# In search of inclusive growth: a concern for fiscal space

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## ABSTRACT

Nigerians are desperately seeking for fiscal space in the means of economic shock. Reflecting upon the urgent need for the government is to mobilise revenue to ensure that Nigeria joins the rest of the world in the campaign for inclusive growth. This paper test whether fiscal impulse respond to fiscal space in a quest for inclusive growth between 1980 and 2014, using Structural Vector Autoregressive model to study the variance composition, impulse responses of key economic variables of concern to fiscal space. The interaction among all variables considered for the analysis included in the VAR are per capita income, unemployment, government expenditure, external debt and debt servicing. The finding of per capital income revealed an incremental positive value for all the periods due to shocks in government expenditure, whereas response of unemployment rate was positive in the first two periods and later reacts negatively in the latter periods to the same shock. This indicates among the fiscal space indicators, external debt and government expenditure are the main shocks causing the variation in inclusive growth in Nigeria.  In all, appropriate policy towards boosting the mobilising additional resource to accommodate fiscal space while keeping debt limits to avoid fiscal shock in the country.

## 1. Introduction

The growing need for fiscal space may explain why a concept that first emerged in developing countries in early 2000s now gaining so much attention in the world. The notion of fiscal space was raised by emerging countries after the Asian crises to underscore the need to provide continuing funding for critical infrastructure irrespective of consolidation needs. To generate fiscal space for such investment they proposed to exclude them from macroeconomic targets. Some international agencies notably UNDP, linked this discussion to be resource need to meet the Millennium Development Goal (Roy, 2006).

Today, the desperate quest for inclusive growth in Nigeria appears due a number of reasons. In particular, the unstable fiscal position of the country obviously is a big concern to the any nation thinking in line of inclusive growth. Other issues of concern are the call for subsides removal, poverty reduction, inequality gap, job creation, social tension, climatic change and poor state of existing infrastructure. The heavy dependence of the economy on crude oil export earning underscored the extent of vulnerability of the economy to exogenous shocks. The tenacious adherence to oil price fiscal rule is imperative to accumulate sufficient savings reserve to cushion fluctuation in government revenue in the likely event in international price downturn. However, the state of domestic debt and debt service obligation of external organization have become major constraints to resource mobilization for growth and development despite the restructuring initiatives (CBN, 2011).

Moreover, the process of budget implementation still left much to be desired despite the budget reform efforts that have been instituted. Nevertheless, inclusive growth cannot be achieved in an environment of poor, obsolete and dilapidated infrastructure. The absence of good infrastructure development is a great challenge to sustainable fiscal system. Consequently, the concern issue of discourse is the implication of fiscal space on inclusive growth in Nigeria with specific focus on the crippling state of the naira, unclear fiscal deficit analysis, job creation and the mounting debt pressure and quest for inclusive growth.

The study look at whether the fiscal policy currently employed in Nigeria is consistent with theoretical view on how fiscal policy would affect fiscal space which is a key ingredient of inclusive growth.

The study also examines the extent to which fiscal space is channeled towards meaningful investment with respect to tax reform, effective utilization of government spending to accelerate investment in Nigeria.

 Specifically, the objective(s) is in three fold perspectives:

      (a)   Investigate the factor that determines fiscal space in Nigeria using the

           Vector Autoregressive model.

      (b) Investigate whether fiscal space can be tailored towards inclusive growth in Nigeria, through prudent government spending.

In pursing this objective, the study helps to address the following questions:

      (a) To what extent does the current fiscal policy employed contribute

          to meaningful inclusive growth?

      (b) Does fiscal impulse has a connection with fiscal space in Nigeria?

To anticipate some results

  (c) First, our model demonstrates that there is a significant causality between fiscal impulse and fiscal space in Nigeria. Here, we determine whether fiscal impulse such as debt servicing, public debt, government spending, response to fiscal space in Nigeria

  (d) Second, we further anticipate that there is statistical significant relationship between and Inclusive growth in Nigeria.

## 1.2 Justification of study

The justification of the study is three fold:

First, many of the objectives of public spending for inclusive growth are financed out of current expenditure but macroeconomic prudent requires a zero debt deficit except in times of temporary economic shock (Roy, 2014). Thus, the recent shift to fiscal space as strategic focus for achieving inclusive growth justifies the call for the study in Nigerian context. On a second outlook, the study embraced the use of fiscal instrument tailored towards long term, job creation, allocation, distribution, and growth enrichment strategy for resolving the recent economic shock affecting target for inclusive growth in Nigeria through inter-temporal government budget constraint by providing appropriate policy measure to buttress the voice for fiscal space in Nigeria economy.

Third, reasonable accounts of fiscal policy have been conducted with conflicting evidence theoretically and empirically, without no sense of direction. Some of this related studies focus on fiscal policy and economic growth (see, for example Ariyo, 2002; Nwaogwugwu, 2013; and  Bankole, 2000) a little departure was Omojolaibi and Egwaikhide (2014) who empirically look at Oil price volatility, fiscal policy and economic growth in Nigeria using a panel autoregressive analysis in some selected oil exporting African countries. Base on the existing knowledge, none of this prominent study explores fiscal space but in terms of the methodological knowledge advancement in VAR analysis none except Omojolaibi and Egwaikhide (2014). Consequently, this study deviates from existing literature by relying on the robust dynamics modeling methodology which relies on VAR popularized by Sim (1980) for this work. The implication of this VAR framework for this analysis is that: (1) it supports to issue for carrying out causality test among variables, which determines variables favor in the VAR model. (2) It facilitates computation of impulse response function, which assists in assessing the potency of fiscal space. (3) It is useful for forecasting purpose.

Against this backdrop, the rest of this paper is made up of five sections. Section two focuses on the theoretical underpinnings as well as review of previous studies while section three provides a robust description of the research methodology. Section four contains the analysis and empirical results of the study while discussion and possible policy recommendation is the focus of section five.

## 2. Literature review

The empirics and theoretical position of fiscal space has generated a hot debate in recent times. Despite the growing literature the issue has remained unsettled due to the divergence in the view of these studies. The celebrated work of Heller (2005) attempt to defined fiscal space as the availability of budgetary room that allow a government to provide resource for a desired purpose without any prejudice to the sustainability of a government financial position. Roy and Hauty (2005) embrace this idea and define fiscal space as a concrete action

for resources mobilisation and reforms necessary to secure the governance, institutional and economic environment for those policy actions to be effective.

Contrary to this, the Development Committee (2006) definition of fiscal space is concerned with raising incremental resources for development. Roy, Hauty and Letouze (2007) made reasonable attempts to present a broader approach to the discussion by incorporating diamond to imply that the focus should be on fiscal space diamond. This new framework assesses the fiscal space at national level. Its attempts to maps out (a) external debt grants in the form of aid or debt relief; (b) domestic revenue mobilisation through tax policy reform; (c) deficit financing through domestic and external borrowing; (d) expenditure switching and raising efficiency of expenditures finance through long term national development strategy. The study further argues that securing a development transformation while ensuring fiscal sustainability makes the answer to the question of fiscal space for what the necessary to address the question of fiscal sustainability.

Heller (2007) on a revisit clarify the difference and the link between fiscal sustainability and fiscal space, while drawing from literature over last decade (starting with, Buiter, 1985) fiscal sustainability is usually defined to exist when a government expected revenue stream is sufficient to allow it to both finance it future expenditure requirements and payback its existing stock of public debt (Chalk and Hemming, 2000). In considering fiscal sustainability, it is necessary to reconsider issues of debt sustainability, since the nature of  government expenditure is structure in terms of constructive budget obligations (continuing recurrent expenditure of high priority, such as education, Medicare , national security among others , that implicit social insurance obligation with civil service pension, public pension) and its exposes to  other fiscal risk (for example, from government guarantees, public private partnerships) and  the elasticity of government revenue (see Hemming and Chalk, 2000, Baldacci and Fletcher, 2003, Heller, 2005, and (Ostry, Ghosh, Kim, Gureshi, 2010). Heller (2005) further argues that fiscal space relates to capacity of government, at least in the future to finance it desire expenditure program, to service any debt obligation (including those that may arise if the created from fiscal space arises from government borrowing).

Although,  Khamfula (2004) once investigate macroeconomic problems facing South Africa since emerged of apartheid era focusing on the objective of reducing poverty, increasing employment, restructuring employment and increasing international trade and economic growth rate introducing the pointer GEAR (Growth, employment and distribution strategy). Khamfula (2004) considered government expenditure, income tax rate and nominal interest rate, foreign aid and domestic credit using a simultaneous equation econometric model. The result of the study indicated that real income growth is positively related to RGDP as a ratio of money stock.

Gauthier et al, (2004) seeks to determines how the dynamic of nominal bond yield curve is related to macroeconomic fundamentals in a small open economy like Canada using a Vector Error Correction Model (VECM).They argued that fiscal position has a sizeable effect on interest rate and unexpected permanent fiscal deterioration exist in the case of Canada.

In the same spirit, Bohn (1998, 2008) look at whether the primary fiscal balance response positively to increase in the level of debts, controlling for other determinants of the primary balance. The study indicated that a sufficiently positive response ensure that is satisfied and that public grow rapidly in the long run. In the same way, Aoyangi and Ganelli (2015)focus on the determinants of growth inclusiveness and suggests option for reforming using a cross country empirical analysis to suggests fiscal distribution , monetary policy aimed at

macroeconomic stability and structural reforms to stimulate trade, reduce unemployment and increase productivity are crucial.

From the above debate, it is obvious that there are serious academic conflicts on the focus of fiscal space based on existing knowledge reviewed. However, it is obvious that this issues surrounding fiscal space are the gap this study intend to fill. This study deviates from existing literatures as it attempt to reconcile the recent economic theory with recent economic shock with specific focus on the Nigerian economies.

## 3. Methodology

### 3.1 Construction of assessment of indicators

The question of measurability of fiscal space has also generated an unresolved argument in literature. While some economists who made reasonable amount of effort to prove diagnostic surgery with specific measure to the scenario (for, example, Heller, 2007) mentioned some specific indicators such as: ratio of debt to GDP (taking account of whether revenue burden would appear low or high). On a second note, the ratio of government subsidies to GDP (as a potential candidate for tax cut which measure values of public asset as an indication to asset holding (see, Heller 2007).

Contrary to this view, some studies consider the approach of sustainability that is characterized the extent of fiscal space or imbalance, taking account of inter-temporal position which is built on projection approach. This approach has been extensively used by IMF and World Bank, (see Heller, 2000, and Gokhale and Aurbuch, 2000) for United State.

The study follow the present value constraint (PVC) modelling of fiscal sustainability as prescribe by Himilton and Charles (1985) and Hakkio and Rush (1991) adapted by Jibao (2012) to determine the inter-temporal government budget constraints which is the set of all sequences of taxes and expenditures that guarantees that the contractual promises associated with the government's debt will be met. It is, however, useful to split the description of the budget constraints into two parts: the government flow constraint and the tranversality condition. The combination of these two will then be shown to be equivalent to the present value representation. For each period (in this case, a period corresponds to one year, since this is what is relevant from the budget standpoint), public debt evolves according to the following expressed by Carlos Eugênio Ellery Lustosa da Costa

$$B_{t+1} = (1+r_t) B_t + G_{t+1} - T_{t+1} \qquad (1)$$

Where $B_t$ is the value of government debt at moment t, r, is the interest rate in t, T, and G, are government revenues and expenditures in t. Obviously, this equation must hold to all periods.

Therefore, in the following period:

$$B_{t+2} = (1+r_{t+1}) B_{t+1} + G_{t+2} - T_{t+2} \qquad (2)$$

Recursively substituting in (1) leads to,

$$B_{t+2} = (1 + r_{t+1})((1 + r_1)B_t + G_{t+1} - T_{t+1}) + G_{t+2} - T_{t+2}, \qquad (3)$$

i.e, $B_t = \dfrac{B_t + 2}{(1 + r_{t+1}) (1 + r_t)} + \dfrac{T_{t+2} - G_{t+2}}{(1 + r_{t+1}) (1 + r_t)} + \dfrac{T_{t+2} - G_{t+1}}{(1 + r_t)}$

The process can be continued to any t + s time and express:

$$B_1 = \frac{B_{1+}}{\prod(1+ r_{t+v-1})} + \Sigma \frac{T_{t+v} - G_{t+v}}{r_v}$$

It is important to define the variables: $r_t$ expresses the interest rate of a security purchased in t, to be paid in t + 1. Likewise, $G_t$ - $T_t$ represents the primary deficit in t. The constraint-flow (1) represents a minimum requirement, which could even be seen as an accounting identity. What makes the concept of sustainability interesting is the transversely condition. To understand it, the price in t of consumption in t + s is given by

$$P_t = \left[\prod (1+ r_{t+v-1)}\right] - 1 \qquad (4)$$

The transversally condition is, in this case,

Lim $P_t B_t \leq 0,$

Thus, forcing the present debt value to approach a non − positive value when a sufficiently long time span is considered. This condition eliminates so-called Ponzi schemes, where a debt is always rolled over and never paid. In other words, it corresponds to the assumption that governments cannot live in a permanent state of indebtedness. Therefore the need for fiscal space is required.

## 3.2 Econometric Framework and Modeling

The VAR approach that this study utilizes to examine the relationship between fiscal space and inclusive growth allows an interaction between all the specified variables. The variables included in the VAR are per capita income (pci), unemployment (uner), government expenditure (gexp), external debt (edebt) and debt servicing (dser).

The VAR model takes each of the variables in the system and relates its variation to its own past history and the past values of all the other variables in the system. A typical VAR model in standard form can be written as;

$$Y_t = C + \sum_{i=1}^{p} A_i Y_{t-1} + \varepsilon_t \qquad (1)$$

Where $Y_t$ denotes the (5x1) vector of the six endogenous variables given by:

$Y_t = [pci_t, uner_t, gexp_t, edebt_t, dser_t]'$, c, is a (5x1) vector of intercept terms, $A_i$ isthe matrix of autoregressive coefficients of order $i$.

The basic identification scheme uses a recursive VAR model (proposed by Sims (1980) in which the ordering of the variables is $[pci_t, uner_t, gexp_t, edebt_t, dser_t]$, where the contemporaneously exogenous variables are ordered first. The variable in the VAR is thus ordered from the most exogenous to the least exogenous one. The government expenditure, external debt and debt servicing were ordered first so that a shock in fiscal space indicators may have an instantaneous effect on the two proxies for inclusive growth vice versa. However, fiscal space variables do not respond contemporaneously to any structural disturbances to the remaining variables. The VAR were estimated using the levels of all the series.

## 4. Data

The study employs the annual time series data sourced Central bank of Nigeria (CBN) and World Development Indicators (WDI) covering a period of 1981 to 2014. This data are source from the Central bank of Nigeria (CBNThe choice of this period is explained by the rapid revenue generated by the country which could have been tailored to inclusive growth.

## 5. Results

### 5.1 Unit root tests

This section reports both the conventional ways of computing unit root and stationarity test. For the purpose of this study, the conventional method employed is the Augmented Dickey Fuller (ADF). Table 4.1 below report the two methods used for the study, as thus:

**Table 5.1 :** Unit Root Test Results

| Variables | Augmented Dickey Fuller Test (ADF) | | Remarks |
| :---: | :---: | :---: | :---: |
| | *Levels* | *First Difference* | |
| **DSER** | -1.5992 (1) [-3.2124] | -7.1949 (5) [-4.3393]* | *I(1)* |
| **EDEBT** | -2.6083 (1) [-3.2124] | -3.5354 (0) [-3.5578]** | *I(1)* |
| **GEXP** | 0.7470 (1) [-3.2124] | -4.5093 (1) [-4.2846]* | *I(1)* |
| **PCI** | -1.6130 (0) [-3.2096] | -5.2199 (0) [-4.2733]* | *I(1)* |
| **UNER** | -2.1447 (0) [-3.2096] | -6.8900 (0) [-4.2733]* | I(1) |

Note : * *significant at 1%; ** significant at 5%; *** significant at 10% Mackinnon critical values and are shown in parenthesis. The lagged numbers shown in brackets are selected using the minimum Schwarz and Akaike Information criteria.*
Source : Authors' computation, 2015.

The unit root tests result using the Augmented Dickey Fuller (ADF) confirmed that all the series are stationary at first difference i.e. I(1). It should be noted that the lag length for ascertaining this stationarity level of our variables as well as unit-root test is automatic and optimally chosen by the Schwarz Bayesian Information Criterion (SBC).

### 4.2    Impulse responses and Variance decomposition analysis

### 4.2.1   Impulse responses analysis

Figure I below presents the contemporaneous response of fiscal space indicators (government expenditure, external debt and debt servicing) to Cholesky one squares variances shocks on inclusive growth. The response of per capital income reacts negatively in the first to fifth periods and thereafter positively smoothly due to shock in both debt servicing and external debt. They however reveal a "U" shape, indicating a minimum value in the fifth period at the value of -12248.9 and -467784.6 respectively for debt servicing and external debt. Contrary, the shocks in debt servicing and external debt revealed distinct movement in the case of how unemployment response to their shocks. Specifically, as the shocks in debt servicing arise, the response of unemployment rate was negative for the first three periods, slight positive for the fourth period and later roughly drifts negatively for the other periods. Unemployment rate reacts slightly negative for first two periods by later maintained approximately positive pro rata for other periods when shocks in external debt occur.

**Figure I :** Impulse Response Plot of Inclusive Growth from Fiscal Space Shocks
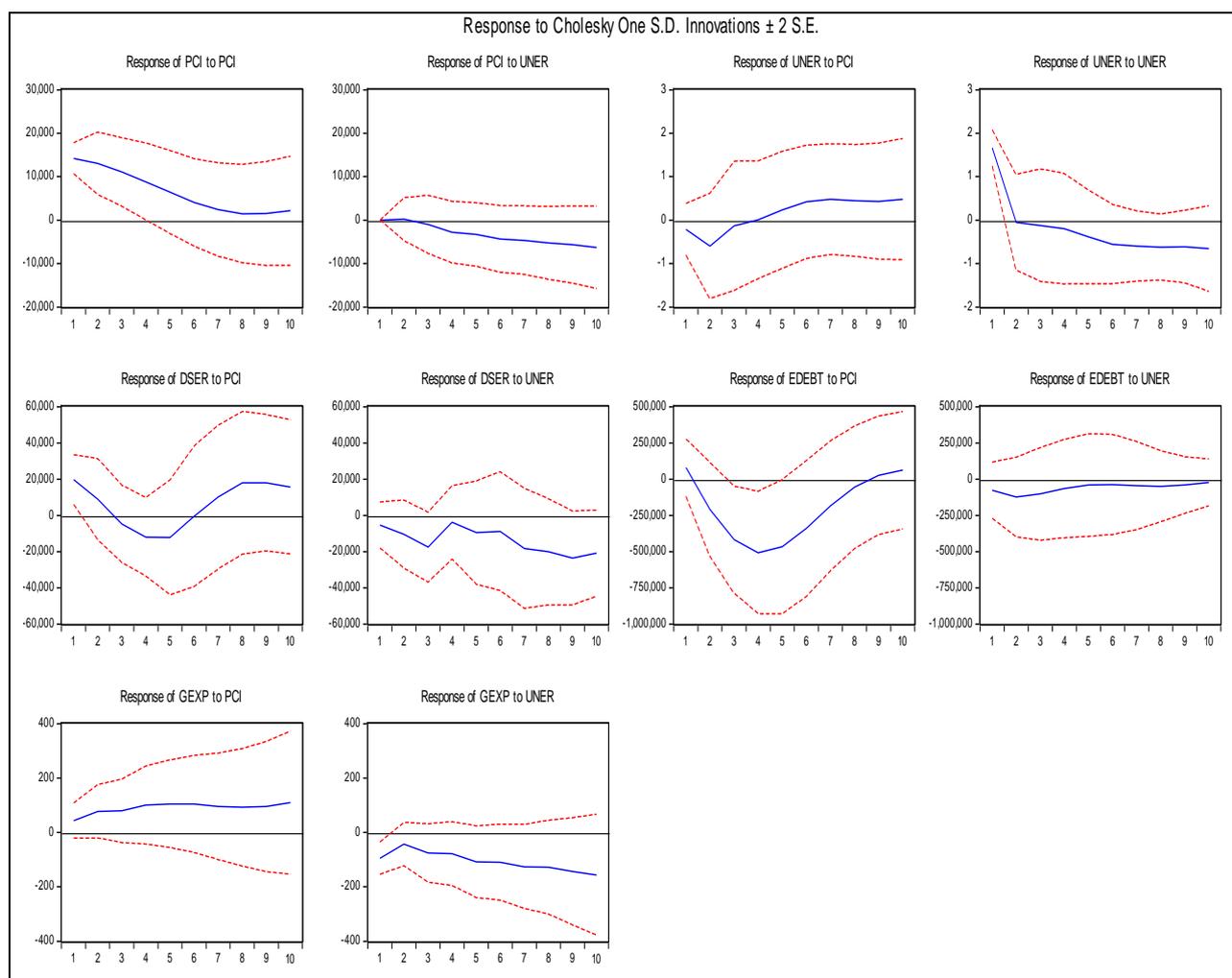


Furthermore, the response of per capital income revealed an incremental positive value for all the periods due to shocks in government expenditure, whereas response of unemployment rate was positive for first two periods and later reacts negatively in the latter periods to the same shock. Nonetheless, the shocks in government expenditure somehow dictate the direction of shocks in fiscal space. This implies that government expenditure played a major role in determining equal distribution income and employment rate in Nigeria.

As shocks in per capita income arise, the response of unemployment rate was positive for the first two periods and later reacts negatively in the latter periods. The response of per capita income to shocks in unemployment rate reports the other way as the first two periods are negative while other periods show direct relationship. Similarly, the shocks of inclusive growth indicators on itself both reports negative throughout their periods at varying magnitude.

### 5.2.2 Variance decomposition analysis

This sub-section presents the variance decomposition, which separates the variation in an endogenous variable into the component shocks of the VAR model. The table 5.2 below presents the variance decomposition of inclusive growth proxy by per capita income and unemployment rate to innovation shocks from fiscal space indicators. In the second column, the labelled "S.E." contains the forecast error of the variable at a given forecast horizon. The

source of this forecast error is the variation in the current and future values of the innovations to each endogenous variable in the VAR. The other columns for each of the fiscal space proxies give the percentage of the forecast variance due to each innovation, with each row adding up to 100.

**Table 5.2 :** Variance Decomposition Analysis of Fiscal Space and Inclusive Growth

| Period | S.E. | PCI | UNER | DSER | EDEBT | GEXP |
|--------|------|-----|------|------|-------|------|
| 1 | 14196.82 | 100.0000 | 0.0000 | 0.0000 | 0.0000 | 0.0000 |
| 2 | 19629.86 | 96.5939 | 0.0104 | 0.8707 | 0.1264 | 2.3986 |
| 3 | 23342.62 | 90.7134 | 0.1900 | 0.7619 | 4.5789 | 3.7559 |
| 4 | 26490.58 | 81.5278 | 1.2451 | 0.6137 | 10.1790 | 6.4344 |
| 5 | 28945.17 | 73.2372 | 2.3509 | 0.6662 | 15.5193 | 8.2264 |
| 6 | 31319.73 | 64.2119 | 3.9281 | 0.6280 | 20.0572 | 11.1750 |
| 7 | 33682.81 | 56.0219 | 5.3015 | 0.6495 | 23.6029 | 14.4241 |
| 8 | 36337.51 | 48.2987 | 6.6602 | 0.5743 | 25.7893 | 18.6775 |
| 9 | 39054.73 | 41.9593 | 7.8525 | 0.4972 | 26.9933 | 22.6978 |
| 10 | 41883.73 | 36.7443 | 9.1180 | 0.4926 | 27.2819 | 26.3632 |

Source : Authors' computation (2015).

Table 5.2 above also presents the variation in inclusive growth due to shocks is decomposed into related fiscal space instruments. The results of the percentage of share of inclusive growth changes accounted by the considered policy instruments shocks are presented in Table 5.3. The table revealed that shocks within itself (i.e. inclusive growth shocks) and fiscal space shocks accounted for 72.6% and 27.4% respectively the total variation in inclusive growth measured by per capita income and unemployment in Nigeria. It indicates that fiscal space instruments are major policy instruments driving the level of inclusive growth in Nigeria between 1981 and 2014.

**Table 5.3 :** Percentage of Per Capita Income Variation due to Policy Instrument Shocks

| Overall % Share of Policy Instrument Shocks | | |
|---|---|---|
| *Inclusive Growth Shocks* | *Fiscal Space Shocks* | *Total Shocks* |
| 72.60% | 27.40% | 100.00% |
| % Share of Fiscal Space Shocks | | |
| *Debt Servicing Shocks* | *External Debt Shocks* | *Government Expenditure Shocks* | *Total Shocks* |
| 2.10% | 56.20% | 41.70% | 100.00% |

Source : Authors' computation (2015).

Moreover, among the fiscal space shocks that account for 27% of the total variation in inclusive growth due to innovation disturbance; debt servicing, external debt and government expenditure shocks account for 2.1%, 56.2% and 41.7% respectively. This indicates among the fiscal space indicators, external debt and government expenditure are the main shocks causing the variation in inclusive growth in Nigeria.

## 6. Discussions

This paper test whether fiscal impulse respond to fiscal space in a quest for inclusive growth between 1980 and 2014, using Structural Vector Autoregressive model to study the variance composition, impulse responses of key economic variables of concern to fiscal space. The interaction among all variables considered for the analysis included in the VAR are per capita income, unemployment, government expenditure, external debt and debt servicing.

The finding of per capital income revealed an incremental positive value for all the periods due to shocks in government expenditure, whereas response of unemployment rate was positive in the first two periods and later reacts negatively in the latter periods to the same shock. This indicates among the fiscal space indicators, external debt and government expenditure are the main shocks causing the variation in inclusive growth in Nigeria.   In all, appropriate policy towards boosting the mobilising additional resource to accommodate fiscal space while keeping debt limits to avoid fiscal shock in the country.

## 7. Conclusions

What are the policy implications?

      (a) First, the finding of the study revealed that focusing on long term inclusive growth through job creation require prudent government spending. In this case, fiscal policy needs to be channeled to improve the welfare of the people through poverty reduction as indicated in our results. On a second thought, the findings give support for long term debt with strategic focus on growth engineering.

      (b) On a second thought, the issue of debt sustainability is revisited in our findings. Although, external debt reacts positively to inclusive growth with a warning signal, we still suggest that fiscal deficit through proper debt management is required to reduce debt levels below the current limits.

In all, many of these points are vibrant options. If fiscal space is given a chance to embrace inclusive growth in the Nigeria economy, therefore the deficit cannot match the rising debt repayments.

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