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Socio-Economic Relationships Between Fiscal Instruments and Economics of Growth in Developing Economies: A Review Of Literature

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Abstract

The goal of this study is to review literature on socio-economic relationships between fiscal policy, fiscal instability and economic growth and their implications on developing countries like Nigeria. The impact of fiscal policy instruments on growth has become an important issue for developing and transition economies. International donor and multi-lateral agencies such as World Bank, IMF, USAID etc have developed interest on the causal relationships between the foregoing macroeconomic variables and are advising developing and transitional economies to evolve a policy model including fiscal decentralization for growth enhancement. Nigeria, being an oil based and monolithic economy is vulnerable to external trade shocks and the use of fiscal policy instruments and increase in government spending to stimulate growth are indispensable actions. More so, the outbreak of the Wuhan-China Covid'19 pandemic has negatively altered the economies of the world and novel remedies are required to revive ailing economies out of economic recession. Based on the indisputable significance of fiscal responsibility, stability and growth to developing economies, the study is not only necessary but timely. The review is therefore divided into (i) introduction (ii) empirical review (iii) conclusion and (iv) recommendations.

Keywords: *Review, Socio-economic Relationships, Fiscal Instruments, Economic Growth*

1.0 Introduction

In this study, we took a deliberate stance to re-emphasize the importance of conceptual definitions to buttress the position of the paper. Based on this, we outlined comprehensive conceptual and contextual explanations of fiscal policy, social polarization, fiscal decentralization and domestic economic growth (GDP). We carefully selected findings of previous studies on the subject of discourse – effects of fiscal policy instruments on economics of growth (if any).

Macro-economic issues such as fiscal policy, social polarization, modern democratic government and economic growth empowered by globalization are age-long socio-economic and socio-political concepts debated at global conferences organised by IMF, World Bank, European Union, African Union and so on. One of the basic objectives of governments across the world is to promote economic activities through purposeful spending. It has been argued that government is an intrusive institution that drains free market Economies of their dynamic strength through stringent manipulative regulations. The interplay between demand and supply are not allowed to regulate economic activities in certain sectors of the economy (especially in developing economies). Basically, revenues are generated through the instrument of taxation and spent on productive economic activities to promote gross domestic product (GDP) of any country.

2.0 Monetary policy involves measures aimed at regulating and controlling the volume, cost and direction of movement of money and credit in an economy to achieve specified macroeconomic policy objectives – price stability, full employment, economic growth balance of payment equilibrium, equitable income distribution. In Nigeria, monetary policy entails actions taken by the Central Bank of Nigeria that affect availability and cost of

commercial and merchant banks' reserve balances and overall monetary and credit conditions in the economy (Akatu, 1993 as cited in Anyanwu and Oaikhenan 1995 ; Cole, 2015; Jhingan, 2008). **Fiscal policy** refers to government policy concerning the raising of revenue through taxation and deciding the pattern of expenditure for the purpose of influencing economic activities and attaining desirable macroeconomic objectives such as to balance the use of resources of the public and private sectors, control inflation, reduce unemployment rate, reduce balance of payment problems and income inequity (Anyanwu and Oaikhenan, 1995; Seyi, 2008; Cole, 2015; Jhingan, 2008).

3.0 Fiscal Decentralization is the action of allowing several levels of government in a polity to make decisions on the use of fiscal policy and responsibility. In other words, it tends to entrench fiscal federalism in a multi-ethnic and plural state. It is the process of removing some powers/functions from the centralized bureacracy and devolve same to the constituent units of the state. Fiscal decentralization may take two forms – decentralization by delegation and decentralization by devolution (Jorge and Robert, 1997). Decentralization by delegation is a top down approach where the central government gives sub-national governments the power to carry out functions and raise revenues while decentralization by devolution means an arrangement that has constitutional backing where sub national governments governs their own affairs, raise revenues through taxes and prepares budgets with no or little interference from the central government.

4.0 Social Polarization entails ethnic fractionalization and income inequity with volatile fiscal and monetary outcomes and evidence of retarded growth. It is one of the oldest ideology debated in political economics (Jaejoon, 2004). An economy with high degree of polarization shows great fluctuations in government spending according to shocks/uncertainties. In this instance, the level of production, and economics of growth depend on social polarization and political uncertainties (Jaejoon, 2004). The dynamics of fiscal spending in response to the dictates of polarization was described by Garvin and Perotti (1997) as pro-cyclicality of fiscal policies in Latin America.

5.0 Economic Growth is seen as increase in current value prices of aggregate product based on evaluated behavioural trend of aggregate expenditure for a period of time. An economy is enjoying growth if there is an increase in per capita output at constant prices over time. Capita output is obtained by dividing the increase in real output by the total number of persons among whom it would be shared (Leonard 2000; Edih and Emasogbe,2021). Growth is usually characterized with increase per capita income, increase in productivity, social and ideological transformation, high rate of structural transformation and so on. **Democratic governance** and democratic institutions are machineries for ensuring prudent management and application of fiscal and monetary policies, fiscal decentralization to ensure sustained growth in an economy. Therefore, the need for credible and transparent electoral system/umpire in developing and transition economies cannot be overemphasized.

From the above postulations, government can use fiscal and monetary policies to propel or strangulate the economy. According to Engen and Skinner, (1992) identified three approaches on measuring the impact of government fiscal policy on economic growth. One, measuring the average level of government spending and tax rates in cross country regressed on growth rates. Studies found a negative correlation between government fiscal activity and output growth rates. In line with new growth model, fiscal policies could have a permanent stamp on equilibrium steady-state growth trajectory. This view is a daily occurrence in the economic and political environments because government and governance is a continuum and fiscal or monetary policies are machineries use to regulate activities of the economy.

Two, government spending or fundamental non-concavities in aggregate production function demonstrates a positive link between expenditure and productive investments. King and Rebelo (1990 as cited in Engen and Skminer, 1992) argued that distorted taxation on output growth rates exceeds the traditional Herberger measures. However, government spending has been considered as a productive investment (Ravikumar, 1991). And third, relaxation of the equilibrium assumption and countries be allowed to follow the transition path where government spending and taxation can vary over a given period. Ram (1986 as cited in Engen and skinner, 1992) found a positive significant effect of increased government spending on output growth.

We can see that some empirical results show significant and negative impact of fiscal action on output growth rates both in the short-term and long-term. This negative impact presupposes the implementation of a contractionary fiscal policy through increased taxation and balanced budget. That means, the traditional mindset of government to boost economic activities and growth may be unrealizable in this circumstance. Therefore, the study must dig deep in order to proffer relevant recommendations to governments.

6.0 Empirical Review

6.1 Studies on Fiscal Policy Instruments and Economic Growth Relationships in other climes

Congressional Research Service (2021) supports the fact that COVID-19 pandemic caused a global economic recession and that government should employ expansionary fiscal policy by increasing spending and reduce tax rates. The impact of government spending and taxes is measured by gross domestic product (GDP). The study sees fiscal policy as influencer of government spending and revenue behaviours. Anja and Gerrit (2011) argue that hike in government spending yields a short term fiscal multiplier of about 0.70 while the fiscal multiplier from an increase in taxes and social security contribution is - 0.66. The authors opine that discretionary revenue policies have limited impact on economic growth in Germany. Karimi and Khosravi (2010) result shows a positive relationship between government expenditure and output growth and a long-run relationship exist among monetary policy, fiscal policy and economic growth.

Theoretically, Engen and Skinner (1992) model the causal effects of government taxation on labour and capital. They classified the economy into two; taxed and untaxed sectors. The untaxed sector includes small-scale trades and services, small holders of agricultural activities (output) while the taxed sector entails large scale manufacturing, exporting industries, corporate tax, payroll tax, imports and excise taxes. The model assumed that taxes distort production decisions and output. Therefore, compelling factor input into the untaxed sector. The flow of inputs from the taxed sector to the untaxed sector allows for production linkages. The model is econometrically represented as;

1.0 $$Y = H (Kn, Ln, Kx\ Lx; g) \quad (1)$$

where 'Y' as general function of private inputs and government services, K, and L, measure capital and labour in taxed (x) and untaxed (n) sectors and 'g' is the share of government expenditure on goods and services to total output and 'H' represents returns; decreasing or increasing returns to scale.

The study of (Engen and Skinner, 1992) concludes that government expenditure and taxation affect gross domestic product (GDP) growth rates of both developed and developing countries but at various degrees. It was revealed that government expenditure and taxation had a negative impact on output growth. It also showed that balanced budget caused 1.4 percent decrease in growth rates. Increase in taxes on labour have

higher effects on output growth than corporate, interest or trade taxes. It therefore recommended an appropriate utilization of the fiscal policy instrument to drive the economy.

It sounds paradoxical if government spending does not boost economic growth? What may be the reason(s)? Studies have stated the obvious – a disbelieving empirical assertion that, government spending consistently showed negative impact on output growth rates (Landau, 1986, Grier and Tullock, 1989). Can these reports be caused by misgovernment, mis-prioritization of programmes, projects and policies or inherent endemic corruption? Or can this be a result of miscalculation or faults from the model used or misinterpretationof empirical results? Levine and Renelt (1992) showed that there were partial correlations between variables due to model specification. However, Aschauer (1989) and Barro (1990) suggest that government capital stock had a positive impact on productivity growth. From the works of (Aschauer, 1989; Barro, 1990) fiscal policy affects equilibrium growth path since diminishing return is absent in the long-run. Ram (1986) in line with Freder (1982) model also affirms that government spending has a positive and significant effect on output growth.

Jorge and Robert (1997) portray a positive correlation between economic development (per capita) and government budget (spending). The study found that public infrastructure spending has positive significant impact on economic growth (Easterly and Rebelo, 1993; Ford and Poret, 1991). Davoodi and Zou (1996) argue that there is no complete fiscal decentralization in any economy and it is not true that the more decentralized a country's fiscal system becomes, does not connote a faster growth rate. The authors said, such fiscal decentralization may amount to optimal degree of establishing economic stability. The argument of direct or indirect linkages between fiscal decentralization and growth is a question of empiricism (Oates, 1993). Hypothetically, ten million US dollars spent on roads, health or education at the local government level should produce positive growth than at the federal level. Guess et al, (1997) affirm that fiscal decentralization creates a number of tradeoffs between efficiency and balance income distribution or economic stability

Jaejoon (2004) presents a dynamic model of fiscal policy in a simple growth framework where social polarization led to fiscal instability and retarded growth. A key feature of the study was the size of fiscal deficit, magnitude of fiscal volatility and size of output reduction and growth rate. It showed that the degree of social polarization wasseen to be the cause of fiscal problems in multi-ethnic countries. The paper concludes that social polarization and fiscal instability may retard economic growth and the need to manage diversities in a plural state was therefore stressed.

7.0 Studies on Fiscal Policy Instruments and Output Growth in Nigeria

CBN (2018) observes that recurrent expenditure exceeds capital expenditure in national budgets. This is why increase in budgetary expenditure has not addressed the challenges of unemployment, poverty, insecurity etc. in Nigeria. Adigwe et al, (2015) contend that developing economies are confronted with problems of development such as price instability, massive unemployment, exchange rate volatility etc. Falade and Folorunsho (2015) study revealed that public expenditure had a negative effect on growth, leading to crowding out effect on private investments in Nigeria. According to Nwankwo et al, (2017), there exist a long run relationship between fiscal policy and economic growth. However, government capital and recurrent expenditure showed insignificant impact on economic growth.

There is a positive relationship between economic growth and government revenue in the short run, but a negative relationship in the long run. It was seen that recurrent expenditure had a significant negative effect

on economic growth in the short-run and insignificant in the long-run (Amusa et al; 2019). Sukuru and Umaru (2010) argue that productive expenditure shows significant and positive impact on growth. The study also confirms a long-run relationship between government spending and gross domestic product (GDP). Agul et al; (2015) observe that government expenditure increases much more than government revenues resulting to deficit budgeting. Public incentives framework may promote or crowd out private investments. The need to ensure economic stability through productive incentive policy was recommended.

World Bank (2003) describes the volatile economic environment of Nigeria as driven by external shocks because of too much reliance on earnings from oil revenue. It has been observed that fiscal recklessness, fiscal irresponsibility and deficit financing of public projects led to inflation, price instability, fiscal instability, accumulated external and domestic debt profit in Nigeria (Ezeoha and Chibuike, 2005). It was also observed that inflation, price fluctuations and fiscal rascality hamper economic growth. Increase in government spending drives aggregate demand as an expansionary fiscal policy while contractionary policy reduces government expenditure, household income, and aggregate demand (Horton and El-Ganainy, 2009). Fiscal policy objectives vary from one country to the otherand governments focusis more on economic stabilization in the short run. Richard et al., (2009) concludes that fiscal policy affects aggregate demand, wealth distribution and the capacities to produce goods and services of an economy. The effects of fiscal actions are more pronounced in the short-run.

Fiscal and monetary policies are regulatory measures used by the government to control inflationary trend, economic depression, and provide reliefs from recession (Adeoye, 2006; Omitigun and Ayinla, 2007). According to Blinder (2006) economic stabilization is solidified through appropriate use of fiscal and monetary policies. He warned about the use of discretionary fiscal policy as a tool for macroeconomic stabilization. Akanni and Osinowo (2013) contend that real gross domestic product, real total recurrent and capital fiscal spending were volatile and not stable in Nigeria. Nigerian economy experienced fiscal instability for the period examined, 1970 – 2010. The study therefore revealed that fiscal policy instrument could not solve the problem of economic instability in Nigeria.

Basically, fiscal policy instruments are public expenditure and taxes while monetary policy includes discount rates, open market operations, reserve requirements etc. Fiscal and monetary policies are the two major instruments use forthe management of macroeconomicvariables. However, fiscal policy is central to the health of any economy. The tax imposed by government directly or indirectly affects the disposable income of citizens, corporations and determines the business climate (Akanni and Osinowo, 2013; Ezeoha and chibuike, 2015). Government expenditure provides infrastructure and favourable business climate for the private sector, thereby creating job opportunities, well being and growth. Contrastingly, some authors have argued that budget deficit may be harmful to the private sector because government will definite borrow money from the banks resulting to the crowding out phenomenon that may outweigh the benefits of expansionary fiscal policy in the short term (Akanni and Osinowo, 2013 ; Falafel and Folorunsho , 2015).

Akanni and Osionwo (2013) examined the effect of fiscal instability on economic growth in Nigeria. The study useHoderickPrescot (HP) to filter the fiscal spending components and output. Results showed that real gross domestic product and real total fiscal spending were volatile between 1970- 1985. The study recommended the application of fiscal discipline to ensure stable economic environment in the country. Also, Engen and skminer (1993) view government fiscal policy as a retardation tool that stifles economic growth through unsteady taxation rates and inefficient spending. The study developed a model of fiscal policy and output

growth that accommodates positive and negative effects of government spending on private production, increasing or decreasing returns to scale, transition path away from the equilibrium path and intra-temporal tax distortions. It gathered data from 107 countries during the period, 1970-1985 and found that taxation reduces output growth rates.

Jorge and Robert (1997) review economics literature on the causal relationship between fiscal decentralization and economic growth and democratic governance. The relationship between fiscal decentralization and growth is mixed. The impact is either direct or indirect as evidenced by the empirical results. However, fiscal decentralization has a symbolic relationship with democratic institutions by bringing government closer to the people. There is therefore need to strengthen fiscal decentralization, in other words, fiscal federalism and democratic institutions in a plural society. Sound fiscal monetary actions are perquisite for a stable macroeconomic environment (Akanni and Osinowo, 2013). Instability, uncertainty and challenges of globalization impede long term growth of an economy (Adeleso and Mobolayi, 2021;Hnatkovska and Loayza, 2005; Fatas and Mihove, 2003; Akanni and Osinowa, 2013). Nigeria's economy have been faced with unprecedented fiscal instability due to unfavourable macroeconomic dynamics (Akami and Osinowo, 2013).

The resultant effects of fiscal irresponsibility, are deficit budgets and reckless borrowing and macroeconomic instability, unemployment and consequential vices (Obiyeluaki, 2006). Essentially, the goals of macro economics are, to generate employment, stabilize price, ensure high and sustainable growth, and external balance of payments. These objectives can only be achieved and sustained through the appropriate use of fiscal and monetary actions by the government through relevant institutions (CBN), fiscal decentralization and stable democratic environment. Economic fluctuation is a negative force to these national aspirations (Omitogun and Ayinla, 2007)

Fiscal stabilization through decentralization provides for greater economic efficiency in the allocation of resources in public sector administration (Jorge and Robert, 1997). The authors contend that, public sector economics had little concern on the objective of economic growth by undermining how taxation distorts economic incentives towards savings and investments, evaluate public investment projects through cost – benefit – analysis, private sector market performance through basic infrastructural provision. The argument of basic infrastructural amenities may be contested on grounds of available capital projects across Nigeria (railways, electricity, though not stable, road networks with pot holes anyway) but insecurity is a mess in the country.

The impact of fiscal policy instrument on growth has become an important issue for developing and transition economies. International donor and multi-lateral agencies, World Bank, IMF, USAID etc have developed interest and advised developing and transitional economics to evolve a policy model including decentralization for growth enhancement embedded with direct or indirect benefits to the economy (Jorge and Robert, 1997; Oates, 1993). The argument put forward by Jaejoon (2004) that social polarization arises from ethnic divisions over income distribution as dangerous to economic growth is exact replication of the Nigerian socio-economic and socio-political dilemma (Rodrik, 1999, Easterly and Levine, 1997; Alesina and Rodrik, 1994). Since independence in 1960, national budgets have been financed through borrowing in an upheaval, tumultuous political environment manoeuvred through incessant coup de'tat. It has been seen that countries with polarized societies have the tendency of adopting growth retarding policies leading to over bloated budget deficits and volatile fiscal outcomes (Jaejoon, 2004). Social polarization therefore, is a major cause of fiscal

policy problems and underdevelopment in developing economies with multi-ethnic nationalities, for instance, Nigeria.

8.0 Conclusion

The study reviewed literature on fiscal policy, fiscal instability, social polarization, democratic governance and economic variables that are intertwined, inseparable and manifest positive- negative causal relationships. The different findings about fiscal policy and economic growth were empirically justified according to model specification used for running the test. In other words, results from empirical analysis were in line with the assumptions of the model (econometric analysis) adopted.

On the face value, fiscal policy should have led to positive growth of the economy but, findings from studies at various times showed contrasting reports. Fiscal policy instrument affects economic growth negatively (Ezeoha and Chibuike,2015 ; Engen and Skinner, 1992) while others posit that fiscal policy had significant and positive effect on domestic growth (Karimi and Khosravi, 2010; Jorge and Robert, 1997). However, a caveat was released on the use of discretionary fiscal policy because of its stifling effects on the economy (Blinder, 2006; Anja and Gerritsen, 2011). Having studied, compared and contrasted several findings there is need to make appropriate recommendations on the applicability of these policy instruments – fiscal, monetary and budgetary policies.

9.0 Recommendations

On the basis of the foregoing empirical findings, we recommend as follows,

1. In order to forestall the cascading effects of multiple taxes in Nigeria and boost economic activities in the private sector, corporate entities should pay relevant taxes to single tier of government. The existing tax regime (structure) where corporate organizations are compelled to pay different (and may be frivolous) taxes to the three levels of government (Federal, State and Local) simultaneously is not only retrogressive but a disincentive to investments. More so, generating revenues at the expense of these entities is tantamount to liquidation/winding up of existing investments because a liquidated/wound up company cannot continue in business, thereby, compounding the problem of mass unemployment and consequential crimes.

2. Government should allow her citizens to pay a minimal percentage as pay-as-you-earn tax to increase their disposable income. A high disposable income will lead to effective demand for goods and services and foster productive activities in the country.

3. Government spending (budgeted expenditure) should be geared towards creating enabling environment for the private sector to thrive. Every borrowed kobo should be channeled to the execution of such capital projects. Funds borrowed for specific capital investments should not be diverted for payment of wages and salaries.

4. We have seen that fiscal and monetary policies are macro-economic instruments utilize by governments to ensure economic stability, boost productive economic ventures, regulate price, control inflation and so on. Hence, they should not be manipulated to suit political gerrymandering or gimmicks of the day.

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