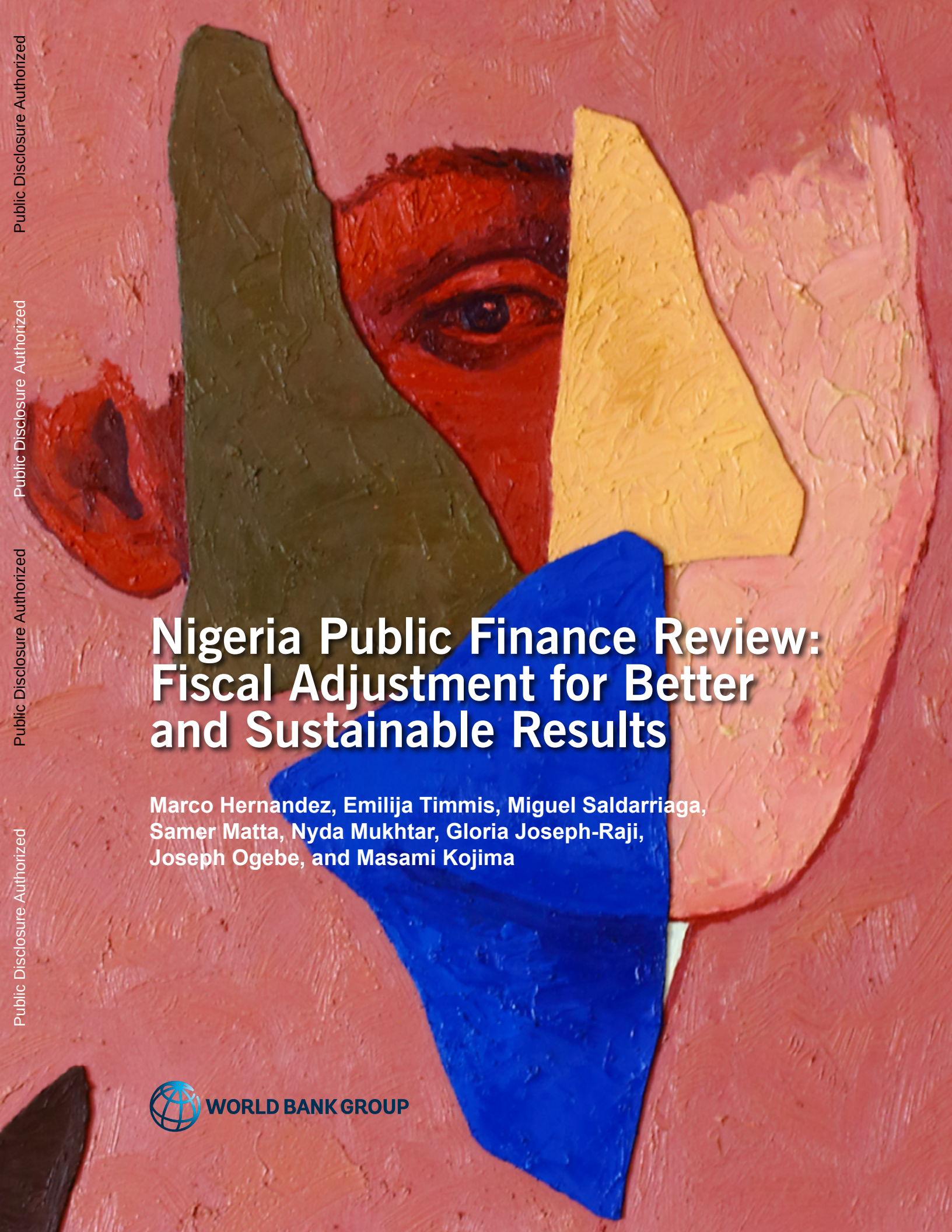

Nigeria Public Finance Review: Fiscal Adjustment for Better and Sustainable Results

Marco Hernandez, Emilija Timmis, Miguel Saldarriaga, Samer Matta, Nyda Mukhtar, Gloria Joseph-Raji, Joseph Ogebe, and Masami Kojima

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Nigeria Public Finance Review: Fiscal Adjustment for Better and Sustainable Results

Synthesis Report

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Cover credits: "**Who am I" by Jimmy Nwanne**. This painting questions the origin of existence and who the inner man within really is. What is the connection of the inner man with everything around it in its physical form? And as beings in physical form, how can our physical appearance and features tell who the person is. In other words, how does identity place one in a given environment?

Acknowledgments

The Nigeria Public Finance Review was prepared at the request of the Federal Ministry of Finance, Budget, and National Planning, and prepared in close collaboration with the Budget Office of the Federation, the National Bureau of Statistics, the Office of the Accountant General of the Federation, and the Debt Management Office. It is an analysis of the efficiency, equity, and impact of public revenue and expenditure management that is designed to inform Nigeria's process of fiscal consolidation, as the country strives to recover from the COVID-19 pandemic and meet the challenges of a dynamic global economic environment.

The Nigeria Public Finance Review is part of a programmatic effort of fiscal analytics that the World Bank is conducting with the Federal Government of Nigeria. Ongoing analyses is shared as presentations and technical notes in a continuous dialogue. The emphasis is on establishing a baseline understanding of key fiscal management challenges, and on highlighting reform options to support the Federal Government's and state governments' agenda to strengthen revenue and expenditure policies and programs to tackle Nigeria's key development challenges.

This Public Finance Review synthesis report was prepared by a World Bank team led by Marco Hernandez (Lead Economist), Emilija Timmis (Senior Economist), Miguel Angel Saldarriaga (Economist), Samer Matta (Senior Economist), Nyda Mukhtar (Economist), Gloria Joseph-Raji (Senior Economist), Joseph Ogebe (Research Analyst), and Masami Kojima (Lead Energy Specialist).

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Abbreviations and Acronyms

CBN	Central Bank of Nigeria
CIT	Corporate Income Tax
COVID-19	Corona Virus Disease 2019
ECA	Excess Crude Account
FAAC	Federation Accounts Allocation Committee
FX	Foreign Exchange
GDP	Gross Domestic Product
IGR	Internally Generated Revenue
JV	Joint Venture
MCP	Multi-Currency Practices
NBS	National Bureau of Statistics
NNPC	Nigerian National Petroleum Corporation
NNPC Ltd	Nigerian National Petroleum Company Limited
OAGF	Office of the Accountant General of the Federation
PIA	Petroleum Industry Act
PIT	Personal Income Tax
SSA	Sub-Saharan Africa
VAT	Value Added Tax
WDI	World Development Indicators

Executive Summary

Nigeria is at a critical historical juncture…

Nigeria has vast potential, but despite this, four major factors have adversely affected its macroeconomic foundations and, in turn, social and economic development. First, an over-reliance on oil exports, coupled with oil production challenges, has reduced fiscal revenues, and increased macroeconomic volatility. Second, a deteriorating security situation has discouraged both public and private investment. Third, restrictive trade policies, weaknesses in exchange rate management, and costly subsidies that mainly benefit the wealthy have hindered the country's macroeconomic performance. Finally, global shocks, including previously the 2015 oil price crash and more recently the COVID-19 pandemic, have exacerbated preexisting weaknesses in Nigeria's fiscal framework and growth model. These four factors have reversed important development gains. Notably, the inflation-adjusted income of the average Nigerian today is roughly the same as it was in the 1980s. Meanwhile, rapid population growth that has not been matched by economic growth caused the number of poor Nigerians to rise from about 68 million in 2015 to an estimated 80 million in 2019.

Nigeria's economic outlook is subject to a significant degree of uncertainty stemming from both domestic and external causes. Absent more investment, the oil sector will continue its secular decline, while the trajectory of the COVID-19 pandemic and the economic fallout from the Ukraine war are impossible to predict. What is clear, however, is that the fate of current and future Nigerians depends on the decisions being taken by policy makers today. In this context, the Federal Government faces a pivotal choice: reform the macroeconomic and fiscal framework to support faster, more inclusive, and more sustainable economic growth; or bind the country to a business-as-usual approach that would only intensify a cycle of slow growth and chronic underinvestment.

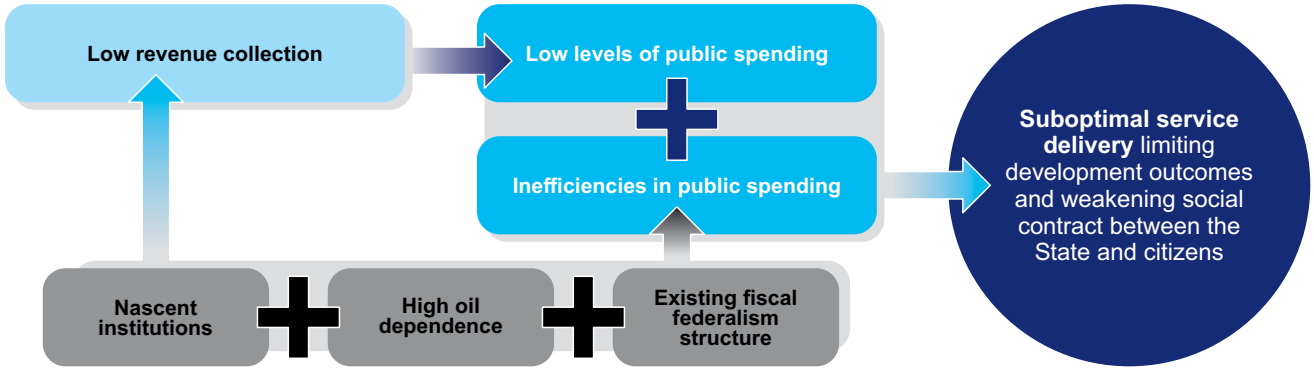
…with a choice to make.

A child born in Nigeria today will be 36 percent as productive when she grows up as she could be if she had access to effective education and health services.[1] She would be expected to live for only 55 years, compared with an average of 70–75 years in other parts of the world. This child, and her peers, will shape Nigeria's experience in the 21st century, but her future will also depend on the path that the country chooses now. What will it take for her to be able to realize her dreams in Nigeria, rather than abroad, and become a more productive member of society? This Public Finance Review aims to inform the public debate on Nigeria's future by providing a thorough analysis of the fiscal reforms necessary to establish a robust growth model that provides broad-based economic opportunity.

Promotion of economic growth and welfare in Nigeria requires higher public spending than the current very low levels. To achieve this in a sustainable manner, fiscal space needs to be created through: (i) mobilizing revenues effectively and equitably to allow the needed public spending increase across development needs; (ii) allocating public spending more efficiently to make the available resources stretch further and reach those most in need; and (iii) strengthening fiscal management institutions to sustain the measures that allow for higher levels of effective spending. The analytical framework guiding this Public Finance Review is summarized in FIGURE ES1.

1 World Bank (2020). Human Capital Index Brief on Nigeria. Washington, D.C.: The World Bank.

FIGURE ES1. Nigeria's fiscal challenges leading to suboptimal outcomes for its citizens.



Nigeria needs to spend more...

Nigeria has one of the lowest public expenditures levels in the world, and most of these expenditures are "rigid". Between 2015 and 2021, total public spending in Nigeria averaged 12 percent of gross domestic product (GDP), less than half the world average of 30 percent. In addition, most public spending consists of interest payments on government debt and wages for public sector workers, which makes spending difficult to reallocate to other priorities. At the general government level, debt-service payments and public sector salaries and pensions together absorb 60 percent of total spending, leaving little room for investments in human capital or physical infrastructure. Moreover, public investment is essentially treated as a residual item—receiving whatever resources are left over after other priorities have been met—which discourages the initiation and disrupts the implementation of projects that must be funded for multiple years. Whether it is a school or a road, the Federal Government or State Governments can invest only when they have the cash to do so.

Public spending on human and physical capital is too low to equip Nigerians for productive lives. Just 17 percent of public spending goes to education and health, which prevents Nigeria from developing the human capital necessary to attract large-scale private investment outside the oil sector. Public spending is also fragmented across three tiers of government (federal, state, and local), which have overlapping and sometimes inconsistent expenditure mandates, and no effective coordination or reporting mechanism. Given the fiscal importance and unrealized potential of Nigeria's state and local governments, this Public Finance Revenue includes an analysis of revenues and expenditures at the subnational level.

…and spend more effectively.

For years, a large share of Nigeria's on- and off-budget resources have financed inefficient and regressively distributed subsidies for petrol, electricity, and foreign exchange. The Federal Government sets administrative prices for petrol and electricity, while the Central Bank of Nigeria (CBN) sets the price of foreign exchange and, when market prices differ, public spending makes up the difference. Not all these subsidies are accounted for in the budget, which makes them difficult to track and scrutinize. However, available data suggest that they benefit primarily wealthy households, while distorting incentives and discouraging investment.

- The **petrol subsidy** is intended to shield households and the private sector from higher petrol prices and the Federal Government spends a vast sum on petrol subsidies. In practice, however, Nigeria's poor purchase only 3 percent of the total volume of subsidized petrol, while the non-poor buy the rest, with the benefits of the subsidy accruing overwhelmingly to wealthy consumers and smugglers. The cost of the subsidy rose from 4 percent of net

oil and gas revenues that the Federation Account received in 2020 to a staggering 52 percent in 2021[2]—more than the amount spent on education, health, and social protection combined.

- The **electricity subsidy** for years posed a massive fiscal burden, equivalent to one-third of value-added tax (VAT) collections between 2019 and 2021, though 40 percent of the population lacks access to the power grid. However, major reforms in 2021 and 2022 brought average electricity tariffs close to cost-recovery levels, cutting the subsidy significantly. Moreover, the tariff alignment was achieved while protecting poor households. Keeping average tariffs in line with costs while ensuring that tariff adjustments are progressive and protect the poor would yield important gains in fiscal equity and efficiency. Nevertheless, the experience thus far with the electricity subsidy reforms shows that politically sensitive subsidies can be removed effectively and equitably and, drawing lessons from this experience, can inform efforts to reduce or eliminate the country's other major subsidies.

- The **exchange rate subsidy** is unique and difficult to quantify, as it stems from Nigeria's multiple-exchange-rate system. For example, the Federal Government uses an overvalued official exchange rate, which yields benefits when the Federal Government buys US dollars (e.g., to service its external debt), but imposes costs when it sells US dollars (e.g., the revenues it receives from oil exports). Because the Federal Government sells more US dollars than it buys, the net cost of using multiple exchange rates is considerable, reaching 0.9 percent of GDP annually between 2016 and 2019. In addition, special exchange rates for certain groups (e.g., households with children studying abroad) have proliferated, benefiting those with access to the special rates at the expense of everyone else. In mid-2020, the CBN aimed to curb the cost of the subsidy by narrowing the differences between exchange rates. While the CBN has made considerable progress in this reform effort, the unification of exchange rates remains incomplete, and the persistence of multiple rates—together with persistent overvaluation of the naira—continues to impose fiscal costs and discourage private investment.

As public finances have become increasingly strained, spending has also become more procyclical, with the result that inadequate savings during good times has required the Federal Government to borrow more during difficult times. Between 2000 and 2008, Nigeria was able to save some of its excess revenue when oil prices were high and used those savings to sustain public spending when oil prices were low. However, since 2009, the country has failed to replenish its savings, and, when oil prices collapsed in 2015, and again in 2020, looming fiscal crises compelled the Federal Government to increase borrowing, causing the debt-to-GDP ratio to double in just seven years. While Nigeria's public debt remains sustainable, interest payments consume an extremely large share of revenues, compounding challenges of already low service delivery expenditures.

At the current rate of expenditure allocation, it would take 300 years to close the country's current infrastructure gap. Closing Nigeria's infrastructure gap would cost at least 4 percent of GDP growth per year.[3] Spending would also need to be more efficient. Notably, budget credibility remains low (though there have been recent improvements) mainly due to optimistic revenue forecasts that hinder fiscal and debt management. A 2019 International Monetary Fund (IMF) analysis found that Nigeria's public investment management system was 33 percent less efficient than those of its peers. Moreover, the analysis of the education sector in this Public Finance Review shows that, if Nigeria were to raise the efficiency of education spending to the average of lower middle-income countries, it could increase schooling by one full year without the need for any additional spending.

2 Calculated using the data from two different sources: (i) NNPC reports for the estimates of petrol subsidy; and (ii) Office of the Accountant-General of the Federation (OAGF) reports from net oil and gas revenues (excluding the 13 percent derivation).

3 Nigeria Integrated Infrastructure Master Plan.

Nigeria is also highly spatially unequal, with living standards differing sharply between the north and south, and between rural and urban areas. In 2018/19, the poverty rate for Nigeria's north as a whole was 57.9 percent compared with 20.3 percent in the south. Similarly, about 84 percent of Nigerians living in poverty in 2018/19 were located in rural areas. The existing fiscal federalism structure, especially the revenue distribution mechanism, is not aligned to help close this gap between the various geographical regions. The fiscal formula only partly aligns with states' populations and their respective development challenges; a large share of the Federation's revenues is simply split equally across the states, while states that generate their own revenues more effectively are also rewarded more. This limits Nigeria's ability to implement pro-poor programs in the states that most need them and prolongs the challenges of the country in improving its social development outcomes as a whole.

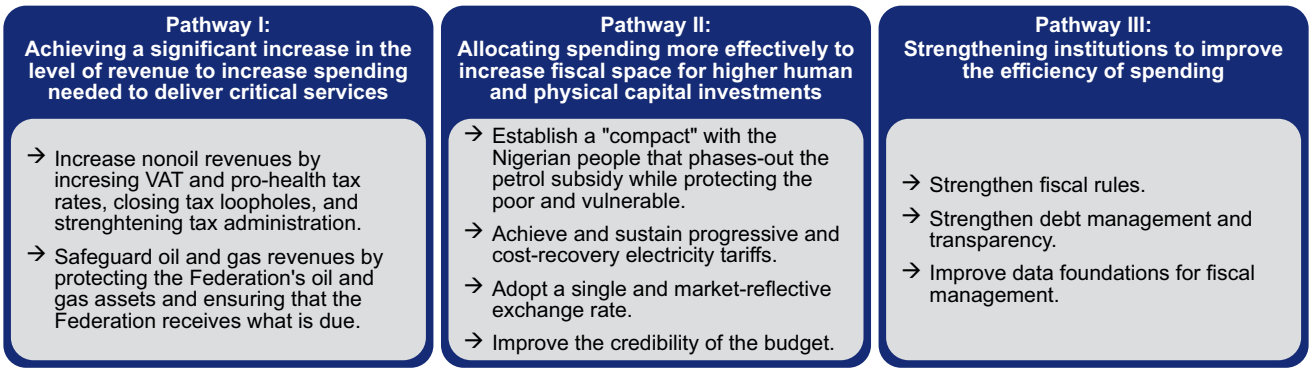
Thus, mobilizing revenues is a key priority…

Spending more requires more resources and therefore the most critical aspect of meeting Nigeria's vast expenditure needs lies in raising more revenues. Currently, Nigeria's public revenues are among the lowest in the world and the scope for improvement is vast. Due to large deductions from oil revenues, coupled with very weak non-oil revenue mobilization, Nigeria consistently ranks among the world's five poorest-performing countries in terms of revenue mobilization. Between 2015 and 2021, for example, total revenue averaged just 7 percent of GDP—far below the global average of 24 percent. Low tax rates, sizeable tax incentives, and weaknesses in the collection of both oil and non-oil revenue undermine Nigeria's revenue performance. In the non-oil sector, Nigeria's "tax gap"—i.e., the difference between how much revenue the Federation collects and how much it would collect if the tax code were fully applied—is large at an estimated 14–15 percent of GDP. In the oil and gas sector, underinvestment including underfunding of the Federation's share of production costs for joint ventures (JVs), security threats leading to force majeures, and other factors have caused the oil output to decline, while the sector's complex and opaque administrative structure has dramatically reduced the Federation's revenues from oil and gas exports. In 2021, for the first time in Nigeria's history, international oil prices increased but the Federation's net oil revenue declined on account of low production combined with the high petrol subsidy cost.

…for achieving and sustaining better results.

Addressing Nigeria's fiscal challenges will require a multi-pronged reform program focused on: (i) achieving a significant increase in the level of fiscal

FIGURE ES2. Fiscal pathways for better and sustained results in Nigeria.



revenues to increase the public spending needed to deliver critical public services; (ii) allocating spending more efficiently to make room for human and physical capital investments; and (iii) strengthening fiscal management institutions (FIGURE ES2). A holistic agenda of this nature that is supported by a broad societal consensus is vital for enhancing the Federal Government's presence and the level of trust between citizens and the state.

Nigeria Public Finance Review: A Synthesis

I. Nigeria is at a critical historical juncture

Nigeria's development progress has stagnated. Between 2001 and 2014, Nigeria was a rising star in West Africa, with an average growth rate of 7 percent per year, and it ranked among the top 15 fastest-growing economies in the world. However, this trend ended abruptly in 2015, as oil prices fell, the security situation deteriorated, macroeconomic reforms were reversed, and economic policies became increasingly unpredictable. In 2019 and 2020, Nigeria suffered slumping oil prices combined with the adverse effects of the COVID-19 pandemic (FIGURE 1). As a result, the GDP growth rate averaged just 1.1 percent between 2015 and 2021. As economic growth slowed, rapid population growth[4] reversed gains in per capita income (FIGURE 2), while the number of Nigerians living in poverty steadily increased.

After decades of uneven and non-inclusive growth, Nigeria remains a poor country marked by stark spatial disparities in social and economic outcomes. Nigeria is one of the least developed countries in the world (FIGURE 3). Prior to the COVID-19 pandemic, about four in ten Nigerians lived in poverty. Between 2010 and 2020, the number of Nigerians living below the poverty line rose from 68 million to about 80 million—the world's second-largest poor population after India (FIGURE 4). Stark differences in human development indicators are evident between the north and the south, and between globally connected urban centers and isolated rural areas. Households with large numbers of dependents, limited access to infrastructure, and less-educated household heads are more likely to be poor. Of those Nigerians living below the national poverty line in 2018–19, 84 percent lived in rural areas, and 76 percent lived in the North-Central, North-East, or North-West regions.

At the end of 2021, Nigeria's real per capita income had fallen to its level in the 1980s. Even at the average per capita GDP growth rate of 1.1 percent observed in 2021 (which was partly a result of base effects following the 2020 recession), it would take roughly a decade for Nigeria to return to the level of GDP per capita seen in 2014, just before the oil shock. Nigeria is one of the world's least-diversified oil producers and, while the growth rate and its fiscal and external positions have historically improved during periods of high oil prices, this will not be the case in 2021 and 2022. The decoupling of macroeconomic and fiscal trends from the cycle of global oil prices will make it harder for Nigeria to benefit from the tailwinds generated by commodity booms.

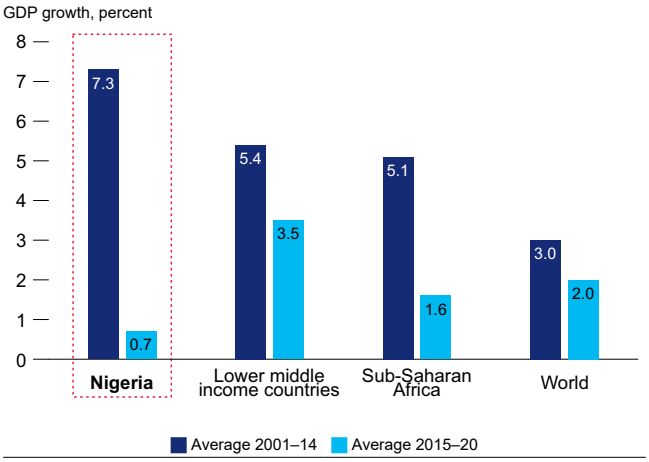
A deteriorating macroeconomic framework is at the root of low growth, heightened economic volatility, and scarce job creation

Macroeconomic stability and policy predictability have steadily deteriorated over the past decade. Nigeria's GDP growth rate is one of the most volatile among lower middle-income countries. Macroeconomic stability[5] has worsened significantly since 2014 (FIGURE 5) and, by 2021, it had reached an all-time low (FIGURE 6). Several factors have undermined macroeconomic stability.

- **An over-reliance on oil exports results in a high degree of external volatility.** Over the past four decades, the oil and gas sector has consistently represented more than 90 percent of Nigeria's total exports, resulting in a high degree of external volatility. In each cycle, faltering oil exports weaken

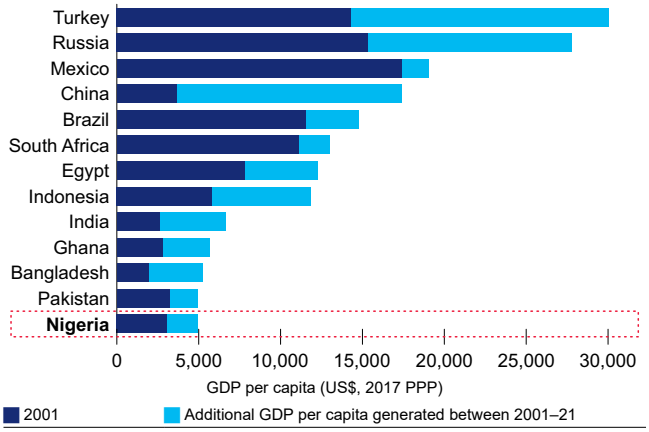
4 Nigeria's annual population growth rate averaged 2.6 percent over the period, one of the highest rates in the region.
5 Measured by a standardized composite index of inflation, current account, and overall fiscal balance, with 2000 as the base year.

FIGURE 1. GDP growth plummeted after the collapse of global oil prices in 2014–15…



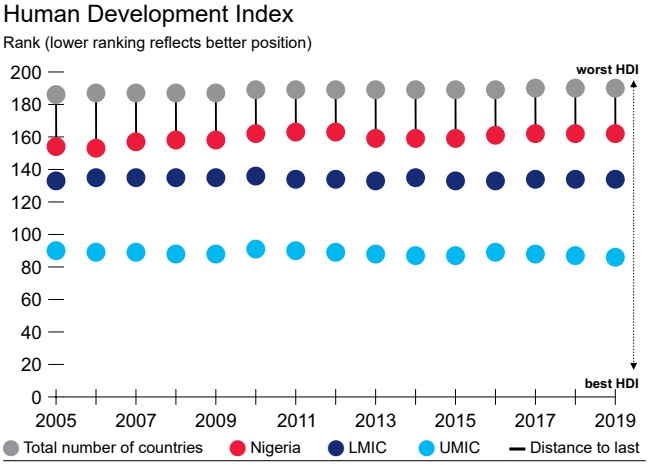
Source: World Development Indicators (WDI).

FIGURE 2. …and Nigeria's GDP per capita remains the lowest among peers.



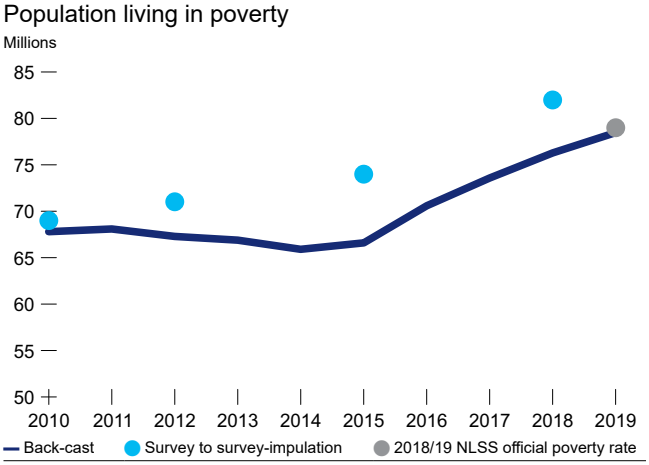
Source: WDI.

FIGURE 3. Nigeria's development progress has stagnated in recent years…



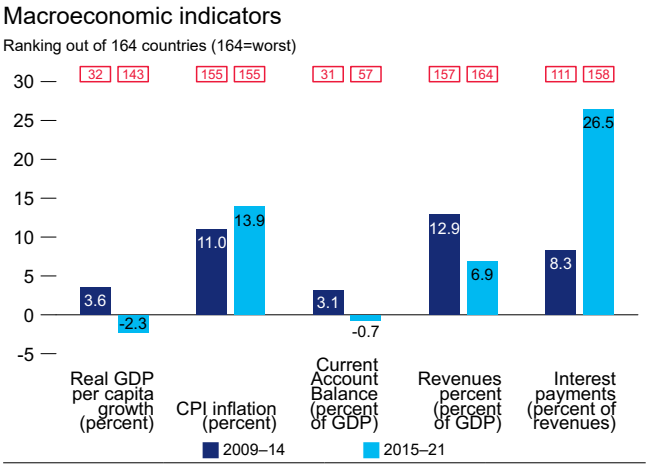
Source: United Nations Development Program (UNDP).

FIGURE 4. …and the number of poor people has risen rapidly as a result.



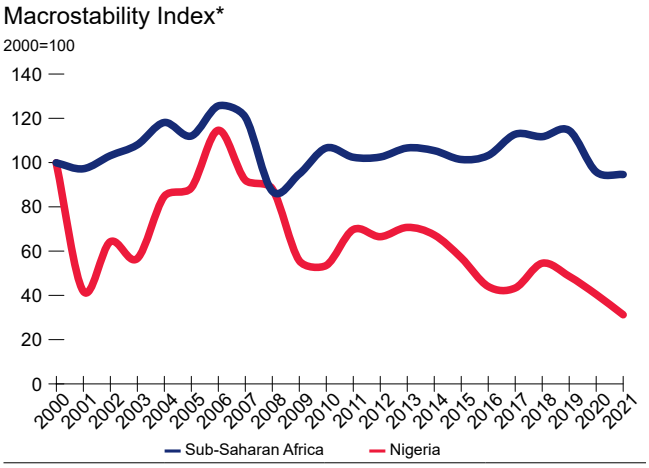
Source: National Bureau of Statistics (NBS) and World Bank Poverty Assessment.
Note: Estimates exclude Borno. Poverty rates are based on the national poverty line, with real consumption deflated temporally and spatially.

FIGURE 5. Most macro-fiscal indicators have significantly worsened…



Source: International Monetary Fund (IMF) and NBS.

FIGURE 6. …and Nigeria's macroeconomic stability reached a low in 2021.



Source: World Bank staff calculations based on World Economic Outlook database.
Note: Measured by a standardized composite index of inflation, the current account, and the overall fiscal balance, with 2000 as the base year.

confidence in the economy, resulting in diminished or even negative net capital inflows, which intensify pressure on the local currency (the naira), further discouraging investment and slowing growth. The collapse of the oil price in 2015 and again in 2020, coupled with production problems in the oil sector, affected the current account balance, which turned from a surplus of 3.7 percent of GDP in 2009–14 to a deficit of 0.7 percent in 2015–20.

- **Limited fiscal space.** Nigeria's limited fiscal space reflects its low total revenues and heavy dependence on crude oil exports. Prior to the COVID-19 pandemic, a full 50 percent of general government revenue came from the oil sector and, similar to the external balances, the budgets of both federal and subnational governments are highly exposed to commodity price volatility. Following the 2015 oil shock, Nigeria's already very low general government revenue fell to an average of just 7.0 percent of GDP between 2016 and 2020, among the lowest levels in the world. Net oil and gas revenues are also stagnating due to high levels of deductions from gross oil revenues. In 2020 and 2021, Nigeria's fiscal position became increasingly precarious as the general government deficit reached an average of 5.6 percent of GDP, breaching the 4 percent statutory ceiling established in the 2007 Fiscal Responsibility Act.[6]

- **Inability to run a counter-cyclical fiscal policy.** The Federation's dependence on volatile oil revenues and depleted fiscal buffers have shifted its fiscal policy stance from countercyclical between 2008 and 2014 to slightly procyclical between 2015 and 2021. Procyclicality in fiscal policies has amplified economic fluctuations, further discouraging new investment, exacerbating unemployment, and weakening debt sustainability.

- **High borrowing costs and an ad-hoc borrowing strategy.** Nigeria's debt-to-GDP ratio surged from 13.7 percent in 2014 to 29.3 percent in 2021, as the Federal Government struggled to maintain basic expenditure in the face of falling commodity prices and revenues. While the public debt thus far remains assessed as sustainable, the debt service-to-revenue ratio has risen to critical levels in recent years (FIGURE 5). The Federal Government's borrowing strategy is also ad hoc, with budget deficit financing targets being split equally between domestic and external borrowing, without consideration for costs, practicalities, and sustainability. Furthermore, systemic under-estimatation of the fiscal deficit constrains the adequate issuance of public debt, which in turn induces having to resort to borrowing from the CBN. The high volume of CBN borrowing is not only costly but also distorts the debt portfolio and borrowing strategies, as this debt is not considered part of the official public debt stock.

- **Inconsistent monetary policies.** Nigeria's monetary policies are not helping to reduce inflation. Since 2018, the CBN has increasingly financed the Federal Government, heightening inflationary pressures. Moreover, the CBN's policy goals are conflicting, as the authorities aim to stabilize the de facto exchange rate, promote economic growth and job creation, and contain inflation simultaneously. Partly due to weak fiscal management, since 2015 the CBN has increasingly focused on directly promoting growth and industrial development. Meanwhile, high inflation rates have worsened poverty and depressed economic activity. Between 2020 and 2021, for instance, the inflation shock is estimated to have pushed an estimated 8 million Nigerians into poverty[7].

- **Unpredictable exchange rate policies.** Exchange rate policy aims to maintain an artificially stable exchange rate through continued foreign exchange (FX) restrictions and administrative measures. The CBN supplies FX to four FX windows at different rates, while maintaining a complete restriction on FX for a group of 42 products and limiting its supply

6 In line with the 2007 Fiscal Responsibility Act, which established a 3 percent of GDP for the Federal Government fiscal deficit, 34 of Nigeria's 36 states have limited their fiscal deficits, with a collective ceiling around 1 percent of the GDP.

7 World Bank, 2022. Nigeria Development Update: The Continuing Urgency of Business Unusual. Washington DC: The World Bank.

for most other imports. In the drive to create jobs and foster economic diversification through import substitution, the CBN has imposed foreign-currency restrictions aimed at boosting the supply of credit to priority sectors, while also directly supporting industrial and agricultural development through subsidized financing. These policies have hurt investor confidence: foreign direct investment inflows have fallen significantly, and domestic producers have curtailed production due to limited access to imported raw materials.[8]

- **Restrictive trade policies.** Unpredictably enforced import prohibitions, cumbersome customs procedures, and a dearth of publicly available compliance information increase trade costs and erode Nigeria's non-oil export competitiveness. While the Federal Government has significantly reduced tariffs in recent decades, the tariff regime remains restrictive. In 2016, Nigeria's weighted average tariff for most-favored-nation trade partners was twice the Sub-Saharan Africa (SSA) average, 5.5 times higher than in Indonesia, and 9 times higher than in Mexico.

Oil-price shocks and mounting fiscal pressures have repeatedly spurred reform efforts but sustaining these achievements has proven difficult. Periods of macroeconomic crisis, such as at the start of the COVID-19 pandemic, have led to diversification and fiscal consolidation measures both at the federal and state government levels.[9] However, reforms that impose costs on vested interests (e.g., reducing subsidies) have met significant resistance. Moreover, once the initial crisis subsides, reform efforts tend to lose momentum (FIGURE 7). This pattern was observed during the period of structural adjustment in the 1980s, after the accumulation of debt in the 1990s, and during the period of low oil prices and declining production volumes between 2015 and 2020.

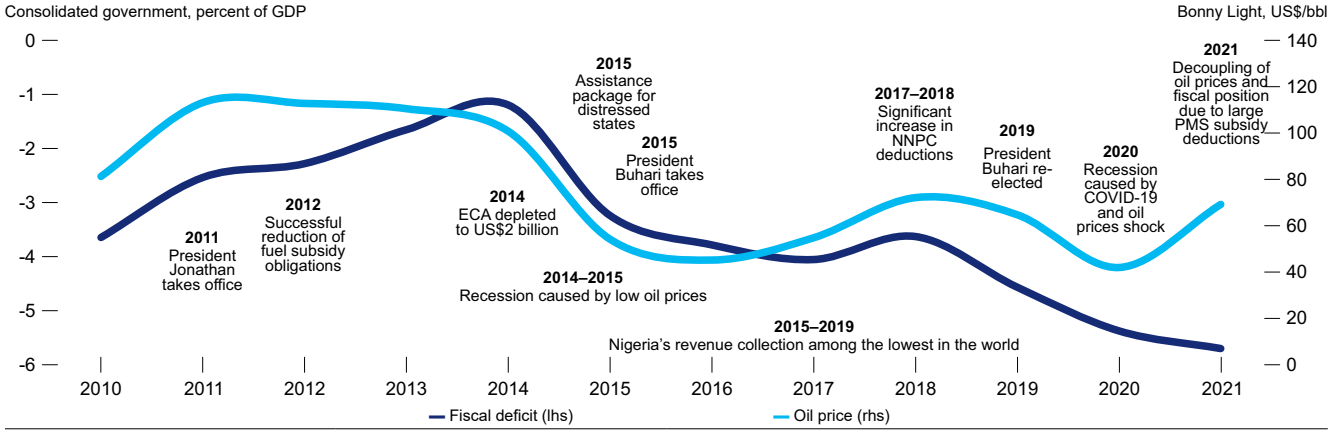
While Nigeria faces serious structural challenges, fiscal reforms that lay the foundation for robust and inclusive growth could rapidly improve the welfare of Nigerian citizens and accelerate convergence with other middle-income economies. Under a scenario in which macroeconomic and structural reforms enable Nigeria to "rise to its potential," per capita GDP growth could outpace population growth by at least 2.0 percentage points over the next decade, rising from 41 percent of Indonesia's GDP per capita in 2021 to roughly 50 percent by 2030 (FIGURE 8). This would require high efficiency and sustainability of fiscal reform efforts. In contrast, under a "business-as-usual" scenario in which risks to fiscal and debt sustainability are left unaddressed, Nigeria's per capita GDP growth would remain positive, but the country would lag its middle-income peers, and by 2030 Nigeria's per capita GDP would be barely 30 percent of Indonesia's and stagnating. Finally, under a scenario in which "things fall apart", as the Federal Government fails to implement new reforms while experiencing reform slippages or reversals, per capita GDP could fall sharply, much as it did in the early 1980s.

To lay foundations for robust and inclusive growth, Nigeria needs to proceed on a multi-pronged fiscal strategy. Leaning on all available oil- and non-oil revenue sources, Nigeria needs to significantly enhance domestic revenues to sufficiently increase public spending to supply essential public services, to spend its resources more efficiently, and to strengthen its fiscal institutions to sustain hard-won gains. The following sections highlight why action is urgently needed on these fronts and identifies policy options to address fiscal risks, restore private-sector confidence, and promote robust and inclusive growth (FIGURE 9).

The following sections are organized as follows. Section II analyzes Nigeria's revenue profile, examines trends, and highlights the key structural obstacles hindering revenue mobilization. Section III focuses

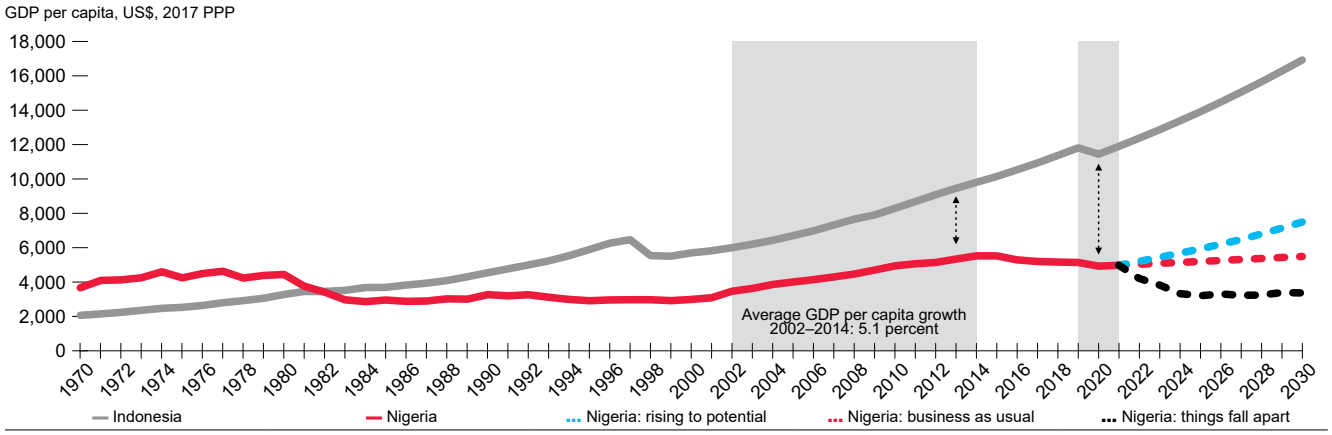
8 World Bank (forthcoming). Nigeria Country Economic Memorandum. Washington DC: The World Bank.
9 World Bank, 2021.

FIGURE 7. Fiscal deficits track oil prices and consolidation measures have not been sustained.



Source: OAGF, NBS and CBN.

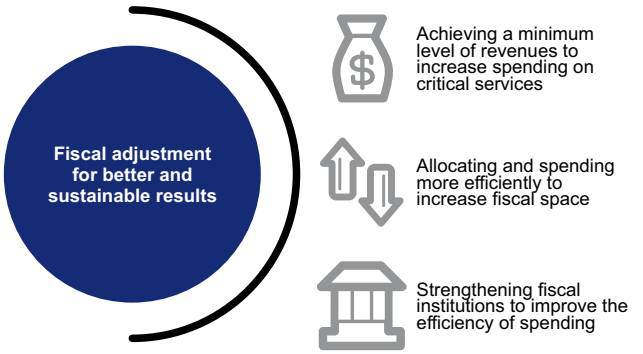
FIGURE 8. Stronger fiscal management is needed for Nigeria to rise to its potential.



Source: NBS and World Bank.

on the level and distribution of public expenditures. Section IV assesses the efficiency of public spending and quantifies the large fiscal costs imposed by subsidies. Section V takes a closer look at the fiscal position of state governments, in the context of the fiscal federal arrangements. Section VI concludes by providing fiscal policy options over the short and medium term.

FIGURE 9. The Federation faces a critical fiscal choice.



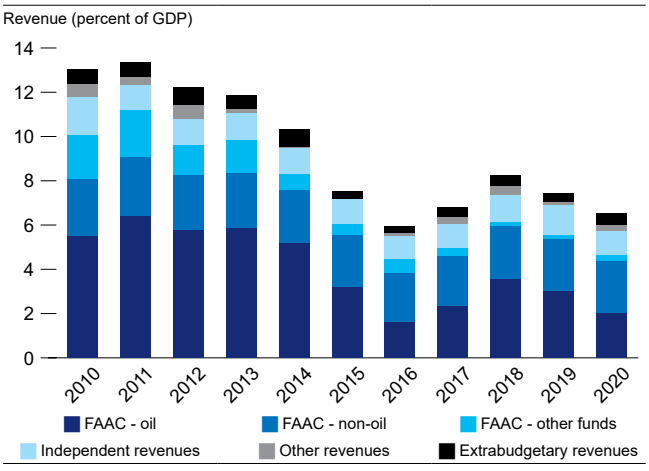
Source: World Bank staff.

II. Achieving enhanced and diversified revenue generation is of utmost importance to finance Nigeria's vast development agenda

Nigeria's revenues are among the lowest globally. Nigeria's revenues are not only low but have also followed a worrying declining trend over the past decade (FIGURE 10). Even during the commodity-price boom in 2012, Nigeria's revenue-to-GDP ratio was only 12 percent, compared with an average of 21.5 percent in SSA. Due to over-reliance on oil, the fall in international prices in 2014–15, and the subsequent economic deceleration of the non-oil economy, revenues plummeted to 5.9 percent of GDP in 2016. Since then, Nigeria has failed to shore up its revenues and the country consistently ranked among the worst five globally in terms of revenue collection between 2015 and 2020 (FIGURE 11). Nigeria's low level of revenues threatens fiscal sustainability and undermines the Federal Government's and state governments' ability to finance necessary expenditures in critical sectors, such as health, education, and security. This highlights the urgency to marshal resources for post-COVID recovery to promote fiscal sustainability and provide sufficient resources in support of inclusive and sustainable development.

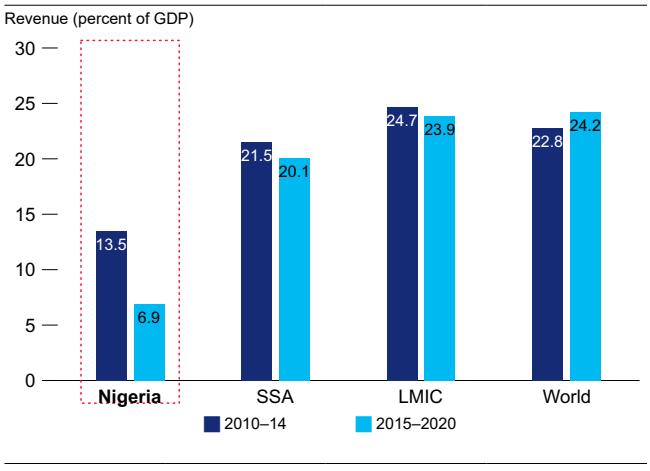
Oil revenues have historically accounted for the largest share of Nigeria's public revenues, but they have been declining over time. Between 2010 and 2014, the oil and gas sector generated about 47 percent of general government revenues, but this share declined significantly thereafter to an average of 36.6 percent in 2015–20. Revenues from other sources, such as non-oil taxation, had stagnated at about 4 percent of GDP due to costly tax incentives, low tax rates, weak tax administration, and burdensome compliance requirements for taxpayers. Other independent sources of non-oil revenue, such as state governments' independent revenues, government-owned enterprises' surpluses, and local government-collected fees and charges, amount to 1.2 percent of GDP. Diversifying away from oil revenues has been Nigeria's core challenge.

FIGURE 10. Nigeria's fiscal revenues have declined steadily over the past decade…



Source: OAGF and NBS.

FIGURE 11. … and are now among the lowest in the world.



Source: IMF and WDI.

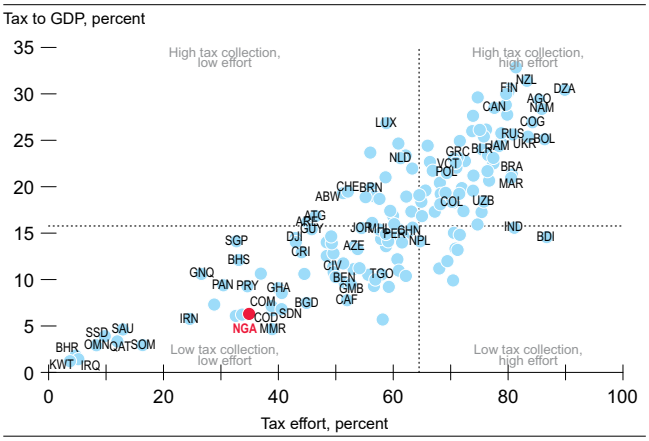
Despite volatilities associated with overdependence on oil, Nigeria has been unable to build broad-based non-oil revenue sources sufficiently. This is partly due to the weak institutional capacity of revenue-collection agencies both on the policy and administration fronts, and partly due to low tax morale, given that public spending is fraught with inefficiencies, the citizens do not see the value of their taxes in good quality services.

Low rates and poor utilization of tax bases, combined with inefficiencies in administration, undermine tax revenues

Nigeria suffers from a very large and broad-based tax gap. During 2017–19, Nigeria's median tax-to-GDP ratio was only 4.5 percent, the 167th lowest level out of 175 countries. Nigeria's tax gap is estimated at 14–15 percent of GDP, and it spans all elements of the tax system. Over the past decade, VAT revenues hovered at between 0.8 and 1 percent of GDP, far below the SSA average of 8 percent, corporate taxes remained below 1 percent of GDP, and customs and excise duties varied from 0.4 to 0.6 percent of GDP. The internally generated revenues (IGR) of state governments have been limited to less than 1 percent of GDP, through recent efforts have been made to shore up subnational resources. Nigeria's weak tax effort—defined as the revenue collected relative to the potential revenue that could be collected—reflects the Federal Government's failure to develop a modern, simple, and efficient tax policy (FIGURE 12).

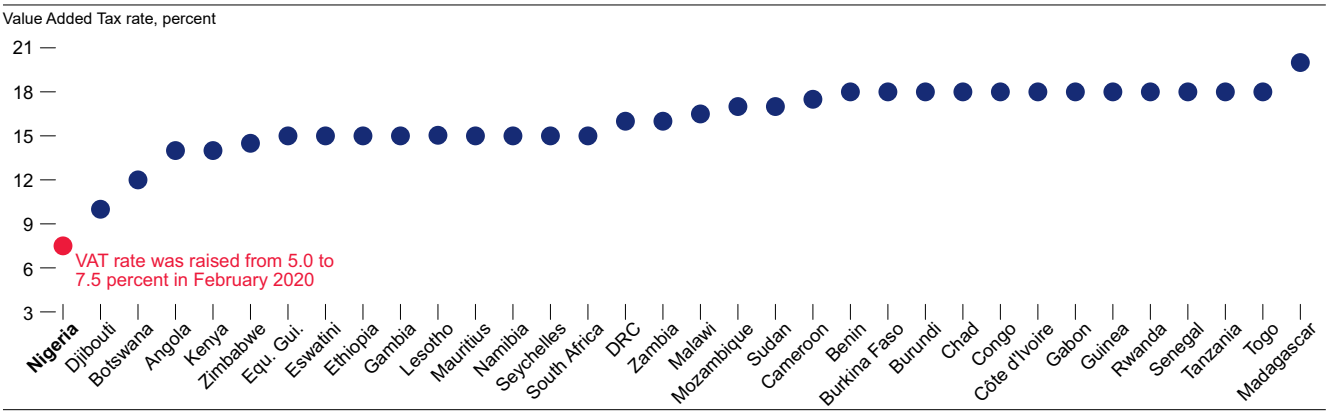
Low tax rates are a major obstacle to accelerating non-oil revenue mobilization. The standard VAT rate was increased from 5 to 7.5 percent in 2020, but it remains by far the lowest in SSA (FIGURE 13). Excise rates are also extremely low: for example, the 20 percent excise rate on tobacco and alcohol products is less than half the median for peer countries and far below the level recommended by the Economic Community of West African States. Moreover, Nigeria does not impose dedicated taxes on environmentally damaging goods (e.g., plastic bags and bottles) and, in defiance of international best practice, petrol is exempt from VAT.

FIGURE 12. Nigeria's low levels of tax revenues reflect weak tax effort…



Source: International Monetary Fund.

FIGURE 13. …combined with very low tax rates.



Source: Deloitte, 2020.

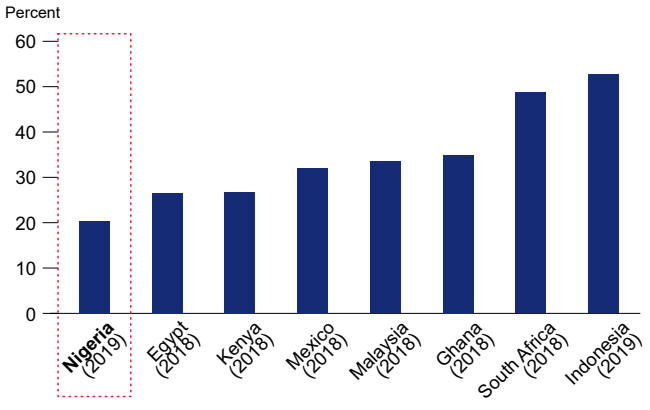
Narrow tax bases and weak tax administration also hinder revenue mobilization. In addition to the low VAT rate, the VAT C-efficiency ratio (i.e., the ratio of actual revenues to theoretical revenues from a perfectly enforced tax levied on all consumption) has been trending downward over the past decade and trails all peer countries for which recent data are available (FIGURE 14). Low VAT efficiency reflects a weak administrative performance. While personal income tax (PIT) rates range from 7 to 24 percent[10]—in line with international comparators—tax evasion is a major problem, especially among certain classes of taxpayers. For example, many high-net-worth individuals have conspicuous consumption patterns but report little or no income subject to PIT. Incomes from firms and property are under-reported, especially revenue from unincorporated business. Moreover, Nigeria's large informal sector includes numerous small-scale firms and sole proprietorships that pay no PIT or corporate income tax (CIT).

There are fundamental weaknesses in the legal design of the "backbone" taxes, including CIT, VAT, and PIT. The Companies Income Tax Act, 1961, and the Personal Income Tax Act, 2011, need regulatory amendments to fix loopholes and reduce potential tax evasion. The 2019 Finance Act introduced an exemption for small firms and a lower tax rate for medium-sized firms. To prevent taxpayers from breaking up a business activity among related persons, anti-fragmentation rules should be added to the legislation. Meanwhile, the VAT Act, 1993, does not include many basic rules that are central to a properly functioning VAT system, including those governing time of supply, value of supply, and place of supply, as well as rules for mixed supplies and adjustment events requiring the issuance of credit and debit notes. The basic international tax rules both for CIT and PIT are deficient. For instance, Nigeria uses the concept of a "fixed base" for taxing non-residents on business income, which is not fully aligned with the similar internationally accepted concept of a "permanent establishment", as it is narrower and has not kept pace with global trends.

Tax morale is low in Nigeria, and the social stigma associated with tax evasion is weak. In a 2018 Nigerian Economic Summit Group Survey of 10,000 households, fewer than 20 percent of respondents reported paying income tax in the past year, and just 7–8 percent reported having paid property taxes.[11] A 2021 Afro Barometer survey found that support for

FIGURE 14. Nigeria's VAT collection efficiency is low compared with peers…

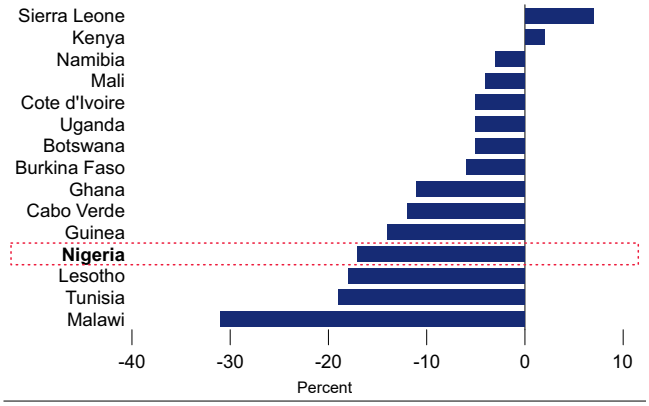
C-efficiency rate: Nigeria vs peers



Source: OAGF and Deloitte, 2020.

FIGURE 15. …and tax morale has declined over the past decade.

Changes in support for governments to collect taxes (2011–20)



Source: Afro Barometer, 2021.

10 Top marginal rate is lower than those in other Sub-Saharan African countries. https://www.cgdev.org/sites/default/files/PP191_Gupta_Determinants_of_Tax_in_SSA.pdf
11 Nigeria Economic Summit Group, 2018.

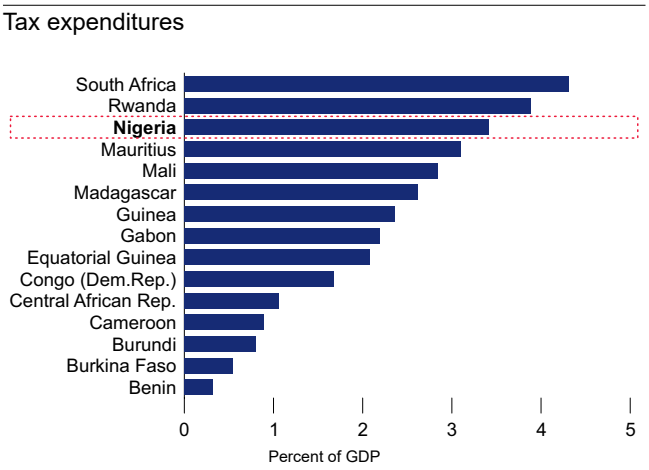
the Federation's right to collect taxes had declined by 17 percentage points between 2011 and 2020, one of the sharpest declines among the 15 SSA countries surveyed (FIGURE 15). Three systemic causes contribute to Nigeria's low tax morale. First, the public's knowledge of the tax system is limited, and little information is readily available. Second, tax administration is often inefficient and opaque. Third, low trust in government discourages voluntary compliance.

Low tax morale affects the registration, filing, and payment rates of all major taxes. Non-compliance is among the key challenges facing the Nigerian tax system. Among the 1 million taxpayers registered for CIT, fewer than 6 percent are estimated to be actively filing taxes.[12] Moreover, just 2 percent of the 761,000 taxpayers registered for PIT are active filers. Estimates of VAT payment compliance range from 15 to 40 percent.

Sizeable tax incentives mean that Nigeria is forgoing revenues that could finance basic service delivery

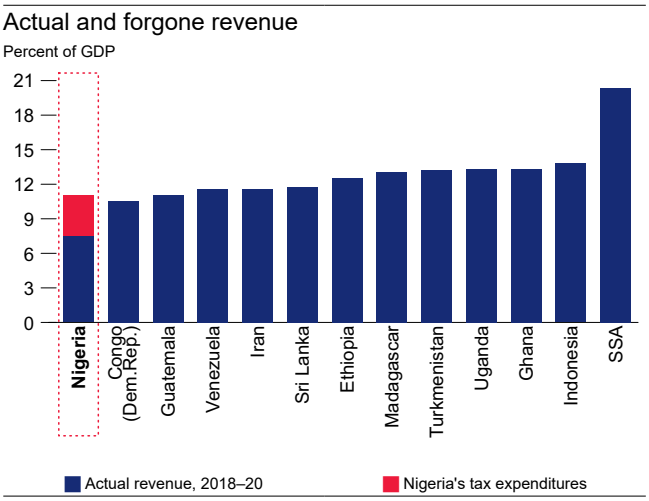
Tax expenditures impose a large cost in terms of forgone revenues. Although forgone revenues are difficult to estimate and compare across countries,[13] Nigeria's tax expenditures cost the Federal Government at least ₦5.8 trillion, or 3.7 percent of GDP (FIGURE 16), one of the largest shares among SSA countries for which comparable estimates are available (FIGURE 17). VAT accounts for the bulk of forgone revenue, as a significant part of the tax base is exempt from the base rate and compliance is low. In 2020, if all commodities in the VAT system had been taxed, Nigeria could have generated about ₦6 trillion from the existing tax structure. However, it only collected ₦1.8 trillion, with a significant part of the revenue loss related to exemptions. The CIT base is being narrowed due to the use of exemptions, which cost the Federation ₦457 billion (0.3 percent of GDP) in 2020 alone, compounding Nigeria's low CIT collection efficiency.[14] The cost of

FIGURE 16. Nigeria's tax expenditures are among the costliest in SSA…



Source: NBS and Global Tax Expenditures Database (GTED) and Budget Office of the Federation.

FIGURE 17. …and eliminating tax expenditures would bolster Nigeria's fiscal position.



Source: OAGF, BOF and WDI.

12 International Survey of Revenue Administration. International Monetary Fund, 2018.

13 The definition of benchmark taxation differs across countries, which implies that a tax measure may be considered part of the national benchmark in one country, while outside of the benchmark (i.e., a tax expenditure) in another country. Furthermore, measurement and data availability, and reliability issues persist in most countries, as capacity to assess and monitor tax expenditures is emerging. Interpretation of the level and composition of revenue forgone across countries and within countries over time should be undertaken cautiously.

14 Medium-Term Expenditure Framework 2022–2024.

customs exemptions reached an estimated ₦780 billion in 2020, equaling more than 80 percent of the collected customs revenue, which totaled ₦932 billion.

Deficiencies in the legislative framework and overlapping institutional mandates weaken the management of tax expenditures. According to international best practice, tax expenditures should be authorized solely through tax laws, approved by the Minister of Finance after appropriate consultations, and administered by federal and state tax authorities. Moreover, the regular application of cost-benefit assessments and the use of sunset clauses should be integrated into fiscal rules and medium-term fiscal projections. However, Nigeria's tax expenditures are not governed by a coherent set of laws, and several institutions have the power to grant tax incentives, including the Technical Services Department of the Federal Ministry of Finance, Budget, and National Planning, the Nigeria Investment Promotion Commission, and the Nigeria Export Promotion Zone Authority, all of which enjoy significant discretion over the design and application of these policies. It is not clear to what extent tax incentives are aligned with each other or whether they support specific policy objectives, such as attracting foreign direct investment.

A first step in designing an effective fiscal management strategy, the Federal Government has started publishing an annual compilation of tax expenditures. In April 2020, the Federal Ministry of Finance, Budget, and National Planning mandated relevant ministries, departments, and agencies to submit annual tax-expenditure statements. These statements will inform the preparation of the annual Medium-Term Expenditure Framework and Fiscal Strategy Paper. The circular mandates that all agencies that are empowered to grant tax incentives report on those incentives in a consistent format in each fiscal year starting with 2019. The circular also mandates the creation of a Tax Expenditures Committee to consolidate the reports into a comprehensive statement. This Committee started operating in May 2020 and is chaired by the Director General of the Budget Office of the Federation.

Safeguarding oil and gas revenues is critical, as the Federation receives only part of what it is due

Oil and gas revenues are inherently volatile and have suffered from declining production volumes and large deductions to finance the petrol subsidy. Oil revenues have historically been the largest share of the Federation's revenues, but that share declined from 47 percent in 2010–14 (an average of 5.7 percent of GDP) to 37 percent in 2015–20 (an average of 2.6 percent of GDP). This decline reflects the oil-price collapses of 2015–16 and 2020 combined with a drop in domestic oil production.[15] While the global economy suffered from supply disruptions in 2020 due to the COVID-19 pandemic, oil production continued to decline in 2021 and 2022 due to inadequate investment, conflicts with workers and local communities, and vandalism.

A complex and opaque governance structure hinders oil and gas revenue collection (FIGURE 19). The oil and gas sector can be divided into three segments. Firms in the upstream segment are involved in the exploration and production of oil and gas. Firms in the midstream segment store, treat, and transport oil and gas, including the Nigeria Liquefied Natural Gas Limited, which receives and liquefies natural gas for export. Firms in the downstream segment include refiners, bottling plants, filling stations, and trucking companies. The National Assembly passes laws affecting the sector, the most significant of which is the 2021 Petroleum Industry Act (PIA), which overhauled the governance of the oil sector

15 In the second quarter of 2016, five oil terminals were under force majeure (Platts Commodity News, 2016). Among the worst was a series of attacks in 2016 on the Trans-Forcados Pipeline, one of the main export routes typically exporting 200,000–250,000 barrels per day. These attacks halted exports for most of the period between February 2016 and June 2017.

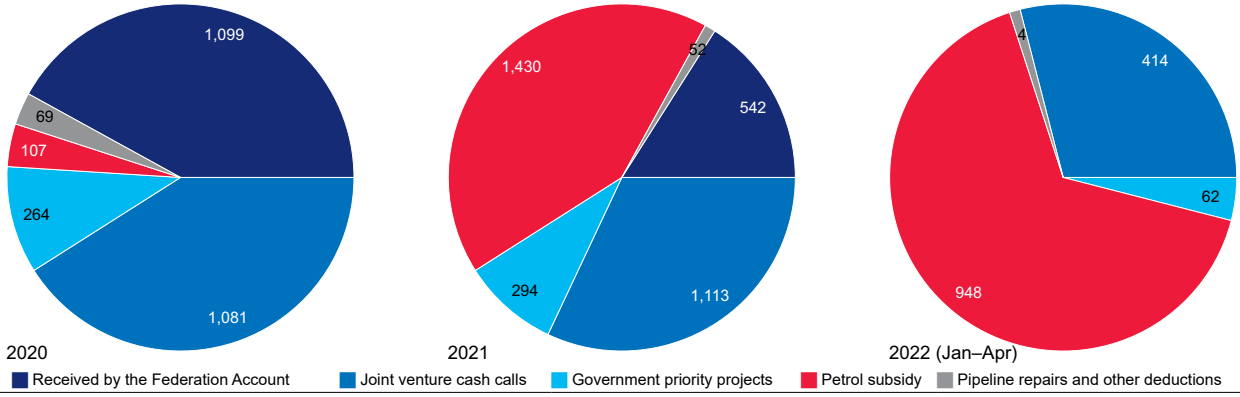
and set a new fiscal framework.[16] The President appoints members of the Boards of the Nigerian Upstream Petroleum Regulatory Commission (the Commission hereinafter), Nigerian Midstream and Downstream Petroleum Regulatory Authority (the Authority hereinafter), and the Nigerian National Petroleum Company Limited (NNPC Ltd). The Nigeria Extractive Industries Transparency Initiative and the Office of the Auditor-General for the Federation independently examine financial and physical flows through the sector.

Several entities are responsible for collecting and administering oil revenues. The Federal Inland Revenue Service collects taxes, the policy for which is set by the Federal Ministry of Finance, Budget, and National Planning. Royalties, bonuses, license fees and fines are collected by the Commission and the Authority. The NNPC, newly incorporated as NNPC Ltd, remains the fiscal agent in production-sharing, profit-sharing, and risk-service contracts. The Niger Delta Development Commission charges a 3-percent fee on capital and operating expenditures for economic development of the Niger Delta region. Meanwhile, the Nigerian

FIGURE 18. More than half of the oil and gas revenues collected by the NNPC are spent before the remainder is transferred eventually to the Federation Account.

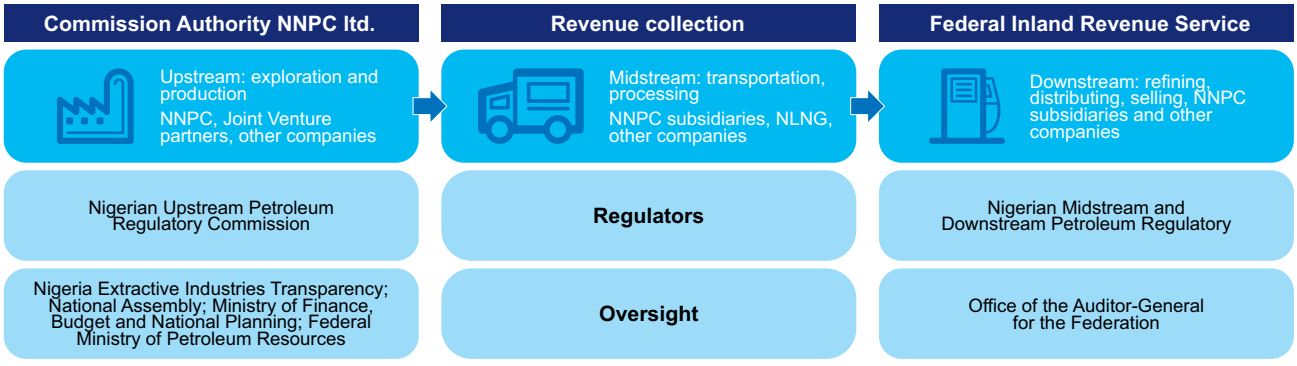
Distribution of oil and gas revenue

Naira billion



Source: Calculations based on data at https://nnpcgroup.com/pages/faac.aspx.

FIGURE 19. The oil and gas sector is composed of various players and institutions.



Source: World Bank.
Note: JV = joint venture, NLNG = Nigeria Liquified Natural Gas Limited.

16 After more than two decades in the making, the PIA was enacted on August 16, 2021. Initiated by the Oil and Gas Sector Reform Implementation Committee that was set up by President Obasanjo in 2000, various drafts of the Petroleum Industry Bill underwent many stages of reviews and consultations. These consultations included the Gazetted Bill of December 2008, the Government Memorandum, the Petroleum Industry Bill 2009, the Inter-Agency Team Memorandum of 2010, and the Petroleum Industry Bill 2012. The PIA, which aims to reform Nigeria's oil and gas sector, is composed of four main chapters: (i) governance and institutions, (ii) administration, (iii) host community development, and (iv) the petroleum industry fiscal framework.

Content Development and Monitoring Board charges a 1-percent fee on all contracts to promote local content development.

Significant deductions are made by the NNPC from the gross oil revenues before they are transferred to the Federation Account. The NNPC handles all of the Federation's equity oil and gas in JV operations and collects all in-kind fiscal payments on behalf of the Federation in the fields governed by production-sharing contracts. The deductions include those for the petrol subsidy[17] and infrastructure projects implemented by the NNPC. During the first four months of 2022, transfers to the Federation Account fell to zero (FIGURE 18) from ₦487 billion during the same period in 2020 and ₦196 billion in 2021. Due to the rising cost of the petrol subsidy (as global oil prices has risen and the pump price in Nigeria has remained frozen), the Federation has cut back on investment in oil production by not fully covering its share of production costs in JV operations (these costs are referred to as JV cash calls), resulting in lower oil production and declining government revenue.

The NNPC has accumulated large payment arrears for the Federation's share of oil production costs in JVs. Over the years, the NNPC fell behind in paying JV cash calls to its partners for the production of the Federation's equity oil and gas. The magnitude of JV cash call arrears before 2016 has not been publicly disclosed but may have been higher than US$6.5 billion.[18] In the negotiated settlement with its JV partners, the Federal Ministry of Petroleum Resources managed to reduce the amount owed to US$4.7 billion and set up a mechanism to pay back the arrears. As of March 2022, US$3.7 billion had been paid back, leaving US$1 billion still to be repaid. The sharp increase in the petrol subsidy in 2021 and 2022 appears to have impaired the NNPC's ability to pay the Federation's share of JV costs, resulting in new JV cash call arrears. Actual amounts paid to JV partners in 2021 were US$2.9 billion (or 44 percent) below planned levels, which may have added substantially to JV cash call arrears and contributed to declining oil production even as global oil prices rebounded in 2021. In 2022, the funding shortfall had similarly reached US$0.9 billion by April.

The PIA substantially altered the institutional setup of the oil and gas sector. After more than two decades of preparation, the PIA was enacted on August 16, 2021. The PIA transfers many powers and responsibilities previously assigned to the Minister of Petroleum Resources to two new regulators: the Nigerian Upstream Petroleum Regulatory Commission, which is responsible for oil and gas exploration and production, and the Nigerian Midstream and Downstream Petroleum Regulatory Authority, which is responsible for activities downstream of oil and gas production. The Minister of Petroleum Resources oversees policy formulation and plays an important role in international relations but, unlike in other countries, is no longer tasked with issuing regulations or conducting licensing rounds. In contrast to internationally accepted good practice, the PIA excludes all ministers and vests the Commission with exclusive authority to decide how fiscal payments are to be made and conduct licensing rounds. The PIA also specifies a new fiscal structure that increases profit oil at the expense of taxes in production-sharing contracts and earmarks 30 percent of profit oil for exploration. Finally, the PIA reduces the overall government take to make Nigeria a more attractive destination for investors. As a result of these amendments, government revenue from the oil and gas sector is likely to decline further in the near term until enough investment is made to increase oil and gas production significantly.

An Excess Crude Account (ECA), established in 2004 to help buffer the revenues from the volatility in the global oil prices, has been gradually depleted since 2015 without being replenished. Every month, all excess oil revenue[19] was supposed to be transferred to

17 As the petrol subsidy is not a budgeted expenditure item, the deductions are made by the NNPC from the revenues it administers to cover its cost.
18 Energy Intelligence 2017.
19 Excess oil revenues are defined as actual gross oil revenues in excess of the budgeted oil revenues.

the ECA, intended to provide fiscal buffers during the periods of revenue shortfalls. During periods of high oil prices, such as 2008 and 2011, the ECA balance reached as much as US$18 billion, almost 5 percent of GDP. These savings provided an important buffer against the fiscal downturn arising from the steep decline in oil prices during the 2008/09 global financial crisis and the 2014/15 commodity-price shock. After 2015, two factors led to the depletion of ECA savings. First, overly ambitious production projections in the budget compared with the actual collection, together with revenue deductions discussed above, reduced the amount of "excess" oil revenue available and deposited in the ECA. Second, the modest ECA inflows were depleted by discretionary spending, including purchases of military equipment and a Paris Club Refund to state governments in 2018.

III. Nigeria needs to spend more on critical public services to achieve its social and economic development objectives

Public expenditures are very low relative to peers and given high needs

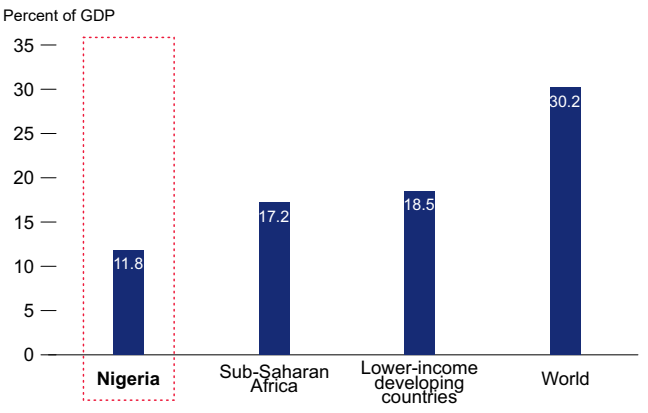
Nigeria's development outcomes are among the lowest globally, indicating high public spending needs. Nigeria is ranked 169th out of 174 countries on the 2020 Human Capital Index, with school enrolment rates for primary and secondary education that have remained flat over the past decade at around 60 and 47 percent, respectively. Over 36 percent of the children under 5 years are stunted and an average Nigerian can only expect to live up to 55 years, lower than the average of over 61 years for SSA.[20] Similarly, the level and quality of Nigeria's infrastructure quality is low, with the country ranked 132 out of 137 countries for infrastructure in the 2018 Global Competitive Index. Nigeria's physical infrastructure gap is estimated to reach US$3 trillion over the next 30 years.[21]

At around 12 percent of GDP between 2016 and 2020, Nigeria has one of the lowest public spending levels in the world. Nigeria's public spending levels fall well below the average of the SSA region (17.2 percent of GDP) and that of countries with similar income levels (18.5 percent of GDP) (FIGURE 20). To achieve its Sustainable Development Goals by 2030 and improve the quality of its citizens' lives, Nigeria needs to spend at least 6 percentage points of GDP more, annually, which represents an increase of close to 50 percent, compared with the current level (FIGURE 21). However, the general government expenditures decreased over the past decade from 15.9 percent of GDP in 2011 to an estimated 11.9 percent of GDP in 2020.

With Nigeria's large and growing population, public spending is particularly low in per capita terms, and not only relative to its economy. With its

FIGURE 20. Low revenues translate into one of the lowest spending levels in the world…

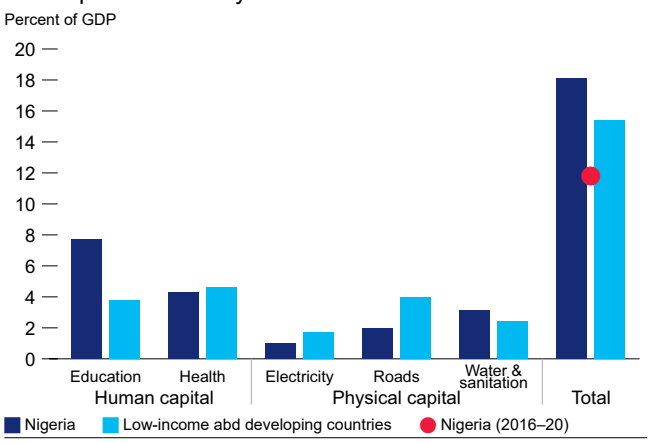
Government spending (2016–20)



Source: IMF.

FIGURE 21. …which needs to increase significantly over the next decade for Nigeria to catch up with its peers.

Annual spending needed to achieve Sustainable Development Goals by 2030



Source: International Monetary Fund, 2020.

20 Nigeria Demographic Health Survey 2018, WDI 2019.
21 Nigeria Integrated Infrastructure Master Plan

population surpassing 200 million, Nigeria's national budget of nearly US$50 billion translates to a per-person allocation of US$220[22] annually across federal and state governments. This is significantly lower than that of comparator countries: for example, in 2020 the Indonesian Government spent US$716 per capita, while the South African Government spent about US$1,833 per capita.[23] In addition, most of this small Nigerian resource envelope is devoted to keeping the government administrative functions going, and the resulting per capita spending on human capital and infrastructure is particularly low.

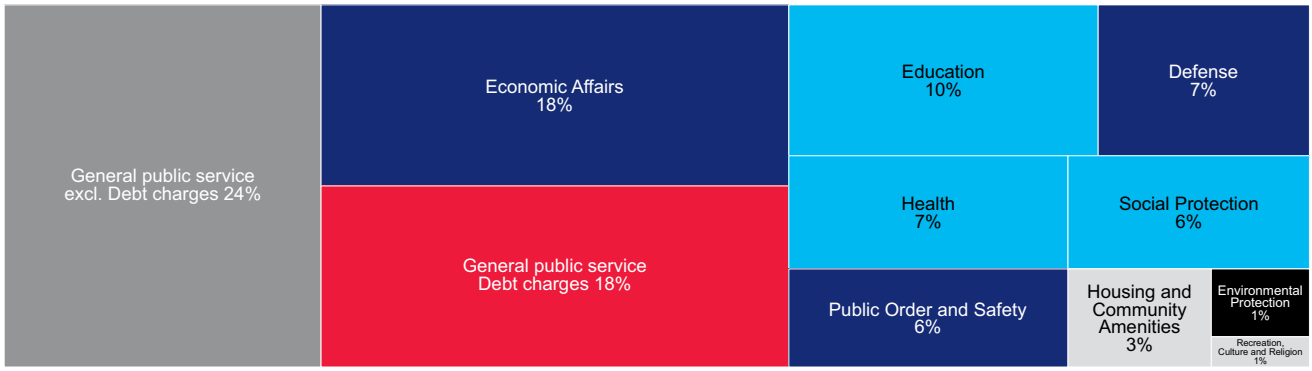
Social spending allocations are too low to plug human capital gaps

Despite Nigeria's high social spending needs, key social sectors receive less than one-quarter of the national[24] budget allocation. The largest single allocation in 2021 general government budgets—42 percent of the national budget (4.9 percent of GDP)—was devoted to general government functions, which include general government administrative functions (24 percent of total budget, and 2.8 percent of GDP), as well as debt servicing (18 percent, and 2.1 percent of GDP) (FIGURE 22). Once allocations are made for economic affairs[25] (18 percent of total budget, and 2.2 percent of GDP) to cover connectivity infrastructure and agriculture spending, public order and safety (6 percent, and 0.7 percent of GDP), and defense (7 percent, and 0.8 percent of GDP),[26] the budget envelope for key social spending is very limited. In 2021, 10.1 percent of the national budget (1.2 percent of GDP) was allocated to education, 6.6 percent for health (0.8 percent of GDP), and 5.8 percent of the budget (0.7 percent of GDP) for social protection.

Compared with similar countries, Nigeria's social spending is too low, both in levels and as a share of budget resources, to ensure human capital growth and convergence to other middle-income economies. In 2021, on average, Nigerians received up to US$15 worth of public health services a year,[27] at a time when the country was battling the COVID-19 pandemic (FIGURE 23). This allocation includes all

FIGURE 22. Social sectors received less than one-quarter of the national budget allocation in 2021.

General government (federal and state) budget allocations across government functions (percent of total national budget) 2021

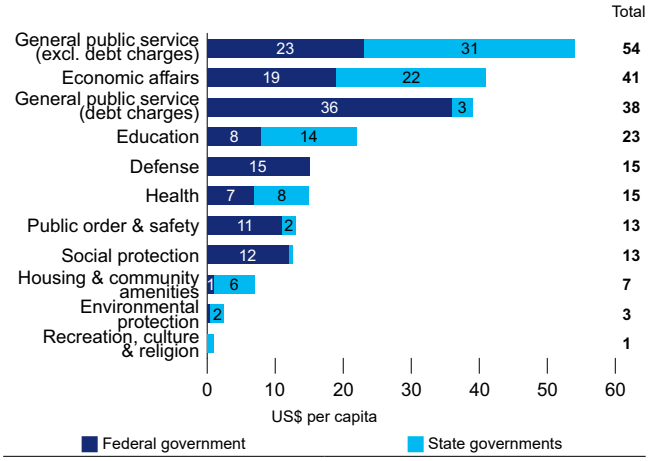


Source: Federal Government and 36 state government budgets 2021.
Note: Estimates exclude FCT, local governments, Federal Government-owned enterprises, and extrabudgetary funds receiving Federation Account allocations.

22 In current (2021) US$-equivalents, derived from naira values converted using official exchange rate prevalent during the preparation of this report (N410/US$). The values are budgeted and not actual spending. National budget estimates include federal and state government budgets; local government data is not available.
23 World Development Indicators (2021) and International Monetary Fund Fiscal Monitor (October 2021).
24 Proxied by the federal and 36 state budgets.
25 Economic affairs function captures the spending on core infrastructure (transport, communications; state support to the mining, manufacturing, and constructions); spending on agriculture; and general economic, commercial, and labor affairs.
26 Spending on Defense and Public Order and Safety together are equivalent to 13 percent of total Federal Government spending, in part reflecting high incidence of conflicts in Nigeria (insurgency in the North-East, farmer-herder disputes in the middle belt, and oil-related conflicts in the South).
27 As proxied by the budget allocations across federal and state government budgets

capital investments, salaries to health personnel, and procurement of medication and vaccines. In Indonesia, the comparable figure is US$55 per person annually—more than three times higher than Nigeria. As a result, more than 70 percent of Nigeria's health expenditure is out-of-pocket (more than twice the level of Indonesia), potentially excluding many of the poor from accessing even the basic health services they need. The annual budgetary allocation to education is similarly low, equivalent to US$23 per person per year (FIGURE 23). The subnational governments, particularly the states, are at the frontier of basic service delivery. Beyond the low averages, there is substantial variation across the states in terms of social spending and social development outcomes (see Section V), further deteriorating the low overall performance on social service delivery.

FIGURE 23. With most expenditure allocated to general public service and debt, social expenditures per capita are extremely low.



Source: Federal Government and state government budgets 2021 and NBS for population estimates.
Note: Estimates exclude FCT, local governments, and extrabudgetary funds receiving Federation Account allocations.

Public investment is a de facto residual public spending item and is insufficient to plug the infrastructure gap

Nigeria's public expenditures are heavily skewed toward recurrent spending. Between 2011 and 2020, about 70 percent of Nigeria's total general government spending was on recurrent items (FIGURE 24). Most of that, on average 56 percent, was allocated to non-debt spending, to cover salaries (on average 30 percent of government resources), overhead costs, and some budgetary transfers. Personnel costs decreased somewhat relative to GDP as the Federal Government capped the wage bill, introduced and implemented International Public Sector Accounting Standards, and moved to remove ghost workers from the payroll. However, as the total spending declined faster, the civil servant compensation envelope absorbed a higher share of total expenditures, going from 28 percent of total expenditures in 2011 to 33 percent in 2020. Nigeria's government spending on personnel is lower than in other countries relative to GDP but consumes a higher share of government resources than comparator countries.[28] Recurrent debt expenditures averaged 13 percent of total government spending over the decade, rising toward the end of the decade.

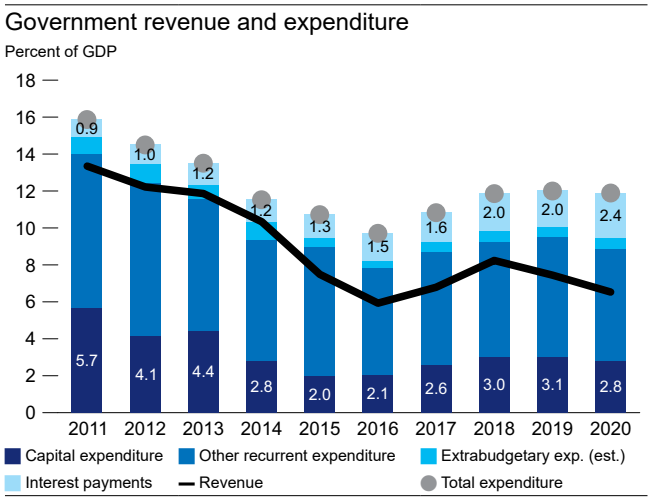
Widening fiscal deficits helped stabilize the expenditure decline but at a high cost. With declining revenues, deficits increased during the past decade to help finance the spending needs. The deficits rose from 1.7 percent of GDP in 2013 to above 5 percent of GDP by 2020. The public and publicly guaranteed debt stock more than tripled during the decade, from 9.6 percent of GDP in 2010 to 36 percent of GDP in 2020.[29] Accompanied by rising effective interest rates, including due to increasing monetization of the deficits, the debt servicing costs put increasing pressure on the public spending: by 2020, interest payments rose to 2.4 percent

28 Personnel costs of the Nigerian general government averaged 3.9 percent of GDP during 2015–19. Relative to the size of the economy, this was broadly comparable to Mexico, whose public salaries consume the equivalent of 3.4 percent of GDP, but much below other comparable countries such as Indonesia or South Africa (5.4 and 12 percent of GDP, respectively). However, the personnel costs burden in total expenditure in Nigeria was the highest among its peer countries, standing at an average of 36 percent during 2015–19, slightly above the proportion in South Africa and Indonesia but significantly higher than that in Kenya, Egypt, and Mexico.

29 These figures include public guarantees in addition to public debt stock.

of GDP and consumed one-fifth of general government actual spending, squeezing the public investment (FIGURE 24).

FIGURE 24. Downturns in revenue and increasing interest payments have resulted in lower capital expenditures.



Source: OAGF, State Audited Financial Statements, and NBS.
Note: Correlation between revenues and capital expenditure is 0.89 between 2011 and 2020. Correlation between interest rates and revenues is -0.71 for the same period.

High and rigid personnel spending, and rising debt servicing costs have squeezed public investments. Personnel expenditure and interest payments remain non-discretionary expenditures, with governments, both federal and state, having limited ability to adjust them in the short term. Since the recurrent non-debt spending has been broadly stable thanks to improving basic public financial management (PFM) practices and despite the minimum wage increases, the rising interest bill is the main driver, squeezing the fiscal room for capital investments, the de facto least prioritized spending category. Capital expenditures collapsed from over 4 percent of GDP in 2011 to as low as 2 percent of GDP at the height of the 2015–16 fiscal crisis, recovering only slightly to 2.8 percent of GDP in 2020. This represents a close to 50 percent reduction in capital expenditures to GDP since 2011, while interest payments doubled in the same period. Public investment also declined as a share of total expenditure, from 36 percent in 2011 to 24 percent in 2020.

Since the 2015–16 fiscal crisis, capital investments have fallen and remained below the overall fiscal deficit levels. Government borrowing, by law (Fiscal Responsibility Act, 2007), is envisaged to only fund capital investments (and human development). From 2011 to 2014, the deficits were lower than the capital investments, indicating that the Federal Government primarily borrowed to fund public investment. Since the 2015–16 fiscal crisis, the revenue envelope was no longer sufficient to fund all recurrent expenditures. Despite the capital investment levels falling, the deficits systemically exceeded the capital expenditures. The Federal Government is the primary driver: similar to many federal countries, the Federal Government of Nigeria carries out core functions for the Federation as such, that focus on the provision of national infrastructure, national defense, and public safety.[30] As such, apart from financing the army and security apparatus of the country, the Federal Government is tasked with plugging a great part of the national infrastructure gap to develop connectivity within Nigeria and link it with its key neighbors and trading partners. Most able to borrow, the Federal Government contracts the large portion (about three-quarters) of the public debt, and therefore most of the debt servicing costs.

Public investment spending is not only low in its level, but also in its relatively low quality and lack of transparency. The efficiency score of public investment in Nigeria is 77 percent away from the frontier of excellence and well below the scores of peer countries.[31] Furthermore, funding shortfalls and PFM/public investment management challenges in capital budget implementation have led the priority projects being increasingly lifted out of the Federal Government budget framework, including to be implemented by the private sector agencies outside the government systems. These

30 The Federal Government is the sole tier responsible for: defense; shipping; federal trunk roads; aviation; railways; post, telegraphs, and telephones; the police and other security services; the regulation of labor, interstate commerce, telecommunications; mines and minerals; social security; insurance; the national statistical system; national parks; guidelines for minimum education standards at all levels; and water resources affecting more than one state.

31 International Monetary Fund, 2019. Nigeria Public Investment Management Assessment. Washington, DC.

off-budget mechanisms have been increasingly used for core power and road projects, diluting, if not fully eliminating, oversight and fiscal transparency as provided under the budget framework.

With the current levels of public investment, it would take some 300 years to close Nigeria's current infrastructure gap.[32] The physical infrastructure gap is estimated to reach US$3 trillion by 2050 and requires annual investments of US$100 billion compared with US$11 billion of general government capital expenditure in 2020. The infrastructure gap, estimated to cost up to 4 percent of GDP annually, reduces profitability and discourages private investment, specifically through lack of reliable power supply, and gaps in transportation, irrigation, and water and sanitation. With the current levels of public infrastructure investment in Nigeria (not including public-private partnerships and other private sector investments), it would take at least three centuries to close the infrastructure gap.

32 This illustration does not consider additional infrastructure gaps potentially arising between 2050 and 2320.

IV. Nigeria also needs to spend more efficiently

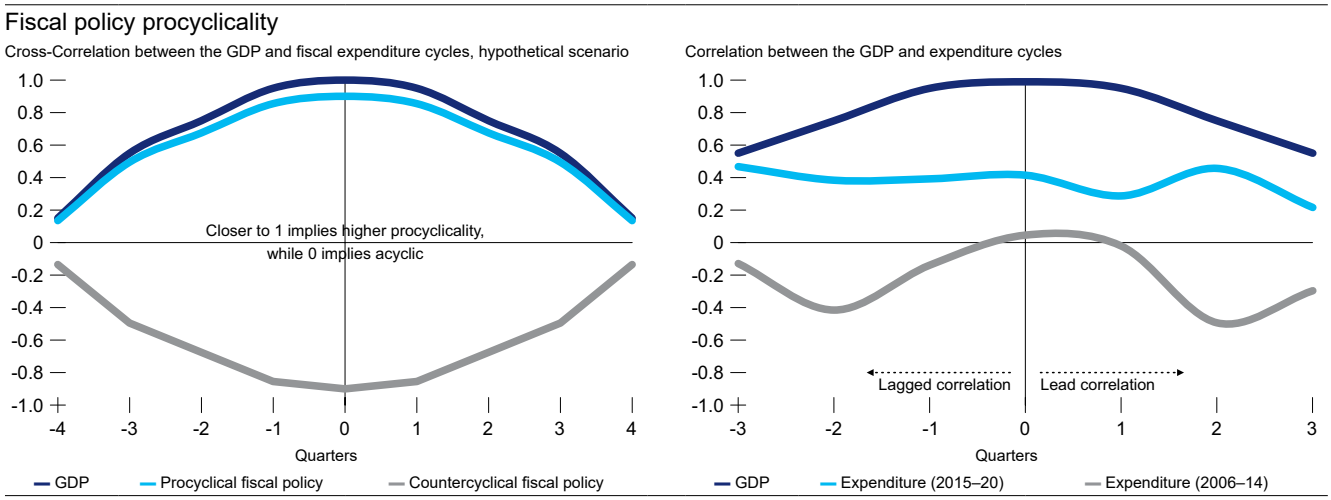
Public spending is volatile and pro-cyclical

Counter-cyclical public spending (i.e., higher public spending in times of lower economic growth, and vice versa) can mitigate the adverse shocks of the economic business cycle. However, with increasingly limited fiscal buffers, Nigeria's public spending has become more dependent on its domestic revenues, which are volatile due to their continued dependence on oil. As such, after the depletion of the Excess Crude Account in 2015, and due to lack of diversification of non-oil revenue sources, Nigeria lost its main buffer to maintain public expenditure at stable levels, let alone to seek counter-cyclicality by boosting public spending during economic slowdown or recessions. Thus, Nigeria's public expenditure, particularly capital spending, is locked into the trend of economic growth (FIGURE 25): it declines when growth (and therefore revenues) declines and increases when economic growth (and therefore revenues) picks up. Boosting capital investment funded by borrowing is not a sustainable path either over the medium term or the short term with the absence of a coherent borrowing strategy.

Spending on key basic public services is not only low, but also inefficient

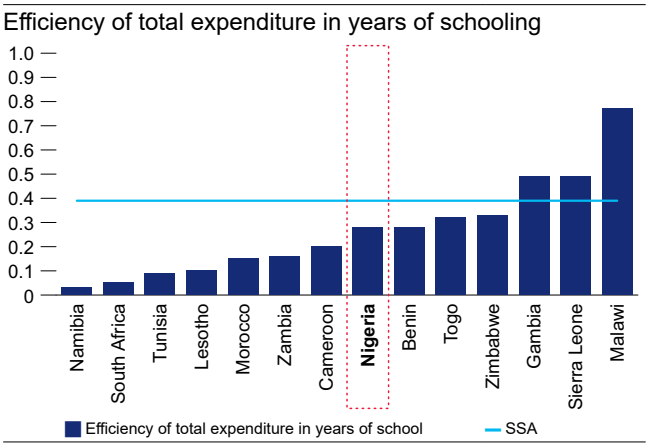
Education and health receive low expenditure allocations and, as such, spending levels in these sectors remain low—and simply not enough to raise human capital. General government spending on education and health was budgeted for only US$26 per capita and US$15 per capita, respectively, in 2021. While resource constraints further reduce overall actual expenditure levels (that is, budgets are not fully implemented), the allocative decisions are also not in favor of social sector spending. General government spending on education and health combined was budgeted at 2.0 percent of GDP in 2021, lower than interest payments budgeted at 2.1 percent of GDP. Defense expenditure had the same allocation

FIGURE 25. Nigeria's fiscal policy became procyclical after the depletion of the ECA.



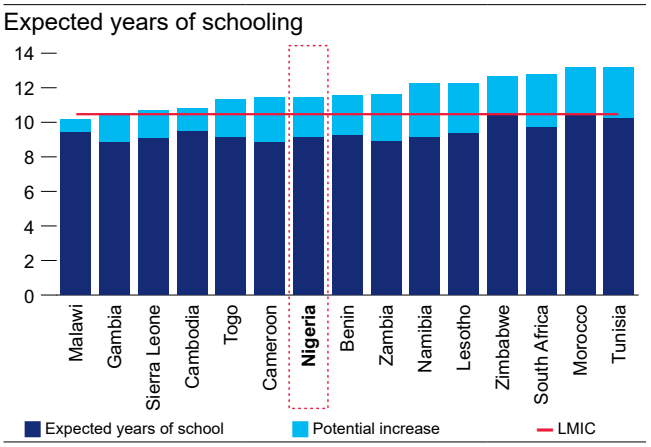
Sources: OAGF, NBS, and World Bank staff calculations.
Notes: Cross-correlation of the cycles of GDP and public expenditure. The x-axis indicates the period of the quarterly correlation; t=0 is the contemporaneous correlation; negative numbers are lagged correlations, and positive numbers are lead correlations. The GDP line depicts the business cycle, and it is used as a benchmark: the closer the variable of interest is to that line, the more procyclical it is because it follows the business cycle.

FIGURE 26. There is room for improving Nigeria's efficiency of spending…



Source: OAGF, State Audited Financial Statements, and NBS.

FIGURE 27. …and if this materializes key development outcomes such as education will improve.



Source: WDI and World Bank estimates.
Note: Countries displayed are those that, similarly to Nigeria, report an intermediate level of expected years of school.

(0.8 percent of GDP) as public health expenditure and was higher than the allocation for social protection (0.7 percent of GDP).

Without any increase in efficiency, Nigeria would need to at least quadruple its spending on education and health to start closing the coverage and efficiency gaps with other lower middle-income countries. Nigeria lags the average level of public spending efficiency scores[33] relative to its peers in education and health. The efficiency scores are 0.39 in education and 0.41 in health in SSA, and 0.39 in education and 0.36 in health for lower middle-income countries. In comparison, the efficiency of Nigeria in using its public spending to provide more years of education is scored at 0.28 (FIGURE 26), which indicates that a similar country performing under full efficiency would be able to spend 72 percent less and provide similar expected years of school to their citizens (FIGURE 27).

Overlapping expenditure mandates across different tiers of government hamper the efficiency in service delivery, including the coordination of investments

Out of the three tiers of Nigeria's government, the Federal Government dominates Nigeria's public expenditures, responsible for over half of the general government expenditures. In 2020, the Federal Government's spending was equivalent to 6.6 percent of GDP and accounted for 55 percent of general government actual spending (11.9 percent of GDP). Thirty-six state governments (and FCT) are estimated to collectively have spent 3.6 percent of GDP, or about 30 percent of general government spending. Collectively, the 774 local governments' public expenditures are estimated at 1.1 percent of GDP (about 9 percent of total government spending). Extrabudgetary funds receiving allocations from Federation revenues have estimated expenditures of 0.6 percent GDP, contributing the remaining 5 percent to general government expenditures (FIGURE 28).

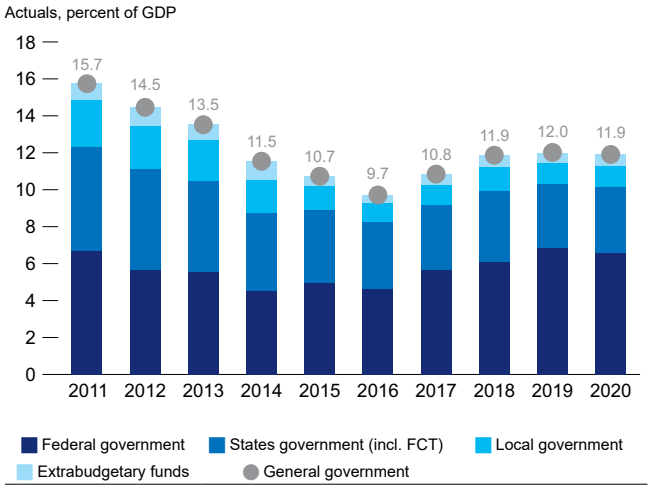
33 To assess efficiency, we use the data envelopment analysis (DEA) technique to calculate the ability of a country to achieve the best possibly development outcome (maximum output) at the lowest possible cost (minimum level of input). Health spending and public final consumption are used as inputs given data constraints on education spending. Expected years of schooling is the education output, and infant survival rate is the health output.

Overlap of the expenditure mandates across the three tiers and limited coordination add to the spending efficiency challenges. While education and health expenditure responsibilities lie primarily with the state governments, the Federal Government also maintains its share of responsibilities in these sectors. Federal ministries of education and health are responsible for setting standards and developing policies related to education and health service delivery that are implemented at the state level. While these intend to bring uniformity on the policy front, it results in overlap and administrative challenges in coordination between different tiers of government. For example, the Federal Government administers the Universal Basic Education Program which, while implemented through state governments, is not a federal responsibility as per the constitutional distribution. Service delivery by state governments across the country remains uneven due to lack of fiscal capacity to deliver, further weakening the relative importance of national standards.

Similarly, the mandates and responsibilities on economic affairs, which capture broad investments in agriculture and key infrastructure, are also split between the various tiers of government. As in most federal countries, the Federal Government of Nigeria carries out the central government's mandated functions that focus on the provision of national infrastructure, national defense, and public safety (thus no or little spending by the states, FIGURE 29). As such, apart from financing the army and security apparatus of the country, the Federal Government is tasked with plugging much of the national infrastructure gap to develop connectivity within Nigeria and link it with its key neighbors, trading partners, and markets. This spans aviation, ports, railways, national roads and highways, and other infrastructure core for the country's connectivity. However, states are responsible for state roads and other infrastructure. The overlapping mandates and lack of efficiency call for the coordination of public spending across tiers of government (for example, on planning federal vs. state roads to avoid duplication).

FIGURE 28. Public spending is spread across tiers of government…

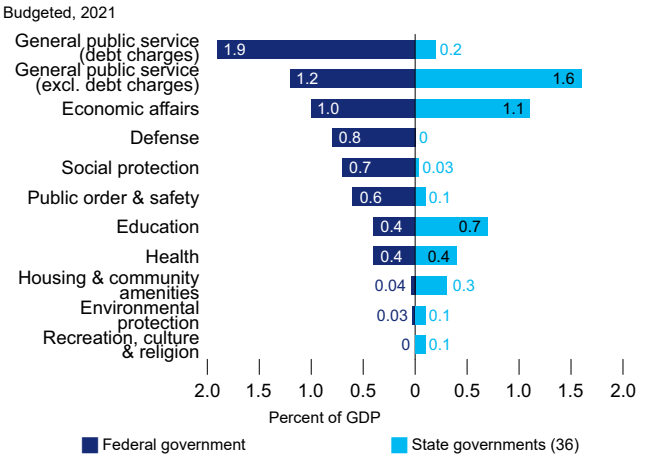
Expenditures by tier of government as a share of GDP



Source: OAGF, State Audited Financial Statements, CBN, Debt Management Office, NBS, and World Bank estimates.
Notes: Actual spending estimates. Federal Government spending estimates are based on the OAGF reports; state governments' expenditures in 2018–20 are based on the state audited financial statements; in 2011–17, state government estimates are based on CBN and Debt Management Office data. Local governments' spending is assumed to be equal to their share of Federation revenues. Extrabudgetary funds refer to funds receiving a share of Federation revenues only.

FIGURE 29. …and across functions.

National budget estimates across federal and state governments



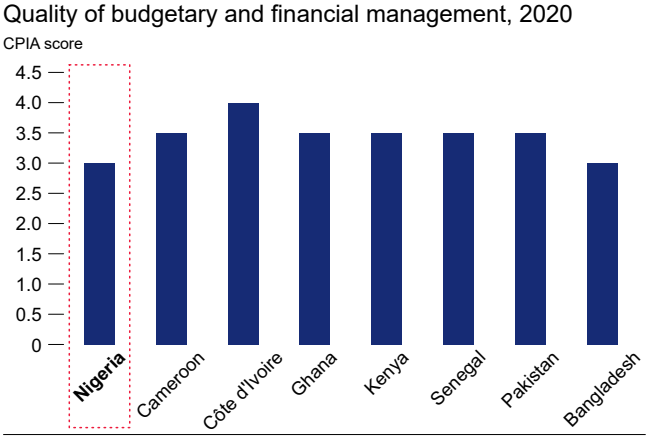
Source: Federal and state governments' 2021 budgets, and World Bank staff estimates.
Note: Budgeted estimates based on federal and state governments' 2021 budgets.

With limited data-sharing mechanisms in place, policy coordination becomes difficult, causing problems in addressing issues quickly. The political chain of accountability on service delivery also becomes diluted, with citizens unable to assign clear responsibility for good or poor service delivery to specific political actors. The recent challenges with the distribution of COVID-19 vaccines across the country highlight the weak coordination. While the responsibility of deploying the vaccines remains at the state level, the emergency nature of the deployment necessitates the National Primary HealthCare Development Agency's involvement in the deployment, which presented coordination challenges and delays in deployment.

Budget credibility is low, hindering sound fiscal and debt management

Nigeria's budget management is weak, contributing to inefficiencies in management and execution of public expenditure. A comparison of the budget and financial management scores from the Country Policy and Institutional Assessment (World Bank 2022)[34] across several lower middle-income countries shows that Nigeria lags its comparators in financial management systems, contributing to its expenditure inefficiencies.

FIGURE 30. Nigeria lags its comparators in quality of budgetary and financial management.



Source: Country Policy and Institutional Assessment World Bank.

One of the core areas that signals strong budgetary and financial management is budget credibility, and the budget credibility of the Federal Government of Nigeria is low, in large part due to systemic revenue over-forecasting. The lack of budget credibility undermines the usefulness of the budget process for policymaking and implementation and erodes public trust in government. If expenditure is under-executed—especially systemically more so for some categories rather than others—beneficiaries may not receive the expected amount of services. Over-executed budgets and poor revenue forecasting may result in budget deficits and increased public debt levels and can influence macroeconomic stability. In Nigeria, between 2016 and 2021, the fiscal deficit of the Federal Government exceeded budget estimates by an average of 1.4 percent of GDP. Two key reasons undermine the capital budget implementation: delays in the budget passing, and systemic revenue shortfalls against budget targets.

- Between 2016 and 2018, federally collected Federation oil and non-oil revenue outturns were around 64 percent of their budget targets. Federal expenditure—especially capital investments—during this period was adjusted downward as well in response, but not to the same extent as revenue shortfalls. Budget execution for the Federal Government's expenditure during this period was 88 percent on average, with recurrent expenditure execution being high, but capital execution—the de facto only buffer to partially absorb the shocks of revenue shortfalls—was particulalry low (FIGURE 34).

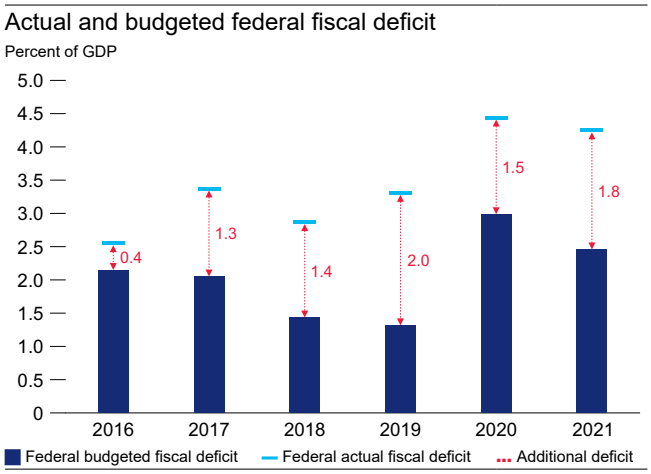
- In addition, from 2019 onward, expenditure pressures increased partly due to efforts to align the effective budget and financial years. As the 2019 calendar year included the pending implementation of the 2018 capital projects, the expenditure performance increased in cash terms. At the same time, average FAAC revenue outturns were only 66 percent of budgeted targets, federal expenditure exceeded budget estimates.

34 The CPIA is conducted yearly by the World Bank across all its IDA recipient countries. It is an internal assessment.

With fiscal balances exceeding their budget estimates, the pressure on debt is high, as financing plans approved during the budget preparation process do not capture the reality of the fiscal situation (FIGURE 31). As the fiscal framework effectively establishes domestic and external borrowing limits for the officially contracted debt of the Federal Government (under the Debt Management Office mandate), this results in the government contracting expensive short-term debt, often from the CBN. It is estimated that if budget estimates were followed between 2016 and 2021, the Federal Government could have saved an estimated ₦12 trillion (1.4 percent of GDP) of fiscal savings by lower and more cost-effective borrowing (FIGURE 32).

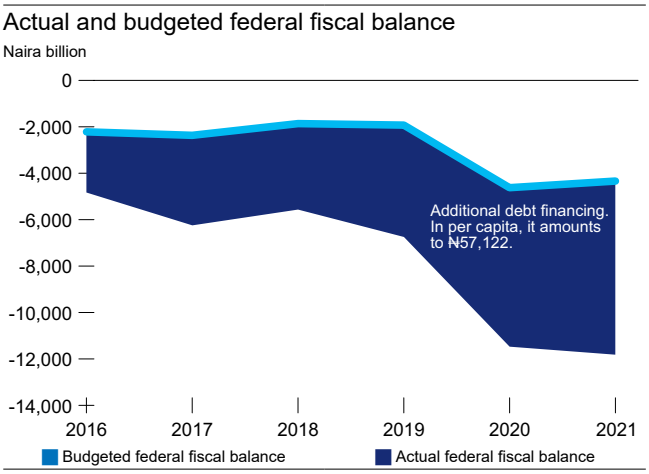
Revenue shortfalls are a common feature of Nigeria's budget due to the excessively optimistic oil production forecasts, expectations of non-oil revenue-related reforms that do not materialize, and weak capacity (FIGURE 33). The Federation's oil and

FIGURE 31. The Federal Government's fiscal deficit has been higher than budget mostly due to lower revenue outturns, and more recently due to high expenditure pressures…



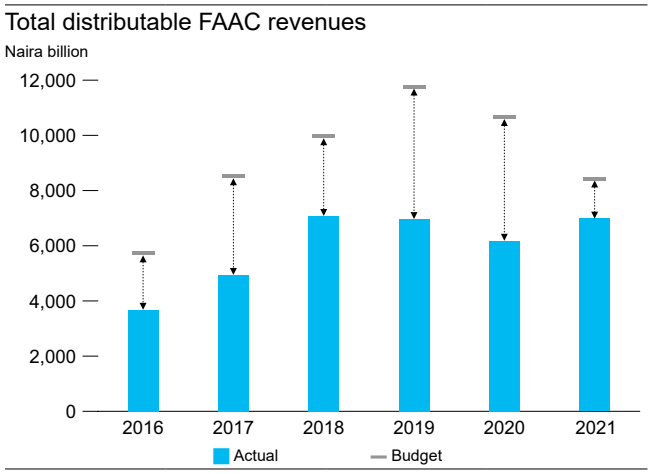
Source: OAGF.

FIGURE 32. …increasing the Federal Government's financing needs and public debt.



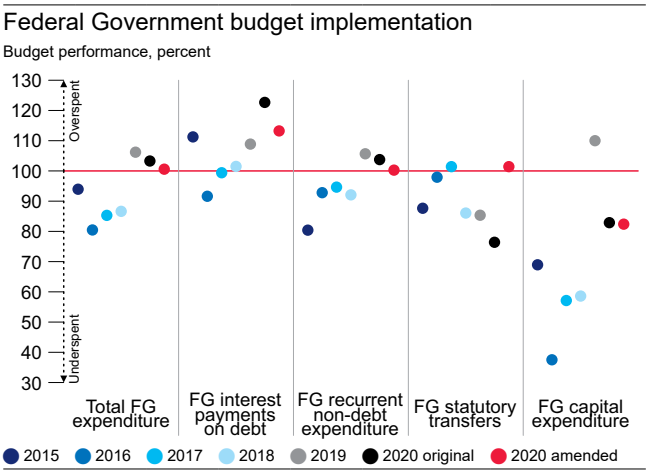
Source: OAGF.

FIGURE 33. Revenue outturns are consistently lower than budget targets…



Sources: OAGF.

FIGURE 34. …and expenditure pressures remain elevated due to high recurrent expenditure outturns.



Sources: OAGF.

gas revenue performance has been affected by a host of factors, including: (i) oil production falling below the budgeted targets; and (ii) discretionary deductions by the NNPC, including for the unbudgeted fuel subsidy. The non-oil revenue underperformance is attributable to an increased revenue target and delays in approving corresponding tax policy or administration reforms to ascertain an increase in the actual collections. Since states rely heavily on the Federation's revenues and have a lower ability to borrow from the market, the budget credibility of state revenues and expenditures is also low.

Budget credibility for capital expenditure is lower than that for recurrent expenditure. Revenue shortfalls result in capital expenditure being impacted more significantly as it is adjusted downward, being the least rigid component of the budget (FIGURE 34). This has significant economic implications as lower capital expenditure impacts capital accumulation in the country and highlights the inadequacy of plugging the infrastructure gap, hampering growth.

Despite the timely submission by the executive, the budget faces considerable delays during the review process at the National Assembly, resulting in late budget enactment. While the implementation of the recurrent budget is effectively undisturbed, with the equivalent of up to 50 percent of the previous year's budget allowed to be spent by June, the capital budget cannot be implemented until the budget is passed into law. Between 2015 and 2019, the budget enactment was delayed on average by five months. Since 2020, following the efforts of the Budget Office of the Federation, the budget has been passed on time and the budget credibility of capital expenditure has improved. However, some additional factors continue to adversely impact its budget execution, such as shocks and changes to amounts or timing of external debt issuance.

Some public investment projects considered a priority are executed outside of the budget framework, undermining sound financial management practices. These public investment projects are taken out of the budget framework to accelerate their implementation as a priority. While most of the projects have to undergo the standard budgetary practices of project costing, feasibility, appraisal, and prioritization, there is a lack of clarity of the oversight and control. This is because the removal of these projects from the budget circumvents systems and procedures, and establishes parallel structures not subject to the same oversight and controls or monitoring and evaluation.

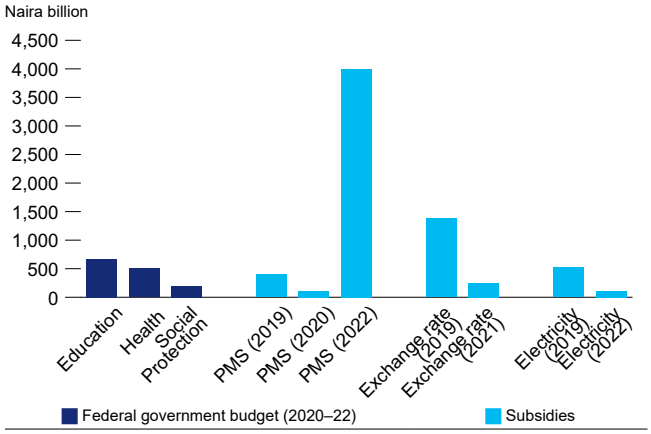
Budget execution is an even bigger challenge at the subnational government level, particularly for the capital budgets. In 2018–19,[35] state governments' budget credibility for total expenditure (excluding interest payments) was only around 50 percent, on average, despite revenue outturns being about 73 percent of their budgeted figures on average. Budget execution for recurrent expenditure is higher, at around 81 percent, as salaries and pensions dominate recurrent expenditure (with an average budget execution of 86 percent). However, capital expenditure execution is very low, at only 34 percent on average, with substantial variations across states.

Nigeria also spends a large share of its limited resources on inefficient subsidies that are not on budget

Price subsidies—mostly in the form of government controls that keep the price of a given good fixed and usually lower than the market rate—impose a huge fiscal cost but, in Nigeria, they are often not treated as expenditure items and are thus difficult to monitor. The Federal Government currently caps prices for petrol, electricity, and foreign exchange. When market prices or production costs differ from the prices set by the Federal

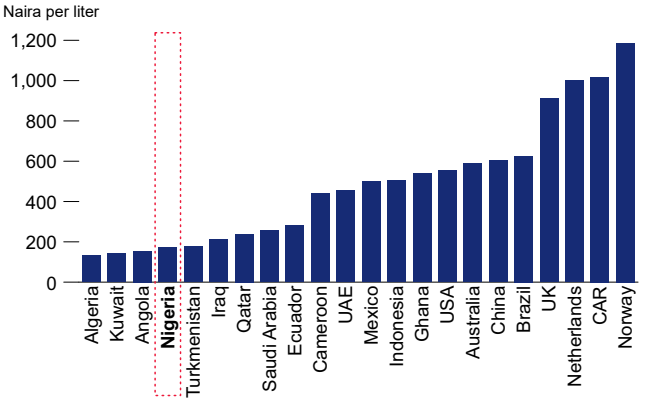
35 The 2020 budget and expenditure are not being considered because 2020 had significant revisions to the budget due to the COVID-19 pandemic. Budget figures available as part of the Annual Financial Statements are for the amended budget not the original budget.

FIGURE 35. Nigeria spends a large amount on untargeted subsidies.



Source: Budget Office of the Federation for budgeted figures; NNPC, Nigerian Electricity Regulatory Commission, CBN, and World Bank estimates for subsidies.
Note: Premium Motor Spirit (PMS) and exchange rate subsidies are reported in total, and their costs fall to all tiers of government.

FIGURE 36. Retail petrol prices in Nigeria are among the lowest in the World.



Source: Global Petrol Prices.
Note: Of the 170 economies in the database, 23 are shown.

Government, public spending makes up the difference. However, subsidy spending is rarely accounted for in federal or subnational budgets. Instead of appearing as expenditures, some subsidies are deducted from the revenues of ministries, departments, and agencies and hence become "forgone revenues"—revenues the Federal Government and subnational governments would have received had the subsidy not been in place. Because subsidies are not treated as expenditures but rather as forgone revenues, the scale of their cost is not "salient" to the Federal Government, subnational governments, or Nigerian citizens. Moreover, subsidies are not targeted, meaning that anyone who purchases a good (e.g., petrol) will benefit from the subsidy, and the more that person consumes, the larger the subsidy she receives (e.g., think car convoys). This section summarizes the cost and impacts of three key subsidies (FIGURE 35).

The petrol subsidy: an unaddressed and unsustainable burden

Nigeria is the only country in the world that subsidizes petrol and no other petroleum products and does not properly budget for it. Nigeria relies entirely on imports for petrol and has no mechanism for reimbursing oil importers for the petrol subsidy. As a result, the NNPC has become the sole importer of petrol. The NNPC pays the full world price for each shipment and sells it to domestic distributors at a heavily discounted price, reimbursing itself for the subsidy by deducting the corresponding amount from what is due to the Federation Account in upstream oil and gas revenues.[36] Nigeria has one of the lowest petrol prices (₦165 per liter) at the pump in the world, ranking eighth lowest in April 2022, when the global pump prices averaged ₦555 per liter (FIGURE 36). The total petrol subsidy reported by the NNPC in 2021 was ₦1.6 trillion,[37] an amount that had been reduced by using an overvalued exchange rate for petrol imports of ₦384–389 to the US dollar after the official exchange rate had been adjusted to ₦410. This makes the costs of petrol imports cheaper in naira than if the market-based exchange rate had been used, thereby understating the cost of this subsidy.

Attempts to eliminate the subsidy have repeatedly failed, but the recently enacted PIA effectively mandated the elimination of the subsidy by February 16, 2022. The Federal Government removed the petrol

36 The cost of the subsidy is calculated by multiplying the difference between the price at which petrol was imported and the price at which it was sold by the total volume imported.
37 Amount reported in the NNPC's monthly reports to FAAC from March 2021 to February 2022, which captures deductions for shipments landing in Nigeria from January to December 2021.

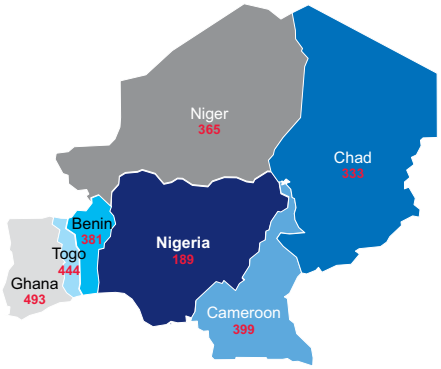
subsidy in January 2012 after months of high global oil prices, but the reform policy was reversed after two weeks of protests. The Federal Government ended the subsidy again in May 2016, this time as the world oil price had just hit a new low, and the authorities introduced a price band designed to move with international petrol prices. However, the Federal Government did not adjust the price band when the naira depreciated sharply later in 2016, and by 2017 the subsidy had returned. In March 2020, amid another oil-price collapse, the Federal Government replaced the subsidy with market-based pricing regulations for petrol.[38] However, when global oil prices recovered, the petrol subsidy returned and, since January 2021, the gap between the government-controlled retail price and the cost of supply has been steadily widening. The PIA allows the subsidy to persist for up to six months as a transitional measure and, as a result, the Federation's authorization to reimburse the NNPC for selling petrol at a loss expired by mid-February 2022. The Federal Government has since decided to extend the subsidy period for the remainder of 2022.

The cost of the petrol subsidy is rising rapidly. Compared with 2022, the total subsidy amount in 2021 was "moderated" by lower international prices of petrol—the benchmark European price averaging about US$670 per ton over 12 months—and the use of an overvalued exchange rate. This year, the benchmark price has risen above US$1,000 per ton, while the official exchange rate is expected to be used—although as of April 2022 an overvalued exchange rate of ₦389 to the US dollar continued to be used. In 2022, it is estimated that the cost of the petrol subsidy would amount to ₦5.4 trillion (2.7 percent of GDP, more than twice total non-oil non-VAT revenue collections in 2021), in anticipation of much higher international prices persisting for the rest of the year, as well as higher consumption than in 2021.

By widening the price gaps between Nigeria and its neighbors, the petrol subsidy results in widespread smuggling. Nigerian petrol prices are less than half of those in the neighboring countries (FIGURE 37). No government has succeeded in stopping fuel smuggling in the face of such powerful financial incentives. In addition to smuggling, in the past, there seemed to have been other factors at play artificially inflating fuel subsidies. For example, there was a sharp spike in the volume of petrol subsidized in 2011—when dozens of approved companies were eligible for subsidy reimbursement—and the petrol subsidy had reached

FIGURE 37. Nigeria's low petrol prices create incentives for smuggling petrol to neighboring countries.

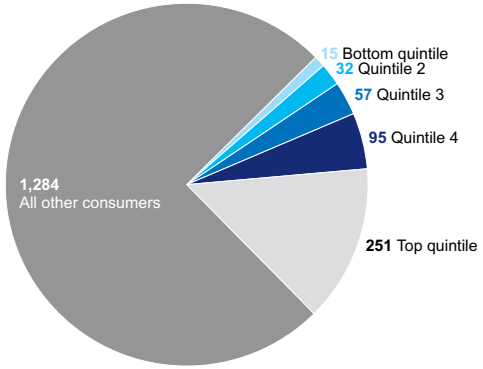
Petrol prices in Nigeria and neighboring countries in September 2022 (naira)



Sources: Global petrol prices.

FIGURE 38. Households in the bottom 40 percent of the income distribution purchase just 3 percent of all subsidized petrol in Nigeria.

Petrol consumption by quintile (million liters)



Source: NBS and NNPC.

38 http://pppra.gov.ng/wp-content/uploads/2020/09/FGN-OFFICIAL-GAZETTE-ON-MARKET-BASED-PRICING-REGIME-FOR-PMS-REGULATIONS.pdf

record levels, strongly indicating that volumes reportedly imported did not match the actual volumes. In addition to smuggling, petrol shortages and black marketing go hand in hand, whereby any shortages create incentives for black marketing and black marketing, in turn, creates shortages of petrol at official prices.

While the subsidy aims to make petrol more affordable for Nigerian consumers, only a tiny fraction of it is purchased by poor and middle-class households. Nigerian households purchase just one-quarter of the subsidized petrol, while the remaining three-quarters are purchased by firms, government agencies, and other consumers. Households in the bottom 40 percent of the income distribution purchase just 3 percent of all subsidized petrol sold in Nigeria (FIGURE 38). Meanwhile, households in the top 40 percent purchase about 20 percent, and firms and ministries, departments, and agencies consume 74 percent. There are some indirect benefits to the poor in the form of lower transportation costs—public transportation, as well as food and other goods transported by petrol-fueled vehicles—but on balance even indirect benefits are likely to accrue primarily to wealthy households because they consume more of everything.

Eliminating the petrol subsidy will be politically difficult, but no other fiscal reform would have comparable fiscal benefits. While marginal improvements could be made by improving the design of the petrol subsidy or by refining crude oil in Nigeria, there is no better policy than phasing out the petrol subsidy and using the savings to establish a "compact" with Nigerian citizens that deliver better development outcomes. Neither self-sufficiency in oil refining nor a transition to automotive compressed natural gas will eliminate the need to phase out the petrol subsidy. The primary savings from domestic refining are in fuel shipping costs, which are relatively small given the size of the unit subsidy. Meanwhile, retrofitting vehicles to run on natural gas instead of petrol would not only be costly but would take years to have a meaningful impact, and has been demonstrated in other parts of the world to be sustainable only if the liquid fuel being substituted—in this case, petrol—is heavily taxed. By contrast, eliminating the petrol subsidy would deliver an immediate and massive influx of revenue to the Federation. The Federal Government's and state governments' COVID-19 pandemic response effort included a vast expansion of targeted cash transfer systems and other priority investments, which the authorities could use to offset any negative impact on household welfare.

The electricity subsidy: thus far a successful reform that needs to be sustained

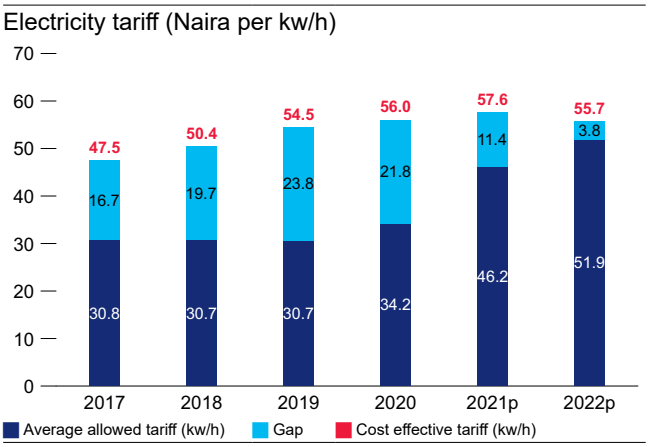
The Federal Government's experience with the electricity subsidy demonstrates that it is possible to reduce fiscal costs while still protecting the poor. Electricity tariffs are set through a Multi-Year Tariff Order, and different tariff rates apply based on how much electricity a user consumes. However, before 2021, average tariffs were below the cost-reflective tariff, i.e., the tariff that fully reflects the cost of generating, transmitting, and selling power to the final consumer, for all consumers. Because the power sector has been private since 2013, the Federal Government has financed below-cost electricity prices through a public subsidy.

As with the petrol subsidy, the benefits of the electricity subsidy accrued primarily to wealthy households. Before 2021, an estimated 80 percent of the public electricity subsidy benefited the wealthiest 40 percent of households, while only 8 percent benefited households in the bottom 40 percent, and less than 2 percent benefited households in the poorest 20 percent.

Between 2015 and 2021, the public subsidy imposed a mounting fiscal burden. Nigeria's electricity tariffs are set in nominal terms, and thus public electricity subsidies are highly vulnerable to global oil prices, exchange

rates, and domestic inflation. Between 2015 and 2020, the tariff shortfall widened significantly because administrative tariffs remained constant while the depreciation of the naira drove up the cost of production and high inflation rates diminished the real value of tariff payments. During the period, the Federal Government was forced to cover an estimated ₦2.2 trillion (roughly US$7 billion) in revenue shortfalls among electricity providers. In 2019 alone, total government support to the electricity sector reached ₦524 billion (US$1.7 billion), or 0.4 percent of GDP (FIGURE 39). In the same year, the Federal Government allocated just ₦428 billion to the health sector.

FIGURE 39. Electricity tariffs have become more cost-reflective in recent years.



Source: Nigerian Electricity Regulatory Commission.

Because budgetary funds were not enough to finance the cost of the subsidy, to ensure that the generation companies and gas suppliers received sufficient payments to continue generating electricity, the Federal Government borrowed over ₦1.3 trillion (US$3.7 billion) from the CBN between 2017 and 2021. These liabilities undermine fiscal transparency and debt management because they are currently not accounted for as part of the Federal Government's debt stock.

In 2020, through the Power Sector Recovery Program, the Federal Government reformed the electricity tariff structure and implemented an annual financing plan to track potential financing gaps to eliminate the public subsidy by 2023. While the Federal Government continues to set administrative prices for electricity, under the new tariff scale the cross-subsidy is almost entirely self-financed: above-cost tariffs on high-volume energy consumers compensate for below-cost tariffs on low-volume consumers, with a relatively small cost to the Federal Government. The reforms increased the average tariff by 38 percent, pushing the overall rate structure close to cost-recovery levels while strengthening payment discipline to reinforce the sector's financial stability. Importantly, poor households were shielded from the rate increase, greatly improving the progressivity of the tariff structure.

The elimination of the electricity subsidy is a major achievement, and tariffs will need to be regularly adjusted to ensure cost recovery. To maintain reform momentum, the Government needs to regularly update Multi-Year Tariff Orders to align the average electricity tariff with average production costs. This process may prove challenging because the sector still suffers from high technical losses, inadequate infrastructure, and a weak regulatory framework.

The exchange rate subsidy: positive steps were taken to reduce this "hidden subsidy," but more are needed to fully eliminate it

Nigeria's multiple exchange-rate regime has created a hidden subsidy. To stabilize the value of the naira against the US dollar, since 2015 the CBN has established a set of preferential exchange rates that differ from the official rate. These policies are collectively known as multiple currency practices (MCP). Under the MCP system, the CBN established two main preferential foreign exchange rates: (i) the official rate, which is used solely by the Federal Government; and (ii) the Investor and Exporter Foreign Exchange Window rate, also called the Nigeria Autonomous Foreign Exchange Fixing, which is used primarily by firms. In addition, there is a bureau

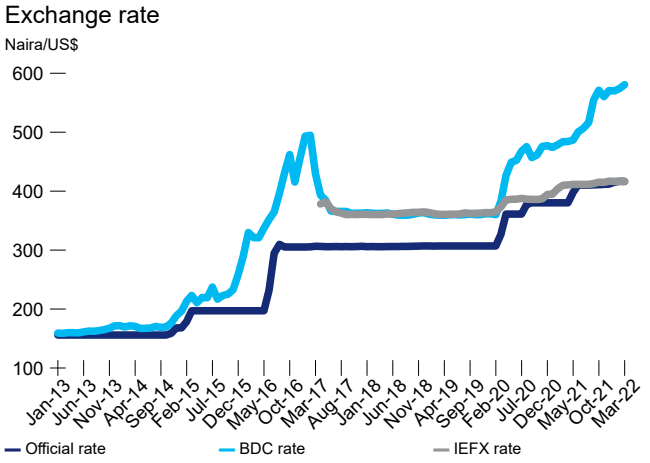
de change rate, which is used by licensed currency traders. The Federal Government also established a set of preferential rates for highly specific purposes, such as families transferring funds to students abroad. Households and firms that lack access to a preferential rate tend to use the parallel (black market or curbside) rate. FIGURE 40 illustrates the differences between the three main exchange rates in Nigeria.

Nigeria's MCP system has incurred an enormous fiscal cost, while undermining the transparency and effectiveness of monetary policy. This cost is borne by all tiers of government, as the Federation exchanges its US dollar-denominated revenues for naira at the CBN using the artificially low official rate. As these revenues derive from the oil sector and customs administration, the MCP system acts as an implicit tax on Federation revenue levied by the CBN. Meanwhile, the CBN accumulates surplus naira, which it has used to implement its expenditure policies—a highly unconventional practice. The system also benefits well-connected currency speculators, and the select group of firms and households with access to preferential rates, distorting economic incentives while creating vested interests that favor the status quo.

In 2020, as the full cost of the MCP system became increasingly clear, the Federal Government implemented an important but incomplete reform. Between 2017 and the first quarter of 2021, the use of multiple exchange rates cost the Federation an estimated US$13 billion, and the Federal Government faced rising domestic and external pressure to reform the system (FIGURE 41).[39] In May 2021, the CBN instituted the Nigeria Autonomous Foreign Exchange Fixing rate as the guiding rate for the economy by replacing the official exchange rate with the daily Nigeria Autonomous Foreign Exchange Fixing closing rate.

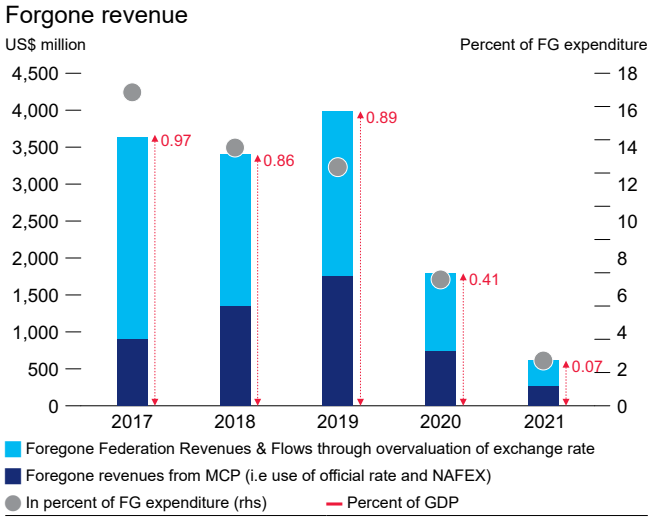
While these measures have greatly reduced the cost of the MCP system, the persistence of multiple exchange rates continues to impose an implicit tax on Federation revenues and financing flows. The CBN continues to execute government foreign-

FIGURE 40. Multiple exchange rates in Nigeria have resulted in large premia between the official and parallel rates…



Source: CBN, FMDQ and Nairametrics.
Note: (i) IEFX is Investor and Export Foreign Exchange Window. (ii) BDC stands for Bureau de Change. (iii) Daily Secondary Market Intervention Sales (SMIS), Small and Medium Enterprises (SME), and Invisible rates are not published and thus, not captured in this chart.

FIGURE 41. …and while the exchange rate has declined, it continues imposing a tax on the Federation revenues.



Source: FMDQ, CBN, Nairametrics, and World Bank staff estimates.
Note: NAFEX is Nigeria Autonomous Foreign Exchange Fixing.

39 In addition to foreign currency-denominated revenues, this amount includes new disbursements from foreign loans. However, this amount is net of external debt service, which is also remitted at the preferential exchange rate, creating an additional subsidy to the CBN.

exchange transactions at a rate of almost 2 percent below the Nigeria Autonomous Foreign Exchange Fixing, effectively diverting 2 percent of Federation revenues to the CBN. Moreover, the MCP system remains complex, opaque, and inherently vulnerable to corruption. Preferential rates continue to protect certain sectors by distorting relative prices, and the current policy systematically advantages market participants that have preferential access to overvalued foreign-exchange windows. The use of different rates for different types of transactions also complicates national accounting practices, weakening fiscal and financial transparency. To fully eliminate the fiscal and economic costs of the MCP system, it would be important to adopt a single and more market-responsive exchange rate.

V. Taking a closer look at the states: fiscal federalism structures affect the quality of spending

Subnational spending accounts for 39 percent of public spending, with state governments mandated with much of the service delivery but, to date, little was known about its composition. States are at the forefront of service delivery in Nigeria, being responsible for primary education and primary and secondary health-care services. However, data on state governments' spending has only recently become available using consistent classification, allowing for better analysis into the volume, composition, and efficiency of expenditure at the subnational level. In large part, the lack of data stems from Nigeria's fiscal federalism structure, whereby the states are entitled to a share of federally collected (that is, most of the Government's) revenues, and are granted full autonomy of spending decisions, without a legal requirement—nor a functional mechanism—for the states to report their spending execution to the central (Federal) government. This lack of regular, consistent reporting led to not only lack of transparency, but also fiscal management challenges, as witnessed in the 2015–16 fiscal crisis. During that crisis, the Federal Government had to step in and bail out most of the states, restructuring debt and revealing arrears, and regularly top up the states' revenue allocations from rapidly dwindling savings to support even the civil service salary payments.

This analysis utilizes recent newly available data to present a closer look into how the public finances of the state governments are structured and what challenges emerge. Since 2018, the Federal Government's States Fiscal Transparency, Accountability and Sustainability program for results established a clear incentive system for states to improve their fiscal reporting. As part of the broader PFM reform program, which rewards states with grants for achieving concrete PFM reform results across budgetary, revenue, expenditure and debt management, the states are incentivized to publish Audited Financial Statements, systemically reporting their budget execution. Furthermore, from 2021, states' budgets have been aligned to the National Chart of Accounts allowing, for the first time, a systemic view of the states' budget allocation across government functions. This section utilizes all these new data to provide a glimpse into public spending across the 36 Nigerian state governments. More future effort will be needed to shed similar light on public spending at the local government level.[40]

Nigeria's federalism is anchored in revenue sharing and the states' fiscal autonomy

Nigeria is a fiscal federation with three tiers of government, with revenue collection and expenditure responsibilities divided among them. The Nigerian Federation consists of three tiers of government: federal (FG), states (36; SG) and FCT, and local (774, LG), accounting for 55, 30, and 9 percent of the public spending, respectively (FIGURE 26), with the extrabudgetary funds accounting for the remaining 5 percent. Fiscal federalism structures devolve substantial spending responsibility to subnational tiers of government, allowing for the level and composition of some core public expenditures to be established as a function of the preferences of the subnational

40 This section focuses on the state government tier; the 744 local government finances are beyond the scope of this report.

constituencies (see TABLE 1 for spending responsibilities across tiers of government). The states enjoy substantial fiscal autonomy without much in the way of any formal structures for reporting or coordinating the spending with the Federal Government.

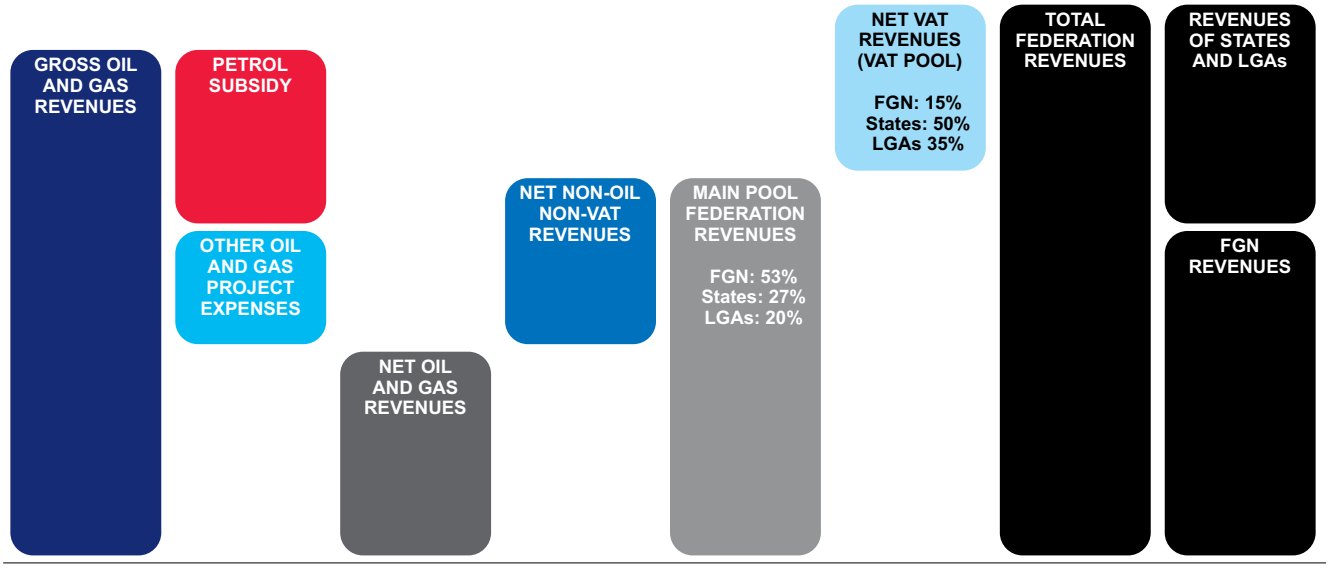
Most revenues accruing to each tier of government are collected at the federal level and then shared across the three tiers of government (FIGURE 42). Once transferred to the Federation Account, the oil and gas revenues, the federally collected non-oil revenues (companies income tax, stamp duties, custom duties, excise duties), and the VAT pool are shared across the three tiers of government by FAAC using established revenue-sharing formulas. According to the vertical sharing formula (TABLE 2), state governments receive about 27 percent of the Federation Account revenues,[41] and 50 percent of the VAT pool. As the monthly distribution decisions are made by FAAC, the federally collected revenues are usually referred to as "FAAC" revenues.

TABLE 1. Distribution of responsibilities between different tiers of government allows for some overlap especially in delivery of social services.

Tier of Government	*Spending responsibilities*
Federal only	Defense; shipping; federal trunk roads; aviation; railways; post, telegraphs and telephones; the police and other security services; the regulation of labor, interstate commerce, telecommunications; mines and minerals; social security; insurance; the national statistical system; national parks; guidelines for minimum education standards at all levels; and water resources affecting more than one state.
Federal-state (shared)	Antiquities and monuments; electricity; industrial, commercial and agricultural development; scientific and technological research; statistics and surveys; university, technological and post-primary education; and health and social welfare.
State-local (shared)	Primary, adult and vocational education; health services; and the development of agriculture and non-mineral natural resources.
Local government	Economic planning and development; cemeteries, burial grounds; homes for the destitute and infirm; markets; sewage and refuse disposal; and roads, streets, street lighting, drains, and other public facilities.

Source: Khemani, 2001. Fiscal Federalism and Service Delivery in Nigeria: The Role of States and Local Governments.

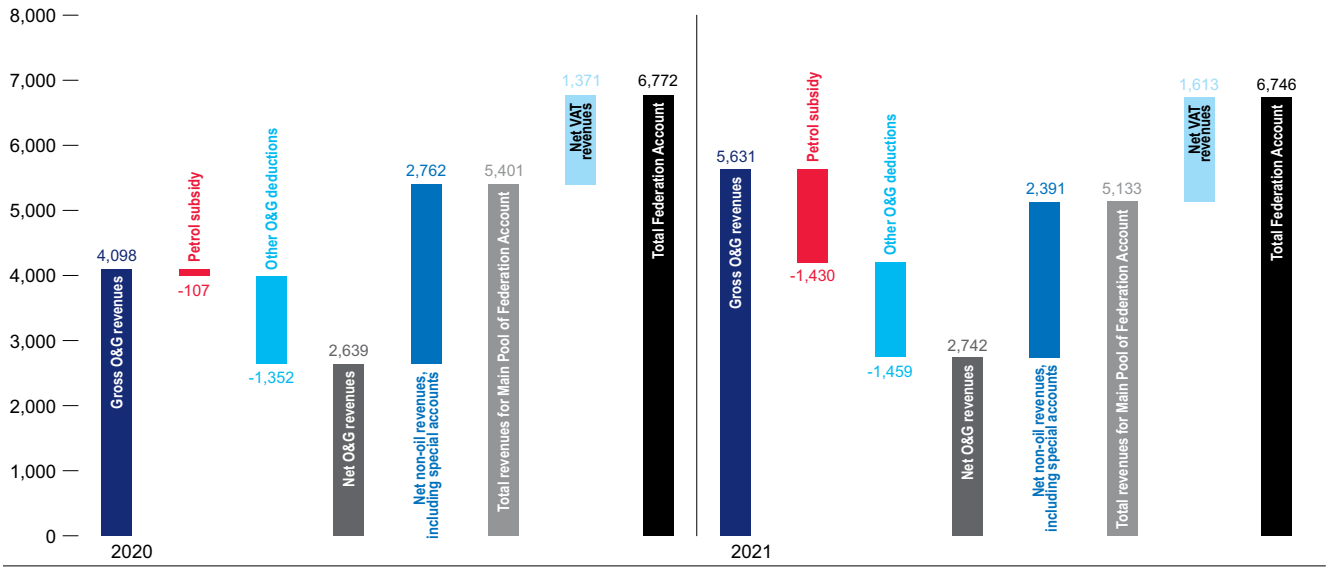
FIGURE 42. Federally collected revenue (gross) and its distribution.



Sources: FAAC and World Bank.

41 Oil producing states also receive 13 percent of oil and gas revenues in proportion to their production.

FIGURE 43. Growing petrol subsidies could jeopardize total Federation Revenues, as net oil revenues comprise the largest share of total distributable Federation Account.



Source: OAGF, NNPC, and World Bank staff estimates.

TABLE 2. Vertical revenue sharing formula for Federation revenues.

FAAC revenue-sharing rules	*%*	*%*
Receiving tier:		
*SG Derivation	13% of FAAC oil and gas revenues prior to sharing across tiers	
Receiving tier:	***Federation Account (Net) =100***	***VAT (Net) =100***
SG share:	**26.72**	**50**
LG share:	**20.6**	**35**
FG Share:	**52.68:**	**15:**
o/w: FG Retained share for FG Budget	48.5	14
o/w: FCT	1	1
o/w: Extrabudgetary Funds (EBFs):	3.18:	n/a
Ecology and Derivation	1	n/a
Stabilization Account	0.5	n/a
Development of Natural Resources	1.68	n/a

Note: the formula for sharing the Other FAAC revenues depends on which revenues the savings are derived from. If (as is mostly the case) the savings originate from oil revenues, they follow the oil revenue sharing: 13 percent of total savings go to the oil-producing states based on the derivation principle; and the net amount is shared across all three tiers based on the Federation Account (net) sharing formula.

Once the Federation revenues are shared vertically across the three tiers, the revenue distribution among states (horizontal distribution) has three components. The major portion of the distribution of revenue (40 percent) is based on equal distribution of revenues to all states. The formula also accounts for a proxy of fiscal needs, measured by population (30 percent), terrain and landmass (10 percent), and social development needs (10 percent). Finally, some elements of "performance" have been added (e.g., 10 percent of the federal transfers of the gross statutory allocation are based on internally generated revenue efforts) (TABLE 3).

While the majority of Nigeria's revenues are federally collected and shared across the three tiers of government, each level of government is also independently responsible for the collection of some revenues within its own jurisdiction. While the

TABLE 3. Horizontal distribution formula.

Source of State revenues	*How much of the total pot goes to the states (vertical formula)*	*Horizontal formula for sharing across states*
FAAC Derivation (oil)	Oil producing states receive 13% of total oil revenues before it is shared across tiers	• Proportional to the state's oil production
Share of Federal Account (FAAC Gross Statutory Allocation)	States receive 26.72% of Net Federation Account revenues (oil and gas and non-oil (customs and corporate tax)	• 40% equally across states • 30% proportionally by population • 10% proportionally by land mass and terrain • 10% based on social development factors • 10% reward generation of IGR
FAAC other revenues (ad hoc, contains various savings, mostly from oil)	Mix: • Oil-producing states receive 13% percent of the total pot before it is shared across tiers; and • all states receive 26.72% of Net pot	• 13% proportional to the state's oil production • 40% equally across states • 30% proportionally by population • 10% proportionally by land mass and terrain • 10% based on social development factors • 10% reward generation of IGR
FAAC VAT	50% of VAT Pool	• 50% equally to all states • 30% proportional to population • 20% on the basis of relative state contributions (derivation)

Note: FAAC revenues refer to the revenues of the Federation Account.

Federal Government collects PIT from its own Federal Government employees and retains some surpluses of the government-owned enterprises, the state revenue services administer the PIT, withholding taxes, various levies and, in some states, property tax, collectively termed IGR. Finally, local governments mainly administer levies. However, the IGR only accounts for 11.2 percent of the general government revenues.

The state governments' revenue streams are established in a complex scheme, making state-level revenues less predictable and visible. First, state governments are largely dependent on federally decided, collected, and distributed revenues (FIGURE 42). The states derive the majority—about 70 percent in 2020—of their revenues from their share of the federally collected oil and non-oil revenues. FAAC "Gross Statutory Allocation"[42]—the states' share of Federation Account revenues—accounts for 32 percent of total states' revenue envelope in 2020, representing the single largest component of revenue inflows for most of the states. While most oil revenues are allocated through the 'Gross Statutory Allocation' across all tiers of government and all 36 states, oil-producing states receive additional FAAC "Oil Derivation", corresponding to 13 percent of the Federation oil and gas revenues and share them in proportion with their production. FAAC "Other Revenues", mostly deriving from the distribution of savings during the episodes of revenue shortfalls, account for 5 percent of total states' revenue envelope in 2020.[43] Finally, of federally collected revenues, FAAC VAT receipts account for 18 percent of total states' revenue envelope in 2019.

42 Collectively, the 36 states receive 26.72 percent of the total net FAAC revenues, based on the vertical sharing formula. This pot is shared across states in line with the horizontal sharing formula: 40 percent are shared equally across states, 30 percent are allocated based on state's population, 10 percent based on land mass and terrain, 10 percent on social development factors, and 10 percent reward the state's IGR.

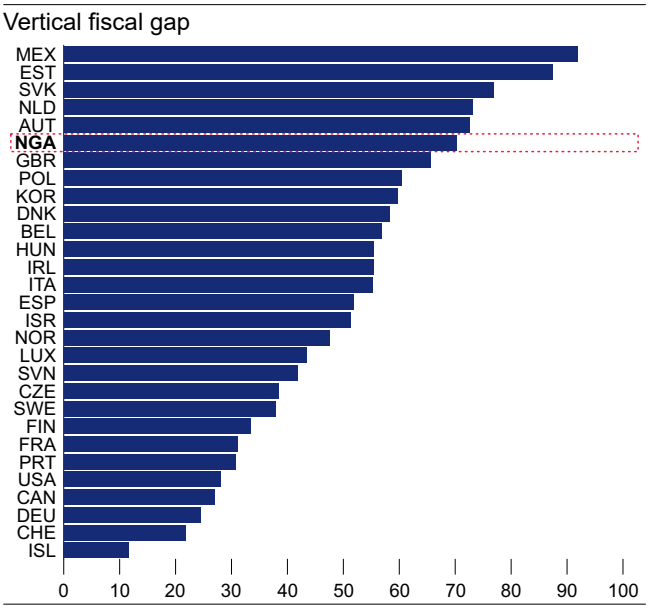
43 Historically, these primarily included oil-revenue savings, used intra-year to smooth oil revenue sharing. More recently, as the oil savings have been depleted, these included distribution of the savings from exchange rate difference, as well as other funds. Since the 2015–16 fiscal crisis, these other funds are distributed to boost total FAAC envelope sufficiently to allow states cover their monthly salary payments to civil servants. As most savings relate to oil revenues, the formula for sharing these other funds takes into account the derivation principle (13 percent distributed to oil-producing states), with the net amount distributed using the FAAC Gross Statutory Allocation principles.

IGR contributed about 30 percent to states' total revenues in 2018–20, on average.[44] The states' IGR derives mainly from PIT and property taxes. In 2020, the IGR is estimated to have stagnated in nominal terms, despite double-digit inflation, due to economic recession, interruptions to revenue administration, and some tax relief measures. Lagos—the state with the largest economy and most advanced revenue policy and administration—collects the most IGR across all the states. The states also receive grants and other revenues outside of the IGR classification (about 4 percent of total revenue and grant envelope in 2018–20).

A mismatch between the states' revenues and their spending needs undermines the efficiency of the federal system

In Nigeria, there is a large mismatch between the revenue generated by the states and their level of spending. In 2020, Nigerian states independently generated only 11 percent of total general government revenues, while they spent 30 percent of the total expenditures. To cover the gap, the states rely mainly on transfers of the states' revenue shares from the Federation Account. This large mismatch—also known as a vertical gap—is an indicator of the poor effectiveness of the federal system to achieve its goals of subnational fiscal accountability through own-tax sources, equity, and the efficiency of service delivery. While it is not feasible to have a vertical gap of zero, the most functionally well-performing federal systems tend to have vertical fiscal gaps of below 40 percent, equal to own-taxes financing 60 percent or more of local public services. In Nigeria, between 2018 and 2020, the states received around 65 percent of their revenues from the Federation, resulting in one of the largest vertical fiscal gaps in the world (FIGURE 44).

FIGURE 44. Nigeria's mismatch between the states' IGR and their expenditures is one of the highest in the world.



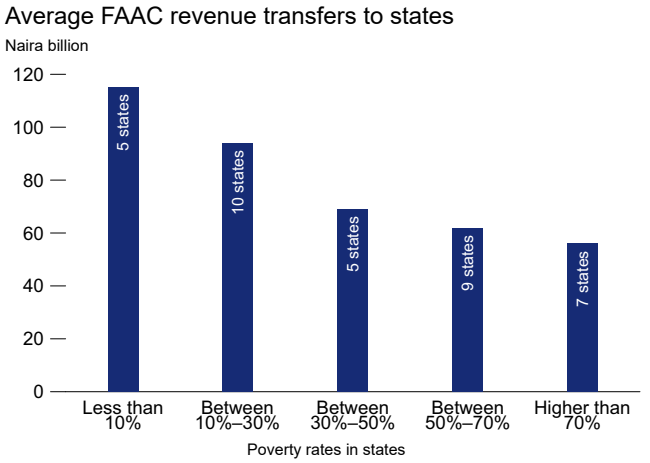
Source: OECD and CBN.
Note: Fiscal Gap = [(Percent SNG Spending - Percent SNG Revenue)/Percent SNG Spending. Figures report the fiscal gap between federal and on unitary countries.

The reliance on Federation resources, rather than own-source revenue generation, dilutes the accountability of the states to their citizens. States have lower accountability for their expenditure, as state governments are not taxing citizens to the same level as the Federal Government. This tends to reduce expenditure efficiency and make budget constraints more malleable, with implications for the fiscal sustainability of both the states and the general government. IGR revenues are highly volatile which, in combination with slightly decreasing FAAC revenues, have made it difficult for states to allocate spending for human and physical capital investments.

The current horizontal formulas to distribute resources across the states puts those states with higher expenditure needs at a relative disadvantage. With 40 percent of most distributable revenues being allocated equally to all the states, the current revenue-

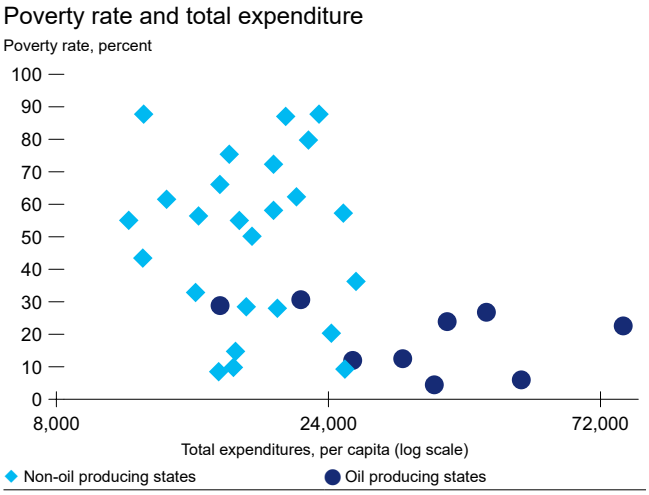
44 Technically outside of the Federation Account but still distributed through the Federation Account Allocation Committee, the VAT revenues follow a separate formula. States collectively receive 50 percent of the total VAT pot based on the vertical distribution formula. This pot is then shared across the 36 states: 50 percent are distributed equally to oil states, 30 percent in proportion to the state population, and 20 percent is based on the derivation principle (where the VAT was collected).

FIGURE 45. States with higher poverty rates receive lower FAAC transfers…



Sources: National Living Standards Survey (2018–19) and OAGF.
Note: Does not include Borno.

FIGURE 46. …and, as such, expenditure per capita is lower for states facing higher poverty rates.



Sources: National Living Standards Survey (2018–19) and OAGF.
Note: Does not include Borno.

sharing formula prioritizes fairness, (i.e., the same share for every state), over equity, (i.e., more resources to those who have the higher needs). This formula has resulted in large inter-regional gaps in terms of service delivery and level of development and has not improved the ability of subnational governments to provide the same services to every citizen of the country (FIGURE 45).

Variability in state revenues in per capita terms arises from oil derivation receipts deriving from a state's oil production and IGR, which depends on both the economic activity and the state's administrative capacity (FIGURE 46). For instance, states such as Lagos (where the highest share of national economic activity is concentrated) and Bayelsa and Delta (the main oil-producing states) have revenues per capita of at least double the national average. For relatively disadvantaged states, it makes it even harder to finance reasonable coverage of public services, since federally shared revenues cover a large part of their funding envelope and with relatively weak own-tax sources to fill the remaining part.

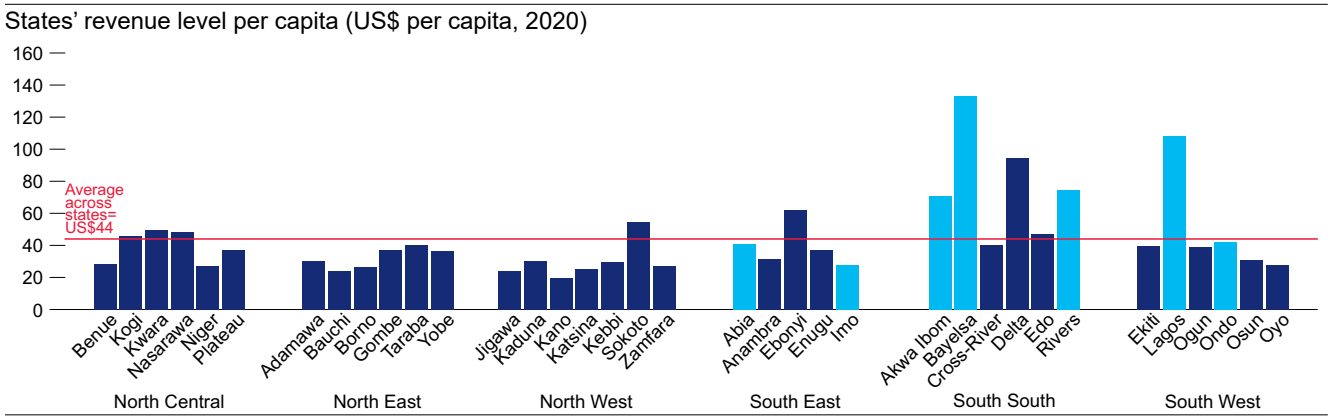
Those states that collect more IGR and rely less on federal transfers to cover their expenditures exhibit better development outcomes. The states that rely less on federal transfers have higher spending per capita and tend to show better human and physical capital outcomes among their citizens (FIGURE 48).

There is substantial variation in the level of spending across the states, driven by variation in revenues

State spending varies substantially in per capita terms, but overall envelopes are small, due to low overall revenue collection. Due to the state governments' limited ability to borrow, the states' spending levels are primarily determined by their revenues. In turn, since state revenues are dominated by their share of federally collected (FAAC) oil and non-oil revenues, state spending is highly correlated with their share of the FAAC allocation, as discussed above. The differences in average spending across states are large: per person, the oil-producing states in the South-South spend nearly 3 times more than states in the North-West and the North-East, where poverty is highest (FIGURE 49). Given Nigeria's large population, and limited revenue collection, states spend on average ₦21,000 per person per year, equivalent to about US$66 per person per year (2018–19).[45]

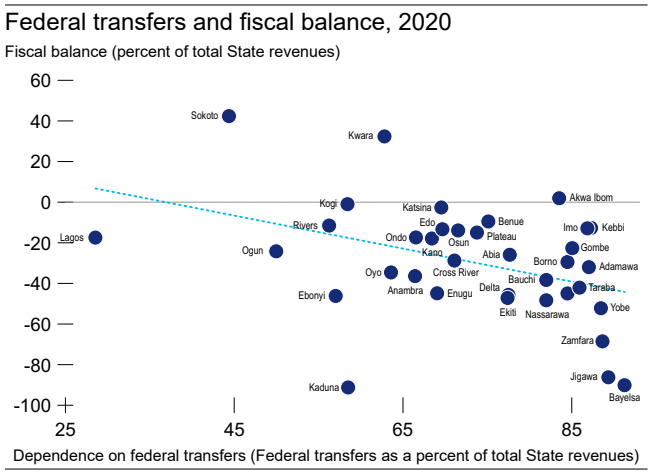
45 Excluding interest payments on debt. State Government 2021 Budget alignment with the National Chart of Accounts enables first-time glimpse into how states allocate budget resources across sectors/functions. While the *actual* state spending composition across sectors is not (yet) available for all states, the 2021 state budgets were aligned with the National Chart of Accounts across all 36 states for the first time.

FIGURE 47. Oil revenues and IGR drive differences in states' revenues.



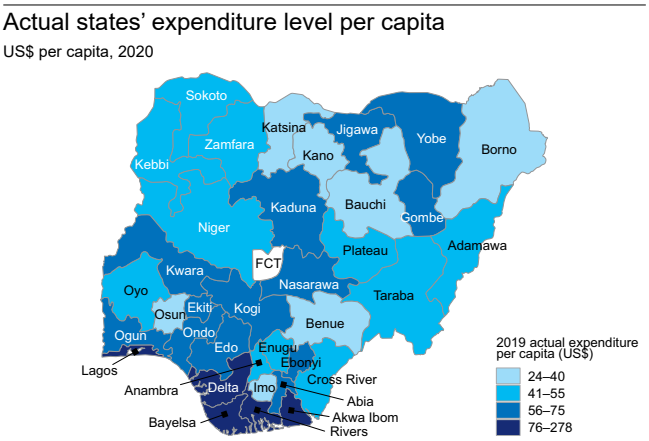
Source: State Audited Financial Statements, NBS, and World Bank estimates.

FIGURE 48. Higher dependence on federal transfers is associated with poorer fiscal outcomes for states.



Source: State Audited Financial Statements, OAGF, and World Bank staff calculations.

FIGURE 49. State spending varies substantially in per capita terms, with North-East states showcasing the lowest spending levels, and oil-producing South-South states (and Lagos) showcasing the highest levels of government spending per person.



Source: World Bank staff estimates using the 2019 State Audited Financial Statements, and NBS population data.

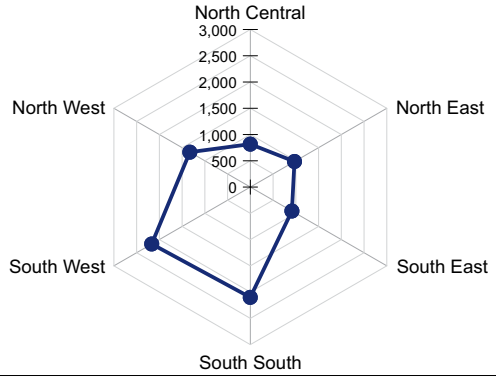
Budget allocations across functions vary substantially across the states, in part reflecting different priorities and needs

The budget allocations vary substantially across regions and states, broadly driven by revenue and population differences. Of Nigeria's six geopolitical zones, the states in the South-South (where the oil-producing states are concentrated)[46] and the South-West (where Nigeria's economic powerhouse, Lagos, is located) have the largest state government budgets (FIGURE 50). While most of the state governments remain dependent on the federally shared revenues, the oil states' ability to budget and spend more rests also on their additional revenues from oil derivation. Lagos, on the other hand, due to the size of its economy and administrative capacity, collects the highest levels of IGR. In addition, Nigeria's relatively economically well-

46 Oil-producing states are mainly concentrated in the South-South (Akwa Ibom, Bayelsa, Delta, Rivers); some are situated in the South-East (Abia, Imo), and South-West (Ondo, and, more recently, Lagos, though the latter's oil production is minimal compared to other states).

FIGURE 50. Budgeted amounts are higher in the oil-producing South-West and South-South.

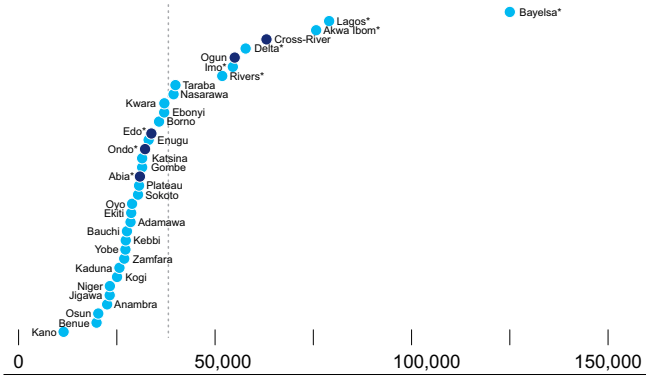
State government total budget, 2021 naira



Source: World Bank staff estimates using the 2021 states' budgets.

FIGURE 51. Oil-producing states and Lagos tend to have higher per capita budget allocations.

State government total budget per capita, 2021 naira



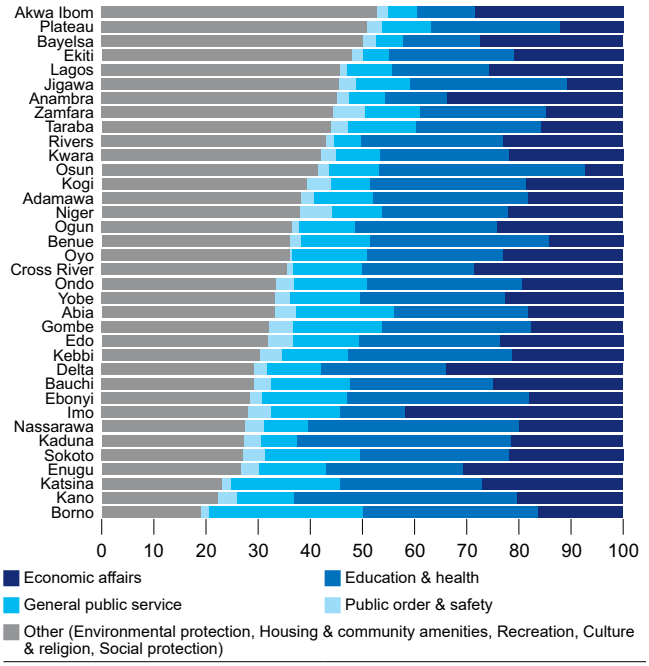
Source: World Bank staff estimates using the 2021 states' budgets and NBS population data.

off South has lower fertility rates and lower populations, leading to higher budgets not only in absolute (FIGURE 49) but also in per capita terms (FIGURE 51).

Similar to the Federal Government, given the low overall level of spending, the states allocate a substantial proportion (37 percent) of their budgets to general public services: broadly government administration and debt service (FIGURE 52). There is substantial variability in the share of limited public resources allocated to these administrative functions, ranging from 20 percent in the North, where resources are scarcer and the development needs and gaps are higher, to 50 percent in the oil-producing states, where the resources are ampler and the basic development needs are less urgent (albeit still high). Note, however, that unlike in the Federal Government, much lower budget allocations are made for debt service, both due to lower debt at the state government level, but also reflecting capacity limitations at the subnational tier to budget for the debt service (which at least for the external debt and state bonds is done by the Federal Government on behalf of the states, funded by deductions from the state's Gross Statutory Allocation prior at source).

FIGURE 52. State budget allocations across functions vary substantially.

State budget allocations by function (percentage of total state 2021 budgets)



Source: World Bank calculations using 36 state governments' 2021 budgets.

The economic affairs function is allocated another 24 percent of the state governments' 2021 budgets. While at the federal level economic affairs spending is broadly concentrated on infrastructure, at the state level it spans both infrastructure (e.g., state roads and other connectivity) but also the importance of agricultural development, and other expenditures. The additional focus on agriculture partly explains the higher overall allocation of budget resources to economic affairs at the state than the federal level. Here too, there is substantial variation across the states, from under 10 percent of the

budget resources in Osun, to over 40 percent in Imo (FIGURE 52).

The states are at the forefront of basic service delivery, but their spending allocations to the social sectors are too low to improve lives and livelihoods. The key basic services that determine Nigeria's human capital—health and education—receive on average one-quarter (25 percent) of state government resources. However, while the proportion of state budget allocations (25 percent of the budget) exceeds those at the federal level (11 percent of the budget), the states are at the forefront of the delivery of these basic services. Here again, there is considerable variation across the states, ranging from just over 10 to over 40 percent of the budget. (FIGURE 52).

Most of the states allocate less than 10 percent of their budgets for health—even in the face of the pandemic—translating to less than US$8 per person per year. As with other spending, there is a large variation across states in the share of the budget allocated to the health sector. Some states allocate as little as 4 percent of their budget to health (equivalent to US$2.5 per person a year), and some states allocate as much as 17 percent (US$22 per person annually). There is also a large variation in the health allocation between the recurrent and capital components, with states on average splitting health allocation evenly between the recurrent and capital allocation (49 and 51 percent, respectively). Considering low budget execution rate across states (averaging about 50 percent in 2018–19), the actual spending on key basic services, similar to health, is likely to be even lower.

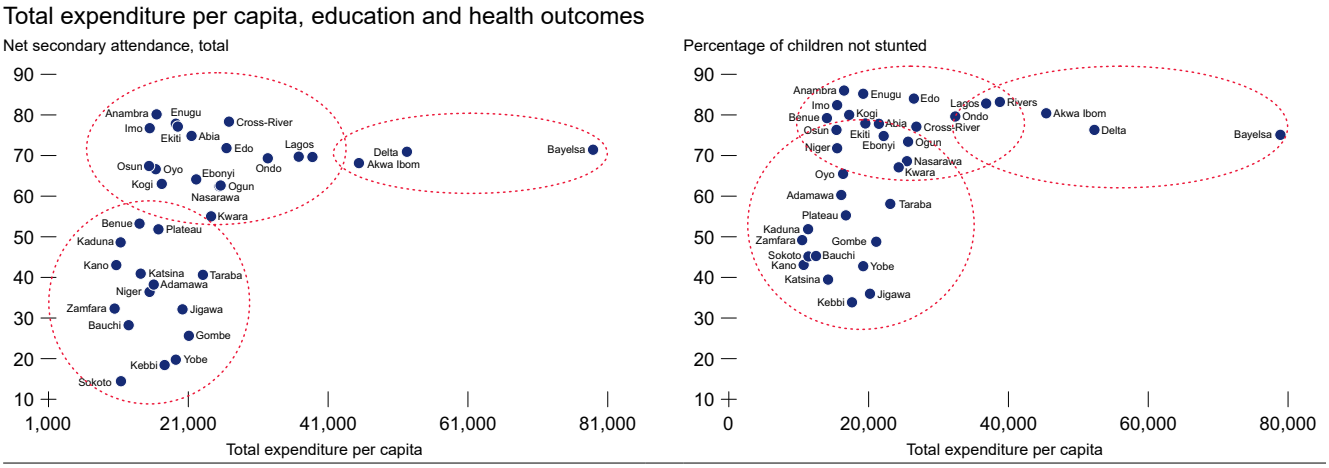
Budget allocation for education is higher than for health: states allocate an average of 16 percent of their budget for education, equivalent to about US$15 per person per year. Similar to health, there is a large difference across the states, with some states allocating as little as 5 percent of their total budget to education (translating to US$3 per person annually), and some states allocating nearly one-third (30 percent) of their total budget to education (US$30 per person per year). Unlike the health allocations, which are split fairly evenly between the recurrent and capital components, states allocate relatively more of the education resources for recurrent (63 percent of the education allocation) than the capital (37 percent) component.

Nigeria's spending on health would need to rise many times over, again reinforcing the importance of revenue generation. The total public spending allocation for health of US$15 per person (an upper estimate, combining both federal and state level budget allocation) falls short of what is needed. Nigeria's health allocation is only about one-third (31 percent) of Indonesia's—a comparable lower middle-income country, whose public health spending amounts to US$49 a year (World Bank, 2020). With states at the forefront of basic service delivery, much of this increase will be needed at the state level. Considering other spending priorities—education, infrastructure, and others—such an increase is simply not feasible without raising more revenues.

There is ample room for states to improve spending efficiency

States within the same region tend to cluster around similar levels of spending efficiency and outcomes. Based on efficiency and fiscal capacity (as reflected in revenue-sharing and relative size and strength of own-tax bases), it is possible to classify states into three groups (FIGURE 53): (i) the first has low spending and poor outcomes in terms of secondary school attendance rates (states in the North-East and North-West, and some from the North-Central region); (ii) the second has relatively higher expenditure and better outcomes (states in the North-Central, South-East, and South-West regions); and (iii) the third has even higher spending, but similar outcomes to group two (oil-producing states in the South-West and South-South). For example, despite reporting similar spending per capita (between ₦16,000 and ₦17,000), states in the South, such as Oyo and Anambra, present secondary school attendance

FIGURE 53. States with relatively higher expenditure and better outcomes are in the North-Central, South-East, and South-West.



Source: State Audited Financial Statements, NLSS 2018/2019, DHS 2018, and World Bank staff estimates.

rates (66.6 and 80.1 percent, respectively) significantly higher than Northern states, such as Adamawa and Plateau (38.1 and 51.8 percent, respectively).

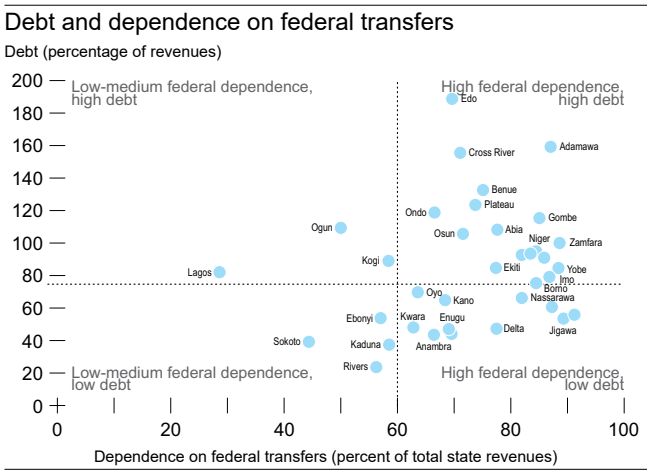
State fiscal sustainability is worsening, and debt levels are rising

Due to the lack of diversification and predictability of the states' revenue sources, an increase is seen in terms of exposure of the states that do not produce oil to the same oil shocks as the rest of the Federation. With most funds coming from federal revenue-sharing transfers, states are exposed to more macro-fiscal shocks than if they were less reliant on federal transfers.

States that do not produce oil, such as states in the North, not only have lower-than-average revenue per capita but also have more volatile revenue flows. When oil revenues contract, due to higher subsidy deductions or global oil shocks, these states are unable to rely upon other sources of revenue. This contributes to larger state and national fiscal deficits. Thus, most states, in absence of enough and poorly diversified bases of resources and inadequate financial management practices, have drawn on new debt and arrears.

In 2021, most states became more fiscally vulnerable. Despite a decline of oil revenues in 2021, the states' collective revenues saw a 10 percent increase due to an increase in VAT collection, of which they receive a majority share, and improved IGR performance. However, this aggregate increase masks considerable disparities among the states. Twenty-five out of 36 states have experienced a significant loss of revenue (e.g., there is an estimated reduction in Sokoto's and Kogi's revenues by 36 and 21 percent, respectively). Thus, the fiscal position of most states has worsened (FIGURE 54) and states' debt stock is estimated to have increased

FIGURE 54. Twenty-five out of 36 states are in a more vulnerable fiscal position.



Source: OAGF and World Bank.

by over 34 percent between 2020 and 2021 in nominal terms. The mounting petrol subsidy expected in 2022, at ₦5.4 trillion, will further complicate the fiscal sustainability outlook for all 36 states by reducing the Federation revenues.

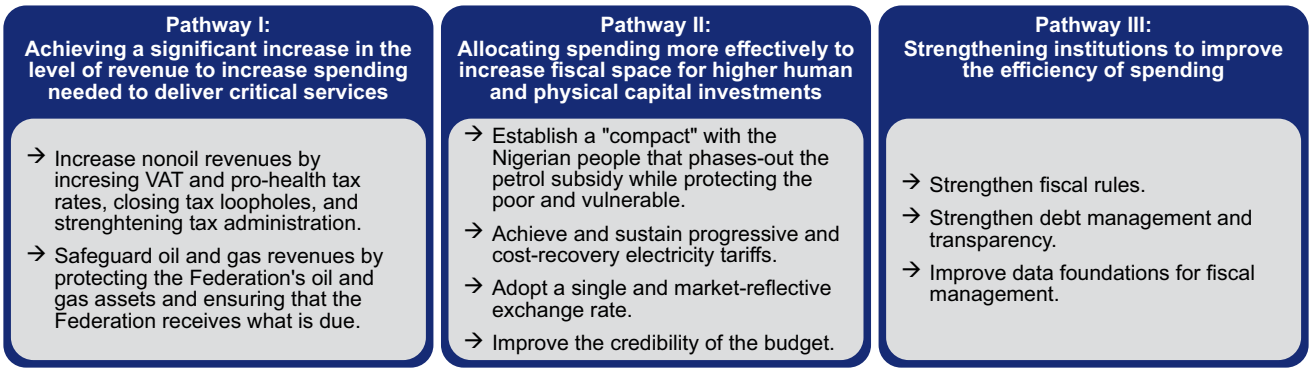
VI. Pathways to fiscal adjustment for better and sustainable results in Nigeria

Putting Nigeria on a sustainable fiscal path with improved service delivery requires a multi-pronged approach anchored around three interlinked and mutually reinforcing pillars (FIGURE 55). For each pillar, the public finance review suggests policy options that are both impactful and technically feasible, most of which can be implemented over the short to medium term. The proposed measures would create fiscal space for much-needed investments in human and physical capital while improving the quality of spending. Further details appear in the Annex.

First, Nigeria needs to significantly increase its revenues to finance critical public services. The top priorities for mobilizing revenues are to: (i) gradually increase tax rates, especially the VAT and pro-health excise rates on alcohol, tobacco, and sugary drinks, to bring them into line with international standards; (ii) require all oil and gas fiscal payments to be made in cash rather than in kind and transferred first to the Federation Account, thereby improving the governance of the oil sector; (iii) address loopholes in the current tax legal framework; and (iv) strengthen tax administration to encourage voluntary compliance, including for example by rationalizing tax incentives to the agriculture, pioneer, and financial sectors. While most of these reforms are the purview of the Federal Government, much can be done at the state level. For instance, states could mobilize property taxes more effectively, and widen the base for personal income taxes.

Second, improved spending allocation would free up fiscal space for the delivery of critical public services. In the short term, no other reforms are more important than to fully eliminate the petrol, electricity, and exchange rate subsidies and enable all tiers of government to use part of the savings to invest in much-needed human and physical capital, and to protect the poor and vulnerable with targeted programs. Public support for removing these harmful and inefficient subsidies can be gained by the establishment of a "compact" that combines the subsidy removal with the identification of key services and support programs (e.g., time-bound cash transfers for the poor) to be delivered with the savings, and a commitment to adhere to expenditure ceilings for general administrative expenditures, which currently absorb a high share of the total spending. Furthermore, strengthening budgeting preparation (e.g., more realistic revenue projections) and monitoring can result in better allocative decisions that enhance the overall efficiency of spending across all tiers of the government.

FIGURE 55. Fiscal pathways for better and sustained results in Nigeria.



Source: World Bank staff.

Third, Nigeria can strengthen its fiscal institutions and governance practices to improve accountability mechanisms, reduce costs, and mitigate fiscal risks. The Fiscal Responsibility Act (2007) sets several good practices—including deficit ceilings and limits to financing from the CBN—but the Federal Government has not fully adhered to these rules in recent years. Given Nigeria's current fiscal situation, there is a need to update the Fiscal Responsibility Act to introduce clauses to improve the adherence to fiscal discipline. This includes the specification of predictable and transparent transfers of oil and gas revenues to the Federation Account, ceilings on budget allocation to general administrative expenditure (e.g., wages), sanctions for breaking the fiscal rules, having a national outlook as part of the Medium-Term Expenditure Framework, and defining the fiscal balance holistically by considering the finances of government-owned enterprises. It would also be critical to enhance the use of the National Chart of Accounts and build good data foundations to better monitor fiscal performance. Better targeting of Federation transfers to the states would improve the efficiency of these transfers toward critical service delivery areas, where current transfers focus broadly on revenue sharing. Own-revenue powers would also benefit from strengthening, by allocating more potent revenue sources to the states and thereby reducing the vertical fiscal gap. Finally, improving debt management could also help reduce fiscal costs. This can be done by having deficit borrowing plans that are based on costs and other fiscal information, improving cash management practices to eliminate the reliance on CBN borrowing, and including CBN financing as part of the public debt stock.

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Annex: Detailed Policy Options

The policy options presented below are based on analytical and advisory work conducted by the World Bank, and consistent with the Government of Nigeria's 2021 Economic Sustainability Plan and the 2019 Strategic Revenue Growth Initiative.

POLICY OPTION	*TIMELINE (ST, MT, LT)**	*IMPACT ON FISCAL SUSTAINABILITY (M, H, VH)***
PILLAR I: ACHIEVING A SIGNIFICANT INCREASE IN THE LEVEL OF REVENUE TO INCREASE SPENDING NEEDED TO DELIVER CRITICAL PUBLIC SERVICES		
Increase non-oil revenues		
1. Increase the **Value Added Tax** rate and improve its collection: ‣ Increase the VAT rate from 7.5 percent closer to the regional SSA average of 15 percent by a 2.5-percentage-point increase every two years to control potential inflationary pressures and negative effects on demand. ‣ Re-introduce the VAT on petrol (Premium Motor Spirit or PMS), which was exempt in by the Federal Ministry of Finance. ‣ Allow input tax credits so that the VAT can function as a true consumption tax, and remove the current distortionary VAT exemptions for certain capital goods. ‣ Amend the VAT Act to clarify the charge to tax, e.g., provide a clear time and place of supply rules, and order of charge for VAT on excisable goods so VAT is due on the duty paid value.	MT/LT	VH
2. Raise **pro-health excise rates** to regional averages: ‣ Gradually increase excise rates on beer and tobacco. For instance, by 2024, the beer excise rate can be increased from ₦35 /liter to a rate equivalent to the Economic Community of West African States excise duty rate of 47.5 percent of the cost of goods, insurance, and freight. For tobacco, by 2024, the excise rate can be increased from ₦2.9 /stick to the Economic Community of West African States rate of ₦8.2 /stick. ‣ Gradually increase the excise on non-alcoholic beverages from ₦10 / liter to a rate that ensures a tax incidence of 20 percent ad-valorem. ‣ Gradually increase the excise on non-alcoholic beverages from ₦10 / Liter to a rate to ensure tax incidence of 20 percent ad-valorem by 2024. ‣ Amend legislation to ensure that excise rates increase each year in line with the CPI.	ST/MT	H

POLICY OPTION	TIMELINE (ST, MT, LT)*	IMPACT ON FISCAL SUSTAINABILITY (M, H, VH)**
3. Close legal **tax loopholes**: ‣ Issue a regulation that gives the Ministry of Finance the sole responsibility for granting tax expenditures. ‣ Legislate a comprehensive set of "source rules" covering all classes of income. ‣ Modernize and strengthen income definitons for non-resident withholding tax. ‣ Align taxation of indirect transfers of immovable property (including mining and petroluem rights) with international norms. ‣ Replace the current "fixed base" concept with the international norm of "permanent establishment". ‣ Update the Nigerian Model double tax treaty in line with the United Nations Model Convention, particularly Articles 12A and 12B. ‣ Include an anti-fragmentation rule to minimize tax evasion practices under the VAT and CIT.	ST	H
4. Strengthen **tax administration**: ‣ Rationalize tax expenditures granted to agriculture, pioneer, and financial sectors. ‣ Implement a risk-based selection system for selecting tax cases for audit. ‣ Improve excise tax administration, including the use of improved technology solutions and monitoring tools for excise stamps and physical controls. ‣ Design a comprehensive communication package that explains the benefits of paying taxes. ‣ Leverage technology and big data to expand the tax base and tax net.	MT/LT	M/H
Safeguard oil and gas revenues		
5. Safeguard the Federation's oil **and gas assets**: ‣ Amend the Petroleum Industry Act to specify that oil and gas assets belong to the Federation and will be transferred to the NNPC Ltd. when it pays the full market value for these assets.	ST	VH
6. Require oil and gas fiscal revenues to be transferred **first to the Federation Account**: ‣ Amend the Petroleum Industry Act and re-insert the language found in the Petroleum Industry Bill sent to the National Assembly in September 2020, which reads "The contracts shall be administered by the Commission and the Government revenues related to the contracts shall be paid to the Federation Account and verified by the Commission."	ST	H
7. Ensure that all oil and gas fiscal payments be **made in cash**: ‣ Amend the Petroleum Industry Act to remove references to tax oil, royalty oil, and production-sharing contracts, and retain only profit-sharing contracts, thereby ending all in-kind fiscal payments.	ST	VH

POLICY OPTION	TIMELINE (ST, MT, LT)*	IMPACT ON FISCAL SUSTAINABILITY (M, H, VH)**
PILLAR II: ALLOCATING SPENDING MORE EFFECTIVELY		
8. Establish a "compact" **that eliminates the petrol subsidy** while protecting the poor and vulnerable: ‣ Phase-out the petrol price subsidy over one or two years. ‣ Roll out a large-scale, targeted, and time-limited cash transfer program to mitigate the adverse effect of that roll-back on poor and vulnerable households. ‣ Identify, commit, and communicate to the public spending priorities for federal and state trust funds that are financed by savings from the elimination of the petrol subsidy.	ST	VH
9. Achieve and sustain **cost-reflective electricity tariffs** to fully eliminate the power subsidy: ‣ Maintain regular annual reviews of the Multi-Year-Tariff-Order, to reflect the actual cost of generating and delivering power in commercial tariffs. ‣ Regularly update the Power Sector Financing Plan to identify all potential uses of funds to settle current and historical electricity tariff shortfalls, define budgetary and non-budgetary sources of funds, and prevent any financing gap that may reverse the removal of the subsidy.	ST	H
10. Adopt a single and market-reflective **exchange rate**: ‣ Unify the current five FX windows into a single window to eliminate the exchange rate subsidy and reduce market distortions. ‣ Communicate a clear exchange-rate management strategy that builds credibility and improves the availability and accessibility of FX. For example, assure a well-defined schedule of regular FX auctions, apply pre-defined exchange-rate bands (with "circuit breakers") to control possible immediate overshooting, and limit CBN FX interventions to episodes of intense market volatility. ‣ Re-establish the FX interbank market and allow commercial banks to trade FX on their behalf, to allow for greater price discovery.	ST	H
11. Improve **budget credibility**: ‣ Publish a monthly report that tracks the cumulative (federal and state) budget execution rates relative to the original budget for each revenue and expenditure category. ‣ Limit the percentage growth to oil production in the budget to 10 percent of the average oil production in the preceding two years. ‣ Adopt a supplemental budget mid-year if there is more than a 10 percent deviation in revenue outturn. ‣ Reduce deviations between budgeted and actual expenditures to less than 15 percent, and impose penalties on ministries, agencies, and departments that surpass this threshold.	ST/MT	VH
12. Strengthen **public investment management**: ‣ Adopt guidelines for enhancing the appraisal and selection process for public investment projects, including the establishment of a single pipeline of appraised projects to ensure that only high-priority appraised projects are included in the budget. ‣ Publish project costs and multi-annual commitments as part of the budget. ‣ Adopt methodologies for determining maintenance needs and related budget costs.	MT/LT	M

POLICY OPTION	*TIMELINE (ST, MT, LT)**	*IMPACT ON FISCAL SUSTAINABILITY (M, H, VH)***
PILLAR III: STRENGTHENING INSTITUTIONS TO IMPROVE THE EFFICIENCY OF SPENDING		
13. Strengthen **fiscal rules**: ‣ Introduce sanctions (and escape clauses) for breach of fiscal and debt rules specified in the 2007 Fiscal Responsibility Act. ‣ Consider re-formulating the 3 percent deficit limit in the 2007 Fiscal Responsibility Act with a focus on the non-oil sector to minimize oil-revenue-related fluctuations.	MT	H
14. Strengthen **debt management and transparency**: ‣ Limit the amount of CBN financing (Ways and Means) available to the Federal Government to no more than 5 percent of the previous year's collected revenues as per the 2007 CBN Act. ‣ Issue regulations to prioritize treasury bills to finance fiscal shortfalls over CBN financing. ‣ Publish the Annual Borrowing Plan along with the budget. ‣ Restructure the borrowing by the Federal Government through Ways and Means Advances at the CBN and publish the stock of outstanding Federal Government debt to the CBN every quarter.	ST/MT	H
15. Improve **data foundations** for fiscal management: ‣ Update the Open Treasury Portal with federal and state in-year budget execution data within 30 days of the end of the quarter/month. ‣ Publish FAAC reports within 30 days of the end of the month. ‣ Publish oil revenues and payouts on websites of the NNPC Ltd., the Commission, and NEITI every month.	MT	M

* The timeline horizons are defined as: ST (short term, 0–12 months), MT (medium term, 1–3 years), and LT (long term, more than 3 years).
** The impact of fiscal sustainability can be categorized as: M (moderate, expected reduction in an annual consolidated fiscal deficit of <0.3 percent of GDP over the medium term); H (high, expected reduction in an annual fiscal deficit of 0.3–0.6 percent of GDP over the medium term); and VH (very high, expected reduction in an annual consolidated fiscal deficit of more than 0.6 percent of GDP over the medium term).

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