

**INVESTIGATING THE 'FLYPAPER EFFECT'
IN NIGERIA'S INTERGOVERNMENTAL
TRANSFERS (IGT)**

By

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**ICGFM 33RD ANNUAL INTERNATIONAL
TRAINING CONFERENCE**

MIAMI, FLORIDA

MAY 17, 2019

CONTENT

Introduction

**Nigeria Fiscal Structure and
IGT**

IGT and Fly Paper Effect in Nigeria

Conclusion

Questions

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)

STRUCTURE OF GOVERNMENT

NIGERIA FISCAL STRUCTURE AND IGT

Nigeria has 3 tiers of government:

- Federal;
- States (36 + Federal Capital Territory); and
- Local Governments (774).

CONSTITUTIONAL PROVISIONS

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

93%

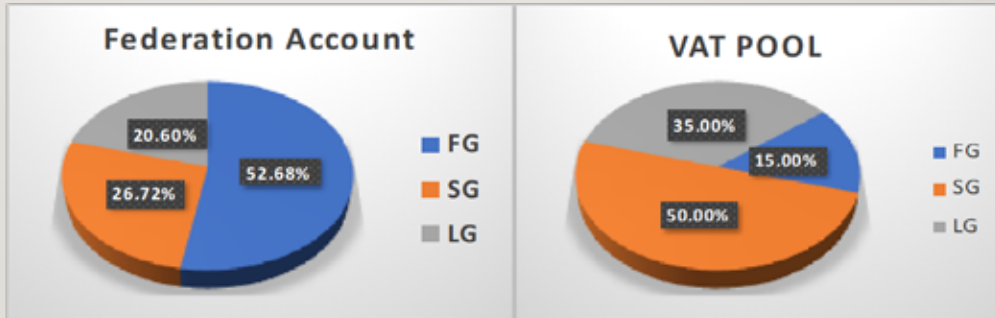
7% CoC

EXCESS CRUDE

REVENUE BUDGET

96%

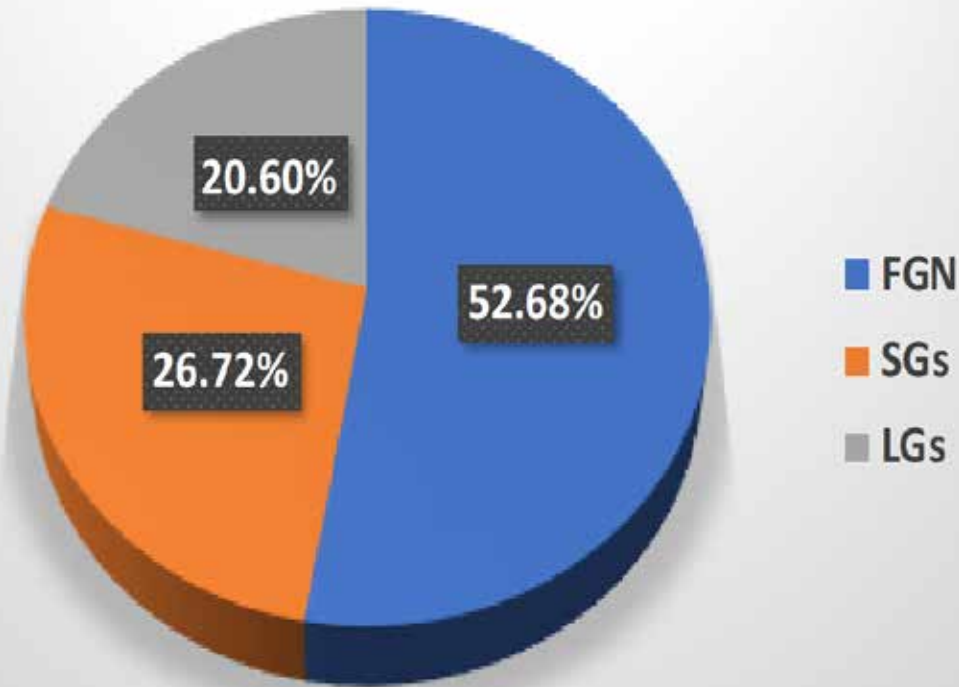
96%



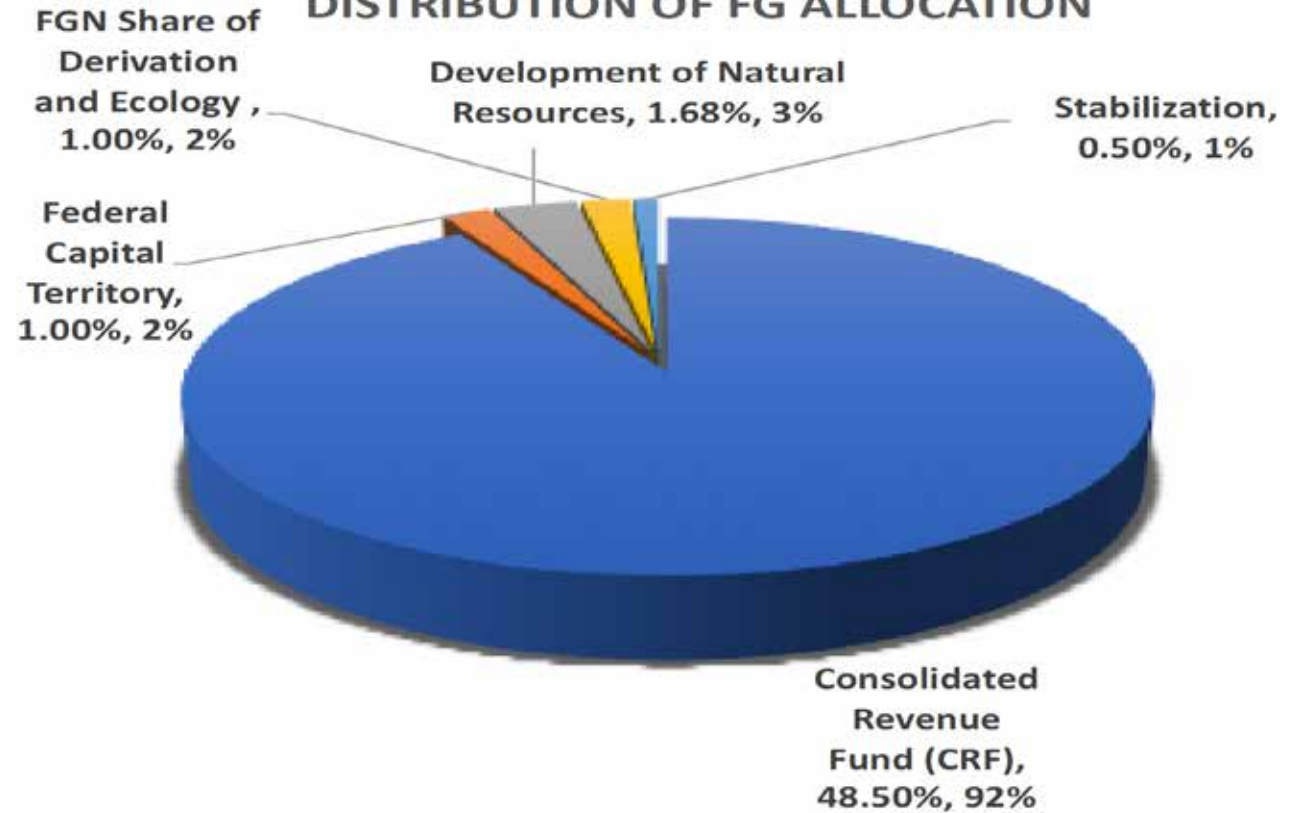
Source: Prepared by Author with information from Budget Office of the Federation, Ministry of Budget and National Planning.

FEDERAL ALLOCATION – IGT/1

FEDERAL ALLOCATION

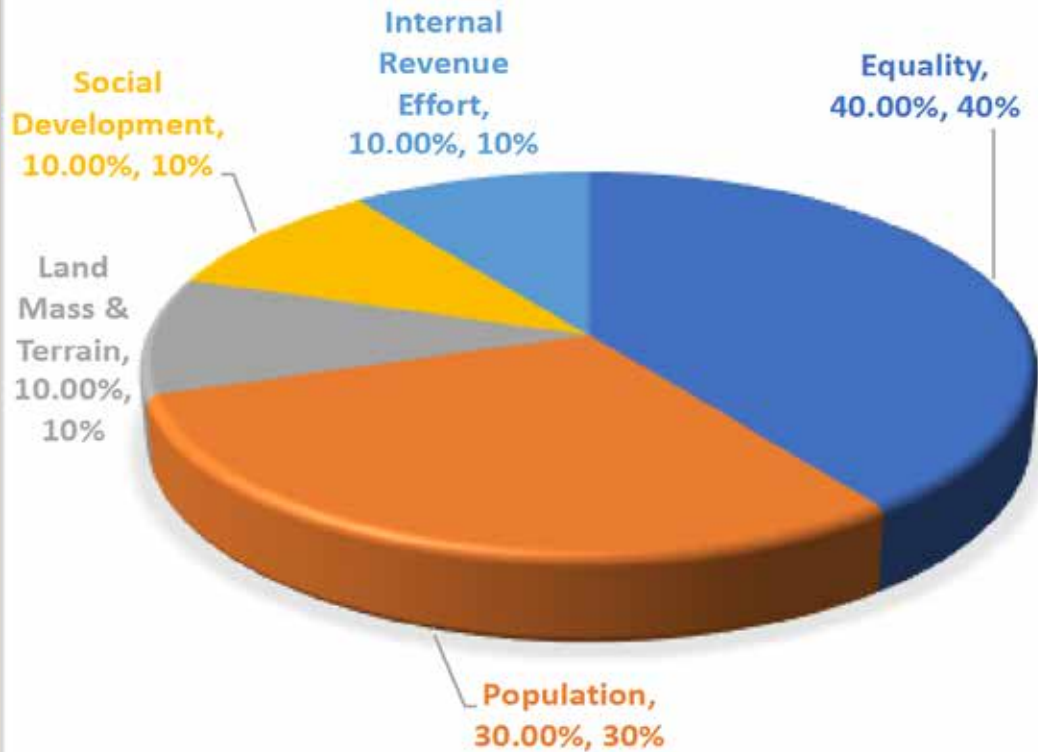


DISTRIBUTION OF FG ALLOCATION



FEDERAL ALLOCATION – IGT/2

HORIZONTAL ALLOCATION

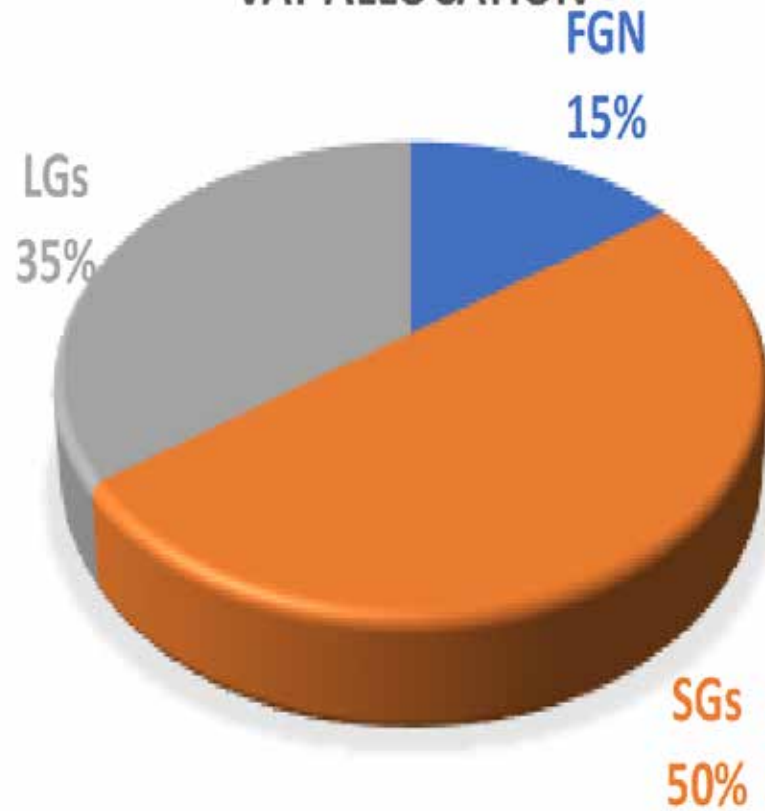


FEDERAL ALLOCATION TO LGS

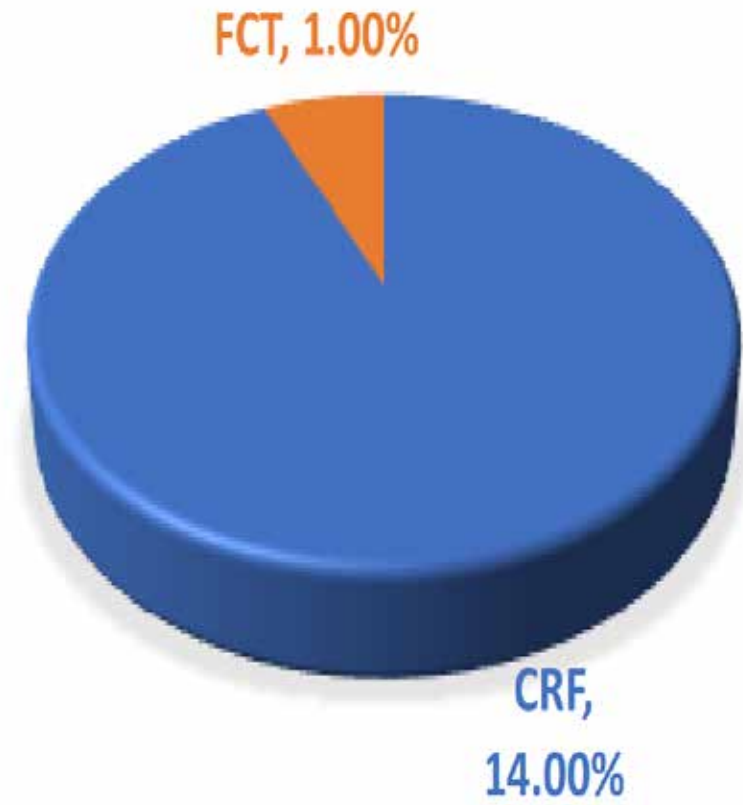


FEDERAL ALLOCATION – IGT/3

VAT ALLOCATION

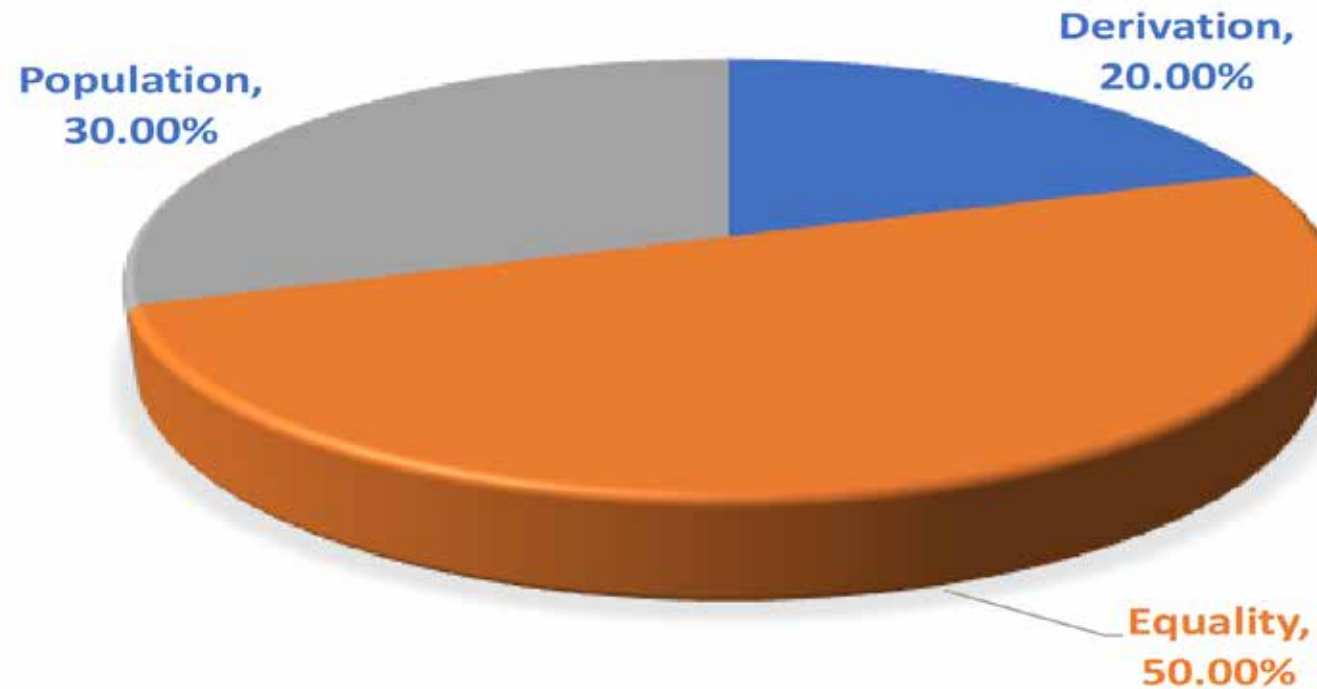


DISTRIBUTION OF FGN VAT ALLOCATION



FEDERAL ALLOCATION – IGT/4

DISTRIBUTION OF VAT ALLOCATION TO STATES AND LGS



CHALLENGES OF HIGH VERTICAL AND HORIZONTAL FISCAL GAPS

Disconnect between:

- spending responsibilities,
- tax powers, and
- revenue resources assigned to different levels of government.

IMPLICATIONS OF FISCAL GAPS/1

§ “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*"¹ - 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)

IGT AND FLYPAPER EFFECT IN NIGERIA

“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.

FLYPAPER EFFECT/1

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 exerts influences on the provision of public services by the SNGs:

- IGT,
- State Govt.'s Internally generated Revenue (SNGsIGR),

EMPIRICAL ANALYSIS/2

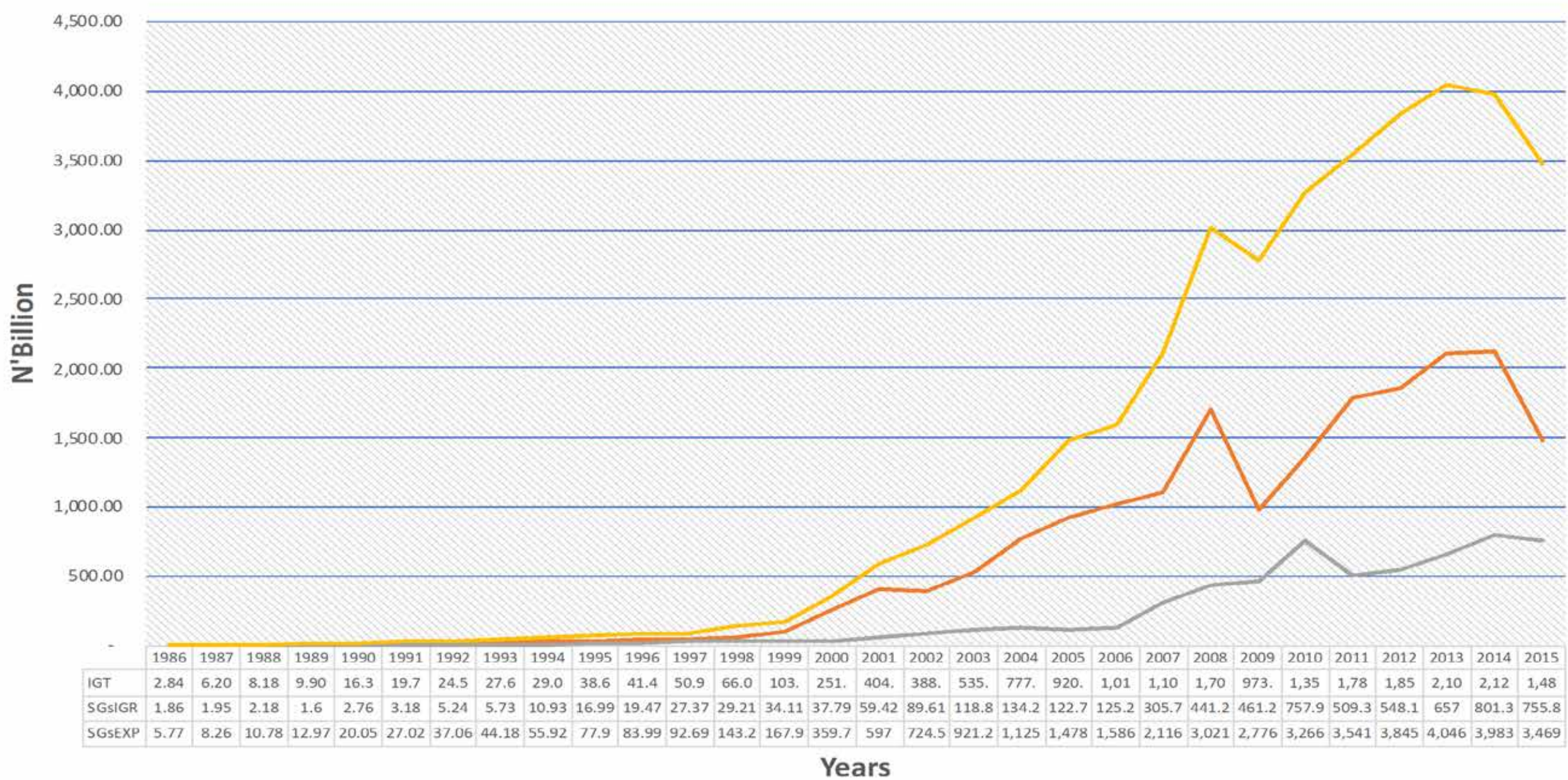


- Human Development Index (HDI),
- Land Area (LDA) and
- Population respectively.

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 GOVTS' IGR AND STATE GOVTS' EXPENDITURE



— IGT — SGsIGR — SGsEXP

Source: Central Bank of Nigeria

CONCLUSION

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.

CONCLUSION/3

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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