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Subnational Tax Autonomy, Vertical Allocation, and Capital Expenditure Responsibilities: A Study of an Emerging Market

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ABSTRACT

It has become imperative that subnational governments in the Nigerian federal system faithfully represent their tax autonomy and statutory receipts through their developmental efforts. The influence of states' independent revenue initiatives and vertical allocations on capital spending is investigated in this study. The analysis spans from 2000 to 2019nd counted on secondary data from the Central Bank of Nigeria's Statistical Bulletin. The goal of this work is to explore how much tax income generated by states and allocated from the federation account influences infrastructure development in Nigeria's 36 states, as well as the Federal Capital Territory (FCT) of Abuja. The point is that economic development can only be achieved if the fiscal decentralization in the country characterized by revenue and expenditure responsibilities is well maximized. Thus, the study uses multiple regression techniques to arrive at the empirical results, which indicate that the states' tax efforts do not express tangible improvement in infrastructural development. On the other hand, the result also highlights that the statutory apportionment to the states significantly affects states' capital projects. Summarily, the study recommends conducive business vicinity and commitment of the government to provide public goods and services required by the citizens.

HIGHLIGHTS

⊙ The influence of state tax autonomy on infrastructural investment.
⊙ The effectiveness of vertical allocation to states in providing social welfare.
⊙ To establish the contribution of other state revenues in capital developments and to assess the strength of fiscal capital expenditure delegation at state levels.

Keywords: Subnational government, fiscal decentralization, infrastructures, revenues, tax autonomy

Revenue independence of various levels of government within a federal system is paramount to the economic growth of a nation. The economic growth of a state or region is influenced by increased public infrastructure but cannot be achieved if the regions concerned are financially incapacitated. Financial autonomy involves sufficient taxing powers at the disposal of all levels of government to tackle its spending responsibilities. Capital spending is critical to the improvement of public infrastructure (Sawitri *et al*. 2020). State spending significantly impacts job creation, public assistance, and the country's national economic prosperity (Pujari and Biradar, 2022). The greater the value of capital expenditure, the greater the projected return influences a state's economic growth. The fact is that capital spending is very crucial for subnational economic growth (Hall *et al*. 2021; Kuntari *et al*. 2019). Understanding the state's characteristics, as well as the authenticities and

requirements of the public, will be critical in determining the type of infrastructure a particular state government should adopt (Budg IT, 2021). Subnational governments (SNGs) play an important role in public investment in most OECD countries. In 2016, subnational governments accounted for nearly 57 percent of all public investment in the OECD region (OECD, 2018). According to (OECD, 2018) report, this ratio is higher in federal than in unitary countries (70 percent on average for the nine OECD federal countries) (51 percent on average for the 26 unitary countries). Subnational investment exceeds 70 percent of public investment in Australia and Mexico and more than 85 percent in Canada and Belgium when federated states and local governments are combined (OECD, 2018).

The success story is not the same in the developing country of Nigeria. The major problem in Nigeria is the lack of infrastructural development due to inadequate capital funding. This reality became very evident when the country could not cope with the challenges of COVID-19 pandemic. As a result, many prominent Nigerians lost their lives due to poor health facilities and other relevant infrastructures. Even the educational system came to a standstill as there were no amenities in place to cope with the online learning pattern that became necessary at the time. The worst scenario was the inability of citizens to deal with the lockdown situation due to hunger. The country was caught in a trap of insufficient food supply and palliatives due to poor agricultural development and capital investment in the primary economic sectors of the nation. Looking at Table 1 below, the 36 states had fantastic capital investment budgets in 2019, but only 1-11 states, as ranked in this study, could realize up to 50 percent and above of the estimate. That is, the ranking of states in Table 1 shows that the states that were able to realize up to 50 percent or more of the capital expenditure budget rank from 1 to 11. Benue and Cross River State could only realize 6% and 3% of their budgeted capital investment, respectively. Out of the 36 states in Nigeria, the states that performed up to 98%, 76%, 75%, and 70% are Kaduna, Yobe, Rivers, and Lagos, respectively.

However, Nigerian subnational governments have a primary task of recognizing, that all capital requirements may not be economically sustainable. This will help assess how helpful a state's estimated capital investment would affect citizens' living conditions. These data are required to avoid unnecessary massive waste of public revenue and execution of projects with little or no economic value. Macwan and Zala (2022) noted that infrastructural development in agriculture can reduce the prevailing poverty rate. Following the recommendation by (Omodero, 2019), Nigeria's targeted economic and human development could be realized if the recurrent expenditure is minimized while stressing more on viable capital infrastructure investment. OECD (2018) argued that public investment is a collective responsibility across levels of government in the vast majority of OECD countries, whether through shared policy competencies or joint funding arrangements. The funding arrangement is also adopted in the Nigerian federation. The report of OECD (2018) confirms that SNG investment accounted for 1.7 percent of GDP in the OECD (total public investment was 3 percent of GDP) in 2016, a share that was higher than 2.5 percent in Japan, Korea, and Canada but less than one percent in Chile, Ireland, Greece, the Slovak Republic, Hungary, Turkey, the United Kingdom, Iceland, and Portugal.

The Nigerian federation has three levels of government: the first tier, second tier, and third tier of administration. The National Administration is the first level of government, the State Rule is the second tier of government, and the Local Management Council is the third tier. This fiscal arrangement allows tax autonomy for state governments, which implies that there are taxing powers within the jurisdiction of the subnational governments in Nigeria. The revenue powers of the states also include vertical transfers from the federation account, which entitles the 36 states, including the Federal Capital Territory (FCT) Abuja to 26.72% of all federally collected revenue. Vertical transfer to the states in Nigeria is done using the Vertical Allocation Formula (VAF), which allows allotment of the federal proceeds amongst the three stages of the administration that make up the confederacy. From the VAF, the federal is entitled to 50.68% while the state is as mentioned above and the local government council is given 20.60% of the federal revenue.

The Nigerian fiscal federalism is such that the

Table 1: 2019 Capital Budget and Actual Output

State	Budgeted Capital Expenditure ₦' Billion	Actual Capital Expenditure ₦' Billion	Capital Expenditure Performance %	Output Ranking
Kaduna	₦152 Billion	₦148 Billion	98	1***
Yobe	₦39 Billion	₦30 Billion	76	2***
Rivers	₦301 Billion	₦225 Billion	75	3***
Lagos	₦345 Billion	₦241 Billion	70	4***
Jigawa	₦ 91 Billion	₦62 Billion	69	5***
Abia	₦72 Billion	₦47 Billion	65	6***
Delta	₦233 Billion	₦138 Billion	59	7***
Enugu	₦43 Billion	₦25 Billion	57	8***
Anambra	₦92 Billion	₦49 Billion	54	9***
Kwara	₦57 Billion	₦30 Billion	52	10***
Gombe	₦61 Billion	₦31 Billion	50	11***
Edo	₦103 Billion	₦50 Billion	49	12
Borno	₦81 Billion	₦38 Billion	48	13
Nassarawa	₦34 Billion	₦16 Billion	47	14
AkwaIbom	₦448 Billion	₦198 Billion	44	15
Kebbi	₦104 Billion	₦44 Billion	43	16
Kogi	₦72 Billion	₦28 Billion	40	17
Sokoto	₦97 Billion	₦38 Billion	39	18
Zamfara	₦73 Billion	₦27 Billion	37	19
Ondo	₦86 Billion	₦30 Billion	35	20
Bayelsa	₦60 Billion	₦20 Billion	34	21
Ekiti	₦51 Billion	₦17 Billion	32	22
Osun	₦93 Billion	₦30 Billion	32	23
Adamawa	₦66 Billion	₦20 Billion	31	24
Plateau	₦68 Billion	₦19 Billion	29	25
Ebonyi	₦142 Billion	₦40 Billion	28	26
Niger	₦129 Billion	₦32 Billion	25	27
Kano	₦134 Billion	₦31 Billion	23	28
Katsina	₦145 Billion	₦32 Billion	22	29
Bauchi	₦131 Billion	₦25 Billion	19	30
Oyo	₦151 Billion	₦29 Billion	19	31
Taraba	₦74 Billion	₦13 Billion	17	32
Ogun	₦231 Billion	₦35 Billion	15	33
Imo	₦205 Billion	₦28 Billion	14	34
Benue	₦82 Billion	₦5 Billion	6	35
Cross River	₦1,044 Billion	₦29 Billion	3	36

States' 2019 Financial Statements.

*** States that were able to realize 50% of their capital expenditure budget.

Source: *Adapted with modification from BudgIT, 2019.*

three levels of government share both revenue and expenditure responsibilities to enhance economic growth and development (Ekpo, 2004; Ojide and Ogbodo, 2015). According to Turska-Kawa and Glajcar (2020), this period of fiscal regionalization necessitates that local income be apportioned for community services and provision of public goods, because it is the manner and style of the government will depict good governance to the citizens. As per the 2nd scheduling system, facet II of the constitution of Nigeria, the fiscal independence of the state authority requires the gathering of taxes from the income of persons but does include those in the force, foreign affairs workers, and individuals residing in the federal capital territory of the country (FGN, 1999). The 2nd scheduling system section 11 of the federal constitution also offers that the state legislatures should shoulder all recurrent and capital expenditure obligations of provinces apart from issues that call for the awareness of the

centralized administration or financing mechanism (FGN, 1999). The normalization fund is primarily meant to reduce the financial load of states who have seen an extreme reduction in revenue owing to circumstances beyond human capabilities. This study aims to examine how well state governments' resources (autonomy of tax revenue generation efforts and statutory vertical allocation) are utilized to achieve infrastructural development in the 36 states in Nigeria, including the FCT, Abuja. The study is divided into six sections: the introductory section, literature review, research methodology, results and discussion, and the concluding section.

Literature Review

Gurdal *et al.* (2021) studied the link between tax collections, public spending, and sustainable progress in the G7 nation-states between 1980 and 2016. The study used many granger-causality techniques, which revealed a bidirectional causative relationship between government expenditure and wealth creation. On the other hand, tax collection and government spending had unidirectional causation. However, the analysis identified taxation policies as a powerful financial instrument for achieving economic growth goals. Hall *et al.* (2021) considered that enough government funding would increase capital investment in public goods and services capable of avoiding child and maternal fatalities. Using 191 nations' panel data and a two-way fixed effect linear regression approach, the study discovered that nations with low per-capita regime revenue had a greater probability of lowering death rates.

From 1995 to 2011, Rompuy (2020) examined the influence of subnational revenues and vertical transfers on economic development in 30 OECD nations. According to the findings, tax income and vertical revenue allocation were significant chauffeurs of regional economic growth. Even though the undesirable peripheral influence of relocations on disproportions decreased and ultimately became affirmative as subnational rules grew more allocation contingent, autonomously created tax income and vertical transfers were identified as potential drivers of regional convergence. According to the findings, subnational tax autonomy should be broad enough to allow less developed areas to construct their income

base and catch up with their more industrialized complements. Omodero and Adeyemo (2020) tested the influence of local government income streams on capital investment in Nigerian Local Government Councils from 1998 to 2018. According to the findings, only statutory appropriations from the federal and state governments significantly influenced local government capital infrastructure development in Nigeria. Nuryani and Firmansyah (2020) recognized the elements that affect the integrity of the monetary organization in indigenous administrations. The study, which lasted from 2013 to 2016, used fiscal statistics from different Java's constituency/municipal administrations. According to the findings, the average level of financial openness in the local governments analyzed was 24.76 percent. The research also revealed that provincial government spending is equivalent to financial transparency, and it recommended appropriate policy creation to promote regional financial openness.

Sawitri *et al.* (2020) scrutinized the impression of indigenous returns and allocation of funds on assets expenditure of Denpasar City from 2017–2019. The study employed a purposive sampling method, and the findings revealed that regional revenue has a direct progressive effect on capital expenditure. Still, the allocation of funds could not affect economic growth and capital expenditure. Orhewere and Ogbeide-Osaretin (2020) explored the impact of oil price fluctuations on Nigerian capital spending. The Vector Error Correction Model was used in the investigation, which lasted from 1970 to 2018. According to the data, capital spending reacted negatively to oil price shocks. Omodero (2020) used macroeconomic data to analyze the determinants influencing federal government capital investment. According to the study, real GDP and population have a negligible negative influence on capital expenditure. Debt servicing was discovered to have a considerable negative impact on government capital costs. According to the study, the exchange rate and overall spending substantially influenced public investment.

Kuntari *et al.* (2019) investigated the effect of municipal income on assets outlay. The inquiry evaluated 35 local governments in Indonesia's Central Java province and used secondary data from 2014 to 2016. The study revealed that domestically

Table 2: Variables Narrative and Source

Variable	Narrative	Source
SCEX	State Government Capital Expenditure	CBN Statistical Bulletin, 2019 edition
AFSG	Statutory Allocation from the Federation Account	CBN Statistical Bulletin, 2019 edition
SIGR	State Government Internally Generated Revenue	CBN Statistical Bulletin, 2019 edition
GORV	Grant and other Revenue Sources of the State Government	CBN statistical bulletin, 2019 edition

Source: Authors compilation, 2021.

produced money, general allocation funds, special allocation funds, and revenue-sharing funds all had a favorable and substantial influence on capital investment. The investigation further disclosed that local governments might enhance economic growth by successfully managing the monies granted to them. Omodero (2019) examined the effect of total government spending on human development in Nigeria from 2003 to 2017. This study aimed to see how the human development index (HDI) reacted to regular and capital government spending by employing a multiple linear regression model that connected the research variables. According to the statistics, government capital investment and inflation had minor adverse effects on HDI. In contrast, corruption had no effect, and recurrent government expenditure had a considerable beneficial impact on HDI.

Osakede *et al*. (2016) used primary and secondary data sources to examine the financial autonomy of Nigerian local governments. The research concentrated on Ojo Local Government in Lagos State, Nigeria. A total of 160 employees from the Council were interviewed and given a questionnaire. The study used the Chi-square method, which found that Nigerian Local Governments lacked financial autonomy. Due to a lack of financial independence, local governments in Nigeria have failed to offer practical and efficient public services, according to the report. Nwosu and Okafor (2014) investigated the influence of government revenue on expenditure in Nigeria using co-integration techniques and an error correction model. The data included in the study ranged from 1970 to 2011. The results demonstrated a one-way relationship between government spending and revenue. Aswar *et al*. (2022) confirmed that fiscal decentralization, government size, and audit findings had a significant positive association with corruption level in Indonesian Local Governments.

Based on the literature that has been reviewed, the following null hypotheses are postulated to realize the objectives of this study:

- H_{01}: Statutory Allocation from the Federation Account (AFSG) does not have a weighty effect On State Government Capital Expenditure (SCEX).

- H_{02}: State Government Internally Generated Revenue (SIGR) does not considerably influence State Government Capital Expenditure (SCEX).

- H_{03}: Grant and other Revenue Sources of the State Government (GORV) do not substantially affect State Government Capital Expenditure (SCEX).

Research Methodology

The purpose of this study is to look at the influence of state governments' tax autonomy and allotted income on the capital expenditure commitments of Nigerian states. The research encompasses Nigeria's 36 states and the Federal Capital Territory (FCT). To evaluate the data gathered from the sources listed in Table 2, this study applies multiple regression analysis using Eviews software. The statistics ranged from 2000 to 2019.

The regression model verified in this study is as presented below:

$$SCEX = f(AFSG, SIGR, GORV) \qquad …(1)$$

Where,

SCEX = State Government Capital Expenditure

AFSG = Constitutional Apportionment (26.72%)

SIGR = State Government Autonomous Produced Income

GORV = Revenue from Other Sources of the State Government

The above mathematical formula is symbolized below:

$$Y_1 = \propto + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \mu i \qquad \ldots(2)$$

Where:

Y_1 = SCEX

X = *Determinant of state capital expenditure*

X_1 = *AFSG*

X_2 = *SIGR*

X_3 = *GORV*

$\propto$ = Calculates the link between the impartial variable X and the output variables or the linear extrapolation lagrangian, which determines the number of variations in Y connected with a unit change in Output. $\propto$ = Perpetual; X_1–X_3 = Recession factors; μi = in accuracy period.

Following the study expectation, we anticipate; $X_1 > 0$, $X_2 > 0$, $X_3 > 0$.

RESULTS AND DISCUSSION

This section provides the results of the data analysis, which include the unit root test, different analytical checks and the regression outcome.

Table 3 shows the outcome of the unit root test, which is used to determine the robustness of the dataset to avoid false regression results. The test results show that the data for all the research variables are stable at first. This indicates that the regression result is credible.

Table 4 ensures that all diagnostic tests performed to assess the accuracy and applicability of the research model and dataset yielded positive findings. Consequently, the p-values of the stability test, serial correlation, normality, and homogeneity of variance tests are determined to be adequate based on the 5% parameter. The variance inflation factor (VIF) is used to examine the interdependence of independent variables, and it is discovered that there is no link between them.

NORMALITY TEST

Discussion

Table 3 shows that all of the variable data sets are stationary at order 1. In contrast, Table 4 emphasizes the numerous diagnostic tests and demonstrates the absence of serial correlation, Heteroskedasticity, multicollinearity, and confirmation of model

Table 3: Unit Root Test

Variables	ADF T-Statistic	Mackinnon Critical Value at 5%	P-Value	Order Of Integration	Remarks
LOGCEXR	-3.718	-3.040	0.013	I(1)	STATIONARY
LOGAFSG	-4.661	-3.040	0.002	I(1)	STATIONARY
LOGSIGR	-3.849	-3.040	0.010	I(1)	STATIONARY
LOGGORV	-4.063	-3.040	0.007	I(1)	STATIONARY

Author's computation, 2021.

Table 4: Symptomatic Assessment Results

Fact-Finding Checks	F-Statistics	P-Value	Result Analysis	Remarks
Ramsey RESET - Stability test	1.547	0.23	p>0.05	Model is stable
Breusch-Godfrey Serial correlation LM test	2.113	0.16	p>0.05	Absence of Serial Correlation
Heteroskedasticity test	0.719	0.55	p>0.05	No Heteroskedasticity
Normality test (Fig. 1) – Jarque-Bera	0.41	0.81	p>0.05	Normal distribution of data set
Multi-Collinearity test: (Independent variables only)	Coefficient variance	VIF	Result Analysis	Remarks
LOGAFSG	0.017	5.26	VIF<10	No inter-connection of predictor variables
LOGSIGR	0.007	5.29	VIF<10	No inter-correlation of predictor elements
LOGGORV	0.001	1.03	VIF<10	No inter-relation of predictor items

Author's computation, 2021.

Normality Test

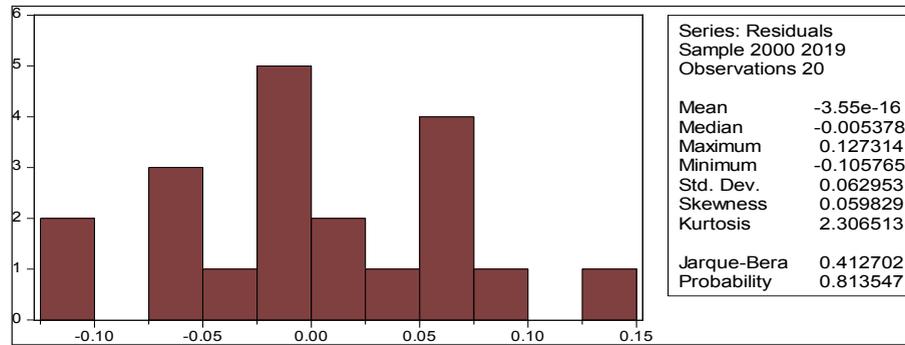|	
Series: Residuals	
Sample 2000 2019	
Observations 20	
Mean	-3.55e-16
Median	-0.005378
Maximum	0.127314
Minimum	-0.105765
Std. Dev.	0.062953
Skewness	0.059829
Kurtosis	2.306513
Jarque-Bera	0.412702
Probability	0.813547

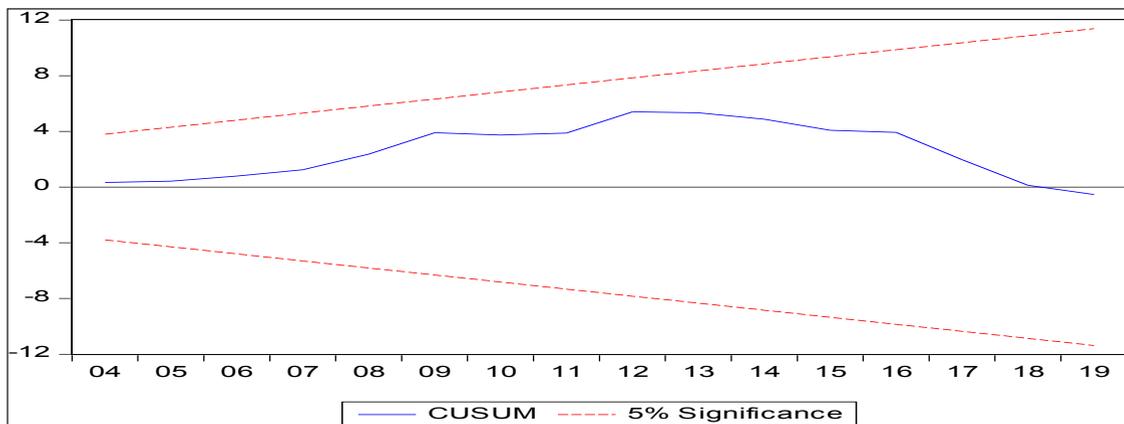**Fig. 1:** Histogram Normality

Rubustness Check

Fig. 2: Recursive estimates of the CUSUM test. CUSUM = Cumulative Sum Control Chart
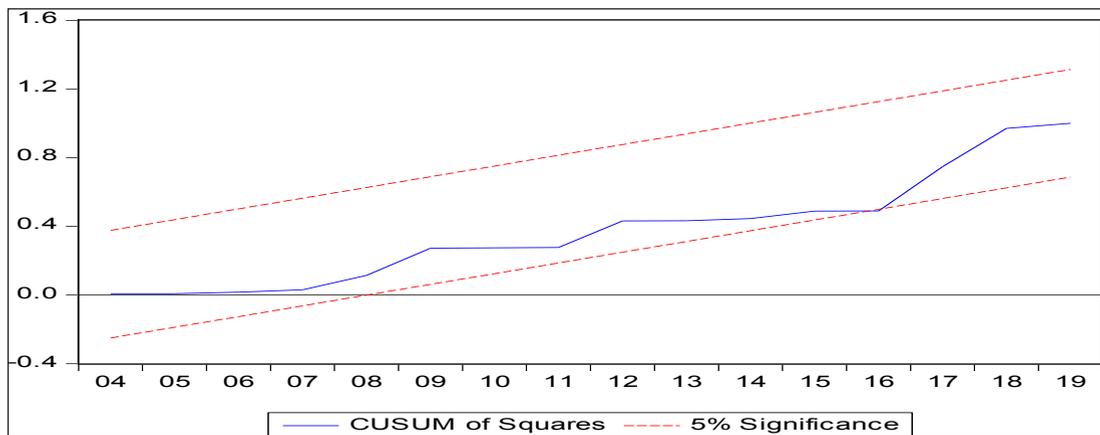

Fig. 3: Recursive estimates of CUSUM of squares test. CUSUM = Cumulative Sum Control Chart

stability. Fig. 1 shows that the data set utilized in this investigation has a normal distribution. Table 5 shows that the dependent and predictor variables are significantly and positively associated at a 98.6 percent level. The coefficient of determination (R^2) score of 97.2 percent simply denotes how well the independent variables explain changes in the response variable. In other words, the remaining 2.8 percent results from characteristics that our model did not consider relevant to the research. The sturdiness tests in Figs. 2 and 3 show that the model employed in this investigation is stable and robust.

Table 5: Regression Result (Dependent Variable: LOG_CSID)

Sample: 2000 2019

Included observations: 20

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LOG_AFSG	0.486	0.222	2.194	0.046***
LOG_SIGR	0.381	0.219	1.733	0.105
LOG_GORV	0.120	0.072	1.679	0.115
C	0.228	0.461	0.496	0.628
R-squared	0.972	Mean dependent var		2.917
Adjusted R-squared	0.962	S.D. dependent var		0.331
S.E. of regression	0.064	Akaike info criterion		-2.382
F-statistic	96.867	Durbin-Watson stat		1.868
Prob(F-statistic)	0.000			

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Source: *Author's Computation, 2021; *** Significant @ 5%.*

The Durbin-Watson value of around 2 suggests that there is no autocorrelation. The standard error of the regression is 0.06, which is smaller than the value of 1. As a result, this result creates the appearance that the study's predictions are error-free. The F-statistic indicates that the model is statistically significant and suitable for this investigation.

AFSG has a t-statistic of 2.19 and a p-value of 0.04 at the 0.05 level of significance. As a result, Ho1 is rejected at this stage since transferring funds from the federation account to state governments has a considerable positive impact on capital expenditures. This observation is consistent with the findings of (Kuntari *et al.* 2019; Omodero and Adeyemo, 2020; Sawitri *et al*. 2020). However, H_{02} and H_{03} are acceptable since the SIGR and GORV have no significant influence on state capital spending in Nigeria.

CONCLUSION

The study investigates the influence of subnational government tax autonomy and statutory vertically allocated income on capital spending, which is adequately represented by the cost of development projects. According to the empirical findings in table 5, the statutory allocation (direct money sent to states from the federation account) considerably influenced infrastructural development in Nigerian states. However, the subnational government's taxation or independent revenue attempts fall short of expectations. This is similar to other yearly income and grants received by governments. These findings suggest that states in Nigeria may need to boost the autonomous revenue drive to promote infrastructure development in their respective regions. As a result, the report recommends governments turn inward and capitalize on all resources and revenue potential inside their constituents. Large-scale farming, fishing, and horticulture are examples of such revenue-generating sectors that have long been overlooked. Nigeria is endowed with lush agricultural fields and streams. Some states (for example, the Niger Delta States) can use the surrounding rivers to generate farm food, which may not be possible in other states with less coastline.

The report also suggests creating a more favorable business climate. Due to the country's tough economic climate and instability, many enterprises have gone into hiding. They intentionally refuse the government access to their income records, allowing them to evade tax with impunity. Companies must operate in a friendly atmosphere, which might reduce the informal sector activities that contribute to the fall in governments' tax revenue efforts. Finally, the state government is encouraged to be devoted to the struggle of its residents by providing basic infrastructure that meets their demands.

The infrastructure funding will help to drive e-governance (Nugraha *et al.* 2022) in a developing country such as Nigeria. The supply of essential utilities in every state will naturally drive taxpayers to regard tax payment as a civic responsibility and to comply with its rules without coercion. The study recommends further research using local communities' development and tax income in the indigenous authorities.

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