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INTRODUCTION TO ECONOMIC THEORY

THE ECONOMIES OF THE GOVERNMENT - BUDGET CONSTRAINTS

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## Introduction

Budget constraints for the government mean that it must raise the income necessary for all of 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 & Johnson, 2017). It points out that borrowing must be made up for because governments cannot accumulate debt forever. As explained by Barro (1979), 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. When a developing country like Nigeria which has limited fiscal capacity and poor public financial management, fails to obey budget restrictions, the economic impact is very severe.

Learning about the economics of government budgets is necessary within public finance since it affects key areas like economic stability, equity between future generations and national authority. In the opinion of Alesina and Perotti (1996), failing to keep finances in order can discourage investors, disrupt resource usage and make inflation more likely when governments print money to pay for deficits. In Nigeria, the budget has been influenced by too much reliance on oil money, pressure to spend more from political groups and lax management of the budget (IMF, 2021). As a result of these flaws, debt keeps building up and the government’s budgetary policies cannot be used 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 different opinions in economic theories about how budget rules affect 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 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 think that during hard times, the private sector does not have enough demand, so the government must use fiscal stimulus. The model has many times encouraged governments in places like Nigeria to spend more resources on infrastructure and social benefits in hard 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 & Johnson, 2017).

In opposition, Barro (1979) states that in the long term, budget deficits are not harmful to an economy. One idea is that strong consumers understand that they might need to pay taxes for the debts 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. If Ricardian Equivalence is present, then fiscal deficits have no impact on aggregate demand which means fiscal policy cannot help stabilising the economy. But this viewpoint counts on many unrealistic things, for example, knowing the future and caring for people who will live long after us and these factors are not present in Nigeria. According to empirical research in Nigeria, increasing government spending leads to more consumption and less saving which means the Ricardian neutrality condition does not exist (IMF, 2021).

Through a political economy perspective, Public Choice Theory says that politics can influence and shape the way fiscal decisions are made, not only economics. According to Buchanan and Wagner (1977), it is common for policymakers to opt for deficit spending, which may harm future fiscal stability, when they try to win votes or please well-established groups. This happens in Nigeria a lot, where government spending tends to match election cycles, budget increases, higher pay for workers and promises to build infrastructure, though most of this is funded by debt instead of reliable earnings. Therefore, a constant deficit bias appears in the financial system which causes high debt and limited investment in areas that support the economy. Therefore, Public Choice Theory suggests reinforcing institutional controls like fiscal rules and having independent watchdogs to combat budgeting mistakes shaped by political gain.

## Economic Theories Related to Government Budget Constraints

The IBC theory in public finance is important but sometimes underestimated and it maintains that over time, a government should meet its expenses by relying on its revenues and simultaneously borrowing (Blanchard & Johnson, 2017). Differs from Keynesian strategies which stress instant fixes, the IBC framework emphasises staying fiscally healthy over time. That is, it means current-year deficits are alright, as long as they are accompanied by future surpluses 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. 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 (1967), states that because government uses indirect taxation, inflationary methods and deficit budgets, voters tend to overlook the full burden of taxes. Because of this illusion, governments can make spending choices that exceed what most people would approve with complete knowledge. Fiscal illusion is revealed in Nigeria by relying on off-budget expenditures, using multiple supplementary budgets and not properly disclosing contingent liabilities. 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, 2022). This means that being more transparent such as letting citizens review budgets, cheque 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 (1943) is that budget outcomes, for example, unemployment, inflation and development—should be the focus, not just the balance of the budget. Lerner believes the state ought to use borrowing, taxation or spending as needed for the objectives, not be held back by arbitrary deficit limits. Even though the theory advises strong fiscal management, in Nigeria, it is limited by the lack of effective institutions. Projecting deficits often toward everyday, non-investment spending conflicts with the goals of functional finance for successful development. 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 budget in Nigeria has been affected by large ongoing deficits due to how spending and revenue collection are not well aligned. For more than twenty years, the federal government has usually failed to achieve a balanced budget. And instead, extra money was raised through borrowing, since higher spending was needed for both current and future projects. The Budget Office of the Federation states (2022) that for most of the past 20 fiscal years, Nigeria’s budgets showed deficits and were funded both by domestic bonds and by external loans. It stems from major imbalances, especially since countries have to spend their income on things that cannot be easily adjusted, including fuel subsidies, wages and taxes they pay on the 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, 2022). 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. Likewise, when the COVID-19 pandemic cut global oil demand, Nigeria’s oil revenue fell sharply, causing a budget gap that required the country to get loans 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.

These issues with 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. 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.

In addition, large financial risks can build up because of extra liabilities and poor performance in handling 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. Usually, these liabilities depend on future earnings for oil which can change 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. It is common for the Nigerian National Petroleum Corporation (NNPC) to hold back income from oil to cover fuel subsidies, as this takes away money that the federal treasury needs and can be misleading for others trying to understand the real state of the budget (BudgIT, 2021).

## Critical Evaluation of Nigerian Fiscal Policy and Sustainability

There is a conflict between Nigeria’s aims for quick political progress and the need to have 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 (2021) mentioned that, by overspending repeatedly 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 by spending. Budget management is still weak since there are frequent extra allocations and updates throughout the fiscal year (World Bank, 2022).

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 (Blanchard & Johnson, 2017). Debt service payments have taken away from spending on health, education and infrastructure which has harmed Nigeria’s ability to grow. Besides, because the Central Bank of Nigeria is trying to keep inflation in check, interest rates are still high which is making it harder for the private sector to invest. 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. If a country follows these rules, it can strengthen its fiscal policy, avoid acting in response to current economic swings and build investor confidence (International Monetary Fund [IMF], 2021). Diversifying the sources of an organisation’s income is necessary. According to the World Bank (2022), because its revenue comes mostly from oil, Nigeria is highly exposed to changes from outside forces. 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 give top priority to affordable loans and limit how much commercial debt is used, especially what comes from selling Eurobonds. When deciding to borrow, make sure it will help projects that can easily be measured for their impact on the economy (Debt Management Office [DMO], 2022). Also, the country needs to tackle the growing cost of interest on its debt by improving the terms and putting in place 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, 1967). 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 its usage in Nigeria. The report pointed out that constant budget deficits which resulted from unpredictable income from oil, unfair economic systems and unnecessary political spending, have made Nigeria’s economy fragile. In spite of having moderate debt, the country’s debt service obligations and revenue shortages increase the risk to its government finances (DMO, 2022; IMF, 2021). 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-year fiscal outlook, being open with their finances and assessing spending based on results.

Moving ahead, Nigeria should introduce changes aimed at responsible finances, raising more money and clear governance. Razor-sharp debt management and strict adherence to fiscal rules will help stabilise the economy again. Future work should also examine the ways in which states manage their finances and cheque whether decentralising finances helps increase both accountability and sustainability. Maintaining old policies might push Nigeria into a downward spiral of debt, undermining its independence in economic matters and stopping it from reaching its development goals.