

# The Impact of Political and Economic Conditions in the Functioning of Nigeria's Excess Crude Account

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## Abstract

Evidence from literature suggests that resource-rich countries tend to experience poor economic performance relative to economies that are not rich in natural resources. One reason for poor performance is that natural resource revenues are volatile due to price fluctuations. Another reason is that resource rents lead to poor economic management in countries without appropriate policy safeguards. Stabilisation funds are increasingly being used by resource-rich countries to mitigate the effects of volatility. As a major exporter of crude oil, Nigeria is one of the countries that has established, and still operates a stabilisation fund. However empirical evidence has also shown that the existence of a revenue stabilisation fund does not in itself guarantee good economic performance, and that underlying political and economic factors influence the establishment and operation of stabilisation funds. This paper identified the political and economic factors that have influenced the functioning of Nigeria's Excess Crude Account. Drawing from relevant literature the paper explains the ways in which (1) the structure of the Nigerian federation and (2) the patterns of political interactions between the federating units on the one hand and major political actors on the other have affected the operation of the country's stabilisation fund. The study also analysed the ways that non-political (i.e. economic) factors have affected the operation of the fund. The paper found that the greatest challenge to effective functioning of Nigeria's Excess Crude Account has been Nigeria's federal system where the constitution not only prescribes fiscal federalism, but also specifies how all revenue accruing to the federation should be disbursed. Thus the fund currently operates somewhat 'illegally' and at the mercy of diverse stakeholders, who have shown little incentive to formalise the rules and ensure fiscal discipline. The study therefore proves that stabilisation funds cannot in themselves change political institutional conditions which exist independent of the funds. The paper proposes the establishment of formal rules backed by legislation through a constitutional amendment, with clear provisions that would bind political stakeholders. The paper also recommends that Nigeria should take advantage of its improving non-oil GDP situation to delink government spending from oil revenue in the long run.

**Keywords:** Stabilisation fund; national revenue fund; sovereign wealth fund; Excess Crude Account; revenue volatility; natural resource revenue; budget-smoothing; procyclical policy; fiscal federalism.

## Introduction

According to the literature of natural resource revenue, resource rich countries seemed to have recorded poor economic performance relative to economies that are sustained by non-resource revenues. This, it is argued, is due largely to the distortions created by volatile revenue sources and poor fiscal management by governments in these countries. As a tool for better management of natural resource revenue, stabilisation funds have become increasingly popular among resource rich countries. Also evident in the literature is the argument (based on empirical studies) that these resources in themselves do not guarantee better management of the economy by resource-rich countries (Truman 2007; Humphreys and Sandbu (2007), and that other (political and economic) factors are crucial to the effectiveness of stabilisation funds.

As a major exporter of crude oil, Nigeria is one of the countries that has established, and still operates a stabilisation fund. Nigeria provides a relevant case analysis for understanding the ways in which economic and political factors affect the performance of such funds. Drawing from relevant literature, this essay will attempt to explain the ways in which (1) the structure of the Nigerian federation and (2) the patterns of political interactions between the federating units on the one hand and major political actors on the other have affected the operation of the country's stabilisation fund. The study will also analyse the ways that non-political (i.e. economic) factors have affected the operation of Nigeria's fund. The study will conclude by considering some of the recommendations (in the literature) that are relevant to operation of Nigeria's stabilisation fund, given the country's political context.

## Stabilisation Fund: Concept and operation

A stabilisation fund is generally described as a mechanism for setting aside some proceeds of a country's resources for future use. It is defined as "an instrument intended to smooth revenue streams from natural resources and bring more predictability into the country's budget" (Bagattini 2011). The literature on the subject explains the logic of the stabilisation funds in terms of (1) volatility of revenue from extractive resources and (2) the finite nature of these resources (see Moss 2011; Eifert, Das et al (2011); Asfaha, 2007; Bagattini 2011). Liuksila et al (1994) provided a more technical illustration of this logic in terms of adopting policy tools that treat natural resource reserves as stock of assets to be managed rather than revenue sources to be exploited.

Similarly, Prior et al (2011) likened revenue from non-renewable sources to the depletion of wealth, thus arguing that such revenue should be made available to future generations through savings funds.

However, according to literature, the mere existence of a stabilisation fund does not in itself guarantee good economic performance. The bigger issues to address are the underlying reasons for poor performance by these countries in the first place (Eifert, Gelb and Tallroth 2002; Bagattini 2011). A further investigation of mineral dependent countries that have set up stabilisation funds have produced, at best, mixed results in terms of economic performance (Asfaha 2007; Bagattini 2011). Drawing from these empirical results, these authors argue that the reason for the less than satisfactory economic performance by mineral dependent countries can be found both in terms of the level of political development of these countries (pre-mineral discovery) and the manner in which the existence of oil rents, for instance, have shaped the nature of political business i.e. political institutions in these countries. Eifert, Gelb and Tallroth (2002) summarised it thus: “Just as political traditions shape the use of oil rents, rents shape the political economy of petroleum exporting nations”.

### **Nigeria: Fiscal Management Pre-Stabilisation Fund**

As one of the world’s largest producers, oil currently accounts for more than 90 percent of Nigeria’s foreign exchange earnings (EIU 2012) and about 75 percent of total revenue (IMF 2011). However, Nigeria has experienced long periods of poor economic performance, mostly attributed to poor economic management. Davies et al (2001) noted that, before 1995, “Nigeria had various types of extra budgetary funds that were financed by oil revenues and used for off-budget expenditure”. By this time, this type of expenditure had grown from 4 to 12 per cent of GDP, and more than a third of the annual budget. The country had a huge debt to GDP ratio and foreign reserves at just \$3.7 billion (CBN 2000).

### **Establishment of the Excess Crude Account**

In 2004, Nigeria established an “Excess Crude Account” (ECA) in order to “manage revenue volatility and improve the conduct of fiscal policy” (IMF 2010). The ECA is “an oil revenue fiscal rule based on a budget benchmark” which sets the price of crude oil and exchange rate at a level below the projected market price and rate. Any price above the benchmark results in “excess” revenue which is subsequently transferred to the ECA at the Central Bank in the name of the three tiers of government (IMF 2011). The ECA is a savings and stabilisation fund aimed at curtailing expenditure, smoothening revenue and saving for the future. The fund is managed by the Federal Ministry of Finance and Central Bank of Nigeria. Withdrawals from the fund is authorised by the Federation Accounts Allocation Committee (FAAC) comprising the Federal and states governments, and disbursements are routinely publicised in the monthly press releases by the committee. For reasons that will become evident in the course of this essay, the fund operates entirely on informal, voluntary rules adopted by the Federal Government, 37 state governments and 774 local governments.

### **The Political and Economic Environment**

While the importance of rules to the effectiveness of a stabilisation fund has been stressed by the literature (Humphreys and Sandbu 2007; Bagattini 2011), a formal rule for the Excess Crude Account was not, and can still not (it appears) be established due to constitutional impediments. The Constitution of Nigeria (1999) clearly prescribe that the country’s revenue should be paid into a “Federation Account” and be shared among the three tiers of government according to a predetermined formula. As it is, this remains one of the major challenges of the ECA to date (IMF 2011).

With the establishment of the Excess Crude Account, all earnings above the price benchmark are transferred to the fund on behalf of the Federal Government, 37 state governments and 774 local governments, while withdrawals are expected (based on the informal, voluntary understanding between the stakeholders) to be made from the fund to finance budget deficits. However, since the expenditure pattern of each of the 812 (federal, states and local) units of governments is independent of the others, deficits and/or surpluses do not occur uniformly across the levels. A close analysis of the country’s financial records show that even in 2008 when all three levels of government each recorded a deficit, the ratio of the federal government’s share of the deficit was about half the ratio of its share of revenue from the federation account; the proportion of the state governments’ deficit, as a percentage of total, was more than twice (63.3%) the percentage of its share of revenue (26.32); the local governments, on the other hand, recorded a deficit of just 2.2% of total deficits compared to the fact that there are entitled to 21.6% of funds originating from the common pool revenue/savings account. from the federation account. These figures clearly show that the size of each unit’s deficit (as a proportion of aggregate deficit) varied widely from the corresponding revenue allocation ratios (see CBN Annual Reports 2008). The implication, therefore, is that whenever withdrawal from the Excess Crude Account has to be made to finance a deficit by any one or more of the federating units, an allocation (of the funds) must be made to every other member of the federation corresponding to its share of the funds to ensure equity and fulfil constitutional provisions.

As a result, one finds that withdrawals were still made from the Excess crude account even when there was aggregate (net) budget surplus.

Operating as a “financing fund”, (receiving surpluses and financing deficits) it would appear that one way to address the wide variation in government expenditure pattern is to adopt the solution proposed by Davies et al (2001), that financing funds are most effective when the “fiscal policy operates in a sound medium-term framework”. However, a close look at Nigeria’s fiscal management in the last few years, especially in relation to the operation of the Excess Crude Account (ECA) shows a different kind of result: In 2007, the federal government adopted a Medium Term Expenditure Framework (MTEF) as part of Nigeria’s financial management reforms (See Nigeria: Federal Ministry of Finance 2010). It therefore adopted a multi-year budgeting framework which was designed to smoothen expenditure over a three-year fiscal period. During this period (2008 through 2010), the government consistently stated in each of annual fiscal reports that its policies were guided by its “commitment to the Medium Term Expenditure Framework” (CBN 2008, 2009, 2010). However, a close examination of the federal government’s accounts shows that aggregate expenditure increased by 32.2 per cent, almost as much as the increase in its aggregate revenue (36.8 per cent) (Central Bank of Nigeria Annual Reports 2008). What happened the following year (2009) indicated that the government’s fiscal management is driven more by procyclical policies than its stated objective of a smoothening framework. In the said year, aggregate revenue and expenditure of all three tiers of government (Local, State and National Governments) moved in the opposite direction (decrease) by 16.6 and 8.4 percent respectively. The next year (2010), aggregate revenue and expenditure increased by almost equal amounts (14.4 and 15.3 per cent respectively). The reality, again, stems from the difficulty in applying fiscal rules in a policy environment where fiscal federalism prevails.

It would also appear that the present situation reflects the point made by Bagattini (2011) that, in the absence of effective safeguards, National Revenue funds would in themselves become problems rather than solutions. In Nigeria’s case, it would appear that the existence of the Excess Crude Account have tended to both encourage each unit of government to spend beyond its means and a disincentive to consider necessary adjustment in adverse economic conditions. In the first case, an analysis of the financial reports since the establishment of the Excess Crude Account shows that even in the period that actual revenue has exceeded budgeted revenue, funds were still withdrawn from the Excess Crude Account (See IMF Article IV Report 2010). In its annual reports, the Central Bank of Nigeria justified these withdrawals on the grounds of “intervention in priority sectors of the economy” (CBN 2008). These kinds of ‘interventions’ show that, in 2009 for instance, two supplementary budgets were passed in the course of the year, in addition to the main budget at the beginning of the year. The IMF (2011) attributes this to the difficulty in implementing the Fiscal Responsibility Act (FRA 2007), which seek to formalise the “voluntary” oil revenue-based fiscal rule. According to the IMF (Article IV) report, the FRA, passed by the National assembly, is not legally binding on the governments at sub-national levels. On the other hand, the 80/20 rule, established by the federating units, requires that 80 per cent of the savings made in the previous year should be distributed to all tiers of government “regardless of movements in world oil prices” (IMF 2011).

This situation leads directly to the political economy point, made by Hallerberg (2009), that “greater centralisation of the budget process increases fiscal discipline”. Owing to the difficulty in binding the subnational government to the Fiscal Responsibility Act passed by the federal legislature, IMF (2011) noted that attempts to domesticate the Law by the 36 states houses of assembly have so far been unsuccessful, as the state legislatures have shown little interests in adopting this legislation since 2007.

Presently, steps taken by the Federal Government to ‘diversify’ the fund by establishing a Sovereign Wealth Fund is being challenged at the Supreme Court by the state governments (The Punch 2012).

### **Measuring the Performance of the Excess Crude Account**

The analysis so far has highlighted the economic and political conditions under which Nigeria’s Excess Crude Account has operated, with some indications as to the effectiveness of the fund in achieving key fiscal objectives of government. Bagattini (2011) offered several assessment criteria for measuring the effectiveness of stabilisation funds. One of these is the debt sustainability measure as a percentage of GDP. The IMF (2011) returned a favourable assessment for Nigeria, with the ratio at the time of report stable at 2.2%. Bagattini (2011) also referred to a significant improvement for Nigeria in a study comprising 12 oil-producing countries. However, it is also important to consider Chalk’s (1998) observation that, in the assessment of sustainability, the relevant indicators may lie beyond some of these indicators, as a sudden, momentary surge in revenue would produce misleading results in these indicators. Bagattini (2011) alluded to this when he observed, in his study, that Nigeria’s one-off settlement of its external debt stock of more than \$30 billion affected significantly, not just its debt-GDP position, but also the cumulative score for the 12 countries that were covered in the study.

As indicated by Budina and Sweder (2008) and Bagattini (2011), an important measure is the composition and growth of the non-resource component of GDP. So far, the IMF (2011) and the Central Bank of Nigeria

(2011) have reported positive figures, with current growth in non-oil GDP rising at 7.5% and projected to be higher. Taken together with the IMF (2011) observation that Nigeria's (1) successful settlement of its entire foreign debt stock (2) ability to weather the global economic recession and to (3) provide huge bailouts for its banks, are all testament to the success of the excess crude account.

From the analysis of Nigeria's national accounts (CBN Annual Reports), it would seem however, that a claim to sustainability would be more challenged by the size of the Excess Crude Account. While the body of literature on the optimal size of stabilisation funds portray a practical dilemma in finding the right balance between holding large reserves (the opportunity cost of doing so) and investment spending, it is difficult to not admit that a large fund was instrumental to Nigeria's ability to effectively address significant multiple challenges almost at the same time. Whether or not the optimal size debate is resolved one way or the other, the point made by Bagattini (2011), that funds should be able to serve the twin functions of stabilisation and savings, seem to fit more the sustainability argument. This means therefore, that there should be a net positive flow of funds to and from the account. While the Excess Crude Account grew steadily between 2004 and 2008 peaking at \$22 billion, even after the huge debt settlement (CBN 2008), there has been overall negative flow since. At the last report on government finances (CBN 2010), the account stood at \$3.1 billion.

It is also worth pointing out that huge income inequality has also exerted serious pressure on the Excess Crude Account. In 2010, for instance, the government finally bowed to sustained pressure from organised labour and civil society to triple the national minimum wage, which, until that time, was fixed at 7,500 (about \$50) per month. Funds for the payment of the new wages was withdrawn from the Excess Crude Account (CBN 2010). It is hardly surprising that increased allocation to the three tiers of government has persisted, as the wage increase is now backed by legislation.

#### **Reasons for Earlier Successes: The Leadership Variable**

One important point to note, which is separated from the previous political economy analysis in order to underscore its significance, is the way in which different executive presidents from the same ruling party and subject to the same democratic constitution have produced different results with respect to the management of the Excess Crude Account. During the tenure of the previous president (2003-2007), the fund was established and built up significantly, in spite of strong opposition from the other units of government and civil society on the grounds that the account was "unconstitutional". This was also achieved in spite of the fact that the National Assembly has consistently raised the oil benchmark in the appropriation act and the resultant threat to override the president's veto and even threats of impeachment. Remarkably, the same Minister of Finance, who was instrumental to the fiscal discipline in the previous regime, has expressed frustration at the steady depletion of the fund (ThisDay 2012), even though she has been given additional sweeping responsibility as the "coordinating minister for the economy". This illustration is remarkably consistent with Hallerberg's (2009) position that the fiscal management effectiveness of finance minister is contingent on the support of the chief executive and the relative power of that chief executive within the cabinet. But then, again, it points to the fact, stressed by Hellger (2009), that institutions rather than individuals determine "the likelihood that actors will indeed interact repeatedly" in the pursuit of stated fiscal goals.

#### **Conclusion**

This essay has tried so far to analyse the operation of Nigeria's Excess Crude Account and the way in which political and economic factors have affected the effectiveness of the fund. As the analysis has shown, the greatest challenge to effective functioning of the fund has been Nigeria's federal system where the constitution not only prescribes fiscal federalism, but also specify how ALL revenue accruing to the federation should be disbursed. So the Excess Crude Account currently operates (somewhat 'illegally') and at the mercy of diverse stakeholders, who have shown little incentive to formalise the rules and ensure fiscal discipline. While the variation in the performance of the fund between the earlier and later (current) periods points to the effectiveness of leadership ability, it also makes a compelling case for formal rules backed by legislation. The obvious recommendation would point, therefore, to a constitutional amendment with clear provisions that would bind political stakeholders. However, recent experience with the federal government's medium-term fiscal policy framework and the Fiscal Responsibility Act offers little hope of a commitment to a decisive constitutional amendment by the political actors. The reality of the management of Nigeria's ECA illustrates, in a striking way, Bagattini's position that, expanded political participation in the process is not necessarily a good thing. Still, some hope lie in the fact that other sustainability possibilities, like Nigeria's improving non-oil GDP situation, can be actively promoted by the federal government and global institutions. Overall, this study shows further concrete proof that stabilisation funds cannot change political institutional conditions which cannot be changed otherwise.

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