CHAPTER ONE
INTRODUCTION

I. SIGNIFICANCE OF THE STUDY

Homogeneity and heterogeneity are two words that hardly get omitted in literatures on federalism. The former implying the social, political, economic and cultural compulsions that bound different regions of a geographical polity into one nation and the latter connoting similar forces that persuade these regions to preserve their own identity, at least, in some matters, at the formation of such a federal nation. Thus, federalism is a bargaining process which divides or seeks to divide power and authority between a set of governments at the vertical (between the centre and the regions or states), and horizontal (amongst the regions or states) lines. Hence, the essence of a federal arrangement is decentralization of decision-making such that the various authorities within such a stratified arrangement possess "sufficient power" to discharge their obligations to the various "interest groups" which they are there to serve.

This would also imply a complete democratization whereby the citizens can vote\(^1\) according to their preferences and personal evaluations. Thus, federalism is most suited in a country where the people although "different and divergent" in many issues find common grounds in other issues. That is, a polity where the people although desiring "union" do not want "unity".\(^2\) Nigeria, indeed, typifies such a country along with other major ones such as U.S.A, Australia, Canada, Germany, and India. In these nations, a peculiar feature of public finance is of dual parallel arrangements - of the Centre on the one hand, and of the Regions

\(^1\) Voting as used here are of two kinds. One, voting through ballot in the selection of decision-makers, and, two, voting by feet, which relates to the action of the citizens to migrate to the jurisdictions where they consider the mixture of public services close to their preferences at a maximum possible benefit and minimum possible cost. For details, see, Tiebout C.M., "A pure theory of Local Expenditure", Journal of Political Economy, October, 1956.

\(^2\) "Union" as used here implies a comparatively loose federal formation that guarantees the autonomy of the Regions or States while the word "Unity" connotes a unitary system where the autonomy of the Regions or States vanishes. For details, see, Dicey A.V, Introduction to the study of the Law of the Constitution, 8th ed. Macmillan Co., London, 1915, p. 137.
or States on the other hand. This feature becomes "all-important" and to a great extent
determines the destiny of the federation because, there is always a pre-transfers mismatch
between the resources of the Centre and the States and their respective expenditures
(with the centre having surplus and the states deficits). While some states may be very
rich, others may be poor. This thereby calls for a financial arrangement that leaves much
room for fiscal adjustment exercise - between the centre and the states, and amongst the
states. Hence, the role of fiscal federalism - the method of dividing "resource" and
"responsibility" between the centre and the states, and the states inter se becomes of
much significance.

Nigeria, as a nation came into existence in 1914 when the British colonial masters
"amalgamated" the Southern and Northern protectorates of Nigeria into a union that was
largely unitary in nature. In 1946, Nigeria became a quasi-federalism\(^3\). It became a
full-flagged federalism in 1954 with weak centre and strong regions. And in 1967 it was
transformed into a Centralistic federalism (with strong centre and weak states). This was as
a result of centralization of most of the major resource bases that were hitherto at the control
of the Regions. Over the years the Nigerian federal system has withnessed lots of crisis and
controversy over division of powers and resources at the vertical and horizontal lines - which
eventually resulted into a civil war between 1967 and 1970. Thus, during these years many
finance commissions were constituted primarily to seek alternative ways of devolving
revenues between the centre and the states, as well as amongst the states.

Nevertheless, the crisis and controversy go on without showing any sign of abating.
In these circumstances, therefore, an inquiry into the historical operation of the Nigerian
Fiscal Federalism assumes greater importance. Such an investigation would not only reveal
the pattern of vertical and horizontal resource devolution over the years, but would also
show whether this "pattern" is in conformity with the established principles of fiscal

\(^3\) Under this system, the federal principles were not well-pronounced. For instance, the Regional
Assemblies could only make legislation in any of the items in the "Regional list" only after getting
permission from the centre.
federalism - especially with regards to vertical and horizontal fiscal equalization. Such a study would involve an indepth examination of the various aspects of the burning issues in Nigeria fiscal federalism. Inspite of this, no such comprehensive work has been done before. Hence, the present study becomes a maiden attempt in this area of Nigerian Public Finance.

II. OBJECTIVE

The objective of this work is to examine the presence or absence of vertical and horizontal fiscal imbalances in Nigeria. This objective is pursued with the view of ascertaining whether or not the resources at the disposal of the vertical governments (the centre and the states), and the horizontal governments (the respective states) commensurate with their respective expenditure obligations. Thus, we have made a thorough evaluation of the vertical and horizontal financial relations in the Nigerian federation -- including the method of dividing the revenues between the centre and the states, as well as the principles followed for inter-states resource devolution. Hence, the title of the thesis "Analytices of Revenue Devolution and Fiscal Imbalances in Nigeria.

III. ISSUES EXAMINED

In order to investigate into the above objectives, the following issues have been examined.

III.1 BASIC CONCEPTS

In research endeavours such as the present one, clarity of the basic concepts used assumes great significance as lack of it may lead to confusion. This is especially so in the field of fiscal federalism where most of the concepts like : Fiscal imbalances, Vertical Fiscal Imbalances, Horizontal Fiscal Imbalances, Fiscal Adjustment, Fiscal Equalization, Vertical Fiscal Equalization, Horizontal Fiscal Equalization and Independent Revenue of the Governments, etc. carry plurality of meaning and interpretation. Hence, we have examined
these concepts and have used in this work, those meanings and interpretations that have general acceptability.

III.2 MAJOR CONSTITUTIONAL ISSUES ON NIGERIAN FEDERAL FINANCE

In every federation, the degree of the conflict and crisis between the centre and the states, and the states inter se depends on the constitutional division of resource and responsibility between the centre and the states on the one hand, and the devolution of resources amongst the states on the other hand. In Nigeria, the vertical and horizontal resource devolution policies gave rise to "strained" intergovernment financial relations which remain unresolved. Hence, the constitutional division of resources between the centre and the states, as well as the various principles adopted for inter-states' resource devolution have been examined in the study.

III.3 MEASUREMENT OF VERTICAL FISCAL IMBALANCES

In most works in fiscal federalism, the vertical fiscal imbalances are measured in terms of simple ratios and proportions. That is, by expressing the revenues of the Centre and the States respectively as proportion of their respectively expenditures. Or by ascertaining the respective shares of the Centre and the States in the total revenue or expenditure of the federation. We have also used these measures to examine the presence or absence of vertical fiscal imbalances in Nigeria, after examining the implications of adopting such measures. In addition, we have made an attempt to construct a new measure -- the Vertical Imbalance Ratio (VIR) -- which links the Revenue-Expenditure ratio of the Centre to the Revenue-Expenditure ratio of the States in a single framework. And, thus gives a single indicator of the revenue-expenditure relations of both the Centre and the States. This method has also been used to measure the presence or absence of vertical fiscal imbalances in Nigeria.

III.4 VERTICAL FISCAL IMBALANCES

The term vertical fiscal imbalance implies the disequilibrium between the revenue and expenditure of centre and the states respectively. That is, a situation in a federal set-up
where the centre generally observes a pre-transfers budget surplus, while the states generally record pre-transfers deficits.

This problem, it is believed, arises from the fact that, on the one hand, the federal resource bases are generally more buoyant whereas its expenditure is generally less "expensive" and less "expansive". On the other hand whereas the revenue bases of the states are generally less buoyant, their expenditure obligations are generally more "expensive" and more "expansive". Hence, in a federal polity, there may be tendencies towards revenue centralization and expenditure decentralization. Therefore, we have examined the presence or absence of vertical fiscal imbalance in Nigeria, and, whether or not it has been caused by the centralization of the buoyant resource bases or by expenditure decentralization. An attempt has also been made to ascertain the impact of the various categories of federal transfers in achieving vertical fiscal equity.

III.5 HORIZONTAL FISCAL IMBALANCES

Horizontal fiscal imbalances connote the disparity amongst the states in fiscal capacity or the variations amongst the states in their per capita expenditure on socio-economic services. Like in any other federation, this problem exists in Nigeria. Hence, we have examined the nature, causes, and the developing pattern of horizontal fiscal imbalances in Nigeria. We have also examined whether or not the various mechanisms of federal transfers have helped to achieve horizontal fiscal equity.

III.6 FISCAL DEPENDENCE OF THE STATES

Fiscal dependence of the states on centre refers to the extent to which the states rely on federal transfers to discharge their expenditure obligations. Thus, the fiscal dependence of the states on the centre is generally expressed as a ratio of aggregate federal transfers to the aggregate expenditure of the states.

The theory of federal transfers tells us that fiscal dependence of the states on the centre is a threat on their autonomy as the states may not be free to use the funds at their
own discretion. And, hence, a threat on their viability. Thus, the more the states rely on the centre for financing their expenditure obligations, the more they lose their independence. However, the loss of autonomy does not arise from federal transfers in general but from conditional federal transfers specifically. This is so because the states lose control on the use-end of the conditional transfers for which the centre directs and monitors its use-end.

Thus, while examining the role of aggregate federal transfers in the aggregate revenue and expenditure of the states, attempts have also been made to ascertain to what extent conditional federal transfers impose a limit on the financial autonomy of the states in Nigeria.

III.7 DEGREE AND TREND OF INEQUALITY AMONGST THE REGIONS AND STATES IN REVENUE AND EXPENDITURE VARIABLES

We have also examined the degree of inequality (as well as the trend of the same) amongst the Regions and states in Nigeria in revenue variables. The revenue and expenditure variables include: Independent Revenue, and the various categories of federal transfers, while the expenditure variables include expenditure on Administration, Health, Economic services, Other Social Services, and Total expenditure. The degree of the disparity has been examined using the Gini Coefficient.

III.8 DETERMINANTS OF STATUTORY TRANSFERS, FEDERAL GRANTS AND FEDERAL LOANS TO THE STATES IN NIGERIA

The theory of federal finance says that the essence of federal transfers is to correct the disequilibrium in the revenue and expenditure of the centre and the states. This in other words implies that the pre-transfers gap in the revenue and expenditure of the states determines the quantum of federal transfers. However, the practice of fiscal federalism in major federations suggests that while statutory transfers to the states are influenced by the size of Federal Current Receipts, Federal Grants and Loans depend on Federal Capital Receipts, States Capital Outlay, the Budget Position (surplus or Deficit) of the Federal Current Account.
Therefore, we have examined whether or not Statutory Transfers to the Nigerian states are determined by Federal Current Receipts, or by Pre-transfers Budget Deficit of the States. We have also examined whether or not Federal Grants and Loans to the States in Nigeria are determined by Federal Capital Receipts, States' Capital Outlay, or by the Budget Position (Surplus or Deficit) of the Federal Current Account.

### III.9 DETERMINANTS OF THE DISPARITY IN THE EXPENDITURE OF NIGERIAN REGIONS ON SOCIO-ECONOMIC SERVICES

It is an established view in fiscal federalism that the variations amongst the states of a federation in their provision of public services depend on two things viz: (a) the variations in their fiscal capacity (as reflected in their respective Independent Revenues), and (b) the variations in federal transfers to the respective regions or states. Hence, we have investigated into the causes of the disparity amongst the Nigerian regions in some public services (using per capita expenditure in such services as an indicator of the service level). The inequality index of the respective expenditure heads are the dependent variables in our regression equation while the per capita Independent Revenue and the respective categories of Federal transfers are the independent variables.

### IV. SOURCES AND COVERAGE OF DATA

The data used in this work have been obtained from the Central Bank of Nigeria Annual Bulletin, Official Gazettes of the Federal and State governments, Statistical Digest of the Nigerian Statistical Board, Presidential Commission of Revenue Allocation, 1980, National Census Commission, and such other secondary sources.

The empirical analysis of this work has a data coverage of thirty-three years, 1956-88. This period of 33 years cuts across various regimes of government and policy, and awards of several Fiscal Review Commissions and Military Decrees.
V. METHODOLOGY

A four-period approach has been followed in the study. While the first period covers the entire time-frame-work of thirty-three years, 1956-88, the second, third and fourth period are subdivisions of the whole period into: twelve (1956-67), twelve (1968-79), and nine (1980-88) years. This division conforms with the three distinct phases of Nigerian federalism -- when it was made up of three, twelve and nineteen federating units respectively, apart from the fact that entirely different formulae of centre-states, and inter-states resource devolution were adopted during each of these periods.

As far as the statistical tools are concerned, simple proportions, rank correlation co-efficients, regression analysis, Gini Coefficient ratios, etcetra, have been used.

VI. LIMITATIONS OF THE STUDY

While we made best possible effort to overcome certain problems in this work, -- such as division of the periods of study, method of classifying the data, indicators of fiscal capacity and states expenditure on socio-economic services, it is admitted that, the study faces following limitations:

First it is admitted that the coverage of data, 1956-88, although extensive is not up to date. Hence, we are unable to investigate into the working of the Nigerian federal system from 1989 to the present day. This limitation becomes of very significance as during this period there have been changes with respect to vertical resource devolution formula with greater administrative and fiscal autonomy granted to the Local Government Areas. Nevertheless, our inability to update the information was mainly due to institutional changes -- with the Military assuming the power and imposing many restrictions that either delayed the publication of data or made it extremely difficult for one to have access to them.

Secondly, due to lack of data with respect to the States' Domestic Product (SDP) as no authentic estimates of the same has been made we have been unable to "classify" or rank
the states accordingly on the basis of their economic profile. In other words, we are not able to say which states are quite richer and which ones are poorer. Hence, we cannot exactly say which of the states have higher fiscal potential, and vice versa. Neither are we able to say what is the impact of federal transfers in the equalization of per capita income of the states. Thus, our profile of the states has been based on their Independent Revenue collection. This may not exactly reflect the economic position of the states.

Thirdly, because of non-availability of data with respect to States' Domestic Product, we have been unable to investigate into the Tax Effort of the states as well as the impact of federal transfers on it. This could not be done as tax effort of any states is generally defined with respect to the SDP of the state, for which as indicated above, Nigeria has no authentic estimates.