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INTRODUCTION TO ECONOMIC THEORY

THE ECONOMIES OF THE GOVERNMENT - BUDGET CONSTRAINTS

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## Introduction

According to Fischer and Easterly (1990), government budget constraints require it to raise the income necessary for all its spending through taxes, loans, and sometimes by creating money. To sum up, government budget decisions now are tightly linked to the taxes or expenditure plans it must make in the future (Blanchard et al., 2024). It points out that borrowing must be repaid because governments cannot accumulate debt indefinitely. As explained by Jørgensen and Ravn (2022), when a country spends more than it earns, it cannot support its finances for the long term, faces higher interest costs, reduces funds for private investment and becomes more vulnerable to shocks from outside. In the context of a developing country like Nigeria, which has limited fiscal capacity, poor public financial management, and fails to adhere to budget restrictions, the economic impact is severe (Onifade et al., 2020).

Understanding the economics of government budgets is crucial in public finance, as it impacts key areas such as economic stability, intergenerational equity, and national sovereignty. In the opinion of Olaoye et al. (2020), failing to manage finances effectively can discourage investors, disrupt resource allocation, and increase the likelihood of inflation when governments print money to cover deficits. In Nigeria, the budget has been influenced by excessive reliance on oil revenue, pressure from political groups to spend more, and inadequate budget management (IMF, 2021). As a result of these flaws, debt continues to accumulate, and the government’s budgetary policies cannot be utilised effectively. This essay analyses why the government is forced to manage its budget carefully, looks at various theories, studies Nigeria’s trend in public spending and proposes changes to improve the country’s budget.

## Conceptual Framework of Government Budget Constraint

There are differing opinions among economic theories regarding how budget rules impact the results and outcomes of fiscal policy. The Keynesian school is in favour of government interventions, mainly when the economy is slowing. According to Keynes, spending money that the government borrows (deficit financing) can increase demand in the economy by investing in public projects, causing an increase in employment and production (Keynes, 1936). Believers in this strategy argue that during economic downturns, the private sector often lacks sufficient demand, necessitating government intervention through fiscal stimulus. The model has usually encouraged governments in places like Nigeria to allocate more resources to infrastructure and social benefits during challenging economic times. On the other hand, public institution efficiency and the ability of the economy to take in such large sums of money are key and these are problems Nigeria deals with regularly (Blanchard et al., 2024)

In opposition, Yigitcanlar et al. (2021) state that in the long term, budget deficits are not harmful to an economy. One idea is that strong consumers understand they may need to pay taxes to cover the debts that today’s deficits are creating. Therefore, the overall result is a decrease in spending and an increase in savings, which counters the stimulus from government borrowing (Oulasvirta, 2021). If Ricardian Equivalence is present, then fiscal deficits have no impact on aggregate demand, which means budgetary policy cannot help stabilise the economy (İkiz, 2020). However, this viewpoint is based on many unrealistic assumptions, such as knowing the future and caring for people who will live long after us, which are not present in Nigeria (Rakib, 2020). According to empirical research in Nigeria conducted by the IMF (2021), increasing government spending leads to increased consumption and decreased savings, indicating that the Ricardian neutrality condition does not hold.

From a political economy perspective, Public Choice Theory suggests that politics can influence and shape the way fiscal decisions are made, not just economics. According to Buchanan and Wagner (2018), policymakers often opt for deficit spending, which can harm future fiscal stability, when attempting to win votes or please established interest groups. This is a common occurrence in Nigeria, where government spending tends to align with election cycles, resulting in budget increases, higher pay for workers, and promises to build infrastructure (Abanikanda et al., 2023). However, most of this is funded by debt rather than reliable earnings. Therefore, a constant deficit bias is evident in the financial system, leading to high debt and limited investment in areas that support the economy (Okoli et al., 2021). Thus, Public Choice Theory suggests reinforcing institutional controls, such as fiscal rules, and having independent watchdogs to combat budgeting mistakes shaped by political gain (Olujobi & Olujobi, 2020).

## Economic Theories Related to Government Budget Constraints

The Intertemporal Budget Constraint theory in public finance is essential but sometimes underestimated and it maintains that over time, a government should meet its expenses by relying on its revenues and simultaneously borrowing (Kim & McLaren, 2024). Differs from Keynesian strategies which stress instant fixes, the IBC framework emphasises staying fiscally healthy over time (Nyambe & Kaulihowa, 2020). That is, it means current-year deficits are alright, if future surpluses accompany them or if growth outpaces the amount owed on the debt. In Nigeria, the country does not usually maintain this balance. Because the government often resorts to deficit financing, both future revenue increases and spending cuts have been lacking which means debt service costs are going up (Lim et al., 2020). The Debt Management Office (DMO, 2022) reported that more than 90% of federal revenue went to debt servicing in recent times which points to a likely violation of the IBC principle and draws near to the country becoming insolvent.

Fiscal Illusion Theory, first put forth by Amilcare Puviani and later developed by Buchanan states that because government uses indirect taxation, inflationary methods and deficit budgets, voters tend to overlook the full burden of taxes (Domenico , 2002). Due to this illusion, governments can make spending choices that exceed what most people would approve of with complete knowledge (Efuntade, 2022). Fiscal illusion is revealed in Nigeria by relying on off-budget expenditures, using multiple supplementary budgets and not properly disclosing contingent liabilities (Okpala et al., 2023). For example, fuel subsidies and assurances to cover government debts are usually not reported in the main budget numbers which can make spending look reasonable but still leads to unsustainable government finances (World Bank, 2023). This means that being more transparent, such as letting citizens review budgets, check on spending, and observe debt records, helps break the cycle and get public expectations in line with the financial situation.

The idea in Functional Finance Theory set out by economist Abba Lerner is that budget outcomes, for example, unemployment, inflation and development, should be the focus, not just the balance of the budget (Shirai, 2022). Lerner believes the state ought to use borrowing, taxation or spending as needed for the objectives, not be held back by arbitrary deficit limits (Liu & Yao, 2024). Although the theory advocates strong fiscal management, in Nigeria, it is hindered by the lack of effective institutions. Projecting deficits often toward every day, non-investment spending conflicts with the goals of functional finance for successful development (Abdullahi & Gupta, 2022). The fact that over 60% of the country’s budget is devoted to recurrent spending in Nigeria leaves little money available for health, education and infrastructure (Budget Office of the Federation, 2022). So, while functional finance is practical, success depends on having effective government, managing finances efficiently and being accountable, areas that Nigeria still struggles with.

## Government Budget Constraints in Nigeria: Empirical Insights

For many years, the Nigerian budget has been affected by large ongoing deficits due to a lack of alignment between spending and revenue collection. For more than twenty years, the federal government has usually failed to achieve a balanced budget (Abanikanda et al., 2023). Instead, extra money was raised through borrowing, as higher spending was needed for both current and future projects. The Budget Office of the Federation (2022) states that for most of the past 20 fiscal years, Nigeria’s budgets have shown deficits and have been funded both by domestic bonds and external loans. It stems from significant imbalances, especially since countries have to allocate their income to things that cannot be easily adjusted, including fuel subsidies, wages, and taxes they pay on their debt.

Nigeria’s budget is mainly dependent on income from oil. The government relies on crude oil for about half to two-thirds of its income and for over three-quarters of its foreign exchange (World Bank, 2023). Being so reliant on oil creates sharp changes in government finances when oil prices surprise the world. Because of the oil price drop in 2014–2016, Nigeria’s revenue declined a lot which pulled the country into a recession and revealed how vulnerable its finances were (OGBODO et al., 2023). Likewise, when the COVID-19 pandemic reduced global oil demand, Nigeria’s oil revenue declined sharply, resulting in a budget deficit that necessitated the country to borrow from institutions such as the IMF (IMF, 2021). Because the oil market goes in cycles and Nigeria hasn’t managed to broaden its sources of revenue, this results in budgets that are too big when oil prices rise and become much smaller or require extra borrowing when prices drop (Onoh, 2021).

These issues with the budget have caused public debt to grow considerably in Nigeria. This was stated by the Debt Management Office (DMO, 2022) which put public debt at ₦49.85 trillion (roughly $108 billion) in mid-2022 which is about 23% of Nigeria’s GDP. While the ratio of debt to GDP is controlled, the figure for debt service as a percentage of revenue went over 90%. Thus, when the Federal Government earns ₦100, nearly ₦91 is used to pay off old debts, so there is not much money left over for other projects or measures to boost the economy (DMO, 2022). A considerable portion of Nigeria’s debt remains domestic, though lately more funding has come from external sources such as Eurobonds and loans by multilateral bodies such as the World Bank and African Development Bank (Mogues & Olofinbiyi, 2020). Having numerous lenders could help reduce borrowing costs; but it also means the country will face exchange rate issues and payments linked to interest rates.

Additionally, significant financial risks can accumulate due to excessive liabilities and inadequate performance in managing public finances. Subnational governments like states have borrowed large amounts of money from commercial banks by issuing bonds and they often do not conduct thorough analyses of their debt sustainability (Oladipo, 2020). Typically, these liabilities are contingent upon future oil earnings, which can fluctuate without notice. Moreover, some activities by state-owned enterprises (SOEs) in essential industries create hidden deficits that are not entirely visible in official government finances (Chukwudi & Victor, 2022). It is common for the Nigerian National Petroleum Corporation (NNPC) to retain income from oil to cover fuel subsidies, as this diverts funds that the federal treasury needs and can be misleading for others trying to understand the actual state of the budget (BudgIT, 2021).

## Critical Evaluation of Nigerian Fiscal Policy and Sustainability

There is a conflict between Nigeria’s goals for rapid political progress and the need for a sustainable fiscal policy. Although the government has tried to increase spending on projects and programs supposedly needed for infrastructure and poverty such expenditures often avoid the required restrictions in the budget. The International Monetary Fund (IMF, 2021a) noted that, by repeatedly overspending on unproductive debts such as fuel subsidies and salaries, governments have made it harder for capital investment to increase and for more money to be generated through spending (Adebisi et al., 2020). Budget management remains weak, as there are frequent extra allocations and updates throughout the fiscal year (World Bank, 2023).

Such fiscal strategies can strongly affect the stability of the macroeconomy. High inflation is partly due to the government printing money to cover deficits and the decline in the currency that occurs with borrowing from other countries (Imoisi, 2021). Debt service payments have diverted funds from spending on health, education, and infrastructure, which has hindered Nigeria’s ability to grow. Additionally, as the Central Bank of Nigeria strives to control inflation, interest rates remain high, making it more challenging for the private sector to invest (Mogues & Olofinbiyi, 2020). A lack of binding policies for government spending and better ways to gather taxes may cause the economy to be less stable, discourage investors and put more debt on future generations.

## Policy Recommendations and Fiscal Reform Strategies

For fiscal sustainability in the long run, changes are necessary in revenue collection, use of public funds and how institutions are managed in Nigeria. Ensuring that fiscal rules exist, like deficit and debt ceilings, that respond to Nigeria’s economic changes, is among the most important steps needed (Ozili, 2024). If a country follows these rules, it can strengthen its fiscal policy, avoid acting in response to current economic swings and build investor confidence (IMF, 2021a). Diversifying the sources of an organisation’s income is necessary. According to the World Bank (2023), as its revenue is primarily derived from oil, Nigeria is highly vulnerable to external shocks. By raising taxes on things other than oil, changing the value-added tax system and better utilising digital tax methods, revenue can become more secure.

Debt management in expenses should prioritize affordable loans and limit the use of commercial debt, especially debt from selling Eurobonds (Yusuf & Mohd, 2021). When deciding to borrow, ensure it will support projects that can be easily measured for their impact on the economy DMO, (2022). Additionally, the country needs to address the rising cost of interest on its debt by improving the terms and implementing limits on interest rates for its domestic debt.

It is just as important to reinforce the structures that monitor public finances. Making budgets clear and transparent, having independent councils and making disclosures on time are ways to discourage inefficiencies and make people less likely to misunderstand government finances (Buchanan & Wagner, 2018). Good coordination among the Ministry of Finance, the Budget Office and the CBN will guarantee that all policies are well coordinated. Lacking these reforms, Nigeria may experience even greater fiscal weakness and problems with its growth.

## Conclusion

The essay analysed the idea of government budget constraints and their usage in Nigeria. The report highlighted that persistent budget deficits, stemming from unpredictable oil income, unfair economic systems, and excessive political spending, have rendered Nigeria’s economy fragile. Despite having moderate debt, the country’s debt service obligations and revenue shortages increase the risk to its government finances (DMO, 2022; IMF, 2021a). Reviewing the concepts of Intertemporal Budget Constraints, Fiscal Illusion and Functional Finance helped explain the various problems in Nigeria’s fiscal system. Because of these frameworks, governments now recognise the value of long-term fiscal outlook, being open with their finances, and assessing spending based on results.

Moving forward, Nigeria should introduce changes aimed at responsible financial management, increasing revenue, and promoting transparent governance. Strategic debt management and strict adherence to fiscal rules will help stabilise the economy again. Future work should also examine how states manage their finances and check whether decentralising finances helps increase both accountability and sustainability. Maintaining old policies might push Nigeria into a downward spiral of debt, undermining its economic independence and hindering its ability to reach its development goals.

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