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FISCAL POLICY AS COMPONENT PART OF PUBLIC FINANCE: A THEORETICAL SURVEY

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Abstract

The aim of this paper is to examine the extent of government intervention in the economy through its fiscal instrument which in itself is the core instrument of public finance, since every national government, whether developed or underdeveloped, requires such intervention for its development process. The paper also looks at the controversy between monetarist and Keynesian schools over the rationale for government intervention in the economy as well as some major problems militating against the smooth operation of public finance in Nigeria. The paper also compares public finance with its private counterpart – the business finance – and summarizes the decision making consideration in both sectors of the economy.

Introduction

One of the acid tests of a good development plan is the effectiveness of the nation's fiscal policy as reflected in the annual budgets. What then is fiscal policy? The term "Fiscal" is derived from the Greek word "*Fisc*" which literally refers to the "emperor's bag which contained the tax money". It means the revenue or tax activities of the treasury.

In functional usage however, fiscal policy, today consists of the steps and measures which government might take both on the revenue and expenditure sides of its budgets. In this regard, fiscal policy is defined as "comprising the deliberate use of taxes, government spending or public expenditures and public debt operations to influence economic activities in a desired direction" (Abubakar, 1985). In this definition, there is the underlying assumption that government can through changes

in its tax structure and expenditure profiles, influence economic activities.

Fiscal policy is a component part of public finance in fact, some writers even make it (fiscal policy) co-terminus with public finance. Taylor (1997) for instance believes that the ultimate goal of the study of public finance is to develop proper fiscal policy. He therefore contends that public finance is a science, its is a fiscal science, it policies are fiscal policies, and its problem are fiscal problems. Although, it is not all of it. For while public finance is concerned with government finances in general, including the issues of equity in raising revenues and spending them, fiscal policy is not addressed to non-tax revenue sources and such issues like the incidence of taxation, budgetary procedures and financial administration. These fell in the area overlapping between public finance proper and public administration. Thus, public finance is by definition much broader concept both in scope and emphasis than fiscal policy (Musgrave, 1984).

In most modern systems of national economic management, there are three broad objectives that fiscal policy is meant to address in a simultaneous and integrated manner. First is the task of moderation resource of allocation and adjusting the price mechanism in the direction of greater satisfaction of public wants. The task of fiscal policy here is to discover the proper balance, both in real and financial terms. Between the benefit of greater resource allocation to the public sector and the opportunity cost of withdrawing such resources from the private sector.

Secondly, is the task of redistributing wealth and income between one group in the society and another, as distinct from redistribution between the public and private sectors. Fiscal policy here is designed to achieve some interpersonal balance in net disposal income, economic opportunity, or social welfare such that the marginal utility of the reallocated wealth or income would be greater in the hands of the recipient individuals or groups than in the hands of those from whom it has been taken.

The third objective of fiscal policy, is the general guidance of the national economy in terms of growth and stability. This often relate to changes in the level of aggregate output, employment, and prices. The task here is to design measures that would facilitate the full utilization of the nation's resources both materials and human in such a way that the value of the national currency as well as the objectives of resource reallocation and distribution are not compromised (Aboyade 1983).

Fiscal policy as a concept and as a body of doctrine came into prominence in the Western World with the Keynesian Revolution in the 1930s. Prior to this period, the views of the classical and neoclassical economists dominated government's attitude towards the use of its fiscal powers. The classical economists did not support the idea of government's intervention in the economy beyond the provision of the barest minimum of social infrastructural facilities necessary for the private sector to function, government was expected to, among others, create a conducive atmosphere for individual, corporate bodies, to conduct their daily business, provide a number of goods and services, provide employment opportunities and so on. The list is indeed endless. In the opinion of the classical, government was expected to balance its budgets – raising taxes just enough to offset its expenditures on the provision of basic infrastructures. The classicists objected to deficit spending on the following grounds: Firstly, they argued that if government was to engage in deficit spending, the money needed for such spending would invariably come from private sources through borrowing, which in effect would mean that money that would have been used for productive investment by the private sector would now be diverted to non-productive and wasteful spending by government (i.e. crowding out the private sector).

Secondly, if government resorts to deficit spending, it could be an indication that government was acting outside its traditional boundaries (ultra-vires), finally, that government's spending outside its income was as prodigal as it was unethical since such spending would amount to shifting the burden of repayment to future generation. But Maynard Keynes and his "new economics" came to change all that. Keynes (1936) believed that one of the most deadly evils that could affect any economy was the unemployment of resources. He established the fact that the total volume of unemployment depends upon aggregate effective demand, which itself is dependent on total expenditure on both consumer and capital goods. In particular, Keynes maintained that government had a more positive role to play in the economy and that it was no sign of prodigality on the part of government to maintain deficit budgets. In fact it was even desirable that government engaged in deficit spending if that would shore up aggregate demand as well as level of unemployment.

In effect, what Keynes or rather Keynesian economics, did was to

establish the fact that government had a more positive role to play in the economy and that its most potent instrument in playing this role was its "fiscal powers" to raise revenue through taxation and to borrow as well as its own spending. By working through these "fiscal powers" government can direct and regulate the level of economic activities in the country.

It is an attempt to examine the validity of these arguments between the classical and Keynesian schools of economic thought that this paper is written. The paper is divided into five parts. Part one is the introduction, part two examines the concept of public finance, part three discusses the relationship between fiscal policy and monetary policy in Nigeria, part four highlights the modern roles of fiscal policy as a major component of public finance, while part five concludes the paper.

The Concept of Public Finance

Public finance can be defined as the system of organizing the finances, especially revenues, expenditures and debt operations, of public authorities in the fulfillment of a number of socio-economic and political objectives. Public finance embraces the structure, distribution and dynamics of governmental revenues and expenditures as well as a number of policy instruments routinely used by governmental authorities in the performance of their statutorily defined functions (Akinyole, 1972).

The study of public finance as we set out to do here, entails an examination of how public authorities apply the dominant fiscal measures of taxation, subsidies borrowing, budgetary expenditures, and intergovernmental fiscal transfers, not only to ensure the common good of their citizens, but also to control, regulate and manage economic activities in desired direction. As Bhatia (1990) pointed out, that even though there are a number of principles which tends to universally inform decision making and policy in the area of public finance, the environment under which decisions are taken is however a decisive factor in making public finance relevant. In effect then, the nature and efficacy of public finance particularly its major tools of operation are basically determined by the nature of the economy being discussed, the extent of government intervention in the mainstream of the economy, and the constraints imposed by the peculiarities of the prevailing political, social and economic conditions governing the ownership of the factors

of production and the allocation of resources in the society and so on. All these added together, define and shape the character of a country's public finance. Hence, the size of the country's economic activities and its major macro-economic policies, it political ideologies will determine the size of its public finance. In that case, the Nigeria public finance should be smaller than the American public finance, even though the American economy is a capitalist one.

As an academic discipline, public finance is best perceived as one of those subjects, which lies between politics and economics. The basic issues which government seeks to address through the use of the fiscal instruments of public finance are largely political – who gets what, when, how and why. But the instruments and processes through which these political ends are attained and appraised are all predominantly economic.

According to Anderson (1996) " in government finance most of the major decisions are made in the political sphere, but the consequences of these decisions are also economic in character". The National budget, which is one of the principal instruments of public finance contains the revenue sources, which is economic in character, the credit side on the other hand contains the information on how and on what; the budget therefore is a political economic document. Public finance should however be distinguished from public sector economics which is an emerging sub-discipline of economics that focuses on the use of the analytical tools of economics in analyzing governmental decisions in the area of resources allocation and income distribution. On the other hand, public finance is closely wedded to public administration, which is a sub-discipline of political science. Since public administration is in itself a sub-discipline of political science, there is a relationship on generic grounds given our earlier observation that public finance lies on the borderline between politics and economics. More importantly however, is the relationship occasioned by the centrality of the budget to both disciplines. Most issues in public finance find their operational expression in the government's annual budget. And the budget is the centerpiece of an administration's action. The examination of the concept of public finance cannot be complete without comparing public finance with business as shown below.

Public versus Business Finance

The subject of public finance differs significantly from business finance on at least four grounds. First in public finance the policy frame work of reference is the entire economy comprising both the public and private sectors. And the benefits accruing from the application of the instruments of public finance have to be seen from the point of view of their impact on the whole economy. In business finance on the other hand, the focus is the individual firm or the micro unit. Secondly, the policy instruments of public finance differ markedly from those of business finance. While the former adopts macro-economic measures of fiscal policy comprising taxation and government budget in addition to number of other non-fiscal measures, the latter operates on the basis of its corporate policy including the ability to alter production techniques, expand or contract output and redeploys staff. The firm uses it budget which contain only economic issues to control corporate activities.

A third area of difference is the decision-making constraints under which policy outputs are determined. In public finance every decision has to pay attention to the twin issues of equity and efficiency. Public policy decisions do not only want to ensure that resource are efficiently employed in production , but also that real and nominal benefits accruing to society in the form of income and wealth are equitably distributed. Business decisions are mainly constrained by efficiency consideration, which is how to use corporate resources to maximize output and consequently corporate profits.

The fourth major area of dissimilarity is the ultimate goals of decision making in public and business finances. The goal in public finance is to provide services to the people at a cost recovery price, while that of the business is to make profit. While the profit maximizing goals of the business sector makes it possible, and in fact necessary, that accounts must be prepared to show the financial position of the organization (balance sheets) as well as its trading position in terms of profits and losses., the records of financial transactions in the public sector tends to be mainly concerned with expenditure control and accountability. In the public sector, cash basis of accounting is mostly used while the business sector uses accrual basis. Table 1 below summarizes the major points raised in the foregoing discussion.

Table 1: A Summary of Decision Making Consideration in Public and Business Finance Systems

Consideration	Public Finance (Public Sector)	Business Finance (Private Sector)
1 Scope	National Economy (Macro Framework)	The firm (Micro Frame Work)
2. Overall objectives and benefits and concept	Welfare maximization, full employment, economic growth and stability	Private benefit and profit maximization
3. Performance indicators	Quality and quantity. Quality of public good services rendered, political stability and sound democracy	Quantitive expansion in pretax level of profits declared
4. Policy instruments	Fiscal policy and Government budget	Corporate budget
5. Decision making constraints	Equity, efficiency and effectiveness (3Es)	Economic efficiency
6 Cost concept	Social and economic costs to the entire society i e real and nominal costs	Nominal costs (Naira & Kobo)
7. Management and accounting tools	Cash-based accounting techniques, control and accountability, financial instructions and *memoranda*	MEO, cost accounting, Management accounting, balance sheets, profit and loss accounting etc

Source: Carl Shoup (1969) *Public Finance*, Weidenfield, London P.23

The Relationship between Fiscal Policy and Monetary Policy

Fiscally speaking, monetary policy is outside the scope of a regular course in public finance, but because in practice it tends to be closely tied to fiscal policy, it therefore becomes mandatory for the beginning students to grasp, at least, the basic dynamics of monetary policy, particularly in view of the fact that in practice monetary and fiscal policies must reinforce and support each other for effective execution of both. Monetary policies are those measures taken by the monetary authorities to control the cost, quantity, quality and direction of credit to achieve national objectives (Afolabi, 1991). As the watch dog of the economy, the central bank has the duty to ensure that policies are set in motion to ensure that the monetary system and real system move hand in hand so as to achieve national objectives. The money supply in the economy will not be too high as to be capable of causing inflation and must not be too low as to hinder investment. If the monetary sector is not controlled in line with changes in the real sector, a situation of disequilibrium will occur that will create problems in the economy.

Basically, monetary policy operates on a number of economic variables all directed at controlling the economy's supply of money and credit through both direct measures in the process of affecting aggregate demand in the desired direction. What constitutes money and consequently its supply differs from one country to the other. In Nigeria, money supply (ms) consists of two variables, one; the aggregation of currency in circulation outside the banks plus demand deposits in commercial banks which make up of m_1 and two; the m_2 which make up m_1 and savings and time deposits with the commercial banks. But in a properly monetised economy without a dual subsistence sector, a third variable m_3 is added to the definition of what constitutes money which is $m_1 + m_2$ plus deposits of non-banking financial institutions or intermediaries, hence, money supply can be represented by the equation below:

$$M_s = m_1 + m_2 + m_2$$

In effect, monetary policy works through a system of periodic expansions and contractions of aggregate demand in the economy. To perform these rather complex operations, a number of policy instruments are usually available to the Central Bank or any other agency responsible

for the formulation and implementation of monetary policy in the country. These instruments can be classified under two groups: (i) Quantitative and (ii) Qualitative.

The quantitative instruments include:

(a) Open market operation
(b) The legal reserve or liquidity ratio
(c) The discount or bank rate and
(d) Interest rates.

The second group of policy instruments is the qualitative instruments. Under this category, there are two policy instruments, (a) selective credit control and (b) the moral suasion.

The distinction is however more for the purpose of analysis because in practice both set of instruments closely complement each other. In Nigeria, for instance, the government not only maps out priority areas, what is officially referred or called "preferred sector", it goes further to give in percentage terms, the minimum share of all loans and advances which should go to the preferred sector. In order words, the government imposes credit ceilings. In 1991 for instance, a minimum of 75 percent of all loans and advances approved in the year was expected to go to the preferred sectors. The less-preferred sectors were to get the remaining 25 percent (CBN, 1991).

It is necessary at this point to consider what fiscal and monetary polices consist of and why they need to be considered together in the discussion of Keynesian macroeconomics. It was not necessary to consider fiscal and monetary policies in the discussion of classical macroeconomics. This was because fiscal policy did not exist in the real sense of the word before the advent of the Keynesian revolution and publication of *The General Theory of Income and Employment in 1936*. The classical economists, including modern day quantity theorist such as Milton Friedman of the Chicago School believe in the ability of the economy to regulate itself with little or no interference from the government. The economy was assumed to possess in-built self regulatory mechanisms, which if left alone would ensure that the economy performed efficiently. Thus left to itself, the economy would always gravitate towards full employment equilibrium with little or no interference from the government. That all the roles performed by the government then was limited to the usual or ordinary investment and

consumption activities just like any other sector within the economy, and not with the explicit objective of regulating the activities of other units, but simply to meet its own needs as a sector (Olofin, 2001).

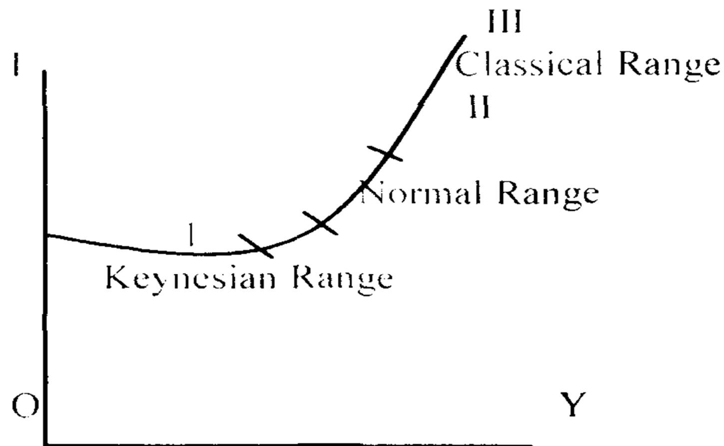
Fiscal and Monetary Policies Dependency

The effectiveness or otherwise of both monetary and fiscal policies is assumed to depend on the elasticity of the IS and Lm functions. Given the major role played by liquidity preference theory in Keynesian macroeconomics model, the elasticity of the Lm curve plays quite a major role in determining the degree of effectiveness of monetary as well as fiscal policy. The Lm schedule is divided into the three ranges reflecting three types of fiscal elasticity. This is illustrated in figure 1 below. The first range in figure 1, that is, the lower portion of the Lm curve is styled as the "Keynesian range". This corresponds to the liquidity trap region at which the Lm curve is perfectly elastic, and the level of speculative demand for money is so high that any increase in money supply, no matter how large is added to speculative cash balances. Monetary policy, therefore is not effective in Keynesian range because of liquidity trap. At the Keynesian range fiscal policy is effective, that means it has been able to move the level of income forward when government increases its expenditure and reduces taxes. This is possible because in the Keynesian range or liquidity trap region, there is enough speculative cash balance to buy government securities, since most government expenditures can only be financed through the sale of securities.

At the other extreme is the third range of the Lm curve, range III which is styled as "classical range", it correspondents to vertical portion of the Lm curve at which the level of speculative demand for money is so low and possibly zero. In this range, monetary policy is effective because there is transaction demand for money, while fiscal policy is ineffective because there is no speculative demand for money at all. So any attempt by government to increase its expenditure through the sale of securities will meet with serious resistance.

The second range, which is labeled II in the diagram, is the normal or so-called intermediate range. Within this range both speculative and transaction demand for money exists. This makes both monetary and fiscal policies to have positive impact on the economy.

Despite the theoretical separation of these macroeconomic policies, it is impossible in practice to apply one of the policies effectively without the other, especially the fiscal policy whose effectiveness depends at which range the IS curve cuts the Lm curve.



Different Ranges of the Lm Curve

Modern Roles of Fiscal Policy in Nigeria

It is generally agreed that fiscal policy, in spite of its inherent limitations, has played a key role in the management of the Nigeria economy since independence. In the earlier days, fiscal policy in the country reflected more on the financial requirements of government and that of maintaining a health balance of payment account. In recent years however, the relative importance of fiscal measures in other areas particularly in maintaining economic stability because recognized and fiscal policy became the centerpieces of government macroeconomic policy in the country.

Fiscal policy is therefore to be seen at all times in the overall context of general economic and development policy. But it goes beyond the conventional accounting relationship of government revenue and government expenditure or of the procedure of government budgeting. Because of increasing importance of government conduct in a nation's development process, the study of modern public finance is the study of resources allocation and preoccupation with the problems of economic growth, economic stability employment, prices, income distribution and social welfare. It is also concerned with the analysis of

the effects of different taxes on incentive to work, to save and invest. Because of this multiple dimension of the subject matter, fiscal policy as the core of public finance has developed an array of instruments to handle different facets of the economics of the public sector.

The main focus of fiscal policy in Nigeria has centered around the attainment of three basic objectives which are essentially organized to:

(i) Mobilize financial resources for financing economic development.
(ii) Maintain reasonable economic and price stability, healthy balance of payment account and
(iii) Minimize existing inequalities in wealth, income and consumption standard which may tend to undermine production efficiency, offend a sense of social justice and endanger political stability (Abdulsalam, 1985).

In current years, these objectives have been expanded to include its (fiscal policy's) use in promoting a rapid expansion of agricultural and manufacturing production as well as the promotion of exports of oil and non-oil resources and the use of the local raw materials in industrial production, protection of infant industries and dispersal of industrial projects.

Fiscal policy is formulated and implemented by the three levels of government i.e. Federal, State and Local Governments. Each tier has defined areas of competence and tax jurisdictions within which to legislate on aspects of fiscal policy but the Federal government tends to dictate its major trend and focus from one year to another.

The question one might want to ask at this point relates to what the overall effectiveness of the fiscal policy has been in Nigeria. This is a difficult question to answer but all the same, one can contend that if the objectives which fiscal policy measures have been designed to achieve in this country are anything to go by, then fiscal policy has not been very a effective policy medium.

The potential of fiscal policy in stimulating domestic production for instance remains to be exploited. The policy has failed to diversify the base of the economy away from oil to something else, say agriculture or manufacturing and has also failed in bridging the deep cleavages in income distributions. The national budgets which are the most important instruments of fiscal policy have not been properly implemented since the arrival of the present so-called democratic regimes. Fiscal policy

in Nigeria remains a veritable tool in the hands of politicians who more often than not have to be guided by what is politically expedient rather than what is defensible from an economic point of view. In Nigeria, the bulk of government's expenditure goes into inflexible government programmes of financing overheads, such as excessive overseas travels, sponsoring of pilgrimages, conduct of undemocratic elections, building of unviable stadia, roads, bridges and the like which have little or no relevance to short-term discretionary stabilization of fiscal goals. Taxation which is another potent instrument of fiscal policy is notoriously administered in Nigeria, taxes are no more used for revenue, for encouraging and discouraging consumption, promoting growth and development, distributing income, but it is being used in reverse direction. The rich no longer pay tax, it is only the poor that pay. The poor do not only pay heavy tax, but they also subsidize the gluttonous consumption of the rich. Fiscal policy whose main instrument is government spending is seen as an instrument for promoting the short or long run goals of rapid economic development, but in Nigeria it is not so, because most expenditure in Nigeria are directed at promoting the economics of foreign countries - through the massive importation of all types of goods, consumed by Nigerians today, including those that can be locally produced. Infact the Nigerian public finance is bleeding as most revenues generated in this country are either banked or invested in other countries of the world.

Conclusion

It is quite possible to conclude from our discussion that Keynesian macroeconomics favours fiscal policy over monetary policy, which is best suited to be effective in classical model. While the classical economists may disagree with this conclusion as it affects their particular models, this form of interpretation of the model has led to what has come to be known as the monetarist-Keynesian controversy (the great debate). The controversy centers on the choice between fiscal and monetary policy as an effective tool of government regulation of level of economic activity.

Fiscal policy more or less comes under the direct responsibility of the Ministry of Finance as an arm of government. On the other hand, the Central Bank as a quasi arm of government has direct responsibility

for monetary policy. If Central Bank as it is normally assumed were to be an independent arm, the possibility exists that it could find itself pursuing policies that run counter to the government's fiscal policy measures. Even if such possibilities were to be ruled out, the fact remains that an analysis of the effectiveness of one set of policy, be it monetary or fiscal cannot be meaningfully carried out without considering the other. The effectiveness of one policy may vary depending on the other.

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