INVESTIGATING THE ‘FLYPAPER EFFECT’
IN NIGERIA’S INTERGOVERNMENTAL
TRANSFERS (IGT)

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INTRODUCTION

IGT strategy in developing economies, are:

- often ad-hoc decisions
- high level of inequity
- contributes to fiscal imbalance
- inefficient and inequitable provision of public goods and services by Sub-National Governments (SNGs).

> High fiscal imbalance (vertical and Horizontal)
Nigeria has 3 tiers of government:

- Federal;
- States (36 + Federal Capital Territory); and
- Local Governments (774).
Section 162 of the 1999 Nigerian Constitution defines the core rules for:

- resource allocation,
- distribution of responsibilities for service delivery, and
- mechanisms for interaction between different tiers of government.

Section 162 (1) of the 1999 Constitution established the maintenance of a “Federation Account” into which shall be paid all revenue collected by the Federal.
FEDERAL ALLOCATION - IGT

Section 162 (3) of the 1999 Constitution states that: - all amount standing to the credit of the Federation Account less 13% (Derivation) of the revenue accruing directly from natural resources as a first charge shall be distributed among the 3 tiers of government.

- Referred to as “Federal Allocation” – IGT

Provisions of the Constitution is further explained by the “Allocation of Revenue (Federation Account) Cap A 15 LFN” which established:

- Federal Account Allocation Committee (FAAC)
FEDERATION ACCOUNT

The following revenue are paid into the “Federation Account”:

- Budgeted Oil Revenue,
- Customs and Excise (C&E)
- Company Income Tax (CIT)
- Value Added Tax (VAT)
INFLOW OF REVENUES

CRUDE OIL REVENUE

CUSTOMS & EXCISE

Company Income Tax (CIT)

Value Added Tax (VAT)

Nigeria Customs

7% CoC

93%

EXCESS CRUDE

REVENUE BUDGET

96%

96%

Source: Prepared by Author with information from Budget Office of the Federation, Ministry of Budget and National Planning.
FEDERAL ALLOCATION – IGT/1

FEDERAL ALLOCATION

DISTRIBUTION OF FG ALLOCATION

- FGN Share of Derivation and Ecology, 1.00%, 2%
- Development of Natural Resources, 1.68%, 3%
- Stabilization, 0.50%, 1%
- Federal Capital Territory, 1.00%, 2%
- Consolidated Revenue Fund (CRF), 48.50%, 92%
FEDERAL ALLOCATION - IGT/2

HORIZONTAL ALLOCATION

- Social Development, 10.00%, 10%
- Internal Revenue Effort, 10.00%, 10%
- Equality, 40.00%, 40%
- Land Mass & Terrain, 10.00%, 10%
- Population, 30.00%, 30%

FEDERAL ALLOCATION TO LGS

- LM&T, 10.00%
- IGR, 10.00%
- Health, 3.00%
- Education, 10.00%
- Water, 10.00%
- Equality, 40.00%
- Population, 30.00%
FEDERAL ALLOCATION – IGT/3

VAT ALLOCATION
- LGs: 35%
- SGs: 50%
- FGN: 15%

DISTRIBUTION OF FGN VAT ALLOCATION
- CRF: 14.00%
- FCT: 1.00%
FEDERAL ALLOCATION – IGT/4

DISTRIBUTION OF VAT ALLOCATION TO STATES AND LGS

- Population, 30.00%
- Derivation, 20.00%
- Equality, 50.00%
CHALLENGES OF HIGH VERTICAL AND HORIZONTAL FISCAL GAPS

Disconnect between:

• spending responsibilities,
• tax powers, and
• revenue resources assigned to different levels of government.
“Soft budget constraint”\(^1\) – “an entity can expand its expenditures without itself facing the full cost”.

- SNGs are wont to spend hugely at the expense of the central government.

Higher vertical imbalance encourages SNG to spend and borrow when revenues fall, in the expectation of a bailout from the central government.

\(^1\) (Rodden, Eskeland and Litvack, 2001)
IMPLICATIONS OF FISCAL GAPS/2

SNGs’ expand expenditures with more transfers, very little is absorbed by savings or tax reductions.

Rodden 2003 also pointed out that transfers create a “fiscal illusion” - the link between taxation and benefits breaks.

1(Rodden 2003)
IMPLICATIONS OF FISCAL GAPS

“Common Pool” problem\(^1\) - SNGs internalize transfer benefits but not its cost and the central government has reduced capacity to monitor the use of funds (“principal agent” problem).

Less local oversight and accountability, which in turn encourages overspending.

\(^1\)(Rodden 2003)
“Median-voter” model - an increase in IGT from FGN to SNG should result in the same amount of increase in SNG spending as that associated with an equivalent increase in SNG internal revenue.

- e.g. if an increase of ₦100 in IGT results in ₦75 SG spending, an increase of ₦100 in SG’s IGR should also result in ₦75 SG spending.
James Henderson (1968) and Edward Gramlich (1969) changed the direction of empirical research on how local taxes are spent through:

- Empirical evidence on the demographic and economic connects with government budgets.
- Specified and estimated demand equations that maximize a representative citizen’s utility subject to the constraint of citizen’s “full income”.
FLYPAPER EFFECT/2

Findings:

• “A $ of personal income increased government spending on the order of $.02 to $.05,
• but an equivalent extra dollar of grants-in-aid increased government spending by $.30 to often as much as a full dollar.”

Arthur Okun, a colleague of Gramlich called this larger effect of IGT “flypaper effect” noting that “money sticks where it hits”.

EMPIRICAL ANALYSIS/1

The investigation was done using important variables established in the literature that may exert influences on the provision of public services by the SNGs:

- IGT,
- State Govt.’s Internally generated Revenue (SNGsIGR),
EMPIRICAL ANALYSIS/2

- Human Development Index (HDI),
- Land Area (LDA) and
- Population respectively.

Evidence of ‘flypaper Effect’ – IGT has a higher income effect than SGsIGR on SGsExp.

- IGT is +ly and statistically significant with coefficient of 0.94.
- SGsIGR on SGsExp is also significant with coefficient of 0.31.
IGT, STATE GOVT's IGR AND STATE GOVT's EXPENDITURE

Source: Central Bank of Nigeria
The investigation established the following:

- FGN - surplus unit, SGs deficit units;
- Flypaper effect;
- Soft Budget Constraint
  - SG expands expenditures with more IGT, very little is absorbed by savings or tax reductions;
- Fiscal Illusion;
- Common Pool Problem; and
- Frequent bailouts of SGs by the FG.
CONCLUSION/2

Fiscal imbalance (Vertical and Horizontal) are rife in Nigeria because:

• Less taxes collected - political will, legislative constraints and or inadequate technical capacity;
• Disproportionate tax bases - uneven economic assets and economic activities;
• Different expenditure needs - population, land area, urbanization etc; and
• The imbalance often leads to fiscal crisis.
Federal Allocation should be redesigned to focus on basic principles of:

- equity, equalisation, benefit-cost spillovers;
- allocative efficiency within government, autonomy;
- certainty in planning, ease of administration;
- Transparency, neutrality towards grantsmanship; and
- consistency with federal and state objectives.
QUESTIONS

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