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Fiscal federalism in Nigeria: Theory and practice

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Abstract

Fiscal federalism, which mirrors the amount of fiscal autonomy and responsibility accorded to subnational government, has been an important subject in the policy equation of many developing, transition, and developed countries.. This paper, therefore, examined the evolution, structure, and practices of fiscal federalism in Nigeria. In achieving this, the paper adopted both descriptive and analytical methods by relying on secondary sources for data gathering. The paper revealed that Nigeria has not operated as a true federation since it adopted a federal constitution. Fiscal responsibility and taxing powers still remain considerably centralized. The practice of fiscal federalism in Nigeria has been inhibited by several factors which include, the dominance of the federal government in the revenue sharing, the protracted period of interregnum rule of the military, and over-reliance on the revenue from the Federation Account. The paper therefore concluded that the federal government ought to devolve some of its tax powers to state governments in order to stimulate healthy fiscal independence and competition among states.

Keywords: Decentralisation, Allocation, Centralism, Military

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1. Introduction

Fiscal decentralization has become fashionable regardless of levels of development and civilization of societies. Nations are turning to devolution to improve the performance of their public sectors. Fiscal federalism is essentially about the allocation of government resources and spending to the various tiers of government. In general the intensification of clamour for greater decentralization is informed by a combination of people desiring to get more involved in government, and the inability of the central government to deliver quality services (Aigbokhan, 1999; Oates, 1972; Tanzi, 1995; Chete, 1998)

Decentralized systems of government give rise to a set of fiscal exigencies referred to as fiscal federalism also known as fiscal decentralization. It refers to the scope and structure of the tiers of governmental responsibilities and functions, and the allocation of resources among the tiers of government to cope with respective functions.

In Nigeria the dismal performance of the public sector since the first half of the 1980s has brought to the front burner the issue of fiscal federalism which has remained dominant and most contentious in Nigeria's polity (Arowolo 2011). In the last three decades Nigerians have contended with not only vanishing real incomes but also unbearable levels of unemployment and inflation, decay in social amenities and failure to maintain, not to talk of improving, the nation's infrastructures. This dismal performance of the public sector has prevented the creation of opportunities for a resilient and sustainable growth and development of the Nigerian economy, which should be the object of rational and functional fiscal federalism.

Long years of military rule and the centralized nature of the military hierarchical structure created the financial hegemony enjoyed by the federal government over the thirty states (36) states and seven hundred and seventy four (774) local governments. This has created disaffection in the Nigerian federation. Thus the worry over the development of a national and functional fiscal federalism for Nigeria is well founded.

2. Conceptual issues

Fiscal federalism is a byproduct of federalism. Federalism is a political concept in which power to govern is shared between national, and subnational governments creating what is often called a federation (Arowolo 2011, Akindele and Olaopa, 2002). Federalism is a political concept in which the power to govern is shared between national, states and local governments, creating what is often called a federation (Arowolo, 2011, Akindele and Olaopa, 2002). Arowolo (2011, p.4) states that "It is a political theory that is divergent in concept, varied in ecology and dynamic in practice". According to Vincent (2001), the concept of federalism implies that each tier of government is coordinate and independent in its delimited sphere of authority and should also have appropriate taxing powers to exploit its independent sources of revenue.

Fiscal federalism demands that each level of government should have adequate resources to perform its functions without appealing to the other level of government for financial assistance (Wheare, 1963):

“If state authorities, for example, find that the services allotted them are too expensive for them to perform, and if they call upon the federal authority for grants and subsidies to assist them, they are no longer coordinate with the federal government but subordinate to it. Financial subordination makes an end of federalism in fact, no matter how carefully the legal forms may be preserved. It follows therefore that both state and federal authorities in a federation must be given the power in the constitution each to have access to and to control, its own sufficient financial resources. Each must have a power to tax and to borrow for the financing of its own services by itself”.

For any federation to be sustained there must be fiscal decentralization and financial autonomy. Fiscal decentralization means delegating decision-making to lower levels of government instead of concentrating it at the centre. Each level of government, therefore, should be free to take decisions and allocate resources according to its own priorities in its own area of jurisdiction. In addition, the federating units should be able to act independently on matters within their own jurisdiction (Ewetan, 2011).

Fiscal federalism is concerned with “understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government” (Oates, 1999). Fiscal federalism is a general normative framework for the assignment of functions to the different levels of government and appropriate fiscal instruments for carrying out these functions (Arowolo, 2011). It is a set of guiding principles or concept that helps in designing financial relations between the national and subnational levels of government, while fiscal decentralisation is the process of applying such principles (Sharma, 2005). Fiscal federalism concerns the division of public sector functions and finances among different tiers of government (Ozo-Eson, 2005).

Fiscal federalism is characterized by fiscal relations between central and lower levels of government. The fiscal relationships between and among the constituents of the federation is explained in terms of three main theories, namely, the theory of fiscal relation which concerns the functions expected to be performed by each level of government in the fiscal allocation; the theory of interjurisdictional cooperation which refers to areas of shared responsibility by the national, state and local governments, and the theory of multijurisdictional community (Tella, 1999). In this case, each jurisdiction (state, region or zone) will provide services whose benefits will accrue to people within its boundaries, and so, should use only such sources of finance as will internalize the costs.

3. Theory of fiscal federalism

The basic foundations for the initial theory of Fiscal Federalism were laid by Kenneth Arrow, Richard Musgrave and Paul Sadweh Samuelson. Samuelson’s two important papers (1954, 1955) on the theory of public goods, Arrows discourse (1970) on the roles of the public and private sectors and Musgrave’s book (1959) on public finance provided the framework for what became accepted as the proper role of the state in the economy. The theory was later to be known as “Decentralisation Theorem” (Ozo-Eson, 2005).

This framework identifies three roles for the government sector. These are correcting various dimensions of market failure, maintaining macroeconomic stability, and redressing income inequality. The central government is responsible for the correction of market failure and maintenance of macroeconomic stability, while the subnational governments and the central government are jointly responsible for redressing income inequality (Ozon-Eson, 2005).

Each tier of government is seen as seeking to maximize the social welfare of the citizens within its jurisdiction. This multi-layered quest becomes very important where public goods exist, the consumption of which is not national in character, but localized. In such circumstances, local outputs targeted at local demands by respective local jurisdictions clearly provide higher social welfare than central provision. This principle, which Oates (1972) has formalized into the "Decentralization Theorem" constitutes the basic foundation for what may be referred to as the first generation theory of fiscal decentralization (Oates, 2006a; Bird, 2009). The theory focuses on situations where different levels of government provide efficient levels of outputs of public goods "for those goods whose special patterns of benefits are encompassed by the geographical scope of their jurisdictions" (Oates, 2006b). Such a situation came to be known as "perfect mapping" or "fiscal equivalence" (Ma, 1995; Olson, 1996).

Nevertheless, it was also recognized that, given the multiplicity of local goods with varying geographical patterns of consumption, there was hardly any level of government that could produce a perfecting mapping for all public goods. Thus, it is recognized that there would be local public goods with inter-jurisdictional spill-overs. For example, a road may confer public goods characteristics, the benefits of which are enjoyed beyond the local jurisdiction. The local authority may then under-provide for such a good. To avoid this, the theory then resorts to traditional Pigouvian subsidies, requiring the central government to provide matching grants to the lower level government so that it can internalize the full benefits.

Based on the preceding, the role of government in maximizing social welfare through public goods provision is assigned to the lower tiers of government. The other two roles of income distribution and stabilization are regarded as suitable for the central government.

From the foregoing, the role assignment which flows from the basic theory of fiscal federalism is summarized as follows: The central government is expected to ensure equitable distribution of income, maintain macroeconomic stability and provide public goods that are national in character. Decentralized levels of government on the other hand are expected to concentrate on the provision of local public goods with the central government providing targeted grants in cases where there are jurisdictional spill-overs associated with local public goods.

Once the assignment of roles had been carried out, the next step in the theoretical framework is to determine the appropriate taxing framework. In addressing this tax assignment problem, attention is paid to the need to avoid distortions resulting from decentralized taxation of mobile tax bases. Gordon (1983) emphasizes that the extensive application of non-benefit taxes on mobile factors at decentralized levels of government could result in distortions in the location of economic activity.

Following from the assignment of functions, taxes that matched more effectively the assigned functions are also assigned to the relevant tier or level of government. For example, progressive income tax is suited to

the functions of income redistribution and macro-economic stabilization and is therefore assigned to the central government. On the other hand, property taxes and user fees were deemed more appropriate for local governments. Benefits taxes are also prescribed for decentralized governments based on the conclusion that such taxes promote economic efficiency when dealing with mobile economic units, be they individual or firms (Olson, 1982).

The final element of this basic theory is the need for fiscal equalization. This is in the form of lump sum transfers from the central government to decentralized governments. The arguments for equalization are mainly two. The first which is on efficiency grounds sees equalization as a way of correcting for distorted migration patterns. The second is to provide assistance to poorer regions or jurisdictions. Equalization is important in a number of federations. For example, Canada has an elaborate equalization scheme built into her inter-governmental fiscal arrangements (Boadway and Hobson, 2009; Weingast, 1995).

It necessary to point out that recent literature emphasizes the importance of reliance on own revenues for financing local budgets. A number of authors (Weingast, 1997; Mckinnon, 1997) draw attention to the dangers of decentralized levels of government relying too heavily on intergovernmental transfers for financing their budgets. These are lessons that Nigeria's fiscal system should draw from in order to ensure macroeconomic stability.

4. The review of revenue commissions and allocation formula in Nigeria: 1946 - 1999

The issue of fiscal federalism is a unique one as it has generated intense debate in Nigeria. Arowolo (2011, p. 9) notes that "It is characterized by constant struggle, clamour for change, and very recently, violence in the form of agitation for resource control in the Niger-Delta". Agitations for more decentralized fiscal arrangement by lower tiers of government have continued to be resisted by a leviathan federal government. Various commissions and committees have been set up to address this issue over the years. These committees will be examined under three phases of revenue allocation in Nigeria.

4.1. The first phase of revenue allocation, 1946-1964

The task of the early fiscal commissions, from Phillipson Commission of 1946 to Sir Louis Chicks Commission of 1954 was limited to allocating equitably to the regional governments total "non-declared" revenue (consisting mainly of import and export duties and excise and company taxes) which, under the Constitution, was determined by the central government. Phillipson Commission recommended the use of derivation and even development as criteria for distribution of revenue. Each region's share were as follows: North, 46 per cent; west, 30 per cent and East, 24 per cent.

The Hick-Phillipson Commission (1950) recommended need, derivation, independent revenue or fiscal autonomy and national interest as the criteria for revenue sharing. Chicks Commission (1954) recommended derivation. Raisman Commission (1957) Raisman Commission recommended a Distributable Pool Account (DPA) shared among the regions as follows: North, 40%; East, 31%; West, 24% and Southern Cameroun, 5%.

In 1961, Southern Cameroun left the federation, and the DPA was redistributed as follows: North, 42%; East, 33% and West, 25%. In 1963, when the Mid-West was created the share of the then Western Region was divided between it and the new region in the ratio of 3:1 (Ewetan, 2011, p. 98-99; Arowolo, 2011, p. 10). The Binns Commission (1964) rejected the principles of need and derivation. In its place, it suggested regional financial responsibility and percentage division of 42% to the north, 30% to the east, 20% to the west, and 8% to the mid-west.

4.2. The second phase of revenue allocation, 1967-1979

Following the creation of 12 states in May, 1967 the Constitutional (Financial Provisions) Decree No. 15 of 1967 was promulgated to share the revenue in the Distributable Pool Account (DPA) among the new states as follows: East Central, 17.5 per cent; Lagos, 2 per cent; Mid-West, 8 per cent; the six Northern, states 7 per cent; South Eastern, 7.5 per cent; Rivers, 5 per cent; West, 18 per cent. The decree did not apply any uniform principle to all states. In particular, it failed to take cognizance of the key elements which formed the basis of the previous allocations of revenue among the regions, namely, population, derivation, consumption, among others (Ewetan 2011, p. 99).

The Dina Commission (1969) recommended national minimum standards, balanced development in the allocation of the states joint account and basic need (Arowolo 2011, p. 10).

Subsequent decrees between 1970 and 1975 aimed at correcting the anomalies of Decree No. 15 of 1967, by reallocating revenue to states on a more equitable basis (Ewetan 2011, p. 99). Aboyade Technical Committee (1977) recommended a national minimum standard for national integration (22%), equality of access to development opportunities (25%), absorptive capacity (21%), fiscal efficiency (15%) and independent revenue effort (18%). Other criteria are (57%) to Federal Government, (30%) to State Governments, (10%) to Local Governments, and (3%) to a special fund (Arowolo 2011, p. 10).

4.3. The third phase of revenue allocation, 1979-1999

In 1979, the federal government set up a six-man Revenue Allocation Commission under the chairmanship of Dr. P.N.C Okigbo. The Commission recommended percentages on principles: population (40%), equality (40%), social development (15%), and internal revenue effort (5%). Percentages for government: Federal (53%), States (30%), Local Governments (10%), Special Fund (7%) (Ewetan 2011, p. 101; Arowolo 2011, p. 10).

The 1979 Constitution had four important consequences on revenue sharing. First, the federal government ceased to monopolize the retention of fast growing revenues such as company income tax and petroleum profit tax. Second, the proportionate share of each level of government was fixed and made more certain. Third, the local governments hitherto regarded as arms of their respective state governments were recognized as an independent revenue sharing unit in the federation. Finally, the derivation criterion almost disappeared as an important principle for revenue sharing.

The 1984 Allocation of Revenue Act further modified the sharing formula as follows: federal, 50 per cent; states, 30 per cent; local governments, 15 per cent and “others”, that is, oil producing areas and ecological fund, 5.0 per cent (Ewetan 2011, p. 102).

Danjuma Commission (1988) recommended percentages for government: Federal (50%), States (30%), Local Government (15%), and Special Fund (5%) (Arowolo 2011, p. 10).

Also, experience has shown that revenue allocation presents the most intractable problem in Nigeria’s fiscal federalism. There is no generally acceptable formula for both vertical and horizontal distribution of revenue. Various criteria used for allocating resources were not based on a rational consideration but on the basis of other primordial consideration. Thus the formulae only crippled the revenue generation capacity of each state, as states rely wholly on the monthly allocation from the federation account. The implication of this revenue allocation dependence is that it limits the capacities of states and local governments to provide public goods needed to promote and sustain governance. The issue is that the federal government takes the lion’s share of centrally collected revenue based on the current formula and other retained revenue, leaving state and local governments with small shares compared to their assigned functions.

5. Nature and challenges of fiscal federalism in Nigerian

The legal basis of fiscal federalism is derived from the past constitutional arrangements and, hence, in any true federalism the fiscal powers of all tiers of government must be related to the functions and responsibilities assigned to them by the Constitution.

Constitutionally, Nigeria is a federation, but in practice, and with the assumption of power by successive military administrations, the constitution has always been suspended and the country ruled more or less like a unitary state. The imposition of a centralized unitary system on a federal structure under the military administration partly explains our experience of poor fiscal management and low economic performance which, over the years, had adversely inhibited the true practice of fiscal federalism.

The establishment of the federal system in Nigeria was based on rounds of constitutional conferences in England prior to the grant of independence by the British government. Constitutions delineated the functions to be performed by each tier of government. The importance of these constitutional arrangements was to ensure that the statutory fiscal functions and the financial resources to be applied for effective performance of these functions by each tier of government was explicitly stated under the constitution and were to be enforced judiciously. Unfortunately, the statutory shares of state and local governments were reduced through ad hoc fiscal measures such as the stabilization fund, dedication of crude petroleum for expenditure on special federal projects, Petroleum (Special) Trust Fund (PTF), upfront deduction of external debt obligations among others. The overall effect of this on the nation was that the disguised movement towards a unitary state under military administration did not advance the practice of fiscal federalism as the federal system was replaced by an ineffective unitary state.

Under military administrations, issues of statutory functions to be performed by each level of administration and the allocation of revenue in support of effective delivery of public goods and services were bypassed. Observing this trend of substantial deviation from fiscal federalism, the Abovade Presidential Commission on Revenue Allocation (1977) stated as follows:

The defacto federal superiority vis-à-vis the states and the huge autonomous increases in revenue accruing to the Federal Military Government resulted in arbitrary aggregation of functions on the part of the centre which normally are matters of constitutional debates and agreement. In addition to legislative measures, executive actions over a number of matters such as the universal primary education, agriculture, higher education, roads, the setting up of ministries of water resources, housing, urban development, environment, and social development youths and sports illustrate the development of this system.

Concluding, the Abovade Commission observed that these measures had tended to detract from true fiscal federalism in Nigeria. This trend, which was first observed in the 1970s, has continued into the 2000s, thus resulting in bloated federal budgets while the fiscal operations for many years resulted in overall deficits. The level of the budget deficits became unsustainable as the federal government assumed fiscal responsibilities which, under the federal constitution, should be performed by the lower tiers of government. The deficit gaps were met largely through credit from the Central Bank with its implications for high rate inflation and low economic growth (Okunroumu 1999).

Another dimension of the military rule that has hindered the practice of true federalism is the incessant and unsystematic creation of new states. The outcome of this was an excessively bloated fiscally structure and many of the states created were not financially viable as they lacked the fiscal capacity to achieve any meaningful development.

Another issue is the dominance of the federal government in the sharing of national resources from the common purse popularly known as the Federation Account. The federal government has always had more than what the revenue-sharing formula stipulated. In relative terms, the share of the federal government from the common purse had declined from 70.0 per cent in 1960 to 65.0 per cent in 1963, 55.0 per cent in 1980, 50.0 per cent in 1990 and 48.5 per cent in 1993, and had remained at that level until 2002 when it went up to about 52 per cent. In absolute terms, however, the average share of the federal government has remained at between 60 to 65 per cent in most cases of the years (Sarah et al, 2003)

Fiscal federalism, from the very beginning, raised several fundamental issues. The assignment of responsibilities among federating units in Nigeria has also created problems. First, there was the question of how each level of government would be given adequate fiscal powers to enable it maximize its revenue and discharge its constitutional duties and still preserve its fiscal autonomy. While a reduction of fiscal independence through central administration of a particular tax may conflict with the principle of fiscal independence of states and local government the hard choice might be between more fiscal powers and less revenue, or less fiscal powers and more revenue. The introduction of value added tax (VAT) which replaces states' sales tax and administered by the federal government is an example of one of such conflicts.

Second, there were problems of allocating the centrally collected revenue equitably among all the levels of governments. In order to resolve this problem, various principles had been tried by different fiscal commissions and, so far, there are yet to be fully acceptable principles for sharing revenue. Very often, lack of adequate data for objective analysis had exacerbated, rather than ameliorated, the revenue sharing problem among states and local governments.

Third, fiscal federalism had been encumbered in the past by non-jurisdictional problems such as imbalance in population, size of land area, resource endowments and levels of development. Consequently, there has been a growing gap between the requirements of individual states and local government and the revenues they are able to raise on their own. This sharp difference between the very rich and the very poor levels of government tended to influence the principles applied in favour of poorer states, and sometimes at the expense of the richer ones.

Fourth, while the creation of states and local governments by the military government was to produce a balanced federation, the emergence and proliferation of states and local governments have continued to pose new problems for intergovernmental fiscal relations. Although, a major objective of the military government in creating states was to reduce the political powers of the regions and play down regional/ethnic politics that was already cracking the new federal structure, unfortunately, it also saw it as an opportunity to use its military might to assert the "supremacy" of federal government fiscal powers over the states.

The present allocation of functions is based on the 1999 Constitution, which divided government functions into three categories of legislative powers. "The exclusive list, on which only the federal government can act; the concurrent list, which contains responsibilities shared by both federal and state governments; and the residual list, which is reserved for state governments. The federal government has responsibility for functions whose benefits extend nationwide, such as, defence, foreign trade, immigration, currency among others" (Akpan, 2011, p. 169). It also has responsibility for important business undertakings through parastatals, for example, railways, electricity among others, while functions whose benefits have the possibility of spilling over state boundaries were placed on the concurrent list. Local governments, on the other hand, have responsibility for functions whose benefits accrue to a limited geographical area such as markets, primary education, and cemeteries among others.

The different formulas that have been used for revenue allocation have consistently increased the financial powers of the federal government against the other levels of government, The allocation of the most productive income-elastic taxes to the federal government have made the centre financially stronger than the states and local governments. The principal effect of this is the increasing fiscal dependence of the lower governments on federally collected revenue (both statutory and non-statutory), and their inability to meet the cost of functions assigned to them.

Over-dependence on oil revenue has impacted negatively and posed serious challenges to the issues of fiscal federalism in the country. It has created the leech syndrome whereby the states have become economic appendage of the federal government and eroded the fiscal autonomy of the federating units. Thus it has created a master servant relationship in which the subnational governments are at the mercy of the federal government. As long as states and local governments continue to depend on the federal government for their

“economic development and survival, the wrangling and controversy surrounding the issue of revenue allocation will remain persistent and a recurrent problem in Nigerian fiscal federalism” (Arowolo, 2011, p. 15).

The overview of the nature and challenges of fiscal federalism in Nigeria have been presented to show deviation from the true practice of fiscal federalism in Nigeria. The main issue is that if the three tiers of government in a federal system were to simultaneously intervene in a market economy, without coordination, and perform the role of the public sector, the situation will be chaotic. Therefore, in order to ensure sustainable growth and national development, it is necessary to understand and institutionalize the policy issues of fiscal federalism.

More importantly, the horizontal distribution principles have remained contentious and have been described as unfair by some political zones. The emphasis on population is the most important issue, resulting from complaints that population figures were manipulated in favour of some states.

Furthermore, the progressive decline of weights on derivation principle for revenue sharing has also been criticized. The basis of emphasis on derivation was to make the units maximize the yield from available tax sources as well as promote fiscal discipline among the sub national governments. The issue of landmass and terrain undermines the interest of the states with small landmass. The trend of progressive opinion is that this criterion of landmass should be excluded from the revenue allocation system. As it is now, Nigerian fiscal federalism is fraught with so many problems.

6. Conclusion and policy implication

The paper analyzed the evolution of fiscal federalism, evolved a theoretical basis for fiscal federalism and discussed extensively on the nature and challenges of fiscal relations in Nigeria. The paper concluded that fiscal responsibility and taxing powers still remain considerably centralized. “The Federal Government always receives larger amount in the sharing formula and with less impact on the people” (Arowolo, 2011, p. 17). Any reliable revenue allocation and utilization system must practically reflect the Federal nature of our country. The lopsided nature of fiscal arrangement in favour of the federal government is detrimental to fiscal operations of state and local governments and this has impacted negatively on socio economic development of Nigeria. Greater emphasis should be laid at the grassroots where the bulk of the people live and where development appears to be virtually non-existent.

A number of factors have inhibited the practice of fiscal federalism in Nigeria. These include the dominance of the federal government in revenue sharing from the Federation Account, the centralist system of fiscal relations, critical issue of over dependence on oil revenue, conflict over sharing principle, and disharmonious federal-state relations.

“The intractable problems arising from the widely unacceptable and constant conflicting fiscal federalism in Nigeria need urgent measures” (Arowolo, 2011). Accordingly, the following suggestions are proffered.

- The need to reverse the age long fiscal dominance by the federal government in order to re-establish a true federal system is strongly recommended. The solution is to redress the prevailing mismatch by raising the level of taxing assignment of subnational governments.
- The need for an efficient formula between the centre and other tiers of government is recommended. This formula should also satisfy the broad objectives of inter-regional equity and balanced national development. To this end the present vertical revenue allocation formula should be reviewed by the federal government to increase the percentage to lower governments in Nigeria to strengthen their fiscal capacity and enable them play strong role in nation building.
- Also, it is imperative to embark on radical diversification of the Nigerian economy to other viable and productive sectors of the economy, such as agriculture, mining, industry and human development
- Urgent reform in fiscal federalism in Nigeria to address the constitutional issue of fiscal powers among the three tiers of government to redress the prevailing fiscal mismatch at subnational levels of government is strongly recommended.
- The need to diversify and strengthen the fiscal base of subnational governments is recommended. To this end, local tax administration should be improved, unproductive local taxes eliminated, and untapped tax potentials identified.
- The need to promote fiscal discipline at all levels of government to sustain macroeconomic stability is strongly recommended. The policy should compulsorily place effective limits on governments' deficits at all levels, consistent with the objective of macroeconomic stability to ensure sustainable national development.

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