NGF-SFTAS Policy Brief Series

HOW REALISTIC ARE STATE GOVERNMENTS' BUDGETS IN NIGERIA?

Evidence from the States' Fiscal Transparency, Accountability and Sustainability (SFTAS) Programme for Results Annual Performance Assessment (APA) Reports for FY 2018 and FY 2019

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Background

Public Financial Management (PFM) remains a core focus for several public sector reforms initiated at both Federal and State level over the years. Development partners have provided support in form of budget support facilities and technical assistance by way of capacity building. This is not surprising given the pivotal role PFM reforms have played as policy instruments in shaping the fiscal environment and behaviour of government – how it responds and how resilient it becomes to macroeconomic shocks, mostly occasioned by the heavy dependence on oil revenue which accounts for no less than 60 percent of total government revenues.

A central objective that underpins most of the interplay between revenue, expenditure and debt management reforms adopted by the government is "Budget realism". Regardless of whether a budget is prepared as an annual budget or medium-term budget, every government strives to develop a financial plan it can execute. This is predicated on the simple notion that "one cannot spend what one does not have". In other words, the government should align its financial planning, development priorities and eventual execution with its fiscal capacity.

A budget is a financial plan that allocates government resources to achieve stated policy objectives. Regardless of whether a budget is prepared as an annual budget or medium-term budget, every government strives to develop a financial plan it can execute. This is predicated on the simple notion that "one cannot spend what one does not have".

Attaining budget realism goes beyond the planning stage of budgeting as it extends to the process of actual execution which if done incorrectly can still make a well-prepared budget unrealistic with huge budget deviations recorded in implementation. Budget realism warrants government to plan with realistic revenue projections (relying more on permanent revenues which represent an expected long-term average income), embrace good cash planning and expenditure prioritization, adopt procurement practices that guarantee greater efficiency in expenditure execution and consider expenditure rationalization where necessary to keep debt stock at a sustainable level. This chain of reforms is expected to reduce waste, expenditure inefficiencies; thereby promoting a more prudent and development-focused spending.

Unfortunately, the government especially at State-level have consistently over the years undertaken increased permanent expenditures both in planning and execution, both of which are primarily based on temporary increases in revenue triggered by periodic increases in oil revenues.

Also, it has always been the practice for State governments' budget to increase annually regardless of whether government revenues increase proportionately or not. This practice (most times motivated by political considerations and unhealthy competition) has threatened the objective of budget realism for a long time.

The World Bank Supported States Fiscal Transparency, Accountability and Sustainability (SFTAS) Programme for Result being implemented across all 36 States in Nigeria seeks to promote amongst the States – Improved fiscal transparency and accountability, strengthened domestic revenue mobilization, Increased efficiency in public expenditure and Strengthened debt sustainability. All of which speaks to strengthening different stages of budget preparation, execution and more broadly budget realism in the context expressed thus far.

Budget Realism Considerations[1]

For a budget to be realistic, State governments must ensure:

a. **Realistic and reliable revenue forecasts are adopted:** State Governments' budget must be based on a realistic forecast of all sources of revenue – both external (e.g. allocations from Federation accounts, grants, loans, and borrowing) and internal (e.g. taxes, fees and charges, and existing funds). The revenue performance of previous years provides a State an indication of how realistic its revenue forecasts have been, especially for more permanent revenues like taxes, fines, levies and fees which are less volatile than oil revenues. It is important that State governments have and work with reliable data, information, and scientifically driven and proven analytical methodologies.

b. **Its total expenditure does not exceed projected revenue*:*** Total capital and recurrent expenditure on programmes, activities and projects must not exceed the sum of projected revenue and other available funds. Where deficit financing is explored, credit facilities should have already been secured or at an advanced stage of procurement. However, it is advisable that State governments, especially those with high debt stock and mounting liabilities as well as contractor arrears consider expenditure rationalization as a planning approach for its expenditures.

c. **It reflects priorities.** Budgets must reflect government priorities and should be diligently implemented and monitored. This extends to government cash and liquidity planning strategies. It is important that programmes and projects core to the State's development plan or unique exigencies (e.g., COVID-19) that may arise are a priority on its financing plan.

d. **Planned priorities reflect collective ownership:** The budget in terms of planning and execution must reflect approved plans and expenditures by the people's representatives (the legislature) and ultimately the existing social contract with the citizens. The latter represents government's promise to the people, input from citizens during budget consultation and civil society groups that advance the cause of various interest groups.

e. **It is clear and will ease re-planning as necessary:** Budgets should be clearly structured with the budget classifications in line with the approved national chart of accounts for easy monitoring and expenditure re-planning. Poor monitoring because of poor budget implementation reporting have led to government undertaking duplicate programmes/projects across Ministries, Departments, and agencies (MDAs). With good

[1] Adaptation from "How to prepare realistic Budgets: A Step-by-Step Guide document prepare by SPARC, April 2016.

budget implementation reports, Government can eliminate "unfunded" positions in the budget and re-prioritize funding to other programs/projects.

Where are States on attaining budget realism?

A retrospective look at States FY18 and FY19 Budget Implementation.

The SFTAS Annual Performance Assessment (APA) is conducted annually with an Independent Verification Agent (IVA) conducting an independent assessment of States' performance across the annual Eligibility Criteria (EC) and Disbursement Linked Indicators (DLIs)/ Disbursement Linked Results (DLRs). Thus far, two APA exercises (2018 and 2019) have been conducted and results published. The evidence shared below is for all 36 States irrespective of their eligibility status during the assessment periods. Note that 24[2] States and 32[3] States passed the eligibility criteria for both years respectively.

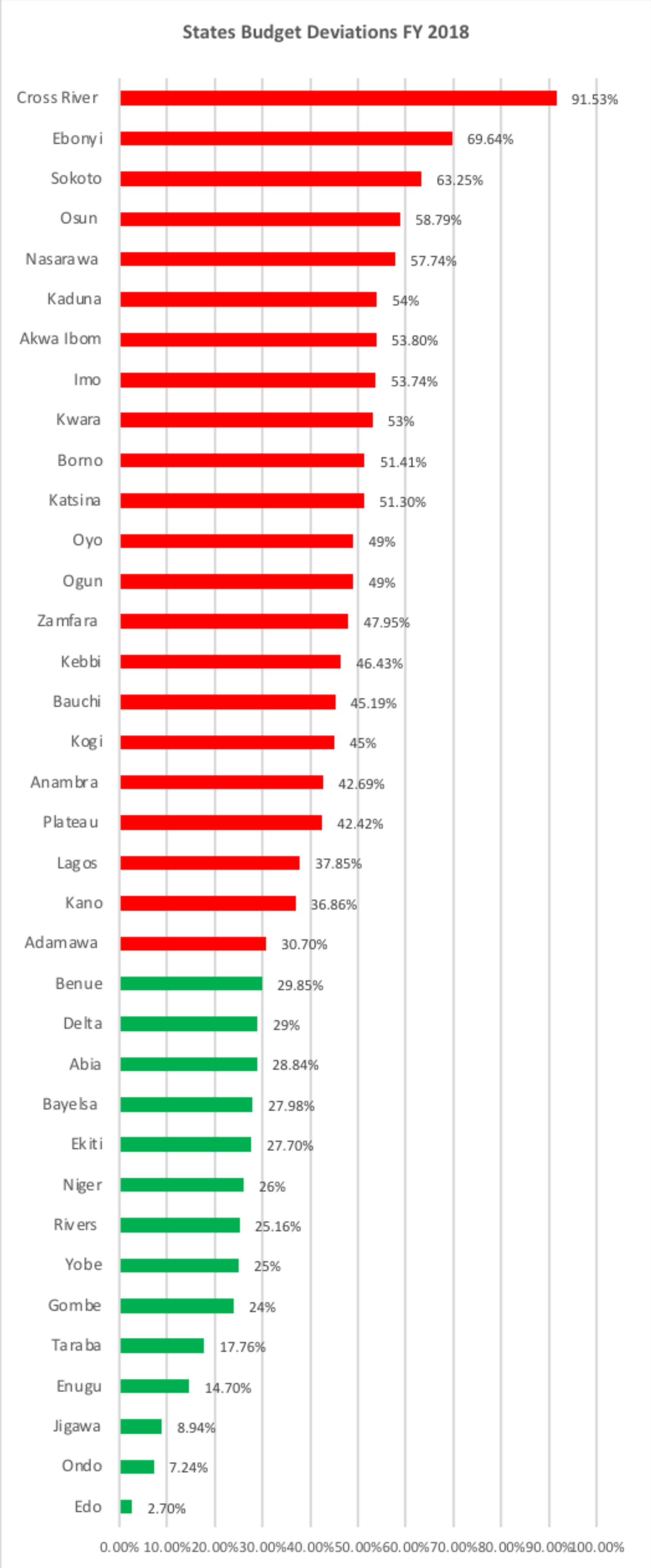
States' performance on Disbursement Linked Result (DLR) 1.2 which assesses the level of deviation of actual government expenditure from planned expenditure raises critical questions around State governments' commitment to achieving budget realism and budget credibility[4]. A detailed review of States' budgets for FY 2018 and FY 2019 suggests a practice by State governments to 'balance' unrealistic budget by including sources of funding, such as grants and loans that will likely not materialize instead of consolidating its expenditures to fit attainable revenue level. This invariably impacts budget execution negatively.

When budgets are not implemented as planned, spending priorities will have to shift, desficits may exceed projections, and the delivery of critical basic services may be compromised.

DLR 1.2 requires that the deviation for total budget expenditure be less than 30% for FY 2018 and 25% for FY 2019, respectively. Evidence from the APA reports and other analyses by the NGF team on DLR 1.2 shows that only eleven (11) States had their budget deviation from the total FY 2019 planned expenditure less than 25% while fourteen (14) States recorded less than 30% deviation from total FY 2018 planned expenditures (See figure 1 and 2 below for detailed findings).

Further analysis shows that the number of States that recorded a deviation higher than 30% increased to 25 for FY 2019 budget compared to 22 States for FY 2018 budget.

Figure 1: FY 2018 States' Budget Deviations

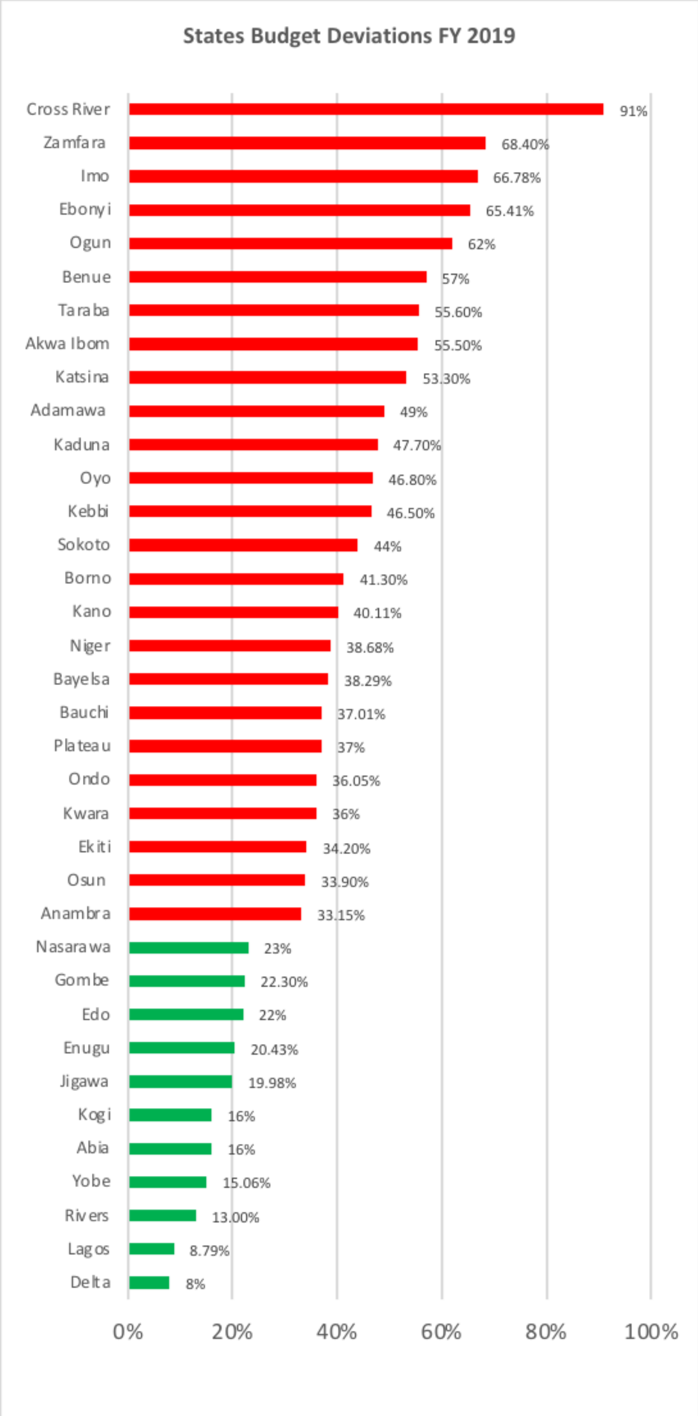


[2] Abia, Adamawa, Bauchi, Benue, Delta, Edo, Ekiti, Enugu, Gombe, Jigawa, Kaduna, Kano, Katsina, Kebbi, Kogi, Kwara, Niger, Ogun, Ondo, Osun, Oyo, Sokoto, Taraba and Yobe State.

[3] Abia, Anambra, Adamawa, Akwa Ibom, Bauchi, Benue, Borno, Cross River, Delta, Ebonyi, Edo, Ekiti, Enugu, Gombe, Jigawa, Kaduna, Kano, Katsina, Kebbi, Kwara, Kogi, Lagos, Nasarawa, Niger, Ogun, Ondo, Osun, Oyo, Plateau, Sokoto, Taraba and Yobe.

[4] Budget credibility is about upholding government commitments and seeks to understand why governments deviate from these commitments.

Figure 2: FY 2019 States Budget Deviations



Broadly, two major variances have been identified as causal factors for the recorded deviations. **These are Revenue and Expenditure variances.**

Revenue Variance: Revenue variance is part of the total budget variance arising from the difference between the actual and expected revenue. Revenue variance is positive, where actual revenue receipt is greater than planned receipt. Unfortunately, evidence from both FY 2018 and FY 2019 APA suggest that very few States were able to record a near accurate revenue based on their forecast. With a negative revenue variance (also known as revenue slack) which is the opposite, there is a high likelihood that the State government will not have been able to meet certain expenditure obligations it planned for in the budget.

Revenue forecasting is a critical part of budgeting. Revenue targets and their realism should be thoroughly examined and agreed upon before every State sets its budget ceiling. A large revenue variance indicates poor revenue forecast and vice versa.

Assessing States based on their revenue variance shows that only Edo, Ondo and Jigawa States had a near accurate[5] forecast of their revenue for FY 2018 budget while only Delta and Lagos States came close to achieving a realistic forecast of their revenue for their FY 2019 budget. This further implies that most States budget apart from those highlighted previously did not adopt a realistic revenue forecast for their FY 2018 and FY 2019 budget.

Expenditure Variance: Expenditure variance occurs when the budget expenditure target is not achieved. Expenditure variance can be in two forms (1) variance in recurrent expenditure and (2) variance in capital expenditure. Evidence from reviewing FY 2018 and FY 2019 budget performance show that the greater the negative revenue variance, the greater the expenditure variance. More particularly, capital expenditure variance recorded a wider variance than recurrent expenditure in all the variance cases. This has serious implications for the overall growth and development of the States. Capital expenditure is intended to finance core developmental projects and programmes in the State including basic facilities and infrastructures to be used by citizens. The consistent under execution of capital expenditure suggests a form of bias in the budgeting process[6] that should be reduced to the barest minimum by government.

Expenditure variance as observed across Nigerian States can be categorized into three (3):
(1) the activities (line items in the budget) are already completed or output has been delivered/achieved, but expenditure allocation was not entirely used, even though this is rare; (2) the activities (line items in the budget) have not been executed; and (3) some activities (line items in the budget) were initiated but could not be completed within the fiscal period due to inadequate funding/cash-backing, late releases, delayed execution and increased cost of project in-year due to inflation.

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[5] By near accurate revenue forecasts, we mean when the difference between the forecast and actual is ± 5 percent.

[6] See Isaksen, 2005; Jones and Euske, 1991; Larkey and Smith, 1989; and Meyers, 1989 for further details.

Policy Recommendations

To ameliorate the decadence of unrealistic budgeting and budget execution, State governments need to urgently consider the following recommendations:

Apply the core attributes of Realistic Budgeting

A logical starting point would be for all States to:

- Budget preparation is framed within sound macroeconomic projections, revenue forecasts and other relevant data.
- Ensure planned expenditures do not exceed projected revenues (including confirmed credit facilities).
- Ensure the budget reflects consensus priorities.
- Ensure the budget is clear and can aid effective monitoring while also allowing for easy re-allocation of resources where and when necessary.

Overall, States must ensure that revenue and expenditure variances are brought to a minimum especially capital expenditure variance which was a reoccurring decimal across States' budget performance between FY 2018 and FY 2019.

Noteworthy already is the response of State governments to the COVID-19 pandemic that hit Nigeria in March 2020. All the States immediately worked out amended budgets considered responsive to the pandemic; revising down their revenue forecasts to reflect the new economic realities while repurposing appropriations to focus on immediate health responses and cutting non-essential spending as well as maintaining a zero-financing gap amongst other economic, health and fiscal reforms. The total budget of States was consequently reduced by 36% from NGN9.4 trillion to NGN6 trillion in 2020, while allocation (recurrent and capital expenditure) for Covid-19 responsive expenditures[7] was put at NGN1.3 trillion, over 21% of their total budget for the year.

Expectations are that similar measures were and are being observed under the recently approved 2021 budget passed by all States.

Consider Previous Years' Budget Performance and Observe Restraint in Increasing Permanent Expenditures in Response to Temporary Revenue Shock

During budget preparation, there is the need for State government to pay rapt attention to actual revenue and expenditure performance from previous years' budget. Given the heavy dependence of States on their Statutory allocation from the Federation Account, it is very crucial to note that the revenue from federation account is equally largely dependent on oil revenues. Consequently, Statutory allocation revenue moves together with the volatility in global oil price and production. It is important State governments treat occasions of boom in statutory allocation revenues as a temporary shock; exercising restraint in up taking a corresponding increase in expenditure but rather be prudent and save to even-out future volatilities that may deliver very low revenues.

Adoption of Medium-term Budgeting

States need to consider adopting medium-term budgeting which requires budgeting for more than one year to provide a longer-term view of the government spending priorities, programme and activities as well as the revenues required for execution. This will allow for better planning for capital projects especially, which most times are long-term in nature and may even transcend government adminstrations at times. Similarly, programmes and projects to implement government policies can take much longer than one year captured in the annual budgeting system.

Adoption of Bottom-up Budgeting and Sector Restoration Strategy (SRS)

Adoption of bottom-up budgeting by State governments will be crucial to address the issue of revenue and expenditure variances. Bottom-up budgeting starts with sector and MDA performance review for the previous year(s). Upon which the State government can identify performing and non-performing sectors and subsectors likewise their responsible MDAs. The results from this are then used to inform trade-offs, resource allocation and prioritization to assist government in actualizing its policies and programmes.

7 Nabena D. (2020). The Impact of COVID-19 on State Taxes. Nigeria Governors' Forum

Leverage Technical Assistance support from Partners

State governments should proactively build the capacity of key personnel in finance and planning ministries to ensure better delivery of State budgets. The government can scout for capacity building opportunities with partners whether international or national. There are opportunities, most of which offer free advisory and training to government ministeries, departments and agencies. In some cases, State governments have gotten partners to design State-specific support programmes/ projects to aid their development objectives. Examples include the Kaduna Fiscal Transparency Accountability and Sustainability Programme for Results (KADFTAS), World Bank implemented State and Local Governance Reform (SLOGOR) Project, Foreign Commonwealth and Development Office – Partnership to Engage Reform and Learn (FCDO-PERL), States Fiscal Transparency Accountability and Sustainability Programme for Results and the NGF HelpDesk programme. Bill and Melinda Gates Foundation; USAID State-2-State; FCDO PERL; International Budget Partnership (IBP) and the World Bank have been active partners in the public financial management reform space, supporting connected reforms to deliver budget realism across the States.

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