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# **POLITICAL REGIME TYPE, LIBERALIZATION AND FISCAL DEFICITS IN DEVELOPING COUNTRIES: EVIDENCE FROM NIGERIA**

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## **Abstract:**

Chronic and persistent incidence of public deficits has been one of the debated issues in the past four decades. Many analysts have attempted to associate the poor fiscal outcome with military rule, thereby wrongly exonerating the democratic regime of not accumulating deficits. This study examines the relationship between government-type and fiscal deficits in Nigeria using time series data for the periods 1970-2010. The study applied econometric technique of ordinary least square method (OLS) and found that government-type does matter for fiscal operations in Nigeria. Specifically, the study found that democratic regimes in Nigeria do accumulate fiscal deficits contrary to earlier expectation. In addition, the findings show that there was strong inclination for fiscal deficits to decrease with financial liberalization, while liberalization of foreign trade leads to the increase in fiscal deficits. It is recommended that government should sustain the financial sector reforms in Nigeria, encourage productive spending on infrastructure for economic growth and development under a democratic atmosphere. Appropriate mechanisms should be put in place for efficiency in public financial management. The principle of value for money should be imbibed in execution of public project to ensure accountability and transparency in the democratic government.

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**Keywords:** Political regime, Liberalization, budget deficits, Nigeria

## **Introduction:**

Chronic and persistent incidence of public deficits has been one of the debated issues in the past four decades. The issue of deficit was initially considered a macroeconomic phenomenon which occurs when ever public expenditure exceeds public revenue. Existing

economic theory predicts that deficits will disappear during the prosperous years of business activities. However, in most Countries the deficits have persisted and even extend to several decades with its attendant increase in public debt burden (Bayar and Smeets, 2009). The servicing of this debt burden leads to more deficits and the process continues.

Other consequences of budget deficits include the deterioration of external reserves, fall in the rate of economic activities, financial imbalances in the public sector, among others. For instance, as output falls, tax revenue mobilized by the government will fall, and appropriate fiscal response may imply tax reduction to stimulate aggregate effective demand, as advocated by Keynesian economics. But this, however, will depend on whether the Ricardian equivalence hypothesis holds (Barro, 1989). Again, this depends on the soundness of the tax system and the ability of the government to roll out fiscal stimulus to counter such conditions as done in the developed countries.

In Nigeria, the fiscal performance over the past four decades or so has not been so impressive. Several years of deficits punctuated by few surpluses leave us with much to desire. Empirical facts have shown that fiscal deficit in Nigeria in 1970 had stood at 455.1 million naira. But this has grown over the years to 810020.70 million naira in 2009 (CBN, 2009). One possible reason for the deficits during the 1970s could be traced to the reconstruction efforts of the government after the civil war. Similarly, the fall in government revenue as a result of falling oil prices in the international market led to the deficits recorded in the early 1980s. Except in 1995 and 1996 when surpluses were recorded, the rest of the fiscal years all recorded deficits.

The debate as to what determine public deficits has been a long standing issue. While some debaters point to economic factors as possible determinants of fiscal deficits, others consider political and institutional factors as possible factors causing deficits. Contrary to the traditional belief of economic determinants of public deficits, the development of political economics in the 1980s has shaded more light by looking at the determinants of budget deficits from both economic and political perspectives. From the political angle, studies (Alesina and Tabellini, 1990; Edwards and Tabellini, 1991; Skilling, 2001; Woo 2003 etc) have found several political factor such as political instability; government fragmentation; political institutions, etc. as possible cause of fiscal deficits. On the institutional ground, factors like budgetary procedures and rules; bureaucratic efficiency; and democracies have been identified as causal factors of fiscal deficits (De Haan and Sturn 1994; Von Hagen and Harden, 1996; killing 2001). While on the social front, income inequality and ethnic divisions have been identified as possible determinants of fiscal deficits.

Despite these studies, the controversy over the role of the structure or government type in fiscal deficits accumulation remains unresolved. The objective of this paper therefore is to examine the determinants of fiscal deficits in Nigeria by focusing on the influence of the structure or type of government on the overall fiscal deficits. The rest of the paper is organized as follows section 2 provides a literature review of related theoretical and empirical studies. Section 3 presents Data sources and the methodology. Empirical Results is presented in section 4, while section 5 is the conclusion.

## **1. Literature review:**

The debates as to what determines the extents of fiscal deficits have been raging on for some decades. The traditional debate focuses on economic factors as determinants of fiscal deficits, while the modern debate considers both political as well as economic factors as determinants of fiscal deficits. This literature unifies both opinions in reviewing relevant literature on the determinants of fiscal deficits.

There are a large number of literatures on economic factors causing budget deficits. One of such study is the study by Woo (2003). In his empirical work, inflation, Real Gross Domestic Product, financial depth, and Population, have been found to exert a positive influence on fiscal deficits in both developed and developing countries.

There are also many studies relating inflation to fiscal deficits. The literature in this respect has failed to reach a consensus on the possible relationship between inflation and budget deficits. On the proponent side, studies such as Dwyer (1982); Choudhary and pari (1991); Darat (1985); Ahking and Miller (1985); Dogas (1992); Metin (1992); Cevdet et al, (1996); Darat (2000); Ignacio Lozano (2008); Oladipo and Akinbobola (2011) among others have found that budget deficits exerted a significant impact on inflation. Other studies however, have found that deficits do not lead to inflation ( Dwyer 1982; Karras 1994; Abizadeh and Yousefi 1998, Sahan, 2010; Marco and Andrew, 2010 among others).

Concerning the link between trade liberalization and budget deficit, most studies agree that there exists significant influence of trade openness on budget deficits. For example, studies such as Cameron 1978; Rodrik1998; Sanz and Velázquez, 2003;Combes and Saadi-Sedik, 2006, among others have found a positive association between trade openness and the size of the public sector, represented by fiscal deficits. One possible explanation from these studies is that government expenditures provide social insurance against external risk. Thus as trade openness increases external risk, citizens will demand more redistribution through additional public expenditures. However, other findings have challenged this result,

suggesting that either the size of governments has not changed to mitigate the effects of greater openness (Islam, 2004). Also, Molana *et al.* (2004) has that causality from trade openness to government size is not supported by data. On the other hand, Iversen and Cusack (2000) have shown the absence of any relationship between globalization and the level of employment and wages.

Furthermore a large number of literature also exist linking budget deficits to interest rates. Once again, the literature in this regard has failed to agree on the relationship between budget deficits and interest rate. For instance, Dwyer (1982); Hoelscher (1983); Kormendi (1983); Dewarld (1983); Darat (1990); Findly (1990) and others have provided no significant effects of government budget deficit on interest rates. In contrast, Feldsteen (1982); Tranzi (1985); Holscher (1986); Wochitel and Young (1987); Zaud (1988); Allen (1990); Knot and De Haan (1999); Vamvoukas (2000), among others, in their separate studies have found that large government budget deficits have a significant effect on interest rates. The divergences in results from these studies have been attributed to differences in choice of variables, methodology used and sample period considered.

Apart from economic factors, a large volume of literature also explains the link between budget deficits and political variables. Studies such as Woo (2003); Roubini and Sachs (1989 a, b); Grilli et al (1991); Alesina et al (1997) have provided evidence of weak government argument. For instance, Roubini and Sachs (1989 a, b), have found that the persistence and size of budget deficits is greatest where there have been multi-party coalition governments. However, this result has been challenged by Edin and Ohlsson (1991) in favour of minority governments.

Concerning the relationship between political instability and budget deficits, the literature is rather mixed in opinions. While studies such as Edwards and Tabellini (1991); Alesina and Tabellini (1990); Pesson and svenson (1989); Pasten and Cover, (2010), have found political instability, proxied by the frequency of government changes, a strong determinant of government deficits, a separate study by Grilli et al (1990) has found no evidence of political instability impact on budget deficits.

There are also various studies stressing the relationship between government fragmentation and fiscal deficits. For instance, Roubini and Sachs (1989); Edwin and Ohlsson (1994); Skilling (2001); Bradbury and Grain (2001); Kontopoulos and Perotti (1999); Volkerink and De Haan (2001); among others have found government fragmentation of various degrees as a major determinants of fiscal deficit. The degree of fragmentation in these studies may be defined in terms of Coalition government (Skilling 2001), size of the

legislature (Bradbury and Cain, 2001), and number of spending ministries (Volkerink and De Haan, 2001). However, Bayar and Smeets, (2009) has found that political fragmentation does not play a significant role in government deficits.

Meanwhile several other studies: Von Hagen, 1992; De Haan and Sturn 1994; Von Hagen and Harden, 1996; killing 2001, among others have indicated a strong link between the degree of budgetary centralization and fiscal deficits. The strong link between the degree of budgetary centralization can however be defined in terms of expenditure, deficits and debts. There are also very influential studies that relate partisan effect to budget deficits. Partisan models are based on ideological motivations which reflect the pattern of deficits, depending on the orientation of the government in office. For example, Alesina and Roubini (1997); Perotti and kontopoulos (2002); Vollcerink and De Haan (2001) and Mulas-Granados (2003), have found no significantly higher deficits for left-wing governments as compared to other governments. And within the opportunistic models, empirical studies (e.g. Mink and De Haan, 2005; Bayar and Smeets,2009) have shown that higher deficits are usually recorded in election year and shortly before, as a result of the government giving bonuses to the electorate and trying to gain popularity before the elections. In an empirical investigation, Mink and De Haan (2005) found that during election years, deficits tend to be higher, whereas in the year preceding the election they are not. Andrikopoulos et al (2004), on the contrary found that right-wing governments tend to be in favour of fiscal stabilization during election times.

Theoretically, there are many theories formulated to explain government performance. This literature reviews the most important ones. The first is the Regime type theory. This theory states that if government performance is measured in terms of economic growth, regime-type does not seem to have much of an impact. These scholars generally share doubt about modernization theory's claim that high growth is difficult under democracy, but however, disagree about the causal relationship between economic growth and democratization in poor countries (Przeworski, Akvarez and others, 2000; Frng 2003; Bueno de Mesquite et al 2001; Mainwaring and Perezlian 2003). Other group of scholars have also argued that if government performance is measured in term of social insurance or other public goods, democracy clearly out-perform authoritarian regime, because they reduce opportunity for rent seeking behavior (Lake and Baun, 2001; Boix 2008). This is especially true among poor democracies which face severe pressure to provide public goods (Brown, 1999). On the contrary, another school has argued that if government performance is

measured in terms of human capital development, authoritarian regimes are often the ones to make such investment (Glaeser et al, 2004).

The fiscal resources theory strive to provide a better causal explanation between government revenue and the degree of performance. The recent literature finds little correlation between regime type and government revenue. However, where this revenue is derived from immobile capital, politicians usually face weaker accountability mechanism against extracting rents (Boix, 2003). Such states, according to Bebkwi (1990) are referred to as “rentier states”, where only a few people are engaged in production while a large number share in the distribution of benefits.

There is also the theory of political coalition. This theory begins from first proposition that all governments, irrespective of regime type, require political coalition in order to govern. It states that authoritarian regimes must form coalitions as well as, choosing from among elites, civil society organizations and sometimes military services. These choices are an important ways in which authoritarian regimes vary among themselves (Roeder, 1994; Barros, 2003; Remmer, 1989; Boix, 2003). A second proposition is that all coalitions face a tradeoff between representation and efficiency and that coalition size determines the balance between these two opposite ends of a continuum. Large coalitions maybe more representative but this must accommodate greater preferences, especially if they are over-size. A small coalition on the other hand may face fewer collective action problems. This is an intuition developed by Olson’s theory of group size and public goods (Olson. 1965).

From the foregoing, though it could be argued theoretically that the relationship between regime type and fiscal deficits remains controversial. With the current global trend towards democracy and all her paraphernalia, namely; openness to trade, financial liberalization and free flow of foreign capital, an empirical test of the impact of democracy on fiscal deficits becomes a pertinent pursuit for a developing country like Nigeria. This paper is an attempt to fill this gap in the literature.

## **2. Methodology and data**

### **2.1 The empirical model**

Woo (2003) derives some important conclusions about variables which can explain cross-country differences in public sector deficits. He categorizes them into two groups: economic and structural determinants. Woo’s empirical evidence indicates that financial

depth, income inequality, assassinations, cabinet size and centralization of authority in budgetary decisions are robust and significant determinants of fiscal deficits among countries.

In studying the determinants of fiscal deficits in Nigeria, we will adopt Woo's model with some modifications to suit the time series technique employed in this study. The basic model for this study is specified as:

$$FISDEF = F (GDP, OPNESS, ILLYGDP, INFLA, DEMO)$$

Where:

FISDEF is the annual budget balance

GDP is annual gross domestic product

OPNESS is measure of trade openness

ILLYGDP is measure of financial depth

DEMO is measure of political regime type (a dummy variable which takes the value of 1 for democratic regime and 0 for military).

INFLA is annual inflation rate.

Assuming a linear functional form, the econometric specification of the model is expressed as:

$$FISDEF_T = \beta_0 + \beta_1 GDP_T + \beta_2 OPNESS_T + \beta_3 ILLYGDP_T + \beta_4 INFLA_T + \beta_5 DEMO + \varepsilon_T \dots\dots\dots (1)$$

Fiscal deficit is expected to be decreasing in the level of aggregate income, GDP. However, it is expected that macroeconomic instability using inflation as a proxy will increase fiscal deficits. With respect to financial depth, Woo (2003) found a negative relationship between fiscal deficits and financial depth. The relationship between trade openness and deficits is indeterminate. If the loss in revenue due to tariff reduction surpasses the gain, openness may lead to fiscal deficit, but if the reverse is the case then fiscal deficit will decrease with trade openness. Concerning the sign of the political regime type, democracy is expected to decrease fiscal deficits.

To avoid spurious regressions, we first conduct a stationarity test using the Augmented Dickey Fuller (ADF) test proposed by Dickey and Fuller (1979):

$$\Delta y_t = c + (\rho - 1)y_{t-1} + \sum_{i=1}^k \gamma_i y_{t-i} + \varepsilon_t \dots\dots\dots (2)$$

Another unit root test is the Phillips-Perron (PP) test proposed by Phillips and Perron (1988):

$$y_t = \alpha_0 + \alpha y_{t-1} + e_t \dots\dots\dots (3)$$

The difference between these two approaches lies in their treatment of any “nuisance” serial correlation. That is, the PP tends to be more robust to a wide range of serial correlations and time-dependent heteroscedasticities. In these tests, the null hypothesis of non-stationarity (presence of unit root) for ADF and PP are given by  $\rho = 0$  and  $\alpha = 1$  respectively. Rejection of the null implies stationarity of the series.

## 2.2 Data and sources

Data used for the estimation and analysis were obtained mainly from central Bank of Nigeria Statistical Bulletin, 2009 and Annual Reports and Statement of Account for various years. Time series data for the periods covering from 1970 to 2010 were used as the main method of data collection. Time series data for this study were collected on annual basis.

## 3. Estimated results

Table 1 in the appendix presents trends in the federal fiscal operation in Nigeria from 1970 to 2010. It is evidence from the table that Nigeria’s Federal government ran budget surplus in six out of 41 years analyzed. Four years of surplus were recorded in the early 1970s. The four years of surpluses were a result 1971, 1973, 1974 and 1979. These surpluses were as a result of oil boom of that period, which provided the government with sufficient revenue to offset the earlier deficit of the 1970. Apart from this period, temporary surpluses were also recorded between 1995 and 1996 fiscal year.

Empirical facts have shown that the overall fiscal balance in 1970 stood at 455.1 million naira, representing 8.7 percent share of the Gross Domestic Product. The deficit recorded in early 1970s could be defended on the grounds that they were incurred as government embarked upon the post war reconstruction. After a temporary break in 1979, deficits resumed again in 1980 and continued up until 1994, when it reached a height of 107735.3 million naira, representing 15.4 percent share of the Gross Domestic Product. Once again, temporary surpluses were recorded in 1995 and 1996 to the tune of 1000.0 million and 37049.4 million naira respectively. The remaining fiscal years after this all recorded deficits. As at 2008, the fiscal deficit in Nigeria had stood at 47,378.50 million naira representing 0.2 percent share of the gross domestic product and increased sharply to 810,020.70 million naira in 2009, constituting 3.28 percent of total output in Nigeria. And by 2010, the overall fiscal deficits in Nigeria had stood at 1235.1 billion naira, representing 4.2 percent of the gross domestic product (CBN, 2010).

From the analysis above, it is clearly seen that military regimes had fewer deficits than their civilian counterparts in Nigeria. The reason for this is not farfetched, as military

rule tends to be similar to single – party governments with greater cohesion and power to enforce fiscal adjustment, since it does not require parliamentary procedures and bottlenecks prevalent in democratic rule.

### 3.1 Unit roots tests

The unit roots test results in levels and first differences are presented in table 1 below. The results show that the null hypothesis is rejected at level for most variables. This implies that most of the series are integrated of order zero. Hence, the Ordinary Least Squares (OLS) method can be used. The other variables that are not stationary can be differenced once and used along with the stationary variables.

**Table 1: Unit Root Tests**

Variables	ADF Tests		PP test	
	Levels	First Diff.	Levels	First Diff.
INFLA	-4.0308	-5.8771	-3.3777	-6.2772
FISDEF	-2.6240	-5.9338	-3.9609	-10.8609
GDP	2.5635	-3.4997	-3.9524	-13.7783
ILLYGDP	-4.5606	-7.6268	-6.6773	-13.5861
OPNESS	-4.4644	-7.7034	-6.6038	-13.6041

*Notes:* The critical ADF and PP values at 5% are -3.5348 and -3.5312, respectively

### 3.2 Estimated coefficients

Table 2 shows the results from estimating equation (1). Despite the low adjusted  $R^2$ , the F-statistics reveals that the model is significant. Further, we implement diagnostics tests, namely, testing for serial correlation (Breusch-Godfrey LM), heteroscedasticity (ARCH), Ramsey RESET test and normality test (Jarque-Bera). These test results presented in table 3 show that our model is correctly specified.

**Table 2: Estimated Coefficients**

Variable	Coefficient	t-Statistic	P-values.
Constant	-5.676560	-3.251353	0.0027
D(LGDP)	0.208796	0.764132	0.4504
LOG(OPNESS)	4.200931	3.398550	0.0018
LOG(ILLYGDP)	-3.087189	-2.431244	0.0208
INFLA	-0.048761	-1.025968	0.3126
DEMO	1.927226	1.266589	0.2144

R-squared	0.323120
Adjusted R-squared	0.217358
S.E. of regression	4.153784
F-statistics	3.055153
Durbin-Watson stat	1.510462

**Table 3 : Diagnostics Tests**

Test	F-statistics	Probability
Normality Jarque-Bera	1.3414	0.5113
Serial Correlation Breusch-Godfrey LM Test	0.7650	0.4741
ARCH LM test	0.3323	0.7196
Heterscedasticity White test (Cross terms)	0.3088	0.9927
Specification Error: Ramsey RESET test	0.9914	0.3828

According to the results, fiscal deficits in Nigeria during the period under review (1970 to 2010) are significantly influenced by two factors: the degree of trade openness and the financial depth. This suggests that the positive effect, in terms of increase export earnings as a result of tariff reduction and exchange rate devaluation, is more than offset by the negative effect on the government revenue as a result of loss of tariff revenues. It also implies that the trade liberalization policy has not impacted positively on the revenues of the government. Caution should therefore be exercised in the adoption of this policy. On the other hand, financial intermediation and financial depth index has a negative sign and is also significant. This conforms to the a priori expectation of an inverse relationship between financial depth and fiscal deficits. Efficiency of the financial system can help in reduction of fiscal deficits.

The coefficients associated with other variables were, however, not statistically significant. Contrary to expectation the political regime variable DEMO has a positive sign

though not significant. The implication of this result is that democratic governments are associated with high fiscal deficits in Nigeria. Moreover, where there are no checks and financial accountability mechanisms, democratic governments are prone to wasteful spending in attempt to impress electorates and secure their votes for the next term in office.

Surprisingly, the level of fiscal deficit is increasing with aggregate income. Economic growth is expected to increase the revenue of the country. However, increase income is also associated with greater demand for infrastructure and other public services. These extra demands for public services increase public expenditure and therefore fiscal deficits.

#### **4. Conclusion**

This study examines the relationship between government-type and fiscal deficits using time series data for the period 1970-2010. The study applied econometric technique of ordinary least square method (OLS) and found that government-type does matter for fiscal operations in Nigeria. In addition, the findings show that there was strong inclination for fiscal deficits to decrease with financial liberalization, while liberalization of foreign trade leads to the increase in fiscal deficits. It is recommended that government should sustain the financial sector reforms in Nigeria, encourage productive spending on infrastructure for economic growth and development under a democratic atmosphere. Appropriate mechanisms should be put in place for efficiency in public financial management. The principle of value for money should be imbibed in execution of public project to ensure accountability and transparency in the democratic government.

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#### APPENDIX:

**Table 1: SUMMARY OF FEDERAL FISCAL OPERATIONS IN NIGERIA, 1970-2010.**

<b>Year</b>	<b>Retained Revenues (N millions)</b>	<b>Total expenditure (N millions)</b>	<b>Overall Fiscal Balance (N million)</b>	<b>Fiscal Deficit as % of GDP</b>
1970	448.8	903.9	-455.1	-8.7
1971	1168.8	997.2	171.6	2.6
1972	1404.8	1463.6	-58.8	-0.8
1973	1695.3	1529.2	166.1	1.5
1974	4537.0	2740.6	1796.4	9.8
1975	5514.7	5942.6	-427.9	-2.0
1976	6765.9	7856.7	-1090.8	-4.0
1977	8042.4	8823.8	-782.1	-2.0
1978	5178.1	8000.9	-2821.9	-7.9
1979	8868.4	7406.7	1461.7	3.4
1980	12993.3	14968.5	-1975.2	-3.9
1981	7511.6	11413.7	-3902.1	-7.7
1982	5819.1	11923.2	-6104.1	-11.8
1983	6272.0	8636.5	-33364.5	-5.9
1984	7257.2	9927.5	-2669.4	-4.2
1985	10001.4	13041.1	-3039.7	-4.2
1986	7969.4	16223.7	-8254.3	-113

1987	15129.0	22018.7	-5889.7	-5.4
1988	15588.6	27749.5	-12160.9	-8.4
1989	25893.6	41028.3	-15134.7	-6.7
1990	38252.1	60288.2	-22116.1	-8.5
1991	30829.2	66584.4	-35755.2	-11.0
1992	53264.9	92797.4	-39532.5	-7.2
1993	83493.6	191228.9	-107734.3	-15.4
1994	90622.6	160893.2	-70290.6	-7.9
1995	249768.1	248768.2	-70270.6	-7.9
1996	325744.1	2888094.6	37048.4	1.6
1997	351262.3	35632.3	-5000.0	-0.2
1998	353724.1	487113.4	-133389.3	-4.7
1999	662585.3	947690.0	-285104.7	-8.4
2000	597282.1	701059.4	-103377.3	-2.9
2001	797000	1018000	-2210489	-3.1
2002	716800	1018200	-301401.6	-3.8
2003	1023200	1226000	-202723.7	-2.0
2004	1253600	1426200	-172601.1	-1.5
2005	1660700	1822100	-161406.3	-1.1
2006	1836600	1938000	-101397.5	-0.6
2007	2337000	2430900	-117200	(0.0)
2008	3,293,440.00	3,240,820.00	-101397.5	-0.2
2009	2646904.70	3456925.40	-810020.70	-3.28
2010	7135.8	8370.9	-1235.1	-4.2

**SOURCE:** Central Bank of Nigeria Statistical Bulletin, 2009 and Central Bank Annual Report and Statement of Accounts, 2010.

**Note:** Retained Revenue and Expenditure figures between 1970 and 2009 are in million naira while figures for 2010 are in billion naira.