

# THE RELATIONSHIP BETWEEN FISCAL POLICY AND ECONOMIC GROWTH IN NIGERIA (1991 - 2005)

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## ABSTRACT

*The study evaluated the effects of fiscal policy on the economic growth in Nigeria for the period 1991 to 2005. The study examined the contributions of tax revenue, government debts, government recurrent expenditure, government capital expenditure, government recurrent budget, and government capital budget to the gross domestic product. Using data both from the Central Bank of Nigeria Annual Reports and Accounts and Statistical Bulletin, we utilized the multiple regressions for the analysis of data. The result indicated that a significant relationship exists between the explanatory variables taken together and gross domestic product, and no significant relationship between the specific explanatory variables contributing to gross domestic product except government recurrent and capital expenditures. On the average 99% of the variations in GDP is explained by variables in the model. The paper concluded that the achievement of economic growth through fiscal policy in Nigeria is a mirage as a result of inconsistencies in government policies, wasteful spending, corruption and poor policy implementation. Therefore, it was recommended among others that government should avoid unnecessary borrowings; ensure that policies are implemented and inconsistencies are minimized; leakages and corruption in the country are tackled with all level of seriousness; and above all, the application of fiscal transparency and responsibility in the running of government business.*

**Keywords:** *fiscal policy, economic growth, budgetary revenue and expenditure, Nigeria*

## INTRODUCTION

Economic growth has received much attention among scholars. According to Khorravi and Karimi (2010), classical studies estimate that economic growth is largely linked to labour and capital as factors of production. The emergence of the endogenous growth theory has encouraged specialists to question the role of other factors in explaining the economic growth phenomenon (Bogdanov, 2010; Gray, Lane and Varoudaskia, 2007). Therefore, fiscal policy is considered an important variable which may determine changes in national income in developing countries like Nigeria. In order to stimulate the economic growth by means of fiscal policy, the country has more instruments: (a) the financing of direct investments which the private sector would not provide an adequate quantities; (b) the efficient supply of certain public services which are necessary to ensure the basic conditions to display the economic activity and long term investments; (c) the financing of public activities so as to minimize the distortions to come up with the decisions to spend and invest

proper in the private sector (Brasoveanu and Brasoveanu, 2008; Ito, Watanbe and Yabu, 2007; Talvi and Vegh, 2005). Fu, Taylor and Yucel (2003), Wyplosa (2002) and Jha (2007) stressed that fiscal policy and economic growth had long fascinated scholars of public finance.

Unfortunately, analyses of that relationship have frustrated empiricists for almost as long. One root cause of that frustration is the array of possible policy indicators. According to Tanzi and Zee (1997) there are three cardinal indicators of fiscal policy - government expenditure, taxes and deficits. Oner (2002) opined that economic policy instruments had been used such as fiscal money, foreign trade, price and employment to achieve specific macroeconomic objectives of full employment, production, price stability, balance of payment, development and redistribution of income. Atac (1991) in Schckrek (2004) stressed that fiscal instruments which government holds, are to be used for protection of stabilized economic framework which is purified from cyclical fluctuation and to obtain price stability, full employment, economic growth and development. To achieve these goals in the Nigerian economy, government expenditures, incomes, debts and budgets as fiscal policies, Osuka and Ogbonna (2010) noted that:

*the magnitude of government's fiscal surplus or deficit is probably an important statistics in measuring the impact of government fiscal activities on the economy as this have effect on the various macroeconomic objectives. Therefore, it is now widely accepted that public sector finances and their related policies constitute a central aspect of economic management which partly influence the overall performance as well as distribution of resources between the private and public sectors. There is a growing recognition that the formulation and implementation of macroeconomic management proposals and reforms must include wide ranging fiscal reforms.*

There have been macroeconomic imbalances of varying degrees in Nigeria. Inappropriate public expenditure and revenue policies, large deficit in the public sector have been identified by experts as responsible for the macroeconomic disequilibrium (Ajisafe and Folorunsho, 2002). Ocran (2009) stressed that there are two main strands of literature regarding the role fiscal policy plays in fostering economic growth. One view is that government's fiscal policy support for knowledge accumulation, research and development, productive investment, the maintenance of law and order and the provision of other public goods and services can stimulate growth in both the short run and long run (Heller and Rao, 2007). On the other hand, there is also the bureaucratic and less efficient procedure and as a result they tend to hinder rather than facilitate growth if they get involved in the productive sectors of the economy (Perez and Herbert, 2002).

Thus government fiscal policy is thought to stifle economic growth by distorting the effect of tax and inefficient government spending. Therefore, in the light of the above, the question that comes to fore is what has been the effect of fiscal policy on economic growth in Nigeria for the period 1991 - 2005? Hence, this

study investigates the effect of fiscal policy tools on economic growth in Nigeria. In order to achieve the objective of this study, the paper hypothesized in null form that fiscal policy components have no significant effect on economic growth in Nigeria for the period 1991 - 2005.

### **FISCAL POLICY AND ITS OBJECTIVES**

Fiscal policy involves the use of government spending, taxation and borrowing to influence the pattern of economic activities and also the level and growth of aggregate demand, output and employment. Olawunmi and Tajudeen (2007) opine that fiscal policy has conventionally been associated with the use of taxation and public expenditure to influence the level of economic activities. They further said the implementation of fiscal policy is essentially routed through government's budget. Valmont (2006) defined fiscal policy as "the economic term which describes the actions of a government in setting the level of public expenditure and the way in which that expenditure is funded". Jhingan (2004), Musgrave R. and Musgrave P. (2004), Oner (2002), Hottz-Eakin, Lovely and Tosin (2009) described fiscal policy as mostly to achieve macroeconomic policy; it is to reconcile the changes which government modifies in taxation and expenditure, programmes or to regulate the full employment price and total demand to be used through instruments such as government expenditures, taxation and debt management. Typically, the objective of fiscal policy is directed towards maintaining sound public finances. This invariably amounts to an unwavering commitment to the maintenance of balanced budget by restricting aggregate spending to the size of aggregate recurrent revenue and a sound public sector balance sheet is by implication achieved (Valmont, 2006; Osuka and Ogbonna, 2010; Jhingan, 2004; Fu, Taylor and Yucel, 2003).

An important objective of fiscal policy is to promote economic conditions conducive to business growth while ensuring that any such government actions are consistent with economic stability (Anyanwu, 1993). Given the central importance of the latter, the key objective of fiscal policy in addition to guaranteeing sound public finances is to promote equity in taxation without creating economic distortions or disincentives to wealth creation (Valmont, 2006). The objectives of fiscal policy tend to differ between developed and developing countries like Nigeria. With regards to the former, the role of fiscal policy is generally to maintain full employment and stabilize growth. By contrast, in developing countries, fiscal policy may be used to create an environment for rapid economic growth. Khosravi and Karimi (2010) maintains that fiscal policy is generally believed to be associated with growth, or precisely, it is held that appropriate fiscal measures in particular circumstances can be used to stimulate economic development and growth (Barro and Sala-i-Martin, 1991; Amin, 1998). The various aspects of this include mobilization of resources, acceleration of economic growth, increasing employment opportunities, minimization of the inequalities of income and wealth and price stability.

## **FISCAL POLICY IN NIGERIA**

The past two decades in Nigeria have witnessed a considerable increase in government indebtedness. Beyond the issue of poor quality of public expenditures, the ability to save windfalls from excess crude oil proceeds by the government remains critical in ensuring that government expenditure is maintained at a sustainable level and consistent with the absorptive capacity of the economy (Baunsgard, 2003). Evidence reveals that there was a substantial increase in government spending, primary deficit and debt in Nigeria between 1991 - 2005. The oil windfall between 1991 - 1992 was followed by rapid growth in government spending with an average of about 21 percent of GDP during that period. However, as the oil market weakened in subsequent years, oil receipts were not adequate to meet increasing levels of demands and expenditures as being reinforced by political pressures, were not rationalized. Although the democratically elected government in 1999 adopted policies to restore fiscal discipline, the rapid monetization of foreign exchange earnings between 2000 - 2004, another era of oil windfall, resulted in large increases in government spending. In 2005 alone, the government spending alone increased to 19 percent of GDP from 14 percent in 2000. Extra ordinary budgetary outlays, not initially included in the budget increased.

According to Baunsgard (2003), experience in Nigeria illustrates the difficulties of implementing fiscal policy in an environment with highly volatile revenue flows. Over the years, there have been a strong deficit bias and procyclically in fiscal policy, driven largely by oil prices 1991-1992 and 2000-2002, revenue and expenditure have increased sharply. This as typically seen followed the scaling back of expenditures as oil prices substantially decline, though at times with a lag. The implications of such boom-burst fiscal policies include transmission of oil-price volatility to the stable provision of government services. This has added to the failure over neither the years of public spending, facilitating the diversification nor growth of the economy.

### **PREDICTIONS OF GROWTH MODELS AND FISCAL POLICY**

Neoclassical growth models imply that government policy can affect only the output level but not the growth rate. However, endogenous growth models incorporate channels through which fiscal policy can affect long-run growth (Barro-Sala-i-Martin, 1991). The later models classify generally the fiscal policy instruments into: (i) distortionary taxation, which weakens the incentives' to invest in physical/human capital, hence reducing growth; (ii) non-distortionary taxation which does not affect the above incentives, therefore, growth due to the nature of the utility function assumed for the private agents; (iii) productive expenditures that influence the marginal product of private capital, hence boost growth and (iv) unproductive expenditures that do not affect the private marginal product of capital, consequently growth (Masson, 2000).

The endogenous growth models predict that an increase in productive spending financed by non-distortionary taxes will increase growth, while the effect is ambiguous if distortionary taxation is used. In the latter case, there is a growth maximizing level of productive expenditure which may or may not be Pareto efficient (Irmen-Kuehnel, 2008). Also, an increase in non-productive spending financed by non-distortionary taxes will be neutral for growth, while if distortionary taxes are used the impact on growth

will be negative (Kennedy, Luu, Morling and Yeaman, 2004). Various extensions of the basic endogenous growth models have been worked out by scholars allowing publicly-provided goods to be productive in stock and/or flow (Tsoukis and Miller, 2003; Ghosh and Roy, 2004), different forms of expenditure to be productive (Gomez, 2007), various forms of taxation and asymmetric equilibria ex-post.

### **FISCAL POLICY AND ECONOMIC GROWTH**

Fiscal policy is generally believed to be associated with growth, or more precisely, it is held that appropriate fiscal measures in particular circumstances can be used to stimulate economic growth and development (Khosravi and Karimi, 2010). There is an upsurge of empirical literature aimed at unraveling the relationship between various measures of fiscal variables and economic growth. In this endeavour, cross section, panel and time series data have been employed. Attempts to underpin the growth relationship are undermined by conceptual statistical and estimation concerns (Amanja and Morrissey, 2005; Mansouri, 2008; Bell, Brunori, Green, Wolman, Cordes and Qadiri, 2005). Nijkamp and Poot (2002) conducted a meta-analysis of past empirical studies of fiscal policy and growth and found that in a sample of 41 studies, 29% indicate a negative relationship between fiscal policy and growth, 17% a positive one, and 54% an inconclusive relationship. One of the contributory factors to these varied empirical results is the measure used to proxy for fiscal policy. Table one shows various empirical studies on the relationship between fiscal policy and economic growth.

### **METHODOLOGY**

This study used data covering 1991-2005 mainly from secondary sources on fiscal policy variables and economic growth; the sources include Central Bank of Nigeria, Annual Reports and Statement of Accounts, Statistical Bulletin and the economic and financial reviews for various years. The choice of these secondary sources is based on their authenticity and reliability. The operational methodology adopted is the multiple regression analysis was ordinary least square (OLS) econometric technique, multiple regressions of the dependent variable (gross domestic product) and the independent variables (tax, recurrent and capital expenditure, recurrent expenditure budget and capital expenditure budget, internal and external borrowing) in the specification of the model with a view to determining the nature and extent of the relationship that exists among the variables. Statistical Package of Social Science (SPSS) for windows application software was used to run the regression for the period 1991-2005.

Statistical significance of the a priori theoretical relationship was tested and statistical significance or insignificance of the coefficients of the independent variables was established. Analysis of the mathematical sign of the coefficients was undertaken. A positive and statistically significant coefficient for the various dependent variables was interpreted as supporting the given hypothesis. The analysis was guided by the following linear models:

$$GDP = \beta_0 + \beta_1 TR + \beta_2 GD + \beta_3 GRE + \beta_4 GCE + \beta_5 GCEB + \beta_6 GREB + \varepsilon$$

Where:

GDP = Gross Domestic Product

TR = Tax Revenue

GD = Government Debt

GRE = Government Recurrent Expenditure

GCE = Government Capital Expenditure

GCEB = Government Capital Expenditure Budget

GREB = Government Recurrent Expenditure Budget

$\beta_0$  = Intercept of the regression,  $\beta_1$ ,  $\beta_2$ ,  $\beta_3$ ,  $\beta_4$ ,  $\beta_5$ ,  $\beta_6$  = coefficient of the regression

$\varepsilon$  = the error term capturing other explanatory variables not explicitly included in the model

Decision rule: We reject the null hypothesis if f-calculated is greater than the critical value of f, ( $f_c > f_l$ ), and accept the alternative hypothesis. The test is conducted at the 1% and 5% level of significance. If the calculated t-value is greater than the table value, the variable is significant. Also, signs borne by the parameter estimates and their magnitudes will be tested in line with the apriori expectation.

The data for this study representing the independent variables tax revenue (TR), government debt (GD), government recurrent expenditure (GRE), government capital expenditure (GCE), government capital expenditure budget (GCEB) and government recurrent expenditure budget (GREB) were pooled together with the dependent variable gross domestic product (GDP) for the period 1991 to 2005. Multiple regression analysis is used to investigate the predictable power of the independent variables on the dependent variable. The analysis was however guided by the specified model as above. The summary of the regression results are presented on tables.

## RESULTS AND DISCUSSION

Table 2 shows that a high and significant relationship exist between all the variables (independent and dependent) taken together. The high level of correlation between the variables has been further supported by the results of other test statistics like the  $R^2$  and adjusted  $R^2$ . This means that 99.2% of the variations in GDP is explained by the variables in the model and the remaining 0.8% is from outside the model and 98.6% of the variations in GDP is explained by the variables while 1.4% is outside the model. Table 4 above also shows that the calculated f-ratio of 163.766 is greater than the F-ratio tabulated at 5% and 1% levels of significance. We reject the null hypothesis ( $H_0$ ) and accept the alternative hypothesis ( $H_a$ ) and this concludes that a significant relationship exists between the explanatory variables (tax revenue, government debt, government recurrent expenditure, government capital expenditure, government recurrent expenditure budget and government capital expenditure budget) taken together and gross domestic product as proxy for economic growth, for the period 1991 to 2005.

Table 4 above shows the specific strength of the explanatory variables in contributing to the variations in GDP. We compare the calculated t-ratio with the tabulated t-ratio. From the t-table, we read t (df = 8) at 5% level of significance is greater than the 0.537 for tax revenue; -0.587 for government debt; -0.790 for government recurrent expenditure budget; -2.440 for government capital expenditure budget. Also, 3.404 for government recurrent expenditure and 4.467 for government capital expenditure is greater than the table value of 2.31. This shows that there is no significant contribution of tax revenue, government debt, government recurrent budget and government capital budget to economic growth. This result is supported by the findings of Osuka and Ogbonna, 2010; Brasoveanu and Brasoveanu, 2008; Kochelakoka, 1996. Also there is significant contribution of government recurrent expenditure and government capital expenditure to economic growth. The result is in consonance with earlier studies conducted (Khosravi and Karimi, 2010; Barro, 1999; Mishkin; 1982).

The analysis shows that government tax revenues, government debts, government recurrent and capital budgets have not individually contributed to the economic growth of Nigeria, but collectively they have. The implication is that factors such as policy inconsistencies, high level of corruption, wasteful spending, poor policy implementation in Nigeria are capable of hampering the effectiveness of fiscal policy in achieving sustainable economic growth in the country. However, government recurrent and capital expenditure programmes have contributed to the growth of the nation. This means that government should ensure that public expenditures are properly managed to achieve the desired macroeconomic objectives.

### **CONCLUSION AND RECOMMENDATIONS**

Fiscal policy involves the use of government spending, taxation and borrowing to influence both the pattern of economic activity and also the level and growth of aggregate demand, output and employment. The achievement of economic growth through fiscal policy in Nigeria has remained a mirage. This is despite the increase in government spending over the years (1990 - 2005), the rate of economic growth has been very sluggish. The poor performance of fiscal policy in Nigeria has been blamed on the problems of policy inconsistencies, high level of corruption, wasteful spending and poor policy implementation. Kwakwa (2003) noted that fiscal policy in Nigeria has been extremely pro-cyclical with expenditures ratcheting out of control on the upswing of the oil price. This has contributed to the observed deficit bias in the conduct of fiscal policy. This is evident from the result of the analysis that revenue and expenditure components of fiscal policy need serious attention for macroeconomic objectives to be attained. On the basis of the above, the following recommendations are proffered:

1. The government should avoid unnecessary borrowings and ensure that existing debts are properly serviced as at when due;
2. The government should ensure that policy inconsistency are minimized and policy reversals are properly checked for both short and long run effects on the economy;

3. Tax and revenue generation policies should be properly addressed economically to avoid leakages in the system;
4. The passage of annual budgets should be done early enough to give room for proper implementation, monitoring and review where necessary to achieve the desired objectives;
5. Government should ensure that expenditure programmes are properly monitored to avoid leakages in the system through the application of fiscal transparency and responsibility and due process.
6. Finally, government should fight the problem of corruption because without a reduction of the level of corruption in the country, fiscal policy components will not achieve the required level of economic growth in Nigeria.

**Table 1:** Various empirical studies on the relationship between fiscal policy and economic growth.

Author(s)	Sample and Methodology	Result and Conclusion
Khosravi and Karimi (2010)	Autoregressive Distributed Lag (ARDL) cointegration. 1960-2006	The results indicated the impact of exchange rate and inflation on growth was negative, government expenditure was found to have significant positive impact on growth.
Brasoveanu and Brasoeanu (2008)	Regression analysis and interval analysis 1990 - 2007	The results show that the correlation relation pattern between the growth rate of the GDP and the categories of budgetary revenues reveals a link of negative causality between the economic growth and fiscal revenues.
Olawunmi and Tajuden (2007)	Solow growth model and Ordinary Least Square method 1981-2004.	The empirical results generated from the estimation shows that there is no significant impact of fiscal policy variables on economic growth in Nigeria.
Osuka and Ogbonna (2010)	Multiple regression analysis 1987-2006	The results show that government revenue and capital budgets have very high significant impact on economic growth.
Amanja and Morrissey (2005)	Autoregressive Distributed Lag (ARDL) model and ordinary least square method using time series data 1964-2002.	The study reveals that productive expenditure has strong adverse effect on growth whilst there was no evidence of distortionary effects on growth of distortionary taxes. Government investment was found to be beneficial to growth in the long run.
Benos (2009)	Ordinary least square and panel economic techniques for 14 EU countries for the period 1990-2006	The study reveals that (a) public expenditure on infrastructure (economic affairs and general public services) exert a positive impact on growth; (b) government outlays on property rights protection (defense, public order safety) have a positive effect on per capita growth; (c) distortionary taxes depresses growth; (d) government expenditures on human capital enhancing activities (education, health, housing, environmental protection, recreation, culture, religion, and social protection) do have a significant effect on per capita growth.
Enache (2009)	Time series data from 1992-2003 using ordinary least square method	The obtained results show a negative and significant impact of the public sector size on economic growth; a negative and significant impact on economic growth in Romania of public revenues. In the same time, the size of budgetary balance is positively correlated with real GDP growth rate.
Fu, Taylor and Yucel (2003)	Time series data set from 1983-2002 using vector-autoregressive methodology	The results obtained show that an increase in the size of federal government lead to slower economic growth, that the deficit is an unreliable indicator of the stance of fiscal policy and that tax revenues are the most consistent indicator of fiscal policy.



**Table 2: Model Summary 1**

Model	R	R <sup>2</sup>	Adjusted R <sup>2</sup>	Standard Error of the Estimate
1	.996a	.992	.986	8643.744

**Table 3: Model Summary 2 (Change Statistics)**

Model	R <sup>2</sup> change	F change	df1	df2	Sig.F change
1	.992	163.766	6	8	.000

a. Predictors: (Constant), GCEB, GD, GCE, GREB, TR, GRE

**Table 4: ANOVA**

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	7.3 E +010	6	12235698284	163.766	.000a
Residual	6.0E + 008	8	74714305.752		
Total	7.4E +010	14			

a. Predictors: (Constant), GCEB, GD, GCE, GREB, TR, GRE

b. Dependent Variable: GDP at 1990 factor cost

**Table 5: Coefficients<sup>a</sup>**

Model	B	Std Error	Beta	t	Sig.
Constant	317795.40	5950.819		53.404	.000
TR	.009	.016	.91	.537	.606
GD	-.002	.003	-.048	-.587	.574
GRE	.206	.061	1.159	3.404	.009
GCE	.174	.039	.386	4.467	.002
GREB	-.039	.049	-.206	-.790	.452
GCEB	-.105	.043	-.287	-2.440	.041

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