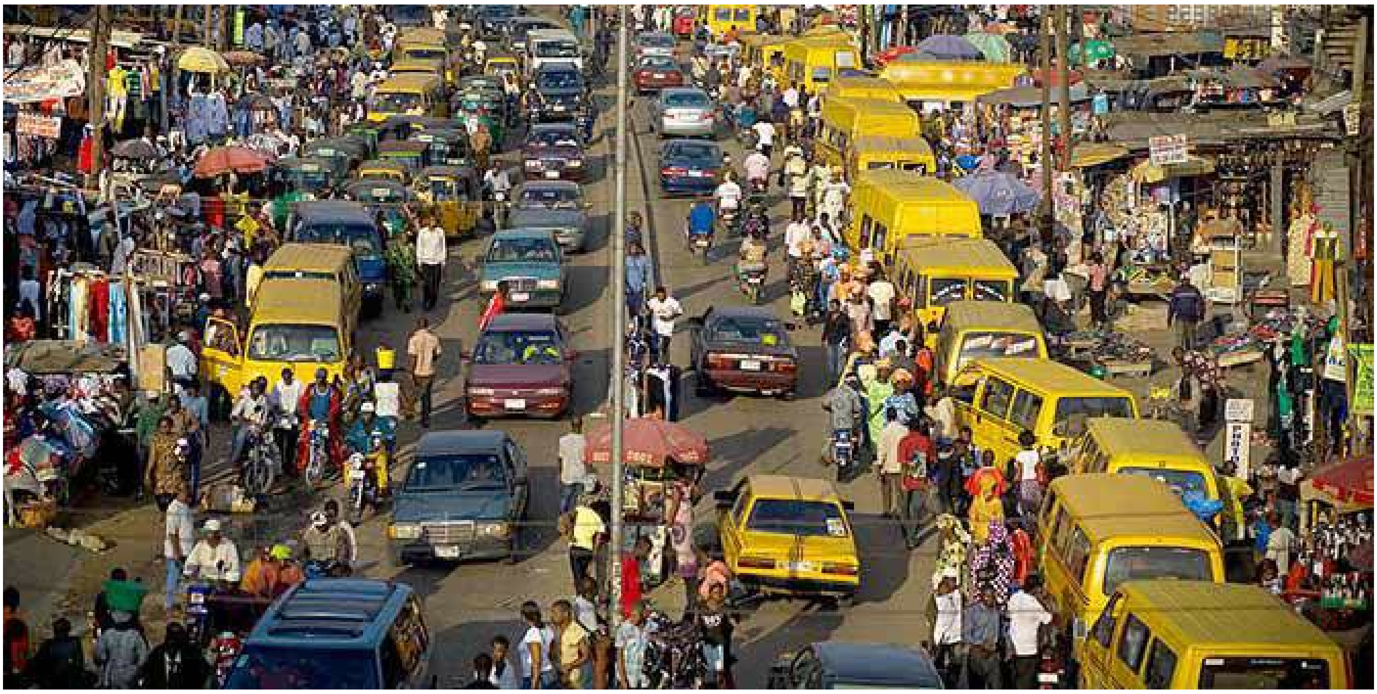
Reducing Incentives for Fiscal Indiscipline at Nigeria's Subnational Government Level

blogs.lse.ac.uk/africaatlse/2017/01/16/reducing-incentives-for-fiscal-indiscipline-at-nigerias-subnational-government-level/

16.1.2017

LSE's Eustace Uzor offers potential solutions for improving fiscal governance in Nigeria's subnational units.

The need to achieve fiscal convergence and consolidation in Nigeria cannot be overemphasised. This is especially important considering that the economy recently slipped into recession, according to data from the National Bureau of Statistics. One notable factor for this is the high level of fiscal indiscipline at the subnational level, which mainly derives from problematic incentives generated by unconditional fiscal transfers from the federal government. Therefore, to incentivise improved fiscal performance at the subnational government level, reforms in compliance with fiscal rules, data openness, as well as the introduction of performance-based grants are required. National anti-corruption agencies (ACAs) should also be used to signal threats of punishment for politicians and top bureaucrats in poor-performing states.



One of the key reasons for poor financial management at the subnational level is the perception of soft budget constraints created by unconditional statutory monthly fiscal transfers from the federal government. Specifically, subnational governments receive nearly half (47.32 per cent) of Nigeria's total consolidated revenue. With the exception of Lagos, all other states are reliant on transfers . As such, there is little or no incentive for state governments to manage their internally-generated revenue by either stepping up tax collection efforts, or broadening their tax base. The scope for political corruption is therefore remarkably high. The recent diversion of federal bailout funds meant for unpaid workers' salaries by state governments for undisclosed purposes is a case in point.

Although most states in Nigeria adopted the 2007 Fiscal Responsibility Act (FRA) to institutionalise fiscal prudence, recent events show that sufficient progress has not been made. The ongoing fiscal sustainability crisis in nearly all subnational governments – after a decade-long oil price boom – is clear evidence of fiscal indiscipline and large-scale corruption. Other critical issues such as the lack of accountability in fund utilisation and the non-availability of public finance data for citizenship engagement still remain unresolved. This is rather unsurprising, considering that Nigeria has a track record of poor political accountability and governance, as highlighted in the 2015 Ibrahim Index of African Governance.

Theoretically, decentralised fiscal spending in countries like Nigeria ought to improve the effective and efficient delivery of public services, since, as noted by renowned Professors Ferris and Graddy, lower-level governments are more knowledgeable about the costs, preferences, and the productive capacity of economic agents in their jurisdiction. In practice, however, delegating responsibilities to states in a federal system creates principal-agent issues, since both levels of government serve different constituents, and therefore have divergent policy objectives. In view of this, a principal-agent problem under adverse selection exists in Nigeria's fiscal relations since the federal government cannot directly verify the economic (and social) fundamentals of states as well as the outcome of their respective policies. Therefore, while fiscal transfers may be well intentioned, their welfare effects may not be optimal, in countries like Nigeria where strong incentive mechanisms are not in place to resolve agency issues at the subnational level.

The federal government has a critical role to play in improving fiscal governance at the subnational level in Nigeria, given its wider macro-economic implications. The current fiscal crisis in Nigeria is, therefore, a unique opportunity for the federal government to harden the budget constraint of subnational governments. As a first step, future fiscal transfers, particularly financial bailouts, should be *conditioned* on compliance with specified fiscal rules (i.e. debt-sustainability ratio, infrastructure prioritisation), as well as the publication of subnational public finance data. Specifically, while the former is expected to enhance fiscal convergence and consolidation in Nigeria, the latter – data openness – would be key to improving the ability of citizens to hold political office-holders and bureaucrats at the subnational government level accountable.

Beyond fiscal rules and an open-data policy, the federal government can incentivise improved fiscal performance and accountability by providing performance-based matching grants to states. However, grant disbursements should be based on agreed performance metrics that are both measurable and verifiable by an independent party. Furthermore, another policy option is to dramatically increase the threat of punishment for non-compliance with fiscal rules. ACAs such as the Economic and Financial Crimes Commission (EFCC) can be used to curb fiscal indiscipline (and corruption) at the subnational government level. An important caveat to note, however, is that this largely depends on the ability of ACAs to follow due process and withstand political pressures.

Three key policy recommendations are proposed. First, future fiscal transfers should be conditioned on fiscal rules as well as the provision of actual revenue and expenditure data. This will significantly reduce the extent of agency issues faced in federal-state fiscal relations. Second, an incentive structure, in the form of 'performance grants,' should be instituted to incentivise and reward fiscal performance. ACAs could be used to signal punishment in states, and consequently reduce the scale of political patronage and corruption. By minimising problems of asymmetric information and moral hazard in federal-state fiscal relations, it is anticipated that these measures can help improve public service delivery in Nigeria.

Eustace Uzor is a Masters Candidate in Development Studies at LSE.