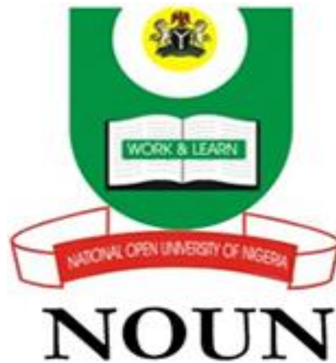

NATIONAL OPEN UNIVERSITY OF NIGERIA

FACULTY OF SOCIAL SCIENCES

PUBLIC SECTOR ECONOMICS

(ECO727)

COURSE GUIDE

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INTRODUCTION

Welcome to ECO727: Public Sector Economics

ECO727: Public Sector Economics, is a two-credit units and one-semester postgraduate course for Economics students. The course is made up of three modules, each module is subdivided into four study units and each unit spread across twelve lecture weeks. This course guide is expected to give the students a wider insight into the concept of taxation and public expenditure including the summary of findings of empirical studies. It also throws more light on the nature of public goods, fiscal federalism and fiscal policy. It is a continuation of knowledge gain in basic concepts of public sector analysis. It tells you about the course materials and how you can work your way through these materials. It suggests some general guidelines for time required of you on each unit in order to achieve the course aims and objectives successfully. Answers to your tutor marked assignments (TMAs) are therein already.

Course Content

This course is basically on Public Sector Economics. As you are aspiring to become an economist, you must be able to apply your knowledge of planning to economic problems. Nigeria is a developing country (with a huge public sector) which needs season planners. This study prepares you to be a good planner. Some of the topics covered include fiscal policy, federalism, social or public goods, taxation and public expenditure and summary of findings of their empirical studies.

Course Aims and Objectives

The course attempts to explain mainly the concept of "government revenue (taxation) and government expenditure" that consumes the revenue. It discusses one critical item consuming public expenditure: social or public goods. The basic meaning of these topical issues is explained as well as empirical findings on them. Studying and understand them enrich student's knowledge. In other words, the course is prepared in a way that the users would easily build on their previous knowledge in public finance. The course aims are to

help users develop critical thinking skills, learn how to evaluate economic phenomenon on public finance and understand the diverse public sector activities of Nigeria and other nations. Concisely, the overall aims are to:

- Introduce you to the fundamental concept and meaning public finance.
- To familiarize students with meaning of fiscal policy, taxation and public expenditure.
- To explain the distinction between government revenue and government expenditure.
- To stimulate students' knowledge on fiscal institutions and independent fiscal institutions.
- To familiarize students with meaning of social goods.
- To point out to the students some of the reasons that makes social or public goods production discouraging to private firm.
- To make the students understand the concept of federalism and fiscal federalism.
- To bring to the knowledge of students the components of the federal system (regional or sub-national governments).
- To highlight the need for equity and fairness in resource distribution under federal system of government.

Course Objectives

To achieve the aims of this course, there are overall objectives, which the course is set out to achieve. Similarly, there are set objectives to be accomplished for each unit. The unit objectives are included at the beginning of each unit; you should read them before you start working through the units. You may want to refer to them during your study unit to guide your progress. You should always look at the unit objectives after completing a unit for self-evaluation. In this way, you can be sure you have done what was required of you by the unit. The objectives serve as study guides; such that student could know if he/she is

able to grab the knowledge of each unit through the sets of objectives in each unit. At the end of the course period, the students are expected to be able to:

- Explain the basic meaning of taxation.
- Define public expenditure convincingly.
- Discuss public/social goods clearly.
- Explain the functions of fiscal policy.
- Analyze major reasons why private sector or market cannot produce public goods efficiently and profitably.
- Explain succinctly the changing function of fiscal policy and non-fiscal policy.
- To summary empirical findings on the practice of taxation and public expenditure in Nigeria and other countries.

Working Through the Course

To successfully complete this course, you are required to read the study units, referenced books and other materials on the course.

Each unit contains self-assessment exercises called Student Assessment Exercises (SAE). At some points in the course, you will be required to submit assignments for assessment purposes. At the end of the course there will be final examination. This course is expected to take **about 12** weeks to complete and some components of the course are outlined under the course material subsection.

Course Material

The major component of the course, what you have to do and how you should allocate your time to each unit in order to complete the course successfully on time are listed as follows:

1. Course guide
2. Study unit
3. Textbook

4. Assignment file
5. Presentation schedule

Study Unit

There are **12 units** in this course which should be studied carefully and diligently.

MODULE ONE: FISCAL FUNCTIONS, INSTITUTIONS AND POLICIES; SOCIAL GOODS,

UNIT 1 Meaning of Fiscal Policy

UNIT 2 Functions/Role/Purpose of Fiscal Policy

UNIT 3 Fiscal Federalism vs Fiscal Institutions

UNIT 4 Social Goods and Optimal Distribution

MODULE TWO: THEORY AND EMPIRICAL EVIDENCE ONEXPENDITURE DEVELOPMENT AND TAX STRUCTURE; (OBJECTIVES OF FISCAL POLICY), DEFICIT FINANCING BUDGET AND PUBLIC DEBT; DEVELOPMENT PLANNING

UNIT 1 Public Expenditure: Role and Function (Objectives of fiscal policy), Deficit Financing, Budget and Public Debt; Development Planning

UNIT 2 Empirical Evidence on Public Expenditure

UNIT 3 Tax Structure and Importance

UNIT 4 Empirical Evidence on Tax Structure

MODULE THREE: THE CHANGING FUNCTION OF FISCAL AND NON-FISCAL POLICY AND ECONOMIC REVENUE STRUCTURES; FEDERALISM AND FISCAL ADJUSTMENT THEORY AND PRACTICE IN SELECTED COUNTRIES.

UNIT 1 The Changing Function of Fiscal Policy in Selected Countries

UNIT 2 The Changing Function of Non-Fiscal Policy in Selected Countries

UNIT 3 Economic Revenue Structures in Selected Countries

UNIT 4 Federalism and Fiscal Adjustment Theory and Practice in Selected Countries

Each study unit will take at least two hours, and it includes the introduction, objective, main content, self-assessment exercise, conclusion, summary and reference. Other areas border on the Tutor-Marked Assessment (TMA) questions. Some of the self-assessment exercise will necessitate discussion, brainstorming and argument with some of your colleges. You are advised to do so in order to understand and get acquainted with historical economic events as well as notable periods.

There are also textbooks under the reference and other (on-line and off-line) resources for further reading. They are meant to give you additional information if only you can lay your hands on any of them. You are required to study the materials; practice the self-assessment exercise and tutor-marked assignment (TMA) questions for greater and in-depth understanding of the course. By doing so, the stated learning objectives of the course would have been achieved.

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Assignment File

Assignment files and marking scheme will be made available to you. This file presents you with details of the work you must submit to your tutor for marking. The marks you obtain from these assignments shall form part of your final mark for this course. Additional information on assignments will be found in the assignment file and later in this Course Guide in the section on assessment.

There are three assignments in this course. The three course assignments will cover:

Assignment 1 - All TMAs' questions in Units 1 – 4 (Module 1)

Assignment 2 - All TMAs' questions in Units 1 – 4 (Module 2)

Assignment 3 - All TMAs' questions in Units 1 – 4 (Module 3)

Presentation Schedule

The presentation schedule included in your course materials gives you the important dates for this year for the completion of tutor-marking assignments and attending tutorials. Remember, you are required to submit all your assignments by due dates. You should guide against falling behind in your work.

Assessment

There are two types of the assessment of the course. First is the tutor-marked assignments; second, there is a written examination.

In attempting the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the Presentation Schedule and the Assignments File. The work you submit to your tutor for assessment will count for 30 % of your total course mark.

At the end of the course, you will sit for a final written examination of two hours duration. This examination accounts for 70% of your total course mark.

Tutor-Marked Assignments (TMAs)

There are three tutor-marked assignments in this course. You will submit all the assignments. You are encouraged to work on all the questions thoroughly. The TMAs constitute 30% of the total score.

Assignment questions for the units in this course are contained in the Assignment File. You will be able to complete your assignments from the information and materials contained in your set books, reading and study units. However, it is desirable that you demonstrate that you have read and researched more widely than the required minimum. You should use

other references to have a broad viewpoint of the subject and also to give you a deeper understanding of the subject.

When you have completed each assignment, send it, together with a TMA form, to your tutor. Make sure that each assignment reaches your tutor on or before the deadline given in the Presentation File. If for any reason, you cannot complete your work on time, contact your tutor before the assignment is due to discuss the possibility of an extension. Extensions will not be granted after the due date unless there are exceptional circumstances.

Final Examination and Grading

The final examination will be of two hours duration and have a value of 70% of the total course grade. The examination will consist of questions which reflect the types of self-assessment practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed.

Revise the entire course material using the time between finishing the last unit in the module and that of sitting for the final examination. You might find it useful to review your self-assessment exercises, tutor-marked assignments and comments on them before the examination. The final examination covers information from all parts of the course.

Course Marking Scheme

The table presented below indicates the total marks (100%) allocation.

Assignment	**Marks**
Assignments (The three assignments are marked)	30%
Final Examination	70%
Total	**100%**

Course Overview

The Table presented below indicates the units, number of weeks and assignments to be taken by you to successfully complete the course (ECO 727), Public Sector Economics

Units	Title of Work	Week's Activities	Assessment (end of unit)
	Course Guide		
MODULE 1: FISCAL FUNCTIONS, FISCAL INSTITUTIONS ANDPOLICIES; SOCIAL GOODS			
1	**Meaning of Fiscal Policy (Objectives of fiscal policy)**	Week 1&	Assignment 1
2	**Functions/Role/Purpose of Fiscal Policy**	Week 2 -3	Assignment 1
3	**Fiscal Federalism and Fiscal Institutions**	Week 3	Assignment 1
4	**Social Goods and Its Optimal Distribution**	Week 4	Assignment 1
Module 2: THEORY AND EMPIRICAL EVIDENCE ON EXPENDITURE DEVELOPMENT AND TAX STRUCTURE, PUBLIC DEBT, BUDGET AND PUBLIC DEBT; DEVELOPMENT PLANNING			
1	**Public Expenditure and Role, and Function, Deficit Financing, Budget, Public Debt; Development Planning**	Week 5	Assignment 2
2	**Empirical Evidence on Public Expenditure**	Week 6	Assignment 2
3	**Tax Structure and Importance**	Week 7	Assignment 2
4	**Empirical Evidence on Tax Structure**	Week 8	Assignment 2

Module 3: THE CHANGING FUNCTION OF FISCAL AND NON-FISCAL POLICY AND ECONOMIC REVENUE STRUCTURES; FEDERALISM AND FISCAL ADJUSTMENT THEORY AND PRACTICE IN SELECTED COUNTRIES.			
1	**The Changing Function of Fiscal Policy in Selected Countries**	Week 9	Assignment 3
2	**The Changing Function of Non-Fiscal Policy in Selected Countries**	Week 10	Assignment 3
3	**Economic Revenue Structures in Selected Countries**	Week 11	Assignment 3
4	**Federalism and Fiscal Adjustment Theory and Practice in Selected Countries**	Week 12	Assignment 3

How to Get the Most from this Course

In distance learning the study units replace the university lecturer. This is one of the great advantages of distance learning; you can read and work through specially designed study materials at your own pace and at a time and place that suit you best.

Think of it as reading the lecture instead of listening to a lecturer. In the same way that a lecturer might set you some reading to do, the study units tell you when to read your books or other material, and when to embark on discussion with your colleagues. Just as a lecturer might give you an in-class exercise, your study units provides exercises for you to do at appropriate points.

Each of the study units follows a common format. The first item is an introduction to the subject matter of the unit and how a particular unit is integrated with the other units and the course as a whole. Next is a set of learning objectives. These objectives let you know what you should be able to do by the time you have completed the unit.

You should use these objectives to guide your study. When you have finished the unit you must go back and check whether you have achieved the objectives. If you make a habit of doing this, you will significantly improve your chances of passing the course and getting the best grade.

The main body of the unit guides you through the required reading from other sources. This will usually be either from your set books or from a readings section. Some units require you to undertake practical overview of historical events. You will be directed when you need to embark on discussion and guided through the tasks you must do.

The purpose of the practical overview of some certain historical economic issues are in two folds. First, it will enhance your understanding of the material in the unit. Second, it will give you practical experience and skills to evaluate economic arguments, and understand the roles of history in guiding current economic policies and debates outside your studies. In any event, most of the critical thinking skills you will develop during study are applicable in normal working practice, so it is important that you encounter them during your studies.

Self-assessments are interspersed throughout the units and answers are given at the ends of the units. Working through these tests will help you to achieve the objectives of the unit and prepare you for the assignments and the examination. You should do each self-assessment exercises as you come to it in the study unit. Also, ensure to master some major historical dates and events during the course of studying the material.

The following are practical strategies for working through the course. If you run into any trouble, consult your tutor. Remember that your tutor's job is to help you. When you need help, don't hesitate to call and ask your tutor to provide it.

1. Read this Course Guide thoroughly.
2. Organize a study schedule. Refer to the `Course overview' for more details. Note the time you are expected to spend on each unit and how the assignments relate to the units. Important information, e.g. details of your tutorials, and the date of the

first day of the semester is available from the study centre. You need to gather together all this information in one place, such as your dairy or a wall calendar. Whatever method you choose to use, you should decide on and write in your own dates for working breach unit.

3. Once you have created your own study schedule, do everything you can to stick to it. The major reason that students fail is that they get behind with their course work. If you get into difficulties with your schedule, please let your tutor know before it is too late for help.
4. Turn to Unit 1 and read the introduction and the objectives for the unit.
5. Assemble the study materials. Information about what you need for a unit is given in the `Overview' at the beginning of each unit. You will also need both the study unit you are working on and one of your set books on your desk at the same time.
6. Work through the unit. The content of the unit itself has been arranged to provide a sequence for you to follow. As you work through the unit you will be instructed to read sections from your set books or other articles. Use the unit to guide your reading.
7. Up-to-date course information will be continuously delivered to you at the study centre.
8. Work before the relevant due date (about 4 weeks before due dates), get the Assignment File for the next required assignment. Keep in mind that you will learn a lot by doing the assignments carefully. They have been designed to help you meet the objectives of the course and, therefore, will help you pass the exam. Submit all assignments no later than the due date.
9. Review the objectives for each study unit to confirm that you have achieved them. If you feel unsure about any of the objectives, review the study material or consult your tutor.
10. When you are confident that you have achieved a unit's objectives, you can then start on the next unit. Proceed unit by unit through the course and try to pace your study so that you keep yourself on schedule.

11. When you have submitted an assignment to your tutor for marking do not wait for its return `before starting on the next units. Keep to your schedule. When the assignment is returned, pay particular attention to your tutor's comments, both on the tutor-marked assignment form and also written on the assignment. Consult your tutor as soon as possible if you have any questions or problems.
12. After completing the last unit, review the course and prepare yourself for the final examination. Check that you have achieved the unit objectives (listed at the beginning of each unit) and the course objectives (listed in this Course Guide).

Tutors and Tutorials

There are some hours of tutorials (2-hours sessions) provided in support of this course. You will be notified of the dates, times and location of these tutorials. Together with the name and phone number of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter, and provide assistance to you during the course. You must mail your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible.

Do not hesitate to contact your tutor by telephone, e-mail, or discussion board if you need help. The following might be circumstances in which you would find help necessary. Contact your tutor if.

• You do not understand any part of the study units or the assigned readings

• You have difficulty with the self-assessment exercises

• You have a question or problem with an assignment, with your tutor's comments on an assignment or with the grading of an assignment.

You should try your best to attend the tutorials. This is the only chance to have face to face contact with your tutor and to ask questions which are answered instantly. You can raise

any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participating in discussions actively.

Summary

This course, Public Sector Economics, ECO727, is one of the vital courses in public sector economics. It exposes you to further analysis of fiscal policy, public expenditure, public goods, taxation, public debt, budget and deficit financing. It also reveals the case studies of experiences of countries concerning public sector financing and expenditure. This course is actually good for a developing country like Nigeria which hitherto remains in a lower/medium range of developmental index. The modules will teach you functions and roles of fiscal policy, fiscal federalism and the concept of social or public goods. In the module, it is emphasized that public expenditure is spent mainly on public goods such as education, roads, hospitals, defence etc., however, public goods have different categories such pure public goods and social goods. Their optimal distribution are also highlighted. The module discusses theory and empirical evidence on expenditure development and tax structure. Tax is a critical aspect of public sector economics. Without tax, there cannot be expenditure. On the other hand, expenditure is essential for the provision of social or public goods. Empirical evidence of selected countries in various regions of the world on tax and public expenditure are discussed extensively. In module three, there is the inclusion of changing function of fiscal and non-fiscal policy. This is because it appears that government fiscal activities in the economy is becoming increasing and going beyond the traditional fiscal functions. In addition, in module one, we discuss budget and deficit financing which is a common practice in modern time. This has led to high and undesirable public debt. Again, it appears government has added monetary policy into its duties, not only in developing countries like Nigeria, but also in the advanced capitalist country like the United States. The influence of the non-fiscal policy on the public revenue and expenditure is explained. The key issues about development planning are discussed in Module 2, unit 1. Development planning is essential if a country must attain speedy

economic growth and development. Finally, economic revenue structures; federalism and fiscal adjustment theory and practice in selected countries are discussed; the key factors involved are highlighted. Without any doubt, when this module is studied extensively by the students, they will definitely understand more key issues that are involved in public sector economics.

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MODULE ONE: FISCAL FUNCTIONS, FISCAL INSTITUTIONS AND POLICIES; SOCIAL GOODS

UNIT 1 Meaning of Fiscal Policy
UNIT 2 Functions/Role/Purpose of Fiscal Policy
UNIT 3 Fiscal Federalism and Fiscal Institutions
UNIT 4 Social Goods and Its Optimal Distribution

UNIT 1 DEFINITION AND MEANING OF FISCAL POLICY,

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1.0 INTRODUCTION

Public sector economics involves the study of government in relation to its income and spending in a bid to stabilize the economy. Government is usually constituted by a group of individuals either elected or appointed in a democratic set up. Implicitly, these group of individuals are like agents and the people they represent or rule are the principals. One of the critical activities performed by government on behalf of the people is management of the economy through fiscal policy. Fiscal policy is necessitated by the fact that the market "invisible hand" may fail to regulate and create balance.

Fiscal policy is the crux of public sector economics. It is the use of government spending and taxation to influence the economy. Fiscal policy in short refers to the budgetary policy, it embraces tax and expenditure policies of the government (Mithani, 2008). It can also be defined as the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. According to Pettinger (2019), Fiscal policy is similar to monetary policy whereby the central bank of a nation influences money supply through interest rate or exchange rate. The objectives of both fiscal policy and monetary policy are analogous. However, while government might achieve quick results through monetary policy, fiscal policy outcomes usually take longer time due to various institutions that might be involved in decision making. Most importantly, politicians or elected representatives of the people may have to consult their constituencies in the process of decision making which usually takes longer time. Government often looks for optimal allocation of resources among various competing groups, constituencies or regions. Sometimes, government may be looking for optimal pricing of public goods. All these pose serious challenges to fiscal authority. In a federal state like Nigeria, fiscal policy decision is cumbersome and with distorted transmission channels which usually elongates implementation lags and thereby reduces effectiveness of the policy.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Define fiscal policy and state its objectives and critical functions
- Explain the concept of public expenditure
- Discuss the concept of fiscal institutions
- List the limitations of fiscal policy

3.0 MAIN CONTENT

3.1 Fiscal Policy and Its Objectives

As discussed earlier in the introduction, in economics and political science, fiscal policy is the use of government revenue (taxes) and expenditure (spending) to influence a country's economy. Smithies (1947) describe fiscal policy as a policy under which government use its expenditure and revenue policies or instruments to produce desirable effects and avoid undesirable effects on the national income, production and employment. The practice of fiscal policy was developed during the 1930s "Great Depression" when the classical economists' laissez-faire approach to economics became ineffective.

Fundamentally, fiscal policy is based on the theories of the British economist John Maynard Keynes. His theory indicates that government changes in the levels of taxation and spending can influences aggregate demand and economic activities. He suggested that fiscal policy can be expansionary or contractionary; both of these are intended to increase/decrease aggregate demand while contributing to deficits or drawing down of budget surpluses; increase or decrease reserves.

Although fiscal policy usually refers to the plans and actions of the national government, but the actions of state and local governments affect the nation's economy as well. For instance, in Nigeria and the United States, fiscal policy is commonly considered to be the relationship between the federal, state, and local governments, with each level of government having specific rights and obligations (Voorhees, 2005).

Self-Assessment Exercise

Define Fiscal Policy

3.1.1 Objectives of Fiscal Policy

Although the objectives of fiscal policy are many, however, the traditional objectives are, to some extent, distinct from all other objectives. Therefore, the traditional objectives of fiscal Policy are:

- Full Level of Employment (equilibrium)
- Economic growth and development
- Economic Stabilization
- Reduction in Inequality
- Ensuring price stability and balance of payment equilibrium

3.1.2 Other specific objectives of fiscal policy, particularly, relating to developing countries include:

- To accelerate the rate of economic growth by increasing the rate of investment and capital formation.
- Providing social goods in large quantity with a view to improve the standard of living of the masses.
- Maintaining sectoral and regional balances.
- Set expenditure priorities effectively to meet its development objectives both with respect to current service delivery and new investment in the future.
- Keep taxation and other revenue in a stable relationship with total economic activity.
- Fund debt in such a manner that does not create undue pressures on financial markets and is sustainable in the long term.
- Planning in a way which is predictable while providing full information so that other sectors of the economy are able to make their own plans accordingly.
- Promoting social justice.

Self-Assessment Exercise

What are the objectives of fiscal policy?

3.2 Instruments of Fiscal Policy

Some of the instruments of fiscal policy comprise taxation, government expenditure, balanced budget and subsidy (Musgrave, 1983 & 1984). The list of fiscal policy instruments is endless. Different countries have both political and social systems which are not similar, as a result, types of fiscal instruments vary with society values. However, in most cases, fiscal policy instruments can be financial or regulatory. Financial instruments include tax, expenditure, subsidy, charges (congestion or pollution charges), import duties etc. Regulatory instruments are fuel economy standards, vehicle occupancy standards, behavioral instruments (e.g., telecommuting, staggering work start times; promotion of multiple function trips) and infrastructure investment policies (e.g., bus rapid transit, metro etc.) (Timilsina and Dulal, 2008). According to Blejer and Khan (1984) aggregate macroeconomic policy instruments cover government expenditure, debt and wage rate among others. Keynes (1936) and Lerner (1953) contend that the principle of judging fiscal measures by the way they work or function in the economy can be called functional finance. Lerner (1936, 1939) add that fiscal operation of the government such as tax, borrowing, public spending, management of public debt and deficit financing, should be designed with the objective of fulfilling certain functions which have an immediate bearing and far-reaching effects on the economic system as a whole. Mithani (2008) maintains that the term functional finance in economic philosophy embraces public expenditure, public revenue and debt management which are regarded as fiscal policy instruments. They are effectively used to achieve objectives like attainment and maintenance of full level of employment and economic stability. The international development efforts, under the Millennium Development Goals and now the Sustainable Development Goals (United Nations, 2015) underscores tax policy and revenue mobilization as critical fiscal policies instruments that are required for national and international development.

3.2.1 Fiscal Policy Actions

The following statements are summarized as fiscal policy actions:

- Increase/decrease in government expenditure: According to Keynes (1936), an increase in government expenditure, *ceteris paribus,* will positively affect aggregate expenditure via multiplier effect, this leads to rise in consumption. Conversely, a decrease will negatively affect the economy causing contraction in consumption.
- Reduction in personal income tax: This reduces disposable income and consequently falls in purchasing power of the consumers.
- Making transfers such as subsidies and social security benefits.
- Increase in the level of investment by affecting the level of company taxation so that profit could be ploughed into the domestic economy (Loto, 2016).

Taxation as a significant fiscal policy instrument may be used to accomplish the following specific objectives:

- Regarded as a dependable component of government revenue.
- Curtailing consumption and thus gathering resources for public sector investment.
- A progressive system of taxation ensures income redistribution and thereby eliminating or reducing inequality.
- Curtailing the use of scarce resources in unproductive private investment and then diverting them to the productive public sector.
- Reshaping the pattern of investment in a socially desirable manner

It should be emphasized, however, that tax adjustment as key instruments of fiscal policy is not flexible. Politicians are neither quick to lower nor increase tax. If tax is lowered revenue falls; if tax is increased politicians fear they might lose the next election. As a result, they often seek alternatives like monetary policy (Seigniorage and, or instruments trading), deficit financing, selling of public properties and cutting or removing subsidies.

3.2.2 How Fiscal Policy can Achieve Full level of Employment

Keynes has mentioned several ways by which fiscal policy can achieve full Level of employment; these can be expressed summarily as follow:

- ✓ Taxation which should be devised to promote and sustain consumption and investment.
- ✓ Budget should be in deficit and should have deficit financing in order to raise the level of effective demand and to overcome depression. Although, the funds obtained by borrowing allow the federal government to bid for scarce resources, private investors and consumers will have less access to loanable funds and be less able to acquire income, goods, or services. Hence, deficit financing allows the government to obtain more resources and, in general, to change the mix of its output in the direction of more public sector goods and fewer private sector goods. Nevertheless, borrowing rather than taxing makes the federal government's claim on resources less apparent (Taylor, 2003).
- ✓ Public expenditure has to be compensatory. That is it has to be in a planned way to finance public works programmes and provide social security measures.
- ✓ Direct taxes should be lowered to encourage savings and investments directed towards creation of more employment opportunities.
- ✓ Public expenditure should be meant for uplifting the level of aggregate demand, investment and employment.

In spite of all the suggestions underscoring the importance of fiscal policy, it comes with some limitations which include:

- Fiscal policy, unlike monetary policy, faces lag (recognition, response, and implementation lags), as a result, its effectiveness takes much longer time.
- The bureaucratic lag may further delay fiscal policy action.

- Fiscal policy induces external debt burden and thereby endangering the external balance position of the nation.
- It is inappropriate to deal with problems relating to structural adjustment (Mithani, 1998).
- It cannot adjust the distribution of money flow.
- In most underdeveloped countries where the financial system is weak, fiscal policy instrument, like tax, usually fails to address economic problem such as inflation thereby making stabilization objective unattainable.
- Determination of fiscal policy magnitude and optimum budget size is difficult.
- Fiscal policy efficiency depends on strict financial discipline on the part of government and its correct value judgement.
- The assumption of the "multiplier effect" is associated with fiscal policy theory, but owing to diverse leakages such as corruption, this cannot be easily estimated. .

Self-Assessment Exercise

1. Define fiscal policy.
2. What are some of the limitations of fiscal policy in developing economies?

4.0 CONCLUSION

This unit has given the conceptual definition of fiscal policy which is a significant topic in public expenditure. Fiscal policy is defined as planning government tax (revenue) and expenditure and making decision relating to its optimal use. It involves distribution of government revenue to meet the needs and increases the welfare of the citizens. Fiscal policy begins with J.M. Keynes, a British Economists who proposed that increase in government expenditure would rescue a nation from depression through increase in aggregate demand. However, fiscal policy execution comes with lags such as recognition and implementation lags. It is pointed out that the lag and complexity in a federal state fair allocation of resources are some of the limitations of fiscal policy.

5.0 SUMMARY

In this unit, we have discussed some important aspect of public finance. The unit discussed extensively fiscal policy under meaning, objectives and its importance in public finance. Financing a nation is the duty of government through public officers who are the elected representatives of the people. We mentioned the economic relations between the masses and public officers, who constitute government; it is like agent-principal relation. It is stated that one of the critical activities performed on behalf of the people is fiscal policy. Fiscal policy is necessitated by the fact that the market "invisible hand" may fail to create economic equilibrium and to promote equity. Among others, we mentioned that tax is a significant fiscal policy instruments and can be used to achieve some specific objectives which are highlighted. The limitation of tax as an instrument of fiscal policy is also stated.

6.0 TUTOR-MARKED ASSIGNMENT

1. Define fiscal policy.
2. List four fiscal policies instruments and explain each of them.
1. State four limitations of fiscal policy?
2. According to Keynes, state five ways by which fiscal policy can achieve full level of employment.

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UNIT 2 FISCAL FUNCTIONS/ROLE/PURPOSE OF FISCAL POLICY

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1.0 INTRODUCTION

In the theory of public finance, the market system failure is recognized as a principle factor necessitating government intervention. This is because the market "invisible hands" cannot perfectly regulate economic activities. Nevertheless, the neoclassical economists advocate minimum government intervention. This means that fiscal activities should not be so large to the extent of triggering "crowding out" effect. Komolafe (1996) outlines some conditions that shape government intervention, he opine that the structure of government's fiscal policy and the degree of involvement in the economy depend on government priorities, prevailing economic ideology and the severity of the crises facing the economy. In this unit, the underpinning functions of fiscal policy will be discussed. This is necessary because government performs various governance functions like monetary, trade and industrial functions which are equivalent to fiscal policy. Primarily, fiscal policy functions include allocation function, stabilization function, distribution function and economic growth function. Each of these is discussed in the sub-units under 3.0. In addition, the nature of fiscal policy in a country like Nigeria and United States is characterized by fiscal federalism explained in unit three.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Discuss the concept fiscal policy and its objectives
- List the critical functions of fiscal
- Explain the stabilization and growth functions of fiscal policy
- List the limitations of fiscal policy

3.0 MAIN CONTENT

3.1 Functions of Fiscal Policy

3.1.1 Allocation Function of Fiscal Policy

By allocation function, we mean **resource allocation**. That is how scarce resources are distributed fairly. But the meaning in a federal state transcends simple allocation of resources, it means given due consideration to the constituent units of the nation. For instance, in a federal state like Nigeria, allocation function of fiscal policy comprises how treasury or resources of goods and services are shared among federal, state and local government. It refers to which of the function and to what magnitude is to be carried out by each tier of government. It also include the provision for social goods, or the process by which total resource used is distributed between private and social goods and by which mix of social goods is chosen.

The allocation function ensures that goods and services are allocated in sufficient quantities either through the market or through government provisioning. For some goods and services, such as defense and weapons, there is agreement that they should be provided by the central governments as there is little incentives for private markets and sub-national governments to provide such public goods at efficient levels (Olson and Zeckhauser, 1966). This provision can also be termed as the allocation function of budget policy. It should be

emphasized that social goods, as distinct from private goods, cannot be provided for through the market system.

The basic reasons for the market failure in providing social goods are that such goods have a characteristic of **non-excludability, meaning that it is non-rivalry**. They are also **not depletable.** That is in its consumption, the same quantity is available for every current and future consumers.

The allocation function is closely related to the issue of taxation and expenditure because the allocation of funds depends upon the collection of taxes and the government using that revenue for specific purposes. However, the issue of allocation is further complicated by the diversity of preferences across decentralized jurisdictions. A commodity or service provided by the central government is often uniform across all jurisdictions (federal, state or local) regardless of the preferences of a particular jurisdiction. Such preferences may extend to both the quantity and quality of the commodity or service provided. As an example, a jurisdiction in Lagos State may prefer an above-average number of health centers for its rapid increase population, while communities in Adamawa State might prefer Fertilizer's subsidy. In USA, while a state might prefer expansion of social goods, another may prefer reduced levels of these goods in exchange for a lower tax rate.

Self-Assessment Exercise

Briefly explain the allocation function of fiscal policy

3.1.2 Distribution Function of Fiscal Policy

This specifically refers to **distribution of income and wealth**. It also means adjustment of the distribution of income and wealth to assure conformance with what society considers a 'fair' or 'just' state of distribution. Assumption of the classical economics is that the market is capable of distributing income and wealth equally via perfect self-regulating mechanism. Because the market is subject to failure and has always been failing, in a scenario whereby

there is a contraction in the wealth of the consumer population, the market for goods and services also contract. Moreover, distribution of wealth by market forces and the existence of inheritance law usually generate high inequality. Going by the theory of general equilibrium, the possibility of market failure for various classes of goods is higher.

To prevent market failure, government needs to redistribute a portion of its population's wealth because local jurisdictions set different social standards for wealth equity among their citizens. In USA, for instance, incentives are created for wealthy citizens to move out of jurisdictions that have a high effort of redistribution and for poorer citizens to move into such a jurisdiction (Voorhees, 2005). Another way out is for government to increase tax and social responsibility of the rich and increase transfers to the poor. Thus, redistribution efforts are generally considered most appropriate at the central or regional government level.

It is important to understand that the function of distribution varies across tiers of government; however, it is best handled at the federal or central government level. On the other hand, allocation function depends on the resources or goods and services being allocated. Although, the federal government is best suited for providing a uniform, public good, if a minimum of diversity in preferences exists, then, decentralized authorities are more efficient at providing goods and services.

Oates (1972) argue that in a fiscal system of governments, these three functions namely, stabilization, allocation and distribution functions are not equally suited for all levels of government and that efficiencies are realized if the appropriate function is properly matched to the appropriate level of government. In general, he bids for central government control over monetary and fiscal policy in the quest for price and employment stability.

Self-Assessment Exercise

Discuss the distribution function of fiscal policy

3.1.3 Stabilization Function of Fiscal Policy

Stabilization and economic growth are the remaining critical functions of fiscal policy yet to be discussed. Although all other functions matter, but fiscal policy cannot achieve economic growth without economic stabilization.

Stabilization is the government's role in maintaining stable prices and employment. The price level is a composite index. Full price movement are being composed into composite of price involve combining all prices together into one, that is the general price level. In Nigeria, for example, the Federal Office of Statistics (FOS) owns the responsibility of calculating the general price level by comparing last period price with the present. To check whether there has been inflation or recession.

It is necessary to clarify that the goal of stabilization can be addressed through both monetary and fiscal policies. Monetary policy setting interest rates and regulating the money supply is done at the central government level. On the other hand, and for obvious reasons in a federal system, it makes little sense for regional or local governments to manage monetary policy like printing and issuance of currency. Such actions may result in uncertainty of currency valuation, aggravates macroeconomic imbalance and create inefficiencies in interstate trade. It can also create fiscal imbalance where by prudential intervention of monetary policy in fiscal policy becomes unattainable. It would also be difficult to synchronize interregional monetary and fiscal policies with national policy.

More importantly on the subject matter, the way fiscal policy can be utilized to manage economic stability is primarily by adjusting the levels of government taxes and expenditures, by this, economic growth can be either stimulated or constrained. Moreover, the known fact, according to Keynes (1936), is that the overall level of employment and prices in the economy depend upon the level of aggregate demand, relative to the potential or capacity output valued at prevailing prices. Similarly, government expenditures add to total demand or overall level of employment, while taxes reduce it (Keynes, 1936). These

suggest that budgetary effects on demand increase as the level of expenditure increases and as the level of tax decreases.

In summary, in public finance, fiscal policy is needed for stabilization, since full employment and price level stability do not come about automatically in a market economy. Without it the economy tends to be subjected to substantial fluctuations, and it may suffer from sustained periods of unemployment or inflation. It can lead to stagflation where unemployment and inflation exist simultaneously. The market might have no solution to this. Therefore, stabilization policy of the government may proffer solution. Nevertheless, according to Smithies (1946), stabilization policy can lead to three categories of government actions:

1. Measures to bring about institutional or structural changes in the private economy itself. Put formally, this means changes in parameters of the structural factors determining the behavior of the private economy. Once the change is accomplished it is hoped that the private economy will function more effectively without further government intervention.
2. Measures to provide government control over endogenous (or internally control-able) variables in the private economy where such control is needed for stabilization purposes though, this category cannot be clearly distinguished from (1 above). Suppose the government were to assume temporary control over the price of diesel, that action may be described either in terms of controlling the variable or as substituting a new structural relation for the old one.
3. Measures to compensate changes in the private economy through the government's conduct of its own program, particularly in the budgetary and monetary fields. This type of action involves public control of variables exogenous (or external) to the private economy.
4. In addition to the three, in less a developed country like Nigeria, stabilization policy may include incentives to rural dwellers which may include social infrastructure like

hospitals, electricity, clean water and roads. Government may also provide agriculture equipment and high yield seeds. These reduce rural-urban migration and crime rate. Government can then leave the function to the market when institutions are established.

Apart from price level and interest rate, other factors government considers in stabilization policy include:

- Exchange rate
- High taxes or tax increase
- Balance of trade and balance of payments
- Global trend in financial market
- Deficits/Surplus

The Concept of Deficit Spending: This is when government expenditure exceeds its income. It occurs when government borrows to finance its spending. This becomes a problem especially when the deficit shows rapid upward movement and continue for a long time. It is common for government to finance its expenditure through deficit. In other words, government expenditure can be controlled through prudential deficit spending.

If we assume:

Government expenditure or deficit (spending) = G

Government tax = T;

Government Revenue = R,

Therefore;

Deficit = $G - T > 0$

Surplus = $G - T < 0$

OR

$G - R < 0$ = Deficit (financing)

$G - R > 0$ = Surplus

Similarly,

$G > T$ = Deficit (deficit spending).

$G < T$ = Surplus

However, as said earlier on, in a federal system, the use of fiscal policy to manage economic stability is usually best done at the central government level. When fiscal policy is utilized at the regional or local level, economic spillovers are often realized across decentralized jurisdictions resulting in economic distortions (Voorhees, 2005). For instance, when one state lowers tax rates, this action tends to stimulate that state's economy at the expense of the neighboring states.

Factors adversely working against government (fiscal policy) functions in developing countries are highlighted below:

- Poor macroeconomic framework.
- Poor money supply management by the apex bank.
- Divided political parties' agenda/manifesto.
- Lack of harmony among the tiers of governments.
- Domestic economy devoid of safety-net to resist external shocks.
- External debt overhangs threatening policy reversals.
- The need for increase in current/re-current expenditure aggravating balance of payments position.

Self-Assessment Exercise

Explain the stabilization function of fiscal policy

3.1.4 Economic Growth Function of Fiscal Policy

Fiscal policy function also includes **promoting economic growth**. Looking at growth specifically, it refers to the neo-classical economic growth, that is, the growth theories

associated with capital formation; savings/investment. These include Harrod-Domar model, Solow model, endogenous growth model etc. These growth models are related with action to create and increase capital formation. In the system of national accounting (SNA), capital formation represents savings out of national income. This is required in the national economy to step up growth. Growth means a process of building capacity. If an economy should grow, it must build its environment to certain capacity, and this is called the process of capital formation. In most underdeveloped countries, capacity building is mainly the responsibility of government via its fiscal policy to achieve stability and promoting economic growth.

The neoclassical theories earmarked the private sector as the engine of growth capable of building capital. Government is required to create enabling environment to strengthen the private sector and increases its productive capacity. Relative to economic growth, government can embarked on the following fiscal actions to boost capital formation:

- Subsidy to reduce input cost or price of output.
- Concessionary interest rate which enables firms to obtain fund for output expansion. This is called fiscal stimulus.
- Tax holidays encourage new investors (firms) to operate for a specific number of period without paying tax. This allows them to consolidate.
- Increase the percentage of capital expenditure in the annual budget.
- Provide incentives to national savings. For instance, in Nigeria, government may set aside certain percentage of oil revenue as savings over time and invest on both human and physical capital.
- Declaration of import substitution policy. This may have long run implication on government income. A successful import substitution may result in decrease import duty, but it puts the nation in a position of self-reliance. It shield the nation against external shocks.

The challenges of fiscal policy function is not only maintaining high employment or of curtailing inflation within a given level of capacity output. The effects of fiscal policy upon the rate of growth of potential output must also be allowed for. Fiscal policy may affect the rate of savings and the willingness to invest and may thereby influence the rate of capital formation. Capital formation in turn affects productivity growth, so that fiscal policy is a significant factor in economic growth.

Succinctly, the four major fiscal policy functions can be stated as follow:

- Allocation function: It refers to apportionment of resources, goods and services evenly among various constituent states or the tiers of government.
- Distribution Function: This is concerned with national wealth or income distribution to reduce inequality.
- Stabilization Function: It means keeping fiscal policy within the society production capacity to restraint economic cyclicality.
- Economic Growth Function: This refers to all fiscal actions leading to the growth rate of output (GDP). A substantial and stable growth for a long time is required for economic development.

Self-Assessment Exercise

1. Briefly highlight the four functions of fiscal policy.
2. Explain the meaning of capacity building.

3.2 Contemporary Functions of Fiscal Policy

The intent of fiscal policy is essentially to stimulate economic and social development by pursuing a policy stance that ensures a sense of balance between taxation, expenditure and borrowing consistent with sustainable growth (Okran, 2009). Although these have been pursued painstakingly in most less-developed countries and significant growth has been attained in some, it appears poverty has been on the increase as well.

The fact is that, fiscal policy actions role have taken a center stage in economic management. The last two decades or so have seen a renewed interest in the role of fiscal policy in stimulating economic growth, diversifying economies and reducing poverty (Addison, Niño-zarazúa and Pirttila, 2018). Some of the fiscal policy new roles are highlighted as follow:

- For some countries, reducing high levels of social inequality has been on the agenda, especially when the pattern of growth is quite narrow in its direct benefits via employment and livelihoods. This situation is largely the case in economies with substantial extractives sectors (Addison *et al,* 2018). This necessitates more reliance on the fiscal system as a means towards achieving 'inclusive growth', whereby effective institutions for revenue policy and collection as well as for public expenditure management are vital to redistributing resource rents (Daniel, Keen, Swistak, & Thuronyi, 2017; Mosley, 2017).

  This broader range of goals for fiscal policy marks a shift from its narrow focus on macro-economic stabilization in the 1980s and early 1990s when a combination of terms of trade shocks and institutional weaknesses in public expenditure management and revenue mobilization led to often desperate fiscal crises and painful 'structural adjustment' (Addison, 2015; Stewart, 1996).
- Population rapid growth, particularly in developing countries, also put pressure on fiscal responsibility.
- Moreover, the sustainable Development Goals (SDGs) also imply large-scale public expenditures to support improved livelihoods for poor people via better infrastructure access, and for instance, more research into small-holder crops with the aim of ending poverty, and also to help close gaps in the distribution of wealth and income by gender, region, and income-category (Fowowe, 2013 and Addision, 2018).
- Finally, climate change will impose large fiscal burdens as the frequency and intensity of extreme weather events increase. It requiring more public expenditure

on disaster relief and, in some cases, reducing the tax base through economic damage consequent on increased drought and flooding. Climate adaption and mitigation, as well as the achievement of other environmental goals such as improved urban air quality and reduced water pollution, are additional substantial demands on the public purse (Fowowe, 2013 and Addision, 2018). However, Fowowe (2013) suggests fiscal incentives which impose large fiscal burden, should focus on reducing infrastructural bottleneck, building valuable institutions and sound legal framework.

Self-Assessment Exercise

Explain the stabilization function of fiscal policy

4.0 CONCLUSION

Public expenditure and taxes or simply fiscal policy is a major economic topical issue require adequate study. This unit has been able to discuss the four major functions of fiscal policy. These are not necessarily the only functions of fiscal policy. Other policies relating to government or national treasury, finances, income and expenditure are integral parts of fiscal policy. Most significantly, government fiscal stance is aim at stabilization and economic growth in order to attain economic development. Unfortunately, however, it seems government efforts at maintaining fiscal balances in most developing countries have proved ineffective. This may be the result of fiscal imbalances and poor macroeconomic framework in most of these countries. It was suggested that fiscal policy function should include building infrastructure and institutional framework.

5.0 SUMMARY

In this unit, we have discussed the four major functions of fiscal policy. These include allocation, stabilization, distribution and economic growth functions. These are interrelated, that is, one complements another. We mentioned that economic growth depends on economic stabilization. Most developing countries have failed to realize fiscal

policy functions outcome and as a result unable to attain economic development. Some factors militating against fiscal policy functions are also highlighted.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain two contemporary functions of fiscal policy
2. Discuss the economic growth function of fiscal policy
3. Highlight some of the fiscal actions government can adopt to attain capital formation.

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UNIT 3 FISCAL FEDERALISM AND FISCAL INSTITUTIONS

CONTENTS

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1.0 INTRODUCTION

In this unit, discussion is focused on fiscal institutions. Before this, we shall introduce federalism and fiscal federalism as the background of fiscal institutions. In most Organization of Economic Cooperation and Development (OECD) countries, fiscal institutions, most importantly, the independent fiscal institutions have been established and are performing in various capacity as "watch dog" or playing advisory role to government institutions concerning budget, expenditure and other financial activities of the political class as related to service to or representative of the people. Fiscal institutions are necessary to address the likely inappropriate execution of government unprofitable fiscal space and profligacy in national wealth consumption.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Discuss the meaning of federalism and fiscal federalism

- List the critical functions of fiscal institutions
- Highlight the deference between government fiscal institutions and independent fiscal institutions.
- State the features of a feasible fiscal council.

3.0 MAIN CONTENT

3.1 Fiscal Federalism as a Core of Fiscal Institutions.

To understand fiscal federalism and then fiscal institutions, it is relevant to discuss first, the concept of federalism and its characteristics. These allow for a wider knowledge of fiscal institutions and the need for its existence.

3.1.1 The Concept of Federalism

The fiscal institutions to be discussed in this module are characterized by federal institution. We begin to understand fiscal institutions better in a federal state when the concept of federalism and fiscal federalism are clearly explained. The following authors have given several definitions of federalism:

- Federalism involves some combination of self-rule and shared rule to enable the parties to the federal bargain govern themselves insofar as possible and share in the task of governance insofar as necessary (Elezar, 1984).
- Federalism is "a method of dividing powers so that the central and the regional governments are each within a sphere coordinate and independent" (Wheare, 1953).
- Federalism may be seen as a bargain defined by three features (1) at least two-tiers of government obtain in the same country; (2) Each level has its own autonomous sphere of authority and (3) the autonomy of each sphere is constitutionally guaranteed and protected (Riker, 1964).

- The new political economy sees federalism as distribution of functions between the different levels of government which also help to explain the success of federalism. They lay emphasis on the importance of independence of regional or sub-national governments to design or operate local economic policies. It also entails budget constraints and the extent of devolution of power (Ejobowah, 2000).

The new political economists (Nwaogwugwu, 2006; Rodden, 2004; Ejobowah, 2000; Ferejohn, Bodnar and Eskridge, 1998; Weingast, 1995; Riker, 1964) explain what should be an ideal characteristics of a typical federalism to enhance a smooth system. These are highlighted below:

- Sub-central government enjoys pragmatic autonomy i.e, exclusive authority to decide a subset of economic policy such as creating, repealing, and adjusting programmes and regulations.
- Legal rules and norms that regulates federal arrangements as well as independent judicial institutions that would restrain national and sub-national authorities from interfering in the bargaining process.
- Characterized by a hard budget constraint on the sub-national governments, so that they fund their own spending largely out of autonomous revenues. For instance, revenue raised through taxes over which the sub-central governments enjoy the authority to set rate and base, or both, and may not have access to credit.
- Regulate the activities of sub-national governments' respective economies without interfering with intra and inter-jurisdictional movement of goods and services.
- The assignment of monetary and central banking functions to the national government.
- An explicit agreement on federal arrangement to make juridical federal restrictions and a separation of power including independent courts.

Nwaogwugwu (2006) submitted that federalism is all about the people, about efficient and effective economic and political decisions, about growth and development, about proper governance and about enhancing the welfare of all in the federal arrangement. Therefore, if a federal system fails to achieve these, then that particular federal arrangement is not worthy the name of a true federalism.

Nwaogwugwu (2006) lists the institutional framework of federalism which depends mainly on the following:

- The constitution
- Constitutional amendments
- Vertical and horizontal fragmentation of government units,
- Institutional approach to fiscal adjustment
- The political system
- The independence of various arms of government
- Voice and partnership mechanism
- Institutional approach to power adjustment.

In addition, it is important to note that the existence of a federal constitution is a prerequisite for the formation of a federal system. This is what Oates (1972) called "the rule of the game". In other words, the federal constitution must clearly state the division of decision making authority between the national and sub-national governments.

3.1.2 Fiscal Federalism/Fiscal Decentralization

From the foregoing, **fiscal federalism** can be summarized as the study of the financial relationships between multiple levels of government. In Nigeria and the United States of America (USA), this commonly is considered to be the relationship between the federal, state, and local governments, with each level of government having specific rights and obligations. However, from a global perspective, fiscal federalism is often considered a

specific case of the more generalized study for fiscal decentralization and thus, eliminates the constraints imposed upon the latter by the federalist form of government.

Voorhees (2005) explained that much of the underlying theory of fiscal decentralization is based upon Richard Musgrave's (1939) functions of government. In his seminal piece, Musgrave defined the economic role of government as threefold. First government must stabilize prices, prevent excessive inflation and ensure full employment. Second, governments need to ensure efficient allocation of resources, either in the market or through government provisioning. Finally, governments must ensure that socially acceptable levels of wealth distribution and market access are maintained and, if they are not, then there is the need to redistribute the wealth.

The study of **fiscal decentralization** is generally from the perspective of three components of the fiscal system: revenues, expenditures, and intergovernmental grants. From the revenue perspective, the primary issue deals with the type of tax a given governmental level should use to ensure an equitable and efficient tax system. From the expenditure perspective, the primary issues are determining what expenditures should be made at each level of government to ensure that the expenditure system is operating equitably and efficiently (Voorhees, 2005).

Decisions on revenue and expenditure assignment are usually made independently of each other. This can often result in a mismatch of revenues to expenditures at one or more levels of government. The third component of fiscal decentralization is the system of intergovernmental grants. Intergovernmental grants are utilized primarily to maintain an efficient and equitable revenue and expenditure system and at the same time correct the mismatch between collection of revenues and disbursement of expenditures.

Self-Assessment Exercise

Mention four ideal characteristics of a typical federalism to enhance a smooth system.

3.2 The Concept of Fiscal Institutions

The concept of fiscal institutions flows out of federalism and the fiscal federalism discussed above. In fact, fiscal institutions are part of federal arrangement concerning smooth practice of federalism. Fiscal institutions could be governmental or independent institutions. While government fiscal institutions may include taxation, budget or budget deficits, political institutions (that constitutes government) and financial ministries, on the other hand, independent or non-governmental fiscal institutions may be non-governmental agencies or intergovernmental institutions like the United Nations, World Bank and International Monetary Fund. The latter acts as a check and watchdog to a nation's financial activities with a view to offering suggestions and cautions about economic cycles; depression or inflation as well as fiscal indiscipline.

One can explain further that fiscal institutions cover the entire range of entities responsible for public resource management: revenue collection, budget preparation, budget planning, expenditure execution, procurement, reporting, and oversight. A government can create fiscal space by raising taxes, securing outside grants, incurring lower priority expenditures or borrowing resources, while making sure that it has the capacity in the short term and the longer term to finance its desired expenditure programs as well as to service its debt (Heller, 2015). Efficient fiscal institutions can help maintain prudential financing or improve fiscal space, which enables countries to increase spending and incur larger fiscal deficits without jeopardizing macroeconomic stability and debt sustainability (Delechat *et al.,* 2015).

Fiscal institutions are created to mitigate crises that may occur in the event of meeting economic, political, and social needs. Crises arise also in the course of political struggle. Von Hagen (2002) explained that both the principal-agent relationship and the common pool of property generate potential for excessive levels of spending, taxation, and public borrowing. The relation between government and the people is like that of the principal-agent and the more rampant the principal-agent problem; the greater will be the divergence between voter preferences and the level and composition of public spending. Similarly, the

more severe the common pool problem, the greater will be the divergence between the marginal social utility and the marginal social cost of targeted public policies (Von Hagen, 2002).

Von Hagen observe some empirical studies which show that the above likely disharmony in a federal system among conflicting interest groups can lead to excessive levels of spending, deficits, and debt (von Hagen 1992; von Hagen and Harden,1994; Strauch, 1998; Kontopoulos and Perotti, 1999). Other empirical studies suggest that government spending and debt increase with the intensity of ideological and ethnic divisions within a society (Roubini & Sachs, 1989; Alesina & Perotti, 1995; Alesina *et al*. 1997), or by ethnolinguistic and religious fractionalization (Annett, 2000).

3.2.1 Institutional factors that can enhance fiscal institutions resolving crises

There are actually some institutional factors that can enhance fiscal institutions resolving crises arising as a result of the above fiscal scuffle or discontentment. According to (von Hagen, 2002), these include:

- Imposing fiscal rules, i.e., ex ante controls such as balanced-budget constraints or referendum requirements for tax hikes that restrict the scope of choices elected politicians can make regarding public finances;
- Designing electoral rules promoting political accountability and competition and increasing the politicians' incentives to deliver the policies voters most prefer;
- Designing the decision-making processes over public finances that induce policy makers to recognize more fully the marginal social benefits and costs of their policies.

In a less developed country like Nigeria, these may also include:

- Designing punishment for political officers who commit financial offences while in government. This may also involve out law from future electoral process.

- Establish investigative institutions that probe past life of a political aspirant on pecuniary issues.
- Create incentives and disincentive methods to restrain political office holders.
- Increase private sector participation in public project appraisal and evaluation.

3.2.2 Independent Fiscal Institutions:

Independent fiscal institutions (IFIs) are defined as non-partisan public bodies, other than the central bank, government or parliament, aimed at promoting sustainable public finances through various functions, including monitoring compliance with fiscal rules, production or endorsement of macroeconomic forecasts for the budget, and or advising the government on fiscal policy matters (Hemming, 2013) and (EU, 2019). In some countries, the IFIs are sometimes called fiscal councils. Setting up independent fiscal institutions, according to Hemming and Joyce (2013), is increasingly viewed as a way to combat a bias toward spending and deficits, to promote fiscal responsibility more generally, and to improve the quality of the fiscal policy debate, all by providing independent scrutiny of fiscal policies, plans, and performance (Calmfors, 2010).

The IFIs can, in principle, play a useful role in disciplining fiscal policy and strengthening government finances, but their benefits should not be oversold, especially for developing countries in which the fiscal policy reform agenda is long and institutional capacity is limited. This conclusion contrasts with that in a contribution by Giugale (2010), which sees the spread of fiscal councils or similar agencies from advanced economies to developing countries as both inevitable and desirable (Hagemann, 2010).

Another noticeable point about the IFIs is that they do not explicitly play normative role. In a few countries like Sweden and Belgium, they have advisory function and recommend budgetary targets. The institutions are primarily financed by public funds and relatively are functionally independent of fiscal authorities. In many European

countries, courts of auditors are included in this definition if their activities go beyond the accounting control and cover any of the tasks mentioned above (Hemming, 2013). However, Joachim Wehner of the London School of Economics says "Faced with growing debt and an uncertain macroeconomic outlook, many governments are experimenting with institutional innovations such as new budgetary rules and fiscal councils. Yet the naive import of reforms has uncertain benefits."

Self-Assessment Exercise

Explain the concept of independent fiscal institutions

3.2.3 Functions of Independent Fiscal Institutions

The Functions of Independent Fiscal Institutions can be summarized as follow:

- Act as "fiscal watchdogs" to the constituted authority.
- Increase accountability and improved fiscal transparency by providing positive and/or sometimes discretionary analysis, assessments, and recommendations in the area of fiscal policy.
- Fiscal institutions can produce or endorse macroeconomic forecasts for the budget preparation that do not suffer from the optimistic biases.
- Impartially monitor the implementation of budget plans and the respect of fiscal rules and budgetary objectives.
- Raise awareness about short and long-term costs and benefits of budgetary measures both among policy-makers and the public.
- Assess whether fiscal measures are appropriate in terms of respect of rules, sustainability of public finances, and stability-oriented fiscal policies.

The European Union (EU) summary of the functions is similar as above, they are:

1. Monitoring of compliance with fiscal rules;

2. Macroeconomic forecasting;
3. Budgetary forecasting and policy costing;
4. Sustainability assessment;
5. Promotion of fiscal transparency; and
6. Normative recommendations on fiscal policy.

   (The EU, 2015; 2017).

Fiscal council may act as advisory body, which could review and comment on many aspects of fiscal policy, including:

- The government's medium-term fiscal policy objectives, which would typically be specified as a debt or deficit path, including the debt sustainability analysis on which it is based;
- Unfunded and contingent liabilities, and other prospective developments and sources of fiscal risk, that determine the need for future fiscal space; whether short-term fiscal targets are appropriate, given medium-term objectives;
- The cyclical position of the economy, commodity price changes, and other economic developments that might warrant a fiscal policy response;
- The size and impact of automatic stabilizers and the design and timing of discretionary tax and spending measures;
- The impact and cost of proposed policies, with a view to providing a check on the natural tendency of those proposing policies to overstate their benefits and understate their costs; and
- Any other aspects of fiscal policy related to the fiscal council's mandate or that are the subject of a request from government.

  (Hemming and Joyce, 2013).

There has not been much thought about IFIs in less developed countries. What mainly constitute fiscal checks and balances are the legislative arms of government. Some pressure

groups and the media also attempt to speak out or venture into probing government fiscal activities. For instance in Nigeria, a handful of human rights group has filed protest against government profligacy and excessive external borrowings. Few individuals have also carry out sporadic criticism against government fiscal mismanagement.

In other words, while most advanced countries are now increasingly setting up fiscal councils or independent fiscal institutions to monitor and ensure fiscal authority's compliance with fiscal rules, and limit set for fiscal space, most developing countries are yet to acknowledge the strategy as a new mean of achieving fiscal discipline and prudential treasury management.

Although, there is yet to be a consensus or formal agreement on requirement for a successful fiscal councils, however, Hemming and Joyce (2013) give the features of a feasible fiscal council, these include:

- **Political support**: that is politicians must give support to the council or institution by providing appropriate information.
- **An appropriate fiscal framework:** Commitment to fiscal discipline which may require medium term budget framework before actual budget is made and addressing other systemic obstacles to sound fiscal policy formulation and implementation.
- **A well-defined mandate**: Once the role of a fiscal council is determined, it should be given a formal mandate specifying the scope and limits of its responsibilities.
- **Clear legal backing**: Legislation should set up the fiscal council; describe its role and responsibilities; and specify the relationship between the legislature, the executive, and the fiscal council. Its role in budget process should be described.
- **Technically qualified staff**: Staff should be fairly large consisting both full time and part time staff. It may simply be made up of committee of experts or technocrats working on part time basis. However, it is important to emphasize that IFIs or a

fiscal council is not a substitute for an effective government, and especially for a strong ministry of finance.

- **Accountability:** The council needs to be checked for quality assurance or good work delivery; although the council's usefulness may depend on the way the government responds to its views and fiscal outcomes.

Self-Assessment Exercise

List the European summary of the functions of fiscal Institutions.

3.2.4 Fiscal Councils and Similar Arrangements in Selected Countries

Below are Selected Fiscal Councils and Similar Arrangements in Selected Countries

S/n	Country	Name of Councils or IFIs	Yr. Established.	Duty/Responsibility
1.	Australia	Parliamentary Budget Office	2011	Provides independent, nonpartisan, and policy-neutral analysis on the full budget cycle, fiscal policy, and the financial implications of proposals, etc.
2.	Austria	a. Austria, Government Debt Committee, and b. The Austrian Institute of Economic Research and the Institute of Advanced Studies.	1970	a. Mandate to focus on deficit financing; analyze and comment on fiscal policy. b. Provides independent forecasts.
3.	Canada	Canada, Parliamentary Budget Office.	2008	Provides advice on all aspects of public finances, prepares forecasts, and scores new policies on request.
4.	Chile	Chile, Two Expert Panels Advisory Committee on Trend in GDP. Advisory Committee for the Reference Copper Price. Produce forecasts of trend GDP and copper prices as a basis for determining deviations from the medium-term structural surplus target. (Responsibility: forecasting)	2001	Forecast: Produce forecasts of trend of GDP and copper prices as a basis for determining deviations from the medium-term structural surplus target.

5.	Germany	Germany, Advisory Board to the Federal Ministry of Finance and Joint Economic Forecast Project Group.	1950	Assess compliance with fiscal rules and debt sustainability, and makes fiscal policy recommendations. Provides independent macroeconomic and fiscal forecasts. The Working Group on Tax Revenue Forecasts provides independent revenue forecasts based on the government's macroeconomic projections
6.	Japan	Japan, Fiscal System Council. Comprises academics	-	Advises across a wide range of fiscal policy issues, provides macroeconomics and fiscal forecast and Evaluation evaluates fiscal performance
7.	Netherland	Netherlands, Central Planning Bureau.	1945	Produces official government forecasts, reviews economic policies of parties contending elections, and reconciles budget policy positions of coalition partners.
8.	United Kingdom	Office for Budget Responsibility. Responsibilities: auditing, forecasting, costing.)	2010	Prepare macroeconomic and fiscal forecasts and to assess progress toward fiscal sustainability. Will also cost budget measures. Auditing, forecasting, costing.
9.	Sweden	Fiscal Policy Council	2007	Monitors compliance with medium-term fiscal surplus target and expenditure ceilings. The National Audit Office assesses forecast quality. Advisory, auditing.)
10	USA	United States, Congressional Budget Office	1975	Analyzes president's budget based on its own assumptions and forecasts; considers alternative paths for fiscal policy, and scores new policies. Forecasting, costing.
11	South Korea	National Assembly Budget Office	2003	Supports the Korean National Assembly by analyzing and evaluating

				issues related to the national budget, fund and fiscal operations. Initiation of government performance management evaluation program. Publication of "Long-term Fiscal Projection 2012-2060"
12	Kenya	Parliamentary Budget Office	2007	Budget watch on key issues regarding the budget estimates in a particular financial year and disseminates such findings to the legislature and the public.
13	South Africa	Parliamentary Budget Office	2014	Support the implementation of the Money Bills Act by undertaking research and analysis for the four committees on Finance and Appropriations in the National Assembly and National Council of Provinces. Providing advice and analysis on proposed amendments to the fiscal framework, the Division of Revenue Bill and money Bills etc.
*14	Nigeria	Fiscal Responsibility Commission. (Established by the FISCAL RESPONSIBILITY ACT, 2007)	2007	Compel any person or government institution to disclose information relating to public revenues and expenditure; carry out investigation and forward a report of the investigation to the Attorney General of the Federation for the possible prosecution.

Sources: Beetsma, Debrun, Fang,…. Zhang, (2018); European Commission (2006); Hemming and Kell (2001); Hagemann (2010); The IMF (2019).

Self-Assessment Exercise

Discuss, in less than half a page, what you understand by fiscal institution

4.0 CONCLUSION

In this unit, federalism and fiscal federalism have been discussed with a view to boost our understanding of fiscal institutions. In the advanced countries, independent fiscal institutions have performed well and have played complementary role in public treasury or public revenue management. This is not the same in less-developed countries where political class undermines the benefit to gain. The fiscal institutions in underdeveloped countries comprises the formal government institutions such as budget and budget office, ministry of finance, debt management office (DMO) and the legislature. Most of these may not be enough to deliver the much needed monitoring of fiscal space.

5.0 SUMMARY

We have discussed fiscal institutions and independent fiscal institutions in this unit. Fiscal institutions are crucial to federalism and play an integral role to its smooth practice. This unit focuses mainly on the independent fiscal institutions which may also be referred to as fiscal councils. Among others, they perform functions such as macroeconomic forecasting, fiscal watchdogs to the constituted authority; increase accountability, improved fiscal transparency; make recommendations in the area of fiscal policy and monitoring of compliance with fiscal rules. Some of the features of a typical fiscal council include political support, an appropriate fiscal framework, a well-defined mandate and a clear legal backing

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain what you understand by independent fiscal institutions.
2. Discuss the position of less developed countries in the context of independent fiscal institutions.
3. Highlight some of the benefits lost if independent fiscal institutions are ignored.
4. List four comments or suggestions a fiscal council can offer to the constituent authority.

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UNIT 4 SOCIAL GOODS AND ITS OPTIMAL DISTRIBUTION

CONTENTS

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1.0 INTRODUCTION

This unit is basically on social goods. These are best referred to as public goods. In public finance, financing social goods are supposed to be done without jeopardizing the financial position of the nation. Relative to federalism, fiscal policy concerning provision of social goods is to be made with due consideration to financial carrying capacity of the whole federal constituency. The social goods are to be provided and distributed evenly and fairly among the component states. Critical to the supply side of social goods, there must be a balance between government revenue and deficits because the supply of social goods tends to pose heavy financial cost. Provision should not cause large budget that may aggravate balance of payments position. In providing social goods, policy makers should understand its (1) **non-excludability features**. Once it is provided, no one can be prevented from its consumption; (2) **Non-depletability** features, that is, the consumption by one person leaves the same amount for another consumer. These two characteristics cause free-ridership, a situation where by beneficiaries pay almost nothing for their consumption. Example of social or public goods are hospitals, schools, roads, national park and national defence.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Discuss the meaning of social goods
- List the main characteristics of social goods.
- Explain how social goods can be distributed optimally.
- Discuss factors that may lead to inadequate provision of social goods

3.0 MAIN CONTENT

3.1 Meaning of Social Goods?

The concept of social goods or merit wants (Musgrave, 1959) appears under several different terms in academic literature, including pure public goods, collective consumption goods, and social goods. **Public goods**, however, is the most commonly used term (Trogen, 2005).

The concept of "merit wants" was invented by the German-born American economist Richard A. Musgrave for his Theory of Public Finance (1959). In an elaborate way, he meant to say that some human needs were of such importance that they merited governmental support in the form of in-kind distribution of specific goods, called merit goods like housing for the poor, school lunches, and healthcare. Musgrave argued that **social goods** or collective, or public goods as they are often called had to be provided by the government because they were technically non excludable. This means that this feature would lead selfish individuals to free ride if the goods were allocated by the market, (Desmarais-Tremblay, 2016).

Sometimes defining some goods as social or public goods may be ambiguous. For instance, at early stage of development, in some less developed countries, health may be regarded as a pure public good. However, in many developed countries, health is a social good. It does not have all the characteristics of a pure public good. Health has positive externalities but

its consumption is not characterized by non-rivalry and non-excludability which are the two typical attributes of a public good (Kulkarni, 2016). **The provision of health care is constrained by the resources at the disposal of the government and private individuals which lead to excludability and rivalry**. Hence, the price mechanism works effectively. The consumption of health can also be regarded as a public good having positive externalities as it results in an increase in collective social benefits. Hence, health can be categorized as a quasi-public good (Kulkarni, 2016).

Only public goods have withstood the persistent trend toward market allocation. Across time and across cultures, public goods have been almost universally provided by governments (Trogen, 2013). According to the author, public goods are both unique and fascinating because it is virtually impossible to allocate a pure public good through market mechanisms. For all other goods, markets have emerged as the dominant means of allocation and distribution, and the current trend is toward even greater dependence on markets to allocate goods.

Until 1930s, markets have been almost universally embraced as the most efficient way to allocate resources, and free markets have emerged as the prevalent world ideology. It is assumed that the market cannot fail because of its “invisible hands” and self-regulating mechanism all that are perfect. But the market failed in the 1930s and could not provide public good and even private goods perfectly. Adam Smith, the founder of classical economics who first developed the argument in favor of free markets, argued for the provision of public goods by government rather than through markets. Smith maintained that the first two primary functions of government are to provide two public goods, national defense and a legal system, and he suggested both should be paid for from the public treasury (Smith, 1776; 1991).

3.1.1 Theoretical Facts about Social/Public Goods

In theory, goods are usually categorized as private or public goods. They could be rivalry (private goods) or non-rivalry (social goods). We can also have pure private or pure public goods. A pair of shoes is totally rivalry as it can only be worn by one person at a time. As a result, there is an additional cost to providing a pair of shoes to each additional person. On the other hand, National defense is totally non-rivalry for all citizens, as each citizen receives the entire benefit of national defense regardless of the number of citizens. That means **there is no additional cost in delivering the exact same level of protection to an additional citizen,** this is the non-excludability characteristic of public goods (Weimer and Vining, 1999; Stiglitz, 2000; Trogen, 2005). **From the fact that the same quantity is available for other citizens describe the non-depletability of a public good.**

Self-Assessment Exercise

Explain the theoretical facts about public goods

3.1.2 Main Types of Public Goods

It should be noted that a good could be pure public goods or impure public goods. These are discussed below,

a. **Pure Public Goods**: Pure public goods are those that are completely non-rivalry and completely non-excludable (Stiglitz, 2000; Bruce, 2001). As a consequence of complete non-rivalry, there is no additional cost to adding an additional user (Bruce, 2001; Stiglitz, 2000). No cost, to an economist, not only implies that there would be no additional cost to the new user but also no costs imposed upon the existing users. Public goods could be international, national or local public good. **International public goods** are pure public goods with the most universal geographical coverage. Internationally, they include international security, knowledge, the environment, and economic stability (Stiglitz, 2000). **National public goods:** are pure public

goods that are non-excludable, but only within a nation's borders (Trogen, 2013). National public goods include national defense, a legal system, and sometimes even efficient government (Stiglitz, 2000). Similarly, **Local public goods** are those pure public goods consumed without payment and no one is excluded. These include open air concert, lighthouses and fireworks. These are available locally or at a particular point, they are available for those who can reach where they are situated.

b. **Impure Public Goods**: Musgrave (1986) called these mixed public goods or "mix cases", or near public goods (Gwartney and Stroup, 1997) or social goods. Each of these less-than-pure public goods violates, to some degree, the assumptions that public goods are non-excludable or non-rivalry. Different types of impure public goods include **excludable public goods**, **congestible public goods**, and **mixed public goods**. Respectively, these include television broadcast signal, a highway (which becomes congested as users increase in number), radio programmes and radio commercials. Concerning radio, programmes are non-excludable and non-rivalry but commercials are rivalry because they are private goods or market oriented goods.

c. **Excludable Public Goods**: An excludable public good is a public good that can be made excludable (Bruce, 2001; Hyman 2002). A good example is a local television broadcast signal which can be made private or rivalry when put in a cable or satellite television.

d. **Congestible Public Goods**: Congestion violates the assumption that public goods are non-rivalry in consumption. A congestible public good is a public good that is non-rivalry under moderate use but becomes congested under heavy use. With congestion, each additional user imposes costs on the other users (Weimer & Vining, 1999; Hyman 2002, Bruce, 2001). Congested public goods are sometimes also called ambient public goods (Weimer & Vining, 1999). A highway is a good example of a congestible public good. During off-peak hours it resembles a public good, but it may become congested during rush hour.

3.2 Optimal Distribution of Social Goods

Distribution of public goods comes with some challenges particularly in developing countries and in a federal system where each constituent unit must be taken into consideration. On a general note, apart from cost of production, production possibility, price and income level, optimal distribution of any commodity is constrained by transportation, and distance. In addition to these, public goods have peculiar constraints such as government revenue, fiscal policy, ethnicity, religion and individual component unit.

In general equilibrium theory, distribution is said to be efficient if it is Pareto optimal, that is, Pareto optimality is an ideal distribution of resources. For instance, the distribution of given commodities X and Y between two states is efficient if it is impossible by a redistribution of these goods to increase the utility of one individual without reducing the utility of the other, (Due and Friedlander, 1973), (Koutsoyiannis, 2002).

Optimal distribution of social goods is difficult to attain because of heterogeneity of consumer preferences. In a federal system, resource endowment, party politics, fiscal space constraints, etc., place limitations on optimal distribution on social goods. As a result, **the concept of value judgment came to place**. Bergson (1939) suggest the use of an explicit set of value judgment in the form of **social welfare function**.

A **social welfare function** is analogous to individual consumer's utility function. It provides a ranking alternative state in which different individuals enjoy different utility levels (Koutsoyiannis, 2002).

Let's assume that the economy consists of two component states, the social welfare function could be presented by a set of social indifferent contours (in utility space) like the ones shown in figure 1.

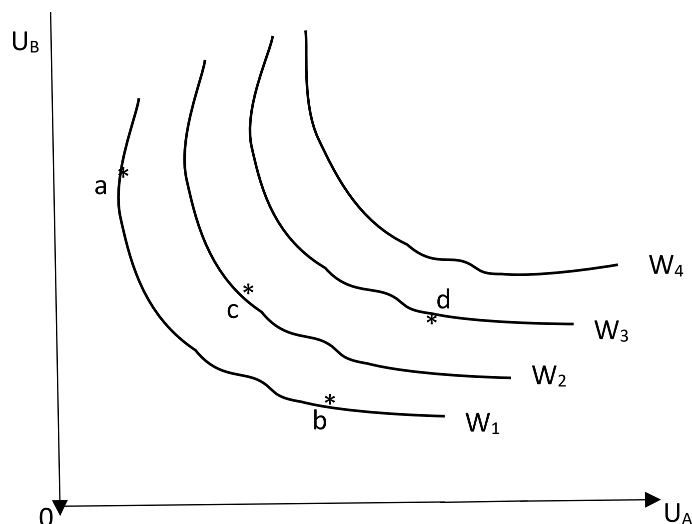

Figure 1: Bergson's Welfare Contours
(Koutsoyiannis, 2002)

From figure 1,

- Each curve is the locus of combinations of utilities of *A and B* which yield the same level of social welfare.
- The farther a social indifference contour is to the right (W_1 to W_4) the higher the level of social welfare.
- The farther a social indifference contour is to the left, (W_4 to W_1) the lower the level of social welfare.
- With these set of social indifferent contours, alternative state in the economy can be unambiguously evaluated.
- A change which would move the society from point a to b leaves the level of social welfare unaltered.

Note that there is no easy method of constructing social welfare function. Its working is an imaginary phenomenon in welfare economics. The truth is that somebody in the economy must undertake the task of comparing the wants and preferences of various individuals (or states in a federal system) and **rank them according to what he thinks is their worthiness**. A democratically elected government is assumed to make such value judgments which the society might accept. Jackson (2010) and Jackson (2013) incorporate

individuals with different tastes, skills and production techniques into the Tiebout model. They observed that intercommunity trade will affect pattern of community development given their taste, skills and production techniques. Therefore, in the distribution of public goods, they suggest that the optimal solution requires that every community will tax everybody according to his marginal social cost. A Pareto efficient redistribution policy can be carried out only by a central government using lump-sum taxes. They maintain that a federal income tax is capable of affecting community patterns and therefore it is inefficient.

In the view of Koutsoyiannis, (2002), the social welfare function cannot be used to derive social (or public) indifferent curves in output space equivalent to a single individual indifferent curve without considering the income distribution among various individuals or states in the economy. The bottom line is that in ensuring optimal distribution of social goods, income distribution must be put into consideration. If for instance regions with greater resources and high income are given poor or less valuable public goods, optimality might be unattainable. This is because, according to Wagner's law, as a nation records economic growth (that is high income) government expenditure is required to increase in order to meet more wants of the people.

3.2.1 Factors limiting optimal distribution of social goods

In underdeveloped countries, there are some peculiar factors limiting optimal distribution of social goods, these are highlighted below:

a. Lack of sufficient and up-to-date statistical data, particularly, of the constituent states.
b. Poor transmission channels to convey the impact of government policy.
c. Shortage of revenue, inducing deficit financing of public projects.
d. Federal versus states tussles over resource sharing or distribution.
e. Greediness and corruption prevalent during project execution stage.

f. Ethnicity whereby political officers giving preferences to their ethnic group.
g. Parties lack clear-cut manifestoes that reveal the direction of intending programmes.

Self-Assessment Exercise

List the factors limiting optimal distribution of social or public goods

3.3 The Challenges of Providing Social/Public Goods

One may say that the reasons for private goods efficient production makes public goods difficult to produce. As pointed out earlier, public goods have the non-rivalry and non-excludability features which generate free ridership and as a result, investors are unwilling to undertake its production.

Apart from shortage of financing, one can also highlight some of the reasons for difficulties in producing public goods, these are explained as follow:

- Non-rivalry creates incentives for individuals to hide their true preferences: a person may enjoy public or social good donated by charity organization. They are expected to show appreciate but not condemnation. As a result, the true utility derived or preferences maybe hidden.
- Because of the inadequacy of public expenditure public goods are insufficiently provided and then attract free riders; this prevents Pareto efficiency.
- Non-excludability creates incentives for beneficiaries not to contribute to public goods cost of provision: the fact that public goods are non-excludable allows people to enjoy them without paying, in other words, this creates incentives to free-ridership.
- Free rider as a flaw in human nature: Milton Friedman once said "there is no free lunch", but in public goods, there is. David Hume had identified this special characteristic of human nature in his "Treatise on Human Nature" in the early 1700s.

- An average consumer is rational and utility maximizers: Being a free rider is also consistent with the economist's picture of rational economic man as a utility-maximizing individual. For instance, the common daily practice is that consumers combine both public and private goods that will maximize his or her welfare. Since each dollar an individual spends on public goods is one less dollar available for private goods, there is a disincentive to contribute one's fair share to public goods

Since all the points summarized above impose challenges to the adequate and efficient provision of public goods, how then can public/social goods be produced with less challenges? The solutions are listed below:

- ✓ Imposition of fees regardless how small, i.e highway toll fee.
- ✓ Voluntary provision; non-governmental or non-for-profit organization may produce social goods.
- ✓ International support. The World Bank has been targeting areas for social amenities all over the World. This effort should be expanded as there are numerous rural areas in underdeveloped countries not yet touched at all.
- ✓ Public provision through tax revenue: Government may slightly increase tax base, but necessarily tax rate. It can increase indirect tax or value added tax. Either of these (not all simultaneously) would increase government revenue and in turn increase public income and boost expenditure. However, in developing countries, this might pose the problem of excess tax burden which becomes a nightmare for the politicians if they must win next elections

Self-Assessment Exercise

1. Define social or public goods.
2. Explain your understanding of non-rivalry.

4.0 CONCLUSION

This unit has given the meaning of social goods. According to various authors, there is no definite different between social goods and public goods. In fact, public goods is the common name given to goods that have feature of non-excludability and are not depletable. The non-excludability causes free-ridership, which makes public goods unprofitable to be produced by private individuals. Public goods can gulp huge government finance, as result government usually borrow fund to finance them. In the case of defense which is a pure public good, government, particularly in developing countries, obtain loan to finance it. This often aggravates balance of payments position. Factors that might reduce the burden of public goods provision and maintenance include imposition of fees, regardless how small, and voluntary provision by non-governmental or non-for-profit organizations.

5.0 SUMMARY

Public or social goods are those produced by the government usually to enhance the welfare of the citizen. Because public goods are not depletable and have non-excludable characteristic, they cannot be produced profitably by the market. Some public goods require large amount to produce which the private sector cannot afford. Therefore, funding is primarily undertaken by the government. Most often, government has to obtain loan to produce them. In less-developed countries, public goods might be insufficient leading to its provision by the market at a great cost.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss the different between private goods and public goods.
2. Highlight five reasons why public goods may be difficult to produce by private individuals.
3. State four reasons why government must provide social goods.
4. List two pure public goods and two impure or mixed public goods.

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MODULE TWO: THEORY AND EMPIRICAL EVIDENCE ON EXPENDITURE DEVELOPMENT AND TAX STRUCTURE; PUBLIC BUDGET, DEFICIT FINANCING AND PUBLIC DEBT. INTRODUCTION TO DEVELOPMENT PLANNING

UNIT 1 **Public Expenditure Role and Function; Budget, Deficit Financing and Public Debt**
UNIT 2 **Empirical Evidence on Public Expenditure**
UNIT 3 **Tax Structure and Its Importance**
UNIT 4 **Empirical Evidence on Tax Structure**

UNIT 1 PUBLIC EXPENDITURE: ROLE AND FUNCTIONS

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1.0 INTRODUCTION

This unit is centered on public expenditure and its significant role in public finance study. It is also concerned with budget, deficit financing and national debt. Public expenditure are those expenses incurred in the process of governance for the provision of common goods, especially those which individual or the people on their own are unable to provide efficiently. Public expenditure tends to satisfy collective social wants (Mithani, 2008).

Typical public expenditure are usually expended on items such as pipe borne water, dam, education, hospitals, roads, etc. Several economic issues are involved in the allocation of public expenditures in a federal fiscal system. Public expenditures can be defined as money allocated by governments for the provision of public goods and services (Leland, 2013). Public expenditures help educate children, keep our streets safe, help people get to and from work, and provide medical treatment to the elderly and poor, to name just a few things. They are also the playing fields for politicians. They reflect compromise, negotiation, and the interpretation of public preferences made in the halls of our capitals and state and local governments. They are part of the budgeting system that must match the revenues derived from myriad sources. Essentially, the decision to allocate public expenditures determines who gets what from government (Leland, 2013). The process of financing public expenditure usually leads to deficit and accumulated to become national

debt. Since government revenue is always lesser than its expenditure, then, it must borrow to meet up with the shortfall.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Explain the concept and meaning of public expenditure
- Discuss the importance and objects of public expenditure.
- List the role of public expenditure
- State the reasons for the growth of public expenditure
- List the limitations of expenditure under federalism with written constitution.
- Discuss the empirical Evidence of public expenditure using two country as example.

3.0 MAIN CONTENT

3.1 Meaning and Important Role of Public Expenditure

Technically, in the structure of a budget, most governments classify public expenditure into two: these are current expenditure and capital expenditure. Current expenditures include all sorts of expenditures on administration, defense and debt services. These are also called non-developmental expenditure. They are intended for continuing the existing flow of goods and services and keep the capital of the community intact. On the other hand, capital expenditures are those on commodities that are supposed to be utilized to produce other useful goods. Capital expenditure includes expenditure on infrastructure and other public utilities that are aids to long term development. They contribute to increase productive capacity of the nation and therefore, are known as development expenditures. Mithani (2008) highlighted that capital expenditures include expenditures on construction of dams, public works, and state enterprises, agricultural and industrial development.

Public expenditure depends mainly on tax and all other avenues that can generate income for the government. Apart from variety of taxes which comprise direct and indirect taxes,

government also generates revenue from public enterprises, public corporations and from borrowing both locally and internationally. All these have present and future implications on fiscal policy and economic state. For instance, imposing tax increases government expenditure, but it might also impose a threat to politicians most especially in the next general election. On the other hand, public corporations have crowding out effects on the private sector when the government borrow from the private sector to establish them, it can also increase interest rate. Borrowing, especially, external borrowings aggravates balance of payments position. As a result of these alternatives undesirable consequences, governments attempt to balance its expenditures among the competing needs of the people. Government is very mindful of its income source, balance of payments positions and fiscal policy.

In a political system consisting federal, state and local governments, maintaining fair distribution of income and allocation of resources among federal and sub-national governments is a factor to be considered while analyzing public expenditure.

Finally, the overall essence of public expenditure is to achieve economic growth and development. This is also one of the major objectives of fiscal policy. In fact, the interesting fact is that public expenditure is meant to improve the living standard of the people and to enhance their productive capacity.

3.1.1 Theoretical Facts about Public Expenditure

3.1.1.1 Market Intervention vs. Government Intervention

The assumptions of the classical economists is that the state should not interfere in the public activities because the government is just an agent of the people to keep the political organization intact, that is, government should spend public fund discretely and sparingly (Mithani, 2008). Government business in the economy is to maintain defense, security and printing of currency. The classical economists argue that if government involve in business, it will chase the private sector out of business knowing well that the private sector is the

engine of growth. It is assumed the market would do the needful in regulating economic activities. This theoretical framework held swayed till the 1930's when the market failed to rescue the world economies from depression.

Nevertheless, Keynes (1936) suggests a new method of economic management which includes government intervention through increase deficit spending to boost aggregate demand. From then on, the theory was adopted by the United States government and the US economy began to come out gradually from depression. However, whether market intervention or government intervention would be the best remains a debate in economics literature till today.

3.1.1.2 The Principle of Maximum Social Advantage (MSA)

This theory is credited to the British economist, Hugh Dalton (1920). The Principle states: "The state should collect revenue and spend the money so as to maximize the welfare of the people. When the state imposes taxes, some disutility is created. On the other hand, when the state spends some money, there is gain in utility. The state should so adjust revenue and expenditure that surplus of utility is maximized and disutility is minimized".

The principle is based on:

1. Marginal Social Sacrifice (MSS)
2. Marginal Social Benefits (MSB)

This principle is however based on the following assumptions:

1. All taxes result in sacrifice and all public expenditures lead to benefits.
2. Public revenue consists of only taxes and no other sources of income to the government.
3. The government has no surplus or deficit budget but only balanced budget.

4. Public expenditure is subject to diminishing marginal social benefit and taxes are subject to increasing marginal social sacrifice.

Marginal Social Sacrifice (MSS) Marginal Social Benefit (MSB)

The MSS is the amount of social sacrifice undergone by public due to the imposition of an additional unit of tax. Every unit of tax imposed by the government result in loss of utility" (Dalton, 1920). This means that every unit of tax imposed by the government result in loss of utility. Dalton says that the additional burden (marginal sacrifice) resulting from additional units of taxation goes on increasing i.e. the total social sacrifice increases at an increasing rate.

Conversely, Marginal Social Benefit (MSB) means the benefit conferred on the society, by an additional unit of public expenditure. Just as the marginal utility from a commodity to a consumer declines as more and more units of the commodity are made available to him, the social benefit from each additional unit of public expenditure declines as more and more units of public expenditure are spent.

3.1.1.3 Wiseman-Peacock Hypothesis

The main thesis of Wiseman and Peacock (1891-1955) is that public expenditure does not increase in a smooth and continuous manner, but in jerks or step-like fashion. At times, some social or other disturbance takes place, creating a need for increased public expenditure which the existing public revenue cannot meet. They gave three separate concepts to justify the hypothesis:

- ✓ Displacement effect: The movement from the older level of expenditure and taxation to a new and higher level probably as a result of contingencies.
- ✓ Inspection effect: Even though there might be no stochastic or contingencies, government has no motivation to return to lower level of tax or expenditure.

- ✓ Concentration effect. Refers to the increase responsibilities of the central government growing faster than the states or local government as a result of rapid economic growth.

According to them, the government and the people review the revenue position and the need to find a solution of the important problems that have come up and agree to the required adjustments to finance the increased expenditure. They attain a new level of tax tolerance. They are now ready to tolerate a greater burden of taxation and as a result the general level of expenditure and revenue goes up. In this way, the public expenditure and revenue get stabilized at a new level till another disturbance occurs to cause a displacement effect. Thus each major disturbance leads to the government assuming a larger proportion of the total national economic activity.

Although, Wiseman-Peacock hypothesis looks quite convincing, but, the authors are only emphasizing the recurrence of unexpected situations which cause noticeable jumps in public expenditure and revenue. Public expenditure has a tendency to grow systematically also a smooth increase in their intensity and quality. Increasing population, urbanization and an ever-increasing awareness of the civic rights on the part of the public, coupled with an increasing awareness of its duties on the part of the state, leads to an upward movement of public expenditure. Thus, Wiseman-peacock hypothesis is still a description of a particular tendency and does not isolate all the relevant causes at work.

Self-Assessment Exercise

Explain the Wiseman-Peacock Hypothesis

3.1.2 Objects of Public Expenditure

The following can be described as the major objectives of public expenditure:

- ➢ Administration of law and order and justice.

- For internal and external defense i.e. Policy and Military equipment.
- Maintenance of diplomats in foreign countries.
- Public administration like payment of salaries and allowances of civil and public servants as well as maintaining their offices, purchase of automobile, office equipment, furniture and fittings.
- Servicing of public debt
- Industrial development which also involves industrial training.
- Provision of infrastructure
- Provision of social or public goods

3.2 Role of Public Expenditure in Developmental Process of a Developing Country

In the developmental process of any developing country, public expenditure is very important for a successful outcome. A well-directed public expenditure can increase the pace of economic growth and development. The following are the essential role public expenditure can play with respect to the growth of developing countries:

1. Building economic and social overheads such as roads, railway, irrigation, electricity, hospitals, schools and low-cost housing, will step up the rate of growth and development.
2. Creating balanced regional growth by channeling resources to regions that are less-developed. This will reduce or eliminate current regional imbalances.
3. Development of agriculture for food security and development of industry for employment generation.
4. Provision of rural electrification and other social amenities, these would increase output production in the rural areas and stop or reduce rural-urban migration.
5. Exploitation of mineral and natural resources on a large scale and to be complemented by industrial development that use the output as input in production line. This is better than exporting the primary output from the mining sector.

Important note is that mining sector does not generate much employment opportunities, a lot of labour force members are left out because the sector is capital intensive. However, a lot of people are involved in the process of converting output of the sector into finished goods. This means that manufacturing is better and economically more rewarding for a developing country.

Self-Assessment Exercise

Highlight the major objects of public expenditure

3.3 Reasons for the Growth of Public Expenditure

Public expenditures in general increased 60-fold during the twentieth century, while per capita spending increased nearly 20 times during this period (Winters, 1996). First, it was Keynes proposition that introduced and stressed the importance of public expenditure. After the Second World War, government's importance took preeminence all over the world and this was because of the need to rebuild the WWII ravage economies particularly in Europe. The market was not adequate enough to step-up the rate of growth needed as at that time. It was at this period (the period after WWII) came the epoch of the theory of development economics as a body of study. As theorists laid emphasis on growth and development, so also was the rise in government responsibilities.

Public expenditure might vary with political ideology, economic system and social needs. Nevertheless, whatsoever political or economic system in place, the following are some of the reasons for the growth of public expenditure:

- Increase in per capita income: As per capita income rises, government responsibilities also increase. This is because per capita income poses rise in demand for public goods, this induces increase in public expenditure and upward pressure on provision of more public goods.

- The need to increase welfare: The state in the modern period, 20th and now 21st Century is a welfare state. It is delighted in provision of goods and services and their equitable distribution among the constituent units.
- Effect of war or natural disaster: War destroys public properties. Government must increase expenditure to replace damage or destroyed public goods and compensate those who suffer severe losses. Likewise, natural disasters such as earthquake, volcanoes, flood, tsunami, violent storm etc., are stochastic events not budgeted for. Their occurrences pose serious burden on government expenditure.
- Population growth: Increase in population means increase in the provision of more public goods. In fact, in most developing countries, population rapid increase put serious pressure on public spending. This usually trigger adverse balance of payments because government has to borrow as the nation's production capacity and taxation are unable to generate income to meet government needs.
- Resource mobilization: According to Mithani (2008) when the government innovates more and more methods of taxation and resource mobilization, its ability to finance public expenditure increases and the size of public expenditure grows. This are used to finance public debt, and providing public goods.
- Provision of basic infrastructure: As a developing country, the need to increase basic needs which the market cannot supply is paramount. Electricity, hospitals, roads, street lights etc., require huge capital which only government can provide.
- National development planning: Government mobilizes resources to execute national development plans. A country at the initial stage of development need accelerated growth and this stimulates increase government expenditure.

- ❖ Urbanization: The spread of urbanization is a significant factor leading to growth in public expenditure in the global age. People migrate from the rural area to the urban centres in search of better life, but the danger of urbanization is that when government fails to provide adequate infrastructure, social crises ensued. To prevent these, government increases its expenditure either through taxation or borrowing.

3.4 Reasons for Poor Outcome of Public Expenditure in Less-Developed Countries.

In less-developed countries, especially, in most Sub-Saharan Africa, it is a known fact that public utilities are in minute quantity. Although government budget for and is willing to supply the utilities such as water, electricity, schools and hospitals in the quantity demanded, but the public expenditure to make adequate supply is inadequate. This poses adverse effects on the living standard of the people. The following are the reasons why public expenditure outcomes seem far from being realized in underdeveloped countries:

- Inadequate funding: In many underdeveloped countries funding of public goods is a great challenge owing to fall in real government revenue. Another issue is the low budget allocation. In Nigeria for instance, much of the relatively low capital budget are usually not executed. Most budgeted fund are never released and when they do sometimes, they are prone to mismanagement and poor accountability.
- Rising cost or crooked increment of the cost of procurement: This relates to the cost of financing public goods. When cost or price of a project or items are inflated, it reduces the effects of public expenditure.
- Planning failure: Often, government plans expenditure to meet certain targets and to achieve some objectives, however, at implementation stage there could be failure because of proper project evaluation or inadequate attention to significant details or logistics.

- Political influence: Unhealthy political games or politicizing critical needs of the people may prevent the provision of essential facilities. It can cause misplaced priority where resources are allocated to regions where they are less needed.
- Foreign debt overhang: Rise in external debt is a threat to any underdeveloped countries. Most encounter adverse balance of payments and as a result are handicapped to borrow more to finance fiscal expenditure.
- Underdeveloped resources: Resources in poor countries are either undeveloped or undeveloped, by this, government loses more revenue which could have been employed to increase expenditure.

Self-Assessment Exercise

Mention two reasons for the growth of public expenditure.

3.5 Public Budget

3.5.1 What is public budget?

The economist views budgeting as a matter of allocating resources in terms of opportunity cost where allocating resources to one consumer takes resources away from another consumer.

The Chartered Institute of Management Accountants defines public budget as a plan stated in quantitative monetary terms which is prepared and approved prior to a defined period of time usually showing planned income to be generated and or expenditure to be incurred during that period and capital to be employed to attain a given objective.

Smith and Lynch (2004) gave an operational definition of budget, "A budget is a plan for the accomplishment of programmes related to objectives and goals within a definite time period including an estimate of resources required, together with an estimate of resources available usually compared with one or more past periods and showing future requirements".

Self-Assessment Exercise

Define public budget

3.5.2 Types of Public Budget

A budget can be surplus balance or deficit.

A budget surplus is when government revenue exceeds its expenditure.

A budget deficit occur when government expenditure exceeds its revenue

A balance budget is the equality of government expenditure and government revenue.

The desire of any responsible government or the best practice is to have balance budget.

Budget surplus is not desirable, particularly for developing countries, because it might lead to waste of national resources or leakage. On the hand, when a nation continues to have budget deficit year-on-year, it becomes a national problem because the nation can enter into adverse balance of payments problem.

3.5.3 Classification of Budget

Budget can also be classified as the executive and legislative budget. The two are explained below.

3.5.3.1 The Executive and Legislative Budgets

A legislative budget is the one which is prepared and adopted by the legislature directly or through its committees. An executive budget, on the other hand, is the one which is prepared by the executive branch of the government. Such a budget is also normally passed and adopted by the legislature but the initiative is in the hands of the executive.

3.5.3.2 Unified Budgets and Multiple

A unified budget is a federal government budget in which receipts and outlays from federal funds and the social security Trust Fund are consolidated. This type of budget is mainly associated with the United States of America. On the other hand, in a **multiple budget,** the true results of the fiscal operations of the government budget get scattered and have to be traced out through various documents.

3.5.3.3 Conventional and Cash Budgets

Another distinction is made between the conventional (or administrative) budget and the cash budget. Apart from the minor differences, the main difference between the two is that in the conventional budget, revenue and expenditure are shown on accrual basis and those flow of funds are excluded which do not belong to the government. Thus, the conventional budget always presents an inadequate picture of the government activities. In the cash budget, on the other hand, all the flows of funds to and from the government of actual payment basis are shown, inclusive of funds which are not owned by the government. Cash budget, therefore, is invariably larger than the conventional budget and better representative of reality.

3.5.3.4 Revenue and Capital Budgets

In many countries, the budget is divided into revenue (current) and capital accounts. Revenue account covers those items which are recurring nature; while capital account covers those item which are in the nature of acquiring and disposing of capital assets. It is maintained that every economic unit must distinguish between current expenses and those incurred for acquiring of capital assets.

Self-Assessment Exercise

State three types of public budget

3.6 Deficit Financing

Financing government expenditure with debt is fast becoming a custom in the modern time. Spending more than earnings makes the incumbent government looks good to the public. But when deficit increases rapidly, then the nation begins to lose credibility at the international financial market and its balance of payments position tends to be worsening. The desire of every nation is to have minimum debt profile and maintain favourable balance of payments.

3.6.1 Definition of Deficit Financing

Deficit financing is when government makes more public expenditure than its revenue. It is a common practice among government in the age of civilization. Deficit financing is a practice in which a government spends more money than it receives as revenue, the difference being made up by borrowing or minting new funds. In the advanced countries, financing deficit means an excess of expenditure over revenue, the gap being covered by borrowing from the public by the sale of bonds and by creating new money. Deficit financing allows the government to obtain more resources and, in general, to change the mix of its output in the direction of more public sector goods and fewer private sector goods (Robbins, 2005). In Nigeria and most sub-Saharan African countries, deficit financing has resulted in to huge public debt and threatening economic instability. Nevertheless, deficit financing, in all ramification is not bad. It can help speed the pace of economic growth and development if properly used. The following are some of the reasons why government goes into deficit financing:

- Large and ever increasing annual budget
- To correct government fiscal position
- To offset short run adverse financial position
- To execute critical capital project
- To maintain existing capital project

- To mitigate the adverse effects of contingencies
- To increase the provision of public goods.
- In a worse scenario, government incur deficit to finance existing debt (debt servicing).
- Huge capital expenditure, but most often, huge current and re-current expenditure.

Deficit financing involved funding and expansion of government expenditure. In developing countries, government revenue or income is often not enough. Government has to borrow. Below are the major financial sources of deficit financing:

- Borrowing from domestic economy. Government can borrow from the financial institutions, but it can affect the private sector by increasing the rate of interest.
- Issuance of both short term and long term financial instruments like treasury bill and bond.
- Government can borrow from foreign countries and foreign creditors. Some of these include London and Paris Club of creditors
- The International Monetary Fund (IMF) and World Bank also give loan to countries to offset recurrent expenditure and capital projects.

For developing countries, the long run implication of deficit financing is huge deficit which must be paid back. Since the ability of paying depends on revenue which often is not substantial enough, then countries go into deficit overhang and unfavourable balance of payments and are unable to embark on profitable and successful developmental programmes.

Self-Assessment Exercise

Highlight four reasons why government has to finance its expenditure with deficit

3.6.2 Effect of Deficit Financing on Economic Growth and Development

Deficit financing has implication on economic growth and development of a country. It has both positive and negative effects. The list of the effects is endless and vary across countries. However, some of the negative effects of deficit financing common in a typical developing country (like Nigeria) are highlighted below:

- ✓ Deficit financing of government expenditure gradually removes a nation's sovereignty and consequently impedes economic growth.
- ✓ It opens a nation to international dependency.
- ✓ It can cause inflation. Inflation is increase in general price level. More debt requires conditions in which one is domestic currency devaluation. This leads to increase in the prices of foreign imported goods, bearing in mind that a developing country like Nigeria is an import dependent country.
- ✓ The pace of economic growth and development becomes sluggish because of the need to pay or service debt from revenue which could have been utilized for development.
- ✓ Rapid population growth placing high demand on infrastructure which in turn requires government spending. However, since government revenue is not always enough, there must be deficit financing.
- ✓ Financing public projects with deficit might generate "crowding out" effect.
- ✓ In the wake of poverty alleviation programme, government often borrow money to meet the challenge of executing the programme, thereby raising public deficit financing.

On the positive side, deficit financing might be beneficial to a nation in order to meet immediate financial challenges and contingencies. Sometimes, the imperativeness of deficit is as a result of the fact that government has to provide public goods which the private sector cannot provide because of huge capital requirement. Therefore, to step-up the pace of developmental programme, government might embark on deficit financing.

Self-Assessment Exercise

List the effect of deficit financing on economic growth and development

3.7 Public Debt

3.7.1 Meaning of Public Debt?

In Public sector economics, public debt only refers to national debt. It is the total sum of money owes by a country both internally and externally. Some economists are of the opinion that public debt is how much a country owes to lenders outside of itself which can include individuals, businesses, and even other governments. The term "public debt" is often used interchangeably with the term sovereign debt. It is sometimes also referred to as government debt. It represents the total outstanding debt (bonds and other securities) of a country's central government. Debt can be domestic or foreign debt. These are discussed below.

Self-Assessment Exercise

Define public debt

3.7.2 Domestic debt or internal debt vs foreign or external debt

Domestic debt are those incurred within the domestic economy such as bond, banks and treasury securities. It is the part of the total government debt in a country that is owed to lenders within the country. On the other hand, **foreign/external debt** is money borrowed by a government, corporation or private household from another country's government or private lenders. It includes obligations to international organizations such as the World Bank, Asian Development Bank (ADB), and the International Monetary Fund (IMF). We can also have **private debt**, this is debt incurred by private individuals or firms for personal purpose. Similarities between private debt and personal debt are highlighted below:

- A private individual or firm cannot borrow from itself, whereas government can borrow from itself, its own subjects and within the country.
- While a private economic unit can repay the debt either out of its earnings, accumulated assets or from other sources, the government is the creator of currency and can pay its debt straight-away by creating more of it. However, external debt can be discharged in this manner only if it is repayable in local currency.
- Public borrowings have a profound effect on various dimension of the economy - distribution, capital accumulation economic growth, income and employment stability, and so on. This way, public debt is both a source of problems and a tool of economy management in the hand of the authority. Private debt is only a problem to individual private person or firm that owes it.

Reasons for public debt are stated below:

- Government revenue is often not enough to offset expenditure. Or putting in another perspective, expenditure is always greater that revenue. In the developing countries the difference between revenue and expenditure is often negatively high.
- Incessant increase in annual budget.
- The need to "bail-out" in the event of global economic melt-down or severe downward trend of trade cycle.
- The need to provide critical infrastructure such as roads, railway and electricity.
- Future occurrence of unexpected disease epidemic like virus or cholera outbreak.
- There may be sudden increase in government expenditure. There may be wars, or natural calamities in which case the government would be forced to incur much larger expenditure and may run into a debt.

The effects of public debt in developing countries are usually severe and might threaten nation's sovereignty. It can cause turmoil and dethronement of a government. It can even lead to bankrupt and unworthy of financial support. Apart from these, below are some

major effects of public debt, especially, when they are large and increasing (like the case of Nigeria):

- The nation that keeps borrowing will eventually become bankrupt and unworthy of credit facilities.
- It can leads to policy reversals as donor nations or foreign creditors may refuse to grant loans.
- It opens domestic economy to external shocks.
- Inflow of foreign direct investment (FDI) or foreign private investment (FPI) stops.
- It subjects a nation to international dependency.
- Development programmes become difficult or almost impossible to attain.
- With all these, development plan, economic growth and development become unattainable.

3.8 Development Planning

3.8.1 Definition of Development Planning

Development Planning can be defined as systematic economic planning made by the central government of a country as a means of accelerating the rate of growth of the economy and improving the standard of living and general social welfare of the people. In other words, national development plans seek to increase the common good of society which should be the ultimate aim of every person and every sector of an economy (Cevat and Dallen, 2001). In a simple sense, "**Planning** is a technique, a means to an end being the realization of certain pre-determined and well-defined aims and objectives laid down by a central planning authority" (Jhingan, 2016).

Self-Assessment Exercise

Define development planning

3.8.2 Rationale or Reasons for Development Planning

The following points are various reasons for formulating development planning in a country.

1. **Market failure**: This is a fundamental problem in economics. The market system assumes perfect adjustment mechanism of the market where by supply can always create its own demand. The assumption in the classical views also include perfect distribution of resources, perfect information, equitable distribution of income, full level of employment and market equilibrium at all time. However, in real life situation, these assumptions do not always hold, therefore the market fails and needs to be corrected. The institution often ready to correct the failure is the government which in turn must plan appropriately to achieve results. Some of the government efforts to correct market failure in planning are explained below:
    - Government may deregulate the economy to allow the market to work more efficiently, but if the market still remains inefficient, then government fully intervenes through direct control. However, neoclassical market fundamentalists believe government would again distort the economy especially by borrowing from the private sector (crowding out effect), creating public goods and strict or direct control.
    - Poverty alleviation programme (PAP) is also part of planning whereby government strategize to channel resources to the less privileged to improve their living standard. Market assumes "no free lunch"
    - Externalities like environmental pollution, and particularly, public goods meant failure to the market system. Public goods might be government created goods such as roads and street light. Market price is not usually charged on public goods. They have special characteristics of non-depletability and non-excludability. However, shadow price becomes an

issue that should be addressed over public goods because in the long run this may cause the market to fail. Privatization or commercialization of public enterprises is another way of correcting market failure. In addition, environmental pollution, which might reduce people's welfare, can be corrected or reduced through taxation or strictly regulate production activities.

2. **Resource mobilization**: Development plan puts pressure on the public sector the need for resource mobilization both internally and externally to finance the plan. Savings, public enterprises profits, borrowings, taxation deficit financing and reserves are the principle internal sources of finance for the public sector. Foreign aids, long term developmental fund from foreign countries, in addition, form the external source of financing the plan. Often, to receive foreign assistance there must be planning policy paper, where the terms, objectives and duration of the plan are clearly documented.

   This gives the creditors assurance of proper and efficient use of the fund and assurance to repay loan received.
3. **Economic growth and Development**: Economic growth is increase in national output over a period of time. Development is growth plus increase in welfare of an average citizen. Growth is prerequisite to development. Development also means substantial reduction in poverty, unemployment and inequality. Therefore, it is necessary to have a well-documented development plan to attain economic development and improved welfare of the citizen. .
4. **Attitudinal and psychological factor**: A country can project to be great in future. With a development plan, this will be itemized in a comprehensive development plan induces mobilization by government and stakeholders to embark on social campaign and sensitization towards realization of the set goals. This then calls for change in mind set, perception, sensitivity, vision, life style and consequent elimination of social factors that does not cooperate with set planning goals.

5. **Foreign aids**: Foreign aids such as official development assistance (ODL), grants and debt cancellation can assist a nation to finance her developmental objectives. A well-documented development plan enhances these foreign aids.

Unforeseen disturbances: There are certain occurrences that are very unpredictable. For instance, there may be disease outbreak or drought, planning cautions the negative effects these might generate in future. With respect to these, good development plan can include in its policy thrusts setting aside certain funds as contingencies and creating public awareness on disaster outbreak. The fund could also include creating adequate social security such as health and auto-insurance, silos or food security etc.

3.8.3 Prerequisite for a Successful Development Planning

For development planning to be successful there are essential points that must be noted. The vital prerequisite for planning are highlighted below:

- Planning commission: In any development plan, planning commission is important. It should be organized in a way consistent with development objectives. It should have many functional components each pursuing common goals. Several divisions and sub-divisions must be made as well as different departments headed by competent leaders. These departments must be made up of trained personnel and technocrats such as scientists, engineers, economists, accountants and sociologists who are working in unity for a common end. It is important to emphasize that a result oriented plan requires a "round peg in a round hole". This means that only those who have values to offer must be involved or employed by the commission. It might be an inevitable plan to failure if planning commission members are employed based on religion, culture or clan.

- Statistical Data: it must be reliable and available for use. This requires adequate funding of the bureau of statistics to provide reliable data as at when due.

- Efficient and corrupt-free administration: Planning induces large use of scarce resources which have alternative uses. Efficiency inculcates the best use of scarce resources to finance developmental programmes. It is therefore necessary to employ the most efficient group of personnel into the planning commission. In addition, efficiency can easily erase corrupt administration. However, corruption can destroy efficiency. Inefficiency and corrupt administration are twin evil that must not be allowed to abort development planning.
- Balanced development strategy: According to Jhingan (2016), a plan should aim at achieving balanced development of the economy to prevent shortages or unnecessary surpluses as plan progresses. For instance, there should be balance between investment and savings, import and export, revenue and expenditure, supply and demand of goods, supply of primary or intermediate inputs and aggregate demand.
- Clear Objectives and Policy Thrusts: The objectives and policy thrusts must be realistic, mutually compatible, and flexible in keeping the means requirement of the economy. The objective should not be conflicting. For instance, we should not have a poverty alleviation programme and simultaneously fuel price increase; Reduction in unemployment and retrenchment; increase in salary and wages and increase in tax.

In spite of all these, it is important to note that planning is not an end in itself. When we plan, it does not automatically lead to economic development. Planning is not necessarily a guarantee for a better economic performance, this is because comprehensive development planning has been made in many developing countries but produced no development. According to Arthur Lewis (1949, 1954) making development planning is the popular activities of developing countries and it is also their biggest failure. Most development plans are set aside soon after they are made. This is common with plans that are not meant for action but for pure political propaganda and pure fantasy. Most plans are swept under the carpet by a new regime or those who made them.

Self-Assessment Exercise

Discuss the rationale for planning

3.8.4 Problems of Development Planning

Development planning is usually associated with variety of problems, some of these are explained below:

1. Dearth in reliable statistical data: In most underdeveloped countries, unavailability of reliable data is prevalent Statistical data is a key foundation for any development planning. Without data that are reliable, planning commission would be handicapped in discharging their duties and be unable to put appropriate planning mechanism in place.
2. Distorted macroeconomic policy framework: Sound macroeconomic policy framework is required for a good plan. Macroeconomic indicators such as inflation rate, exchange rate, and interest rate must be stable for the goals of development plan to be attained.
3. Price Volatility: Let us consider the issue of the exogenous price factor. Development is based on a constant external price like oil price which is exogenous. Crude oil price is determined at the international level. If an accurate prediction of this price is not made, it may serve as a doom for planners. For instance, the Nigerian Third National Development Plan (1975-1980) was based on constant high oil price in the 1970s. The gradual decline in oil price from 1975-1980 resulted in failure of full implementation of the plan.
4. Future uncertainties: Development planning is designed with future optimism. Planning commission expected that the vision of a plan would be reached. However, future uncertainty such as natural disaster, war, bad weather, diseases and price volatilities may halt the dream of a plan.
5. Assumption of fixed relation between factor input and output: Factors inputs such as labour and capital are resources a company uses to generate output of goods and

services. Often, planners assume these are in fixed proportion, but sometimes, distorted planning implementation and unexpected economic or social factors may prevent planners or planning commission from attaining the desired relations. Increase return to scale is the most desirable outcome of planning.

6. Lack of harmony between private and public sector plans: In most underdeveloped or developing countries, there is always disjointed communication between the private and public sector as well as difficulty to agree on a particular pattern of planning. This slows down planning process and prevents smooth implementation.
7. Non synchronization of development plan and annual budget: Although, development plan and annual budget are, to some extent, two different mode of planning, but one can complement another. If there is a separation between them, each might be affected negatively thereby leading to planning failure.
8. Lack of proper project monitoring and evaluation: Projects are key instruments to attain planning goals. If the projects are not properly monitored and evaluated, they might prevent planning objectives from being realized.

3.8.5 Types of Planning

There is no world-accredited formality for planning types because planning may vary proportionally to the economic development and economic system. Planning still has some characteristics though. The strategy to use in this unit is to explain comparatively, types of planning that are common.

1. **Budget and Development Plan**: A budget, is a financial plan on income and expenditure of a government of a country expressed in monetary terms. Although budget could be done periodically, but usually, it is made to last for one year and this is why it is called annual or yearly budget. The Nigerian government made annual budget usually read by the president. Government explains the expected revenue or income for the year and expenditures to make. In a military regime, the budget may be made by the president and the supreme military council alone. It is

not the same thing in a democratic government where the national assembly must examine and approve the budget. On the other hand, **development planning** is usually adopted by the government to direct the country towards resource mobilization and resource distribution in order to step-up economic growth. It can also mean an agenda or policy of a new government towards fast economic growth and development. Development planning may cover a period of 5 to 20 years. Nigeria as well as other developing countries in Africa had various national development plans. Some of the key objectives of a typical development plan are:

- Increase the pace of economic growth and development
- Resources mobilization and redistribution
- Identification of priority sectors and setting targets to attain developmental strategy for such sectors.
- Direction of people's orientation towards national goals
- Formulating policy thrust to attain set developmental goals

2. **Perspective planning and annual planning**: Perspective plan refers to long term planning whereby long range targets are set to achieve a goal. It is a scheme of development to be undertaken over a long time. For instance, government may set a target to eliminate infant mortality within a period of 15 years and within this period government may set short term plan or target like 3-4 year's goals to achieve a certain number of infants that must be saved. There may be some unpredictable future events which might limit the effects of long term plan, this induced division of perspective plan into short term like 3 to 5 years plan. These short periods plan enable necessary adjustment to policies in the plan. Government may also set poverty eradication goals such as "poverty eradication by year 2030"; "Attaining global heights in human capital development by year 2025". In the past, Nigeria had 'vision 2010' under the General Abacha government, and 'Vision 20:2020' after the expiration of 'Vision 2010'. The vision '20:2020' aims at Nigeria becoming one of 20 most developed countries in the world by year 2020. The main

purpose of a perspective plan is to provide a background to short term plans so that problems that have to be solved over a long period can be taken into account in planning over a short term.

On the other hand, annual planning may refer to the national budget or planning to complement development goals in the perspective plan. It could also be a short term planning for quick resource mobilization. It is necessary for planning to have these because if a country does not have absorptive capacity of foreign capital inflow, it may fall into debt crises and planning failure. In summary, annual planning and medium term planning are usually sandwiched between a perspective plan to attain the objectives.

3. **Indicative and imperative planning**: Indicative planning is a kind of flexible planning adopted by a nation in an effort to solve the problem of imperfect information in the capitalist and mixed economies in order to increase economic performance. The government made plan to fix price and determine the appropriate price of factors, and type of quantity of products to be produced. This type of planning is common in mixed economy like France and in capitalist economy like the United States. Indicative planning is in contrast to directive or imperative or mandatory planning where a state sets compulsory output or price requirements. Indicative planning is not compulsory; it is just part of government efforts to regulate the economy so that the private sector can cooperate in the success of planning targets.

   Imperative planning requires heavy presence of the state in resource allocation, price and output settings. The resources are used intensively in order to attain the goals of a plan. There is no consumers' sovereignty, but they obtain commodities in fixed price and quantity. What to produce and how to produce are set by the state and the planning commission disseminates the information to the firms which must be strictly followed. This type of planning is common in socialist or communist

countries like China and North Korea. Nevertheless, efficiency and competitiveness of firms remain a debatable issue under this type of plan.

4. **Authoritative planning and democratic planning**: In authoritative planning, there is central control of all planning apparatus. It is a totalitarian planning where planning is grounded on the supreme leader's hegemony. There is central control and direction of all economic activities in accordance with a single plan. The people must obey the planning scheme and are not allowed to act contrary to it. The North Korea might be a good example of authoritarian planning model in the 21st Century. Some theorists like Francis (2015), Hayek (1938) and Lippman (1934) & 1925 have argued in favour of totalitarian planning. They claim that planning is incompatible with democracy, that "what was promised as the road to freedom was actually a high road to serfdom". Lippmann (1934) was in support of social liberalism whereby the state dictates means of production. The strict adherent to planning model in this type is to increase the pace of attaining the targets set within stipulated period and according to schedule. Still, authoritarian planning is not strictly recommended for most underdeveloped or developing countries because of the heavy price to pay and the inherent welfare lost that the people may face. On the other hand, democratic planning, where there can be inclusiveness and maximization of society welfare may be better. A well designed democratic planning is more like to be Pareto optimal.

   Democratic Planning; in democratic planning, nearly every member of the economy is carried along**.** Democratic planning means planning within democracy that is, planning with the people or with their representatives. The philosophy of the people's representative is accepted as the ideological principle. This means that every step taken towards achieving plan objectives is with the consent of the people.

Self-Assessment Exercise

1. Discuss two types of planning

2. State four effects of ceaseless public debt
3. Distinguish between authoritative and democratic planning

Government should not always borrow, especially, in the way of the Sub-Saharan African countries, in order to achieve favourable balance of payments and sound external balances. The following are what can be done to avoid borrowings that are detrimental to the economy in the long run:

- Stability of macro economy
- Increase domestic production capacity
- Cut down unproductive recurrent expenditure
- Government should desist from ambitious projects
- Seeking favourable terms and conditions of debt and its re-payment
- Prudential financial management

Self-Assessment Exercise

1. State four reasons why government has to borrow
2. What can government do to avoid debt?

4.0 CONCLUSION

This unit has given the meaning and definition of public expenditure. It also discusses national deficit financing, budget and public debt. The topic is an integral part of public finance. Government makes both current and capital expenditure for the growth of the economy. Government also uses its expenditure to provide public goods. Tax collection is the major source of public expenditure. However, tax is hardly always enough to meet the unlimited government wants. This is because government budget is always huge and always want to meet its obligation as the masses mount pressure. Although, public expenditure has achieved great outcomes in developed countries, but in developing countries, owing majorly to financial incapacitation, there has not been much successful

outcomes of public expenditure. Development planning is also highlighted in this section. Planning is needed to step-up economic growth.

5.0 SUMMARY

In this unit, we have discussed some important aspect of public finance. The unit discussed extensively public expenditure, meaning and objectives. We also discussed the important role of public expenditure and some theoretical underpinnings. The role of deficit financing, debt and budget are also discussed. The roles of public expenditure in developing countries are also highlighted which include building economic and social overheads such as roads, railway, irrigation, electricity, hospitals, schools and low-cost housing; creating balanced regional growth and development of agriculture for food security; and development of industry for employment creation. Yet, all these require huge budget, public debt or deficit financing. Finally, a comprehensive development planning may assist in achieving growth and development and emancipation from international dependency if the plan is inclusive and value oriented.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the concept of public expenditure.
2. List four fiscal reasons why public expenditure might not achieve desirable outcomes in underdeveloped countries.
3. Discuss the problems of development in Nigeria
4. Differentiate between deficit financing and public debt.

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UNIT 2 EMPIRICAL EVIDENCE OF PUBLIC EXPENDITURE

CONTENTS

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    3.1 Empirical Evidence of Public Expenditure in OECD/Europe
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1.0 INTRODUCTION

The empirical evidence of the effects of public expenditure on the economy varies across countries and regions. In Europe, America and South East Asia, public expenditure has recorded great achievement in economic development. The purposeful budget estimates, functional fiscal policy, sound macroeconomic framework and relatively macroeconomic stability have ensure public expenditure delivered the expected outcomes. This is not the same in Africa, particularly the Sub-Saharan Africa (SSA) where public expenditure is far from meeting the targeted outcomes. The effect is felt from inadequate social infrastructural provision, prevalence of diseases, high mortality rate and high underdeveloped human resources. This module unit focuses on the empirical evidence of the effect of public expenditure on different countries of the world. To prove our argument, we look at different research work done by several authors.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Discuss the empirical evidence of public expenditure in OECD/Europe or the advanced countries.

- Discuss the empirical evidence in Sub Saharan Africa
- State the reasons for diversity in public finance in OECD and Africa

3.0 MAIN CONTENT

3.1 In the discussion of public expenditure, the countries in the Northern hemisphere appears to have done greatly well. The European Union (EU) and North American countries have had mixed experiences about effects of public expenditure on various economic variables. They come under one umbrella called the Organization of Economic Cooperation and Development (OECD) and tend to have the same pattern of capitalist economies. Literature abound to prove that public expenditure has both positive and negative effects on the economy, nevertheless, with reference to expenditure on roads, defense, education and health, the OECD and the EU public expenditure in general is one of the most significant in the world. While most studies on public expenditure in these countries confirm positive effects of public expenditures on social goods such as health and education, few others find negative effects. The position of some studies is ambiguous though. Moreover, in Africa, performance of public expenditure appears to be relatively insignificant. This may be as a result of several factors limiting effectiveness of fiscal policy. Some of these factors include poor policy design, poor planning, and improper variables (transmission channels) to successful policy targets and outcome. The relevant literature on the effect of public expenditure are reported in the next sub-sections.

3.1.1 Public Expenditure Evidence From the EU/OECD and the Emerging Economies

For the advanced countries in European or the Organization of Economic Cooperation and Development (OECD), there were both positive and negative effects of public expenditure on various economic variables. Bech, Christiansen, Khoman, Lauridsen and Weale (2011) examine the effect of public expenditure on health care of ageing population in 15 European countries; Bartels, Cozzi and Mantovan (2013) on public expenditure versus volunteer donations. These authors found that public expenditure produced desirable outcomes and that more (private support or donation) is required in addition to public

spending to improve the peoples' welfare. While Bartels *et al.,* (2011) suggest that volunteering should complement expenditure, Khoman *et al.,* (2011) noted that, health expenditure is not enough and should be increased.

In a number of models to test the performance of public expenditure growth for USA and Britain. Alt and Chrystal (1981) find that government expenditure grows in proportion of national income. They observe a probable limited role of public expenditure in economic stabilization policy. It is suggested that institutions for expenditure control also matter to determine the growth of public sector consumption expenditure rate. Gould (1983) for Japan examine the composition of public expenditure. They note that though public sector composition of public expenditure is smaller in developing countries relative to the Western world, but this has started to increase in favour of provision of public goods and services in order to increase the Japanese standard of living. For United States and some countries, Anderson (1997) and Anderson *et al* (2000) find that even though the USA has spent more on per capita health than other countries, its health outcomes are not near the top. On the other hand, Wolfe (1986) argues that there is a positive link between medical expenditures and health status once lifestyle factors such as cigarette and alcohol consumption are considered

Still on the positive effects of public expenditure, Hauptmeier, Heipertz and Schuknecht (2007) carry out research on expenditure pattern in some developed countries, part of the work is to examine the effect of reforms which include expenditure cutback, macroeconomic framework reforms and other structural reforms, on economic growth, they discover that ambitious expenditure retrenchment or reduction result in improvements in fiscal and economic growth indicators. This appears to be contrary to Lamartina, and Zaghini (2008) for the OECD countries. They submitted that increase public expenditure follows Wagner's law because it increases economic growth in the OECD countries.

While the literature above proved positive economic effects of public expenditure, on the other hand, there are some literatures that establish negative effects. In Italy, Prota and

Grisorio (2018) suggest that fiscal consolidation strategies have not had growth-friendly expenditure composition, and that it reduces the share of discretionary spending such as public investments. Vu Le and Suruga, (2005) did a cross country of the effect of public expenditure on economic growth. Their findings suggest that public non-capital expenditure has a negative impact on economic growth, and excessive spending in public capital expenditure can hinder the beneficial effects of FDI. These are supported by the work of Furceri (2007), Poterba (1994), Levinson (1998), Lane (2003).

As pointed out earlier, the advanced capitalist countries record obvious increase in public expenditure particular since the 1950s. It means fiscal policy has been one of the major policy instruments employed to manage the economy. Even though there seems to be ambiguity in the effectiveness of fiscal expenditure on public goods provision, most authors underscore public spending as a key impetus to economic growth and therefore recommend more of it.

For the BRICS, that is, economic cooperation among developing countries comprising Brazil, Russia, India, China and South Africa, Kulkarni, (2016) study supports the finding that in developing economies, where the per capita incomes are low, indiscriminate increase in the government expenditure, particularly on health, with its high opportunity cost, can have adverse effect on health outcomes. The possible reason for this anomaly can be that the marginal benefit from increased public expenditure can be less than the marginal cost of higher taxes. They found a negative relationship between public health expenditure and infant mortality rate. These findings support the evidence from the prior literature that an increase in the size of public health expenditure cannot assure increased health outcome. Furceri (2007) examine cross country effect of government expenditure on growth for both developing and developed countries. He found that expenditure volatility has negative effect on growth in developing countries; however, its effect on developed countries is not significant in the long run.

In addition, there is a significant number of Asian countries recording diverse effects of public expenditure on economic performance. Also, there are some examining factors determining or inducing growth of public spending. Saez and Sinha (2010) examine factors determining public expenditure increase in India, their findings are that political activities are very significant in determining effectiveness and rise in public expenditure in the country. Political activities are found responsible for increase in public expenditure on education, health and provision of crucial social amenities to step up economic growth. In fact, quite a good number of empirical literature for the Asian economies stress public expenditure essential role in providing social goods like education and health. These, according to them, have significantly contributed to productivity, and raise living standard. Some of these literature include (Li, Lian and Zhang 2018; Devarajan *et al* 1996; Zagler and Durneker, 2003). From these series of literature, one notices importance of government expenditure in provision of some essential goods and services for the purpose of economic development.

The less-developed countries can copy these ideas and the zeal to bring government close to the people through adequate provision of goods and services basically to improve the living standard of the people. Moreover, specifically for the BRICS, the authors unambiguously pointed out negative effect of excessive spending and its volatility. Note theoretically, as a nation develop rapidly (Wagner, 1911), public expenditure increases, and this is followed by further rise in public expenditure and growth which again prompts more public spending. This appears to be the background of fast developmental story of the emerging economies in Asia. The authors working on the BRICS, however, caution against spending profligacy of political officers to prevent deficits overhang.

3.1.2 Public Expenditure Evidence from the Sub-Saharan Africa (SSA)

Diverse literature also exist for the SSA. Quartapelle (2013) observe that aids from foreign countries have been the major sources of government expenditure on public goods such as education and health. Adding that as long as there is an increase in demand for public

goods, expenditure will increase and be financed from aids. This might jeopardize self-reliance effort. Dowrick (1993); Tanzi and Schuknecht (2015) observe that it is unproductive to increase government size beyond certain level because of diminishing return to welfare gain. Therefore public spending should be minimal to prevent too powerful government. Dowrick (1993) do not find a significant and systematic effect of the size of government on growth.

In the late 1980s to the mid-1990s, some authors examine the effects of public spending on defense being a pure pubic good. There was handful of sectarian and tribal wars in Sub-Saharan Africa in the period. Dunne and Mohammed (1995), Mohammed (1992), Sampson (1991) and Ron (1989),to mention a few, are some of the authors who attempt to understand defense expenditure with welfare of the citizen. It is found that expenditure on defense is rather too high, hinder provision of critical public goods and produce zero economic growth. In summary, they suggest that less spending on military hardware in favour of increase spending on health, education and critical infrastructure. Like previous authors on Asian economy, government concentrating on provision of infrastructure and essential goods, other than defense, add to the economic prosperity of the South East Asia. He advised the SSA should do same.

Some recent literature on Sub-Saharan Africa, focus on public expenditure effects on health delivery and strategies to provide qualitative health services. It has been observed that government spending is too low to sustain health services probably own to corruption in individual country. Micah *et al.,* (2019) noted that the global health community begins to focus on ways to generate and track domestic government health spending in countries in SSA. They suggest that individual country sociopolitical characteristics such as perceptions of corruption in the public sector may be important in explaining whether countries are able to generate more resources for health. This result was supported by Akinlo and Sulola, (2019) who examine the impact of public health expenditure on under-five and infant mortality rates in 10 selected SSA countries for the period 2000–2008. The

results show that government health expenditure has a positive effect on under-five and infant mortality. However, GDP per capita, health aid, HIV prevalence and immunization have significant negative effects. It was suggest that health care expenditures have not been translated to improvement in under-five mortality in SSA which might be a result of high level of corruption adversely affecting SSA countries.

Self-Assessment Exercise

The SSA have public expenditure experience, explain

3.1.3 Empirical Evidence of Public Spending in Nigeria

Like many developing countries, in Nigeria, government has played a major role in public financing. The main objectives/targets of public expenditure in Nigeria are stated below:

- Accelerate the pace of economic growth.
- Achieving set target for development plans.
- Poverty reduction via various poverty alleviation programmes.
- Provision of infrastructures and rehabilitation of the existing ones. Adequate infrastructure enhances self-employment, ease the burden uneasy life.
- Increase human resource development through provision of public schools and hospitals.
- Protect the territorial integrity through functional and reliable defense corps.

Nigerian government performs these objectives and are stated in the annual budget. The issues that come up are how much of these are needed and how much is attainable subject to cost or revenue constraint? How much has the government expended to achieve the existing ones? What are the effectiveness of the spending on living standard? There are plethora of literature on public expenditure in Nigeria, their findings examine public spending and its significant role. Like most SSA countries, they found that Nigerian government has spent heavily on defense at the expense of social infrastructures and

economic growth. The relative expenditure on defense and many unproductive activities are too high. These have reduced the proportion available for social goods and maintenance of welfare of the citizenry.

Few authors in recent times have shared this line of thought, they include Matthew and Mordecai (2016); Isaac, Sunday and Adeleye (2017); Otiwu, Chukwu and Okere (2018); Adedeji1, Ajayi and Tizhe (2019). Although, there are some authors who also believe otherwise, but it was generally highlighted that public spending effects is negatively related to growth in Nigeria. In few cases where they are positive, they are not significant. There is a need to revisit the proportional swap between defense and social goods. Elimination of corruption and prudential management of spending are suggested by the authors. In other words, if public expenditure are directed to productive sectors and is adequate, economic growth would be attainable.

Significant number of authors confirmed that in less developed countries public spending is mainly used for defense and acquisition of military hardware. The amount spent on social goods, like health and education, is not adequate because much has gone to defense. Since public expenditure has alternative uses and cannot be increased in a hurry to meet all wants, if much is allocated to defense and armaments, less will be available for social goods. In addition, if too much is consumed in the process of corruption, a little or nothing is left for developmental projects. On the hand, in the advanced countries as well as emerging economies, as observed, significant level of public expenditure is been spent on infrastructure, bailouts, subsidies, parks and recreation. All these have complemented developmental process and the people's wellbeing. We might underscore the sources of such significant expenditure level: tax and domestic debt sourced from private savings.

Now, let us take Japan as an example as a typical developed country with sufficient fund, making public expenditure and providing effective and adequate public goods. The flow of private savings into public spending is very high in Japan. A key fact characterizes Japanese public spending is the source. The Japanese government would rather source fund

from the Japanese private savings. The private individuals are indifference to zero interest rates on their savings. As a result, government or prospective investors can borrow at zero interest rate. This is the reason for the high Debt-to-GDP ratio the country, about 236% (WDI &IMF, 2017) the highest in the world. It does not hurt the Japanese economy because it is sourced from within the economy. It is not wasted and it is for provision of efficient and adequate public goods and also for human development. The inference drawn here is that the wealth of Japan, relative to international movement of capital, appears to be sticky upward except for investment. This strategy has helped retaining real fund in the Japanese financial system. The fact is that the Japanese system is implicitly analogous to many developed countries.

From the analysis of public expenditure presented in this unit, one can mention some of the reasons for public spending's ineffectiveness in less-developed countries, these are highlighted below:

- Poor macroeconomic framework,
- Large defence and arms budget, to the detriment of public goods budget.
- High and rising unsustainable level of corruption,
- Unavailability or non-existing independent fiscal institutions for project evaluation and appraisal,
- Deficit overhang.
- Distorted transmission channels.
- Politicizing welfare objectives.
- Lack of continuity in government policy, hence, successive governments tend to initiate new policies and abandon the existing ones including expenditure already dispensed to realize set target.

Self-Assessment Exercise

1. List two major sources of public expenditure

2. State five targets of public expenditure in Nigeria.

4.0 CONCLUSION

In this unit we have reviewed a handful of relevant empirical literature on public spending both in less developed countries and the advanced countries. In less-developed countries, it is established that substantial amount of public finance is devoted to defence or purchase of fire arms; additional noticeable amount also ends up in corruption thereby leaving a little less for education, health and basic infrastructure. Private sector support is also insignificant. All these add up to the fact that public expenditure in poor countries has not achieved desirable objectives. The reverse is the case in the advanced countries, even in the capitalist economy, public spending financing of social goods and economic stabilization are found to be significant. Although corruption is minimal and defense spending is large, but the government as well as the private sector is able to raise substantial and adequate funding of public goods.

5.0 SUMMARY

In this unit, we have discussed some important empirical research on public expenditure. Summary of relevant literature based on government spending is presented. Having read the relevant literature painstakingly, we found asymmetric effects of public expenditure on economic growth. In less-developed countries, public spending positive effect on the entire economy is largely dampened by poor macroeconomic framework, corruption and unprecedented expenditure on defense and contingencies. Because government expenditure is funded by external loans, it has always resulted in deficit overhang. The situation is different from the advanced countries where public spending plays significant role in promoting economic development. The authors suggest a reduced budget proportion allotted to defense and increase the portion allotted to public goods. As a recipe for stopping or reduce corruption, prudential management of public spending must be taken seriously.

6.0 TUTOR-MARKED ASSIGNMENT

1. State the reasons why public expenditure may not achieve its objectives in underdeveloped countries.
2. Discuss the reasons why public expenditure is more effective in developed economies.
3. Compare the nature of public finance in the OECD and SSA.
4. Discuss private savings or domestic debt as core source of public expenditure.

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UNIT 3 TAX STRUCTURE AND IMPORTANCE

CONTENTS

1.0 Introduction
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3.0 Main Content
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 3.2 Basic Theory of Taxation
  3.2.1 The Expediency Theory
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  3.2.3 The Benefits-Received Theory
 3.3 Tax Structure
  3.3.1 Theoretical Facts about Tax Structure
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5.0 Summary
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1.0 INTRODUCTION

This unit is centered on taxation. There are several sources of government revenue of which tax is one. Government obtains income from public corporations or public enterprises. Government also privatized government businesses. Government can borrow from commercial and merchant banks as well as central bank. It can borrow from individuals and businesses by issuing debt instruments such as Treasury bill and treasury certificate. It can issue bunds for long term loan. Government also obtains grants and foreign loans. All these constitute government income. However, tax is widely acknowledged as the major sources of government income or revenue. It is from the income/revenue generated from tax that government makes its expenditure. If taxes are not enough, then government seeks loans. If government is unable to secure enough tax for its expenditure, there would be need for borrowing and consequently might plunge the nation into debt. In most underdeveloped and developing countries aspiring to develop fast, tax revenue is always inadequate and this always resulted in deficit spending.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

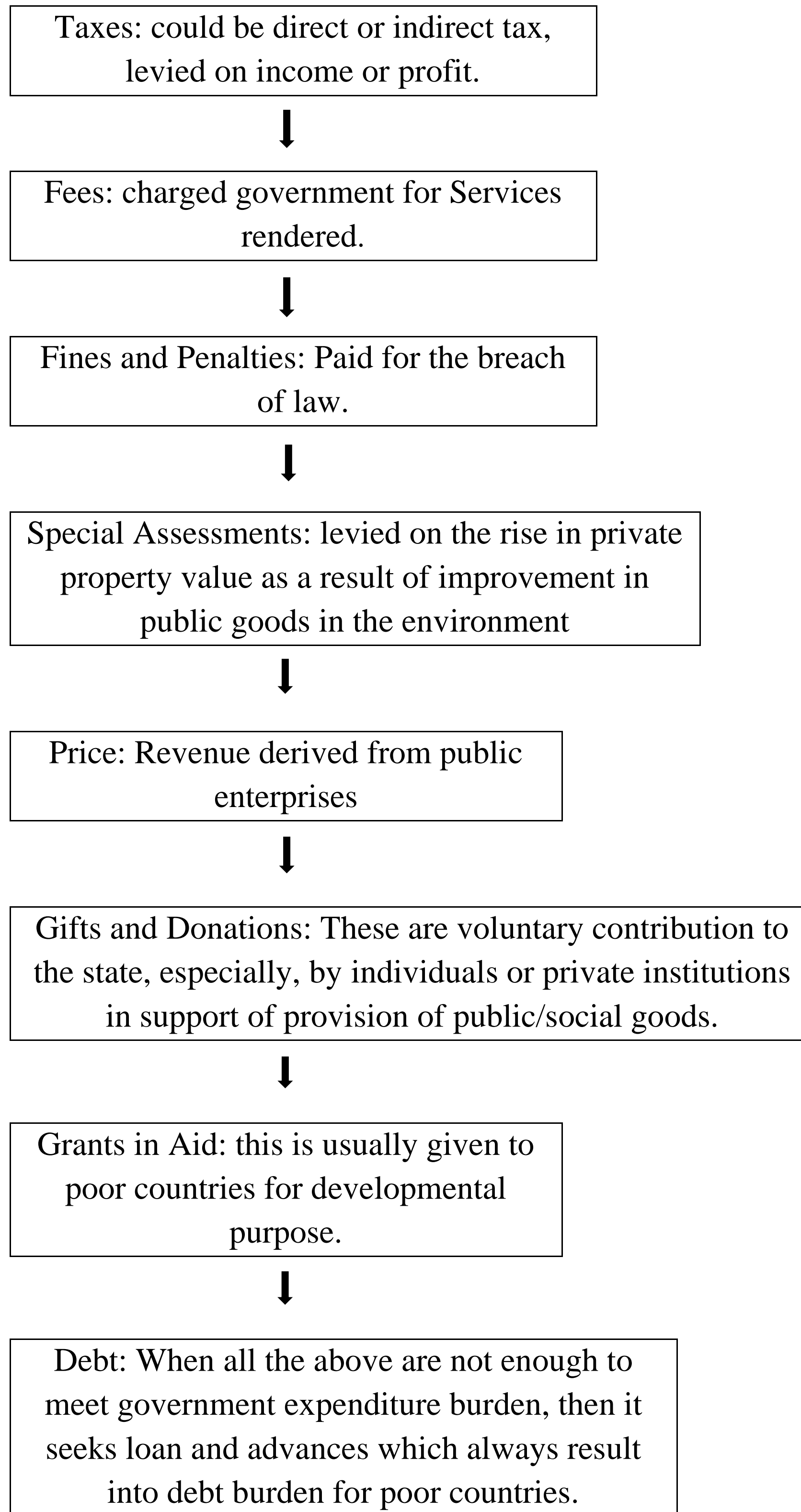
- State the sources of government revenue
- Discuss tax as a critical government revenue.
- Highlight features/characteristics of tax
- Explain the theoretical facts about tax structure

3.0 MAIN CONTENT

3.1 Technically, analyzing tax is complex. Tax can be analyzed from the perspective of type of taxation, canon of taxation, optimal tax rate, optimal tax revenue, burden of tax and its bearer and the rest. Relating to tax burden for instance, Rosen (2005) reiterated, among other things that price changes are the key to finding the burden of a tax. However, price changes depend on a lot of things such as market structure, elasticity, of supply and demand, mobility of factors of production etc. In other words, tax is dynamic and analyzing tax under partial equilibrium (ceteris paribus) is quite different from general equilibrium when all other factors are considered.

What is a tax? It is compulsory payment made to the government or constituted authority. It is meant to be used for all developmental purposes that will lead to the welfare of the entire nation.

SOURCES OF GOVERNMENT REVENUE



The Main Features/Characteristics of Tax

- It is essential that government collect tax, in fact, government must collect tax to raise fund to finance its expenditure. Tax is the fundamental source of government revenue or income.
- A tax is a compulsory payment, it must be paid by the citizens, the company or any institution liable. Hence, refusal to pay a tax is punishable under the legal system.
- There is no direct *quid pro quo* between the tax payers and the public authority. That is the tax payer cannot claim commiserate benefit of the tax, although the state must provide goods and services to justify tax collection.
- It is not necessary that tax incidence (that is the party that bears the burden) must rest at the point of its impact (that is, its point of collection).
- A tax is levied to meet public spending incurred by the government in the general interest of the nation. It is a payment for the good and services to be performed by the government as agent of the people and on behalf of the people.
- A tax is payable regularly and periodically as determined by the taxing authority.
- When government levy or increases tax, the people react.
- Tax is always inadequate to meet government revenue and so, government will always borrow.

In less developed countries, taxes are usually not generating the much desirable outcomes for various reasons ranging from poor collection principle, narrow tax bases, inflexible tax rate, to mismanagement of revenue derived from tax, excessive tax burden, tax avoidance or tax evasion. However, since government must collect tax and the citizen must pay tax, then, there must be certain characteristics or attributes a good tax must possess. These are stated below:

- Recall in the theory of public expenditure discussed earlier, it was stated that tax payers, who bear the burden of public expenditure must derive maximum social

advantage. In other words, tax should be used to finance public goods and services to the optimum satisfaction of the people.

- It should cause minimum aggregate social sacrifice. A good tax should be impose base on ability to pay so that tax burden falls more on the rich and less on the poor.
- A good tax should be progressive. That is the proportion or percentage of tax rate payable should be higher as income increases. In summary, a good tax system should not be regressive or proportional.
- A good tax system should be simple and straight forward. This means there should be absence of any unnecessary and avoidable complexity.
- Flexibility is essential in a good tax to allow for change as economic activities changes. For instance, government can use contractionary fiscal policy, via tax increase, to reduce the effect of inflation. Conversely, it can use expansionary fiscal policy, via tax cut, to rescue the economy out of depression.
- It should satisfy most of the cannons of taxation: Equitable, Convenient to pay, Productive, Economical, certainty and flexible.
- A good tax should be international trade friendly. Corporate income tax as well as indirect taxes like import duties, export duties, and value added tax can discourage business investors if they are too high.

Self-Assessment Exercise

State the future characteristics of a tax.

3.2 Basic Theory of Taxation

3.2.1 The Expediency Theory

This theory asserts that every tax must be the only consideration weighing with the authorities in choosing a tax proposal. The economic and social objectives of the state as well as the effects of a tax system should be treated as irrelevant. It is useless to have a tax

which cannot be levied and collected efficiently. Therefore, the administrative set up must be efficient enough to collect the tax at a reasonable cost of collection.

A major drawback of this theory is that it is difficult to build an entire tax system solely on the considerations of expediency. Taxation provides a powerful set of policy tools of the authorities and should be effectively used for correcting economic and social ills of the society such as income inequalities, regional disparities, unemployment, cyclical fluctuations, and so on. However, it must be remembered within the limits of practicality, the authorities will have to do a lot of maneuverings regarding the considerations of equity, economic stabilization, growth, regional imbalances, and so on.

Self-Assessment Exercise

Discuss the concept of expediency theory of taxation and the major drawback

3.2.2 The Socio-Political Theory

Adolph Wagner advocates that social and political objectives should be the deciding factors in choosing taxes. The theory advocates that a tax system should not be designed to serve individuals, but should be used to cure the ills of society as a whole. In other words, this theory advocates a modern welfare approach in evolving and adopting a tax policy. Wagner specifically favours using taxation for reducing income inequalities.

Wagner's ideas received much criticism at the time it was proposed. However, it is now the hall-mark of fiscal policies of several modern states. Today, it is widely accepted that taxation should be used to curb inequalities. Progressive taxation is now a rule rather than an exception. A modern government believes that tax policy should be effectively used for several purposes such as fighting cyclical fluctuations, unemployment, production of undesirable goods and services, monopolistic and restrictive trade practices, hoarding, and so on. The socio-political theory also believed that taxation can also be used in bringing about a more balanced growth as between different regions.

3.2.3 The Benefits-Received Theory

The benefits-received theory has a long-dated origin and its roots lie in the contract theory of the state. This theory proceeds on the assumption that there is basically an exchange or contractual between tax-payers and the state. The state provides certain goods and services to the members of the society and they contribute to the cost of these supplies in proportion to the benefits received. Hence, this theory proceeds on the assumption that there is basically an exchange relationship between the citizens and the state via taxation. The state provides certain goods and services to the members of the society and they contribute to the cost of these supplies in proportion to the benefits received.

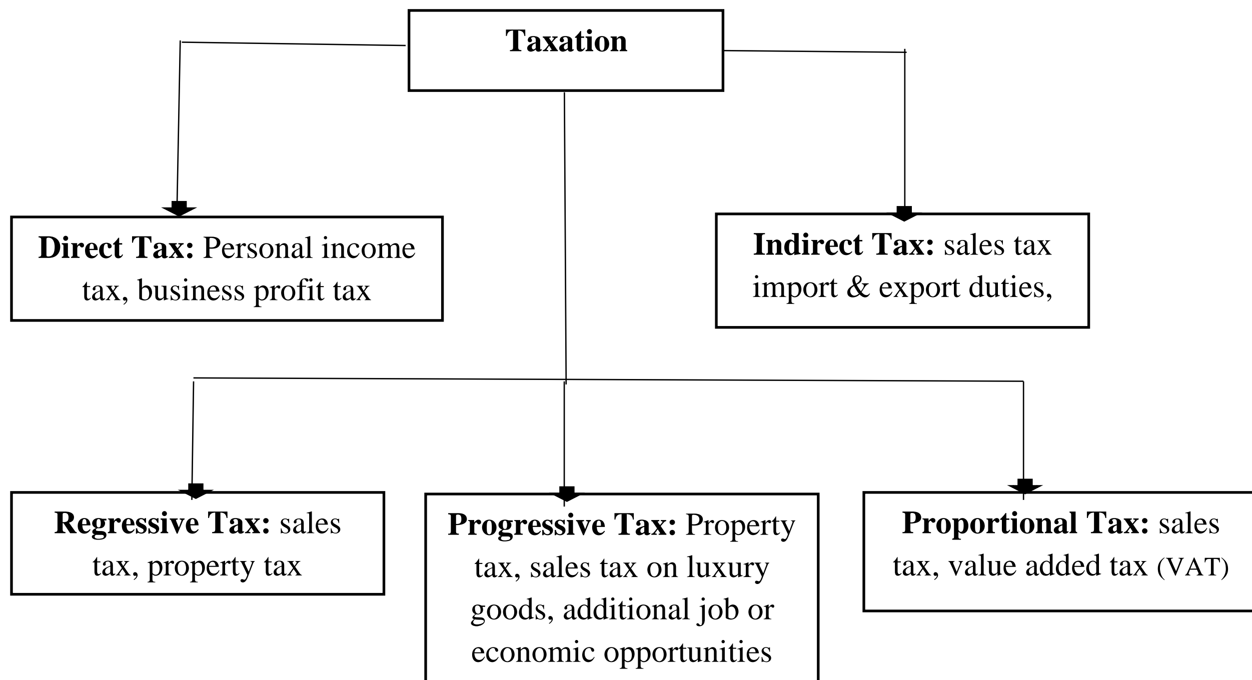
In this set up, there is no place for issues like equitable distribution of income and wealth. Instead, the benefits received are taken to represent the basis for distributing the tax burden in a specific manner. This theory overlooks the possible use of tax policy for bringing about economic growth or economic stabilization in the country.

As in the case of other theories, several problems crop up to apply this theory in practice, since tax burden is to be distributed between tax payers in proportion to the benefits received by them from state activities, the authorities have to identify the beneficiaries and measure the benefits derived by them. This poses a great challenge because the benefit would have to be normatively determined by the political authority. However, this is not an easy task. For example, since benefits are ultimately a subjective thing, there is no scientific way of measuring it.

Self-Assessment Exercise

Explain the benefit received theory of taxation

3.3 Tax Structure



Source: From the Author

Theoretically, we can have direct tax or indirect tax; regressive, progressive or proportional tax.

Direct taxes are those levied on the income of the payer. That is before the payer receives the income tax is already deducted. In a system of national account (SNA) direct tax is usually called personal income tax. For a body corporate, it is often referred to as corporate income tax. However, in the theory of tax incidence, corporate income tax may be passed onto the consumers in form of higher prices on goods and services offered by the firm. Other examples of direct tax are property tax which include capital gain tax, wealth tax, gift tax, estate duty, urban property tax, house rent and land revenue. Registration, non-judicial stamp are not exempted.

Indirect taxes are those levied on the products and services consumers purchase in the market. It is indirect because the consumers do not feel the impact directly on their income although it might diminish their purchasing power. Example of indirect tax includes sales

tax, value added tax (VAT) import duties, export duties, custom and exercise. Government often uses indirect system of taxation to prevent reactions like industrial action.

Taxes generally increase prices or inflation, reduces consumers' purchasing power, and make government become unpopular. The type of tax to levy depends on the level of economic development and socio-political factors.

Regressive Tax: A tax is regressive when it is applied uniformly in such a way that it takes a larger percentage of income from low-income earners than from high-income earners. It is in opposition to a progressive tax, which takes a larger percentage from high-income earners. Examples of regressive taxes include sales taxes and property taxes, which are set at a flat percentage, regardless of who the purchaser or owner is.

Progressive tax: A progressive tax is a tax that imposes a lower tax rate on low-income earners and a higher tax rate on high-income earner, making it based on the taxpayer's ability to pay. That means it takes a larger percentage from high-income earners than it does from low-income individuals. Example

For example, a wealth or property tax, a sales tax on luxury goods, or the exemption of sales taxes on basic necessities, may be described as having progressive effects as it increases the tax burden of higher income families and reduces it on lower income families.

Proportional Tax: A proportional tax is an income tax system where the same percentage of tax is levied on all taxpayers, regardless of their income. A proportional tax applies the same tax rate across low, middle, and high-income taxpayers.

The sales tax is an example of a proportional tax because all consumers, regardless of income, pay the same fixed rate. Although individuals are taxed at the same rate, flat taxes can be considered regressive because a larger portion of income is taken from those with lower incomes

Self-Assessment Exercise

Discuss the progressive system of tax

3.3.1 Theoretical Facts about Tax Structure

The methods by which individuals reduce their tax liabilities take a variety of legal and illegal forms, all of which are influenced at least in part by **incentives created by the tax structure**. These methods can be broadly classified as **avoidance and evasion** (Alm, Bahl, and Murray, 1990). Tax avoidance is any legal activity that lowers taxes, such as worker substitution between wage and non-wage compensation.

Tax evasion is an illegal activity in which a person or entity deliberately avoids paying a true tax liability or underreporting income on tax return. Those caught evading taxes are generally subject to criminal charges and substantial penalties. Tax evasion is more obvious and appears illegally more severe than tax avoidance, but this may not be so because tax avoidance may be an avenue where people decide not to pay tax and thereby reducing government revenue.

The public sector depends on taxes as a source of funding to purchase goods and services that affect all citizens. However, when governments raise taxes, people alter their behaviors and make decisions they would not make otherwise. Again, to a great extent, the state of economic development of a country and its socio-political institutions determine the level of taxation and its composition. It is the combination of these premises that determine how tax can be structured to generate maximum revenue for the government. For instance, at the initial stage of economic development when subsistent agriculture and mining are prevalent, government is forced to rely on land taxation for revenue. In this case, direct but regressive tax, like poll tax, provide the major source of revenue. Only a few large scale establishments become the effective bases for raising revenue during this stage of economic development and only few products contribute to lion share of tax revenue.

As the nation accelerate to industrialization and economic development, businesses, firms, services, and several means of payment expand. International trade in goods and services is performed by economic agents. As a result, tax structure begins to change. Indirect taxes generally takes over but it is more regressive as the same proportion in the form of sales tax, VAT and custom duties are charged (Chowdhury & Hossain, 1988). When the economy is fully developed, accounting systems are fully standardized and widely practiced; implementation of direct system of taxes to tap different sources of income feasible is visible. Hence, direct tax again becomes source of revenue. However, they are now made progressive in nature as a mean of reducing inequality and creating an egalitarian society. As the economy becomes more advanced in development, it becomes greatly monetized though different means of payments, other than cash carrying may spring up. This then induces expansion or widening of the tax base. In response to the changing structure of the economy and the tax system adopted, economic agents may also adjust their financial expenditure to avoid or evade tax wherever possible.

Murray, 1997 and Murray, 1999 gave some structural ways economic agents may reduce their tax liabilities:

1. They may change their spending patterns toward favorably taxed items,
2. They can make purchases and pay sales tax in low-tax jurisdictions,
3. Choose to live in a low-tax region,
4. Take production and sales to the black market,
5. Self-provide otherwise sales-taxable goods and services.

Self-Assessment Exercise

Explain the difference between direct and indirect tax.

4.0 CONCLUSION

This unit clearly defined taxation and why it is important to the growth and development in an economy. Tax is one of the major sources of government revenue. It is important that the citizen pay tax. Not paying tax is a criminal offence under the law of any nation. The demand on government to provide public goods and services is usually much and increasing. Other sources of revenue may not be enough and so government needs tax, particularly, to maintain its services and provide public goods. However, the way tax system is being structured in a country plays a major role in determining how much revenue can be realized there to.

5.0 SUMMARY

This unit examines tax structure and other characteristics of a good taxation. This unit also discussed the theory of tax and some theoretical facts about tax structure. The basic structural type of a tax is direct and indirect tax. Tax can also be structured as progressive, regressive and proportional system of tax. Progressive tax is widely agreed as the best because it helps in income re-distribution and reducing income inequality. Three basic theories of tax are discussed which include the expediency theory, the socio-political theory and the benefits-received theory.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss the socio-political theory of tax.
2. State the characteristics or attribute of a good tax system
3. List two ways tax payers may reduce their tax liabilities
4. Explain why a progressive tax may be better than regressive tax.

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UNIT 4 EMPIRICAL EVIDENCE ON TAX STRUCTURE

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
    3.1 Empirical Evidence of Taxation in General Terms
    3.2 Empirical Evidence Taxation Structure in Africa and Nigeria.
        3.2.1 Authors' Findings on Tax Structure In Nigeria Africa
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Readings

1.0 INTRODUCTION

This unit is majorly on the empirical evidence of tax structure. Quite a good number of authors have carried out research on how structure of tax can sometimes be a distortionary factor in government revenue earnings. For instance, a progressive tax that takes too much from the income of the payer may end up generating low revenue for the government so that tax becomes negatively related to government revenue and to economic growth. Generally, when a tax is too high, it provides incentives to tax avoidance. In fact, in developing countries, it may induce tax evasion. Therefore, in this unit, we shall review the findings of a handful of research studies which have worked on tax structure and its effect on government revenue and growth.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Discuss the empirical evidence of tax effects on economies of selected countries.
- Discuss the empirical evidence of tax structure in Africa and Nigeria

3.0 MAIN CONTENT

3.1 Empirical Evidence of Taxation and its Structure in General Terms

The study on structure of a tax cannot be overemphasized because it allows us to understand the responses of tax payers to tax imposed in terms of the degree of tax avoidance or tax evasion. Normally, when government imposes tax, the payers react with the hope that such a tax may be repealed or the rate reduces. Reaction varies with tax structure. For instance, a marginal direct tax to goods consumed by the poor may spark violent reaction, whereas a significant tax imposed on luxury goods may spark little reaction because they are consumed by the rich. The fact is that the effect of taxation on the overall economy depends on the existing structure of the tax. The research studies to examine the effect of tax on income of payers abound. While some authors found that an indirect but progressive tax is better than direct tax, some argue that the progressive tax does not really have any significant effect on economic growth and business entrepreneur.

Baliamoune-Lutz and Garello (2014) examine the effects of taxation and tax progressivity on entrepreneurship in a large group of European countries Using macro-level panel data, they discovery that tax progressivity at higher-than-average incomes has a robust negative effect on nascent entrepreneurship. Liu and Feng (2015) examine tax structure and corruption in a cross country European countries. They confirm that countries relying more heavily on direct taxes tend to exhibit less corruption and that countries with more complex tax systems tend to have a higher level of corruption. According to them, these results are also shown to be robust across alternative measures of corruption and tax structure. They submitted that from a policy perspective, it is important to note that the optimal choice of tax structure, especially the mix between direct taxes and indirect taxes, usually involves the discussion of its impacts on the key aspects of the economy mainly economic growth and income distribution. Therefore, a systematic evaluation of the current tax structure requires taking all its possible impacts into consideration, and further tax reforms should be built on both positive and negative knowledge that we have gained.

Combating tax evasion and avoidance, in tax structure and tax compliance, is the subject matter in Alm, Bahl and Murray (1990). Also, Long, and Gwartney (1987) work on similar topic. They discover that in the era of structural reforms, addressing evasion and avoidance will require major changes to elicit a significant response from taxpayers, and the impacts of reform on all compensation types must be carefully identified to achieve the desired results. Moreover, Long, and Gwartney (1987) findings are that the impact of higher tax rates on tax avoidance is large enough in the upper-income classes to produce an inverse relationship between tax rates and tax revenue. Their findings suggest that lower marginal tax rates alone will prove an effective weapon against tax avoidance in the upper income brackets.

The issue of effects of personal income tax progressivity in the sense of rising marginal income tax rate on self-employment is taken as a central study in Schwarz (2009), Ferede (2013) and Hansson (2012) for the American entrepreneur risk taking, Canadian provinces and for the Swedish economy respectively. Among others, they discover that high income tax rate is detrimental to the economy, and both average and marginal taxes have negative impact on the decision to become self-employed. Schwarz (2009) note that the adverse impact of income tax on entrepreneurial risk-taking outweighs the tax evasion opportunities for the self-employed. Gentry and Hubbard (2000) provide evidence that a progressive personal tax structure discourages risk-taking. Important implication of their results is that a reduction in income tax progressivity encourages self-employment.

In a likewise manner, Widmalm, F. (2001); James and Hines (2017) study aimed to test whether US multinationals and businesses engage in profit-shifting activities in order to minimize their tax burden. It also examine how businesses respond to tax generally relative to structural adjustment. The results of this study support the fact that tax-mix matters and that progressive taxes and tax systems have adverse growth effects. Therefore, tax must not be too high and fair to support economic growth.

From these literature, it appears most authors support progressive system of tax but the effect of the tax upward movement may be counter-productive, and discourage entrepreneurship and hard work. It can also create incentives for evasion and avoidance. Taxes generally are meant to raise revenue not to create burden. It is therefore important to highlight the required responsibility of government concerning social contract, government should consult the stake holders in the event of tax levy and reach a fair deal in tax increase. This deal should include the type of tax to charge and the likely implications regarding the incidence.

3.2 Empirical Evidence of Taxation in Africa and Nigeria

A handful of research on tax structure and effect on individuals, Nigerian and some African countries have emerged. In Kenya, Owino (2019) examine the effect of value added tax (VAT) on GDP. The empirical result indicates that a positive and insignificant relationship exist between value added tax and economic growth in Kenya. He also finds that a positive and insignificant correlation between VAT revenue and GDP means there are some problems inhibiting its potency. The study conclude that the effect of value added tax on the economy is not large enough to influence the economic growth. Their recommendation urge government to reform VAT system to engineer a system that would have a significant impact on economic growth. This would increase the growth of VAT revenue to accelerate production and economic growth.

In Ghana, Abena (2019) accesses tax impact on economic growth and found that there exits significant positive relation between tax structure (direct taxes and indirect taxes) and growth. The study also establish that even though both direct taxes and indirect taxes improve growth, a percentage increase in indirect taxes impact growth more than direct taxes. Moreover, taxes impact growth significantly through recurrent expenditures more than through capital expenditure. However, he suggest that other forms of indirect taxes like VAT, excise tax, and communication service tax reduce growth.

3.2.1 Research Findings on Tax Structure in Nigeria.

Some authors focus their research on Nigeria, some of them include Cornelius, Ogar and Oka (2016); Nwaobia, Kwarbai and Ogundajo (2016); Ya'u1 & Manukaji (2018) and Saadon (2019). These authors examine the impact of tax revenue for the Nigerian economy. Their findings can be summarized as follow:

- There is no significant relationship between company income tax and the growth of the Nigeria economy.
- Cornelius, Ogar and Oka (2016) study reveal that there is a significant relationship between petroleum profit tax and the growth of the Nigeria economy. They recommend that government should try to provide sufficient public goods in return. There should be complete re-organization of the tax reforms to reduce the problems of tax evasion and tax avoidance. To widening the tax base, government should create employment opportunities to enhance good environment for entrepreneurship and innovation. Prudential use of tax revenue can make all these happen.
- Ya'u1 and Saadon (2019) work on voluntary tax compliance in Nigeria, they reveal that fairness perceptions of tax has a positive and significant relationship on voluntary tax compliance and trust in authority has significant and positive relationships with voluntary tax compliance.
- Manukaji (2018) finding stipulates that nearly all the tax components study (Value added tax revenue, personal income tax revenue, petroleum profit tax revenue and company income tax revenue) have significant effect on economic growth in Nigeria. The study also submit that tax administrative loopholes should be plugged for tax revenue to contribute immensely to the development of the economy.

In addition, government should embark on policies and programmes that will enhance the level of income of the citizens so as to raise the consumption level of

the people with a view to accelerating investment, employment, output, and ultimately value added tax revenue.

- The Nwaobia, Kwarbai & Ogundajo (2016) investigate tax planning on firm value for Nigeria. They identify that Nigerian tax laws and environment are complex and volatile as they change almost on yearly basis. These make it difficult for an average corporate management to navigate, understand and fully explore the opportunities and gaps in the tax statutes for beneficial tax planning.

  1. They recommend firm use of tax professionals and consultants for effective tax planning that will meet corporate tax needs.
  2. Firms should not hinge their firms' value maximization mechanism on tax planning alone since this has been found in this study to explain variations in firm value indicator from a weak position.
  3. Finally, there should be holistic approach to tax planning and optimal mix of tax planning strategies are important determinants of their effect on firm value in Nigeria.

These literature emphasize importance of tax on economic development in the developing countries. The authors also highlight the need to make tax easy in order to encourage the citizen to pay. When tax are simple and used for public purpose, the incentive to pay more may be automatically created. However, unlike the advanced countries, the base of taxes in underdeveloped countries are narrow and make it difficult to be attractive to pay. Decentralization or flexibility of the base makes tax cheaper and easier to pay.

Self-Assessment Exercise

Discuss the findings of some authors concerning Nigerian experience on taxation.

Discuss why a progressive tax reduction may lead to employment generation.

4.0 CONCLUSION

Empirical studies on tax structure in Nigeria, Africa and selected advanced countries have been reviewed in this unit. It is found that the decision to comply or not to comply with the individual income tax depends fundamentally upon the incentives introduced by the tax system and the use of the tax. The results presented in the studies suggest that individuals and corporate body responses to incentives to pay tax will produce fruit if tax is made simple and lowered and the benefits increased. Government responsibility and readiness to use tax for state affairs also matter. In the case of structural reforms, to combat tax evasion and avoidance, major changes may be necessary to elicit a significant response from taxpayers In addition, the impact of reforms on all compensation types must be carefully identified to achieve the desired outcomes.

5.0 SUMMARY

This unit examines empirical studies on effects of tax structure on selected advanced countries and Africa as well as Nigeria. The foreign countries selected are USA, Canada and Sweden, while Ghana, Kenya, South Africa and Nigeria are selected in Africa. The findings of these studies show that tax effects is not significant in most African countries because of its structural deficiencies. The researchers urge government to reduce tax burden to sensitize the people to refrain from tax evasion and tax avoidance. By doing so and creating many other incentives to pay tax, government can boost its revenue.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss why incentive to pay tax is not significant in developing countries.
2. Explain why Nigeria government revenue on tax is inadequate.
3. List four beneficiaries of tax in any country and explain how they benefit from the tax.

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MODULE THREE: THE CHANGING FUNCTION OF FISCAL AND NON-FISCAL POLICIES AND ECONOMIC REVENUE STRUCTURES; FEDERALISM AND FISCAL ADJUSTMENT THEORY AND PRACTICE IN SELECTED COUNTRIES.

UNIT 1 **The Changing Function of Fiscal Policy in Selected Countries**

UNIT 2 **The Changing Function of Non-Fiscal Policy in Selected Countries**

UNIT 3 **Economic Revenue Structures in Selected Countries**

UNIT 4 **Federalism and Fiscal Adjustment Theory and Practice in Selected Countries**

UNIT 1 THE CHANGING FUNCTION OF FISCAL POLICY IN SELECTED COUNTRIES

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1 A Further outlook on fiscal policy
    3.1.1 The Fiscal Rules
    3.1.2 Factors Necessitating the Changing Function of Fiscal Policy
  3.2 Changing function of fiscal policy in selected countries
    3.2.1 Changing Function of Fiscal Policy in the European Union and the Organization of Economic Cooperation and Development (OECD).
    3.2.2 Changing Function of Fiscal Policy in Selected African Countries
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Readings

1.0 INTRODUCTION

Traditionally, the four basic functions of fiscal policy include allocation of resources, distribution of income, economic stabilization and economic growth. All these are performed in order to achieve full employment level of income, sustainable level of economic growth and economic development; lessening inequality and promoting self-reliance. However, due to globalization as well as rise in unemployment and poverty, fiscal policy appears to have taken a new dimension. The ever rising population, arms conflicts, environmental factors and the need to attain the year 2030 sustainable development goals (SDGs) have all changed fiscal policy primary role in the economy. There appears to be too much pressure on the government. Today, fiscal authority has extended fiscal actions to address monetary and trade issues. Governments have attempted to perform monetary policy functions such as vehemently given concessionary interest rates to businesses and tourism. They have also set standard for trade instead of the traditional regulatory roles. This unit will discuss the critical changing functions of fiscal policy and the issues involved.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Explain the content of fiscal rules relative to the changing function of fiscal policy.
- Discuss factors necessitating the changing function of fiscal policies.
- Discuss the empirical evidence of fiscal function in EU and SSA in not more than one page.
- State the fiscal policy actions that are being embarked upon by the Nigerian government.

3.0 MAIN CONTENT

3.1 A Further Outlook on Fiscal Policy

Fiscal policy is about manipulating government spending and taxation in order to manage the level of aggregate demand. As Smithies (1947) explain in the module one of these course material, fiscal policy is a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment. In the new age of globalization, government responsibility is becoming larger and larger. As (Rodrik, 1998; Mosley, 2005; Erauskin-Iurrita, 2008) observed, one of the most pervasive problems in public finance is the upward drift of government expenditure and deficits over time. The economic literature adopts various theories to explain the upward drift of expenditures as a percentage of GDP. The cause of deficit levels becoming unsustainable is, however, more often attributed to political economic factors but not essentially provision of public goods or the need to meet the requirements of globalization.

Whenever the discussion of fiscal policy comes up, the issue of deficit takes center stage. Among the most commonly discussed theories is the deficit bias hypothesis, which contends that politicians increase public expenditures in excess of taxes for their own political gains, including by providing benefits to favored interest groups and increasing spending during election years (Eden, khemani and Emery, 2013). An issue raised in developed economies is that discretionary fiscal policy is often applied asymmetrically or unequally during the business cycle. For instance, government expenditures are raised in a recession but not sufficiently lowered in boom/inflation to balance the budget over the course of the business cycle.

Although fiscal stimulus is strongly supported during recession, consolidation is pursued with great hesitancy. The fear of suppressing an emerging economic recovery, or the attempt to stimulate the economy out of structural problems, often leads to the

postponement of fiscal consolidation efforts. Fiscal policy that is not applied equally over the business cycle often leads to unsustainable growth in government expenditure and debt (Eden, *et al*., 2013). Therefore, some authors have suggested **fiscal rules** to reduce the excesses of fiscal authority regarding public financing.

3.1.1 The Fiscal Rules

Fiscal rules are laws aimed at reducing the incentive to accumulate debt, and many countries adopt them to discipline local government, Kopits and Symansky (1998); Budina, Kinda, Schaechter, and Webe (2013). They maintained that fiscal rule is a long-lasting constraint on fiscal policy using numerical limits on budgetary aggregates. Numerical limits on a particular budgetary aggregate set limits for fiscal policy that cannot be changed often and provide operational guidance. However, the demarcation lines of what constitutes a fiscal rule are not always clear. This is because fiscal rules are complex and they go beyond simplicity as suggested by Kopits and Symansky (1998).

Since the age of globalization, fiscal policy has taken a new dimensions that actually impose heavy responsibilities on public expenditure. In fact, setting fiscal rules has been a major trend in the changing functions of fiscal policy.

As identified by Budina, Kinda, Schaechter, and Webe (2013), there are four major types of fiscal rules that can be discerned based on the type of budgetary aggregate they seek to constrain, these are discussed as follow:

- **Debt rules** set an explicit limit or target for public debt as a percentage of GDP. A debt rule is relatively easy to communicate and by definition, will most effectively ensure convergence to a debt target. However, recognition lag cause debt levels to be affected by budgetary measures. In addition, certain exogenous factors (that is factors that cannot be determined or controlled within the system) such as changes in interest rates and exchange rate may results in a situation whereby debt rules do not provide clear short-term guidance for policymakers.

- **Balance budget rules** limit the variable that primarily influences the debt ratio, and these rules are largely under the control of policymakers. Such rules provide clear operational guidance and can help ensure debt sustainability. Budget balance rules can apply to the overall balance, structural balance and cyclically adjusted balance. However, estimating the adjustment, typically through the output gap, makes the rule more difficult to communicate and monitor.
- **Expenditure rules** set limits on total, primary, or current spending. Such limits are typically established in absolute terms, apply to growth rates, or occasionally, are established as a percentage of GDP. The time horizon most often ranges between three and five years. These rules are not linked directly to the debt sustainability objective given that they do not constrain the revenue side. However, expenditure rules perform the following function:
    - They can provide an operational tool for triggering the fiscal consolidation required for consistency with sustainability when they are accompanied by debt or budget balance rules.
    - They can constrain spending during temporary absorption booms, when windfall revenue receipts are temporarily high and headline deficit limits and easy to comply with.
    - They do not restrict the economic stabilization function of fiscal policy in times of adverse shocks because they do not require adjustments to cyclical or discretionary reductions in tax revenues.
    - Expenditure rules are not consistent with discretionary fiscal stimulus, although expenditure ceilings directly define the amount of public resources used by government, and are in general relatively easy to communicate and monitor.
    - Nevertheless, expenditure rules can be manipulated by creative accounting like shifting toward more tax expenditure (that is expenditure must be within tax collected, debt, not included).

- **Revenue rules** set ceilings or floors on revenues and are aimed at boosting revenue collection or preventing an excessive tax burden (or both). Most of these rules are not directly linked to control of public debt because they do not constrain spending. Furthermore, setting ceilings or levels on revenues can be challenging because revenues can have a large cyclical component, fluctuating widely with the business cycle. However, like expenditure rules, they can directly target the size of government.

Self-Assessment Exercise

Highlight the four major types of fiscal rules

3.1.2 Factors Necessitating the Changing Function of Fiscal Policy

- Continuous increase demand on government income/revenue, driven by population surge which imposes large expenditure which government cannot meet overnight,
- Globalization (for instance, global economic meltdown, that requires bail out),
- The Millennium Development Goals (MDGs) and now the Sustainable Development Goals (SDGs) have placed fiscal policy, including domestic resource mobilization, at the centre of national and international development efforts (United Nations, 2015).
- Global diseases that require treatments and preventions that impose pressure on government income ,
- Environmental factors (disaster) like global warming,
- Rising unemployment and poverty putting pressure on government to provide social security,
- Rising criminal activities inducing government to spend more on internal security,
- Insurgencies incursion into the mainland from neighboring countries leading to the need to purchase sophisticated firearms by the government to stop the insurgencies

i.e Bokoharam, from the border land North East Nigeria and hoodlum from North West Nigeria.

- The need to increase current expenditure, for instance, for the remuneration of large number of political office holders,
- The need to service debt; yet, all the above fiscal responsibilities require large funding which government in underdeveloped countries do not have, it then pushes them to obtain loan at high interest rate, induce debt service and debt overhang.

Self-Assessment Exercise

List the factors necessitating the changing function of fiscal policy

3.2 Changing Function of Fiscal Policy in Selected Countries

3.2.1 Changing Function of Fiscal Policy in the European Union and the Organization of Economic Cooperation and Development (OECD)

What have long been established in the literature is the key objectives of public financial management which are: maintaining a sustainable fiscal position, effective allocation of resources, and efficient delivery of public goods and services. Since the early 1990s, these objectives have been the standard public financial management objectives used in academia and by the IMF and the World Bank and other international financial institutions Cangiano, Curristine, and Lazare (2013). Nonetheless what needs to be established now is the changing function which has centered on economic stability, and deficits avoidance or reduction.

In the 21st Century, the European Union has been at the center stage of economic reforms in order to stabilize the region. Specifically, various governments, as the representative of the people, have intensified effort at protecting the nations from external shocks like the global economic meltdown that started from the United States in 2008. In order to achieve a great policy outcome, the EU has embarked on merger and acquisition, bail outs and

privatization, consolidation and generally structural reforms of public enterprises (Steinbach, 2013; Steinbach, (2018) Steinbach (2019).

In the work of Budina, Kinda, Schaechter, and Webe (2013); (Steinbach 2018) the need for fiscal rules in the EU countries has been observed. The analysis of European Commission (2015); Steinbach (2018); European Commission (2018), European Commission (2019) suggest there should be coordination of economic policies recognizing the interdependent nature of fiscal policy and structural economic policies. They also discuss future institutional arrangements which should reflect that enforcement of fiscal adherence and should not be pursued as a short-term objective. Rather, such arrangements should incorporate the positive long-term fiscal impacts associated with sound structural policies. They conclude there should be design and interpretation of legal fiscal regimes with reference to the interdependency between fiscal policy and structural economic policies. However, they suggest that fiscal rule must be flexible and there should be no strict application of fiscal rules.

The recent fiscal stimulus packages embraced by many leading economies are deemed of as a necessary prescription to assuage the consequences of the current global economic slowdown (IMF Staff Note Position 2009). The environment of low interest rate close to the zero bound further heats the discussion. Another new function that exist include Fiscal decentralization. Rodríguez-Pose and Sandall (2008); Blochliger and Rabesona (2009) and Sacchi and Salotti (2016) research on the European countries discover that most European countries have undertaken fiscal decentralization reforms since the mid-1990s, assigning more expenditure functions to lower levels of governments. These have also step-up the pace of development in the European region.

We can now summarize some of the new noticeable functions emerging from the European countries. It should be emphasized that the same goes for most of the advanced countries in the Northern hemisphere. Therefore, the new changing functions of fiscal policy as earmarked in the literature include:

- ✓ Making fiscal rules to caution the excesses of public officers.
- ✓ Establish independent fiscal institutions as watchdog to fiscal administration.
- ✓ Fiscal decentralization involves increase power sharing between central and sub-national government.
- ✓ Assigning more expenditure functions to lower levels of governments
- ✓ Economic stabilization which include bailout, merger and acquisition, privatization etc.
- ✓ Fiscal stimulus packages to assuage global economic slowdown.
- ✓ Fiscal action to address the global warming.
- ✓ Enforcement of adherence to fiscal rules which must be pursued for a long time.
- ✓ Increase aids and assistance to poor countries.
- ✓ Making donations to recovery from disease outbreak and natural disaster.

Self-Assessment Exercise

List the new changing function of fiscal policy as earmarked in the literature

3.2.2 Changing Function of Fiscal Policy in Selected African Countries

In recent time, the new functions of fiscal policy in Nigeria and the underdeveloped countries in Africa centers on poverty alleviation, reducing unemployment, increasing current and re-current expenditure. It also involves financing party politics (as African nations are becoming more democratic), fighting diseases and natural disasters. It is important to mention that while the advanced countries might increase fiscal space, as a result of public demands, and remain safe from debt, Africa's public spending has resulted in deficits overhang. Therefore a critical issue in the new face of changing function of African fiscal policy is debt management or deficit reduction.

In **Mozambique** for instance, recent literature by Afonso and Ibraimo (2018) observe that public debt has been a serious economic problem. An empirical test conducted indicates that public debt has no effect on the real output. This means that even though there has

been significant increase in public investment to foster the growth of the real sector, this has not led to the growth of the entire economy. They notice external debt is a bigger problem which has no effect on interest rate but rather can destabilize the economy. They suggest there is a need to look into the performance of fiscal policy and national debt in order to solve the problem of unemployment and poverty in the country.

An example of fiscal policy function is the case of Zambia where Mpundu, Mwafulirwa, Chaampita and Salwindi (2019) note that government fiscal policy has focused on poverty alleviation by increasing investment in the real sector. However, this has yielded no desirable result as they have no significant relationship with economic growth. They suggest the new policy need more focus on poverty reduction which include investment, export diversification and external debt management to generate employment and to ensure long run positive and consistent impact on the economy.

In **Sub-Saharan Africa (SSA)** Micah *et al.,* (2019) identify Africa joins the global health community in delivering good health services, but what concerns them is the amount of public health spending in the SSA. They notice that attaining the health-related SDGs will require substantial resources. Both the Millennium Development Goals (MDGs) and SDGs coincide with a period of impressive growth in global health resources. This is evidence from both government health spending and development assistance for health in the whole world except the SSA where government spending on the programme is low probably as a result of high level of corruption.

In Nigeria, new fiscal policy function is not necessarily different from other SSA countries. It include poverty alleviation, subsidizing drugs to combat diseases, and meeting contingencies such as natural disasters and bailout for financial institutions in the wake of economic recession.

Literature on recent fiscal policy in Nigeria direct attention to health and poverty issues as key factors in economic growth. For instance, Abubakar (2016) and Odetayo and Adeyemi

(2017) and Aliyu, Ndagwakwa, Zirra, Salam, and Mohammed (2019) in recent times have all investigated the impact of fiscal policy on growth, employment and general performance of the economy. Their findings is that even though there has been significant rise in fiscal expenditure in the past two decades, there is yet to be noticeable improvement in economic growth, poverty, health and living standard. In other words, there will be a continuous demand on the government to do more. This means that cutting fiscal space or fiscal expansion might be difficult in Nigeria. As a result government will always be in need of more money to finance its ever increasing expenditure. This implies that more borrowing and more debt would be incurred.

From the review of literature we find out some significant issues such as government effort to increase growth, maintaining stability and reduce poverty. All these have consumed a large portion of public expenditure. In fact the United Nations has constantly criticized the SSA and particularly Nigeria for lagging behind in the realization of MDGs strategies to reduce poverty and unemployment. Presently, large spending is incurred to stop insurgency and breach of internal security. For the Nigerian economy, the changing fiscal functions can be summarized as follow:

- ❖ Government engages the Central Bank of Nigeria (CBN) heavily in fiscal actions. The implication may be rise in domestic debt and crowding out effect.
- ❖ Compulsory rice cultivation to safeguard Nigerian foreign exchange and to be self-reliant in food production. This fiscal action consumes large revenue earning including declining import duties on foreign rice importation.
- ❖ Continue rise in people entering the poverty space requiring government needs to spend more to reduce poverty.
- ❖ Poverty driving too many people into crime leading to government spending more on crime fighting.
- ❖ Recurrent expenditure ever rising because of creation of large number of political and office space.

- Population surge driving people to where they are susceptible to natural disaster. War ravaged people also stay in internally displace people's (IDP) camps. For instance, people living close to streams and rivers in some cities to earn living. In the event of disaster, government spend huge amount on relief.
- The need to fight or eradicate diseases.
- The need to meet the UN standard to achieve the SDGs.

Constraining factors to the new fiscal function include:

- Decreasing real revenue as a result of poor production growth
- The fear of deficit overhang.
- Increasing rate of corruption.
- Inequality in self-determination at international debt negotiations.
- The new declaration by the ministry of finance, "dwindling revenue".

How developing countries can mitigate the constraining factors:

- Widening tax base with a view to generate more income.
- Set fiscal independent institutions as the Europeans and the OECD.
- Set fiscal rules which should include fiscal limits on expenditure
- Fiscal authority should desist from unrealistic and unsustainable fiscal space.
- More fiscal decentralization and fiscal autonomy
- Intensify effort on auditing activities.
- Award of punishment and jail term to the offenders of fiscal activities.

Self-Assessment Exercise

Discuss five fiscal policy functions that show there have been changes in fiscal policy function.

Discuss the changing functions of fiscal policy in selected African countries

4.0 CONCLUSION

This unit emphasized the changing functions of fiscal policy in the last two decades. In most developed countries, fiscal policy has been developed to include fiscal rules which caution or limit political officers spending. There have been set percentages of debt-to-GDP. In the EU, there have also been independent fiscal institutions to check the activities of political officers in fiscal expenditures. All these help to ensure a prudent fiscal atmosphere where deficits are minimal. In the less developed countries or developing countries, although much fiscal policy actions appear to have been undertaken, but not much efforts have been made to manage fiscal actions in today's era of new fiscal policy functions. As a result, fiscal policy actions are yet to meet the desirable objectives of poverty elimination, employment creation and economic growth.

5.0 SUMMARY

This unit examines the changing functions of fiscal policy. In fact, fiscal policy has changed to include, among others, performing some monetary related actions and shielding the entire economy from external shocks like the global economic meltdown. The unit discusses factors necessitating new forms of fiscal actions which include poverty alleviation and disease control or elimination. Also discussed is fiscal rules established in the European countries focusing on monitoring fiscal actions, which also sets limits for public officers and raises alarm when necessary. In developing country like Nigeria, the new fiscal policy functions center on poverty alleviation, fighting crime and insurgency as well as expanding recurrent expenditure; all which put heavy burden on the government. The unit also list some constraining factors to fiscal action as it is today which include decreasing real revenue as a result of poor production growth and the increasing rate of corruption.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the constraining factors to fiscal policy changing structure in developing countries.
2. State the current fiscal policy actions that are being performed by the Nigerian government.
3. State the new changing functions of fiscal policy as earmarked in the literature.
4. Discuss the major factors limiting Nigeria's new fiscal policy function

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UNIT 2 THE CHANGING FUNCTION OF NON-FISCAL POLICY IN SELECTED COUNTRIES

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  3.2 Non Fiscal Policy in Selected Countries
  3.3 Non Fiscal Policy in Nigeria
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6.0 Tutor-Marked Assignment
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1.0 INTRODUCTION

Having discussed the changing function of fiscal policy in the previous unit, this unit focuses on non-fiscal policy changing function. Non-fiscal policy are government actions that do not include spending or deficits. It excludes any government activity leading to using national treasury. Non-fiscal policy functions include setting rules to safeguard fiscal policy and incentives measures to entice people to cooperate with government fiscal actions.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Discuss the meaning of non-fiscal policy.
- Explain the evidence of non-fiscal policy in some US states.
- List the non-fiscal policy actions in Nigeria

3.0 MAIN CONTENT

3.1 Meaning of Non-Fiscal Policy

By non-fiscal policy, we mean activities that are not related to government fund, national treasury or generally, not related to public financing. It is normal for a rational person to assume non-fiscal policy, under macroeconomics definition, is simply monetary or trade policies, but this is not necessarily so. Non-fiscal policy specifically refers to government actions that are not related to spending from the treasury or not requiring government financing. Some non-fiscal policy functions include:

- Setting production quotas probably to reduce pollution;
- Setting gas emission quotas also to reduce environmental pollution;
- Fiscal rules usually set to prevent fiscal indiscipline associated with political officers;
- Educating the citizens about environmental protection;
- Restricting illegal immigrants for the purpose of national security;
- Local content. For instance, in Nigeria it involves giving directives to firms to use Nigerian inputs such as human capital and locally sourced raw materials. It also include given contracts which might not require high technical or skill demand.
- Budget monitoring and scrutiny, using incentives and disincentives methods etc.

3.2. Non Fiscal Policy in Selected Countries

The literature to substantiate non-fiscal policy stresses the need to have more non-fiscal actions to buttress government finances and to achieve prudential management of public revenue. It also helps to minimize government unproductive expenditure and to create incentives that show the direction to focus public spending. Some of these literatures include:

In the United States (US), studies that examine the significance of non-fiscal policy focus on policy influences on special education identification rates and placement decisions (Mahitivanichcha and Parrish, 2005). Other studies such as O'Reilly (1995), Hasazi et al., 1994, Weikart (1998), and Magnetti (1982) point to the influence of geographic region and the history of state policy on special education practice. They examined non-fiscal factors described the possible influence of social, political, and organizational considerations on special education practice in United States. The O'Reilly (1995) work discovers evidence of non-fiscal influences on the kinds of placement used by individual states in US. The author concludes that state policy and practice appear to be important determinants in special education placement decisions.

In a study examining placement patterns of students with disabilities in New York, New Jersey, and Louisiana, Weikart (1998), among others, their research findings suggest these states have had a long history of segregating students with disabilities and have segregated students for a longer period than most other states, regardless of disability type.

Furthermore, Magnetti's (1982) study suggests that states tend to diff the type of funding formulas they adopt. The author shows that the south tends to use formulas that are similar to one another but different from those use by states in the North East, Midwest and West. Most authors also suggest factors that enhance fiscal incentives such as the organizational structure, program constraints and regulations, characteristics of advocacy groups, commitment and leadership of staff and legal requirements.

For the **Polish economy**, Głuszak, Marona and Oleksy (2015) examine the effect of area based property tax, that is different tax are designed to different areas base on the value of estate established. The non-fiscal action is that luxurious house owners would pay higher tax than ordinary house owners. It is called the ad valorem property tax reform in Poland. It was observed that the discussed tax reform could arouse political opposition because of the redistribution of the property tax burdens, negative public attitude and the lack of public knowledge about it. Since the property tax reform is new in Poland, they conclude there is

a need for more in-depth research that will provide empirical evidence in respect of the property tax reform.

Local content implementation becomes an issue in Ghana's oil and gas industry. Obiri, Bjeirmi, and Boateng, (2019) research work notes there is not enough local content inform of involving local construction firm in infrastructural development in Ghana oil and Gas industry. They suggest there should be non-fiscal policy directing the industry to involve Ghana's local contractor in infrastructural development in the industry. Some non-fiscal actions suggested include:

- Strengthening of regulatory institutions and legal framework to attract private investment in infrastructure development. This will help eliminate unnecessary red-tape and streamline the processes and procedures in the sector application,
- There should be a long-term industrial policy for the country with specific sectoral policies across the wider economy and,
- The use of infrastructure-for-oil trade as practiced in Angola.

In what seems to be a similar suggestion, Brears (2018) suggest that in order to develop the circular economy for the New Zealand, governments at all levels can use a variety of non-fiscal tools to promote development and uptake of circular economy-related technologies and services by modifying the attitudes and behaviour of producers and consumers towards natural resources.

Economic integration has been employed in the **Zambia** as a key non-fiscal policy to achieve growth. This is because the policy has attracted foreign direct investment (FDI). As a result, government has entered into economic integration agreements (EIAs). Mulenga (2019) research indicate that since 2000, Zambia has signed various EIAs with investment provisions and implemented unilateral investment liberalization programmes to attract FDI. Although the study establishes that EIAs have had a significant positive impact on FDI in Zambia, but the volumes have been relatively low, suggesting that enacting liberal

trade policies through EIAs alone is not sufficient as the country needs to do more in facilitating investment. He suggests that countries should engage in future negotiations to formulate policies to attract FDI in the regional and extra-regional EIAs.

Self-Assessment Exercise

Discuss non-fiscal policy action suggested for Ghana?

3.3 Although there may be fewer literatures on non-fiscal policy in Nigeria, implicitly, Nigerian government has performed several non-fiscal functions, particularly, since the civilian regime of 1999. For instance, there have been commercialization, privatization and nationalization of public enterprises. Moreover, Baunsgaard (2003), investigate how fiscal rules can strengthen the performance of fiscal policy. On the other hand, Grossman, and Rosenzweig (2016) explain a new channel through which policy can empower citizens and initiate a non-fiscal social contract, even in rentier and patronage states. Using polio vaccine as an example, Grossman and Rosenzweig (2016) found that government non-fiscal action such as using the polio vaccine as an incentive can actually align the people with government spending and empower them towards national development. Baunsgaard (2003) discovers that fiscal rule nested in long run sustainable development can provide more stable framework for fiscal policy formulation. As he explains, a fiscal rule is no panacea for all fiscal-related ills in Nigeria; unless a rule is supported by measures to strengthen the quality of spending, addressing corruption and transparency issues, little real improvement will be achieved. Nonetheless, he gave some non-fiscal rules to address budget and managing government finances:

- Developing procedures for a more proactive budget monitoring,
- strengthening cash management practice,
- Consolidating the automation of the budget execution procedures,
- Designing a system to monitor and control expenditure arrears accumulation,
- Enforcing payroll controls (e.g. IPPIS in Nigeria).

- Facilitating the preparation of timely audits of government operations,
- Strengthening the reporting of fiscal operations by sub-national governments.

The literature so far pointed to one important fact for fiscal rule, that it is necessary for government to intensify effort in laying the foundation for fiscal rule to facilitate accountability and good management of public finances.

Self-Assessment Exercise

Explain what you understand by the term “non-fiscal policy”.

4.0 CONCLUSION

This unit clearly defines non-fiscal policy functions or activities which differentiate it from fiscal policy. The changing function of non-fiscal policy includes setting fiscal rules to maintain a prudential fiscal expenditure for optimal use of government revenue. In the long run, non-fiscal policy will be a key factor in public financial management. Therefore, the less developed countries should avail themselves of the inherent opportunities in non-fiscal policy. This may include setting fiscal rules and giving incentives to obey the rule.

5.0 SUMMARY

This unit has examined the non-fiscal function as it relates to the modern day. In the age of globalization, non-fiscal function might be a short cut to improve government financing. Also in this unit, we discuss likely rules that may be advantageous and achieve desirable goals. We also review non-fiscal functions evidence practiced in Poland, United States, Zambia, and Nigeria. We learn that fiscal rules are one of the major non-fiscal functions in the today’s globalization era and creating incentives to comply with fiscal rules measures is another.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss the non-fiscal rule in the US.
2. Give the highlights of four non-fiscal policy functions
3. List five non-fiscal rules to address budget and managing government finances as suggested by Baunsgaard (2003).
4. Discuss the non-fiscal policy function in Poland.

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UNIT 3 ECONOMIC REVENUE STRUCTURES IN SELECTED COUNTRIES

CONTENTS

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    3.1.1 Sources of State Revenue
  3.2 Public Revenue Structure in Selected Countries
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1.0 INTRODUCTION

The empirical evidence of public expenditure has been discussed in module two. It is explained that public expenditure depends on public revenue and that the major source of public revenue is taxation. In this unit, we shall examine the revenue structure in selected countries. Revenue is crucial to the activities of government for efficient management of the state. Basically, revenue could be generated from tax and non-tax. Tax can be direct or indirect, while non-tax can be royalties or profits derived from public corporations. Statistical data have shown that tax, especially personal income tax, remains the major source of government revenue particularly in the developed countries.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Explain the sources of government revenue.
- Discuss the structure of government revenue.

- Explain the structure of revenue in selected countries

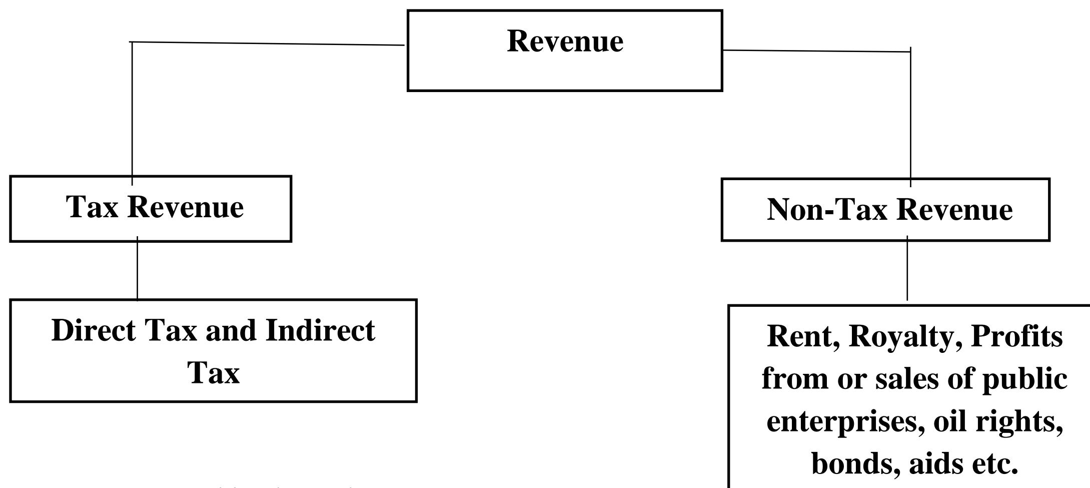
3.0 MAIN CONTENT

3.1 Meaning and Structure of Revenue

3.1.1 Sources of State Revenue

In any modern economy revenue is very crucial. It must be adequate, prompt, regular and growing to meet the needs of the people. Revenue in public finance specifically refers to government revenue or government income. It is used to finance government functions such as payment of salaries and wages of government employees and political office holders. Revenue is used to provide infrastructure and other public goods. Government also uses revenue to purchase security equipment for the services corps. It is the sources of debt payment or debt services. The major sources of revenue are taxes. There are non-tax sources which include profits from public corporations, licenses and rights to explore natural resources, returns from sales of government or public enterprises and much more.

A Typical State Revenue Structure



Source: Prepared by the author

The state revenue above displays both taxation and non-taxation sources of government revenue. Notwithstanding, government revenue is complex depending on countries socio-political background. While taxes on some items such as alcohol and illicit activities are

regarded as income sources, in other countries, they are prohibited. Research from various sources have indicated that to have an effective and adequate revenue source, revenue base must be flexible, decentralized and multiple. Revenue collectors like Federal Inland Revenue Services (FIRS) in Nigeria or Internal Revenue Service (IRS) in the United States must be efficient.

3.2 Public Revenue Structure in Selected Countries

Different countries have diverse revenue structure. They also have various sources of revenue for optimal revenue collection. Gianakis and McCue (1999) argue that the efficiency of a revenue source refers to the cost of collecting it, including the compliance costs borne by the payer.

Schunk and Porca (2004) observe that state revenue portfolios (and potentially revenue stability) are the result of many different and often competing factors. As mentioned above, a critical issue in judging various determinants of state revenue is to test whether there is instability in growth and whether the instability is a result of structural or cyclical budget imbalances. The authors argue that cyclical imbalances through economic fluctuations do not necessarily require making changes to the revenue system; rather, they are a natural feature of the business cycle. A structural imbalance, that part of revenue variability caused by the mix of revenue sources, generally requires making permanent changes to the revenue portfolio.

3.2.1 Public Revenue Structure in the United States of America (USA)

The United States (US) is a federal state comprises of about 50 states, that is, 50 sub-national governments. The nation is a typical capitalist state deriving revenue mainly from taxes. This means that as a capitalist state (as against a mixed economy) the government does not engage in any serious business and therefore does not generate revenue from profits of or sales of public enterprises. The government depends mainly on tax as the main source of revenue. Therefore, the revenue to be discussed will be focusing on taxation.

In general, according to the tax law, a United States citizen or resident alien generally is subject to the US individual income tax on his or her worldwide taxable income. Taxable income equals the **taxpayer's total gross income less certain exclusions, exemptions, and deductions**. Graduated tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability.

A taxpayer may face additional liability if the alternative minimum tax applies. A taxpayer may reduce his or her income tax liability by any applicable tax credits. Adjusted gross income Under the Code, gross income means **"income from whatever source derived"** except for certain items specifically exempted or excluded by statute.

In the wake of these, sources of income/revenue accrued (or included) to the US government are listed below:

- Compensation for services,
- Interest, dividends, capital gains, rents, royalties,
- Alimony and separate maintenance payments, annuities,
- Income from life insurance and endowment contracts (other than certain death benefits),
- Pensions,
- Gross profits from a trade or business,
- Income in respect of a decedent, and
- Income from corporations, partnerships,
- Estates or trusts,
- Statutory exclusions from gross income include death benefits payable under a life insurance contract,
- Interest on certain State and local bonds,
- The receipt of property by gift or inheritance, as well as employer-provided health insurance, pension contributions, and certain other benefits.

Source: USA Joint Committee on Taxation, 2018.

The tax law document prepared by the staff of the Joint Committee on Taxation (Joint Committee staff), provides a summary of the present-law Federal tax system as in effect from 2018. Mainly, the current US Federal tax system has four main elements which include:

- An income tax on individuals and corporations (which consists of both a "regular" income tax and, in the case of individuals, an alternative minimum tax);
- Payroll taxes on wages (and corresponding taxes on self-employment income) to finance certain social insurance programs;
- Estate, gift, and generation-skipping transfer taxes; and
- Excise taxes on selected goods and services.

The tax law provides a broad overview of each of these elements. A number of aspects of the Internal Revenue Code of 1986 (the "Code"), are subject to change over time (IRS, 2018).

For example, some dollar amounts and income thresholds are indexed for inflation, including the standard deduction, tax rate brackets, and the annual gift tax exclusion. In general, the Internal Revenue Service (IRS) adjusts these numbers annually and publishes the inflation-adjusted amounts in effect for tax years beginning in a calendar year before the beginning of that year. However the IRS publication for 2018 (Rev. Proc. 2017-58) is out of date3 due to the December 2017 passage of Public Law No. 115-97, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, often referred to as the Tax Cuts and Jobs Act ("TCJA").

Self-Assessment Exercise

List the source of revenue accrue to the USA government

Summary of the US Composition of Revenue Reported by the Organization of Economic Cooperation and Development (OECD).

About 48% of federal revenue comes from individual income taxes, 9% from corporate income taxes, and another 35% from payroll taxes that fund social insurance programs, the rest comes from a mix of sources (OECD, 2018). State government revenue comes from income, sales, and other taxes; charges and fees; and transfers from the federal government. Taxes account for about half of all general revenue.

Tax-to-GDP ratio Compared to the OECD

According to the **OECD report, 2018,** in 2017, the United States had a tax-to-GDP ratio of 27.1% compared with the OECD average of 34.2%. In 2016, the United States was ranked 32nd out of the 36 OECD countries in terms of the tax-to-GDP ratio. This means a lower proportion of revenues from taxes on corporate income & gains and social security contributions. During that period the highest tax-to-GDP ratio in the United States was 28.3% in 2000, with the lowest being 23.0% in 2009.

The United States ranked 33rd out of 36 OECD countries in terms of the tax-to-GDP ratio in 2018. In 2018, the United States had a tax-to-GDP ratio of 24.3% compared with the OECD average of 34.3%. In 2017, the United States was ranked 32nd out of the 36 OECD countries in terms of the tax-to-GDP ratio. In addition, relative to the OECD average, the tax structure in the United States is characterized by:

- Substantially higher revenues from taxes on personal income, profits & gains, and higher revenues from property taxes and goods & services taxes (excluding VAT/GST).
- A lower proportion of revenues from taxes on corporate income & gains and social security contributions.

- For the year 2017, no significant revenues from payroll taxes; and value-added taxes.

It can be observed that the US government revenue is fundamentally based on taxes of various degrees. Taxes are so structured that nearly all income attracts a form of tax following Musgrave (1983) proposition. The flexibility of tax system in the country might be emulated by developing countries with a view to boost revenue base.

3.2.2 Public Revenue Structure in China

The Chinese government, unlike US, has great Challenges on taxation, therefore bid for tax reforms. However, much of China's tax revenue is generated from indirect taxes. It is important to note that China is a communist state where government takes significant role in the economy.

China has a multi-level government structure that shares national tax revenues through a system of tax sharing and transfers. The current tax system was put in place in 1994. In 2013, local revenues increased of 13% compared to 2012, contributing to a large extent to overall increase of public revenues in China. China sub national funding model is based mostly on taxation, through tax sharing arrangements with the Central.

Inefficiencies in the tax system are an obstacle in China's path toward a new growth model. However, the overall tax burden in China is lower than OECD average.

Fiscal policy also plays a smaller redistributive role, which reflects the reliance on indirect taxes and the regressive design of direct taxes, particularly social security contributions. As a result, low-income earners often pay a much higher effective tax rate than higher income households. In addition, in part because of the mismatch between revenue and spending responsibilities, local governments have often relied on costly and inefficient revenue sources to finance their spending (Lam and Wingender, 2015). Because of all

these, there is considerable scope for tax reforms to improve economic efficiency and lift living standards, especially for lower income groups.

Revenue sharing between central and local governments takes various forms according to prescribed ratios. Tax revenue broadly consists of three types;

- Central taxes exclusively to finance central government spending, which mostly include taxes related to foreign trade such as duties, trade-related VAT, luxury taxes, and export rebates);
- Local government taxes under exclusive control of local governments such as property-related taxes and business operation taxes; and
- Shared taxes between the central and local governments, including direct tax such as personal and corporate income taxes and the VAT (excluding trade-related VAT). *Source: (Lam and Wingender, 2015).*

Current tax System in China

- **Turnover taxes**. These include three kinds of taxes, namely, Value-Added Tax, Consumption Tax and Business Tax. The levy of these taxes is normally based on the volume of turnover or sales of the taxpayers in the manufacturing, circulation or service sectors.
- Income taxes. These include Enterprise Income Tax (effective prior to 2008, applicable to such domestic enterprises as state-owned enterprises, collectively owned enterprises, private enterprises, joint operation enterprises and joint equity enterprises) and Individual Income Tax. These taxes are levied on the basis of the profits gained by producers or dealers, or the income earned by individuals.
- **Resource taxes**. These consist of Resource Tax and Urban and Township Land Use Tax. These taxes are applicable to the exploiters engaged in natural resource exploitation or to the users of urban and township land. These taxes reflect the chargeable use of state-owned natural resources, and aim to adjust the different

profits derived by taxpayers who have access to different availability of natural resources.

- **Taxes for special purposes**. These taxes are City Maintenance and Construction Tax, Farmland Occupation Tax, Fixed Asset Investment Orientation Regulation Tax, Land Appreciation Tax, and Vehicle Acquisition Tax. These taxes are levied on specific items for special regulative purposes.
- **Property taxes**. These encompass House Property Tax, Urban Real Estate Tax, and Inheritance Tax (not yet levied).
- **Behavioural taxes**. These include Vehicle and Vessel Usage Tax, Vehicle and Vessel Usage License Plate Tax, Stamp Tax, Deed Tax, Securities Exchange Tax (not yet levied), Slaughter Tax and Banquet Tax. These taxes are levied on specified behaviour.
- **Agricultural taxes**. Taxes belonging to this category are Agriculture Tax (including Agricultural Specialty Tax) and Animal Husbandry Tax which are levied on the enterprises, units and/or individuals receiving income from agriculture and animal husbandry activities.
- **Customs duties**. Customs duties are imposed on the goods and articles imported into and exported out of the territory of the People's Republic of China, including Excise Tax.

China Tax Revenue

Tax-to-GDP ratio Compared to the OECD

Tax to GDP ratio: New OECD data in the annual Revenue Statistics 2019 publication show that on average, tax revenues as a percentage of GDP (i.e. the tax-to-GDP ratio) were virtually unchanged in 2018, with a very slight increase of just under 0.02 p.p. of GDP relative to 2017. This ends the trend of annual increases observed in the OECD average since the financial crisis in 2009, excluding 2016, which was a special case due to the one-off stability contributions in Iceland in that year. The small change in 2018 was largely due

to the fall of 2.5 percentage points in the tax-to-GDP ratio of one country (the United States, following the reforms described in the publication). However, due to rounding, the OECD average tax-to-GDP ratio was 34.3% in 2018, compared to 34.2% in 2017 (34.24 % and 34.26%, respectively).

The System of Revenue Sharing and Fiscal Transfers in China

The following statements further give revenue sharing Ideas in China:

The main features of China's current sub-national finance arrangements date back to the 1994 tax reform. China has a multi-level government structure that shares national tax revenues through a system of tax sharing and transfers, and divides spending assignments and responsibilities.

Local governments have hardly any discretionary power to modify taxation, though they have some non-tax revenue from fees, levies and penalties. They can also spend the profit from the sale of land-use rights subject to central government restrictions. As the 1994 tax reform recentralized revenues and decision-making power, vertical gaps between revenue and expenditure at sub-national levels have grown. In order to accommodate this, the central government has raised the scale of transfers.

Over the past decade, China's transfer policy has addressed the horizontal imbalances and becomes markedly more redistributive. Nevertheless, fiscal disparities within provinces remain high and are much greater than between regions in OECD countries. The extent of fiscal equalization within provinces varies, thus affecting the delivery of services.

The government's plan to equalize service provision across the country therefore calls for fine-tuning the transfer system and improving local revenue. Some local governments are testing a residential property tax but not in a form that would substantially raise tax revenue. A significant property tax would tend to lower the revenue from the sale of land-use rights

and would, in general, improve the fiscal position of those local governments that already have strong budgets (OECD, 2013, 2020).

It can be deduced that China has a system of revenue sharing different from the United States. The Chinese government use transfers to local regions to meet their needs. Indirect tax constitutes Chinas main source of revenue. However, the country is currently undergoing through lots of revenue reforms to expand its income.

Self-Assessment Exercise

Discuss the Current tax System in China

3.2.3 Public Revenue Structure in Kenya

OECD and African Union Report on Kenya

The Kenya Revenue Authority says in a statement that its collections grew to 1.58 trillion shillings ($15.32 billion) during the year to end-June, up from 1.435 trillion shillings in 2017/2018. The government had a projected revenue target of 1.643 billion shillings for 2018/19.

Sources of government revenue in Kenya

Some types of these local revenue sources include rates, single business permits, parking fees, building permits, and fees from billboards and advertisements. All these local sources of revenue for county governments in Kenya constitute the local revenue.

Kenya has a multi-level government structure that shares national tax revenues through a system of tax sharing and transfers; land-based taxes: property tax (2.3% of local revenues), urban and township land use tax (2.5%), land appreciation tax (4.8%).

The sources of revenue for county governments in Kenya include revenue received from the national government, revenue generated locally, and revenue from external sources.

Githinji (2019) identifies Major sources of government (county) revenue in Kenya, these include:

- **Equitable Share:** The equitable share is the money parliament shares vertically between the national and the county governments. The money comes from the ordinary tax revenue the national government raises at the national level. The Senate then allocates the equitable share for the counties (from the vertical share) horizontally among the 47 counties. The equitable share is the biggest source of revenue for the county governments in Kenya and should not be less than 15% of all the revenue raised by the national government.
- **Local Revenue:** Article 209 (3) of the Constitution empowers the county governments to impose two types of taxes and charges. These two sources of revenue for county governments in Kenya are property rates and entertainment taxes. The county governments can also impose charges for any services they provide in accordance with the stipulated laws. Some types of these local revenue sources include rates, single business permits, parking fees, building permits, and fees from billboards and advertisements.
- **Conditional Grants:** The county governments can receive additional allocations from the national government's equitable share of revenue (from the vertical sharing). These additional allocations are known as conditional allocations or conditional grants. They are conditional because the national government imposes restrictions on how county governments will spend them.
- **Loans:** Loans as sources of revenue for county governments in Kenya may come from external sources or private lenders. The external sources include foreign lenders such as multinational corporations (IMF, World Bank, etc.). The private lenders include commercial banks and other financial institutions. The County

Governments can borrow or access loans, which they repay with interest. However, the counties must meet two conditions in order to access the loans.

1. They can only access a loan if the national government guarantees the loan, that is, if the national government will repay the loan.
2. The County Assembly must approve any loans that the county government intends to borrow.

- **Donor Funding:** Donor funding as a source of revenue for county governments in Kenya involves aid from international donors or development partners. International donors or development partners provide aid in the form of loans and grants. The international donors include:

a. United States Agency for International Development (USAID);

b. Denmark's development cooperation (DANIDA); and

c. United Kingdom's Department for International Development (DFID).

- **Investments:** This is a minor source of revenue for county governments in Kenya. Counties earn returns or profits from undertaking investments. That is, the counties can invest in some resources and the resulting returns or profits become revenue for the county government.

The OECD Report for Kenya.

Tax structure refers to the share of each tax in total tax revenues. The highest share of tax revenues in Kenya in 2017 was contributed by other taxes on goods and services (28%). The second-highest share of tax revenues in 2017 was derived from personal income tax (25%).

In 2017, Kenya's non-tax revenues amounted to 2.0% of GDP. This was lower than tax revenues (18.2% of GDP). Sales of goods and services represented the largest share of non-tax revenues in 2017, amounting to 0.6% of GDP and 29.7% of non-tax revenues.

Tax-to-GDP in Kenya (OECD, 2019)

The tax-to-GDP ratio in Kenya decreased by 0.1 percentage points from 18.3% in 2016 to 18.2% in 2017. In comparison, the average for the 26 African countries in Revenue Statistics in Africa 2019 remained at 17.2% over the same period.

Over a longer time period, the average for the 26 African countries has increased by 1.5 percentage points, from 15.7% in 2008 to 17.2% in 2017. Over the same period, the tax-to-GDP ratio in Kenya has decreased by 0.7 percentage points, from 18.9% to 18.2%. Since 2001, the highest tax-to-GDP ratio in Kenya was 19.3% in 2014, with the lowest being 16.1% in 2002. Kenya's tax-to-GDP ratio in 2017 (18.2%) was higher than the average of the 26 African countries in Revenue Statistics in Africa 2019 (17.2%) by 1.0 percentage points.

Self-Assessment Exercise

State the Sources of government revenue in Kenya

3.2.4 Public Revenue Structure in Nigeria

Like the United States, Nigeria is a federal state sharing revenue between the three tiers of government: Federal, States and local governments.

The main source of revenue for all the levels of government in Nigeria is from the federal allocation account. This account derives revenue from both tax and non-tax sources. The tax revenue include personal income tax, corporate income tax, value added taxes, social security contributions, other taxes on goods and services. In the spirit of attaining equal development for each 36 states including the Federal Capital Territory (FCT), revenue is shared almost equally among the states. **The major sources of revenue are corporate income tax (45% of tax revenue**) and petroleum related taxes such as rents and royalties. Of the non-tax revenue, there are no significant tax revenue from property income, sales of

goods and services, fines, penalties and forfeits, and other unidentified revenue sources and these have been the trend for over a decade. It may be the result of the fact that the Nigeria's private sector is largely informal. Common characteristics of the informal sector are tax evasion and operating outside the coverage of system of national accounting. The informal sector employees and businesses are not registered and government cannot record their activities. It makes tax collection from the sector almost impossible.

OECD Report on Tax Revenue

The tax-to-GDP ratio in Nigeria increases by 0.4 percentage points from 5.3% in 2016 to 5.7% in 2017. In comparison, the average for the 26 African countries in Revenue Statistics in Africa 2019 remains at 17.2% over the same period. Over a longer time period, the average for the 26 African countries has increased by 1.5 percentage points, from 15.7% in 2008 to17.2% in 2017. Since 2010, the highest tax-to-GDP ratio in Nigeria is 9.6% in 2011, with the lowest being 5.3% in 2016.

Non-tax Revenue Structure

In 2017, Nigeria's non-tax revenues amounted to 2.5% of GDP. This was lower than tax revenues (5.7% of GDP). **Rents and royalties** represented the largest share of non-tax revenues in 2017, amounting to 2.4% of GDP and 95.1% of non-tax revenues (OECD, 2019).

From the 2019 statistics on Nigeria, it can be noted that corporate income tax is the major sources of government revenue which is about 48% as against the USA about 9%. This statistics reflect the average tax structure of Nigeria. Putting all the three tiers of government together relative to revenue structure, one notes that Nigeria is far behind other countries both in Africa and advanced countries. For instance, Nigeria tax to GDP in year 2017 is 5.7%, much more lower than many developing countries. The percentage for the OECD, South Africa, Kenya and Ghana are 34.2%, 28.4%, 18.2% and 14.1% respectively (OECD, 2019; AU, 2019). In other words, Nigerian government should emulate, most

especially, the United States in tax-revenue collection. There should be multiplicity in tax base and payment made attractive, easy and beneficial to the payers. Diversification and serious reforms are required in this regard. .

State government revenue comes from income, sales, and other taxes; charges and fees; and transfers from the federal government.

Self-Assessment Exercise

Discuss the Nigerian tax structure with reference to tax-to-GDP ratio in 2019 OECD Report.

Explain the OECD Report on Tax Revenue

4.0 CONCLUSION

Public revenue is vital to the development of a country. It is need to provide public goods and finance government expenditure. United States and the OECD appear to have performed significantly well in revenue generation, especially, through taxes. Nigerian government should emulate, most especially, the United States and the OECD in tax-revenue collection. There should be multiplicity in tax base and payment made attractive, easy and beneficial to the payers. Diversification and serious reforms are required in this regard for the Nigerian economy.

5.0 SUMMARY

In this unit we have discussed revenue structure in selected countries which include, USA, China, Kenya and Nigeria. It is emphasized that the US is a federal state generating revenue from taxes. Taxation is very crucial to the governments of all levels. **About 48% of revenue in the US is obtained from personal income tax, meaning that every individual that are employed are taxed and pay regularly, meaning that most work places or the simply, the private sector is highly formalized.** Tax based is also complex

and flexible. In China, taxes are shared between the central communist party and the local regions. However, there is a great need for tax reforms to realize the Chinese potential public revenue. The same analysis goes for Kenya except that Kenya's position in tax-to-GDP ratio is better than Nigeria. Nigeria should embark on a tax system that incorporates flexibility and tax base multiplicity. This will help salvage the today's government dwindling revenue.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss, the general tax structure
2. Itemize the current tax system in Nigeria.
3. Explain comparatively, the current tax system in Nigeria and USA.
4. State the major sources of government revenue in Kenya

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UNIT 4 FEDERALISM AND FISCAL ADJUSTMENT THEORY AND PRACTICE IN SELECTED COUNTRIES

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1.0 INTRODUCTION

This unit is centered on federalism and fiscal adjustment theory, and the practice in selected countries. Federalism has been discussed in the previous module of this course material. It is defined as a system of government involving distribution of functions between different levels of government. It involves different sub national governments coming together to form a national government. Modern federalism is a system based upon democratic rules and institutions in which the power to govern is shared between national and sub national or state governments. Today, leading examples of the federation or federal state include the United States, India, Brazil, Mexico, Russia, Germany, Canada, Switzerland, Argentina, and Australia. Nigeria is a typical example of a federal state comprises 36 states including the federal capita territory (FCT).

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Discuss the concept of federalism.
- Explain fiscal adjustment process in federalism.
- Discuss the practice of federalism and fiscal adjustment in selected countries.

3.0 MAIN CONTENT

3.1 Federalism, Meaning and Theory

Fiscal federalism is part of broader public finance discipline. The term was introduced by the German-born American economist Richard Musgrave in 1959. An important aspect of Federalism is fiscal federalism which deals with the division of governmental functions and financial relations among the levels of constituent governments.

3.1.1 Four Main Types Federalism are:

1. **Dual Federalism** is the idea that the union and the state share power but the Federal Government holds more than the individual states. This is currently how the U.S. system works.
2. **Cooperative Federalism** is the idea that the federal government and the state government share power equally. It has never been attempted but it seems unlikely that it would work as the state governments and the federal government would be locked in a stalemate unable to reach compromises over important legislation.
3. **Fiscal Federalism** is the type of Federalism in which money bag controls everything. This gives Congress massive amounts of power as it is responsible for the treasury. It can therefore limit the budget of any other political department.
4. **Creative Federalism** is common in the United States even till now. The key aspects of Creative Federalism also known as "picket fence federalism" is that the federal government determined the needs of the states and provided services for them. In this case, the federal government works directly for the states, and caters to their

needs. This involves common planning between the federal and state governments to achieve goals that work for the states. However, this type of federalism is becoming unpopular.

Self-Assessment Exercise

What are the four main types of federalism

3.1.2 Theory of Federalism

Economic regional integration conceptual framework

Leaning on Bela Balassa's works on stages of economic integration Willem Molle (2006) and Michael Holden (2006) sketched the stages of economic integration, moving from economic cooperation to supranational integration, beginning with the lowering and removal of trade barriers and ending with an economic union. Holden operates with four stages and Molle with three, but Dosenrode (2010) suggest six stages which include: Ad hoc cooperation, free trade agreement, common market, customs union, partial integration and full integration, where the hitherto sovereign member-states formally hand over the major part of their decision making power and their sovereignty to the new state.

There is also what is referred to as **political regional integration** where stages from political cooperation to political integration can be listed in a parallel fashion to the economic integration process, where one begins with a purely inter-governmental cooperation and ends with full integration.

The Realist School of Federalism states that federalism is one way to solve the problem of enlarging governments. Each advance in the technology of transportation makes it possible to rule a larger geographic area from one center another. Dynamism of federalism is to fill a treasury more abundantly, to maintain a larger bureaucracy and police, and, most important of all, to assemble a larger army. Once one government enlarges itself, then its

neighbours and competitors feel compelled to do likewise in order, supposedly, to forestall anticipated aggression.

Neo-Functionalism

According to Tranholm Mikkelsen (1991); Schmitter (2005); Dosenrode, (2010), a central concept of the analysis was 'spill-over'. They claim that agreement on integration in one economic area would or could over time cause other economic policy areas to integrate too, in order to secure the full benefit of the integration in the first policy-area. Over time, the integration would become political. But, according to Tranholm-Mikkelsen (1991). Haas (1958) recognized that a political impetus in the right direction might be necessary, and that a high authority, looking after the integration project's common interest – not that of the individual member states would be needed. The driving forces of integration would be the pursuit of the politicians' interests. The assumptions made concerning the Neo-Functionalism are as follow:

- Integration is an attempt to create a stronger unit than the individual member states before the integration.
- Interests drive the process of integration, not ideology.
- An external 'kick' (threat, crisis) may be necessary to ignite a higher stage of integration.
- The attitude of the elites is important.
- The participating states are democratic.

Self-Assessment Exercise

Discuss the Neo-Functionalism theory of federalism

3.1.3 The Classical Theory of Federalism

The classical theory tries to explain what federalism is. The outstanding proponents of the classical theory are Dicey, Harrison Moore, Jethrow Brown, Bryce, Robert Garran and Wheare. Robert Garan, an eminent Australian scholar, defined federalism as "a form of government in which sovereignty or political power is divided between the central and local governments, so that each of them within its own sphere is independent of the other. Lord Bryce, describe the federal and state governments as "distinct and separate in their action". Further, he says, the system is like a great factory wherein two sets of machinery are at work, their revolving wheels apparently intermixed, their bands crossing one another, yet each set doing its own work without touching or hampering the other.

Self-Assessment Exercise

Explain the classical theory of federalism

3.2 Fiscal Adjustment Theory

A fiscal adjustment is a process of reduction in the government primary budget deficit, and it can result from a reduction in government expenditures, an increase in tax revenues, or both simultaneously. Fiscal adjustment may include fiscal **reform** or fiscal **consolidation.** **By Reform** we mean making any change to the current condition for the sole purpose of improvement or in economic terms-to get better off. “Fiscal policy deals with the taxation and expenditure decisions of the government”.

Fiscal Consolidation refers to the policies undertaken by Governments (national and sub-national levels) to reduce their deficits and accumulation of debt stock. Key deficits of government are the revenue deficit and the fiscal deficit.

Self-Assessment Exercise

Discuss fiscal consolidation.

3.2.1 Fiscal Adjustment and Macroeconomics

A number of influential studies present evidence that fiscal consolidation can have expansionary effects on economic activity in the short run. Perotti, (1997) says a fiscal consolidation of 1% of GDP reduces GDP by 0.43% and raises the unemployment rate by 0.28 percentage point within two years.

3.3 Federalism and Fiscal Adjustment, Practice in Selected Countries

3.3.1 Federalism Practice in the United State

Federalism in the United States, also referred to as the doctrine of shared sovereignty, is the constitutional division of power between U.S. state governments and the federal government of the United States. Since the founding of the country, and particularly with the end of the American Civil War, power shifted away from the states and toward the national government. Garcia-Milà, McGuire and Oates (2018) give an insight into federal practice in selected countries like USA and Canada. As for the US, the fiscal federal system is composed of the federal government, 50 state governments and thousands of local governments, both general purpose (cities and counties) and specific purpose (school districts, library districts, etc.).

The US system is quite decentralized in that sub national levels of government, both state governments and local governments have significant revenue-raising authority and spending responsibility. The states have played a large role in the fiscal federal system since the beginning of the federation. Indeed, at the dawn of the country in the late 18th Century, the states were the predominant player (Dilger, 2018). It was not until early in the 20th Century, when the country adopted a federal income tax and the central government responded to the Great Depression with an array of federal programs, that the central government began to overtake the state and local sector in terms of size.

Today, both the share of total (federal, state and local) revenues raised by state and local governments and the share of total spending undertaken by state and local governments is around 45 percent (Garcia-Milà, McGuire, & Oates, 2018).

State and local governments in the U.S. have significant spending responsibility, including responsibility for all three levels of education (primary, secondary and postsecondary), healthcare for low-income families, highways and public transit, and police and fire protection.

The federal government provides funding in each of these areas, in some instances substantial funding, but sub national levels of government undertake the actual spending.

While state governments have significant revenue-raising authority, imposing a wide array of taxes including income and sales taxes as well as user charges and fees, they also receive meaningful support from the federal government in the form of intergovernmental transfers.

The Medicaid program provides healthcare insurance for low-income families. Funded jointly by the federal government and the states, the program is administered at the state level.

The federal grant is a matching-grant program, providing a minimum matching rate of 50 percent (states with a matching rate of 50 percent receive a dollar of federal grant money for each dollar of state spending).

The matching rate is higher for states with lower average per capita income in 2018. For example, Mississippi had the highest match at 75.65 percent).

Other important grants from the federal government to state governments include grants for transportation, education, and income security.

3.3.2 Fiscal Adjustment Practice in the US.

The United States has passed through several stages of fiscal adjustment to stabilize the economy. During the great depression of 1930s, there was advocacy for increase in public spending suggested by Keynes (1936). After the WWII, there was economics of recovery and continuation of the supply-side economics. This continued till the late 1960s when fiscal policy was becoming ineffective to address rising inflation.

In the 1960s, Democratic Party president John F. Kennedy advocated a drastic tax-rate cut in 1963 when the top income tax rate was 91%. He argued that tax rates were too high and tax revenues too low. The soundest way to raise revenues in the long run is to cut rates now. The Revenue Act of 1964 emerged from Congress and was signed by Kennedy's successor Lyndon Johnson on February 26, 1964. The stated goals of the tax cuts were to raise personal incomes, increase consumption and increase capital investment.

Reagan made supply-side economics a household phrase and promised an across-the-board reduction in income tax rates and an even larger reduction in capital gains tax rates. The trend continue until the President Bill Clinton years in the mid 1994-2001 represent a counter-example to supply side economics as tax increases coincided with record job creation. From 1998 to 2001, the budget was in a surplus for the first time since 1969. During his presidency, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 and Jobs and Growth Tax Relief Reconciliation Act of 2003.

The current President Trump implemented individual and corporate income tax cuts which took effect in 2018. His team of economists claimed that the Trump tax cuts were an example of supply-side tax policy like in the past administration. These are the fundamental fiscal adjustment that set pace for other fiscal activities of the government. Fiscal adjustment is a continuous exercise to ensure economic stability and growth.

Self-Assessment Exercise

Discuss the fiscal Adjustment Practice in the US

3.3.3 Federalism and Fiscal Adjustment Practice in Canada

In the Canadian federalism, the federal government has jurisdiction over the entire country and each provincial government has jurisdiction over particular portions of the population. Both levels of government derive their authority from the written constitution.

The Canadian federal system is made up of federal government, 13 regional governments, ten provinces and three territories and approximately 3,900 municipalities.

Fiscal responsibility is shared between the federal government and sub national governments, with the federal government raising approximately 45 percent of total revenues in the country and being responsible for just over 30 percent of direct spending (Garcia-Milà, McGuire, and Oates, 2018).

The ten provinces have significant revenue-raising authority and spending responsibility. They impose taxes on income (both personal and corporate) and on sales, and they are responsible for spending on education, healthcare and other social services. Canadian provinces raise a substantial amount of revenue via the broad authority granted to them by the Canadian Constitution (section 92.2); own-source revenues comprised more than 80 percent of provinces' total revenues in 2015.

The major grants from the federal government to the provinces take two forms: two grants support specific services and a third grant equalizes resources across provinces.

The Canada Health Transfer is the largest of the grants and funds healthcare, ensuring "universality, comprehensiveness, portability, accessibility and public administration" as delineated in the Canada Health Act of 1984. The Canada Social Transfer is a block grant that provides support for all Canadians for post-secondary education, services for children, and social programs.

The federal government distributes both grants on an equal per capita basis, so that in each province the federal government provides the same amount of funding support per person.

The **Equalization grant** is a federal grant that addresses fiscal disparities among the provinces. Provinces with below average fiscal capacity receive grants to ensure that they have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. There are no constraints on how the provinces can spend these grant monies. In FY 2018-2019, six provinces, including Quebec and Ontario, the most populous provinces, qualified for equalization payments.

Self-Assessment Exercise

Discuss the fiscal Adjustment Practice in the Canada

3.3.4 Practice in India

The Government of India (referred to as the Union Government) is the governing authority of a federal union comprises of 28 states and 9 union territories. Indian government is based on a three tiered system, in which the constitution of India defines the subjects on which each tier of government has executive powers. In the current arrangement, The Seventh Schedule of the Indian Constitution delimits the subjects of each level of governmental jurisdiction, dividing them into three lists which include:

- **Union List** includes subjects of national importance such as defense of the country, foreign affairs, banking, communications and currency. The Union Government alone can make laws relating to the subjects mentioned in the Union List.
- **State List** contains subjects of states and local importance such as police, trade, commerce, agriculture and irrigation. The state governments alone can make laws relating to the subjects mentioned in the State List.
- **Concurrent List** includes subjects of common interest to both the union government as well as the State Governments, such as education, forest, trade

unions, marriage, adoption and succession. Both the Union as well as the State Governments can make laws on the subjects mentioned in this list. If their laws conflict with each other, the law made by the union government will prevail.

There are two distinct characteristics of Indian federal system which distinguish it from other federal states:

- ✓ Indian federalism, unlike many other forms of federalism, is asymmetric or unequal and gives limited autonomy to only some Indian state.
- ✓ It has a system of President's Rule in which the central government (through its appointed Governor) takes control of state's administration for certain months when no party can form a government in the state or there is violent disturbance in the state.

Concerning fiscal adjustment aspect, Article 282 accords financial autonomy in spending financial resources available to the states for public purpose. Article 293 allows States to borrow without limit without consent from the Union government. However, the Union government can insist upon compliance with its loan terms when a state has outstanding loans charged to the consolidated fund of India or a federally-guaranteed loan.

In addition, the president of India constitutes a finance commission every five years to recommend devolution of union revenues to state governments. Under Article 360, the president can proclaim a financial emergency when the financial stability or credit of the nation or of any part of its territory is threatened. However, no guidelines define "financial emergency" for the country or a state or a union territory or a panchayat or a municipality or a corporation.

A state of financial emergency remains in force indefinitely until revoked by the President. The president can reduce the salaries of all government officials, including judges of the supreme court and high courts, in cases of a financial emergency. All money bills passed

by the State legislatures are submitted to the President for approval. He can direct the state to observe economy measures.

Self-Assessment Exercise

Discuss the fiscal Adjustment Practice in India

3.3.5 Federalism and Fiscal Adjustment Practice in Nigeria

Nigeria is a federation comprises of 36 states. Although the country's federal system is fashioned after the United States', but its practice appears to be different from that of the US. Federalism in Nigeria has been in practice since the former British colony was reorganized into a federation of three regions in 1946. Regionalism was introduced to the Nigeria system by the Richards Constitution. At independence, there were three regions created and Lagos was a separate central government territory outside the three regions. In other to achieve fiscal balance, there has been creation of states from the Mid-West, to 19 states and 36 states including FCT. Agitation for more state creation continues. The question is whether creating more states can give answer to economic backwardness of the nation or it can generate more wastage?

It has been observed that the relationships among the federal, state and local government in a federal system of government, like Nigeria, are complex and cannot be simply described by a simple examination of their revenue generation and expenditures. This complex situation has further be compounded by continuous shifts and changes in fiscal responsibilities from the federal government to other levels of government. For example, primary healthcare and primary education should be predominantly local government responsibility. However, the three tiers of government provide fund for all these activities.

On fiscal adjustment, for the Nigerian economy, the recent bid for increase in tax, especially, value added tax might be a welcome development if this will boost the government revenue base. Typically, Nigerians are among the lowest tax payers in the

world. As indicated above, the tax-to-GDP ratio is about 5.7% as against Ghana and Kenya 14.1% and 18.2% respectively. Oil rents and royalty constitute the greater portion of government revenue. Oil and gas sales also generate about 94% of foreign exchange and 75% of total government revenue. Currently, the government is facing with declining revenue and is eagerly seeking avenue to raise fund.

Deficit overhang is a major threat to the nation as government continues to borrow from the international community. Several fiscal adjustments are open to the government to increase its revenue base. These are highlighted below:

a. Diversification of revenue source, the need to focus on non-oil revenue.
b. Widening of the tax base.
c. Reduce the value of current expenditure to lessening the unnecessary pressure on government revenue.
d. Maintaining responsible and accountable government to reduce or stop tax evasion.
e. Employment creation to increase the number of feasible tax payer.
f. Investigate the integrity level of the officials of Federal Inland Revenue Services (FIRS), customs and agencies other appointed to collect revenue on behalf of the government.

Self-Assessment Exercise

Explain the classical theory of federalism.

Discuss the fiscal Adjustment Practice in Nigeria

4.0 CONCLUSION

This unit discusses the concept of federalism and fiscal adjustment and review their practice in selected countries like USA, Canada, India, and Nigeria. The practice in most

countries is almost similar. However, Nigeria federalism seems to have deviated from true federalism but incline towards unitary system. This is because the federal government plays dominant roles in the country, acquiring over 50% of revenue accrued to the nation. While this exists, the government is yet to realize its full potentials in revenue collection as the avenue to collect tax is narrow. As a result, the government faces revenue shortage. Therefore, there is a need for restructuring of federal system in Nigeria for a successful fiscal adjustment process.

5.0 SUMMARY

In this unit we have examined federal system and fiscal adjustment in selected countries. It is defined that fiscal adjustment is a process of managing government finances in such a way to achieve fiscal policy objectives of economic growth and stability. We highlight federal system practiced in selected countries as well as their fiscal adjustment. It is noted that Nigeria federal system has come a long way since the 1946 Richard Constitution. To create fiscal balance, there has been creation of more states and geo-political zones. However, agitation for more states rages on even though it appears more states creation may not induce significant economic growth.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss federalism as it relates with Nigeria.
2. Discuss the concept of fiscal adjustment.
3. Explain the difference between the US and Nigerian Federalism
4. Highlight the federalism practice in India and state the lesson Nigeria can learn.

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