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Nigerian Fiscal Federalism Seen from a Comparative Perspective

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Mr. Chairman, Honourable Governors, other distinguished elected representatives, and guests. Let me start by thanking you for the great honour of addressing the Governors' Forum at such an historic meeting. Having been invited, I was determined to come given the obvious importance of the gathering and because Nigeria is one of nine partner countries of the Forum of Federations. I should mention that the Forum benefited greatly from the wisdom of Dr. Alex Ekueme, who recently stepped down after seven years as a director. And finally, you invitation was special because the Forum of Federation played a role in the early history of the Governors' Forum. In 1999 and again in 2000 we brought a number of distinguished visitors to participate in your meetings.

Having agreed to come, I faced the daunting challenge of thinking what I might say that deserved your attention. I had been here only once before, in November 2006. One of the highlights of my trip, was a visit with then-Governor Adamu in Nasarawa state. So here I am, clearly no expert on Nigeria.

What I do know a little about is the practice of federalism around the world. In my previous visit I was struck by the appeals of various politicians and commentators that Nigeria needed to follow "real federalism". In my reading about your country I have seen the same theme time and again. What do people mean by this? A recent article put it this way:

> *Most critical… is that Nigeria must be quickly returned to a truly democratic and true federal*

> *arrangement where every level of government will be free within the constitution to do its own thing, in its own way and at its own pace.*

In my job I have become very familiar with many different federal regimes. There over 25 of them and federalism is the form of government for 40 per cent of humanity. The fundamental hallmark of federations is variety: presidential vs. prime ministerial regimes; classic dualist regimes versus interlocking federalism; centralized versus decentralized, and so on.

What I can tell you that while there is some truth about the above notion of federalism, it is a limited and extreme view. It does not represent the reality of the practice of federalism and nor, in my view, would such a "true federalism" lead to good government. All federations involve complex arrangements of cooperation, collaboration and conflict between their states and central governments. The modern world of federalism is very much one of intermingled responsibilities and objectives.

What about Nigeria? How does its federalism compare to other federations of the world? With over 130 million people, two or more major religions, a few major and many minor languages, major geographic differences, and 36 states you are one of the largest and most complex federations in the world. It has been said that countries are not difficult to govern because they are federations; they are federations because they are difficult to govern. Surely, Nigeria exemplifies this.

Your size and complexity, while daunting, are in no cause for despair. If Nigeria is large and complex, India is even more so, yet it has just celebrated 50 years of independence in a mood of optimism and accomplishment. In 1947 many doubted that democracy could endure in this vast, poor, and deeply divided country that had never been governed as a single political community and with literacy of only 11 per cent.   But India has defied the skeptics and today we talk of India's growing economy and role in the world.

Nigeria's experience of democracy and federalism has not been as successful as India's, but I think your prospects are very good. You had the misfortune to start your federation with only four states, one of which had over half the population. Experience in many federations demonstrates how difficult it is to manage federations with very few units. In your case, the system broke down, the military took over and you suffered a terrible civil war. Most of your history since independence has been under centralizing military regimes. Your new structure of 36 states, combined with the plurality of Nigeria presents an institutional and social framework that, in my view, is promising.

While I do not know your country well, I am going to hazard a prediction. It is that as your federal democracy matures, you will face strong decentralist forces driven by your diversity. My hunch is that much of the current rhetoric in Nigeria about excessive centralization is fighting the last war: a reaction to the over-centralization of what my friend Isawa Elaigwu calls "military federalism".

These comments provide some context for the subject on which I have been asked to speak: Nigerian fiscal federalism in a comparative context.

My basic message will be the following. Nigeria is the most oil dependent of all established federations: oil revenues dominate public finance, as they do much of your politics. You have made significant progress in managing oil revenues from a macro-economic point of view. Your arrangements for the collection and distribution of governmental revenues—notably the Federation Account—are unusual compared to other federations and have perhaps led to an excessive emphasis on watertight compartments in your system. Moreover, your fiscal arrangements have resulted in a very wide disparity in the fiscal means of states compared to other federations and your accountability systems are weaker than those found in most federations. Finally, your system appears to be relatively weak in terms of policy coordination and transparency compared to most other federations.

I shall start my remarks by looking at how the assignment of the major revenue bases in your federation and the mechanisms for managing central revenues compare with experience elsewhere. I shall then look at four major challenges of fiscal federalism in Nigeria.

The Assignment of Revenue Bases

There are four principal revenue bases in Nigeria. Three are federal: oil and gas royalties, licenses and fees; corporate income tax; and the VAT. One is state: the personal income tax.

Experience in other federations around the assignment of these revenue bases varies a good deal. Personal and corporate income taxes are typically either exclusively federal or shared. I am not aware of another federation that has assigned personal income taxes exclusively to the states. VAT and sales taxes are also usually exclusively federal or shared.

Revenues from oil and gas can come from royalties, licence fees, profits from state oil companies, and export taxes (as well as indirectly from corporate taxes). Royalties and licence fees are associated with ownership of the resource and are typically the major source of revenue from oil and gas. In the older federations, such as the USA, Canada and Australia, onshore resource ownership is normally with the states, though there are substantial "federal lands" in the Western states of the US and in Alaska. Typically, newer federations have assigned natural resources exclusively or substantially to the federal government. In virtually all federations, offshore resources are federally owned, though Canada has effectively transferred management and the royalties and license fees to the contiguous provinces. In most federations with twentieth century constitutions, natural resources are owned by the federal government.

This is particularly true of the heavily oil dependent federations: Mexico, Venezuela, and Russia. The issue is still not settled for Iraq's federal arrangements. And Sudan's federation is based on a shared control of oil and gas, with the Southern states getting half the revenues. Thus Nigeria's arrangement whereby oil and gas ownership and revenues are federal is not unusual, particularly given the centrality of oil and gas for your economy.

The Federation Account

Where Nigerian practice is unusual is in the arrangements around the management of federal revenues. As you know, your constitution provides that all federal revenues must go into the Consolidated Revenue Account. This is standard, good practice in most federations. However, your constitution also establishes a second account, the famous Federation Account, into which the vast majority of federally raised revenues must flow. Funds from this account are then to be allocated by formula amongst the federal and state governments. I believe this is a unique arrangement.

There are a number of federations where certain taxes that are levied and collected by the federal government are deemed to be "shared"—so that a portion goes automatically to the states. In some cases, states get a share of what was collected within their borders; in other cases, they get a share of the national tax revenue. What is unique, so far as I know, is an arrangement where the vast majority of federal revenues should be placed into an account that is to be shared between the two orders of government. Moreover, the constitution sets out certain broad principles for allocating the funds and this is to be done “by formula”. Finally, one element of that formula—the percentage of oil revenues to be allocated according to the principle of derivation—is actually given in the constitution.

Of course, as a practical matter, the government—the President and the National Assembly—has a fair measure of control over what actually happens with the Federation Account. They have established four special funds representing 6.5% of the revenues in the Federation Account and these seem to be allocated with a large measure of federal discretion. It has also chosen to make some tied transfers or conditional grants from its share of the Federation Account. The program for Universal Basic Education is the clearest example of this where the federal government has made 2 per cent of its statutory allocation available to the states, which are to match this up to 70 per cent. This is consistent with the Supreme Court’s finding that the federal government may make *supplementary* grants to the states “in such sum and subject to such terms and conditions as may be prescribed by the National Assembly”. So there are some minor elements of flexibility. From a comparative perspective I would make two points:

- The Federation Account is unique amongst federations.
- The existence and terms around the Federation Account have given a very particular cast to the fiscal

debate and fiscal relations in Nigeria, notably a relatively narrow focus on the appropriate formula for sharing the major revenues rather than on other issues of public and fiscal policy.

Nigeria's Major Fiscal Challenges

With this background, I would now like to consider four major fiscal challenges that I see for Nigeria. They are:

- managing a petro-economy with its swings and the eventual depletion of the resource;
- providing regional and vertical equity in the distribution of fiscal resources;
- promoting coordination of major policies within the federal system; and,
- ensuring transparency and probity in the management of public finances.

The Challenge of Oil

Oil revenues account for about 80 to 85 per cent of all government revenues in Nigeria. The only federation that comes close to that is Iraq, though its federal system is not truly functioning. Other federations such as Venezuela, Mexico and Russia have a very large proportion of their revenues coming from oil and gas, but significantly less than in your case.

You are familiar with the problems associated with such a huge dependence on oil revenues:

- First, it poses issues of *political accountability* because the federal government raises its revenues from such a narrow base and most states contribute very little to national or their own revenues. Only 6 of your 36 states produce petroleum, with 4 being the most important. Thus the large majority of states turn to the federal government for the vast majority of their revenues <u>and</u> most of those revenues are effectively collected in other parts of the country. The public, for its part, pays little of the cost of government programs.
- Secondly, it can be a *source of major tensions* between the producing and other regions of the country.
- Thirdly, it appears to have led to an *underdevelopment of alternative revenue sources* because it is easier to tax oil than citizens. This has longer-term implications for your economy.
- Finally, it creates problems of *stability* in public finances tied to a resource whose value swings widely and that will deplete over time. This poses *short-term issues* about the central government's ability to manage cyclical pressures on the economy as well as *longer-term issues* about the sustainable level of public services. This issue has lead a number of countries—Russia is probably the best federal example—to be very aggressive in developing revenue stabilization funds. My understanding is that you have largely succeeded in this regard, with the policy of basing budgets on a $40 a barrel price. But this type of policy inevitably gives rise to conflicts over the appropriate level of spending, as well as over the control and purposes of the stabilization funds. Even

with this policy, you have had rapid fiscal expansion of about 12 per cent a year in real terms, driving by higher oil revenues.

These challenges associated with a heavy dependence on oil revenues are all actively debated in Nigeria. The question is whether your current arrangements are adequate to meet them, and if not, what approaches might meet your needs.

Regional and vertical equity

Every federation confronts the need to achieve some sort of fit between the revenues of the federal, state and local governments and their responsibilities. There is also the very closely related need to promote some measure of equity between the regions of the country.

In Nigeria's case, you have had a very rapid decentralization of revenues to state and local governments to address their responsibilities. Sub-national spending went from 23 per cent of the consolidated budget in 1999 to 46 per cent in 2005—in fact, it is a few points higher because this number does not include transfers from the special funds or from programs such as that for Universal Basic Education. I know of no recent example of such a dramatic shift of fiscal resources in a federal system. One would have to go back to World War II to find anything comparable—first with rapid centralization to meet war needs, and then a more gradual decentralization after the war ended.

With the federal government now spending somewhat less than 54 per cent of total government spending (after all transfers to the states), Nigeria falls in the broad company of federations such as Argentina, India, Mexico, Russia, Spain, South Africa and the United States. Your spending is a good deal more decentralized than in Brazil, Malaysia and Venezuela. However, some federations are still more decentralized. In Belgium, Canada, Germany and Switzerland, the federal government accounts for between 30 and 40 per cent of direct government spending.

In virtually every one of these countries there are continuing debates about whether the shares of the different orders of government adequately reflect their responsibilities. In Canada, Switzerland and the United States, these debates take place in a context where central transfers to the states are only 13 to 25 per cent of state revenues—so the states can always raise taxes as an alternative to getting larger transfers. But in many federations the federal government is the largest funder of the states and a number of them—Mexico, Spain, and South Africa—have levels of dependence on central transfers approaching or matching those in Nigeria. *Such heavy dependence on central transfers tends to create an environment where the federal government seeks some control or oversight on state spending.*

Federations typically give the same responsibilities to all their states regardless of the fiscal means of the states. In many countries, this has led to equalization programs, which are a special transfer to poorer states designed to bring them up to some minimum or national standard.

Here in Nigeria you have addressed this issue through the allocation formula applied to the Federation Account. You have had numerous commissions around revenue sharing and the issue has typically been cast around the weight to be assigned to each allocative criterion. My reading is that there has been less debate around the criteria themselves or the whole architecture of your fiscal regime—by which I mean the concepts underlying the Federation Account, the possible mix of conditional and unconditional transfers, the use of more variable sharing formulas, e.g., depending on the price of oil.

From a comparative perspective, your formula is unusual—probably unique—in giving such a heavy weight, 40 per cent, to equality of states—which of course are quite different in size. The other criteria of population, social development, internal revenue effort and land mass all find some reflection in the distributive formulas of other federations. For example, Canada makes big bloc transfers to its provinces for social programs essentially on the basis of population and then addresses different abilities to raise taxes through its equalization program. Australia does much the same, but its equalization regime is based on very complex calculations of need and means before concluding what is needed to bring public services up to comparable levels. Germany and Switzerland also have elaborate equalization regimes. India has an arrangement that mixes central grants designed to assure all states some basic comparability in fiscal capacity with many more program specific grants. The United States has no equalization program as such. The upshot is that federations have quite different approaches to equalization between their states with quite different results. I shall come back to this in a moment.

A critical element of Nigeria's fiscal arrangements is the principle of derivation. In fact, it is the only criterion for distribution from the Federation Account where the amount—currently 13 per cent of oil revenues—is set in the Constitution. As I said earlier, federations vary in terms of who owns natural resources. But in several federations (including the USA, Australia and Canada) there are significant revenues associated with the offshore oil and other natural resources owned by the federal government. Do federal governments in other countries recognize, in some way or another, a derivation principle for sharing federal revenues from natural resources? My best understanding—and this is a subject which requires further work—is along the follow lines:

- Many federations have no derivation principle applied to federal oil revenues. This is the case in Mexico, Brazil, Australia, and the United States.
- Some make minor special transfers to the producing states. India and Russia appear to adopt this practice—in fact, in Russia's case the federal government has significantly centralized oil revenues, but its spending places a good deal of emphasis on strategic investments, which may be in oil and gas producing regions.

- Finally, Canada's federal government has turned over its offshore revenues to the contiguous provinces. To date these revenues have been relatively small and have gone to poorer provinces. As well, Canada has recently given special, favourable treatment to provinces' own oil and gas revenues, discounting them by 50 per cent when calculating equalization payments so as to favour these provinces in the calculation.

Thus there is a good deal of variation in how other federations handle both the ownership of oil and gas and the sharing of any federal oil and gas revenues.

A critical question at the end of day is the overall net effect of the various fiscal arrangements—own sources revenues of all kinds and transfers—on the fiscal means of the different states of a federation. In Nigeria's case, according to Lev Freinkman of the World Bank, the per capita, statutory finances available to the states from the Federation Account and the VAT vary enormously, with the top state receiving *seventeen times as much* per capita as the bottom state. The four major oil producing states received 34 per cent of total transfers in 2005, up from 25 per cent in 2001. Presumably their share is even higher with today's oil prices. While there is no doubt the delta has been neglected in the past and has significant needs to address environmental and other problems, the current approach to derivation is based not on need but a simple percentage.

If the numbers on the disparity between your state revenues after allocations are correct, Nigeria probably has the most unequal distribution of state revenues of any federation in the world. This seems little recognized. In my reading, the debate has seemed strongly focused on various detailed allocations and rights, with not much attention to the bottom line question, namely, the overall consequences of your fiscal regime. This spread in per capita revenues is all the more important in that it has come at a time when the state and local share of government spending has grown considerably—by about 400 per cent between 1999 and 2005, while federal spending grew by only 50 per cent.

Promoting coordination in major policies

Let me turn now very briefly to the last two challenges of fiscal federalism in Nigeria.

The first of these is that of coordinating major policies across your federal system. The classic or simplistic notion of federalism is that each order of government has its responsibilities gets on with doing its business in water tight compartments. The reality is quite different because all federations face the need to coordinate some major policies. There are essentially three devices for achieving such coordination:

- Concurrent powers;
- The use of the federal spending power; and,
- Intergovernmental meetings and mechanisms.

Concurrent powers is a classic way in which to try to balance the need for a national framework policy with the need for flexibility on the part of states. While you have a concurrent list attached to your constitution, it appears that many of your problems of coordination lie outside that list.

The second way to promote coordination is through the use of the federal spending power. In most federations, the federal government can spend on any object and can make conditional payments or grants to the states. In the USA, *all* transfers from the federal government to the states are program specific, frequently requiring matching funds and state compliance with very detailed conditions. The use of conditional grants is quite a typical means for federal governments to try to shape national programs. In Canada, such grants were used to establish some of the major programs of the welfare state, but as the programs became established the conditions became less and less onerous, so as to permit the provinces to experiment with aspects of program design. There have been some such programs here in Nigeria, such as that for universal basic education, but they are typically small and the federal government does not have the resources to make great use of the spending power because most revenues are allocated out of the Federation Account by formula.

Finally, intergovernmental mechanisms and meetings can be helpful. Nigeria has a large number of these, but I am in no position to comment on their effectiveness. I would make the point that in many federations these mechanisms are very important not just for policy coordination at high levels, but also for detailed information gathering and exchange regarding implementation. Given the weakness of the first two instruments for coordination in Nigeria, you have a heavy stake in effective intergovernmental mechanisms.

Transparency and probity

The final fiscal challenge on which I wish to say a few words is that of transparency and probity. I know you have had a separate session on this, but I wish simply to draw out the issue in relation to theories of federalism.

The last time I was in Nigeria the National Assembly was engaged in a major debate around the Fiscal Responsibility Bill and one of the major issues was its application to the states. In the end, a modified bill passed, but without application to the states. Is it right to argue that the federal government has not right to impose these kinds of conditions on the states?

It seems to me that it is difficult to give an absolute, black and white answer. One aspect of such fiscal responsibility bills in other federations—Brazil is a good example—is the management of debt at the sub-national level. Some federations have had major problems in this area. Whether the federal government can impose rules on this matter can depend on whether it has a direct constitutional authority—which does exist in some federations—but also on whether the federal government can attach this kind of condition to transfers it makes to the states—for example, holding back transfers if states don't properly manage their debt.

The same question arises with transparency and probity in public finances. I understand that in a federal regime, it would not normally be appropriate for the federal government to establish conditions of fiscal transparency in relation to a state's internally generated funds. But there are many precedents for federal governments attaching conditions to transfers. Often these are program conditions. But equally—are arguably less intrusive—they could require various financial procedures and reporting to be followed. Perhaps the existence of your Federation Account has created a sense of entitlement to transfers which would deny such a possibility. I don't know. But it is clear as Dr. Usman, the Minister of Finance, argued on your opening day that Nigeria has a problem in this area at the state and local level, which needs to be addressed in one fashion or another.

Conclusion

I have tried, in the brief time available, to give an outsider's perspective on your fiscal challenges and debates. I have taken the risk of being a bit opinionated in drawing out possible lessons from practice in other federations. No doubt I have missed the mark in some regards, but I did want to give you some clear messages to react to. I think this type of meeting and so much else that is happening in Nigeria now is evidence that you are truly open to addressing some of the tough challenges before you. You are to be congratulated for what you are doing and to be given every best wish for the future.

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