Economic performance of nigeria

CHAPTHER ONE

1. 1 BACKGROUND OF STUDY

One of the biggest challenges for oil-producing countries is how to use its oil wealth strategically to promote sustainable growth, for example, in Nigeria, the massive increase in oil revenue as an aftermath of the Middle-East war of 1973 created unprecedented, unexpected and unplanned wealth for Nigeria. Then began the dramatic shift of policies from a holistic approach to benchmarking them against the state of the oil sector. Now, in order to make the business environment conducive for new investments, the government began investing the newfound wealth in socio-economic infrastructure across the country, especially in the urban areas (Adedipe, 2007). Over the past three decades, gulf cooperation council (GCC) countries have generally followed procyclical fiscal policies to changes in oil revenue. Following the sharp increase in global oil prices in the 1970s and early 1980s, government spending in all these countries rose as fast as oil revenue through a massive public investment program in infrastructure, fiscal incentives to develop the industrial sector, and the adoption of a generous welfare system.

Notwithstanding the increase in spending, sizable overall fiscal surpluses were recorded in all GCC countries during those years, leading to a sharp accumulation of official asset. The existence of large foreign official assets facilitated a relatively low level of adjustment in spending in the period 1980-86, when crude oil prices declined significantly. Concerns for sustaining domestic demand in order to stave off a sharp reduction in non-oil growth has usually militated against significant fiscal adjustment in the face of falling oil prices in GCC countries. Spending was only cut by the equivalent to

about half the fall in total revenue in Saudi Arabia, 20 percent in the United Arab Emirates, and 10 percent in Qatar. Facilitated by the completion of major infrastructure investments, the cutbacks fell mostly on outlays for projects, while current expenditure rose in all these countries, except in Saudi Arabia. In Bahrain and Kuwait, spending continued to rise across the board. In contrast, in Oman, lower oil revenue was more than offset by higher investment income and fees and charges, leading to a further increase in expenditure in the period (Fasano, 2000).

According to Piana (2001), Public expenditure is the value of goods and services bought by the State and its articulations. It plays four main roles: contributes to current effective demand, expresses a coordinated impulse on the economy which can be used for stabilization, business cycle inversion, and growth purposes, increases the public endowment of goods for everybody and gives rise to positive externalities to economy and society, the more so through its capital component.

According to Ely and Wicker (2002), government expenditure can be classified into the following: The direct cost of national defence includes the pay and equipment of troops, and the cost of ships, and cannon, and ammunition, etc. The indirect cost is represented by the pension list, as well as by the great waste of resources and opportunities for labor in times of war, expenditures for internal security includes the cost of our police system in all its branches, and that of our judiciary system, since both of these are occupied almost wholly in securing persons and property from injury, expenditures for the poor and unfortunate, that is, every advanced government recognizes an obligation to extend relief to paupers, to the deaf,

the blind, the insane, and the feeble-minded, who, from natural defects, are unable to hold their own in the struggle for existence, expenditures for fulfilling the commercial functions and expenditures for fulfilling the developmental function. All these cumulate into improving the economic performance of a country. The economic performance of any nation is measured by the rate of growth of its gross domestic product (GDP).

According to Piana (2001), public expenditure has an immediate impact on GDP. An increase of public expenditure raises GDP by the same amount, other things being equal. Moreover, since income is an important determinant of consumption, that increase of income will be followed by a rise in consumption: a positive feedback loop has been triggered between consumption and income, exactly as in the case of shocks in export, investment or autonomous consumption. In more microeconomic terms, public expenditure may be directed to consumer goods and thus substitute families' expenditure, as with the case of health drugs. By contrast, in other cases, as with education, public expenditure may trigger further consumption (books and all the other goods whose consumption depend on culture levels).

According to World Bank (2006), gross domestic product is the sum of gross value added by all resident producers in the economy plus any product taxes (fewer subsidies) not included in the valuation of output. It is calculated without deducting for depreciation of fabricated capital assets or for depletion and degradation of natural resources.

1. 2 STATEMENT OF THE PROBLEM

An economy's growth is measured by the change in the volume of its output or in the real incomes of its residents (World Bank, 2006). Therefore, oil exporting countries are said to experience growth due to large influx of income or revenue derived from exports and an opportunity to increase public spending, but most oil exporting countries have poor public sector management, that is, they have had difficulty managing funds with rigid operational rules, as tensions have often surfaced in situations of significant exogenous changes or with shifting policy priorities. Earmarking the resources of oil funds for specific uses, and allowing extra budgetary spending by the funds can complicate fiscal and asset management and reduce efficiency in the allocation of resources. Transparency and accountability practices for funds differ across Organisation of Petroleum Exporting Countries (OPEC) (International Monetary Fund, 2007). This leads to fall backs in the real gross domestic income.

This research hopes to show the relationship between revenue from oil exports, overall expenditure and changes in output levels in Nigeria.

1. 3 SCOPE OF THE STUDY

The scope of the study is on the economic performance of Nigeria. The data used will be obtained from the publication of statistical bulletin of Central Bank of Nigeria (CBN), International Monetary Fund (IMF), and Organisation of Petroleum Exporting Countries (OPEC). It covers the GDP relative to oil exports, public expenditure rates and value of oil exports.

1. 4 RESEARCH QUESTIONS

In the light of the above, this study is set to provide solutions to the following problems: what is the relationship between oil revenue and government expenditure, what is the relationship between oil revenue and economic performance, and does the way government spends affect the growth level of the country.

1. 5 OBJECTIVES OF THE STUDY

The main objective of the study is to show interrelationship between public expenditure, oil revenue and economic performance in Nigeria. The specific objectives are to:

1. Investigate the effects of oil receipts to the performance of an economy;
2. Highlight the relationship between oil receipts and public expenditures; and
3. Show the significance of increasing public expenditures to growth of an economy.

1. 6 RESEARCH HYPOTHESIS

In line with the objectives stated above, the following hypothesis shall be tested:

H0: there is no significant relationship between oil revenue and economic growth

H1: there is a significant relationship between oil revenue and economic growth

H0: there is no significant relationship between government expenditure and economic growth

H1: there is a significant relationship between government expenditure and economic growth

1. 7 SIGNIFICANCE OF THE STUDY

This study is very important and paramount because of the importance of the subject matter on explaining the determinants of economic growth and development in Nigeria.

1. 8 RESEARCH METHODOLOGY

The study focuses on the relationship between oil revenue, public expenditure and economic performance in Nigeria and due to the nature of the study, secondary data will be used. To carry out an econometric analysis of the study, the Ordinary Least Square (OLS) estimating techniques will be used because it possesses a unique property of Best Linear Unbiased Estimator (BLUE) when compared to other estimating techniques. The OLS method also possesses the desirable properties of un-biasness, consistency, and efficiency.

Other parametric tests (such as T-test, F-Test, Durbin-Watson, and others) would also be engaged as research instruments in providing detailed explanations to the results obtained with respect to the hypotheses afore stated.

1. 9 SOURCES OF DATA

As a result of the format of the research work, secondary data will be used. The data will be obtained from publications of International Monetary Fund,

World Bank Development Data center, Statistical data of Central Banks, OPEC.

1. 10 DEFINITION OF SOME TERMS

Gross domestic product (GDP): the sum of gross value added by all resident producers in the economy plus any product taxes (less subsidies) not included in the valuation of output.

International Monetary Fund (IMF): established to promote international monetary cooperation, facilitate the expansion and balanced growth of international trade, and promote exchange rate stability.

The World Bank: established as a development bank, providing loans, policy advice, technical assistance, and knowledge sharing services to low- and middle-income countries to reduce poverty.

Public Expenditure: is the value of goods and services bought by the State and its articulations.

CHAPTER TWO

LITERATURE REVIEW

2. 1 INTRODUCTION

The objective of this chapter is to examine theoretical and empirical literature on the determinants of economic growth and development in Nigeria through the relationship of oil revenue and public expenditure. To this end, the rest of this chapter is organized as follows: Section 2. 2 focuses on the relationship between public expenditure, oil revenue and economic growth in other countries, such as, United Arab Emirates, Saudi Arabia, and

Venezuela. Section 2. 3 focuses on the relationship between public expenditure, oil revenue and economic growth in Nigeria.

2. 2 PUBLIC EXPENDITURE, OIL REVENUE AND ECONOMIC GROWTH IN OTHER COUNTRIES

Gulf Cooperation Council (GCC) countries have consistently recorded overall fiscal deficits since the early 1980s after oil prices peaked in 1979-81. In addition, with oil revenue accounting for about three-quarters of government revenue in most of these countries, fluctuations in crude oil prices have led to volatile revenue and swings in spending.

Following the sharp increase in global oil prices in the 1970s and early 1980s, government spending in all these countries rose as fast as oil revenue through a massive public investment program in infrastructure, fiscal incentives to develop the industrial sector, and the adoption of a generous welfare system. The existence of large foreign official assets facilitated a relatively low level of adjustment in spending in the period 1980-86, when crude oil prices declined significantly.

Concerns for sustaining domestic demand in order to stave off a sharp reduction in non-oil growth has usually militated against significant fiscal adjustment in the face of falling oil prices in GCC countries. Spending was only cut by the equivalent to about half the fall in total revenue in Saudi Arabia, 20 percent in the United Arab Emirates, and 10 percent in Qatar. Facilitated by the completion of major infrastructure investments, the cutbacks fell mostly on outlays for projects, while current expenditure rose in all these countries, except in Saudi Arabia. In Bahrain and Kuwait, spending continued to rise across the board. In contrast, in Oman, lower oil revenue

was more than offset by higher investment income and fees and charges, leading to a further increase in expenditure in the period.

According to Elhiraika and Hamed (2001), economic growth and development in the United Arab Emirate is as a result of government investment in physical and social infrastructure which helped to boost economic activity in general and private investment in specific, a stable macroeconomic environment, which is characterized by low inflation rates and semi-fixed exchange rate, and government policies, availability of capital and absence of restrictions on capital movement together with a high degree of openness opened the door for remarkable growth in foreign trade.

With widely fluctuating and generally declining oil prices and revenues in the last two decades, the country has since the mid 1980s exerted notable efforts aimed at achieving economic diversification. These efforts have led to sustained investment in the non-oil sectors, especially in manufacturing and other sectors that are increasingly dominated by private capital. By the turn of the 1990s, non-oil exports and non-oil GDP have exceeded their respective oil counterparts for the first time since the oil evolution began. As a result, the UAE economy has been recently classified as the most relatively well diversified economy in the gulf region (Askari and Jaber, 1999) with an average real GDP growth rate of about 5% for the period 1975-1999.

The period from the mid 1970s to the early 1980s was characterized by high growth performance. This was the period when the government directed the surpluses from high oil prices into the physical and social infrastructure. The period from around mid 1980s witnessed significant reduction in economic

growth due to a sharp drop in oil prices. Subsequent government austerity measures were directed largely toward capital expenditure for two reasons. First, most of the basic infrastructure projects had by then been completed, and second, most of the current expenditure categories have become long term commitments.

The gross domestic investment rate was 34. 1% in the 1970s period, declined to 25. 6% in the 1980s before rising to 29. 5% in the 1990s period. The UAE average growth rate for the whole period is well above that achieved by other Gulf Cooperation Council countries. A notable aspect of domestic investment is the fact that although public investment continues to dominate, the share of private investment has generally been rising remarkably, especially in the 1990s period. Private investment rose from 6. 6% of GDP in the 1975-85 period to 11. 7% in 1996-98.

Meanwhile, the share of petroleum investment in aggregate investment declined from the average of 36% in 1975-89 to 17. 7% in 1990-98. While public investment is concentrated on infrastructure and services sector, most of private investment is in the services and real estate sectors. In explaining the private investment behavior in the UAE, Elhiraika and Hamed (2001: 13) found that in the long-run, GDP has the largest stimulating influence, followed by bank credit to the private sector and a human capital development variable. The real lending rate and government investments are found to have strong but adverse effects on private investment. In the short-run, GDP, bank credit and investment in human capital still have positive but weak effects on private investment behavior, whereas the lending rate and government investment variables still have significant

negative coefficients. The expansion of private investment, both domestic and foreign, is supported by the creation of industrial zones that provide a variety of facilities and services at attractive prices.

Sharp rises in non-oil exports that jumped from the average of 19. 8% of total exports in 1975-1985 to 61. 5% in 1996-1998. By 1992, non-oil exports exceeded oil exports for the first time amounting to about 40% of GDP. The increases in exports are mainly due to re-export. The UAE is the third largest re-export center in the world, after Singapore and Hong Kong. Again liberal trade, absence of capital controls, exchange rate policy, low tariff rates and absence of income taxes may be considered as the major factors contributing to the expansion of the non-oil export sector. A major weakness of the non-oil export sector is the dominance of re-exports over exports. This reflects a rather weak domestic production base than what the trend of total exports suggests. Between 1982 and 1999, re-exports accounted for about 88% of total exports. The re-export sector is expected to face fierce competition from the free trade zones that are rapidly developing in the region, especially in Oman that has a relative advantage in terms of having seaports that are closer to major sea routes. Therefore, sustainable growth in the no-oil export sector would require increased domestic production of export goods. Increased investment in human capital has led to notable increases in the primary and secondary school enrollment ratios, from less than 40% in the 1970s to about 80% in the 1990s. Besides the increased education of the local labor force, educated foreign labor is easily accessible given the relatively high wages paid in the UAE compared to other labor surplus countries in the Middle East and Asia. Immigrant labor accounts for

about 70% of the labor force in the country and are generally better educated than the local population.

In spite of high fluctuations in oil price and revenue that lead to similar, though smaller fluctuations in real GDP, the UAE economy remained remarkably stable in terms of inflation rates and the exchange rate. Since 1981, the UAE dirham has been fully pegged to the US$ at the rate of 3. 67 and the inflation rate never exceeded the average of 2. 5% over the period considered. It is believed that because oil is priced in US dollars and because the UAE has huge investments in the US the benefits from the peg in terms of economic stability and reduced macroeconomic uncertainty is greater than the cost arising from inability to use exchange rate policy to promote domestic investment and international competitiveness. There is no hard statistics to support or negate this argument. Since the turn of the 1990s, the consolidated budget (including the federal government and emirates governments) has experienced sustained deficits.

According to Hamed and Elhiraika (2001), The UAE government does not rely on fiscal policy tools in achieving macroeconomic stability. Rather it relies mainly on monetary policy tools, particularly the link between the Dirham and the U. S. dollar, to maintain macroeconomic stability, and that the governments of the dominant emirates finance their budget deficits by drawing down their own abundant overseas assets, thereby eliminating inflationary pressures, and avoiding crowding out of private sector activities. This suggests the absence of any important link between macroeconomic performance and the budget deficits, but government spending undoubtedly stimulates private economic activity.

According to Siddiqi (1999), in Saudi Arabia, the hydrocarbon sector contributes over 40 percent of the Saudi GDP, and generates 80 percent of government revenues and total export earnings respectively. The slump in oil revenues – by over a third in 1998 – has led to ballooning twin deficits on the balance of payments and budget, amid a general slowdown in government and consumer spending, as well as falls in fixed investment in the non-oil private sector. The economy, after expanding in 1996-97, may experience a negative growth in nominal GDP for the first time in five years. However, the IMF projects a real GDP growth of 0. 4 percent, compared with 2. 7 percent in 1997. Total earnings of Saudi banks in the year to September rose 11 percent. This indicates that the business sector after two years of higher liquidity remains in a relatively sound position. But a sustained weakening of world oil prices will sooner or later have deflationary effects on key economic sub-sectors. The economy has benefited from a subdued inflationary environment with consumer price increases averaging only 1. 4 percent annually from 1990-98. Zero inflation, projected in 1998, reflects slowing domestic demand, lower non-fuel commodity prices, and cheap Asian imports. A stable/firmer Saudi Riyal (SR) has contained imported inflation. The Washington-based Petroleum Finance Corporation (PFC) projects a budget deficit in 1998 of SR50 billion, or 10 percent of GDP, the highest in a decade, compared to a low of SR6 billion in 1997. As a result, a mildly tighter fiscal policy is now in place; public sector recruitment and salaries are frozen and all ministries have been ordered to curtail spending by 10 percent. Some capital projects and military programmes have either been scaled-down or postponed and the payments period on state contracts has been extended to six months. The government has implemented

measures for dealing with revenue shortfall and to cushion the impact on the kingdom’s indigenous 12 million plus population. Government spending – a key determinant of business confidence – has been sustained by issuing Saudi Special Government Bonds (SSGBs), worth about SR14 billion in the year to October. These SSGBs can be sold by contractors to local banks at a discount. The kingdom’s domestic debt, already exceeding 100 per cent of GDP, has increased further because of increasing issuance of Development Bonds and Treasury bills mainly to banks and state pension/social security funds. The well-capitalised Saudi banking sector, with a capital asset ratio of 11. 4 percent, is strongly-positioned to meet credit demands from state and private sectors. Analysts say about SR19 billion of shortfall can be covered by domestic borrowing and cutting public expenditure (mostly on defence).

In Venezuela, the first commercial drilling for oil occurred in 1917 and by 1928; it was a leading exporter of oil (United States Library of Congress, 82). During this period Venezuela can be characterized as a dictatorship. By 1930, oil represented 90% of the export revenue in Venezuela. In 1948 a fifty percent royalty rate was introduced. This royalty rate revenue was to be used in “ sowing the oil” to stimulate agriculture primarily and later industry. Prior to oil the coffee industry had been the main export in Venezuela. Oil revenues had clearly taken first place in Venezuela however the country’s people remained relatively poor. A democratic government took power in 1958 and swiftly intervened in the economy using the oil revenues. In 1960 the government made two significant movements; it began to create regional development corporations to decentralize planning and it became one of the founding members of OPEC. Throughout the 1960s Venezuela

spent money on education, health, electricity, portable water, and other basic projects. This led to a 25% increase in per capita income by 1973. However when the world price of oil soared during the seventies and so did the Venezuelan government’s spending. In the years between 1973 and 1979 the government spent more than it had since its independence in 1830. The oil industry was nationalized in 1976. Government spending steadily increased because of increased surges in oil revenue. Negative growth rates characterized Venezuela during 1980-1982. By 1983 oil revenues could no longer support the spending on government subsidies, price controls, exchange-rate losses, and the operations of more than 400 public institutions. In 1983 the government attempted to reform the economic downturn through devaluations of the currency and a multi-tier exchange-rate system. However, this did little to stall the impending crisis and the 50% reduction in the price of oil in 1986 did nothing to help the situation. In 1989 the IMF stepped in with loans and the price increases related to the reforms necessary for the loans caused rioting and the worst violence the country had seen since it became a democracy. The increase in the price of oil in the 1970s caused Venezuela to be affected negatively although its peak oil production point had already been reached in 1970.

Because of the increase in the price of oil the government relied completely on oil revenue and like Mexico, was reluctant to take steps to prevent a crisis. The IMF had to impose the increases in domestic prices necessary to complete the cycle that played out. Protectionism through government subsidies and spending held domestic prices low enough to remain competitive imports. In this sense Venezuela was escaping Dutch Disease.

However, these prices were supported not through true market value but through borrowing and extra revenue. As soon as those avenues shut down so did the government’s ability to control domestic prices. The sudden jump in prices imposed by the IMF caused a recession so severe that rioting was induced. Another case of the lack of value-added industry creation led to the eventual downfall of an economy given the opportunity to grow.

Bourguignon and Gelb (1988) suggest that the stagnation of the Venezuelan economy started after 1978, coinciding with the second oil shock in 1979. According to their calculations, the non-oil sector did not seem to gain from the 1970s windfall. They further argue that inappropriate economic policies resulted in steep declines in private investment and massive capital flight. Combined with a large upsurge in consumption during the decade of revenue windfall, these effects meant that Venezuela was subject to severe internal and external imbalances that ultimately lead to its decline in economic performance.

2. 3 PUBLIC EXPENDITURE, OIL REVENUE AND ECONOMIC GROWTH IN NIGERIA

According to Adedipe (2004), by the time Nigeria became politically independent in October 1960, agriculture was the dominant sector of the economy, contributing about 70% of the Gross Domestic Product (GDP), employing about the same percentage of the working population, and accounting for about 90% of foreign earnings and Federal Government revenue. The early period of post-independence up until mid-1970s saw a rapid growth of industrial capacity and output, as the contribution of the manufacturing sector to GDP rose from 4. 8% to 8. 2%. This pattern changed

when oil suddenly became of strategic importance to the world economy through its supply-price nexus, Crude oil was first discovered in commercial quantities in Nigeria in 1956, while actual production started in 1958. It became the dominant resource in the mid-1970s. On-shore oil exploration accounts for about 65% of total production and it is found mainly in the swampy areas of the Niger Delta, while the remaining 35% represents offshore production and involves drilling for oil in the deep waters of the continental shelf. Nigeria has proven reserves of about 32 billion barrels of predominantly low sulphur light crude, which at current rate of exploitation could last another 38 years. The intention is to expand the reserves to 40 billion barrels and production capacity to 4 million barrels per day (mbd). The massive increase in oil revenue as an aftermath of the Middle-East war of 1973 created unprecedented, unexpected and unplanned wealth for Nigeria. Then began the dramatic shift of policies from a holistic approach to benchmarking them against the state of the oil sector. Now, in order to make the business environment conducive for new investments, the government began investing the newfound wealth in socio-economic infrastructure across the country, especially in the urban areas. As well, the services sector grew. This shows that as government increased as a result of increases from oil, government expenditure also increased.

The Nigerian labour market has been characterized by high rate of unemployment, low wage and poor working conditions. This unwholesome situation evolved after the oil boom of the 1970s and remained so till date. Prior to the oil boom, the Nigerian economy was largely agrarian and about 70% of the working population was engaged in agricultural activities in the

rural areas. Wage rates were also comparable to international standards and the average Nigerian worker could afford decent living. In the 1960ies, the emphasis of employment policies was that of shifting labour from the agricultural sector to the manufacturing sector. This appeared to be the natural path of economic growth and development, following the experienced of the developed countries. However, the Nigerian peculiarities of land tenure system, tenancy and the very rudimentary processes of farming made it extremely difficult to deploy substantially advance technology in the sector. Moreover, at that time economic policies concentrated more on the development of the manufacturing sector, under the much touted “ import-substitution strategy”. Rather, labour moved from the agricultural sector to the services sector, with little productivity gains. Both agriculture and manufacturing lost out. The oil boom started the rural-urban drift of the population, depleting the rural population and adversely affecting agricultural output. Rising revenue profile of Governments created the illusion that job creation is a primary function of the public sector. Nigerian Governments embarked on ambitious expansion programmes in secondary and tertiary education. Quality research could be conducted, as adequate funding support was available.

Education was strictly treated as a social service, which should be provided at little or no cost to the beneficiaries as a matter of right. This mindset precipitated the crisis of 1978, when the Federal Government introduced tuition fees in its universities. The decrease in oil revenue affected funding of tertiary education, necessitating a policy shift that has been difficult for the operators of the system to come to terms with. Attempts to raise fees are

being resisted, while the private sector funding support that could lessen the burden is not forthcoming. In particular, the curriculum design of many of the institutions is dated and not so relevant to the needs of prospective employers. Most of the products therefore, end up in the labour market and have difficulty securing jobs because they need further training to be able to fit properly into the corporate world. The weak economy itself choked out several business enterprises and curtailed employment opportunities. Staff retrenchment became pervasive, starting first in the private sector and later the public sector.

CHAPTER THREE

THEORETICAL FRAMEWORK AND METHODOLOGY

3. 1 INTRODUCTION

In previous chapters of this study, we looked at how the relationship between public expenditure and oil revenue affect growth in Nigeria and other oil exporting countries. Based on these reviews, one would know the level of importance attached to them, being an important macroeconomic issue that affects the pace of growth and development of an economy.

Therefore, in this chapter of the study, we shall be looking at the various theories of the subject matter as propounded by different schools of thought. We shall be placing oil revenue and public expenditure in a functional relationship to see their level of significance to economic performance of Nigeria. To this end, this chapter is divided into the following sections. Section 3. 1 is the introductory part while 3. 2 focuses on the theoretical background, 3. 3 focuses on methodology while 3. 4 is concerned with the sources of data and the type of data used in the study. Section 3. 5 is

concerned with the estimation technique of the model that shall be stated in the study.

3. 2 THEORETICAL BACKGROUND

In this part three different models of economic growth will be introduced, Solow's neo-classical theory, endogenous growth model and Harrod-Domar model.

3. 2. 1 Solow's Neo-classical Theory

The Solow theory believes that