Nigeria Economic Report

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Table of Contents

List of Figures and Tables

Figures

Tables

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Introductory Note

The Nigeria Economic Report represents a new World Bank product intended to be produced on a biannual basis. Each Report will provide an assessment of the current economic situation in the country and give special attention to selected topics of high policy relevance for Nigeria. The Nigeria Economic Report will also be a vehicle for the dissemination of existing World Bank studies that are deemed to be of particular relevance for Nigeria.

This first Nigeria Economic Report will give some attention to longer term trends in the country, including the puzzle of why a decade of rapid GDP growth by official statistics, concentrated in the pro-poor areas of agriculture and trade, did not bring stronger welfare and employment benefits to the population. Trends in the balance of payments (movement in reserves) are linked not only to oil prices, but to changes in macroeconomic policy in recent years. Despite serious data challenges, an attempt is made to present and examine the general government budget of Nigeria and document the progress in consolidation since 2011.

The second chapter of this Report turns to the question of Government oil revenues and related future budgetary challenges to the country. Due to relatively slow expected growth in oil production and the real appreciation of the naira, the share of Government oil revenues in GDP fell significantly in 2012, and will likely continue to fall in the medium term. Three different world economic (oil price) scenarios are examined that highlight both the expected challenges for accumulating a sufficient fiscal reserve to protect Nigeria from oil price volatility, and the associated high opportunity cost of the fuel subsidy.

The third chapter addresses a question that has been at the center of many recent controversies and initiatives in Nigeria: fiscal federalist relations. The chapter argues that the current basic model of fiscal federalism may actually suit Nigeria very well, and could be consistent with the rapid successful development of the country. But the success of this model will depend on developing mechanisms for better cooperation between the Federal and State Governments in three key areas: (a) effective macroeconomic management of the country's oil wealth, (b) the coordination of fiscal policies, particularly for the connectivity of markets and improvement of public services, and (c) the realization of national standards for accounting and disclosure of information.

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Executive Summary

Growth and social welfare

Nigerian economic statistics reveal a puzzling contrast between rapid economic growth and quite minimal welfare improvements for much of the population. Annual growth rates that average over 7% in official data during the last decade place Nigeria among the fastest growing economies in the world. This growth has been concentrated particularly in trade and agriculture, which would suggest substantial welfare benefits for many Nigerians. Nevertheless, improvements in social welfare indicators have been much slower than would be expected in the context of this growth. Poverty reduction and job creation have not kept pace with population growth, implying social distress for an increasing number of Nigerians. Progress toward the fulfillment of many of the Millennium Development Goals has been slow, and the country ranked 153out of 186 countries in the 2013 United Nations Human Development Index.

What explains the disparities between economic growth and most welfare indicators in Nigeria? Further data collection and investigations will be necessary to clarify this picture. Although data on the geographic distribution of growth in Nigeria are scarce, the economic expansion would appear to have a very high geographic concentration. The most obvious example is Lagos State, which is experiencing exceptionally rapid growth, and succeeded in reducing its poverty headcount from an estimated 44% of the population to 23%between 2004 and 2010.At the same time, poverty headcount rates actually increased during this period in half of Nigerian States. It is imperative that Nigeria finds a recipe to unlock rapid growth and job creation in a larger part of the country, as well as to increase standards of education, health, and other social services to enable its citizens to find gainful employment in the emerging growth poles.

During the last decade, Nigeria made significant progress in the effective management of its (fiscal) oil wealth, but remaining institutional weaknesses need to be addressed. International experience in oil dependent countries suggests that countercyclical fiscal policy is a key to conquering the "oil curse" of periodic instability and slow development. In this regard, Nigeria made a giant step forward during 2004-2009 through the establishment of the Excess Crude Account (ECA) fiscal reserve that successfully insulated the country from the sharp swings in oil prices during this period. But the year 2010 revealed remaining weaknesses in the institutional framework for macroeconomic management. Despite the recovery in oil prices, Nigeria expanded its fiscal stimulus significantly, increasing consolidated spending by an estimated 2.5% of GDP and drawing down the remaining balance of the ECA at the same time that many other oil exporters were building back their reserves. Under this fiscal expansion, the balance of payments remained in deficit, the naira came under pressure, and investor sentiment toward Nigeria became more cautious.

The trends in macroeconomic management during 2011-2012 have been quite positive. The Government has reined in the excessive fiscal expansion of 2010. The general government deficit (including budgets, extrabudgetary funds, the fuel subsidy, and net accumulation in the Excess Crude Account) was reduced from an estimated 5.7% of GDP in 2010 to 2.2% in 2011 and a projected 1.9% in 2012. In this context, the Excess Crude Account balance increased from negligible levels at the end of 2010 to an estimated US$ 8.6 billion in 2012. This is still far less than the US$ 22 billion that the country had accumulated on the eve of the world financial turmoil in 2008. Two primary factors prevented a more rapid increase in the ECA balance during the time of generally strong oil prices in 2011-2012. In 2011, a major increase in fuel subsidy payments (4.6% of GDP) limited the accumulation of the ECA. In 2012, the Government succeeded in reducing fuel subsidy obligations significantly, but a decline in oil output and revenues tightened the budgetary position of the country.

Nigeria's balance of payments position has strengthened along with oil prices and the improved management of fiscal policy. Since September, 2011, the balance of payments has been in surplus most of the time, allowing the Cen-

tral Bank to build its foreign reserve position from US$ 32 billion naira in mid-2011 to US$ 49 billion by April, 2013. Foreign inflows to the Government bond market have been acontributing factor to a stronger BoP surplus in 2012 and early 2013. Portfolio investment inflows by official data amounted to US$ 17 billion in 2012, in contrast to US$ 5billion in 2011. While these inflows have helpedstrengthen the balance of payments and reserve position of the country, they also pose new risks. Following a balance of payments shock, these inflows could be expected to reverse very quickly, thereby even magnifying the BoPswing

In the absence of an oil price shock, Nigeria's short term macroeconomic outlook looks generally strong. The foreign inflows and balance of payments surplus should continue at the existing exchange rate. The macroeconomic policy stance should also succeed in reducing the pace of inflation in 2013. The Government thus has a prime opportunity to make major progress on key reforms and public investments associated with the Transformation Agenda for job creation, diversification, and more effective governance. Given the continuing trend of slow output growth in the oil sector, however, the budgetary situation of the country should remain rather tight. Chapter 2 examines the fiscal challenges for managing the country's oil wealth through 2015 in more detail.

Oil revenues and fiscal stability

Baseline, high oil price, and low oil price scenarios are examined pertaining to Government oil revenues and their distribution through 2015. The baseline, high, and low scenarios have oil prices converging to 140, 170, and 50 dollars a barrel, respectively, by end-2015. It is assumed that oil output will follow the path projected in the Government's Medium Term Fiscal Framework, the fuel subsidy will remain for a 97 naira petrol price, and cash calls will remain at a size equal to a fairly constant share of GDP. Annual GDP growth rates are projected in the range of 5-9%, depending on the particular scenario. The pace of inflation declines somewhat in the baseline and optimistic scenarios.

Oil revenues as a share of GDP decline in all three scenarios. In the case of high oil prices, the US dollar value of oil revenues certainly increases, but the dollar value of Nigerian GDP grows even faster. This is due to a more rapid expansion of GDP than growth in oil and the real appreciation of the currency (significant inflation under a strong naira). Thus, unless Nigeria can realize major compensating increases in non-oil revenues, Government budgets may experience increasing pressures. The year 2012 was informative in this regard. These factors, combined with negative growth in the oil sector, already caused Government oil revenues to decline from 23.6% of GDP in 2011 to 19.7%in 2012.

Accumulating a sufficient fiscal reserve to protect the country against oil price volatility will continue to be a challenge. Simulations were run under the assumption that the distribution of oil revenues from the Federation Account to budgets and extra-budgetary funds will be limited to 3% real growth every year through 2015. In this case, even in a high oil price scenario, the ECA balance stands at roughly US$ 8 billion at the end of 2015, close to the same level as at the end of 2012. The limited degree of accumulation is due to two factors: (a) declining oil revenues as a share of GDP and,(b) a rising burden of fuel subsidy payments to finance the 97 naira petrol price under higher world oil (and thus petrol) prices. To accumulate a balance of US$ 15-18 billion in the baseline and high oil price scenarios, Nigeria would have to limit Federation Account distributions of oil revenues to zero real growth during these years.

The opportunity cost of the fuel subsidy should increase. Under declining oil revenues as a share of GDP, the enforcement of the 97 naira petrol price through the fuel subsidy will account for an increasing share of Government resources. If these same simulations are performed without the fuel subsidy, Nigeria would be able to accumulate a sufficient reserve to protect the country already in 2013. In the low oil price scenario, the cost of the fuel subsidy under an assumption of zero real growth in Federation Account distributions would exhaust the Excess Crude Account balance in one year. In the absence of the fuel subsidy, in the low price scenario, the current

Excess Crude Account balance plus additional borrowing of US$ 6 billion would finance Federation Account allocations under a zero growth assumption through 2015.

The effective fiscal managementof oil wealth in Nigeria (i.e. countercyclical fiscal policy) is related to issues in federalism. In Nigeria, the fiscal reserve is owned and managed not only by the Federal Government, but by the 36 Nigerian States as well. Thus, a national consensus is needed to support a strong institutional base for countercyclical fiscal policy that is essential to Nigeria's success and stability. A number of other key issues for development in Nigeria are also related to the particular nature of federalist relations. Chapter 3 of this Report examines fiscal federalism in Nigeria from this point of view.

The Nigerian federalist system has a number of positive features that can potentially support rapid economic development.

- Subnational autonomy. Nigerian states operate with a high degree of legal and de facto autonomy. States with dynamic leadership thus have the authority to move ahead on their own. This kind of decentralized autonomy has been consistent with rapid growth and development in countries as institutionally diverse as the United States and China.

- Hard budget constraints. A primary problem in many large decentralized countries has been the so-called soft budget constraint. Subnational governments may have weak incentives to improve budgetary performance, or even to remain financially solvent, if they expect that the Federal Government will compensate for their losses through transfers and bailouts. In countries where the Federal Government controls the size of transfers to subnational governments, they typically face strong political pressures to favor less successful regions, including bailouts of regions that become financially distressed. In Nigeria, by contrast, the Federal Government does not have a natural instrument to offer direct assistance to weak or poorly-performing States.

- Allocation according to rules versus discretion. While the rules involving the division of Government revenues between the Federal Government, States, and other allocations have always been controversial in Nigeria, the Constitution grants them a strong institutional durability. They have changed very little over the last decade. In addition to advantages for hard budget constraints, this is arguably an important safeguard in a country like Nigeria against the politicization of transfers, i.e. if state-by-state allocations were at the constant discretion of politicians, there is a danger that this discretion could be abused.

International experience has shown that the combination of subnational autonomy and hard budget constraints can be a powerful tool for development, as competition between subnational governments for the attraction of business and investment can provide a strong motivation to improve the local business climate. What has so far limited the potential of Nigeria in this regard?

- Lack of market connectivity. Due to problems in infrastructure, particularly transportation, as well as institutional barriers, markets in Nigeria are quite fragmented. Investors with the potential to set up large scale operations and create many jobs will be reluctant to do so if they cannot service a larger market. Under these conditions, a number of Nigerian States have limited opportunities to attract significant investors.

- A low share of own revenues in State revenues. This is a particular manifestation of the "oil curse." It appears that a large number of Nigerian States receive less than 10 percent of revenues from internal sources. The lack of dependence on internal revenues can be a disincentive to expend significant resources and effort to improve the business climate and attract major investors. This is particularly the case if market connectivity is weak.

- Poor coordination in fiscal policy.The Nigerian model of federalism has no natural

mechanism for the coordination of Federal and subnational budgetary policies. In most federations, this is facilitated by the fact that transfers to subnational governments come from the Federal budget. This lack of coordination can be associated with multiple development challenges. First, there is the difficulty of reaching a consensus for the effective conduct of countercyclical fiscal policy, which is essential for stability and a strong investment climate. Second, poor coordination prevents the efficient concentration of government resources toward priority investments and interventions that could unlock the country's economic potential, including achieving a better connectivity of markets. Third, the lack of unified standards for accounting, disclosure, and service delivery hinderthe achievement of greater accountability of public officials and improved governance.

Making the Nigerian system of federalism work for economic development will thus require reaching a national consensus in three key areas

- to maintain strongly countercyclical fiscal policy to protect the country from oil price volatility

- to achieve a coordination in fiscal policies, particularly for the connectivity of markets and improvement of public services

- to realize national standards in public finance management, especially for accounting and disclosure to the population

While reaching such a consensus poses some challenges in the Nigerian political context, this consensus should follow from an increasing awareness that the benefits from countercyclical and coordinated fiscal policy have mutual benefits for all of Nigeria. Chapter 3 outlines a number of directions for moving forward toward the national consensus and cooperation that could have major implications for accelerating development in Nigeria.

- For effective macroeconomic management, the key task is to establish an institutional framework that can effectively de-link Government expenditures from oil prices. A campaign of advocacy and dissemination of information can help increase awareness of the strong international evidence that countercyclical fiscal policy is a necessary condition for freeing Nigeria from the "oil curse." The country should work toward a longer-term commitment for benchmark oil prices, as opposed to the current yearly debates and bargaining that surround budget preparation.

- The Federal Government and Nigerian States can compensate for falling oil revenues relative to the size of the economy through the development of the domestic tax system and internally generated revenue. As illustrated in Chapter 2, the dependency of budgets on oil revenues is likely to create pressures already in the immediate future. The Federal Government and a number of States have on-going initiatives in this area.

- The expansion of federal programs involving co-financing or conditional/matching grants for States around priority infrastructure and the implementation of national standards could help solidify needed trust and cooperation. To be successful, these programs must recognize the autonomy of States on their territories. International experience suggests that the conditionality of these grants should focus on outcomes rather than processes, i.e. the resources should be managed entirely by subnational Governments under the condition that certain objectives be reached. The design of these programs should also include safeguards to prevent the allocation of these grants becoming politicized.

- The connectivity of markets should be a priority. A more unified national market will not only facilitate naturally the expansion of private economic activity in Nigeria. It will increase the incentives for Nigerian States to become more active in improving the business climate on their territories, thereby unlocking the advantages of the Nigerian federalist system for economic development. Infrastructure investments should be exam-

ined and prioritized from this point of view, important regulations should be harmonized across States, and the Federal Government should work actively to prevent unnecessary road blocks that hinder connectivity.

- The realization of minimal standards in education, health, and other social services should be another priority. While economic development in Nigeria should continue to remain geographically uneven for many years, and centered around a limited number of growth poles, the welfare of the greater population will depend critically on basic educational skills and health that would enable young Nigerians to migrate to these growth poles and find gainful employment.

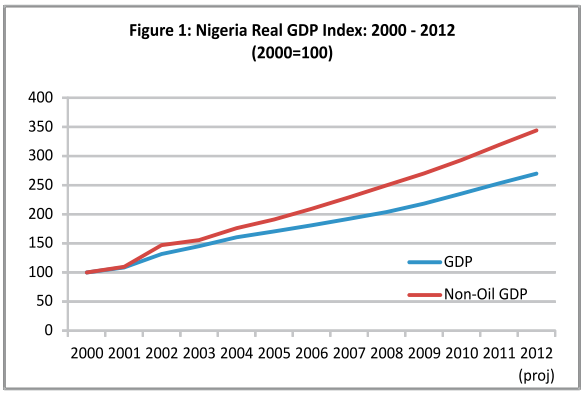
I. Macroeconomic Overview

Over the last decade, Nigeria has registered consistently high official GDP growth rates and experienced unprecedented momentum in prudentmacroeconomic management, economic stability, democracy, and reform.A few areas of the country, most particularly Lagos State, have achieved visible and inspiring progress in development and service delivery. A more prudent fiscal stance since mid-2011 has restored countercyclical fiscal policy in the country and helped boost investor confidence in Nigeria. This is reflected in the current balance of payments surplus and reserve accumulation.Some ambitious reforms are being pursued, particularly in the key areas of Power and Agriculture. An increasing number of State-level Governments are also showing determination to accelerate the pace of development on their territories.

While Nigeria iscurrently in anadvantageous position for accelerating economic development, the country still faces a number of major challenges. Despite the high economic growth reportedin official statistics, Nigeria has yet to find a formula for translating its resource wealth into significant welfare improvements for the population. Job creation and poverty reduction are not keeping pace with population growth, implying that the number of underemployed and impoverished Nigerians continues to grow. With a median age of 14 and population growth at close to 3%, the very stability of the country depends on a major acceleration in the creation of jobs, opportunities, and basic social services for the population. Nigeria's progress toward the MDGs has been largely disappointing, with indicators in many areas resembling those in the poorest countries in Africa. With a fiscal reserve still less than US$ 10 billion, the macroeconomic picture in Nigeria is also still quite vulnerable to an oil price shock.

Economic Growth

According to official statistics, the Nigerian economy exhibited strong GDP growth over the last decade that averaged over 8%.As illustrated In Figure 1, this would imply that the size of the Nigerian economy is 170% times larger today than at the beginning of the decade. Reported growth in the non-oil economy has been even higher, implying that the Nigerian non-oil economy is now 240% times higher than a decade ago. Furthermore, in contrast to the boom-bust cycles of earlier years, Nigeria experienced no general macroeconomic crisis over this period, and the pace of annual GDP growth never fell below 6%.Growth in 2012 slowed somewhat relative to the recent past, registering at6.6% by preliminary estimates, as opposed to 7.4% in 2011. Growth weakened, in particular, in oil, trade, and agriculture. Slower growth in trade and agriculture likely reflects a combination of fallout from the national strike in January, higher energy prices (tariffs), poor weather conditions (flooding), and growing security challenges in some parts of the North.



The oil sector comprises 40% of Nigerian GDP at current prices,[1] but growth in oil has been consistently slower than that of the non-oil economy. In fact, oil production (exports) in Nigeria was essentially stagnant in 2011-2012. Growth in oil is expected to remain low over the medium term, pending potential investments that couldexpand production significantly. Non-oil growth has been driven by domestic demand,and therefore

[1] The Nigerian Bureau of Statistics gives an official estimate that the oil sector comprises only 14-15% of GDP. However, this calculation is based on prices from 1990 when the relative price of oil was very low.

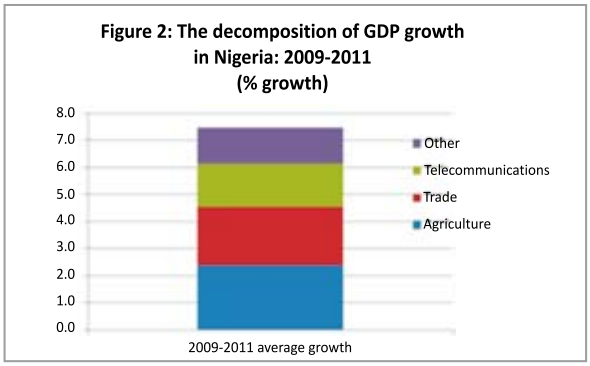
concentrated in sectors servicing the domestic market. This fits the basic pattern observed in many other oil-dependent emerging market economies. Non-oil exports remain quite small in Nigeria (5% of all exports). As trade and agriculture comprise 75% of the non-oil economy, the strong registered growth rates in those sectors have been particularly important for explaining the non-oil economic expansion. As indicated in Figure 2, agriculture and trade have accounted for the majority of official GDP growth in recent years, while the rapidly growing sector of telecommunications has also been significant. Real estate and housing/construction have also witnessed double digit growth in recent years, although their shares in GDP remain modest.

Table 1: GDP Growth in Nigeria By Sector: 2011-2012 (% growth)

	2011	2012
Total	7.4	6.6
Oil GDP	0.1	-0.9
Non-Oil GDP	8.8	7.9
Agriciulture	5.6	4.0
Solid Minerals	12.5	12.5
Crude Petroleum and natural Gas	0.1	-0.9
Manufacturing	7.5	7.6
Telecommunicationsd and Post	34.6	31.8
Finance and Insurance	4.0	4.1
Wholesale and Retail Trade	11.3	9.6
Building and Construction	12.1	12.6
Hotels and Restaurants	12.1	12.2
Real Estate	10.6	10.4
Business and Other Services	9.5	9.7
Others	5.0	5.2

Source: National Bureau of Statistics

Table 1 gives the breakdown in GDP growth by sector for 2011 and 2012, which represents a continuation of the general trends of recent years, although the contributions of agriculture and trade have become somewhat smaller.



Source: National Bureau of Statistics, Bank Calculations

Poverty and Unemployment

While official statistics place Nigeria among thefastest growing economies in the world, with growth concentrated in the pro-poor areas of small scale agriculture and trade, more direct indicators of social welfare of the population would appear to tell another story.Estimated poverty rates declined only marginally between 2003-2004 and 2009-2010, implying that, given growth in the population, the number of Nigerians living in poverty is increasing significantly. Progress toward a number of the other Millennium Development Goals in Nigeria has also been disappointing, and Nigeria was ranked 153 out of 186 countries in the 2013 United Nations Human Development Index. Unemployment rates have been steadily increasing and younger Nigerians are encountering increasing difficulty in finding gainful employment.Given the seeming inconsistencies between the national accounts data summarized above and statistics based on other surveys, it is imperative to conduct further investigations and statistical tests to uncover the true growth and development story in Nigeria.

The national poverty rate (headcount) declined only slightly between 2004 and 2010. Table 2 gives poverty (headcount) rates as measured using data from comprehensive household surveys conducted in 2003-2004 and 2009-2010. The official poverty line in Nigeria is drawn on the basis of income sufficient for per capita consumption of 3000 calories a day plus other essential non-food items. The first estimates show the estimated percentage of the population living below the poverty line by this definition[2]. The sec-

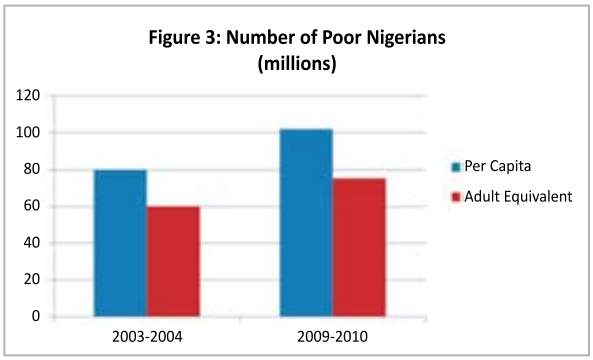
[2]It should be noted that the urban-rural breakdown is based on the last available census data from 1991. Thus, caution should be used for gaining any inference from this particular breakdown.

ond estimates employ the accepted international practice (adult equivalent approach) of weighing children in households less than adults due to the fact that children generally need to consume fewer calories. This correction serves to reduce estimated poverty rates.

Table 2: Nigerian Poverty Rates (% of population)		
	2013-2014	**2009-2010**
Per capita		
Poverty rate	64.2	62.6
Urban Poverty	52.2	51.2
Rural Poverty	73.4	69
Adult equivalence		
Poverty rate	48.3	46.1
Urban Poverty	36.8	34.3
Rural Poverty	57.4	52.9

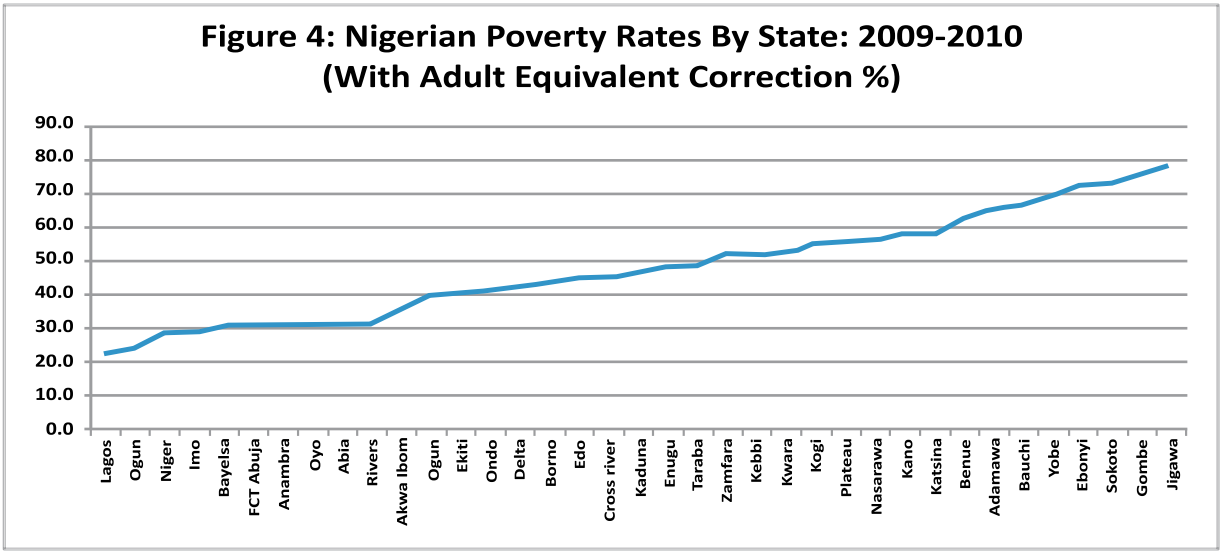
Source: National Bureau of Statistics, Bank calculations

As indicated in Table 2, poverty rates remain high in Nigeria, particularlyin rural areas. These rates declined between 2003-2004 and 2009-2010, although not nearly as fast as would be expected from the pace of economic growth in the country. While the officially reported growth rates of GDP well exceed population growth in the country, the pace of poverty reduction does not. As indicated in Figure 3, this implies that the number of poor Nigerians living below the poverty line has grown measurably.



Source: National Bureau of Statistics

Poverty rates and their dynamics differ considerably in different parts of the country. Figure 4gives poverty rates by State for 2009-2010 (adult equivalent definition).[3] Lagos State has the lowest estimated poverty rate of 22.9%, while Jigawa has the highest at 77.5%. Figure 3 confirms the fact that poverty is particularly concentrated in the Northern part of the country, while the South West experiences the lowest poverty rates. Average poverty rates for the North East and North West areas are 59.7 and 58 percent, respectively, while the North Central has an average rate of 48.8. By contrast, average rates in the South West, South East, and South South are 30.6, 39, and 37.6 percent respectively. By far, Lagos State made the greatest strides toward poverty reduction between 2003-2004 and 2009-2010, reducing its estimated poverty rate from 43.8 to 22.9%. One half (18) Nigerian States actually experienced increases in the estimated poverty headcount between 2004 and 2010.



Source: National Bureau of Statistics

[3]Unfortunately, some irregularities in the household questionnaires received from Niger State (ranked 3rd lowest in poverty above) raise serious questions about the accuracy of the poverty number for that State.

Data on unemployment suggest a similar story to the household budget data. Job creation in Nigeria has been inadequate to keep pace with the expanding working age population. As illustrated in Figure 5, the official unemployment rate has steadily increased from 12% of the working age population in 2006 to 24% in 2011. Preliminary indications are that this upward trend continued in 2012. The official definition of employment in Nigeria (under 40 hours worked in the past week) is unusual, and is therefore not comparable to that in most other countries. The negative dynamic is very consistent, however, with perceptions of the population of increasing difficulties for finding gainful employment. The problem in Nigeria might best be interpreted as underemployment in contrast to unemployment proper. Many Nigerians work in the informal sector doing variouslow paying tasks that do not add up to regular employment, and work performed often correspondspoorly to qualifications. Wage jobs in Nigeria are scarce and provided mostly by Government. In addition, a rather large number of working age Nigeriansare categorized as being out of the labor force. As shown in Figure 5, 44.6% of the working age population in Nigeria was categorized in 2011 as being either unemployed or out of the work force.

Source: National Bureau of Statistics, Bank Calculations

In sum, statistics on poverty and unemployment in Nigeria, together with other direct indicators of welfare, suggest a story that is rather different from the national accounts data. GDP growth has not been sufficient to support levels of poverty reduction and job creation necessary to prevent a growing number of poor and unemployed (underemployed) Nigerians. While the household survey data document a slight increase in inequality between 2003-2004 and 2009-2010 (The gini coefficient moved from .39 to .42), this is not sufficient to explain why non-oil GDP growth of almost three times the rate of population growth, consisting of goods and services produced almost entirely for the domestic market, would not have had a stronger positive impact on the welfare of the population[4]. While data on the geographic distribution of growth are scarce, the economic expansion would appear to have a very high regional concentration. The most obvious example is Lagos State, which is experiencing exceptionally rapid growth, and succeeded in reducing its poverty headcount from an estimated 44% of the population in 2004 to 23% in 2010 at the same time that poverty rates actually increased in half of Nigerian States.Nigeria could profit from monitoring levels of economic activity better on a State-by-State basis, which could bring the national growth story into better focus.

The Balance of Payments

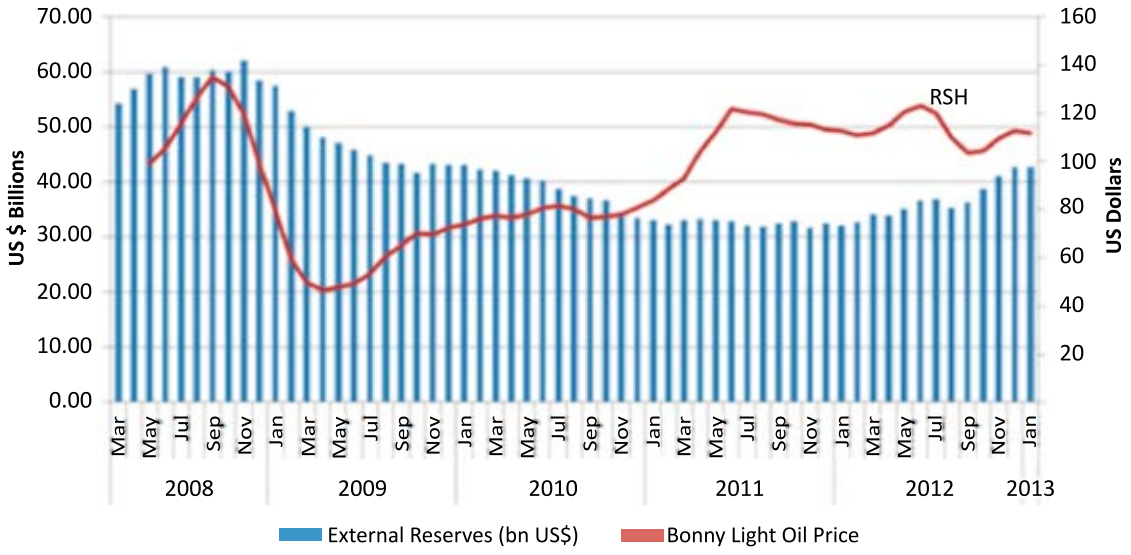
The very high dependence of Nigeria on inherently volatile oil revenues presents major balance of payments risks to the country. As in other oil dependent emerging markets, a sharp decline in oil prices not only has a strong impact on the current account, but the capital account as well, as investors'general attitudes toward Nigeria depend critically on oil prices. As illustrated well in the recent past, they also depend on expectations of investors about the capacity of the country to manage the risks of oil price volatility. With oil accounting for 95% of exports and 75% of consolidated budgetary revenues in Nigeria, the potential for radical swings in the Nigerian macroeconomic picture is particularly high.

Figure 6shows the gross official reserve position of the Central Bank and the price of Bonny Light oil, thereby mappingthe evolution of the balance of payments in recent years and its relationship to the export price of oil. A decline in reserves indicates a balance of payments deficit and visa-versa. Following the major increases in world oil prices in the years up to 2008, the Nigerian balance of payments exhibited a strong surplus, allowing for the accumulation of US$ 62 billion in

[4]One problem with the gini coefficient here is that household surveys do not adequately capture the very rich, who typically decline to take the time to do the survey. So this is probably an underestimate of income inequality in Nigeria. Nevertheless, the officially recorded growth in small scale agriculture and trade, both pro-poor areas, should have had a stronger impact on poverty reduction.

gross monetary reserves by the third quarter of 2008. Conversely, the sharp decline in oil prices in the last quarter of 2008 and 2009 opened up a substantial balance of payments gap that forced a 26% depreciation of Naira duringlate 2008 and early 2009. Nigeria lost US$ 20 billion in monetary reserves in 2009, including the majority of its US$ 22 billion fiscal reserveused for budget support.

Figure 6: Nigeria's Gross Monetary Foreign Reserves (US$ Billion) vs. Bonny Light Oil Price (US$ 3-month moving average)



Sources: Central Bank of Nigeria, Bonny Light Oil Price Index

The years of 2010-2012 are quite informative on how investor expectations and the balance of payment can be strongly affected by the nature of macroeconomic management in Nigeria, and by fiscal policy in particular. Figure 6 clearly suggests thatthe dynamic of reserve accumulation cannot be explained by oil prices alone during these years. The conduct of fiscal policy has also had an important impact on the balance of payments.

Despite the recovery of oil prices in 2010, which enabled manyother oil-dependent emerging markets to restoreBoPequilibrium. Nigeria's balance of payments remained in strong deficit, and the country lost another US$ 10 billion in monetary reserves during the year. Under stronger oil prices, Nigeria actually expanded its fiscal stimulus during this time (see section on fiscal policy below), drawing not only on higher oil revenues but the remaining balance of its Excess Crude Account. Under this expansion, imports recovered strongly and the balance of payments remained in deficit at the exchange rate of 150 to the dollar defended by the Central Bank. By the third quarter of the year, investors became uneasy at the continued BoP weakness and depletion of the fiscal reserve. They began to move out of naira, thereby accelerating the decline of reserves in the latter part of 2010. This pressure on the naira was relieved only by a fortuitous further increase in oil prices in the fourth quarter of 2010. Nigeria's balance of payments deficit (reserve depletion) stabilized only at the significantly higher oil prices realized in 2011. Investors still feared vulnerability due to the continued absence of reserve accumulation at higher oil prices, a still depleted Excess Crude Account

and uncertain fallout for future oil prices from the Eurozone crisis. Another move against the naira in the fall of 2011 precipitated a decision by the Central Bank to depreciate the currency by moving the center of the band from 150 to 155 naira to the dollar.Stronger oil prices at the end of the year again contributed to the stabilization of the forex market. Since October 2011, the Nigerian balance of payments has been in surplus most of the time, with the exception of late Spring-early Summer2012, which wasagain related to concerns about the world economy and oil price weakening.

In 2012, the Nigerian Government began re-accumulating its fiscal reserve for the first time since 2008, which had a notable positive effect on the expectations of investors. This, combined with higher interest rates and better access for foreigners to Nigerian financial markets,started attracting substantial foreign inflows to the Government bond market. Portfolio investment inflows to Nigeria by official data amounted to over US$ 17 billionin 2012, which can be compared to US$ 5 billion in 2011. These inflows, against the backdrop of tighter fiscal policy, primarily explain the widening of Nigeria's balance of payments surplus in the second half of the year, despite somewhat weaker oil prices. By April 2013, gross monetary reserves reached US$ 49 billion.Another potentially important factor behind the strengthening of the balance of payments in the second half of 2012 is reported lower imports of petroleum products. The rapid increase in imports of petrol in 2011 is believed to be connected to widespread fraud. The efforts of the Government to crack down on fraud may have paid some dividends in this regard in 2012. According to preliminary BoP figures, imports of petroleum products declined by more than 100% in2012 relative to the same period in 2011. However, non-petroleum imports also reportedly declined significantly which is very puzzling, given continued growth in incomes and the real appreciation of the naira. This is yet another point in official statistics that needs further investigation and clarification.

While relieving immediate pressures on the balance of payments and allowing for a needed accumulation of reserves, the strong portfolio inflows to the Government bond market that commenced in 2012 also present new challenges. These short-term and largely speculative inflows reflect both growing confidence in exchange rate stability and the exceptionally high (12-14%) returns. Following a balance of payments shock, however, these short-term inflows can be expected to reverse very quickly, thereby magnifying the oil-price related BoP swings. Thus, the Nigerian balance of payments has become potentially even more volatile.

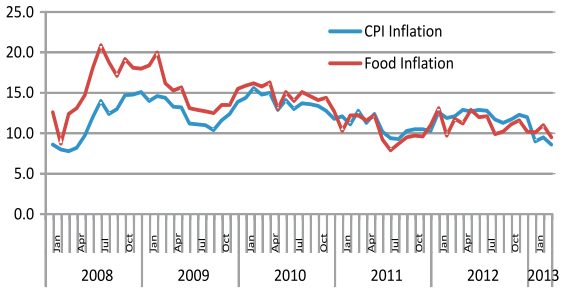
Nigeria faces a medium-term challenge in managing the balance of payments related to the fact that, given the present stagnation in oil exports, the pace of import growth is likely to exceed export growth for a number of years. Thus, the trade and current account surplus will very likely narrow, and more exchange rate flexibility might be necessary.Over the longer term, it is hoped that non-oil exports will begin a strong expansion and foreign direct investment will pick up. In addition, the country still possesses ample oil reserves that could also increase export revenues from oil substantially for several decades. The expected passing of the Petroleum Industry Bill in the near future may help to resolve uncertainty that has been delaying investments in the oil and gas sectors, although recent drafts of this Law have been controversial in that regard.

Inflation

Consumer price Inflation has remained stubbornly high in Nigeria (Figure 7). Contrary to some expectations, given the tightening of macroeconomic policy, CPI inflation (Dec./Dec.) registered at 12% in 2012. High food prices drove up inflation in 2008 in the context of poor weather conditions in Nigeria and increases in world food prices. The continued high inflation in Nigeria in 2009-2010, despite declines in food and commodities prices, no doubt reflected the strong fiscal expansion during those years. Monetary policy was also eased in the context of the Nigerian banking crisis that unfolded in 2009, but without any corresponding rapid expansion in money supply or credit that could have been inflationary. Inflation rates began a steady fall in 2011 in the context of both fiscal and monetary tightening, but started trending upward again in the first half of 2012. Part of the explanation for

this concerns one-off effects on inflation from administrative increases in petrol prices (50% reduction of fuel subsidy) and electricity tariffs. In addition, severe flooding and security challenges in parts of the country reduced supply and trading of some goods. In the context of tighter macroeconomic policy and assuming the absence of oil price shocks, inflation in Nigeria should be expected to trend downward again in 2013. March/March inflation fell to 8.6% in 2013. There is a possibility, however, that strong BoP inflows could increase inflationary pressures somewhat if the naira (nominal) exchange rate is not allowed to appreciate in such a case.

Figure 7: CPI and Food Price Inflation in Nigeria (year-on-year)



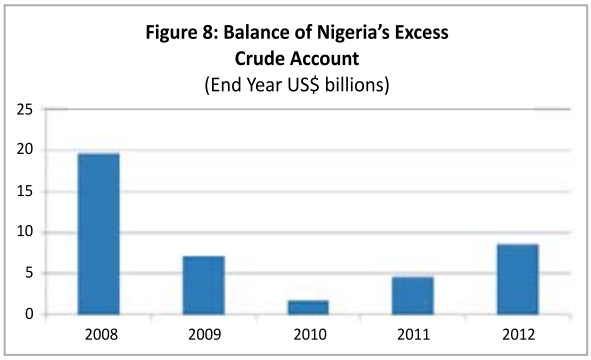
Source: National Bureau of Statistics

Fiscal Policy and the Government Budget

Like most other oil dependent emerging markets, much of the responsibility for managing the risks from oil price fluctuations inevitably falls on fiscal policy. Many oil-dependent countries, including Nigeria, have fallen victim to boom-bust cycles magnified by pro-cyclical fiscal spending. Conversely, countries that have transformed the oil curse into an advantage for economic development have managed to implement countercyclical policies that build fiscal buffers during times of high oil prices that can finance stimulus spending in the aftermath of a negative oil shock. The particular nature of federalist relations in Nigeria adds a layer of complexity to this problem, as the Federal Government alone does not have the authority to manage the country's fiscal reserve. This reserve (Excess Crude Account) is under the joint management of the Federal and State Governments. Thus, a political consensus involving a critical mass of Nigerian States is essential to the realization of responsible fiscal management at the national level.

Nigeria has made very important progress toward the implementation of countercyclical fiscal policy during the last decade. In 2004, the Government established an Excess Crude Account fiscal reserve fund governed by a benchmark oil price rule. The Excess Crude Account reached US$ 22 billion by the fall of 2008, and was then used successfully to finance a stimulus package in 2009 that insulated the Nigerian economy to a large degree from the world economic turbulence. Since 2009, however, Nigeria found it difficult to reach a political consensus to rein in the fiscal expansion and re-accumulate its reserve (Figure 8).

Figure 8: Balance of Nigeria's Excess Crude Account
(End Year US$ billions)



Source: National Bureau of Statistics

Since 2011, the Federal Government has exhibited new momentum for re-establishing countercyclical fiscal policy, pursuing fiscal consolidation, limiting ad hoc distributions of the ECA, and realizing new legislation for the creation of a Sovereign Wealth Fund under institutional rules that may be less vulnerable than the Excess Crude Account to short run political pressures. From very low levels in 2010, the Excess Crude Account accumulated to US$ 4.6 billion at the end of 2011 and US$ 8.6 billion at end-2012. These efforts continue to face political challenges from some Nigerian States, and the replacement of the Excess Crude Account with the Sovereign Wealth Fund has so far been delayed.

The high general government deficits in 2009-2010 have been reduced significantly.Table 3 presents estimates for the General Government Budget of Nigeria, as consisting of Federal and State (Consolidated State and Local) Budgets, Extra-Budgetary Funds, deductions for financing the fuel subsidy (executed from oil revenues before distribution to budgets), and changes in

the fiscal reserve position. Due to uncertainties over data, some of the estimates in Table 3 should be understood as approximations from only indirect calculations. This particularly concerns estimates for consolidated State and local budgets, as there is still no implementation of uniform accounting standards and data collection that could provide a fullpicture of the consolidated budget execution in the country.

Table 3: The General GOvernment Budget of Nigeria: 2008-2012 (Shares of GDP)

	2008	2009	2010	2011	2012{proj}
Total					
Government Revenues	30.2	19.4	22.6	25.5	22.6
Federal	11.0	9.7	9.9	8.3	7.7
State {est.}	12.2	11.8	11.7	10.0	9.4
Extrabugetary Funds	1.1	1.9	1.5	1.4	1.7
Deductions for Fuel Subsidy	2.6	1.7	2.2	4.6	2.7
Net Accumulation to ECA	3.4	-5.7	-2.7	1.2	1.3
Expenditures					
Federal	10.7	11.0	13.5	10.9	10.0
State {est}	11.2	11.4	11.2	10.8	10.2
Extrabudgetary Funds	1.1	1.9	1.5	1.7	1.7
Fuel Subsidy	2.6	1.7	2.2	4.6	2.5
Balance					
Federal Budget	0.3	-1.3	-3.5	-2.6	-2.4
State Budgets {est}	1.0	0.4	0.5	-0.8	-0.8
Consolidated Federal and State	1.3	-0.9	-3.0	-3.4	-3.2
General Government	4.7	-6.6	-5.7	-2.2	-1.9

Note: General Government includes Federal, State, and Local Budgets, Extra-Budgetary Funds, Fuel Subsidy Payments, and Net Accumulation to the ECA

Sources: Office of the Accountant General of the Federation, Budget Office of the Federation, Central Bank of Nigeria, IMF, Bank estimates

The general government deficit widened significantly in 2009-2010. As indicated in Table 3, the General Governmentbudget in Nigeria was in surplus by an estimated 4.7 percent of GDP for the year of 2008, but then moved into deficit of 6.6% in 2009 following the decline in oil prices. This general government deficit in 2009 was financed primarily by the Excess Crude Account (5.7% of GDP or US$ 12,6 billion). In 2010, the General Government deficit remained high at 5.7% of GDP, despite the recovery in oil prices, due almost entirely to strong increases in federal expenditures that were financed by a higher federal deficit (borrowing) and a further drawdown of the Excess Crude Account that almost completely depleted its balance by the end of the year.

Fortunately, the year 2011 brought much needed progress toward consolidation. In 2011, actual federal expenditures grew by less than 7 percent in nominal terms, representing a decline of 1.8 percent in real terms. The progress toward general government consolidation in 2011 would have been much more dramatic had it not been for a mushrooming in Government fuel subsidy payments that reached 4.6% of GDP, and understandably became the focus of a major scandal in the country. In 2012, the Government succeeded in reducing fuel subsidy expenditures through a reduction in the subsidy rate itself and a crackdown on corruption, while continuing progress toward real expenditure compression and deficit reduction. The preliminary estimated General Government deficit for 2012 is1.9% of GDP, representing continued progress in consolidation despite lower-than-expected Government revenues. The draft 2013 Federal Budget and Medium Term Fiscal Framework propose even further consolidation; however, there are significant risks to this picture coming from oil price uncertainty, as well as political issues/conflicts that could affect the size of fuel subsidy payments and the ability of the Government to accumulate surplus revenues in its reserve.

Following the Paris Club restructuring, Nigeria still has a strong debt position that can be used to meet some of the possibleBoP and budgetary challenges described above in the short and medium term. External sovereign debt remains less than 3% of GDP, while domestic debt has reached 16%.[5] The recent rapid growth of domestic debt and still quite high domestic borrowing costs has prompted the Government to plan a reduction in domestic borrowing. Correspondingly, the 2012 Debt Sustainability Analysis recently conducted by the Debt Management Office recommends a shift from domestic to external sources of borrowing, specifically stating that 60 percent of borrowing requirements for 2013 be raised from external sources while only 40 percent of financing should be sourced from the domestic market. External borrowing is indeed potentially much cheaper for Nigeria at present, although two important issues still need to be considered in that regard. Firstly, Nigeria's open foreign currency position is critical to stabilization and protection against oil price volatility. This is a reason why it can still make financial sense for Nigeria to accumulate resources in its fiscal reserve (Excess Crude) account at the same time that it is borrowing domestically in naira. Secondly, given remaining weaknesses in the Nigerian banking sector in the aftermath of the banking crisis of 2009, it is important that Nigerian banks have access to a sufficient supply of Government securities to balance the risks in their portfolios.

Economic Outlook

Assuming that oil prices do not decline sharply and oil output stabilizes, the macroeconomic outlook for Nigeria in 2013 appears fairly strong. The foreign inflows that generated the balance of payments surplus and reserve accumulation should continue, and will stimulate domestic demand. In this context, particularly if there are better weather conditions in 2013, the pace of economic growth could accelerate somewhat. Overall, 2013 should provide a favorable context for the realization of key reforms and investments (power, roads, business climate, education, health, agriculture, etc.) that could generate the non-oil growth, productivity increases, and jobs needed to ensure the country's prosperous future.

[5]The Debt Management Office has recently improved its ability to monitor debt at the State level, and plans to make available comprehensive information in this area.

Even if oil prices remain strong, Nigeria still faces some important challenges in maintaining the positive momentum in fiscal consolidation and reserve accumulation witnessed since 2011. Given the fact that oil exports, which represent the primary source of budgetary revenues in the country, should exhibit only modest growth in the near future relative to the economy as a whole, the budgetary stance of the country could face increasing pressures. Chapter 2 of this report serves to illustrate the exact nature of this challenge.

Table 4: Selected Economic Indicators

	2008	2009	2010	2011	2012 (prelim)
GDP Growth (%)	5.98	6.96	7.98	7.43	6.58
Oil GDP	-6.08	0.5	4.56	0.14	-0.7
Non-Oil GDP	8.95	8.33	8.49	8.8	7.89
Inflation Rate (CPI avg.%)	11.6	12.5	13.7	10.8	12.2
Inflation Rate (CPI Dec/Dec, %)	15.1	13.9	11.8	10.3	12
General Govt. Fiscal Deficit* (% of GDP)	4.7	-6.6	-5.7	-2.2	-1.9
Federal Govt. Fiscal Deficit (% of GDP)	0.3	-1.3	-3.5	-2.6	-2.4
Federal Reserves (ECA/SWF) US$ b	19.7	7.1	2.7	4.6	8.6
Guss Monetary Reserves ($ b)	53	42.4	32.3	32.6	46
in months of import cover	12.7	6.7	4.7	4.5	5.6
Normal Exchange Rate (N/US$), eop	132.6	149.7	150.5	158.2	157.3
Sovereign Debt (% of GDP)	11.6	15.4	15.3	17.1	18.4
External	2.2	2.4	2	2.3	2.5
Domestic	9.4	13	13.3	14.8	15.9
*Includes Federal, State, Local Extra-Budgetary Funds, Fuel Subsidy, Net Accumulation to ECA.					

Sources: National Bureau of Statistics, Nigeria Central Bank, Debt Management Office, Bank Calculations

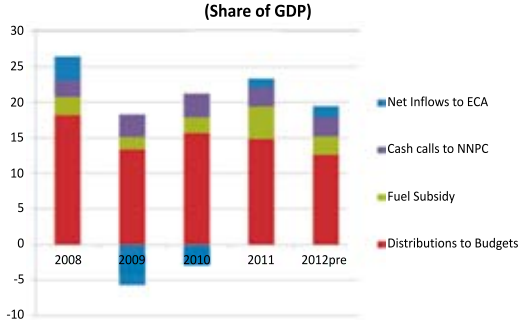
II. Oil Revenues and Fiscal Sustainability in Nigeria

As oil revenues comprise 75 percent of budgetary revenues and 95 percent of exports in Nigeria, the effective management of the country's oil wealth is critical to stability and fiscal sustainability in the country. This chapter examines this question partially, looking only at various scenarios for Government oil revenues and their allocation to budgets, the fiscal reserve (Excess Crude), the fuel subsidy and NNPC (cash calls). As discussed in the previous section, the Federal Government has recently pursued a determined path of consolidation to restore countercyclical fiscal policy and accumulate a fiscal reserve of adequate size to protect Nigeria from oil price volatility. This analysis serves to verify the importance of this policy priority as well as the imperative of increasing non-oil sources of tax revenue. Due to a slow expected expansion in oil output in the short term, together with GDP growth, and expected real appreciation of the naira, the share of oil revenues in GDP should continue to decline, as was the case in 2012. Thus, maintaining sizeable distributions of oil revenues to budgets and building up a fiscal reserve to protect the country from oil price volatility will likely become even more of a challenge. The opportunity cost of the fuel subsidy is likely to increase in that regard, particularly if oil prices remain strong.

Government oil revenues in Nigeria are allocated to three main areas (a) Federal, state, local budgets, and extra-budgetary funds, (b) "cash calls" to NNPC (to finance expenditures and investments in the oil sector), (c) the fuel subsidy, and the (d) Excess Crude Account[6]. Allocations to the Excess Crude Account can be either positive (accumulation) or negative (drawdowns) that augment the oil revenue allocated to the other directions. Figure 9 summarizes the division of oil revenues in Nigeria as shares of GDP from2008 -2012 (2012 figures still preliminary).

6For simplicity, this analysis abstracts from extra-budgetary funds and other minor allocations/deductions, lumping these together with allocations to budgets.

Figure 9: The Distribution of Oil Revenues in Nigeria: 2008-2012 (Share of GDP)



Sources: Office of the Accountant General of the Federation, Bank calculations

The dynamics of the distribution of oil revenues during 2008-2012 shown in Figure 9 reflect very different factors and policies during each of the respective years.

- In 2008, oil revenues surged under record high prices, supporting exceptionally large allocations to budgets (18.2% of GDP) and an accumulation to the ECA (3.4% of GDP)

- In 2009, in light of a sharp decline in oil output and revenues, significant allocations from the Federation Account (13.5% of GDP) and fuel subsidy payments were financed by a large drawdown of the Excess Crude Account (5.7% of GDP).

- In 2010, an increase in oil prices was nevertheless insufficient to finance large increases in allocations to budgets (15.7% of GDP) and higher fuel subsidy payments, entailing another drawdown of the Excess Crude account of 2.7% of GDP.

- In 2011, oil prices and revenues increased notably. The Government kept distributions to budgets close to the same level (share of GDP) as in 2011, but a major surge in payments of the fuel subsidy (4.6% of GDP) limited accumulation in the ECA to only 1.3% of GDP.

- In 2012, oil output declined and Government revenues dropped to an estimated 19.5% of GDP. Only through considerable fiscal consolidation and the reduction of fuel subsidy payments did the Government succeed in not depleting the ECA, which accumulated by another 1.5% of GDP.

The 2012 fiscal year is illustrativeof a general challenge concerning oil revenues and fiscal sustainability in Nigeria. Nigerian oil output and exports have been rather flat in quantity terms in recent years, and are not expected to increase much pending key investments that could expand output significantly in the medium term. In this case, even if (dollar) oil prices remain stable, their size relative to GDP should fall.

To illustrate the macroeconomic challenges that Nigeria faces, three different scenarios are examined for the world economy (oil prices) through 2015: a baseline scenario, optimistic scenario, and pessimistic scenario, which are presented in Tables 5-7. In all three scenarios, projections for oil output are based on growth rates in the Nigerian Government's Medium Term Expenditure Framework, which presumes that oil output will grow annually by 2.8 percent in 2013, but then taper off to slightly less than 1% in both 2014 and 2015. For these scenarios, it will also be assumed that the share of all oil revenues accruing to the Government will remain constant. The share of oil revenues received by the Government averaged 54% during 2010-2012, and this is the share projected for each of the three years, 2013-2015. In fact, an expected increase in production sharing contracts relative to joint ventures may decrease this share slightly in the near future. When more detailed information on oil contracts becomes available, it will be possible to account more accurately for how Government oil revenues should fluctuate with oil prices.[7]

7 Due to the nature of oil contracts, the share of revenues accruing to the Government changes when oil prices change. It would appear that many of these contracts actually allocate a larger share of the oil price risk to the Government, i.e. if oil prices decline, government revenue declines more than proportionally. This was indeed the case in 2009. The simulations below will not account for this additional risk to the Government, as insufficient information was available on the nature of these contracts at the time that this Report was being prepared.

Table 5: Assumptions for Scenario 1

	2013	2014	2015
Bonny Light Oil Price	120	130	140
GDP Growth	7.0	7.0	7.0
Oil Output (min b/day)	2.55	2.58	2.60
Naira Exchange Rate	156	156	156
Inflation (CPI)	9	8	7

In the baseline scenario (Scenario 1), the average dollar price of Bonny Light oil is assumed to be 120 dollars a barrel in 2013, increasing gradually to 140 dollars a barrel in 2015. GDP growth is assumed at 7 percent. The gradual increase in the oil price should roughly compensate for import growth, thus keeping the current account and balance of payments close to equilibrium at the exchange rate of 156 naira to the dollar. Finally,tighter macroeconomic policy should begin paying dividends in 2013 in a steady decrease in the inflation rate. This presumes that the Government is able to maintain the budgetary consolidation efforts outlined in the MTF, despite the likely increase in political pressures leading into the 2015 elections.

In the optimistic scenario (Scenario 2), the average oil price increases sharply to 150 dollars a barrel in 2013 and reaches 170 dollarsin 2015. The corresponding inflowshave a stimulus effect on investment and growth in the country. It is assumed that GDP growth increases to 8% in 2013 and 2014, and to 9% in 2015. The inflows will generate a strong balance of payments surplus. Given interventions by the Central Bank to smooth exchange rate movements, it is assumed that part of the pressures for the appreciation of the naira will be realized through nominal appreciation, whereby the naira will reach 125 to the dollar in 2015, and partly through inflation (10% annual rate in each of the three years).

Table 6: Assumptions for Scenario 2

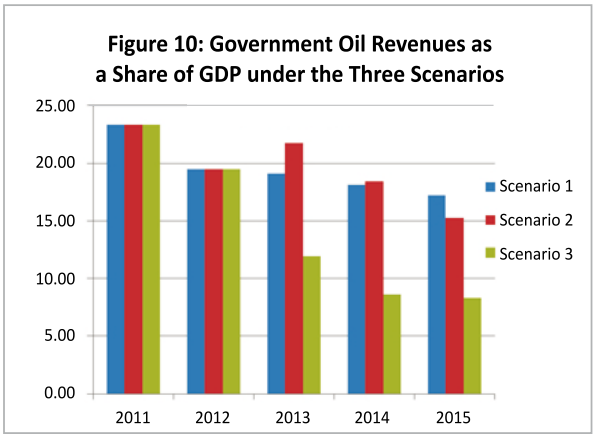
	2013	2014	2015
Bonny Light Oil Price	150	160	170
GDP Growth	8	8	9
Oil Output (min b/day)	2.56	2.58	2.80
Naira Exchange Rate	145	135	125
Inflation (CPI)	10	10	10

Finally, in the pessimistic scenario (Scenario 3), the average price of Bonny Light falls to 70 dollars a barrel in 2013, and then 50 dollars a barrel in 2014 and 2015. GDP growth is adversely affected, falling to 6 and then 5 percent. The naira depreciates to 170 to the US dollar in 2013, reaching 225 in 2015. Annual inflation remains high at 12%, driven largely by the increasing cost of imports.

Table 7: Assumptions for Scenario 3

	2013	2014	2015
Bonny Light Oil Price	70	50	50
GDP Growth	6.0	5.0	5.0
Oil Output (min b/day)	2.55	2.58	2.60
Naira Exchange Rate	170	200	225
Inflation (CPI)	12	12	12

Given these three scenarios, one important conclusion can be drawn immediately: in all three scenarios, the share of Government oil revenue in GDP can be expected to continue its decline over the medium term (Figure 10).In the baseline scenario (Scenario 1), GDP growth and inflation under exchange rate stability and slow oil output growth continue to reduce the share of Government oil revenues in GDP. Given the assumed increases in oil prices, the pace of the decline is more moderate than observed in 2012. Between 2011 and 2015, oil revenues fall from 23.3 to 17.2 percent of GDP. In the optimistic scenario (Scenario 2), the assumed sharp oil price rise is sufficient to increase the share of oil revenues in GDP in 2013 (21.8%), but this sharefalls thereafter, reaching 15.2percent of GDP in 2015. The even more rapid decline of oil revenues as a share of GDP in Scenario 2 as opposed to Scenario 1 is due to higher assumed GDP growth, inflation, and appreciation of the naira. All of these factors reduce the share of dollar oil revenues in GDP, despite the fact that these dollar revenues continue to grow in nominal terms due to higher oil prices and somewhat higher oil output. Finally, in the pessimistic scenario, oil revenues fall to an estimated 11.9 percent of GDP in 2013, and then decline to a low of 8.3% in 2015. The depreciation of the naira and slower GDP growth mitigate the declines in 2014 and 2015.



The dynamic in Figure 10 implies that, relative to the size of the Nigerian economy, oil revenues are likely to become increasingly scarce, even in the case of substantially higher oil prices. At the same time, the Nigerian Government faces the imperative of accumulating a fiscal reserve of sufficient size to protect the country from oil price volatility, and of preserving priority expenditures for infrastructure and public services. The remaining part of this section serves to illustrate the seriousness of this challenge.

What will be the size of cash calls, fuel subsidy payments, and distributions of oil revenues from the Federation Account in 2013-2015?This will be largely a function of politics, as well as the degree to which the Federal and State Governments can succeed in increasing non-oil tax revenues to substitute for the declining share of oil. Cash calls to NNPC have been rather stable at close to 3% of GDP in recent years. At these levels, however, cash calls appear to have been inadequate to finance the costs of planned joint venture investments, resulting in increasing debts owed by NNPC to international oil companies and, by implication, additional costs of debt service that also need to be financed by future cash calls. This would suggest that the share of cash calls to GDP might need to be increased over the medium term, although it will be assumed here that they remain at the average of recent years at 3% of GDP from 2013-2015.

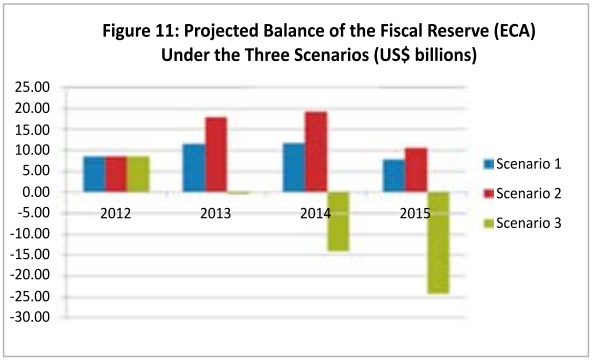
The maintained assumption here will be that political pressures will keep the official internal price of petrol at 97 naira through 2015. While the Government succeeded in reducing the burden of the fuel subsidy significantly in 2012, this came at major political cost, including a national strike in January of that year. The cost of the subsidy will depend on the difference between world and internal petrol prices, which will be different in the three assumed scenarios due to the close link between petrol, kerosene, and oil prices. Assuming that petrol and kerosene demand will increase at the same pace as GDP, estimating world petrol and kerosene prices on the basis of the assumed oil prices and applying the Nigerian methodology for subsidy payments gives estimates of the cost to the Government of maintaining the 97 naira price in scenarios 1-3 (Table 8). In Scenario 3, even though the world (FOB) price of petrol falls below the fixed 97 naira price on the domestic market, subsidy payments still remain nontrivial due to the need to finance the landing costs and distribution margins.In Scenario 2, the cost of the fuel subsidy as a share of GDP increases notably in 2013, but then declines a bit due to the appreciation of the naira, which compensates somewhat for the higher dollar price of petrol.

Table 8: Estimates Size of Fuel Subsidy Payments That would be Needed to Keep the Naira Price of Petrol at 97 Under Scenarios 1- 3(share of GDP)

	2013	2014	2015
Scenario 1	2.9	3.2	3.5
Scenario 2	3.7	3.5	3.3
Scenario 3	1.1	1.3	1.5

The size of distributions to budgets through 2015 will depend on politics.For Scenarios 1 & 2, it will be assumed that annual growth in the size of (naira) distributions of oil revenue to budgets are held to 3% in real terms (i.e. over and above inflation).

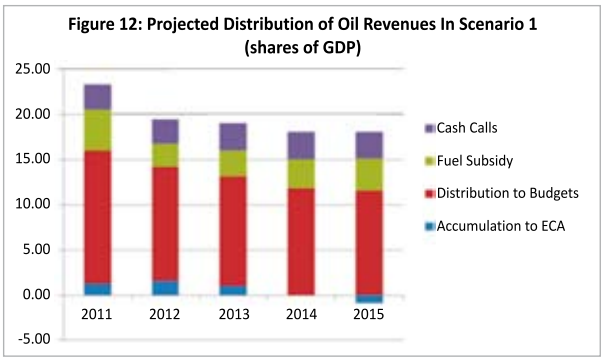
For Scenario 3, it is assumed that the crisis situation will provide a context for maintaining no growth in the naira value of distributions to budgets of oil revenues. Therefore, in this Scenario, the distributions of oil revenues from the Federation Account are assumed to remain at the constant level in naira of that realized in 2012.

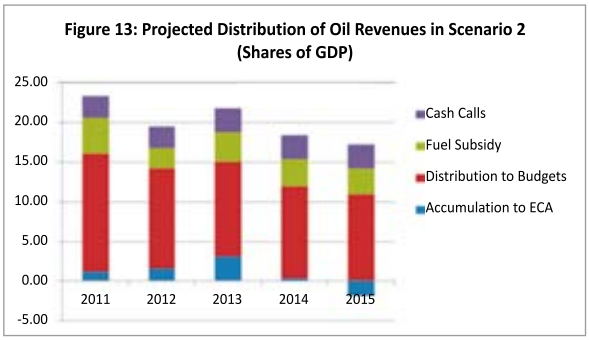


Under these assumptions, Figure 10 shows the projected balance of the country's fiscal reserve under scenarios 1-3.

Under both Scenarios 1 & 2, the fiscal reserve increases in 2013 and 2014, but declines in 2015, winding up close to the level observed at the close of 2012. Thus, despite strong oil prices and a fairly conservative stance regarding distributions to budgets, there is little movement in the ECA balance by 2015.While the fiscal reserve accumulates in 2013 and 2014, Government oil revenues nevertheless become insufficient to finance budget distributions, the fuel subsidy, and cash calls in 2015 under the maintained assumptions, and the ECA balance begins to decline even in the optimistic scenarios.In the case of Scenario 3, the balance of the ECA is almost sufficient to finance the gap in 2013, but a large unfinanced gap opens up in 2014-2015, reaching US$ 24.2 billion at the end of the period. This serves to illustrate the continued vulnerability of Nigeria to an oil price shock with an ECA balance under US$ 10 billion.

Why does the ECA balance fail to experience a sustained accumulation in the baseline and optimistic scenarios? Firstly, as shown earlier in Figure 10 above, available oil revenues as a share of GDP decline, despite the higher oil prices. In both cases, with oil revenues declining as a share of GDP, an increasing relative burden of financing the fuel subsidy and cash callscrowd out both distributions to budgets and the accumulation of the ECA (Figures 12 & 13). The share of oil revenues devoted to the fuel subsidy and cash calls increases from 27% to 38% in Scenario 1, and to 41% in Scenario 2. Distributions to budgets, although assumed to increase in real terms by 3% annually, fall steadily as a share of GDP, from 12.7% to 11.6% in Scenario 1, and to 10.9% in Scenario 2.





If the Government would limit the size of distributions of oil revenue to budgets, the scope for accumulation of the fiscal reserve would increase. For example, if distributions of oil revenue to budgets were held at zero real growth (annual increases equal to the rate of inflation), the fiscal reserve would accumulate to an estimated US$ 15.4 billion in 2015 in Scenario 1, and to US$ 18.3 billion in Scenario 2. However, the same qualitative issues would emerge, with growth in the fiscal reserve ending in 2014, and challenges beginning after 2015.

Several important policy relevant conclusions can be drawn from the above simulations.

- The particular trends in Nigeria in oil production, GDP growth, and inflation imply that oil revenues as a share of GDP should decline significantly in coming years. Unless Nigeria can realize major compensating increases in non-oil revenues (IGR), Government budgets may experience increasing pressures.

- The current balance of the Excess Crude Account may only be sufficient to pull Nigeria through one year following a sharp decline in oil prices. Thus, unless Nigeria can manage to accumulate a stronger fiscal reserve, macroeconomic stability faces major external risks. The world economic situation is still highly volatile, and an associated macroeconomic crisis would imply high inflation, currency depreciation, and increased hardship for a large part of the population.

- In light of the above, the fuel subsidy represents a high and growing opportunity cost to the country. In the absence of the fuel subsidy from 2013-2015, under the maintained assumptions, the ECA would have accumulated to over US$ 20 billion already in 2013 in both Scenarios 1 & 2, and to well over US$ 40 billion in 2015. Thus, in the absence of the fuel subsidy, under the first two scenarios, the country could succeed in both accumulating a sufficient reserve to protect itself from oil price volatility, and in realizing strong increases in distributions to budgets of oil revenues. In Scenario 3, without the fuel subsidy, the fiscal gap by 2015 would also be reduced to less than US$ 6 billion, which is a generally manageable situation, given Nigeria's current strong debt position.

- Even under strong oil prices, the accumulation of an adequate reserve to protect the country may entail very little growth in distributions from the Federation Account in the near future.

The above considerations serve to highlight the importance of reducing the dependency of the country's budgetary position on oil, and to ensure measurable increases in internally generated revenues to compensate for increasingly scarce oil revenues. Assuming that the fuel subsidy is maintained, the accumulation of a fiscal reserve sufficient to protect the country against a sharp decline in oil prices promises to be a difficult task, even with strong oil prices. In this light, current efforts by the Government to prioritize the accumulation of the fiscal reserve through the choice of a conservative benchmark oil price are understandable, as are the efforts underway to increase non-oil revenues. The implementation of a fuel subsidy to support fixed naira prices for petrol and kerosene will always pose challenges to fiscal sustainability, as the size of the subsidy in this case moves directly with changes in world market prices for fuel or the value of the naira. If the subsidy is maintained, an alternative mode of implementation, such as a percentage or even constant markdown from a prevailing market price, would be less threatening to the Government's financial position than the guarantee of a fixed naira price.The concluding section of the next chapter contains some specific suggestions on how the fiscal oil wealth of Nigeria could be managed effectively in the light of these conclusions.

III. Making Fiscal Federalism Work for Development in Nigeria

In a large country like Nigeria, a proper division of resources, authority, and responsibilities between different tiers of Government is critical not only for ensuring effective service delivery to the population, but for achieving growth and stability on a national scale. The Federal Government in Nigeria receives close to half of all consolidated revenue and has primary responsibilities in infrastructure, utilities, and security. The 36 Nigerian States and their respective local governments are responsible for most social services and local infrastructure. States operate with a rather high degree of autonomy in regulation and the allocation of resources in these and other areas. This type of state or provincial level decentralization has been consistent with rapid growth and development in countries as institutionally diverse as the United States and China. Nigeria also has the potential to take off into sustained and diversified output and employment growth under these conditions. For this to be achieved, among other policies and reforms, the note argues that the Federal and State Governments need to deepen cooperation in a few areas, most particularly:

- to maintain strongly countercyclical fiscal policy to protect the country from oil price volatility
- to achieve a coordination in fiscal policies, particularly for the connectivity of markets and improvement of public services
- to realize national standards in public finance management, especially for accounting and disclosure to the population

If progress can be made in these directions, Nigeria can achieve an important degree of macroeconomic and exchange rate stability, despite its significant dependence on oil. This will increase the incentives of investors, who, given a greater connectivity of markets, will increasingly look beyond local markets and choose States with relatively hospitable business climates to service the larger Nigerian or world market. States will have incentives to compete in improving their business climates to attract such investors, who can bring much needed job creation and local revenues. The current growth agglomerations in congested cities like Lagos and Kano could be expected to spread rapidly to surrounding regions. The close coordination of fiscal and infrastructure policies will create greater opportunities to concentrate resources on improving market connectivity in strategic areas, and for increasing the quality of public services. Finally, the adoption of national standards for accounting and disclosure will serve to increase the accountability of public officials at all levels of government, thereby supporting the realization of public programs that are essential for growth and welfare.

The first part of this chapter briefly describes current fiscal federalist relations in Nigeria, including the basic legal framework and related areas of controversy in the country. The second section assesses both the advantages and challenges to development that are inherent to Nigeria's variant of federalism. The third section emphasizes the importance of developing deeper intergovernmental cooperation in the three key areas highlighted above in light of international experience. A final section considers the way forward, including the possitbleexpansion of federal programs involving co-financing or conditional grants to states as a mechanism to help solidify this greater cooperation.

Fiscal federalism in Nigeria

The legal framework

The current federalist structure of Nigeria corresponds to the Constitution of 1999, which prescribes rules governing the division of functions and responsibilities between the Federal, State, and Local governments. Although some notable gaps and ambiguities exist with regard to the allocation of responsibilities, the basic division is similar to a number of other federations, with the Federal Government being responsible for security and infrastructure /public goods of

multistate significance, while subnational governments deliver most services to the population, and are responsible for public goods of local significance. While basic health care and education are primarily under State jurisdiction, the Federal Government also plays an important role in both areas. The Constitution is somewhat vague on the division of responsibilities between the State (second tier) and Local (third tier) Governments. This division in practice is largely at the discretion of State governments.

The Constitution specifies that the revenues from oil, as well as from the VAT, customs, and corporate income tax be divided between federal, state, and local levels of government strictly according to formulae developed by the Revenue Mobilization Allocation and Fiscal Commission and approved by the National Assembly. In addition, a small share of revenue to the federation (currently 4.18%) accrues to four Special Funds (Federal Capital Territory, Ecology and Derivation, Statutory Stabilization, and Development of National Resources). Although the subject of continual political debate, the revenue-sharing formulae in Nigeria have proven quite stable over time, and have not changed much in the last decade. Table 9 summarizes revenue sharing between different levels of government and Special Funds from 1958-2004.

Table 9: Revenue Sharing in Nigeria

Year	Allocation of Federation Account (out of 100%)				Derivation Formulae[1]
	Federal	State	Local	Special Funds	
1958	40	60	0	0	50
1968	80	20	0	0	10
1977	75	22	3	0	10
1982	55	32.5	10	2.5	10
1989	50	24	15	11	10
1995	48.5	24	20	7.5	13
2002	48.5	24.72	20.6	6.18	13
2004[2]	48.5	26.72	20.6	4.18	13

Source: Stevens, M., Gboyega, A., and Barkan, J.D., 2001, State and Local Governance in Nigeria, World Bank

[1] The percentage of net oil revenues distributed to oil producing states before Federation Account distribution.

[2] In 2004, the revenue sharing formula was adjusted so the FGN could provide a 2 percent grant to states from its own share of federation account revenues

Oil revenue currently accounts for approximately 75% of all consolidated government revenue in Nigeria. Under the current formulae, oil revenues are divided according to a rule that first gives 13% to oil producing states (derivation principle) and then splits remaining revenues between the Federal Government (53%), State Governments (27%), and Local Governments (20%). Revenues from customs, excise, and corporate income taxes are divided by the same formula without the derivation principle. Revenues from the VAT are divided according to 15% Federal Government, 50% State Governments, and 35% Local Governments. In each case, a small part of the implied federal share is divided among the Special Funds.

The formula for division of oil (after application of the derivation principle), customs, excise, and corporate income tax revenues between States has followed a rather simple rule: 40% is allocated equally to all states, 30% is allocated proportionately to population, 10% is allocated proportionately to land mass and terrain, 10% accounts for "social development factors (education, health, and water)," and 10% rewards states that generate more internal revenue (IGR) themselves. In practice, a large portion of the 20% designated for social development and IGR also gets divided equally among States. VAT revenues are divided as follows: 50% equally to all states, 30% proportional to population, and 20% on the basis of relative state contributions to VAT revenues (derivation principal).

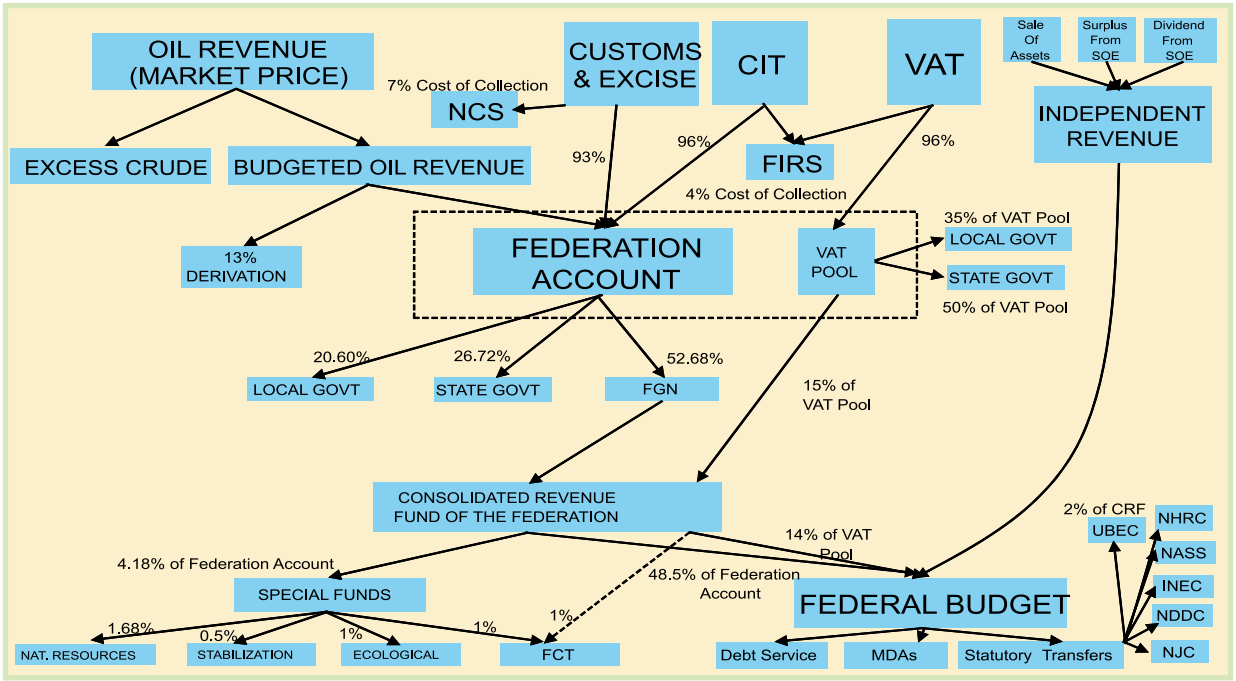
As stipulated in the Constitution, allocations to Local Governments actually accrue to a "State Joint Local Government Account" that is under the authority of the State Government. For this reason, State Governments have the de facto power to determine the allocation of the funds designated for both the State and local governments on their territories. In some States, local governments have very small budgets and responsibilities, while other States delegate more functions and resources to the local level.

In addition to the allocations from the Federation Account and VAT Pool stipulated above, State and Local Governments have their own local sources of tax revenue. In a typical Nigerian State, internally generated revenue does not usually account for more than 10% of all consolidated state revenues. A notable exception is Lagos State, where the majority of State revenues come from internal sources. Kano also has a relatively high share of internal revenue. By far, the most important local source of State revenues is the personal income tax. A few States also generate significant revenues from land (property) taxes or user charges.

As opposed to most other federations, States do not generally receive transfers from the Federal Budget, but from the Federation Account over which the Federal Government has no direct authority. Thus, the Federal Government cannot regulate the size of transfers that States receive. Any changes in the allocation formulae should be approved by the National Assembly. Under these conditions, Nigerian States manage their finances quite independently of the Federal Government, and can even employ different accounting standards. National initiatives in public finance management (such as the Fiscal Responsibility Act) have proven difficult to implement at different levels of government. To date, comprehensive data on State and Local budgets are not collected by any administrative or statistical body in Nigeria.

Since 2004, Nigeria has managed an Excess Crude Account consisting of surplus oil revenues. Revenues from oil over and above a benchmark price in the approved annual budget (revenue framework) accrue to the Excess Crude Account. In the event that the oil price falls below the benchmark price, Excess Crude Account reserves are used to support planned budgetary revenues. The Excess Crude Account is managed jointly by the Presidency, the Federal Government, and State Governments. This authority has sometimes been used to distribute resources from the Excess Crude Account to budgets on an ad hoc basis to finance additional expenditures or extra supplementary budgets. When resources from the Excess Crude Account are distributed to budgets, they follow the same distribution formula as for other oil revenues. The flows of revenues to different levels of Government are illustrated in Figure 14:

Figure 14: Revenue flows in the Nigerian Federation



See annex for list of abbreviations

Rules for subnational borrowing in Nigeria are more restrictive than might be expected in such a decentralized federation. Nigerian States can only borrow externally with permission of the Federal Government, and the servicing of state-level external debt is managed centrally. External debt service is deducted from the given State's share of Federation Account revenues before distribution. Domestic borrowing is monitored by the Federal Government Debt Management Office (DMO) and is subject to ceilings. Domestic bond issues by States also require approval of the DMO. Debt servicing by Nigerian states are not to exceed 40% of their average monthly allocations from the Federation Account. In practice, the DMO would appear to have more control over State bond issues than other types of commercial borrowing, and it is not clear what kind of sanctions would apply to States that exceed their prescribed debt ceilings.

Primary areas of controversy in Nigeria surrounding federalist relations

Primary areas of controversy in federalist relations since the adaption of the 1999 Constitution include (a) the formula for the division of revenues from the Federation Account, (b) the division of tax authority, (c) the financing of the fuel subsidy, (d) the management of the fiscal reserve of the country (Excess Crude Account, Sovereign Wealth Fund), and (e) the division of some revenues between Federation Account and Federal Government Budget. There have also been controversies around a perceived uncertain division of responsibility and authority between different levels of Government in some areas.

As could be expected, the formulae for the division of Federation Account revenues in Nigeria have been a continual focus of debate in the country. The size of the Federal Government's share is one point of contention, with many States lobbying for a higher subnational distribution. The division between States is also a source of controversy, particularly the derivation principle that gives a substantially larger share of revenues to the oil-producing states in the Niger Delta. The oil-producing States have lobbied for an even greater share of oil revenues, citing international examples such as Alaska that receive a large share of their resource wealth, as well as pointing out significant environmental degradation and other negative externalities from oil production in the region.[8] Other States argue against the much larger share of revenues received by the oil-producing region on equity grounds. There have also been claims of a general bias toward Southern States in the distribution formula, although the figures given in Table 10 suggest that this only really concerns the four major oil producing states of the Niger Delta. Lagos State receives a relatively large distribution due to the derivation principle for the VAT, for which Lagos is by far the largest contributor. But even with these extra resources, the per capita distribution to Lagos State is not relatively high due to the State's large population. Given that population by State is only one factor in the allocation formula, States with smaller populations generally receive higher per capita allocations.

[8]Sam UguChijoke et al (2012) maintain that a strong derivation principle for oil revenues is essential for maintaining stability in the Niger Delta region.

Table 10: Monthly Shares of Distribution From The Federation Account By State

(Including Derivation, December 2011)

Rank	State	Gross Allocation (Billion Naira)	Region		Rank	State	2011 Estimated Population (million)	Per capita Allocation (Naira	Region
1	Rivers	23.99	South-ND		1	Bayelsa	2.0	9,077	South-ND
2	Akwa-Ibom	23.79	South-ND		2	Akwa-Ibom	4.7	5,026	South-ND
3	Delta	20.34	South-ND		3	Delta	4.9	4,110	South-ND
4	Bayelsa	18.30	South-ND		4	Rivers	6.3	3,793	South-ND
5	Lagos	11.01	South		5	FCT	2.4	2,389	North
6	Kano	7.55	North		6	Nasarawa	2.2	1,814	North
7	Ondo	7.36	South-ND		7	Ondo	4.1	1,789	South-ND
8	Kaduna	6.00	North		8	Taraba	2.7	1,699	North
9	FCT	5.73	North		9	Yobe	2.8	1,611	North
10	Katsina	5.71	North		10	Ebonyi	2.6	1,547	South
11	Imo	5.71	South-ND		11	Gombe	2.8	1,471	North
12	Borno	5.57	North		12	Kwara	2.8	1,469	North
13	Oyo	5.6	South		13	Cross-River	3.4	1,464	South-ND
14	Bauchi	5.50	North		14	Edo	3.8	1,407	South-ND
15	Niger	5.46	North		15	Ekiti	2.9	1,394	South
16	Edo	5.32	South-ND		16	Abia	3.3	1,334	South-ND
17	Jigawa	5.22	North		17	Adamawa	3.8	1,257	North
18	Benue	5.14	North		18	Plateau	3.8	1,227	North
19	Cross River	5.00	South-ND		19	Kebbi	3.9	1,213	North
20	Sokoto	4.94	North		20	Imo	4.7	1,210	South-ND
21	Anambra	4.82	South		21	Kogi	3.9	1,204	North
22	Kogi	4.75	North		22	Zamfara	3.9	1,177	North
23	Kebbi	4.74	North		23	Enugu	3.9	1,556	South
24	Adamawa	4.72	North		24	Niger	4.8	1,134	North
25	Ogun	4.67	South		25	Sokoto	4.4	1,121	North
26	Plateau	4.66	North		26	Borno	5.1	1,094	North
27	Zamfara	4.64	North		27	Osun	4.1	1,080	South
28	Taraba	4.61	North		28	Ogun	4.5	1,029	South
29	Yobe	4.58	North		29	Benue	5.1	1,015	North
30	Enugu	4.49	South		30	Jlgawa	5.2	1,013	North
31	Abia	4.45	South-ND		31	Lagos	11.0	1,003	South
32	Osun	4.44	Sough		32	Anambra	4.9	982	South
33	Gombe	4.19	North		33	Bauchi	5.7	973	North
34	Kwara	4.12	North		34	Katsina	6.9	826	North
35	Nasarawa	4.04	North		35	Kaduna	7.3	823	North
36	Ekiti	4.00	South		36	Oyo	6.8	822	South
37	Ebonyi	3.96	South		37	Kano	11.4	662	North

1. These Revenue allocation figures are those for December 2011, and they reflect the general monthly pattern.

2. "ND" refers to the Niger Delta states that benefit from the oil derivation principle.

Source: Office of the Accountant General of the Federation

The Nigerian Constitution specifies an "Exclusive Legislative List" of areas under the jurisdiction of the Federal Government. This includes the right to levy taxes on incomes, profits, customs, and capital gains. Although there is no corresponding Exclusive List for State Governments, Nigerian courts have sometimes interpreted one section (Part II, 7) of the Constitution to imply that States have tax authority in all areas not specified in the Exclusive Legislative List, i.e. that States and localities in Nigeria have all residual tax authority. In addition, a Taxes and Levies (Approved List for Collection) Act prescribes a more specific division of tax authority, under which taxes on incomes are ceded to the States, profits, capital gains, customs, excise and natural resource taxes are confirmed as federal, while others such as roads, property, lotteries, etc. are granted to the subnational tiers.

Some controversies in Nigeria have emerged in light of the interpretation of the Constitution that States have all residual tax authority. Firstly, some States maintain that the restrictions in the Approved List For Collection on allowable tax instruments are thereby unconstitutional. Second, as the VAT is a tax on consumption, and therefore not identified in the Exclusive Legislative List, some States maintain that it should not be a federal tax. Some states have been campaigning to have the VAT repealed on these grounds, and possibly replaced at the state level with a sales tax. In fact, the VAT was first introduced in Nigeria in 1993-1994 as a substitute for state sales tax that was simultaneously repealed. For this reason, it is widely perceived in Nigeria as a state-level tax. An initial federal share (5%) was justified as being a cost of collection, but this share was subsequently increased to 10% and then 15% to the displeasure of many States.

Another dispute surrounds the classification of revenues received by the Federal Government from the sales of assets and the profits/dividends of state-owned (federal) enterprises. One interpretation of the Constitution is that any such revenues should accrue instead to the Federation Account, and therefore be subject to distribution to Federal, State, and Local budgets by formula. The Supreme Court may soon give a ruling on this.

The financing of the fuel subsidy, which has absorbed an ever larger share of consolidated government resources in recent years, has been a major source of debate in Nigeria. An initial agreement in 2006 required financing the subsidy according to 50% by the Federal Government and 25% each from State and Local Government resources. But this proved difficult to enforce. Since 2007, the allocation for the fuel subsidy has been deducted directly from oil revenues before they reach the Federation Account for allocation to budgets. For this reason, a number of State Governments have supported the removal of the fuel subsidy in the interest of freeing up more resources for distribution.

The Excess Crude Account, as well as its designated successor, the Sovereign Wealth Fund, have also been controversial, with a some States contending that withholding revenues from distribution through the Federation Account is a violation of the Nigerian Constitution. The Constitution is somewhat ambiguous on this point, although a High Court ruling from 2002 would appear to support this contention. The controversy continues, and the Sovereign Wealth Fund has still yet to replace the ECA as the country's fiscal reserve almost two years after the requisite legislation for its establishment was passed by the National Assembly.

Nigerian-Style Federalism: Advantages and Challenges for Economic Development

As indicated above, Nigerian fiscal federalist relations have a few peculiarities relative to most other federations. These peculiarities can be associated with both potential advantages and disadvantages for economic development. This section argues that the basic foundation of fiscal federalism in Nigeria appears to be largely appropriate for realizing the objectives of effective governance and accelerated economic development. Nevertheless, realizing a national consensus for cooperation between different levels of Government in few key areas will be critical for unlocking the development potential of the Nigerian model.

A large body of literature in economics examines the advantages of centralization and decentralization in a federation for economic development, and still another related literature examines the question of why some decentralized federations have experienced more successful economic development than others. Weingast (2006) summarizes conditions found in many economically successful federations as (a) a hierarchy of government with a clearly delineated scope of authority, (b) subnational autonomy (subnational governments have primary authority over public goods and service provision for the local economy), (c) a common unified market in the country (no barriers to the mobility of goods and factors), (d) hard budget constraints (less successful or financially distressed subnational governments cannot expect bailouts), and (e) an institutionalized allocation of political authority. Under these conditions, subnational governments can operate under strong incentives to compete for the attraction of business and investment to their territories, thereby creating conditions conducive to growth and job creation.

Some studies have related a number of past successes and failures of decentralized federations to the presence or absence of the above conditions. The United States is held up as an example where the combination of decentralization and a particularly fluid common market can be associated with vibrant and rapid historical economic development. Although China is not a formal federation, a number of specialists highlight the high degree of autonomy of provincial governments in competition for the attraction of business and investment as a key ingredient to the country's economic success story (Montinola, Qian, and Weingast (1995)). Conversely, numerous bouts of instability in Brazil and Argentina in the 1980s and 1990s can be associated with largely irresponsible behavior of subnational administrations functioning with a high degree of autonomy under soft budget constraints. Given a wide-spread expectation that the Federal Government would bail provinces or states in the event of failure, subnational finance became excessively risky, leading into crisis (Rodden (2003), Webb (2003)). In the 1990s, Russian regions (oblasts) functioned under conditions of de facto high subnational autonomy, but were not granted much explicit autonomy by law. Consequently, it became difficult to hold subnational officials responsible for financial management of their official budgets, which were determined largely by federal expenditure mandates and centrally-determined tax rates. Russian regions then used their de facto autonomy to create "shadow" or informal budgets that favored collusion with a few large incumbent firms operating on their territories to the detriment of competition and development (Lavrov, Litwack, & Sutherland (2000)).

Advantages of the Nigerian system of fiscal federalist relations relative to common alternative arrangements.

Potential development advantages of Nigerian federalism include:

a) Subnational autonomy. While there exist a number of areas of dispute, Nigerian States operate with a high degree of legal and de facto autonomy. States with dynamic and progressive leadership have the authority to move ahead on their own.

b) Hard budget constraints. Although Nigerian States receive a large part of their budgets as transfers, the problem of soft budget constraints is largely absent. In other countries where the Federal Government controls the size of transfers to the States, it typically faces strong political pressures to favor less successful regions, including the provision of bailouts to regions that become financially distressed. In Nigeria, by contrast, the Federal Government does not have a natural instrument to offer direct assistance to weaker or poorly-performing states. In fact, as indicated above, the formula for transfers of oil revenue to the States is actually increasing in internally-generated revenue, i.e. States that succeed in raising more internal revenue actually receive somewhat larger transfers.

c) Allocation according to rules versus discretion. Responsibilities and revenues are divided among the Federal and State Governments according to rules that can only be changed by law through the National As-

sembly. In addition to implications for harder budget constraints emphasized above, this might be seen as an additional strong advantage for a country like Nigeria where policy decisions can be highly politicized, i.e. if state-by-state allocations were at the constant discretion of politicians, there is a danger that this discretion could be abused.

Thus, Nigeria already possesses the combination of subnational autonomy and hard budget constraints, which has been identified with successful decentralized federalism. Along with these advantages are several basic challenges that Nigeria will need to overcome:

a) Achieving coordination. There are a number of areas where a coordinated fiscal policy involving different levels of Government can be extremely important, including macroeconomic stability (management of oil wealth and the general government budget), the concentration of resources in priority areas, and meeting minimal national standards in public finance management and service delivery. Given the very strong financial independence of State Governments in Nigeria from the Federal Government, building a national consensus for coordination in these areas can be a difficult task, particularly considering the political and cultural complexities of Nigeria.

b) Creation and Defense of a Common Unified Market. As indicated above, a unified and strongly connected internal market is a key advantage for successful federations. Otherwise, opportunities for competition between States will be limited, and States may face little prospect for economic development outside of local (agricultural) markets and services. Connectivity in Nigeria has suffered from many administrative as well as infrastructure barriers. Markets in Nigeria remain predominantly local. The enforcement of a unified market also requires a national consensus.

c) The Low Share of Internally-Generated Resources in State Revenues. This is not a challenge of the nature of fiscal federalist relations per se, but the combination of federalist arrangements with the high oil dependency of Nigeria. The (mostly oil) revenues received by typical Nigerian states as guaranteed unconditional transfers from the Federation Account often amount to over 90% of state revenues. A low dependency of the State Government on internally-generated revenues, together with limited economic opportunities due to largely fragmented markets in the country, can weaken significantly the positive incentives for State officials from decentralization and hard budget constraints discussed above.

d) The Development of Local Government. Given the large size of many Nigerian States, effective decentralized service delivery can depend critically on Local Governments. The very strong position of States vis-a-vis local governments in Nigeria implies that the development of effective institutions of local government depend on state-level initiatives. The experience in Nigeria is of yet quite uneven in this regard. A number of federations have stronger provisions in the Constitution and other legislation for the autonomy of local government[9].

The importance of cooperation between the Federal and State Governments

The remaining part of this note will give primary attention to problems in coordination (a), and by implication to the issues raised in (b) and (c). The important issue (d) is out of the scope of this note.

At present, Nigeria possesses weaker institutions than in most federations to ensure cooperation between the Federal and State Governments. Transfers from the Federal Government to States are very small, and legislation that affects simultaneously different levels of Government can be difficult to enforce in practice. Nevertheless, there exists a basis for deeper cooperation in the common interest of reaping the advantages of Nigerian Federalism described above for acceler-

[9]Akindele et al (2002) argue that the strengthening of local government in Nigeria is essential to effective service delivery.

ated growth, job creation, and improved service delivery. Three critical areas in this regard are:

- to maintain strongly countercyclical fiscal policy to protect the country from oil price volatility
- to achieve a coordination in fiscal policies, particularly for the connectivity of markets and improvement of public services
- to realize national standards in public finance management, especially for accounting and disclosure to the population

Maintaining countercyclical fiscal policy

Given Nigeria's very strong dependence on inherently volatile oil prices, effective countercyclical macroeconomic management is essential to the successful development of the country. Many resource-rich countries, including Nigeria, have fallen victim to the so-called "resource curse." A high dependence on resource exports is often associated with lower growth and greater economic instability due to "boom-bust" government spending under highly volatile commodity prices (Auty, 2001). During boom times, economic overheating hinders development in labor-intensive sectors that compete on world markets, while investment becomes concentrated in speculative high-risk areas that collapse along with commodity prices. Declines in commodity prices precipitate macroeconomic instability. Among other costs to the country and population, the fear of inevitable instability is a major disincentive to private investment, particular in the non-oil economy.

World experience also suggests that the responsible macroeconomic management of resource wealth can transform the resource curse into an advantage for economic development. This is demonstrated by the example of the United States, and more recently by countries such as Indonesia, Malaysia, and Botswana. All of these countries took sufficient measures to insulate their economies from volatility in commodity prices and prevent excessive real appreciation of their currencies, while at the same time exploiting resource wealth to provide key public inputs to infrastructure, education, and other areas essential for building a competitive economy. This entails saving a substantial portion of the surplus in times of relatively high resource prices and spending this surplus to maintain government expenditures and stimulate the economy during times of relatively low resource prices.

For the case of Nigeria, this goal can be achieved only through a national consensus, as the management and allocation of the fiscal reserve of the country is under the joint authority of the Federal and State Governments. This adds more complexity to an already politically difficult task. Nevertheless, Nigeria already took a huge step toward improving the management of the country's oil wealth by establishing the Excess Crude Account in 2004. Accumulating a fiscal reserve during 2005-2008 mitigated the overheating of the economy from exceptionally high oil prices, while Excess Crude Account resources proved invaluable for maintaining strong growth in domestic demand and GDP during the global financial crisis of 2009.

Despite major progress in Nigeria during the past decade, the experience of more recent years indicates that institutions surrounding the macroeconomic management of Nigeria's oil wealth are in need of strengthening. Despite the recovery of oil prices, Nigeria proved unable to rein in the stimulus spending of 2009, and instead fell victim to a further fiscal expansion in 2010 that depleted its remaining Excess Crude Account reserves. While the Federal Government has made some progress in consolidation since 2011, an unprecedented increase in the cost of the fuel subsidy prevented what could have otherwise been a strong accumulation in fiscal reserves. The Government and National Assembly passed an important new law allowing for the creation of a Sovereign Wealth Fund to replace the Excess Crude Account. But this Fund has not yet been established and a number of Governors are still challenging its constitutionality.

The essential political goals of protecting Nigeria from oil price volatility and strengthening the confidence of investors should be shared by all levels of Government in Nigeria. On the basis of this common interest, the country will need to

find a way to establish durable institutions that can insure the needed countercyclical fiscal policy in the face of oil price risks. Otherwise, Nigeria's development will continue to fall victim to boom-bust cycles, and longer term investors outside the oil industry will likely place their money elsewhere.

The adoption of a Sovereign Wealth Fund with a stronger institution foundation than the current Excess Crude Account would appear to be a promising first step. However, given that the Sovereign Wealth Fund (SWF) will hold both foreign and domestic assets, with a large degree of potential managerial discretion in that regard, there is not yet a guarantee that the SWF will even perform its primary function of enforcing countercyclical fiscal policy needed to defeat the "oil curse." That will depend on the particular rules that will be implemented for the operation of the Fund.

Achieving coordination in fiscal policies, particularly for the connectivity of markets and improvement of public services

Nigeria's development depends critically on the creation of a unified national market and on improving social services to the population. Both of these objectives can be greatly facilitated by a coordinated approach from Federal and State Governments.

The connectivity of markets

As highlighted in the World Bank Development Report of 2009 (Reshaping Economic Geography, 2009), rapid economic development throughout the world almost always follows a common spatial pattern. Rapid growth emerges first in urban agglomerations where the close proximity of suppliers, consumers, and market services generate economies of scale and decrease costs of doing business. As these cities grow and become more congested, costs increase and businesses find it increasingly attractive to move to outside areas to service the market. As this process proceeds, the growth agglomeration itself spreads steadily to surrounding regions. In a decentralized federation, this process can be facilitated by competition among surrounding regions to attract the business and investment that could provide the catalyst for joining the larger growth agglomeration (Box 1).

Nigeria already has important urban growth agglomerations, including the very large non-oil growth center of Lagos. Despite the fact that Lagos has become quite congested, with a corresponding rapid increase in real estate and other costs, the Lagos agglomeration has not yet spread to other parts of Nigeria to the degree that would naturally be expected. Most Nigerian states still function largely in isolation and face an enormous challenge to transform their local economies into something larger than subsistence agriculture plus local services.

Box 1: The Moscow Agglomeration in the Russian Federation

The Russian Federation provides an interesting recent experience in the potential role of States for expanding growth agglomerations. Due to a seventy year legacy of central planning, Russia did not yet have effective market agglomerations at the outset of economic transition in 1991. The city of Moscow emerged as the first such agglomeration and, for almost a decade, attracted the vast majority of investment, new businesses, and the best and brightest migrants. At the same time, surrounding regions suffered severe economic decline and complained bitterly about the loss of their best resources and workers to Moscow. However, the second decade of transition became a different story altogether, as Moscow became increasingly congested and expensive, and investors began looking to surrounding regions for servicing the greater Moscow market. A number of these regions began to experience economic growth and revival at an even faster pace than Moscow. But the experience in surrounding regions has been highly uneven. Oblasts such as Kaluga that made the strongest efforts to attract investors grew very rapidly, while some regions that instead chose strategies that offered high levels of protection and favoritism to their incumbent local producers (Tver) developed much less successfully. Saint Petersburg has since become a second major growth agglomeration in Russia. See Regional Development and Growth Agglomerations… (2008).

The primary barrier to the expansion of the Lagos and other growth agglomerations in Nigeria is clearly the weak connectivity of markets. The poor condition of roads, along with (often) multiple check points that impose huge costs and delays on transportation, quickly discourage investors contemplating servicing the Lagos or other urban agglomerations from outside. Questions about less reliable power supply in outer areas are still another major cause for concern.

The key decision variable for investors'is the relative expected costs of a given location for servicing the larger market. By coordinating and concentrating efforts at the Federal and State level to remove the most important infrastructure and administrative bottlenecks to market connectivity, Nigeria can unlock major opportunities for growth and job creation in the country. The Federal Government and Nigerian States can cooperate in identifying the key infrastructure bottlenecks to market connectivity on a region-wide basis with the goal of concentrating Federal and State investments in a manner that will unlock the most market potential. For this purpose, Nigerian States can constructively unite in organizations for regional cooperation in larger geographic areas. Enforcing the absence of excessive check points and other institutional barriers to transportation is an important part of this agenda.

Service delivery

With its vast resource wealth, Nigeria has greater opportunities for providing effective social services to the population than do most African countries. Quality basic services in education and health are not only essential for the welfare of the population, but for the success of any growth, job creation, and modernization agenda. A large number of Nigerian citizens currently do not receive sufficient quality services in these and other areas, as witnessed by slow progress measured by many MDG indicators.

While many problems can be identified in this area, a stronger cooperation between the Federal and State Governments in promoting minimal national standards in service delivery, and encouraging States or localities that meet or exceed these standards, can potentially play an important role in improving service delivery in Nigeria. There exists extensive relevant experience in other countries that can be usefully examined.

National standards in public finance management, especially for accounting and disclosure to the population

Problems in governance have hindered the ability of Nigeria to translate its resource wealth into the infrastructure and public services needed for a take-off into sustainable and diversified growth. As in other countries, the ability of the public to hold Government officials accountable depends on the degree to which information on public finances is monitored and available for the scrutiny of civil society. In Nigeria, much too little of this information is currently available at every level of Government. In some cases, the problem can be related to the actual absence of information, i.e. some key information is likely not gathered or accounted properly. In other cases, the information may exist, but is not disclosed to the public in a regular and clear manner. At the level of the Federation, the latter category includes information on the implementation of the Revenue Framework, the balance and activities of the Excess Crude Account, and the external audit reports of the Auditor General.

In this regard, a number of Nigerian States, as well as the Federal Government, have adopted initiatives to harmonize regulations and make important information on public finance more readily available, particularly through the Internet.An increasing number of Nigerian States have passed modern Fiscal Responsibility, Procurement, Audit, and PFM laws, and an initiative is underway to implement a unified chart of accounts. States have also taken the initiative through the Governors' Forum to launch a peer review mechanism under which States assess and learn from each other for improving public finance management and other key institutions and indicators. There is potential for competition among States for realizing the MDGs and other key development challenges.

In spite of these efforts and initiatives, the experience so far has been very uneven, and much more progress is needed. In this regard, a greater coordination of Federal and State efforts around

joint priorities and consistent national standards could be very useful. This includes uniform standards of budget accounting that would allow for the critical examination of a single consolidated budget of the Nigerian Federation from the points of views of both macroeconomic stabilization and strategic sectoral/regional allocations.

The Way Forward

Given the importance of closer cooperation and coordination between the Federal and State Governments in these and some other areas for Nigeria's successful development, how can the country best move ahead on this agenda? As highlighted above, a number of past initiatives that prescribe greater coordination and cooperation have not yielded the desired results. There is not yet a bond of mutual trust between the Federal and State Governments, which is prerequisite for successful cooperation.

In this regard, any initiative at the federal level that does not recognize the high degree of autonomy exercised by Nigerian States will likely fail. Nigerian States have become weary of federal initiatives designed to compel them to behave in a certain manner. This is particularly the case for States with a different dominant political party to that in Abuja. Successful initiatives need to be based primarily on voluntary behavior by States, and on an approach that respects the States' basic authority to manage their own programs in their areas of jurisdiction. Given the fact that the realization of cooperation in the above critical areas is in the interest of States as well as the Federal Government, such an approach should be possible.

Macroeconomic management of oil revenues

As the Federal Government and States of Nigeria have a common strong interest in maintaining macroeconomic stability and increasing the confidence of investors, there should be common ground for reaching a consensus on some basic principles for the effective macroeconomic management of oil revenues. The building of this consensus will need to involve advocacy and dissemination of information in the country of the strong international evidence that the enforcement of countercyclical fiscal policy is a necessary condition for freeing Nigeria from the "oil curse" of boom-bust cycles, frequent instability, and slow growth. The high degree of macroeconomic stability in Nigeria in the past decade directly reflects important progress in this direction, but challenges remain.

The key task is to establish a mechanism that can effectively de-link Government expenditures from oil prices. In this context, the volatility in oil prices can be absorbed by changes in the size of the fiscal reserve, while the Government can maintain stability in the realization of its priorities in public investments and service delivery. This will help to avoid both "overheating" in inflation and excessive real currency appreciation in times of high oil prices, and unexpected cuts in expenditures in times of low oil prices. This is, in effect, what the Nigerian Government does when it plan a medium term fiscal framework at stable benchmark oil prices. It would be constructive to limit the yearly debates and conflicts surrounding budget preparation over the choice of an appropriate benchmark price through legislation that fixes the allocation rule for a longer period of time.

What levels of annual distribution of oil revenues to budgets should the Government plan for? This is a political decision that should provide sufficient revenues to finance priority projects and services, but not allow for a fiscal expansion that could be inflationary, cause overheating, or jeopardize the accumulation of a needed fiscal reserve. At the present time, Nigeria faces both the challenge of (high likely) declining oil revenues relative to GDP and the imperative of building a sufficient fiscal reserve to ensure stability. As illustrated in Chapter 2, planning a high rate of real growth in the distribution of oil revenues to budgets would place fiscal sustainability at risk, particularly if the fuel subsidy is maintained. This speaks for the expediency of choosing a conservative (low) benchmark price in the budget and medium term fiscal framework. While somewhat lower revenues may restrict public investments, the strong accumulation of a fiscal reserve should increase private investment through greater confidence of investors in macroeconomic stability. Once a sufficient reserve is accumulated to protect the country, the

strategy can constructively change somewhat to favor priority expenditures and limit the borrowing costs to Government.

The Federal Government and States can compensate for falling oil revenues relative to the size of the economy through the development of the domestic tax system and internally generated revenue. Given that oil revenues are due to become increasingly scarce relative to the size of the Nigerian economy, the task of building a strong domestic tax system at the Federal and subnational levels becomes increasingly critical. The Federal Government has recently launched a campaign to increase non-oil revenues on the basis of a recent diagnostic report, and a number of States have also taken serious initiatives in this area.

Achieving better coordination in fiscal policy

As highlighted above, the influence of the Federal Government in most federations concerns transfers from the Federal Budget to States. It is common practice for these transfers to be conditional on the achievement of certain minimal national standards or designated for the support of specific policies. While Nigeria has adopted a few programs involving conditional federal transfers to States, the use of this type of instrument is still relatively insignificant. Consequently, the Federal Government has little formal means for supporting or rewarding States that move ahead with key reforms in close alignment with the Transformation Agenda. For this reason, existing cooperation among the Federal Government and States in Nigeria often takes the form of informal political bargaining.

In light of the above, the expansion of federal programs involving co-financing or conditional grants for States around priority infrastructure and the implementation of national standards would appear to be a logical step toward solidifying trust and cooperation in some of the key areas highlighted above. This would support programs primarily managed by States, while also monitored by the Federal Government. In addition to significant world experience in the design of these instruments, Nigeria can study its own experience in the implementation of the Universal Basic Education Program (UBE) and the MDG Conditional Grants program. A recent evaluation of the UBE Program highlights some negative attitudes at the State level regarding perceived attempts at federal interference in the management of State education programs. In this regard, the MDG Conditional Grants Program, which has been assessed as largely successful, may provide a better initial blueprint for the design of future initiatives. Local ownership and management will be critical to success.

World experience in the use of conditional transfers and matching grants is quite extensive and informative. World experience suggests that the most effective such transfers use simple and transparent criteria and objectives, while the conditionalities are imposed on outcomes or the realization of standardsrather than on inputs or processes, i.e. the resources should be managed entirely by subnational governments under the condition that certain objectives are reached. In Indonesia, a matching grant scheme focused on achieving minimum standards in education was apparently critical in modernizing the country's eductation system.Canada has experienced success with a health care conditional transfer scheme to ensure universal access to basic care irrespective of geographic region. Brazil also has both education and health conditional transfer schemes that have generally performed well (Shah, 2007).Capital transfer schemes are also quite common in many countries, although the results have been somewhat mixed. The schemes used by the United Kingdom in housing and Australia in roads have received particular attention (Petchey and MacDonald (2007)).

If the Federal Government increases the scope for co-financing and conditional/matching grants for States, the design of the scheme should warrant careful attention so as not to politicize the allocation of transfers[10]. This could sacrifice what is currently an important advantage of Nigerian federalism. For political reasons, the amount of associated funding that is potentially

[10]The politicization of transfers has been a particular problem in India (Choudry and Perrin (2007)), reflecting a process where a larger share of transfers came to be determined by the Government on a discretionary basis. In South Africa, there is some concern that conditional transfers may have grown too fast without proper regulation since their introduction in 1998-1999 (Makube, 2011).

made available to various macro-regions in Nigeria may need to be stipulated by a fixed rule that is not subject to manipulation. The degree to which respective States are able to access these resources, however, should depend on their own initiatives and results in line with national priorities. The monitoring of the implementation of minimal national standards in service delivery can build on the current Peer Review Mechanism of the Governors' Forum and, for credibility, should also involve the strong participation of outside experts and organizations.

The Governors Forum can expand its role with regard to (a) pooling and gathering information State-by-State on public finance, economic activity, and key business climate / welfare indicators (b) scaling up the Peer Review and other programs for fostering greater constructive cooperation and competition among Nigerian States.

As is the pattern in other countries, economic growth in Nigeria should continue to be highly concentrated geographically around a handful of growth polls. Establishing a greater connectivity of markets should foster the rapid growth of urban growth polls in parts of Nigeria other than Lagos. While growth will likely remaining inherently unbalanced geographically for some time,Nigeria can ensure enhanced opportunities for its citizens through meeting basic standards in service delivery in education, health, and social assistance. Young Nigerians growing in areas experiencing slow growth, but who are well equipped to work productively, can potentially migrate toward the growth polls. At the same time, special attention can be devoted to unlocking the potential and comparative advantages in different regions of Nigeria.

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List of Acronyms

CIT	Companies Income Tax
DAWN	Development Agency for Western Nigeria
DMO	Debt Management Office
ECA	Excess Crude Account
FAAC	Federation Account
FCT	Federal Capital Territory
FGN	Federal Government of Nigeria
FIRS	Federal Inland Revenue Service
LGAs	Local Government Areas
MDA	Ministries, Departments and Agencies
MDGs	Millennium Development Goals
NASS	National Assembly
NCS	Nigerian Customs Service
NDDC	Niger Delta Development Commission
NHRC	National Human Rights Commission
NJC	National Judicial Council
RMAFC	Revenue Mobilization Allocation and Fiscal Commission
SOE	State-Owned Enterprises
SWF	Sovereign Wealth Fund
UBEC	Universal Basic Education Commission
VAT	Value Added Tax