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## Issues in Fiscal Policy Management under the Economic Reforms (2003–7)<sup>1</sup>

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# Issues in Fiscal Policy Management under the Economic Reforms (2003–7)

*Bright Okogu and Philip Osafo-Kwaako*

## **1 Introduction**

Oil-dependent economies face two interrelated challenges in the management of oil resources: in the short run, there is the need to create a stable macroeconomic environment by delinking oil revenue earnings from public expenditures, while in the long run it is necessary to maintain a sustainable use of resources that ensures inter-generational equity. In most of the past three decades, Nigeria's management of oil resources was poor. The Nigerian economy has experienced significant macroeconomic volatility, driven largely by external terms-of-trade shocks, the country's large reliance on oil export earnings and poor policy choices in the management of oil revenues. By some measures, Nigeria ranked among the most volatile economies in the world for the period 1960–2000. Moreover, contrary to the received wisdom of increasing financial assets as a means of saving oil revenues, Nigeria had accrued significant domestic and foreign liabilities.

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 development 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). The NEEDS programme emphasized the importance of private sector development to support wealth creation and poverty reduction in the country, and focused on four primary areas of reform, namely macroeconomic reform, structural reform, public sector reform and institutional and governance reform.

This paper reviews recent policy measures introduced by the federal government to enable a more prudent management of oil revenue and also to improve the quality of the government's capital spending. The broad conclusion of this paper is that, although recent fiscal policy measures have yielded significant positive results, these measures need to be sustained in order to maintain a stable macroeconomic environment, which is a precondition for sustained long-term growth. In addition, by consolidating recent improvements in budget planning, execution and monitoring, as well as in implementation of programmes based on the millennium development goals (MDGs), the Nigerian government can make significant progress in improving service delivery to its citizens. Large capital investments projects which are currently being implemented by the government must also be closely monitored to ensure the quality and effectiveness of such expenditures.

The rest of this paper is structured as follows. In section 2 we discuss the theoretical literature on the challenges of revenue management in oil-dependent countries. In section 3 we review Nigeria's history of oil revenue management, examining its effects on macroeconomic volatility as well as public savings. In section 4 we discuss recent policy measures that have been introduced by the federal government as a means of improving the management of oil resources. Challenges in sustaining the fiscal reforms are discussed in section 5, while conclusions are presented in section 6.

## **2 Review of the literature on oil revenue management**

The central policy challenge in oil-dependent economies arises from two observations: the volatility of oil prices and the exhaustible nature of oil resources. First, in the absence of appropriate domestic policies, the volatility of oil prices (and therefore of oil revenues) is transmitted into the economy, resulting in macroeconomic volatility, which hinders long-term fiscal planning. Second, the exhaustible character of the resource also implies that due care must be taken of intergenerational equity issues, in order to ensure that future generations also partly benefit from the oil wealth. This entails limiting current consumption in any period to the size of the permanent income flow from the stock of oil wealth. The volatility of oil prices therefore raises short-term challenges with ensuring macroeconomic stability, whereas the exhaustible nature of the oil resource raises a long-term issue of intergenerational equity. Below, we briefly examine each of these short-term and long-term challenges.

### **2.1 The volatility of oil prices**

The historical behaviour of oil prices indicates that they tend to be susceptible to huge shocks. These shocks are often persistent, and mean reversion tends to be slow (IMF, 2005a,b; Okogu, forthcoming). Volatility of oil prices results in significant terms-of-trade volatility, particularly in countries with a large concentration of ex-

ports in the oil sector. If oil earnings constitute a significant share of total government revenue, external volatility results in substantial revenue volatility which may result in fluctuations in public expenditure. In principle, revenue fluctuations should not result in macroeconomic volatility if the government is able to smooth public expenditures either by saving or by borrowing. However, few oil-dependent countries have a successful oil savings programme, and these countries often have limited access to international financial markets during periods when they most need it: when the international oil market is weak.

Large fluctuations in public expenditure that move in tandem with oil revenue earnings result in macroeconomic instability, which is harmful for growth. A procyclical fiscal policy affects the short-run dynamics of macroeconomic variables: sudden increases in government expenditure tend to be inflationary; volatility in government spending may cause resources to be reallocated to accommodate changes in domestic demand and prices with significant adjustment costs. Volatile fiscal spending also tends to destabilize the real effective exchange rate; in particular, a fiscal expansion driven by oil revenues may result in an appreciation of the domestic currency, creating Dutch disease concerns, and reducing competitiveness of the non-oil economy (Barnett and Ossowski, 2002). An unstable macroeconomic environment is undesirable, as it lowers long-run economic growth, particularly in low-income countries with weak domestic institutions (Hnatkovska and Loayza, 2003). Volatility can lower growth via a number of channels, such as by reducing the productivity of the government's public spending or by reducing the level of private investments. For example, an unstable macroeconomic environment creates uncertainty, which hinders planning by the private sector and reduces long-term private investments (Aghion *et al.*, 2004; Aizenman and Marion, 1993).

## 2.2 Exhaustible nature of oil resources

Oil is an exhaustible resource, which should benefit all citizens of the country in the present generation as well as future generations. In the long run, it is important to achieve a sustainable use of resources that ensures intergenerational equity by spreading government wealth over time. In other words, it is important that oil income, or financial assets obtained from such income, is consumed over a long period, and adequately preserved for future generations.

In the standard framework, government wealth is viewed as the sum of oil wealth (present discounted value of future oil revenues), financial assets and physical assets. In each period, the model assumes that oil wealth is converted into assets; fiscal policy aims at distributing the total wealth equitably across generations by restricting government expenditure in each period to only the *implicit return* obtained on the total government wealth. This is not always easy to measure because, for example, the returns from physical infrastructure are not easily quantifiable, even though productive infrastructure is widely viewed as important for economic growth. However, the

limitation of current consumption to the permanent income flow requires a calculation of the size of the total wealth. In reality, this cannot be done with any degree of certainty because the underlying variables, such as the size of recoverable reserves, future price of oil and cost of production, are uncertain. Assuming risk-averse behaviour, decision-making under conditions of uncertainty requires that the government adopts a conservative fiscal policy stance.

A more stringent variant of the above theoretical position is the so-called 'bird-in-hand' approach, which proposes that the projected income should be the income on the financial asset *already in hand* rather than the totality of all income that includes an estimate of oil still in the ground (Barnett and Ossowski, 2002). This model, though somewhat unrealistic because it totally ignores the value of the existing reserves, has the main advantage of protecting the financial planning process from the risk of obsolescence of oil (no matter how small the probability).<sup>1</sup> This realization has the potential to force the government to be more fiscally responsible. Overall, for countries that depend on an exhaustible resource, the objective of fiscal policy should be to accumulate as much stock of financial assets as possible, particularly when market conditions are favourable, such that the flow of income from the stock can finance the non-oil fiscal deficit after the exhaustion of oil.

An important consideration in determining the optimal level of current fiscal spending relates to the size of financial assets already saved. Some countries like Kuwait have built up dedicated funds for future generations (complemented by a stabilization fund for budget support purposes) whereas others have oil stabilization funds (such as Libya, Oman, Qatar, Azerbaijan). The purpose of these funds is to smooth financing of annual budgets, and strengthen the structure of the budget from both the revenue and expenditure sides.

In the conversion of oil wealth into assets, the government is also faced with a choice between *financial assets* and *physical assets*. It is often the case that, following the discovery of oil in commercial quantity, there is an immediate pressure for large capital expenditures based on the political economy of such developments. This may be justified if the existing stock of productive government capital (such as roads and bridges) is particularly low or if infrastructure is needed to improve development targets (for example in hospitals and schools). Yet the empirical reviews suggest that over-investment in infrastructure has sometimes been the cause of weak growth of oil-dependent countries, following resource discovery, partly because of poorly conceived projects as well as weak governance issues (Rodríguez and Sachs, 1999). Although public investments are important, it is critical that they are aimed at productive infrastructure which is likely to yield positive returns. Moreover, from an implementation viewpoint, a sudden upsurge in fiscal expenditure programmes may also suffer from poor quality in design and programme implementation. Rapid expenditure growth during commodity booms is often inflationary, quite apart from threatening the quality of projects.

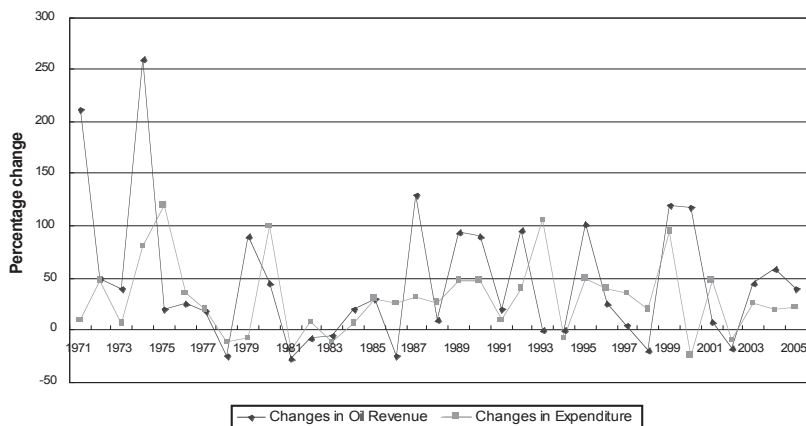
A related viewpoint is that many oil-producing countries have not always been successful in managing their oil funds, either because there is usually a strong temptation to dip into the funds or, more disturbingly, because less prudent future leaders fritter away the savings of many prior years. In order to guard against these eventualities, some studies propose a radical alternative under which the funds are committed to worthy uses that would have a long-term benefit for the economy.

For example, Sala-i-Martin and Subramanian (2003) and others have argued that all revenue accruing from oil, after some transition period, should be distributed directly to adult women in Nigeria. Arguments of this nature have some merit – there is evidence that women tend to be more prudent custodians of household resources, and may probably be better channels for delivering some social services (see Duflo, 2000). However, distributing a nation’s entire revenues to women for social programmes appears rather drastic, and is premised on the negative assumption that resource-based developing countries are not capable of improving institutional quality over the long term. It is a frustration-driven proposal – frustration with the failure of Nigerian menfolk as managers of the nation’s resources, and frustration with existing institutions in Nigeria. Such a proposition risks trivializing a serious issue, and detracts from the central question of the need to improve public investments in productive infrastructure and to address institutional weaknesses. The subject of strengthening domestic institutions is revisited in section 5.

### **3 History of oil revenue management in Nigeria**

Prior to recent economic reforms, Nigeria’s history of oil revenue management had generally been poor. Addison (2008) notes that Nigeria was one of the most volatile economies in the world over the period 1961–2000, as observed by the standard deviation of the growth rates in its real variables, domestic prices and money growth. According to these estimates, Nigeria ranked among the top 10 economies in terms of volatility of government revenues, terms-of-trade volatility, real exchange rate volatility and volatility of real GDP growth. Moreover, volatility in oil revenue earnings was often directly transferred into the domestic economy via fluctuations in public expenditures. Public expenditures closely followed oil revenue inflows as shown in Figure 1.

The costs of such macroeconomic volatility were significant for Nigeria.<sup>2</sup> First, expenditure volatility resulted in low quality of government public spending, often resulting in many abandoned government capital projects, and accrual of arrears to local contractors. Second, macroeconomic stability also hindered long-term planning by the private sector, resulting in low investment and low growth (see Table 1). There was an increased concentration of economic activity in various short-term arbitrage opportunities (particularly in retail trade) rather than productive long-term investments. Overall, Addison (2008) estimates that, compared with other



*Hfi wt g 1* Pro-cyclical public expenditure pattern, 1992–2005.

Source: Federal Government of Nigeria estimates.

countries, macroeconomic volatility could have reduced growth in Nigeria by as much as 3.4 percentage points per annum.

Moreover, contrary to the conventional wisdom of increasing financial assets (as a means of saving oil revenues), the Nigerian government in the 1980s and 1990s had accrued significant financial liabilities particularly in the form of external debts to both the Paris Club and London Club creditors (see Table 2). By 2002, Nigeria’s stock of debt amounted to about \$40.5 billion (about 87.9 per cent of GDP), of which \$31.0 billion was in external debt and the equivalent of \$9.5 billion of domestic debt. High debt servicing costs placed a significant strain on government fiscal resources, and crowded out space for other necessary social expenditure and public investments.

In the late 1980s, attempts were made to smooth government revenues by saving incomes above a reference price for oil in a special stabilization fund. The operation of such funds was generally weak owing to a lack of transparency and fiscal discipline governing the use of such funds. As an example, in 1989, a total of 14.6 billion naira accrued into this fund, of which about 6 billion naira was withdrawn for use by the federal government despite rising oil prices (see World Bank, 2003).

#### 4 Recent policy measures and results

Based on the above short- and long-term considerations, the literature on fiscal management recommends a number of prudent practices for oil-dependent economies such as Nigeria which are summarized below.



Table 1 Selected economic indicators (annual percentage changes)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Average 1992-2002
Total GDP	2.43	0.58	-1.61	2.29	6.20	2.77	0.23	1.49	5.64	3.31	1.42	2.25
Oil GDP	2.27	1.24	0.12	2.17	4.48	1.47	-5.39	-4.13	11.54	1.42	-11.63	0.32
Non-oil GDP	2.52	0.21	-2.58	2.35	7.17	3.51	3.40	4.39	2.84	4.28	7.96	3.28
CPI inflation (year on year)	48.8	61.3	76.8	51.6	14.3	10.2	11.9	0.2	14.5	16.5	12.2	28.94

Source: Federal Government of Nigeria (unpublished data) and IMF (2001, 2003, 2005).

Table 2 Consolidated government operations

	1999	2000	2001	2002
Total revenue (% of GDP)	30.7	45.0	46.9	36.4
Total expenditure (% of GDP)	38.0	38.6	50.2	40.7
Fiscal balance (% of GDP)	-7.4	6.4	-3.3	-4.2
Total debt (% of GDP)	106.3	89.2	81.3	87.9
External debt (% of GDP)	81.8	69.1	62.2	67.2
Domestic debt (% of GDP)	24.5	20.1	19	20.7
Total debt (\$ billions)	37.3	39.0	38.8	40.5
External debt	28.7	30.2	29.7	31.0
Domestic debt	8.6	8.8	9.1	9.5

Source: IMF (2001, 2003, 2005) and Federal Government of Nigeria (unpublished data).

- 1 Institute appropriate rules to avoid pro-cyclical government spending patterns and to foster a stable macroeconomic environment, for example by using fiscal rules to insulate domestic fiscal programmes from external oil shocks.
- 2 Develop some form of a rules-based stabilization fund, thereby creating a form of precautionary savings. A stabilization fund or, alternatively, accumulation of government reserves serves as an insurance tool by providing resources for future fiscal activities in case of unforeseen adverse oil market developments. This follows from theory that income uncertainty results in reduced consumption decisions and higher savings (Deaton, 1992; IMF, 2005a).
- 3 Aim at ensuring long-term income (after natural resources are exhausted), by converting the natural resource into physical and financial assets, while also taking steps to reduce external debt as an integral part of prudent fiscal policy (World Bank, 2003; Barnett and Ossowski, 2002). A reduction in the overall stock of public debt reduces future debt service obligations, and thereby creates additional fiscal space for social expenditures.
- 4 For physical assets, it is important to invest in productive, public infrastructure and to minimize prestige ‘white elephant’ type projects. Projects must target productive public investments (in roads, bridges, power plants and so on) that reduce private sector ‘transaction costs’, and enhance productivity in the economy. In this context, an *ex ante* system of cost–benefit analysis framework is needed (incorporating costs, anticipated social benefits and the like) to guide government investments.
- 5 Finally, it is important to improve transparency in the oil sector as a means of strengthening governance of the sector, and reducing the likelihood of conflict (Collier *et al.*, 2003). This is an important recommendation as the lack of

transparency in natural resource sectors, as well as competition over resource rents, could result in conflict particularly in ethnically fragmented societies such as Nigeria.

As part of the recent economic reforms by the Obasanjo administration, many components of these policies have been implemented. Progress has been made by introducing an oil-price based fiscal rule, by strengthening the budget planning process (via the use of the Medium-Term Expenditure Framework, MTEF, and the Medium-Term Sector Strategy, MTSS), by improving the efficiency of government spending, and by targeting expenditures for the MDG-based activities. In addition, a number of initiatives have been introduced to improve transparency in government public expenditures as well as in the oil and gas sector. Sections 4.1 to 4.6 below review some of the recent areas of reform.

#### **4.1 Use of an oil price-based fiscal rule**

The operation of fiscal policy in Nigeria under the reform programme has revolved around the adoption of an oil-price based fiscal rule and strict adherence to that rule in budget implementation. Any revenue earned above the benchmark price is saved in a common account ('the excess crude account') for all tiers of government. Benchmark prices of \$25/barrel, \$30/barrel and \$35/barrel were used in 2004, 2005 and 2006 respectively, despite higher realized prices of \$38.3 and \$54.2 in 2004 and 2005 respectively and a projected average price of \$68.0 for 2006. The 2007 budget, which was passed by the National Assembly in December 2006, was based on an oil price of \$40 per barrel. Adoption of the fiscal rule has resulted in a significant fiscal surplus for the federal government, as well as for the federation on a consolidated basis: a consolidated fiscal surplus of about 9.9 per cent of GDP in 2004, increased slightly to about 10.7 per cent of GDP in 2005, and estimated to be about 11.9 per cent in 2006. Following the strong performance of the fiscal sector, international reserves grew steadily from about \$7.5 billion at the end of 2003 to about \$43.8 billion at the end of 2006 (Table 3). The increased level of reserves has partly underpinned the attainment of a stable exchange rate, with the elimination of a previous black market premium.

Fiscal management has been further strengthened by the management of government finances by a Cash Management Committee. For the period 2004–6, government did not utilize the Ways and Means window of the Central Bank, nor did it borrow from the banking sector.<sup>3</sup> The growth of excess liquidity was curtailed, thereby enabling the Central Bank of Nigeria (CBN) to meet its broad money targets in recent years. This has resulted in a significant reduction in inflation levels: end-year inflation (point-to-point) declined from 21.8 per cent in 2003 to 10.0 per cent in 2004. Inflation increased slightly to 11.6 per cent at the end of 2005 but declined to 8.5 per cent at the end of 2006 (CBN, 2006).<sup>4</sup>

Table 3 Selected economic indicators

	1992-8 (average)	1999-2001 (average)	2002	2003	2004	2005	2006
Real GDP (at 1990 factor cost) (% change)	1.84	3.48	1.42	10.90	6.10	7.20	5.67
Oil GDP (% change)	0.91	2.94	-11.63	26.50	3.50	4.20	-4.51
Non-oil GDP (% change)	2.37	3.84	7.96	4.40	7.40	8.60	8.93
Inflation rate (% change)	39.27	10.40	12.20	21.80	10.10	11.60	8.50
Money supply (M2) (% change)	...	35.03	21.55	24.11	14.02	16.03	28.40 <sup>a</sup>
Exchange rate (IFEM/DAS) (naira/\$, average)	...	102.3	121.30	129.50	133.5	131.8	126.50
External reserves (\$ billion)	3.60	8.40	7.70	7.50	17.00	28.30	43.80
Total revenue (consolidated) (% of GDP)	...	40.90	36.40	37.10	43.00	43.50	45.40
Total expenditure (consolidated) (% of GDP)	...	42.30	39.00	37.10	35.30	34.20	33.50
Fiscal balance (% of GDP)	...	-1.40	-2.50	0.00	7.70	9.30	11.90

Source: Central Bank of Nigeria (2001, 2004, 2005, 2006), Federal Government of Nigeria (unpublished data), IMF (2001, 2003, 2005).

a estimated.

However, an important result of the introduction of the oil-price based fiscal rule has been the increase in government public savings: a total of \$5.9 billion was saved in the excess crude oil account in 2004 and a further \$13.4 billion in 2005.<sup>5</sup> In a sense, the Nigerian excess crude account serves as both a savings and a stabilization fund. In keeping with prudent policy, savings in the fund have, in particular, been used for reducing Nigeria's financial liabilities (Table 4): primarily in financing Nigeria's payment of its debt obligations to the Paris Club<sup>6</sup> and, more recently, part of its London Club debt.

#### **4.2 Strengthening the budget planning process**

The actual budget preparation process has also been strengthened in order to increase the efficiency of government capital spending and also improve service delivery. As part of recent economic reforms, an annual fiscal strategy paper is prepared which outlines the government's anticipated expenditures and projected revenue earnings. Medium-term expenditure frameworks (MTEFs) and medium-term sector strategies (MTSSs) have been introduced to ensure that sectoral spending plans reflect existing government development priorities and are also in line with their projected resource envelopes. These three-year rolling budget frameworks have the advantage of ensuring that projects that span more than one year can be adequately budgeted for, with a clear plan for funding such projects over succeeding budget years, and thus avoiding the incidence of abandoned projects that historically plagued the economy. The MTEF and MTSS process also forces government agencies to make hard choices between using available resources to start new projects and completing existing ones. Partly as a result of these recent measures, there has been a notable improvement in the implementation ratio of government capital budgets to about 90 per cent in 2004 and 2005 (albeit with some extension beyond the fiscal year; see Federal Ministry of Finance, 2005, 2006).

#### **4.3 Improving the efficiency of government capital spending**

Following an extensive review of public procurement systems in Nigeria, a Value for Money audit or Due Process mechanism was introduced in government procurement contracts. The Due Process mechanism has promoted an open tenders process with competitive bidding for government contracts. Any projects exceeding 50 million naira (or \$400,000) in value require formal approval from the designated government agency (the Budget Monitoring and Price Intelligence Unit, BMPIU) and the award of a due process certificate. To ensure competitive costing of contracts, a database of international prices has also been developed to serve as a guide during the bidding process, while a public tenders journal is also regularly published by the government as a means of reducing patronage in the award of contracts. Finally, certification of completed government projects is also required before payments are made. With the introduction of the due process mechanism, there has been a notable improvement in

Table 4 Total public debt (1999–2006)

	1999	2000	2001	2002	2003	2004	2005	2006
Total debt (\$ billion)	37.3	39.0	38.8	40.5	43.1	46.6	31.9	17.7
External debt (\$ billion)	28.7	30.2	29.7	31.0	32.9	35.9	20.5	3.5
Domestic debt (\$ billion)	8.6	8.8	9.1	9.5	10.2	10.7	11.4	14.2
Total debt (% GDP)	106.3	89.2	81.3	87.9	74.8	65.3	32.5	15.1
External debt (% GDP)	81.8	69.1	62.3	67.2	57.1	50.2	20.9	3.0
Domestic debt (% GDP)	24.5	20.1	19.0	20.7	17.7	15.1	11.6	12.1

Source: Federal Government of Nigeria (unpublished data) and IMF (2001, 2003, 2005).

the efficiency of capital spending. It is estimated that by the application of this policy the federal government has saved over 200 billion naira (approximately \$1.5 billion) since 2001 in the form of reductions from otherwise inflated contract prices.<sup>7</sup> Moreover, in recent years, initial prices quoted by various government contractors have also declined significantly as a direct result of the vigilance of the Due Process mechanism.

#### **4.4 Improving pro-poor, MDG-based, expenditures**

In the process of strengthening fiscal policy management in the country, particular attention was also given to pro-poor expenditures within the budget which were needed to improve Nigeria's MDG indicators. The quantity and quality of social sector spending had declined significantly in Nigeria following years of military rule and poor economic management. In many cases, human development indicators in Nigeria at the end of the 1990s were comparable to those of other least developed countries. To address the deteriorating human development indicators in the country, annual savings from debt servicing (amounting to about \$1 billion, with a federal government share of \$0.75 billion) were channelled to various poverty reduction programmes. The utilization of debt relief savings is being monitored through a Virtual Poverty Fund Mechanism, named OPEN (Overview of Public Expenditure in NEEDS), which was designed to track utilization of these funds in the budget on pro-poor programmes. In the 2006 budget, OPEN was piloted by 10 government ministries, departments and agencies (MDAs): the Ministries of Health, Education, Water, Agriculture, Power, Works, Housing and Development, Environment, Women Affairs and Youth. As an example, in the 2006 budget, the Delta State in the South South zone of Nigeria obtained financing for primary health care centres, for refurbishment of the local college for education, and for irrigation and rural water supply projects, as well as various rural electrification projects.

#### **4.5 Improving transparency in public finances**

In the past, poor public expenditure management in Nigeria greatly hampered the quality of government capital projects, resulting in poor service delivery to citizens. Oversight of public expenditures was further made difficult by fiscal decentralization in Nigeria, which allocates about half of total government revenues to states and local governments, with the remainder being allocated to the federal government. While increased resource allocation to states and local governments may potentially encourage more direct interventions in pro-poor programmes, capacity constraints and the lack of transparency at the sub-national level posed serious challenges. Therefore, to improve transparency at all levels of government, but particularly the sub-national level, a monthly publication of federal, state and local government shares of revenue from the country's federation account was introduced. Since January 2004, details of these revenue shares have been published: for the federal government,

the 36 state governments and the Federal Capital Territory (FCT) as well as 774 local governments. The publication has increased transparency, particularly of sub-national finances, and opened up a dialogue on public revenues and expenditures at all tiers of government. Prior to this initiative, citizens had no way of challenging their governments on the size of funds received from the federal government. In the 1990s, it was quite common for teachers and other civil servants to go without pay for several months, and it was not unusual for state governments to blame such salary arrears on delays in receiving funds from the central government. In most cases this was correct, but there were other instances when it was simply used as a convenient excuse for poor management of public resources.

#### **4.6 The oil and gas sector and the N-EITI initiative**

The lack of transparency in the Nigerian oil and gas sector, particularly under past military administrations, also presented a major governance issue. The necessity for the establishment of the Nigerian Extractive Industries Transparency Initiative (N-EITI) became obvious after a government-commissioned study by the World Bank in 2000 revealed some disturbing findings.<sup>8</sup> Among other things, it found lapses in four broad areas: crude oil output and disposal; funds inflows; funds outflow; and institutional effectiveness. Clearly, such lapses created a fertile environment for corrupt practices to thrive. It became imperative for the administration to take decisive steps to institutionalize a system of regular independent audits of hydrocarbons reserves, financial flows and practices in the extractive industry. In this regard, Nigeria was the first country to sign on to the EITI in the fourth quarter of 2003, and the federal government inaugurated the National Stakeholders Working Group (NSWG) in February 2004 to help improve governance of the sector.<sup>9</sup> Specifically, the NEITI commissioned an independent audit of the oil and gas sector for the period 1999–2004, comprising financial, physical and process audits.

The audit report presented a number of instructive findings. It pointed to a history of poor data-keeping, particularly in the financial and physical audits of the oil and gas sector. On the financial audit, only minor disparities were observed between revenues that oil companies reported as paid and the actual amounts reported as having been received by the Central Bank.<sup>10</sup> However, the coordination among government agencies was found to be weak, and government data-keeping was also poor, such that reported revenues fluctuated: in some years reported income exceeded what the Central Bank received, whereas in other years the reverse occurred. The physical audit pointed to the systematic loss of crude oil between the wellhead and export metering terminals. Poor metering infrastructure also hampered proper data collection on gross volumes. Finally, the process audit highlighted some concerns with the discretionary powers of the Petroleum Minister in oil block allocation, arising from the Petroleum Act of 1969. The findings of the study were subsequently disseminated to the general public, while remediation measures were initiated by the government.<sup>11</sup>



## 5 Challenges in sustaining the fiscal reforms

Given its history of poor oil revenue management, Nigeria has recently made significant progress in improving its fiscal policy management as part of current economic reforms. However, despite recent improvements in the management of oil resources and public expenditures in Nigeria, significant challenges remain. We focus here on two main challenges: first, the need to institutionalize recent reforms; and second, the challenge of extending reforms to the sub-national level.

### 5.1 Institutionalizing recent reforms

The strategy for sustaining and deepening the reforms lies in institutionalizing them through appropriate legislation to lock in the reforms – a strategy that has always been emphasized by the government. The role of institutions in economic development is now widely recognized, as most social scientists now agree that ‘institutions matter’ in the development process. The presence of strong institutions insulates the reform process to the extent that there is much less dependency on the personality of the leadership. With strong domestic institutions, private sector investors are less concerned about the risks of policy reversals by future administrations. Strong institutions prevent arbitrary reversals of policy and underscore the rule of law.

The centrality of institutions was well argued in the 1970s by Douglas North, who stressed that strong institutions were an important factor in explaining the rise of the Western economies in the eighteenth and nineteenth centuries. More recently, Acemoglu, Rodrik and others have also stressed the importance of institutions in explaining cross-country growth differences among developing countries (Acemoglu *et al.*, 2001; Rodrik, 2003). For example, Acemoglu discusses the case of Botswana, where strong economic performance was closely linked with the development of institutions to secure property rights, to ensure law and order, and also to improve governance of diamond resources (Acemoglu *et al.*, 2003). In the area of macroeconomic management, Satyanath and Subramanian (2004) have also observed the importance of democratic institutions in promoting disciplined monetary policy and supporting macroeconomic stability. As Fukuyama (2005) has noted:

Recognition that ‘institutions matter’ and that good governance is a key part of any development strategy has become widely accepted within the development policy community in recent years. ... reforms need to be accompanied by positive acts of institutional reform and state-building.

From interactions with the Nigerian public, who have seen several false starts in economic policy, it is clear that sustainability of the reforms is the single most important issue to them.<sup>12</sup> Accordingly, the government has initiated several bills designed to institutionalize the recent reform measures. Several bills directly related to the

transparency in natural resource sectors, as well as competition over resource rents, could result in conflict particularly in ethnically fragmented societies such as Nigeria.

As part of the recent economic reforms by the Obasanjo administration, many components of these policies have been implemented. Progress has been made by introducing an oil-price based fiscal rule, by strengthening the budget planning process (via the use of the Medium-Term Expenditure Framework, MTEF, and the Medium-Term Sector Strategy, MTSS), by improving the efficiency of government spending, and by targeting expenditures for the MDG-based activities. In addition, a number of initiatives have been introduced to improve transparency in government public expenditures as well as in the oil and gas sector. Sections 4.1 to 4.6 below review some of the recent areas of reform.

#### **4.1 Use of an oil price-based fiscal rule**

The operation of fiscal policy in Nigeria under the reform programme has revolved around the adoption of an oil-price based fiscal rule and strict adherence to that rule in budget implementation. Any revenue earned above the benchmark price is saved in a common account ('the excess crude account') for all tiers of government. Benchmark prices of \$25/barrel, \$30/barrel and \$35/barrel were used in 2004, 2005 and 2006 respectively, despite higher realized prices of \$38.3 and \$54.2 in 2004 and 2005 respectively and a projected average price of \$68.0 for 2006. The 2007 budget, which was passed by the National Assembly in December 2006, was based on an oil price of \$40 per barrel. Adoption of the fiscal rule has resulted in a significant fiscal surplus for the federal government, as well as for the federation on a consolidated basis: a consolidated fiscal surplus of about 9.9 per cent of GDP in 2004, increased slightly to about 10.7 per cent of GDP in 2005, and estimated to be about 11.9 per cent in 2006. Following the strong performance of the fiscal sector, international reserves grew steadily from about \$7.5 billion at the end of 2003 to about \$43.8 billion at the end of 2006 (Table 3). The increased level of reserves has partly underpinned the attainment of a stable exchange rate, with the elimination of a previous black market premium.

Fiscal management has been further strengthened by the management of government finances by a Cash Management Committee. For the period 2004–6, government did not utilize the Ways and Means window of the Central Bank, nor did it borrow from the banking sector.<sup>3</sup> The growth of excess liquidity was curtailed, thereby enabling the Central Bank of Nigeria (CBN) to meet its broad money targets in recent years. This has resulted in a significant reduction in inflation levels: end-year inflation (point-to-point) declined from 21.8 per cent in 2003 to 10.0 per cent in 2004. Inflation increased slightly to 11.6 per cent at the end of 2005 but declined to 8.5 per cent at the end of 2006 (CBN, 2006).<sup>4</sup>

made. A further area of critical importance is how to deepen the reforms to the sub-national levels in order to improve service delivery to ordinary Nigerians and help in tackling poverty. In this context, several bills, including the Fiscal Responsibility Bill, the Public Procurement Bill, the N-EITI Bill and some tax bills, are currently under consideration by the National Assembly and are at different stages of passage. Their swift passage into law would not only help to institutionalize the reforms, but also quicken the drive to transmit the benefits of reforms to Nigerians.

## Notes

- 1 Obsolescence in this case does not necessarily mean that oil usage would be obsolete but that technological advancement might make alternative fuels more competitive in the energy markets so that it will no longer be competitive to invest in oil production.
- 2 For further discussion on the impact of volatility on growth, see Bleaney and Greenaway (2001), Fatas and Mihov (2003) and Servén (2003).
- 3 In 2005, the CBN granted total advances of 54.04 billion naira in a Ways and Means overdraft facility to the federal government. However, this facility was within accepted limits of the West African Monetary Zone (WAMZ), and was repaid by the end of December 2005, in line with statutory requirements.
- 4 The slight increase in inflation during 2005 was attributed to increases in food prices caused by a rise in food exports (particularly cassava and grains) to neighbouring countries, Chad and Niger, during their drought episode in 2005.
- 5 Of the amount saved in 2004, 50 per cent was shared among all tiers of government in 2005, leaving the balance on the account at \$16.3 billion at the end of December 2005.
- 6 As part of a debt agreement with the Paris Club, Nigeria paid its outstanding arrears of \$6.4 billion, received a debt write-off of \$16 billion on the remaining debt stock (as under Naples terms), and purchased its outstanding debt under a buy-back agreement at 25 per cent discount for \$6 billion. The entire debt relief package cost \$12.4 billion in payment of arrears and buy-back, in return for \$18 billion or 60 per cent debt write-off.
- 7 Source: Government of Nigeria (Budget Monitoring and Price Intelligence Unit, BM-PIU).
- 8 The EITI scheme is a 'publish what you pay' scheme initiated by Tony Blair and George Soros, and aims at improving transparency in the oil and gas sector of the country. The Nigerian EITI (N-EITI) acts as the secretariat for the Initiative and carries out the day-to-day work of the agency.
- 9 The National Stakeholders Working Group (NSWG) is comprised of representatives from government, the national assembly, the oil industry, civil society, trade unions and the media.
- 10 The final audit report showed that only 0.01 per cent of aggregate revenue for the period was unaccounted for, mostly in the form of old invoices. The auditors have pointed out that this is within the conventional margin of error of 5 per cent for auditors.
- 11 Also available online at [www.neiti.org](http://www.neiti.org).
- 12 See also, for example, *Business Day* newspaper of Tuesday 16 January 2007.

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