding the implementation of the Fiscal Responsibility Act at the sub-national level in Nigeria. It proceeds on the following basis: In the first section, an analysis of global perspectives on fiscal federalism and FRAs is provided. This is followed by a discussion of public financial management and fiscal federalism in Nigeria, and subsequently, an analysis of the national FRA and the sub-national FRAs adopted in several states in Nigeria. The paper highlights the influence of the national political economy on fiscal prudence and public sector transparency at the sub-national level. In conclusion, policy recommendations on strategies to enhance the impact of sub-national FRAs on the economy and polity are provided.

⁵ The adoption of FRAs by the local governments is not addressed in this paper, although many of the issues in fiscal federalism and the management of public finances at the sub-national level discussed here are applicable to the local governments.

II Fiscal Federalism and Fiscal Responsibility Acts - Global Perspectives

Federalism is a constitutionally established political system with at least two levels of government, each of which retains a degree of autonomy.⁶ These two orders of government would typically be the federal or central government, and sub-national governments - the states, and local or municipal governments. The roles of each level of government are often explicitly laid out via formal rules in the constitution, supported by informal norms that evolve over time. Fiscal federalism is concerned with the respective roles and interactions between governments in federations, with regards revenue generation, expenditure, saving and borrowing, and public debt. It studies fiscal processes in federal countries, and the implications of fiscal arrangements for political relations within the federal system.

Normative questions relating to the purposes for which government revenue is raised, allocation to economic sectors, transparency of public spending and the boundaries between the central and sub-national governments of the federation are instrumental to the analysis of fiscal policy arrangements in the federal countries. While debates over the fiduciary powers of the central and sub-national governments address the degree of centralization or decentralization of fiscal arrangements,⁷ and there is a rich body of literature that deals with issues of horizontal and vertical fiscal equity between the levels of government in a federation,⁸ perhaps the most contentious area in fiscal federalism is the delineation of fiscal powers between central and sub-national governments, and the autonomy that sub-national

⁶ See generally, Anderson (2010) for a discussion of the foundations of political federalism and the various forms of federalism that exist in different countries. Federations include countries with large populations (India, Nigeria, Pakistan), or large territories (USA, Canada, Brazil), to small countries with diverse populations (Switzerland, Belgium), island states (Comoros, Mauritius) and recent entrants into the league of federal countries (South Africa, Ethiopia, Malaysia).

⁷ Shah (2007) pp. 9-11. There is a great diversity in the allocation of fiscal powers within federal countries. For example, Brazil, Canada and Switzerland are highly decentralized federations, whereas Australia, Germany, Malaysia and Spain are relatively centralized. The distribution of fiscal powers among members may also be asymmetric. For example, some members may be less equal, and thus enjoy a lower degree of autonomy because of special circumstances, than others. This is the case for Jammu and Kashmir in India and Chechnya in Russia. Or some members may be treated more equally than others, for example, Sabah and Sarawak in Malaysia and Quebec in Canada. A federal system may also offer members the choice to be unequal or more equal, such as inclusive and escape clauses in Canada; Spanish agreements with the separatist devolving regions; and European Union treaty exceptions for Britain and Denmark.

⁸ See for instance, Spahn (2007) and Gamkhar and Shah (2007) on the role of intergovernmental fiscal transfers in promoting fiscal equity between regions in a federation, and sub-national economic stabilization. Fiscal conflicts which arise due to competition between sub-national governments, or between central and state governments, can be minimized through the use of fiscal transfers to address inequity and co-ordinate government taxation and expenditure.

governments should be allowed for the purposes of fiscal policy coordination and macroeconomic stability. This delicate balance between the political reality of respecting the autonomy of sub-national governments, and maintaining economic stability for growth and long-term development is one that many federal countries are grappling with. The fiscal profligacy that many governments engage in to meet popular expectations, which is often pronounced during electoral cycles, can be damaging to macroeconomic stability and growth. Thus, the use of Fiscal Responsibility Acts (FRAs) to entrench fiscal prudence and macroeconomic stability has become increasingly commonplace in both federal and unitary countries. However, there are unique challenges posed by fiscal federalism for the adoption of FRAs, which constrain the effectiveness of fiscal rules⁹ in federal countries.

Fiscal Responsibility Acts (FRAs) are designed to enhance fiscal prudence by placing statutory obligations on central, regional and local governments to commit to transparent fiscal and budget practices that can be evaluated over time. Examples of countries with FRAs are Argentina, Australia, Brazil, Canada, Chile, Columbia, Ecuador, France, Germany, India, Indonesia, Italy, Mexico, New Zealand, Peru, Russia, South Africa, Spain, the United Kingdom, and Venezuela.¹⁰

While there are a broad range of FRAs that fit specific country contexts, we can generally identify two types of FRAs. These are *numerical rules*, which guide and benchmark performance against quantitative indicators (such as the fiscal balance or debt levels), and *procedural rules* that establish transparency, coverage, and accountability requirements.¹¹ In principle, FRAs are binding on all levels of government to collectively adhere to agreed fiscal targets, and to pursue transparency in public expenditure. In practice, federal systems that allow autonomy for sub-national governments may also require concurrent FRAs to be passed by constituent units of the federation. Sub-national FRAs may be imposed by the central government or voluntarily adopted by states in a federation where they are constitutionally empowered to do so. There are four primary and overlapping objectives which sub-national fiscal rules address, namely: *long-term fiscal sustainability*, *short-term economic stability*, *aggregate efficiency* (balancing the benefits of public spending with the costs of taxation), and the *allocative efficiency of public spending* (matching public spending to local priorities). In advanced countries, the choice of fiscal rules is conditioned by the institutional arrangements

⁹ We use the terms ‘fiscal responsibility acts’, ‘fiscal responsibility legislation’, or ‘fiscal rules’ in short, interchangeably in the study.

¹⁰ Alok (2008), p. 109.

¹¹ For an extensive discussion on fiscal rules and fiscal responsibility legislation, see generally, IMF (2007) and Kopits and Symansky (1998).

governing central and sub-national government relations, such as the degree of revenue autonomy, expenditure responsibilities, the role of financial market oversight, and the political context.¹² In developing and transition countries, the failure of centralised fiscal arrangements to improve fiscal discipline, the poor record of sub-national governments in the pursuit of sectional interests that may undermine national objectives, the use of ‘beggar-thy-neighbour’ fiscal transfers that reward sub-national fiscal profligacy, and the role of judicial activism in generating new legislation to conform to constitutional rights in federal countries have been identified as motivating factors in the adoption of FRAs.¹³ It would be useful to illustrate the experiences of several federal and non-federal countries with FRAs, to gain insights on measures to address peculiar challenges posed by fiscal federalism for FRAs.

In India, federalism is constitutionally recognised, and there is a three tier system of government, comprised of the Union (central) government, states and local governments. While the union government is entitled to a higher share of tax revenues, states are responsible for the provision of social services (including education, healthcare and water supply). The distribution of tax revenues between the union and state governments is determined by the Finance Commission. In the 1980s and 1990s, soaring consolidated public expenditure by the union and states pushed the overall fiscal deficit to 11 percent of GDP, while combined debt levels stood at around 80 percent of GDP.¹⁴

To put an end to this practice of high fiscal deficits and public debt, the union government passed the Fiscal Responsibility and Budget Management Act (2003) which set a target to eliminate the revenue deficit by 2008, and limit the overall deficit to 3 percent of GDP. This helped to push down the overall fiscal deficit to under 3 percent of GDP since 2004. The FRBMA also placed restrictions on public borrowing, and improved the transparency of the budgetary process by mandating the union to present a Medium Term Fiscal Policy Statement and Macroeconomic Framework Statement, and a three-year rolling Medium Term Fiscal Plan to the parliament each year, as well as quarterly progress reviews. By 2005, 23 states had introduced FRAs, and only three states had not done so by 2006. The states’ FRAs have the same provisions as the FRBMA, including the restriction of the fiscal deficit to 3 percent of GDP. The process of consolidation started in 2004 and has continued since then with the states planning to almost eliminate (on average) their revenue deficit in 2006 and reduce

¹² Sutherland, Price and Jourmard (2005), p.7.

¹³ Musonda (2007), p. 830.

¹⁴ Alok (2008), p. 110.

their fiscal deficit to 2½ per cent of GDP,¹⁵ although a surge in subsidies and wage hikes kept the general government fiscal deficit at 10 percent of GDP in 2008.¹⁶ The rapid adoption of complementary FRAs by the states has been tied to an incentivisation scheme by the 12th Finance Commission, which mandated a process of fiscal consolidation and partial write-off of state's debts to the union government that required states to adopt FRAs as an eligibility requirement for debt waiver.¹⁷ The introduction of FRAs in India, aside from the economic benefits of reducing fiscal deficits and public debts,¹⁸ and enhancing fiscal discipline and budget transparency, has also yielded political gains, by strengthening the federal system through an expansion in the fiscal space available to the states, enabling them to be more autonomous of the union government and increasing their capacity to provide social services to citizens in a more prudent and transparent fashion.

Brazil's federal system is comprised of the central government, state governments and municipalities. In Brazil, the adoption of FRAs is linked to states' accumulation of public debt, resulting in sub-national debt defaults in 1989, 1993 and 1997. The strategies to reduce future debts always involved concessions from the central government to limit sub-national debt levels, which itself created a moral hazard (with the expectation that the centre would write off states' debts and save them from bankruptcy). No penalties or fines were imposed on states which violated fiscal agreements, and the centre was left to bear the debts of sub-national governments.

Brazil passed a Fiscal Responsibility Law (2000) which applies uniformly to the federal, states and municipal governments. The FRL sets out borrowing criteria and penalties for default of this rule. It places limits on public spending, the size of the fiscal deficit, and public debt, and disallows debt refinancing between the state and central governments.¹⁹ In spite of the improved fiscal discipline at the sub-national level elicited by the FRL, critics describe the Brazilian law as 'coercive', since states cannot opt-out of the legislation, and the law constrains public borrowing by states.²⁰ However, given the importance of the sub-national sphere in Brazil's federal structure, and the historically high levels of sub-national debt, the uniform FRL has been designed to prevent another round of debt accumulation and default by states, and improve fiscal prudence in the country.

¹⁵ Herd and Lebfritz (2008), p. 6.

¹⁶ Credit Suisse (2009), p. 2.

¹⁷ Alok (2008), p. 111.

¹⁸ Simone and Topalova (2009).

¹⁹ See generally, Alok (2008), and Afonso (2008) for a discussion on the factors that led to the adoption of the FRL in Brazil.

²⁰ Serra and Afonso (2007).

In Argentina, the national government co-exists with provincial governments and powerful municipalities in a federal system. Argentina has also strengthened its fiscal rules, resulting from a decade of high public sector deficits and growing debts. The 1998-2001 recession prompted drastic measures to fund public projects at all levels of governments, including the use of 'quasi-currency' after the peso's market value was wiped out. By 2002, stabilisation measures were being gradually introduced, by way of fiscal transfers from the national government to provinces to cover revenue deficits and debt repayments, which were in turn required to commit to sound fiscal principles. As a result, the ten-year deficits of the provinces became surpluses in 2004, and highlighted the need for fiscal policy coordination between all levels of government.

Argentina subsequently adopted the Fiscal Responsibility Act (2004), which formalised the prior fiscal adjustment strategies adopted in the wake of the country's financial crisis. The FRA provides for uniform budgetary categories (for consolidation of public accounts and vertical and horizontal accountability), presentation of the projected fiscal framework by the national government to the legislature every year, regular and synchronised release of fiscal data by governments', places limits on public spending and establishes anti-cyclical funds to reduce fiscal imbalances, sets requirements for debt servicing by provinces (15 percent of current revenues), and creates a Federal Council for Fiscal Responsibility.²¹ The provinces have voluntarily assented to the FRA, with 17 out of 24 provinces abiding by its provisions, and this initiative has also been extended to the municipalities. It is important to acknowledge the institutional factors that warranted the national government's adoption of the FRA. There was strong political momentum to restore fiscal balance and the credibility of the national government in managing its fiscal affairs, underscored by the visceral reminders of the financial crisis which rocked the country, and the quest to prevent a future reoccurrence.²²

Furthermore, in the OECD countries, autonomous borrowing by sub-national governments, linked to fiscal crises has motivated the adoption of stronger fiscal rules. For example, in some sub-central governments in Canada and Australia, recession in the early 1990s coupled with chronic deficits and mounting debt levels strained the existing fiscal frameworks, leading to rating downgrades,²³ and several European Union federal countries (Italy, Spain, Germany) have introduced domestic stability pacts for sub-national governments to align domestic

²¹ Arlia (2005), pp. 19-20

²² See for instance, Afonso (2008).

²³ Landon and Smith (2003) show that credit ratings of some sub-national governments in Canada were affected by the indebtedness of other provinces.

fiscal arrangements with international commitments on borrowing and government deficits under the EU Stability and Growth Pact and the Maastricht Treaty.²⁴

FRAs have also been adopted in many oil producing countries as a means of addressing the problems caused by macroeconomic volatility and pro-cyclical fiscal policy. Oil dependent countries such as Nigeria are plagued by peculiar challenges, notably the 'Dutch Disease' – the decline of non-tradable sectors following an oil windfall.

The impact of the discovery of significant natural resource deposits and the sudden increase in international commodity prices (or booms) is seen to have negative effects on the non-tradable sector, including agriculture and manufacturing. Formal models of the *Dutch Disease* by Corden and Neary (1982), van Wijnbergen (1984), Neary and van Wijnbergen (1986) have illustrated two important effects of commodity price windfalls, namely a *resource movement effect* and a *spending effect*. Firstly, the booming sector attracts capital and labour resources from agriculture and mining, and results in an appreciation in the real exchange rate. Secondly, booming commodity exports make imports cheaper for domestic consumers, leading to import dependence and a displacement of domestic industry. Furthermore, exchange rate overvaluation, pro-cyclical fiscal policies, macroeconomic volatility and inflation are also perennial concerns in oil-dependent countries.²⁵

²⁴ Sutherland, Price and Jourmard (2005) discuss the role of domestic stability pacts in strengthening fiscal rules where sub-national governments accumulate debt that is borne by the national government.

²⁵ For a discussion of the impact of oil dependence and economic performance in the oil-abundant countries, see generally Gelb (1986, 1988), and Auty (1990, 1993, 1994, 1995).

Box 1: Use of fiscal rules and FRAs in oil producing countries

In OPCs, fiscal rules and FRL often enshrine a desire to reduce the pro-cyclicality of fiscal policy and/or to promote long-term savings and sustainability objectives. While oil funds are more common, fiscal rules and FRL can have a more critical role, as they are intended to constrain overall fiscal policy. The design of appropriate fiscal rules in OPCs is more challenging than in other countries. This is due to the characteristics of oil revenue—highly volatile, uncertain, and dependent on a non-renewable resource. As such, the applicability in OPCs of fiscal rules frequently used in other countries would be questionable. For instance, rules that target specific overall or primary balances or particular debt ratios to GDP could be highly procyclical—as they would transmit oil fluctuations to expenditure and the non-oil balance.

The past experience of OPCs with fiscal rules and FRL has been relatively limited, but a growing number of countries are starting to implement them. There are only a few cases of FRL in OPCs. One of the first and more comprehensive was in Alberta in the early 1990s. Ecuador introduced FRL in 2002, but the main focus was on numerical fiscal rules. Venezuela passed an organic budget law in 1999 as a step toward improving fiscal policy and accountability. Mexico also passed FRL in 2006. In cases where countries have set numerical fiscal rules or guidelines, targets have typically been set on the non-oil balance (Norway and Timor-Leste), the overall balance (Alberta and Mexico), expenditures (Equatorial Guinea), or on several fiscal variables (Ecuador).

Norway and Alberta have adopted different institutional frameworks that have been relatively successful in managing fiscal policy—although both face challenges. While Norway implemented a relatively flexible framework, using the non-oil deficit as an anchor, Alberta introduced comprehensive FRL. Both cases have in common strong institutions and a broad consensus in favor of fiscal discipline.

Source: IMF (2007)

While FRAs can play an effective role in managing oil revenues and reducing macroeconomic volatility in oil producing countries, it is recognised that the implementation of the rules is constrained by political economy and technical factors relating to the design of the legislation. In Ecuador, Equatorial Guinea and Venezuela, the fiscal rules weakened or were ignored over time, although other oil producing countries such as Azerbaijan, Sao Tome and Principe, Timor Leste and Mexico have introduced some form of fiscal rules since 2004.²⁶

These comparative experiences with the adoption of national and sub-national FRAs in federal, unitary and oil producing countries offers some insights for the objectives of the study. The adoption of FRAs has often been preceded by fiscal crises, by way of excessive government deficits, unsustainable debt levels and general economic collapse. In some cases, national governments have been compelled to extend fiscal responsibility rules to sub-

²⁶ The IMF (2007) discussion offers several instances of fiscal rules not living up to expectations in various oil producing countries as an indication of the effect of broader institutional and technical limitations on the effectiveness of these rules. In particular, weakness of informal norms in restraining public expenditure and the lack of political will to contain pressures to spend oil windfalls, as well as the focus on short-term considerations that renders the fiscal rules too rigid and unable to adapt to economic fluctuations are identified as prevailing factors in the limited success of using fiscal rules in oil producing countries.

national jurisdictions, although, in some countries, such as India and Argentina, there were incentives for states' voluntarily adopting the legislation. In oil producing countries where the primary concern has been with the pro-cyclical of fiscal policy, fiscal rules have played an important role in stabilising government revenues, though their overall impact has been limited by wider institutional factors.

III Public Financial Management and Fiscal Federalism in Nigeria

Nigeria has long grappled with the negative effects of oil windfalls, and the management of public finances in the midst of pro-cyclical government spending, substantial fiscal deficits and severe macroeconomic volatility. From the onset of the first oil boom in 1973, public financial management in Nigeria has been far from adequate. This has further constrained the effectiveness of fiscal policy as a driver of economic growth, employment, and productivity. The low profile of non-oil taxation in government revenue also isolates the state from governance norms that prescribe its accountability to the citizenry. Coupled with this scenario, Nigeria's federal structure encroaches on genuine attempts to reform the management of public finances.

Fiscal federalism has evolved within the context of the transition from military to civil rule, and the popular response to buoyant state revenues from oil windfalls. Nigeria's ethnic diversity and the ensuing competition for state patronage create intense distributive struggles at the regional level. A twin strategy of state expansion, by decentralising political organisation and increasing the representation of minorities in the national government through the Federal Character (Proportionality) Principle, has been complemented by alterations in the formula for revenue distribution between the three tiers of government. The legitimacy of local rulership by community chiefs was recognized by the British colonial governments under the system of indirect rule, and retained after independence, with the emergence of four geo-political regions, which enjoyed extensive fiscal and political autonomy.

During the civil war in 1967, the Gowon military regime embarked on a state creation programme, leading to the division of the four regions into twelve states. The intention was to diminish the power of the regional governments, especially the secessionist South-Eastern (Biafra) region, and increase the share of minority ethnic groups in the distribution of petroleum revenues. Conservative Northern elements in the military and political class were also keen to increase the distribution of revenues to their region, to counter the power and influence of Southern ethnic minorities. The application of the Federal Character principle in the allocation of state revenues, determination of appointments to national office and state-owned enterprises, military recruitment and development projects, were collectively expected to accommodate the interests of Nigeria's diverse ethnic minorities within the polity without disrupting the hegemony of the three dominant ethnic groups.

The number of states grew to nineteen in 1975, twenty-one in 1991, and by 1999, there were thirty six states and a federally administered capital territory. A similar process was replicated within the states, with the creation of a total of 776 local government councils which are also constitutionally entitled to revenue allocations from the central government. While the size of the surplus available to the state for the creation of opportunities for distributive patronage was enhanced by the centralisation of oil rents, linking state creation to revenue allocation only elicited greater agitation for political accommodation and inclusion by various ethnic groups. As an illustration, between 1946 and 2003, the revenue allocation formula was altered eighteen times, or once in every three years.²⁷ The failure of the state to incorporate multifarious demands for representation and greater share of federal revenues is interpreted as an attempt to exclude aggrieved ethnic minorities.

Decentralisation of political organisation, starting with the abolition of the regional governments in 1967, led to the modification of revenue distribution in favour of the federal government. After the civil war, the states were mandated to contribute their revenues to a federally administered *Distributable Pool Account*, which were allocated on the basis of need, population and other measures.²⁸ The *Derivation Principle*, by which revenues from economic activities were retained by the geographical area in which they were derived, was increasingly deemphasised (*See Table 1 below*).

In 1960, each region was allowed to retain 50 percent of derived tax revenues, but by 1970, the proportion of derived revenues had fallen to 45 percent, and 20 percent in 1975. In 1982, the derivation principle was completely eliminated, and a special 'development' account

²⁷ Ross (2003, p. 9).

²⁸ Human Rights Watch (1999, p. 42).

allocated 1.5 percent of total government revenues to the oil producing states.²⁹ Ethnic minority groups in the oil-bearing regions of Nigeria were the biggest victims of the decline of the derivation principle and the centralised distribution of oil revenues after 1967. The increasing tensions between the indigenes of the Niger Delta and the oil companies operating in the region warranted the federal government to make concessions on the proportion of oil revenue entitlements of the oil-bearing states. In 1991, the Babangida military dictatorship grudgingly increased the derivation factor from 1.5 to 3 percent.

By 1995, the situation in the Niger Delta had rapidly escalated into a major uprising by indigenous communities against the Nigerian state and multinational oil firms, and after the brutal execution of the environmental activist and author, Ken Saro-Wiwa by General Abacha in 1995, the Constitutional Conference increased the proportion of derived revenues allocated to the oil-producing areas to 13 percent.³⁰

As a concession to the agitations of impoverished oil communities in the Niger Delta, the federal government re-introduced the *Principle of Derivation*, by which revenues from economic activities were retained by the geographical area in which they were derived. At the start of the new democratic era, the 1999 constitution ratified the 13 percent derivation provision. A landmark judgement by the Supreme Court in 2002 stipulated that the 13 percent derivation factor applied to all onshore oil deposits in the Niger Delta littoral states, and a proportion of offshore oil deposits. Collectively, both decisions strengthened the position of the states relative to the federal government.³¹ After the deduction of the 13 percent provision for the oil producing states, the remaining 87 percent of national revenue is distributed as follows; the federal government is allocated 52.7 percent, while the states get 26.7 percent, and local governments 20.6 percent. Thus, the historical revenue disparity between the North and South has been reversed, with the oil producing states now receiving the highest revenue allocations from the federal government.

²⁹ Frynas (2001, pp. 32-33).

³⁰ Avuru (2005) p. 205.

³¹ Ahmad and Singh (2003) pp. 9-13. As a result of Nigeria's federal structure, states have a wide degree of autonomy in the use of allocated revenues, and are not required to coordinate their fiscal policies with the federal government.

Table 1: Evolution of Fiscal Federalism in Nigeria

| Period | Revenue distribution between levels of government |
|--|---|
| Colonial Era (1946-1959) | While Nigeria was initially administered as a unitary state, the Phillipson Commission (1946) devised a revenue-sharing formula based on the principles of derivation and <i>balanced development</i> . The formula was subsequently revised by the Hicks-Phillipson (1951-53) and Chick (1953-59) Commissions, adding several new criteria, including need, fiscal autonomy, and national interest. |
| Post-independence Period (1959-68) | The allocation formula was further revised by three commissions: Raisman (1958), Binns (1964), and Dinns (1968). The new allocation criteria were based on the need to maintain continuity of government services, responsibilities of the regional governments, balanced development, derivation, and population (added by decree in 1967). |
| Military Rule and Oil Boom (1968-80) | The military government centralised the distribution of oil revenues and downgraded the derivation principle, mainly by decrees issued in 1970, 1971, and 1975. The Aboyade Technical Committee (1977) suggested the establishment of a new mechanism to share all federally-collected revenues with the states and local governments, but its recommendations were rejected by the Constituent Assembly. |
| Structural Adjustment and Political Transition (1980-1999) | The Okigbo Commission offered a new approach, rejecting the idea of derivation and advocating an allocation formula for states and local governments based on population, social services, and lump sum transfers to help fund administrative costs. The federal government reinstated the principle of derivation, however, by introducing a special fund for the oil producing areas. Minor changes in the new arrangement were brought about by the Revenue Act of 1982, by decree in 1984, and by the Danjuma Commission in 1989. |
| Democratic Rule (1999 to date) | The 1999 Constitution set a new arrangement for allocating oil revenues among the federal, state, and local governments, while placing a portion in special funds. Ten factors were identified as the basis of transfers to states, including a 13 percent derivation grant. In April 2002, the Supreme Court ruled that the federal government's subtraction of certain costs from total oil revenues before transfer to the Distributable Pool Account for sharing with the states and local governments was unconstitutional. In October 2002, the National Assembly altered the basis of the derivation grant, raising it from 60 percent of total oil production (the assumed amount of onshore oil) to 100 percent. |

Source: Adapted from Ross (2003), pp. 9-10.

Expenditure assignments within the federation grant the federal government exclusive jurisdiction over the provision of security and defence of the nation's borders. All three tiers of government are mandated to prepare independent budgets and maintain autonomous fiscal policies. The federal government is also responsible for the provision of basic social services (including education, healthcare and infrastructure), jointly with the states and local governments. For instance, while the federal government is solely responsible for universal primary education, states can own secondary schools and tertiary institutions. The Central Bank of Nigeria is the sole monetary authority in the federation, with the responsibility of printing the national currency, and acts as a banker to the federal government. Taxes can be levied by all tiers of government, which are collected and pooled in the Federation account, while states and local governments are constitutionally entitled to statutory allocations, and other intergovernmental fiscal transfers.

The contribution of sub-national expenditure to the public exchequer in Nigeria cannot be overstated. States and local governments jointly accounted for an average of 52 percent of consolidated government spending from 2003 to 2007. This figure increased to 57 percent in 2008. The share of states and local government spending in total spending also represented 17 percent in 2007 and 23 percent of non-oil GDP in 2008 (*see table 2 below*).

Table 2: Consolidated Government Spending in Nigeria 2007-10

| | 2007 Act. | 2008 Act. | 2009 Prel. | 2010 Proj. |
|--|--------------|--------------|---------------|---------------|
| <i>(Percent of non-oil GDP, unless otherwise stated)</i> | | | | |
| Revenues | 45.2 | 53.1 | 31.4 | 43.3 |
| of which: oil and gas revenue | 34.8 | 43.0 | 21.1 | 32.7 |
| Expenditure | 40.5 | 47.1 | 44.0 | 43.5 |
| Federal government | 15.4 | 17.3 | 16.8 | 15.6 |
| States and local governments | 17.0 | 23.2 | 16.8 | 17.1 |
| Extrabudgetary and power sector projects | 7.7 | 5.8 | 9.6 | 10.8 |
| Non-oil primary balance | -30.3 | -30.8 | -27.0 | -27.0 |
| Overall balance (<i>percent of GDP</i>) | -1.1 | 3.7 | -9.0 | -0.1 |
| Memorandum Items: | | | | |
| Real primary spending (percent change) | 16.4 | 4.3 | -2.1 | 3.2 |
| Excess crude account balance (US\$ billions) | 14.2 | 18.3 | 13.6 | 20.6 |

Source: IMF Country Report on the 2009 Article IV Consultation in Nigeria, November 2009.

The long spell of military rule facilitated the centralization of power in the federal government, and the allocation of lucrative oil rents to competing ethnic interests by autocratic military rulers. It is also under military rule that Nigeria reached the heights of fiscal indiscipline and state corruption, warranting the painful Structural Adjustment Programme (SAP) of 1985 to 1992.

The transience of the 1970s oil boom and the radical restructuring of the economy under structural adjustment had created additional paradoxes of deindustrialisation and the failure of social provisioning in Nigeria. Similarly, volatile exchange rates and high inflation posed a challenging setting for stable economic growth. GDP growth had plunged from an annual average of 5.5 percent between 1965 and 1970 to 2.6 percent by 2000, while inflation had steadily risen from around 5 percent to over 30 percent during the same period.³² Foreign debt stood at 103 percent of GDP in 2000 and the Naira/US dollar exchange rate had depreciated from just under a N1 per US\$1 in 1965 to N35 per US\$1 in 2000.³³ 70 percent of Nigerians were estimated to be under the national poverty line, subsisting on less than US\$1 per day.

A former military ruler with international clout, Olusegun Obasanjo was elected president of Nigeria in May 1999, and immediately promised to deliver a 'home-grown' economic reform programme directed towards state withdrawal from the economy, poverty reduction and market liberalisation. In contrast to the SAP, the government voluntarily initiated the reforms, and not as a response to an exogenous oil price shock. The political leadership realised that comprehensive economic reforms were necessary to address the poor economic growth outcomes, and tackle the challenges associated with oil revenue management. The National Economic Empowerment and Development Strategy (NEEDS) was initiated in 2004 and designed to elicit changes in four main areas: macroeconomic stability, public expenditure management, structural reforms, and institutional reforms. The NEEDS was modelled on the Poverty Reduction Strategy Programme (PRSP), and officially recognised by the IMF in 2006, with the approval of a two year non-borrowing Policy Support Instrument (PSI) for Nigeria.

Nigeria's macroeconomic recovery began in 2005, underpinned by two important external developments, namely an oil windfall from the Iraq war, and a weak US dollar. Another significant distinction from the first oil boom 30 years ago is the concurrent acceleration in non-oil GDP growth. Fiscal reforms were designed to detach public expenditure from oil export receipts by introducing a fiscal rule in which public spending was based on a modest

³² World Development Indicators Database (2003).

³³ IMF International Financial Statistics (online)

reference oil price, and excess revenues accumulated above the reference prices would be saved in a special revenue stabilisation account.

Legislative backing was provided by the embodiment of these reforms in a Fiscal Responsibility Act that was ratified by the National Assembly in 2007. The federation account committee agreed that 1 trillion naira (about \$8.5 billion) be set aside for the Excess Crude Account (ECA), and eighty percent of all excess revenue would then be shared among the three tiers of government, while twenty percent would be saved. The fiscal position of the federal government was enhanced by the adoption of a medium-term policy benchmark of US\$25-30 per barrel, as the previous deficit of 3.2 percent of GDP in 2003 became a consolidated fiscal surplus of about 10 percent of GDP per annum between 2004 and 2006. Public revenues were also been boosted by strong oil prices; total federal revenue averaged 40 percent of GDP between 2003 and 2007(See table below).

Table 3: Federal Government of Nigeria Finances (1998-2008)

| | 1998 | 2003 | 2004 | 2005 | 2006 ^e | 2007 ^p | 2008 ^p |
|--|------|------|------|------|-------------------|-------------------|-------------------|
| <i>(Percent of GDP)</i> | | | | | | | |
| Total revenue and grants ^a | 17.5 | 37.1 | 43.1 | 43.3 | 42.1 | 38.9 | 37.3 |
| Tax revenue | 7.2 | 8.3 | 7.3 | 6.2 | 6.6 | 6.4 | 6.2 |
| Oil revenue | 10.2 | 28.1 | 35.2 | 36.6 | 35.1 | 32.1 | 30.7 |
| Total expenditure and net lending ^a | 25.5 | 37.1 | 33.2 | 32.6 | 32.3 | 33.8 | 35.2 |
| Current expenditure | 8.1 | 11.8 | 9.8 | 10.8 | 10.0 | 10.0 | 9.9 |
| <i>Excluding interest</i> | 4.9 | 8.6 | 7.4 | 7.8 | 8.3 | 8.4 | 8.4 |
| Wages and salaries | 2.0 | 4.9 | 4.3 | 4.0 | 4.1 | 4.2 | 4.1 |
| Interest | 3.2 | 3.2 | 2.4 | 2.9 | 1.7 | 1.7 | 1.5 |
| Capital expenditure | 10.3 | 9.5 | 7.5 | 6.7 | 8.1 | 9.4 | 9.8 |
| Primary balance | -4.8 | 3.2 | 12.3 | 13.6 | 11.5 | 6.8 | 3.6 |
| Overall balance | -8.0 | 0.0 | 9.9 | 10.7 | 9.8 | 5.1 | 2.1 |

a - Only major items are reported, e – estimates, p – projections.

Source: African Development Bank/OECD African Economic Outlook 2008.

The combined improvement in fiscal and monetary policy implementation initially provided a stable macroeconomic setting for overall strong economic growth (see Table 4 below). Real GDP growth averaged 7.9 percent between 2003 and 2007, an impressive record, but still below the ambitious 10 percent annual growth rate targeted by the government. Non-oil GDP growth rose from 5.8 percent in 2003 to 8.6 percent in 2005 and 9.4 percent in 2006. In contrast, disruptions to oil production caused by unrest in the Niger Delta have caused a slowdown in oil GDP, which fell by -5.6 percent in 2007 and -4.5 percent in 2006, following a

weak 0.5 percent increase in 2005. The country successfully negotiated a debt relief deal with the Paris Club of creditors in 2005, with the repayment of US\$12.4 billion or a write-off of 60 percent of its total debt. A smaller payment of US\$1.4 billion was made to the London Club in 2006, implying a reduction in its debt burden from around 64 percent of GDP in 2004 to 3 percent in 2007.³⁴ Gross excess crude oil savings grew from US\$5 billion in 2004 to US\$17.3 billion in 2007. Nigeria's foreign reserves also rose sharply from US\$7.5 billion in 2003 to US\$52 billion in 2007. The 2007 budget was implemented within the limits of the Nigerian government's medium-term fiscal strategy (MTFS), and the 2008 budget adopted a reference oil price of US\$53 per barrel. Shortfalls from falling crude oil production due to the Niger Delta crisis were financed by draw-downs on the excess crude account in 2008.

Table 4: Selected Economic Indicators in Nigeria (1999-2008)

| | 1999- 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 ^a | 2008 ^a |
|---|---------------|------|------|------|------|------|-------------------|-------------------|
| Real GDP growth ¹ (%) | 4.7 | 21.3 | 10.2 | 10.5 | 6.5 | 6.0 | 6.4 | 6.0 |
| Oil GDP | 2.9 | -5.7 | 23.9 | 3.3 | 0.5 | -4.5 | -5.6 | -6.2 |
| Non-oil GDP | 5.8 | 33.8 | 5.8 | 13.2 | 8.6 | 9.4 | 9.0 | 9.0 |
| Agriculture | 4.0 | 55.2 | 7.0 | 6.3 | 7.1 | 7.4 | 8.0 | n.a |
| Manufacturing | 4.6 | 10.1 | 5.7 | 11.9 | 9.6 | 9.4 | 9.0 | n.a |
| Telecommunications | 202.7 | 27.0 | 23.8 | 55.8 | 29.6 | 33.7 | n.a. | n.a. |
| External debt /GDP (%) | 80.3 | 67.8 | 64.4 | 50.2 | 20.8 | 3.0 | 2.8 | 2.8 |
| Foreign reserves (US\$ billions) | 8.4 | 7.7 | 7.5 | 17.0 | 28.3 | 49.0 | 52.1 | 73.2 |
| Excess Crude Oil Account (US\$ billions) | - | - | - | 5.1 | 9.9 | 13.2 | 17.3 | 18.3 |
| Nigerian oil price (US\$bbl) | 23.5 | 25.0 | 28.9 | 38.3 | 55.3 | 65.3 | 71.1 | 97.5 |

¹ – Real GDP growth in 1990 constant prices; a-actual; n.a. – not available.

Sources: CBN Statistical Bulletin 2005; ADB/OECD African Economic Outlook 2007; IMF Country Reports on the 2007 Article IV Consultation in Nigeria, February 2008, November 2009.

In May 2007, Umaru Yar'Adua was sworn in as successor to Olusegun Obasanjo, marking an unprecedented democratic transition in Nigeria's political history. The ruling People's Democratic Party (PDP) controls 80 percent of the national legislature and state governments.

³⁴ The annual savings from debt servicing amounting to US\$1 billion were to be invested in infrastructure provision and poverty reduction programmes. However, the significant challenge for the government was the domestic debt burden, estimated to be 12 percent of GDP in 2005, which was to be capitalised through the issuance of three to five year bonds at market interest rates.

Nevertheless, the 1999, 2003 and 2007 elections were marred by widespread electoral malpractices and violence in many parts of Nigeria. The political intrigues caused by the demise of President Yar Adua, and subsequent elevation of Goodluck Jonathan also posed challenges for managing oil revenue volatility and state corruption. The Yar Adua and Jonathan regimes retained the oil-price based fiscal rule and other public expenditure management reforms instituted by Obasanjo. In the midst of an oil-induced euphoria, Nigerian policymakers based the 2009 national budget on a reference price of US\$56 per barrel. Oil production was also predicted to rise to 2.5 million barrels a day in 2009 and 2.6 million barrels a day in 2010. These ambitious projections were hit by several external and internal developments that left the economy extremely vulnerable to an oil price shock in the short-term.

The economic crisis in the world's industrialised nations, the main consumers of oil, hit otherwise buoyant oil prices, leading to a twofold drop in the price of 'sweet' crude from US\$147 to US\$77 between July and October 2008. Annual global demand for oil in 2008 fell by 1.3 million barrels a day, the steepest decline since 1982,³⁵ and oil demand fell further in 2009 and 2010, as energy consumption habits are altered to cope with the lean economic times. Nigeria and the other OPEC nations have been taken unawares by the steep price reduction, as many leading forecasters predicted that oil prices would stay above US\$100 per barrel in the near future, before dropping to US\$80 per barrel in the medium to long term, as supply concerns are eased with rising production from Brazil, Mexico and Russia. In contrast to these buoyant predictions, the price of Bonny light, Nigeria's reference crude oil, fell below US\$60 by the first quarter of 2009.

To avert the looming oil price shock, Nigeria needed to sell its crude oil at a price of at least US\$80-100 per barrel, to finance the 2009 national budget, meet debt and financial obligations, and save the excess crude oil export proceeds. The YarAdua regime was unable to resist distributive pressures by the states and local governments for draw-downs on the excess crude account (ECA), further reducing the fiscal cushion available, and the ECA was rapidly depleted from US\$18 billion in 2008 to under US\$ 2 billion by mid-2010. The external oil price shock was also aggravated by the effect of unrest in the Niger Delta on daily oil production, and underinvestment in the oil sector.

Crude oil shut-ins from the crisis averaged 600,000 barrels a day in 2009. Daily output in 2009 averaged 1.9 million barrels, well below the OPEC quota of 2.3 million barrels, and total installed capacity of 3 million barrels. Nigeria's oil output also suffered from poor investment

³⁵ United States Energy Information Administration (2009).

outlays by the government.³⁶ Major investments in liquefied natural gas (LNG), expansion of existing oilfields, and upstream (deepwater) exploration projects were stalled due to poor funding, leading to lower output growth in medium to long term.

While fiscal deficits have been financed by the (depleted) excess crude account in 2009 and 2010, government spending would have to be reined in, and coupled with rising inflation and unsettled domestic financial markets, in the short-term, the policy response of the Nigerian government is crucial to maintaining fiscal prudence and macroeconomic volatility. Real GDP and non-oil growth in 2009 were estimated by the IMF to be 2.9 percent and 4.5 percent respectively, as growth in key non-oil sectors such as agriculture and telecommunications is hit by the knock-on effect of falling commodity prices and the global credit squeeze.

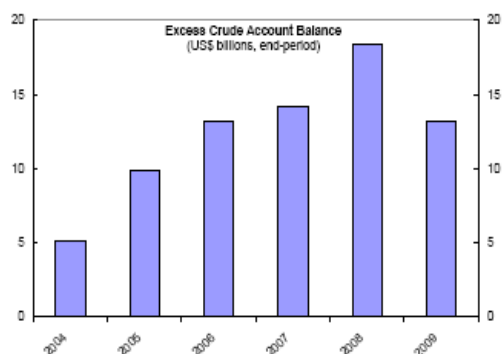
The preceding discussion illustrates that the recent fiscal reforms have relatively enhanced Nigeria's ability to cope with the cyclicity of oil revenues and external oil price shocks (*see Box 2 below*). In spite of the depressed global economy, non-oil GDP growth has remained somewhat resilient. However, the transmission of relatively improved public financial management at the federal level to other levels of government has been hampered by political factors, by way of the practice of fiscal federalism in Nigeria. In the following section, we will examine the provisions of the national FRA and lay out the underlying economic principles that should be contained in the sub-national FRAs, as well as the implications of the political environment for the implementation of FRAs by the states.

³⁶ Production is carried out by joint ventures between the state oil company, Nigerian National Petroleum Corporation (NNPC), and the oil majors (Shell, ExxonMobil, ChevronTexaco, and Total). The oil companies have been very critical of the underfunding of the NNPC's equity share of production, and the government has been forced to borrow funds from the oil majors. In 2008, the Ministry of Petroleum requested for US\$8.8 billion for oil investments, but received only US\$5 billion. The oil majors were asked to seek credit to fund the shortfall. With global credit evaporating, it was difficult for the companies to secure good credit terms.

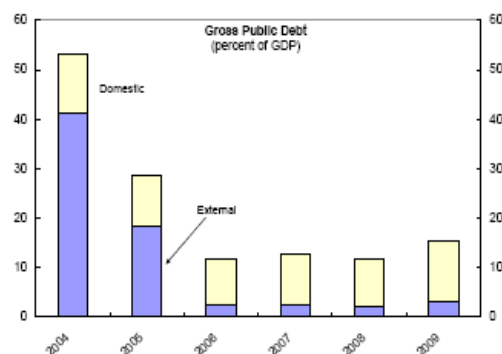
Box 2: Fiscal Developments in Nigeria (2004-2009)

Driven by falling oil revenues, the fiscal accounts moved from surplus to deficit. The overall balance of the consolidated government is projected to swing from a surplus of 3.7 percent of GDP in 2008 to a deficit of 9 percent of GDP in 2009. This turnaround is entirely due to the drop in oil revenue: the non-oil deficit is expected to narrow by almost 4 percentage points to 27 percent of non-oil GDP. A modest increase in spending by the federal government is more than offset by significant spending compression at state and local government levels where access to borrowing is limited.

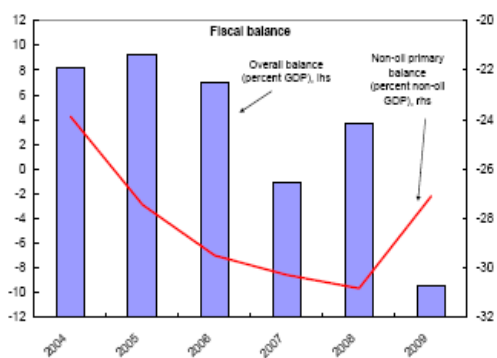
Prudent fiscal policy led to oil savings



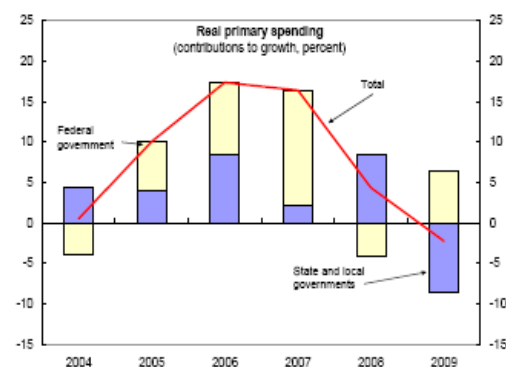
...and moderate public debt



...has enabled the partial accommodation of a large fall in oil revenues...



...and reduced the need for real spending compression



Source: IMF Country Report on the 2009 Article IV Consultation in Nigeria, November 2009.

IV State-Level Fiscal Responsibility Acts in Nigeria: Principles and Policies

In Nigeria, lofty ambitions of entrenching fiscal discipline and improving the quality of public expenditure for Nigerian citizens, who have long been denied any form of accountability from political leaders, have been confronted by a lack of political will to adhere to the provisions of the FRA 2007.

In the preamble of the federal FRA, it is stated that the Law was enacted to:

*'provide for prudent management of the nation's resources, ensure long-term macro-economic stability of the national economy, secure greater accountability and transparency in fiscal operations within the medium term fiscal policy framework (MTFF), and the establishment of the Fiscal Responsibility Commission to ensure the promotion and enforcement of the nation's economic objectives..'*³⁷.

The FRA contains a mix of procedural and quantitative rules – procedural rules relate to adherence to the MTFF, governance of the budget process, savings and asset management, provisions on audits and reporting requirements for the government, and transparency and accountability standards. The quantitative rules, on the other hand, outline the oil price-based rule, the size of the fiscal deficit, and the limits for accumulating public debt, as well as the reservation of public borrowing exclusively for capital (development) expenditure.

Furthermore, sub-national governments are encouraged to enact their own FRAs in section 17 of the Act, which allows states and local governments to voluntarily manage their fiscal affairs within the MTFF, in co-ordination with the federal government. Section 31 also states that the provisions of Section V on budget execution and fiscal targets can be adopted by states and local governments, with minor modifications. The oil-price-based fiscal rule is set out in Part VII, section 35 of the Act, and penalties for violating this provision are laid out.

There are several limitations in the federal FRA which have constrained its effectiveness and impact. As the FRA is a federal law, it is non-applicable to the states and local governments, except in debt and borrowing matters, which are on the exclusive Legislative list. Furthermore, in a considerable omission, the FRA was singularly enacted by the federal government, while the 36 states were to be 'persuaded' to enact complementary FRAs. This omission has watered down any impact that the FRA would have on fiscal discipline in the

³⁷ Federal Republic of Nigeria (2007) Fiscal Responsibility Act, 2007 Act No. 31.

states, while the overriding political culture allows state governors and other regional overlords to manoeuvre the federal government into making substantial concessions from the ECA, given shortfalls in statutory allocations caused by volatile oil prices.

The combination of low technical and institutional capacities in strategic government agencies and the influence of distributive patronage in shaping the tenor of national politics have affected the implementation of the federal FRA. The introduction of the MTFF, MTEF and a coherent budget cycle by way of the FRA, have not made a significant dent on the accountability of public revenues and quality of public spending. The inability of the federal government to curtail ballooning recurrent expenditure, a sizeable domestic debt stock valued at US\$28.6 billion (the equivalent of 17 percent of GDP), and rising fiscal deficits in excess of 3 percent of GDP, indicate that the FRA is not being properly implemented. The Fiscal Responsibility Commission, with the mandate of monitoring compliance with the legislation, is hampered by low capacity and a lack of political will within the national leadership, leaving it unable to adequately execute its mandate.

While the FRA was designed to improve public expenditure management in Nigeria, the practice of fiscal federalism and the interplay of political economy factors have also constrained its success. State governors trenchantly argue that their constitutional rights should not be usurped, while pocketing massive statutory allocations from the Federation Account, and compelling the federal government to turn to the ECA to fund revenue shortfalls caused by weak oil prices. It is noteworthy that there have been moves to adopt FRAs in several states. However, this has proceeded, in any case without any significant reform in public financial management or negotiation of political settlements with the federal government that would harmonise fiscal policy co-ordination between all levels of government.

In addition, the states are not compelled maintain independent revenue stabilisation accounts, except this is a voluntary measure. In the case of Cross River state which established a Reserve Fund in 2009, by saving N 50 million monthly, accumulated savings rose to N3.4 billion in April 2010. Rivers State has a law before the House which requires N1 billion to be saved every month. The Edo State Executive Council decided that 5 percent of their federation account receipts should be invested in shares and kept in reserve, and in Borno State, 20 percent of the statutory receipts are transferred into a development account (local

governments transfer 10 percent) which is not to be spent until it reaches a certain level, while Katsina State has established an investment fund.³⁸

These are encouraging developments in the states mentioned here, as the establishment of a Reserve Account and accumulation of savings remains essential to implementing a sound and pragmatic FRA. To ensure conformity with the federal government's development priorities, the NEEDS was localised through the conception of individual State Economic Empowerment and Development Strategies (SEEDS). The states' expenditure priorities, set within the MTF, are expected to conform with the development programs outlined in the respective SEEDS.

Following a commitment by the Nigerian Governors Forum (NGF) to ensure adoption of the FRA across the country in 2007, 20 states have now adopted fiscal rules, and in 13 states, FRAs have been presented to the Legislature, and are currently being debated, or will shortly be ratified (*see Table 5 below*). The evidence presented here suggests that there is now broad awareness of the importance of FRAs at the sub-national level, and it is notable that all of the oil producing states in the Niger Delta, with the exception of Akwa Ibom, have initiated fiscal responsibility legislation. It is also intriguing to see that more states in southern Nigeria have rapidly enacted FRAs, while the northern states have been slower in passing legislation.

³⁸ See for instance, the discussion with state representatives in Gillies (2009).

Table 5: Fiscal Responsibility Acts in Nigerian States³⁹

| State | Population ¹ (in millions) | GDP ² (in N' millions) | FRA ³ |
|-------------|--|--------------------------------------|---|
| Abia | 3,051,841 | 156,581.86 | Yes |
| Adamawa | 3,352,085 | 88,296.94 | No* (The FRA is being debated in the House of Assembly) |
| Akwa Ibom | 3,841,712 | 1,843,218.56 | No |
| Anambra | 4,459,236 | 91,536.39 | No* (The FRA is being debated in the House of Assembly) |
| Bauchi | 4,563,897 | 95,798.53 | Yes |
| Bayelsa | 1,788,957 | 1,212,867.01 | Yes |
| Benue | 4,390,184 | 792,405.51 | Yes |
| Borno | 4,044,366 | 269,473.62 | No |
| Cross River | 3,048,375 | 231,901.19 | Yes |
| Delta | 4,130,761 | 1,208,594.31 | Yes |
| Ebonyi | 2,317,922 | 57,568.38 | Yes |
| Edo | 3,463,629 | 142,784.30 | No* (The FRA is being debated in the House of Assembly) |
| Ekiti | 2,449,007 | 97,551.83 | Yes |
| Enugu | 3,388,168 | 131,168.00 | No |
| Gombe | 2,374,698 | 105,286.06 | No* (The FRA is being debated in the House of Assembly) |
| Imo | 3,963,039 | 205,609.17 | Yes |
| Jigawa | 4,585,695 | 574,713.28 | Yes |
| Kaduna | 6,276,729 | 558,386.58 | Yes |
| Kano | 9,266,314 | 797,251.26 | No* (The FRA is being debated in the House of Assembly) |
| Katsina | 5,984,866 | 748,767.07 | No* (The FRA is being debated in the House of Assembly) |
| Kebbi | 3,928,579 | 211,057.04 | Yes |
| Kogi | 3,424,637 | 63,348.45 | No* (The FRA is being debated in the House of Assembly) |
| Kwara | 2,469,200 | 99,420.24 | Yes |
| Lagos | 9,131,112 | 2,935,593.30 | No* (The FRA is being debated in the House of Assembly) |
| Nassarawa | 1,926,153 | 297,301.17 | No* (The FRA is being debated in the House of Assembly) |
| Niger | 3,862,030 | 820,194.99 | No* (The FRA is being debated in the House of Assembly) |
| Ogun | 3,721,345 | 115,791.01 | Yes |
| Ondo | 3,587,265 | 762,093.19 | Yes |
| Osun | 3,441,186 | 79,271.30 | Yes |
| Oyo | 5,505,815 | 194,182.18 | Yes |
| Plateau | 3,356,070 | 82,165.65 | No* (The FRA is being debated in the House of Assembly) |
| Rivers | 5,084,192 | 3,333,507.68 | Yes |
| Sokoto | 3,822,365 | 716,154.16 | Yes |
| Taraba | 2,411,441 | 43,020.00 | No* (The FRA is being debated in the House of Assembly) |
| Yobe | 2,232,186 | 73,308.50 | Yes |
| Zamfara | 3,305,851 | 659,406.94 | No* (The FRA is being debated in the House of Assembly) |

Sources: 1 and 2/ from the UNDP Nigeria Human Development Indicators 2009. State GDP is computed using a proxy derived from indicators of economic activity in the 36 states. Population data is based on the 2006 Census data. 3/ Compiled by author based on public announcements of state FRAs enacted between 2008 and 2010.

³⁹ There are difficulties in obtaining data on state-level fiscal operations, which limits our ability to analyse the provisions of individual state FRAs, although some progress is being made by several states to publish information on budgets and fiscal legislation electronically, and through government departments responsible for disseminating information.

Given the discussion of the key issues in the paper, it would be useful, in any case to identify several (standard) elements which should be incorporated in the states' FRAs. While the federal FRA could serve as a useful template for the states, there are specific factors in each state that must be recognised in formulating the Acts. The following guidelines should inform debates on specific provisions of the states' FRA that have the greatest impact on public financial management and fiscal discipline in Nigeria:

Objectives or Statement of Fiscal Principles:

This sets out the objectives of the state in the conduct of its fiscal policy. This may explicitly state that the state subscribes to principles of fiscal prudence, accountability, transparency and macroeconomic stability. Specific goals may include: stable public expenditures and revenues, to guard against oil-related volatility, low indebtedness, prudent management of (natural) resources and a commitment to pro-poor expenditure and pro-poor development projects.

The Medium Term Fiscal Framework (the MTFF):

The centrepiece of the FRA is the MTFF. The MTFF ties planned annual expenditure within a three year time frame to broader developmental priorities of the state, contained in the SEEDS. The MTFF should contain the economic and fiscal strategy, the medium term expenditure and revenue review, statement of public debt and borrowing, and a section on contingent risks to the fiscal strategy of the state. The MTFF should be prepared in consultation with stakeholders in civil society and be freely accessible to the public. A timeline for preparation of the MTFF and presentation to the state House of Assembly should be specified within the FRA.

The Budget and Expenditure Limit:

The FRA should stipulate that only expenditures contained in the annual budget prepared according to the MTFF, and within the government's appropriation bill, are allowed. The appropriation bill should also conform with the MTFF, and the process for its preparation should be clearly identified in the Act. An upper limit on expenditure (as a proportion of total revenue) may also be set within the MTFF. To ensure consistency with central government fiscal strategy, the budget process must be co-ordinated with federal institutions.

Implementation Institutions:

The FRA should define the specific organisation with the responsibility of independently monitoring the fiscal strategy of the state to ensure compliance with the provisions of the FRA. This organisation can be modelled on the federal Fiscal Responsibility Commission (FRC). The FRC or other implementation institution should be composed of credible, technically adept individuals from the state public and private sectors, academia and civil society. The institution should provide periodic public reports on the state's fiscal strategy and its compliance with the FRA. The institution should have the mandate to enforce penalties for violating the act, with the support of the law enforcement agents and the judiciary, which may be monetary fines or serving jail time, and clearly laid out in the act.

Savings and Asset Management:

The principles of the oil-price based fiscal rule adopted by the federal government, and the arrangements governing the use of the ECA, and Sovereign Wealth Funds (SWF) should be concurrently reflected in states FRAs. Rules on the use of revenues, size of fiscal deficits (which should be similar to other states and the federal government), and the establishment of Savings/Reserve Funds for accumulated revenues should also be spelt out in the Act. These rules should reflect the principles of fiscal prudence and revenue stability which the Act subscribes to.

Public Borrowing and Indebtedness:

The Act should clearly state the limits of public debt allowed under the MTFF, and the guidelines for borrowing, which must be in accordance with the SEEDS, restricted for capital projects only, and only carried out after examining the benefits of such loans, seeking the approval of the Legislature, and with the full involvement of relevant federal institutions.

Transparency and Accountability:

The public should have access to all fiscal plans and budget documents of the state government. Periodic reports on budget execution and updates on the MTFF should be provided to the public. State governments should create public websites that serve as repositories for all fiscal strategy documents, and involve non-state actors in formulating fiscal plans. Individuals should be given rights to seek legal remedies in the event of non-disclosure of fiscal plans by the state government.

While the increasing emulation of the federal FRA by the states is laudable, it is questionable if provisions of the enacted state FRAs are being adhered to, and if there have been significant changes in the transparency of public spending. Individual progress in public expenditure management and budget transparency (in Lagos and Cross River, for instance) cannot be the basis for forming any conclusions on improved sub-national fiscal discipline across the board. In general, wider political norms on distributive patronage and state corruption also constrain the implementation of the legislation by the state governors and the civil service. There is also some argument as to whether the NGF is constitutionally recognised and if it has binding powers on ruling party governors and those who belong to other political parties.

The energy expended by the leadership of the NGF can be linked to the rapid adoption of state FRAs between 2008 and 2010, and not due to economic considerations warranted by falling revenue allocations from the centre, due to the global economic crisis, or pressures from the political leadership of Umar Yar'Adua and Goodluck Jonathan. This reflects a specific feature of Nigeria's political economy – the combination of sizeable oil revenues (from the federal government) and the political expediencies of fiscal federalism have magnified the power of the state governors and practically rendered them non-accountable to their constituents and other local and foreign stakeholders.

There are also pertinent issues regarding the constitutionality of attempts by the federal government to improve fiscal discipline. In the box below (*Box 3*), we observe that while states' claims on the ECA have resulted in its depletion and truncated the objectives for which it was established, there is still much confusion surrounding the status of the ECA in the states. The proliferation of FRAs is also contradicted by low public access to the legislation. The availability of the enacted FRAs in the public domain is problematic. Many states do not have functional websites where ratified legislation can be downloaded for public consumption, and only physical contacts with top government functionaries may guarantee access to the legislation. For poor and non-literate Nigerians, aside from gaining access to the state FRAs, understanding the technical provisions of their individual state FRAs and holding elected officials accountable based on the provisions of the Acts will be a difficult task. Furthermore, the extent of involvement of grassroots civil society groups in the states, in drafting the legislation, and monitoring state governments' compliance with fiscal rules is unclear.

Box 3: The Excess Crude Account Debate

“Where the reference commodity price rises above the predetermined level, the resulting excess proceeds shall be saved....The savings of each Government in the Federation shall be deposited in a separate account which shall form part of the respective Governments Consolidated Revenue Fund to be maintained at the Central Bank of Nigeria by each Government”

- Excerpt from Part VII, Section 35 of the 2007 federal Fiscal Responsibility Act

The federal FRA contains the oil-based fiscal rule clause, which requires proceeds from oil above a certain price (the Reference Commodity Price) to be saved in the Excess Crude Account (ECA). This practice began prior to the law’s passage in 2007, and has greatly expanded Nigeria’s capacity to maintain economic stability and control inflation in the face of the current oil price boom. The Reference Commodity Price is set each year as part of the Appropriations process, and is \$59 per barrel in FY2008. Revenues above this amount go into the Excess Crude Account which is held by the Central Bank of Nigeria (CBN). As oil prices reach historical highs, the balance of the Account has soared to trillions of naira. In late 2009, a conflict had surfaced between the federal government and several states over whether the ECA funds should be allocated to the states. The Constitution holds that all federally-collected revenues should be distributed to the various governments of the federation according to the established formula. Several states argue that the ECA is thus unconstitutional, as it represents a growing store of revenues which are kept at the federal level rather than being distributed. They are advocating for the distribution of some or all of the funds.

The federal FRA, as quoted above, indicates that the ECA is not meant to be a single account, but rather a collection of savings accounts held on behalf of all governments by the CBN. However, some stakeholders in the states were unaware of this intention. Many others questioned seriously whether this is in fact happening. Even if it is, some felt federally-held savings which they could not access represented an unacceptable infringement on their right to fiscal autonomy.

This view clearly demonstrates an urgent need for federal-state dialogue on the ECA. There was serious confusion over the status of ECA funds, how the CBN will manage accounts on behalf of states, and the negotiations regarding disbursing some ECA funds (such as the recently released N400 billion and the so-called “80-20” split). These negotiations, which include a court case brought by 7 states against the federal government, are ongoing, leaving the issue of the ECA very much in flux.

Source: Adapted from Gillies (2009).

V Conclusion and Policy Recommendations

This paper has presented a discussion of the policy, technical and wider institutional factors relevant to the implementation of fiscal responsibility acts at the state level in Nigeria. From the analysis here, it is evident that some progress has been made by 20 of the 36 states in Nigeria in enacting FRAs, to complement and extend the federal FRA, while another 13 state governments have presented FRAs to their state legislatures for ratification. While this development is laudable, there is still much to be done to improve the impact of the FRA on public financial management and the anti-corruption efforts of the government. Furthermore,

as the example of the controversy and confusion surrounding the ECA illustrates, there is a lot of mistrust and antagonism between the states and federal governments on fiscal autonomy and constitutional entitlements to pooled Federation revenue. These tensions are occurring against the backdrop of an increasingly loose fiscal policy stance, warranted by the approaching 2011 elections, and the growing claims by states on the ECA and to influence political decision-making through the NGF. The opaque nature of public finances in Nigeria also poses challenges for civil society transparency groups, and Nigerian citizens' engagement with the budget process and fiscal plans of the various levels of government.

With regards to the policies to enhance implementation of fiscal rules at the state-level, firstly, it is imperative to provide technical support to the states for macroeconomic and fiscal policy analysis, and to review draft FRAs to identify technical lapses, in order to strengthen their implementation. This requires a proactive and not reactive (after a debt or financial crisis) approach that also involves engagement with civil society transparency groups. These fiscal transparency advocacy initiatives will in turn, require technical, financial and logistical support for grassroots monitoring of FRA compliance. The objective of such advocacy initiatives would be to educate local communities on the provisions and implementation of sub-national FRAs, while engaging with political actors on their accountability to the electorate, fiscal discipline and transparency.

The country experiences with FRAs discussed here demonstrate the effectiveness of clauses that limit borrowing and the accumulation of debt by sub-national governments. In Nigeria, state governments played a major role in accumulating unsustainable debts that caused a debt overhang in Nigeria in the 1980s and 1990s. The growing indebtedness of several states that have issued development bonds and obtained loans from multilateral institutions is therefore, a cause for concern. In general, the inclusion of clauses to harmonise fiscal policies at the central and state level in the national and state FRAs is crucial to maintaining macroeconomic stability.

To strengthen the framework for implementation of FRAs at the national and sub-national level, Nigeria can learn from the Indian federal model, where prudent fiscal policies were incentivised by fiscal transfers from the national revenue commission. By adopting such a model, states in Nigeria will be rewarded with stable, equitable intergovernmental transfers for implementing fiscal responsibility legislation. This approach would also serve to delink revenue allocation from population and ethnicity in the Nigerian federation, which is heavily politicised and prone to frequent reversals in order to accommodate distributive patronage. To further enhance macroeconomic stability and the implementation of FRAs by all tiers of

government, Nigeria can also adopt the Brazilian approach, whereby a constitutional provision on fiscal policy co-ordination between the federal, state and local governments is introduced. This would serve as a binding rule on the governing units of the Federation, and minimise any distortions to fiscal discipline caused by political manipulations that stem from the application of fiscal federalism. Constitutionally mandated fiscal policy co-ordination would also resolve the controversy surrounding the ECA, and enhance the legitimacy of other revenue management tools, such as the proposed national Sovereign Wealth Fund.

Given the cyclicity of oil revenues, which are the major source of state finances, fiscal discipline in the Nigerian federation will also be enhanced by the institutionalisation of the oil price-based fiscal rule at the national and sub-national level, by all three tiers of government. This should be supported by the use of the MTFF in preparing government budgets and overall fiscal strategy, and would address the pro-cyclicality of government expenditure and enhance fiscal transparency and accountability. To ensure compliance with the provisions of the federal FRA, the Fiscal Responsibility Commission (FRC) requires technical and financial support, in carrying out its functions. The law enforcement agencies and judiciary must also play a more active role to support the activities of the FRC, enforce penalties for violations of the Act, and maintain checks and balances in governance. If established state FRCs receive similar support in executing their duties, the implementation of FRAs in the federation would be considerably improved.

There are also several political considerations on the nature of the Nigerian state and the interpretation of federalism, which have a bearing on the implementation of state FRAs in Nigeria. The unprecedented revenue concessions made by the Nigerian state towards the oil-bearing communities in the Niger Delta arose from the extreme alienation of these ethnic minorities, and the failure of accommodative strategies such as state creation and political decentralisation. Perversely, the expansion of the state by integrating various claimants over the distribution of oil rents heightened the contradictions in its composition, and thereby weakened its authority and legitimacy. Firstly, the degree of xenophobia grotesquely manifested during the Civil War, which emerged from the politicisation of ethnic identities by regional elites, indicates that state patronage cannot resolve underlying ethnic tensions, since political opposition is accommodated through the distribution of material rewards, and not an appeal to shared ideological or cultural values.

Secondly, the Federal Character Principle suffers from several critical flaws; the allocation of state resources occurs on the basis of states as political units, and not ethnic minorities as social groups. Since ethnic boundaries do not correspond to state boundaries in Nigeria,

dominant ethnic groups in each state still exercise control over state patronage, to the detriment of minorities.⁴⁰ Furthermore, while Nigeria operates as a constitutional federation, state creation by the military rulers was designed to consolidate political authority in the (unitary) military government. Democratisation has not significantly altered the political calculus, as regional elites still compete for federal patronage, while internal generation of revenue by the state governments remains very low. Thus, states are no more than outposts of a political administration that is more unitary than federal, which remain financially dependent on the centre, but are politically autonomous. State creation has also contributed to minority problems by throwing up differences between communities that constitute the new states, which are not sufficiently recognised prior to administrative reorganisation.⁴¹

Paradoxically, the scope for fiscal profligacy, minority exclusion and abuse of power by state officials has been magnified by the attempt to incorporate the political rights of ethnic minorities. Fiscal decentralisation under democratic rule has increased the excesses of state governors, and created more localised opportunities for distributive patronage. The fractured relations between the state and the indigenes of the Niger Delta have not been repaired with the increased revenue flows from the centre.

In conclusion, the adoption of FRAs at the state level still does not address the problems relating to the lack of political will among Nigeria's leadership to push through difficult fiscal reforms. Nor does it provide political strategies for resisting distributive pressures in the aftermath of an oil windfall. The rise of 'Godfather' political magnates and zero-sum politics also pose fundamental challenges for the emergence of credible political institutions. In the face of decentralised opportunities for distributive patronage, proponents of sub-national fiscal responsibility are confronted with an uphill task. However, it is unarguable that the importance of fiscal prudence and good revenue management has been ingrained in the public consciousness, due to the scale of state corruption in Nigeria. An incremental approach that draws together reform-minded elements in the state, private sector, grassroots civil society groups, academia and the media may hold the greatest promise for elevating the debate on state-level fiscal responsibility to the forefront of the policy discourse in Nigeria.

⁴⁰ Williams (1992), p. 106.

⁴¹ Akinyele (1996), p. 91.

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