Nigerian States' Financing System: Reform Is Well Focused On Paper, But States' Full Engagement Is Key

The public finance system for Nigerian states is evolving. While the federal (i.e., central) government (Federal Republic of Nigeria {foreign currency BB-/Stable/B, local currency BB/Stable/B}) has inspired much of the spirit of reform, several states are also engaged and are demonstrating a taste for market discipline and transparency. Much is at stake. Standard & Poor's Ratings Services views the states' ability to manage oil price volatility, enhance transparency, and, more generally, forge ahead with the public finance reform as key to achieving their goal: To deliver on economic development while preserving financial soundness.

Successfully implementing ongoing changes is not a minor challenge, given what we see as the entrenched flaws of the system--such as information gaps that hamper benchmarking of financial and service variables, accountability, and intergovernmental coordination. To succeed, more than just federally inspired legislation is necessary, in our opinion; local and regional governments (LRGs) must actively embrace the spirit of reform.

Our Current Assessment Of The System, At A Glance

According to our rating methodology, the ongoing changes in the Nigerian public finance system should be favorable for the states' credit profiles (for more information about our rating methodology, see our criteria article "Rating International Local And Regional Governments: A Primer" published on March 7, 2007, on RatingsDirect).

Particularly, over the past few years, states have been increasingly protecting their share of oil revenues from federal government interference, thereby increasing the system's revenue predictability. Also, in 2007, the National Assembly passed a set of fiscal rules at the federal level aimed at sheltering the revenues of all Nigerian government tiers from oil price volatility. These rules, better known as the "Fiscal Responsibility Bill" (FRB) and thus far applied de facto, reduce the risk of a revenue-expenditure mismatch, which we see as another positive rating factor.

The states have argued, however, that, under the constitution, these rules cannot not be imposed from above. Consequently, the states are now passing their own legislation that concurs with the broad goals of the federal law. We believe that the states' FRBs should strengthen their fiscal policy framework, through, for example, multiannual expenditure planning and debt management guidelines. Thus, state-specific fiscal policy laws--depending on their final shape and implementation--could have positive implications for Nigerian states' credit profiles.

Despite ongoing and planned reforms, Nigerian states' public finance system remains very weak, based on our rating methodology. Dependency on oil revenues and potential expenditure pressures are high, which works against a good revenue-expenditure match. In addition, what we see as unclear distribution of expenditure responsibilities, with much overlapping between government tiers, reduces visibility and introduces risks into the system. More importantly, financial management is built on poor foundations, in our opinion, with deep-seated flaws regarding transparency and accountability; we currently view this as the largest constraint for the credit profile of Nigerian states.

Table 1 below summarizes the main strengths and weaknesses of Nigerian states' financing system from a credit

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rating perspective.

Table 1
Nigerian States' Financing System--Weaknesses And Strengths

Weaknesses	Impact	Rating drivers
1. Weak transparency and disclosure	Poor financial information hinders government coordination, accountability, financial forecasting, debt sustainability appraisals, and efficient resource allocation. Distribution rules for the Excess Crude Account are not completely transparent.	Transparency and accountability
2. Dependency on oil revenues (exacerbated by generally low IGR)	Increases revenue volatility in the absence of a stabilizing fiscal framework.	Revenue-expenditure match
3. Potential expenditure pressures (owing to large economic-development needs)	Increases the possibility of a revenue-expenditure mismatch, given oil revenue volatility, low IGR, and lenient fiscal rules.	Revenue-expenditure match
4. Absence of significant tax legislation powers	Reduces financial flexibility to maintain adequate financing of competencies.	Revenue-expenditure match
5. Unclear distribution of expenditure competencies	May decrease visibility on expenditures and effective dependency on federal-government funding.	Expenditure predictability
Strengths	**Impact**	**Rating drivers**
1. A moderately stable revenue framework, owing to: • States' proven capacity to ring fence their Federation Account revenues from federal-government interference; and • Revenue-sharing agreements that will likely be subject to only minor, gradual adjustments, if any.	The Nigerian states' revenue framework reasonably ensures timeliness and predictability of the statutory allocation (the main source of revenues in the majority of states).	Revenue predictability
2. State-specific fiscal policy bills (currently being passed), which we understand should introduce: • Oil-based fiscal rules, • Multiannual planning, and • Debt management rules	The individual fiscal bills could have positive rating implications, depending on their form and final implementation in each state and provided they decrease oil revenue volatility and enable better analysis of debt sustainability.	Fiscal policy framework
3. Substantial room for increasing IGR, through efficiency gains in tax management.	Potential IGR proceeds somewhat increase financial flexibility to maintain adequate financing of competencies.	Revenue-expenditure match

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We expect current revenue-sharing arrangements to remain stable or undergo only minor modifications. We also anticipate that all Nigerian states will pass and gradually implement their own versions of the federal government's FRB during 2009. Some uncertainties exist as to the composition of the legislation at the state level, but we believe that the states will generally provide for a wide range of reforms, including an oil-based fiscal rule, medium-term expenditure planning, and debt management guidelines. That said, while ongoing reforms have positive rating implications on paper, Standard & Poor's will not upgrade its current appraisal of the Nigerian states' financing system (Group 5, "very weak") until the system's flaws, mainly in the domain of transparency and disclosure, have been thoroughly addressed.

For a systematic overview of the key analytical issues we assess in our evaluation of the Nigerian states' financing

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system, see "Public System Overview: Nigerian States" published on March 2, 2009, on RatingsDirect.

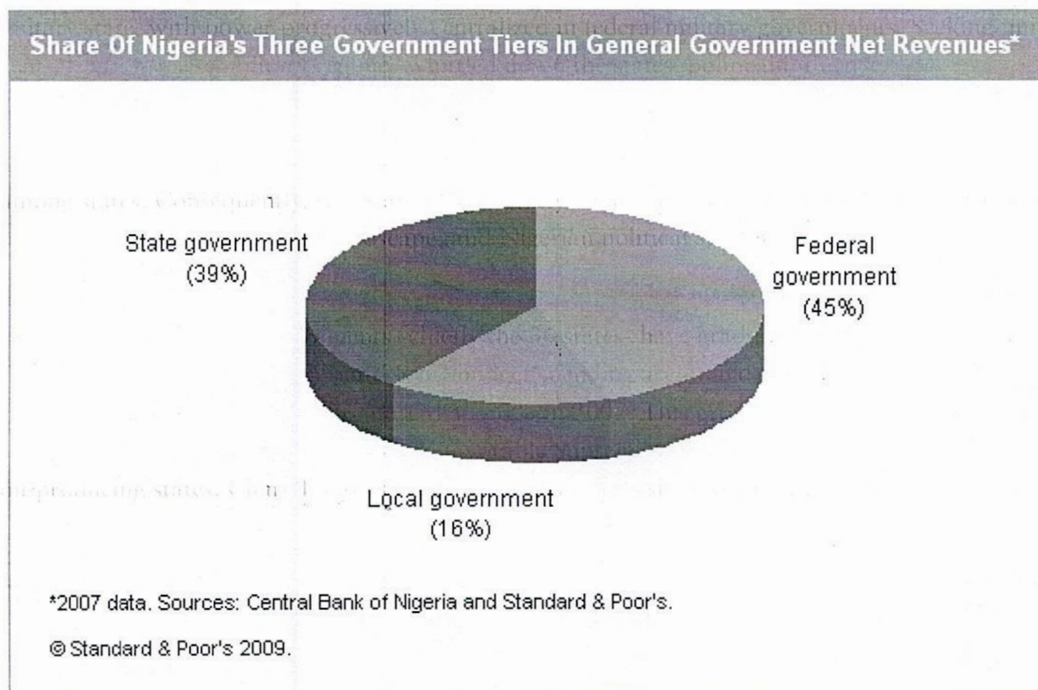
A Complex Political Landscape Where Fiscal Federalism Plays A Key Role

Nigeria is a large heterogeneous nation, with more than 140 million inhabitants, 250 ethnic groups, and as many languages. However, throughout much of its history since independence in 1960, the country has operated as a unitary state, with power progressively centralized in federal military governments. Seeking unity through centralization, these military regimes whittled down the states' political influence.

The advent of civilian democratic rule in 1999 opened the door for a larger role for the states. While not overly accepting of a full delinking, the system is now, in our view, much more decentralized and respectful of diversity among states. Consequently, states are progressively enhancing their presence in Nigeria's overall fiscal, macroeconomic, and political landscape, and Nigerian political stability now relies largely on the ultimate success of fiscal federalism.

Nigeria's subsovereign governments--chiefly the 36 states--have gradually increased their weight in the country's public finances. In 1999, Nigerian LRGs' budget spending accounted for less than 25% of the general government budget--a share that increased to more than 50% in 2007. This growth resulted from stricter enforcement of constitutional revenue-sharing rules and favorable Supreme Court rulings, including privileged treatment for oil-producing states. Chart 1 shows each government tier's share of general government revenues in 2007.

Chart 1



The states as a whole now enjoy enhanced economic importance. However, since 1960, when there were just three regions, the country has gradually been subdivided into the current 36 states. Although this trend preserves Nigeria's

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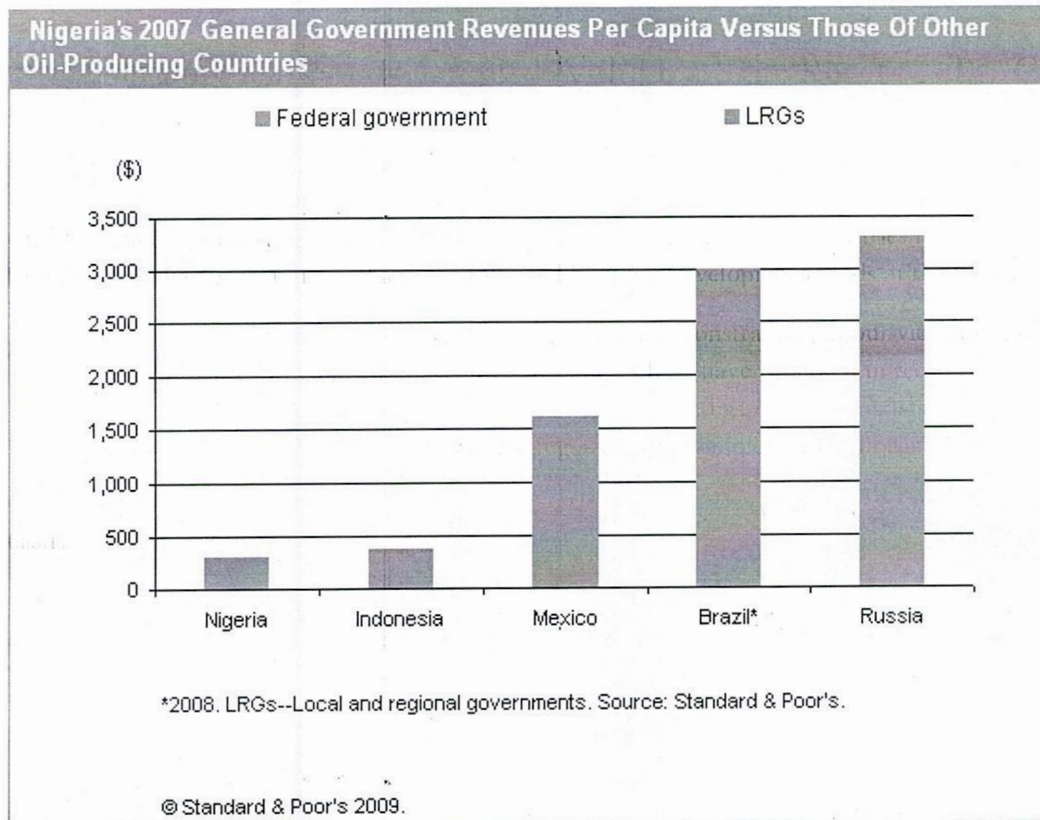
so-called "federal" character, with its multifold ethnicities and languages, the constant subdivision has left some states overly reliant on transfers rather than economically viable as autonomous entities.

Large Development Needs Coupled With Low State Revenues Per Capita

In the long run, we believe that the success of fiscal federalism will depend largely on the public finance system's ability to deliver effectively on economic development. In our opinion, under military rule, debilitated institutions and chronic underinvestment stunted economic growth and generated a large development gap incommensurate with the nation's potential--Nigeria being one of the largest oil-producing countries in the world. Consequently, the democratic civilian governments that have followed have put development needs at the top of the political agenda.

The overall capacity to tackle development needs, however, is, constrained, in our view, by low federal and LRG revenues per capita, as shown in chart 2 below. Although LRGs have benefited in recent years from rising revenues thanks to strong oil prices, we believe that significant unexploited capacity still exists for internally generated revenues (IGR). Only a few states--with Lagos being a salient example--have managed so far to spur non-oil-related revenues.

Chart 2



From a rating perspective, Nigerian states' fiscal sustainability is structurally challenged by potentially high expenditure requirements and low revenues per capita. If states implement ambitious capital-expenditure programs

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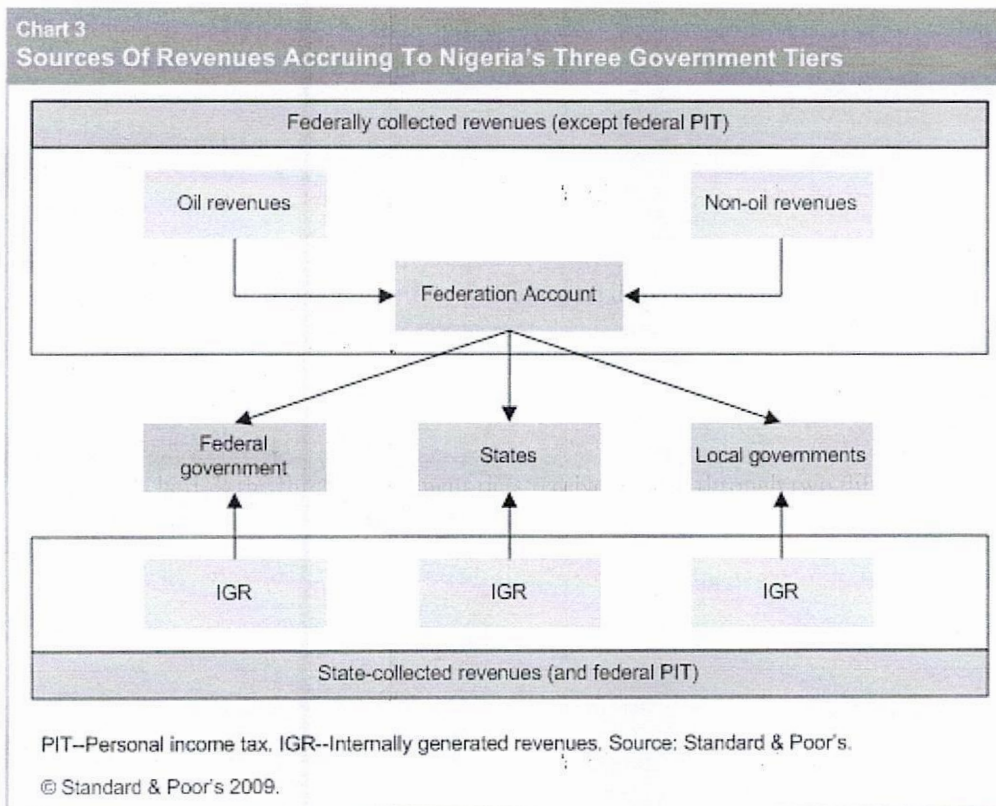
and increase operating expenditures to improve service delivery, a systemic imbalance may emerge on the back of oil revenue volatility. Ongoing reforms to the states' fiscal policy framework are addressing this potential risk.

A Twofold Revenue System: The Federation Account And IGR

As shown in chart 3, the three government tiers receive income through two different channels, namely, the Federation Account and IGR.

Chart 3
Sources Of Revenues Accruing To Nigeria's Three Government Tiers



PIT--Personal income tax. IGR--Internally generated revenues. Source: Standard & Poor's.

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The federation account (FA)

The federal government legislates on, manages, and collects certain oil and non-oil revenues. A number of these federally collected taxes are centrally pooled in the so-called FA for monthly distribution by the federal government among the three government tiers. Table 2 below specifies the tax items that feed the FA. Generally, about 70% of total net revenues in the FA stem directly from oil revenues. The remaining 30% is composed of non-oil revenue proceeds, mainly from the corporate tax, VAT, and custom and excise duties.

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Table 2
Federation Account Tax Items

Tax items	Legislation	Administration and collection	Retention
Oil revenues - Crude oil and gas exports - Petroleum profits tax - Other	Federal	Federal	Federation Account, to be distributed among the three government tiers.
Value-added tax			
Corporate tax (company income tax, CIT)			
Stamp duties			
Import and excise duties			
Development levy			

Sources: World Bank and Standard & Poor's.

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IGR

In addition, the three government tiers manage and collect certain revenues (the so-called IGR), of which the main item is personal income tax (PIT) (see table 3 below). However, the states' IGR as a whole accounts for only about 15% of their total revenues and is heavily concentrated in two states: Lagos (with 46% of total states' IGR) and Rivers (7%).

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Table 3
IGR Tax Items

<table>
<tr><th colspan="4">Federal government's IGR</th></tr>
<tr><th>Tax items</th><th>Legislation</th><th>Administration and collection</th><th>Retention</th></tr>
<tr><td>PIT on:
- Army
- Police
- Residents of Abuja
- External Affairs personnel</td><td>Federal</td><td>Federal</td><td>Federal</td></tr>
</table>

<table>
<tr><th colspan="4">State governments' IGR</th></tr>
<tr><th>Tax items</th><th>Legislation</th><th>Administration and collection</th><th>Retention</th></tr>
<tr><td>PIT
- Pay as you earn
- Self and government assessment</td><td rowspan="8">Federal</td><td rowspan="14">State</td><td rowspan="14">State</td></tr>
<tr><td>Witholding tax</td></tr>
<tr><td>Capital-gains tax</td></tr>
<tr><td>Stamp duties</td></tr>
<tr><td>Development levy</td></tr>
<tr><td>Road taxes</td></tr>
<tr><td>Business registration</td></tr>
<tr><td>Betting and gambling</td></tr>
<tr><td>Street naming</td><td rowspan="6">State</td></tr>
<tr><td>Right of occupancy</td></tr>
<tr><td>Markets</td></tr>
<tr><td>Non-tax items</td></tr>
<tr><td>Fees and charges/interest income/asset sales</td></tr>
<tr><td colspan="4">IGR--Internally generated revenues. PIT--Personal income tax.
Sources: World Bank and Standard & Poor's.</td></tr>
</table>

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Reasonable Revenue Predictability, But Autonomy Constrained By Low IGR

Two constraints on revenue autonomy and flexibility: dependency on oil revenues...

As shown in chart 4, oil transfers from the FA represent the lion's share of Nigerian LRGs' budgets. LRGs receive these transfers as a part of their monthly statutory allocation (for a complete definition of the statutory allocation, please see chart 5). On average, about 60% of state government's total revenues--and some 70% of local governments'--originate from oil. Given that oil prices have been buoyant in recent years, LRGs have benefited from booming revenues.

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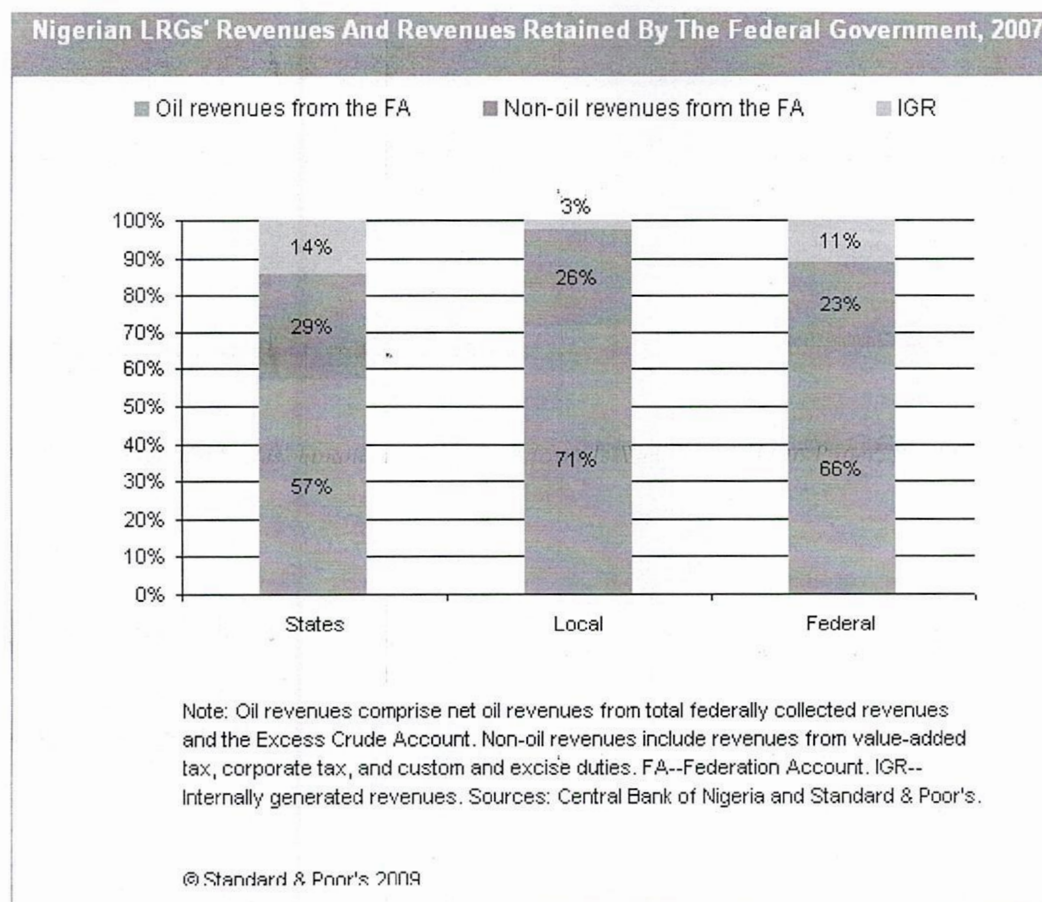
Chart 4



Conversely, IGR remains negligible for many states, which we see as a negative rating factor. Only a few reform-oriented, economically vibrant states, like Lagos, have forged ahead with efforts to develop their IGR. Stronger IGR would, in our view, help plug the development gap by decreasing exposure to oil revenue volatility and improving revenue per capita (thereby enabling higher capital expenditures without fiscal mismatches).

...and the absence of tax legislation powers

In addition, the distribution of tax legislation responsibilities leaves the states with little tax flexibility. The majority of state-collected taxes (more than 95%, according to our estimates) fall under the National Assembly's jurisdiction. For these taxes, states cannot modify the base, raise the rate, or apply a surcharge. The constitution does grant the states full legislative powers over some revenue-raising items, such as lotteries, road taxes, and right-of-occupancy fees, but we see them as being of limited utility since their revenue-raising capacity is low. This lack of significant legislative powers is one of the reasons that we would cap any ratings on the states at the sovereign level.

States benefit, in theory, from greater autonomy regarding tax administration (management) and collection, as they can manage and collect all of their own taxes (i.e., IGR items). These include the PIT, which has strong revenue-raising capacity on an international basis. In practice, however, Nigerian states' IGR is a very weak funding source, except in the economically core states, like Lagos.

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Substantial room, however, for building up own revenue capacity

We must put our view of Nigerian states' low revenue autonomy and flexibility into perspective, however. Despite the states' very limited legislative powers, we believe there is room to expand IGR--especially with respect to the PIT. This applies not only to the main industrial states, but also to the less wealthy nonindustrial ones. In Nigeria, states' chronically low IGR is not only due to low per capita income. The experience of Lagos--with an impressive estimated compound annual IGR growth rate of 55% from 2005 to 2008--suggests that it is possible to increase IGR effectively and vigorously by improving tax administration.

Effective tax administration is, in our opinion, hampered in many states by a number of factors, including 1) the absence or unreliability of data on tax bases, 2) the lack of well-trained professional personnel, and 3) weak administrative and judicial machinery to enforce fiscal laws and prosecute tax offenders. Equally important, the Nigerian public finance system does not provide incentive for tax administration reforms, and the federal government cannot impose them. Specifically, low IGR leads to reliance on oil revenues, as the latter easily cover the expenditure capacity of the less wealthy states, especially in times of high oil prices.

We believe that only a reform-oriented spirit will be able to make certain states shift away from this vicious circle of oil transfer dependence and low IGR. If the ongoing success of certain high-IGR-generating states were imitated across the board, it would, in our opinion, endow the entire financing system for Nigerian states with a larger cushion against oil price volatility and expenditure pressures. We would consider this a positive rating factor.

A rather sound institutional framework for revenues...

Nigerian states' significant dependency on oil revenue transfers no longer translates into the type of federal-government dominance that was prevalent, however, during the years of military regimes. Since the advent of civilian democratic rule, oil revenues--whether extracted onshore or offshore--effectively belong to all tiers of government as a whole. The Supreme Court legally corroborated this principle in April 2002. In practice, this means that the federal government:

- Should act solely as a trustee charged with the distribution of oil proceeds to the other government tiers according to a set of determined rules;
- Has no power to withhold revenues without the consent of the LRGs; and
- Cannot debit first-line charges (see section below) from the FA before sharing the oil revenues with the LRGs.

This framework paves the way for an enhanced role for the states, since it further protects their revenues from federal-government interference.

We view the states' present capacity to ring-fence their revenue allocation as positive for their credit profiles. Conversely, credit quality might suffer if intergovernmental relations create a volatile financial framework for the states, with uncertainties impairing the timeliness and predictability of the statutory allocation.

...with quite stable vertical and horizontal revenue-sharing arrangements

Revenues accruing to the FA--chiefly oil revenues, corporate taxes, and VAT--are vertically distributed between the three government tiers according to clear revenue allocation formulas. Chart 5 below shows the 2007 FA and the ongoing revenue-sharing agreements.

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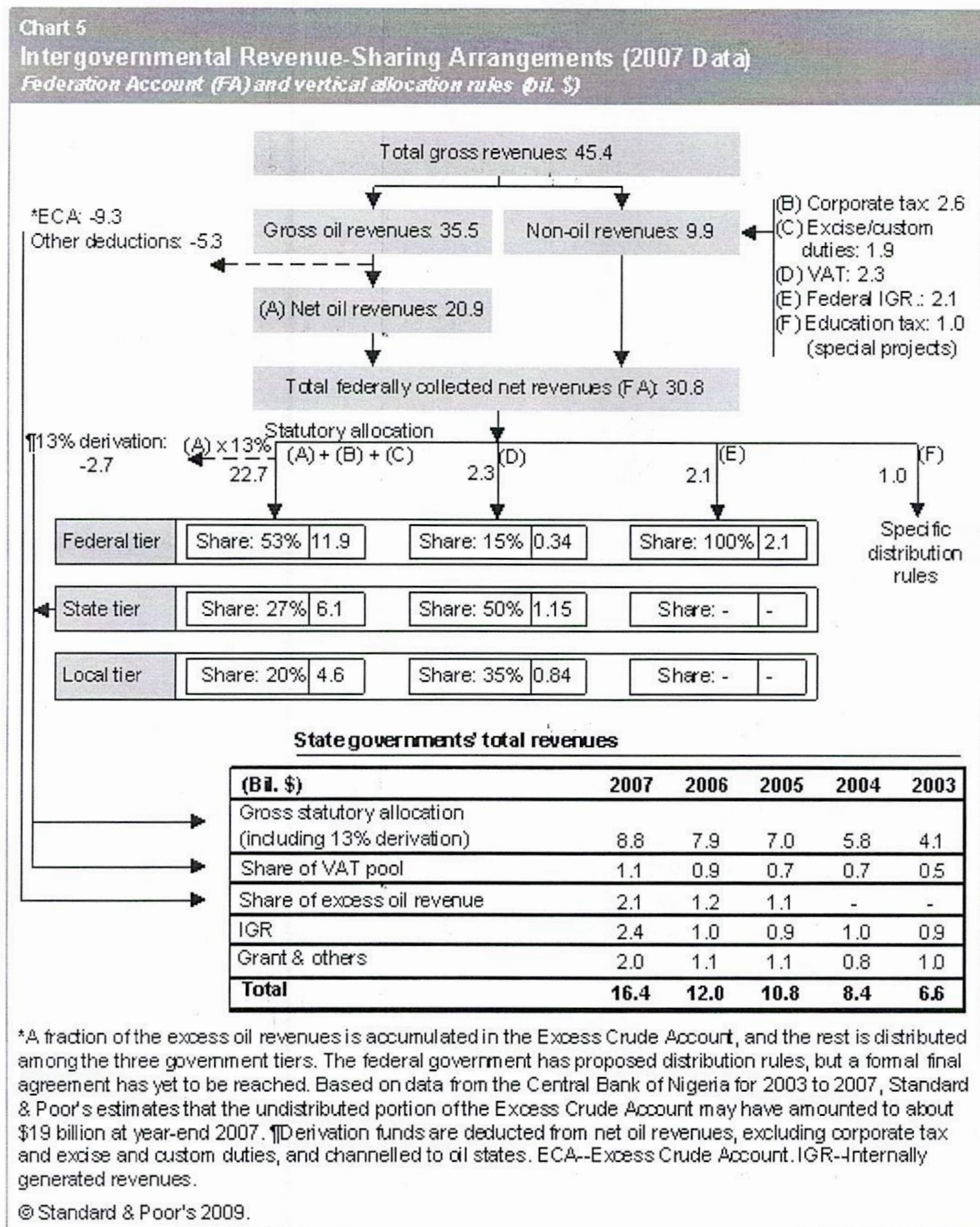
Chart 5

Intergovernmental Revenue-Sharing Arrangements (2007 Data)

Federation Account (FA) and vertical allocation rules (Bil. $)



State governments' total revenues

(Bil. $)	2007	2006	2005	2004	2003
Gross statutory allocation (including 13% derivation)	8.8	7.9	7.0	5.8	4.1
Share of VAT pool	1.1	0.9	0.7	0.7	0.5
Share of excess oil revenue	2.1	1.2	1.1	-	-
IGR	2.4	1.0	0.9	1.0	0.9
Grant & others	2.0	1.1	1.1	0.8	1.0
Total	**16.4**	**12.0**	**10.8**	**8.4**	**6.6**

*A fraction of the excess oil revenues is accumulated in the Excess Crude Account, and the rest is distributed among the three government tiers. The federal government has proposed distribution rules, but a formal final agreement has yet to be reached. Based on data from the Central Bank of Nigeria for 2003 to 2007, Standard & Poor's estimates that the undistributed portion of the Excess Crude Account may have amounted to about $19 billion at year-end 2007. ¶Derivation funds are deducted from net oil revenues, excluding corporate tax and excise and custom duties, and channelled to oil states. ECA--Excess Crude Account. IGR--Internally generated revenues.

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Within this framework of revenue-sharing agreements, oil-producing states receive preferential treatment. Specifically, 13% of the funds accruing to the FA from oil and other natural resources (which represented 68% of total net federally collected revenues in 2007) are diverted to the oil-producing states before applying the allocation formulas among the three government tiers. This constitutionally protected 13% first-line deduction (known in Nigeria as the "derivation principle") highlights the way in which Nigerian fiscal federalism copes with centrifugal tensions. Nevertheless, the issue of derivation is difficult to manage in our view, as oil-producing states continue to argue that the 13% derivation rule is inadequate.

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The same goal of an equitable revenue distribution among the states applies with regard to "horizontal" allocation formulas--that is, the way revenues from the FA are distributed among the 36 states (see table 4 below). Thus, in the case of the horizontal arrangements for VAT proceeds, 50% of collected VAT is distributed to the industrial states (Lagos, Rivers, Ogun, and Kano), which account for the bulk of the VAT tax base.

Table 4

Nigerian States -- Horizontal Revenue-Sharing Arrangements

Principle	Weight applied to transfers from oil revenues, corporate tax, and excise and custom duties (%)	Principle	Weight applied to transfers from the VAT pool (%)
Equality (equal amount to each state)	45.2%	Derivation to industrial states	50.0%
Population (number and density)	27.9%	Equality (equal amount to each state)	40.0%
Landmass and terrain	10.7%	Population	10.0%
Own revenue generation effort	8.3%		
Education and health	6.0%		
Other	1.9%		
Total	100.0%	Total	100.0%

The allocations (horizontal and vertical) are set by a constitutional body (the Mobilization and Fiscal Allocation Commission) in which each state has representation, and are subsequently approved by the National Assembly. The constitution allows modifications to the FA-sharing formula every five years to adapt to changing realities. Since civilian rule, however, changes have been minor.

Periodically there are controversies and calls for further-reaching reform. For example, Lagos, Nigeria's economic core and its primary source of VAT, has traditionally called for a larger share of VAT proceeds, presenting the same territorial arguments that led to oil revenue derivation in favor of oil-producing states. Nevertheless, we expect the formulas to remain stable for the most part in the medium term, with any adjustments being only very gradual.

From a rating perspective, the system's supportiveness could weaken if allocation formulas change significantly and unpredictably instead of gradually in order to avoid a sudden revenue-expenditure mismatch.

Improved Oil Revenue Management For Better Revenue Predictability And Revenue-Expenditure Match

From a public finance perspective, Nigerian LRGs' extreme dependence on oil revenues can generate fiscal imbalances. This might occur due to volatility in oil prices and, to a lesser extent, in production, due mostly to ongoing instability in the Niger Delta. Lower oil revenues could lead to revenue-expenditure mismatches if subsovereign governments scaled up expenditures when oil prices were higher. From a macroeconomic standpoint, high oil prices may entail massive injections of liquidity into the system in the absence of a fiscal rule. For our complete analysis of the macroeconomic implications of Nigeria's oil revenue management, see our full analysis "Nigeria (Federal Republic of)" published on July 2, 2008, on Ratings Direct.

In order to counter these risks, the federal government has been applying, de facto, an oil price-based fiscal rule. Under this rule, it conservatively budgets an oil price ($45 per barrel in the 2009 federal budget proposal, down

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from $53 in 2008); any oil revenues generated above this price are saved in an account called the Excess Crude Account. The account funds legally belong to each LRG according to the existing revenue-sharing arrangements. Withdrawals from the account should, in principle, occur only when the oil price falls below the predetermined level for three consecutive months. Consequently, the Nigerian oil revenue management framework is a mixed stabilization and savings mechanism, since it protects against price volatility and builds up a cushion for "intergenerational equity" (the preservation of wealth between current and future generations).

This framework is formally contained in the 2007 Fiscal Responsibility Bill (FRB), which was enacted by President Umaru Yar'Adua and prepared by the previous administration. However, President Yar'Adua has adopted a more accommodating approach toward the states than his predecessor Olusegun Obasanjo. Former President Obasanjo directed above-budget revenues into the Excess Crude Account, de facto, in line with the FRB's oil-based fiscal rule. In contrast, President Yar'Adua--a consensus-seeking former state governor--has been more receptive to the arguments of the states, which deem that the federal government has no right to siphon off savings in their name.

Thus, the president and states have been engaged in a process of dialogue under which a number of principles have been agreed, enabling distribution of funds in the account, with two limitations:

- The Excess Crude Account must maintain a minimum of Nigerian naira 1 trillion at all times, and
- Inflows must exceed withdrawals (with withdrawals limited to 80% of the inflows).

Importantly, the states have also agreed, in principle, to pass FRBs at their own level. This should lead to the voluntary adoption of rules to save above-budget revenues, along with measures to improve transparency, discipline, and planning.

The states currently receive a portion of the Excess Crude Account funds. Visibility concerning distribution rules should become clearer as the states decide whether and how to enact their own legislation. Once the states have set up their own FRBs, the Nigerian oil-based fiscal rule should stabilize their main source of income and thus provide a key mechanism for offsetting the cyclical public expenditures of the past. We believe that this is likely to prove a supporting factor for Nigerian states' credit profiles. However, the states' capacity to offset revenue volatility will largely depend on the state-specific legislation and its final implementation. If the states do not tie the Excess Crude Account proceeds to effective stabilization rules, revenues could become structurally volatile and, in conjunction with increasing expenditures, lead to unpredictable budgetary deficits. The absence of a prudent, wide-ranging fiscal rule covering excess crude proceeds would be a negative rating factor in our opinion.

That said, given economic development-related expenditure pressures, we do not believe that a wide-ranging fiscal rule will be sufficient to fully prevent fiscal imbalances. Three weaknesses--with negative rating implications in our view--still exist in this respect: low IGR, poor transparency and accountability, and weak coordination of public expenditure responsibilities between the states and the federal government.

Overlapping Responsibilities And Limited Expenditure Coordination

Expenditure assignments are a hazy area in Nigeria since there is no clear-cut separation of roles among the government tiers (see table 5 below). In our opinion, the current expenditure framework has mostly negative rating implications:

- The Nigerian public expenditure system is complex, as the three government tiers share many spending

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responsibilities. This can lead to overlapping. Enhanced intergovernmental coordination is necessary to overcome the resulting inefficiencies, such as suboptimal resource allocation and de facto dependence on recurrent federal funding. Some steps have been taken in this direction, but there is much room for improvement, in our view.In addition to their exposure to potential inefficiencies, Nigerian LRGs are also subject to expenditure pressures. Democratically elected state governments are under great pressure from their populations to deliver on their constitutionally assigned expenditure mandates.

- Another problem is the LRGs' ingrained practice of using growth in federal-government wages as a benchmark for growth in their own public sector wages. Changing this practice may lead to opposition from the trade unions and institutional inertia.

Table 5

Legislative Competencies For Nigerian Government Tiers

Federal government	Federal and state governments	State and local governments	Local governments
Oil and gas	Higher education	Higher, secondary, and primary education	Sewage and waste disposal
Interstate transport	Electric power	Health care services	Local markets
Air, sea, and rail transport	Banking and finance	Water supply	Cemeteries
Currency	Agriculture and industry	State roads	Local streets (construction and maintenance)
Defense	Justice	Land use	Motor parks (parking lots)/open spaces
External affairs		Firefighting	Slaughter houses
Law and order			Public conveniences
Post and communications			Open clause: construction and maintenance of any facility, as prescribed by the State Assembly

Unclear distribution of competencies...

Responsibility sharing is set by the constitution and is also a legacy of past centralism. Over the years, the federal government has extended its scope of responsibilities to subsovereign areas such as universal basic education, primary health care, agriculture, and poverty alleviation programs.

Therefore, federal-government responsibilities are not limited to establishing a legal framework and regulation; they also extend into service delivery and activities that are typically the realm of the subsovereign sector. For example, according to the Central Bank of Nigeria, federal spending on education and health care outstripped that of the states by 34% in 2007.

The scope of the states' responsibilities is also broad. States have extensive legislative and spending powers, and are free to operate in areas outside the federal government's exclusive competency. They can also assume responsibility for federal competencies if allowed by federal law.

In contrast to the legislative freedom granted to the federal and state governments, the role of local governments is restricted. Indeed, states effectively oversee local governments, which can only exert their responsibilities in accordance with legislation passed at that state level; in fact, states can even override local councils' taxation powers.

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...may generate inefficiencies

The maintaining and sharing of spending responsibilities by upper levels of government is reasonably justified, in our view, by capacity constraints at the lower levels. But mixed roles and responsibilities can lead to duplication of efforts and other inefficiencies--particularly serious where state and federal responsibilities overlap. We believe that these inefficiencies are more likely if intergovernmental coordination is weak.

For example, federal government-built primary health care centers may run into inadequate operation and maintenance funding by the states and therefore remain underutilized. Similarly, uncoordinated investments in water facilities and road networks can generate duplication or undermaintenance of existing assets.

...and cause financial pressures

In the past, efficiency losses were partly mitigated by low constituent expectations for service quality and growth. But as Nigerian democracy consolidates, state governments could become more pressed to deliver on development and service quality. We believe that this context increases the need for efficient spending to avoid revenue-expenditure mismatches.

Equally important, a hazy distribution of responsibilities may translate current expenditures incurred by the federal government into future, unexpected financial obligations for the states. Specifically, whenever rigid expenditure responsibilities are financed through federal-government grant programs--such as the Universal Basic Education Program--subsovereign governments may become tied to hopefully recurrent, but also unpredictable, federal funding sources.

The federal government's substantial involvement in LRGs' responsibilities has broader consequences in terms of expenditure pressures. In particular, public sector workers--such as teachers--instinctively look to federal government pay scales for wage bargaining. Harmonized pay scales across the board reduce the states' expenditure autonomy.

We see a more subtle but equally negative effect of government interference. If the public does not clearly perceive that some services are fully delivered and funded by the states, the legitimacy of state IGR-raising campaigns could weaken.

Expenditure coordination hampered by low transparency

The more expenditure responsibilities overlap, the more federal and state governments must coordinate their spending choices. In this respect, several intergovernmental coordinating councils exist, but, as far as we understand, actual coordination has been weak. Insufficient information on key economic sectors undermines expenditure planning, as well as project selection, monitoring, and evaluation, which significantly saps coordination efforts. In the absence of intergovernmental coordination, the tangled expenditure-sharing system can generate inefficiencies.

Nevertheless, the federal government has taken the issue of coordination seriously. Efforts to improve intergovernmental coordination and to strengthen governance are already in motion (as in the case of the 2007 National Health Bill). These include improving information disclosure, clarifying responsibilities, and setting standards for service delivery.

Well-defined expenditure autonomy, with clear spending responsibilities, can have positive rating implications. We believe that the system might evolve in such a way as to increase states' expenditure autonomy by gradually reducing the scope of federal involvement to a role restricted to setting and monitoring a national policy. For this to occur,

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however, the LRGs must, in our opinion, build up capacity, raise their IGR (to significantly increase the IGR-based funding of state responsibilities), and further improve transparency and accountability.

Strengthening The Foundations Of Fiscal Discipline And Debt Management

We believe that the main risk of budgetary imbalances stems from the absence of hard fiscal constraints, with development needs exerting strong expenditure pressure that is not commensurate with LRGs' low revenue per capita. Consequently, states might eventually be tempted to generate unsustainably large debt-financed fiscal deficits in their drive to upgrade service delivery and develop infrastructure. This risk has heightened owing to limited federal government monitoring and only soft constraints on domestic borrowing (see tables 6-8).

However, the states are revamping their fiscal policy framework. The federal government is pushing the states to set up mechanisms that actively promote fiscal discipline. Following the enactment of the federal FRB in 2007, the federal government is encouraging the states to embrace similar oil-based fiscal rules (see the section "Adequate Oil Revenue Management Should Increase Revenue Predictability And Limit Revenue-Expenditure Mismatches" above), a framework for debt management, and public borrowing rules. The FRB also sets a medium-term expenditure framework coupled with transparency and accountability rules.

If adopted, a fiscal policy framework would be a positive rating factor, as it would result in public awareness of debt sustainability, lead states to refrain from ultimately unaffordable spending, and, more generally, promote fiscal discipline. However, the state-specific implementation of these fiscal rules remains a key issue. In addition, a lack of transparency--for instance, regarding accounting procedures, fully or partially government-owned companies (parastatals), pension contingencies, and payments in arrears--may hinder fiscal coordination and consequently the effective execution of a new fiscal framework.

Table 6

Nigerian States' Borrowing Limits--External Borrowing

The major fiscal constraint to date for Nigerian states has been on external borrowing. To borrow externally, states need authorization from the federal government. The federal government contracts the loans and on-lends the funds to the states in exchange for an irrevocable standing payment order. Thus, the states authorize the federal government to deduct debt service payments from the Federation Account transfers. In addition, the states must abide by certain conditions, including:

- Evidence of debt sustainability, which we view as generously assimilated to a maximum ratio of external debt service to Federation Account transfers of 40%;
- A "golden rule," by which the debt proceeds must be applied to concrete, feasible investment projects for infrastructure or poverty alleviation; and
- Concessional terms for the debt.

These external borrowing rules aim to avoid past cases of excess borrowing, like at the end of the 1980s when the federal government had to embargo the states' access to external markets and assume some of their financial obligations. These rules, and, to some extent, the 2007 Paris Club debt write-off, have helped keep the states' external borrowing under control. According to the federal Debt Management Office, 42% (about $1.53 billion) of Nigeria's consolidated general government external debt stock was owed by state governments to multilateral creditors at year-end 2007. On average, external debt service deductions absorbed a modest 3.2% of the states' 2007 gross statutory allocation.

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Table 7

Nigerian States' Borrowing Limits--Domestic Bonds

Domestic bond issuance is not constrained by fiscal rules, but rather is subject to regulatory requirements under the Investments And Securities Act. Essentially, states must give authority to the federal government's Accountant General to repay bonds, in case of default, through deductions at source from the statutory allocation. Repayment is facilitated through sinking funds associated with each bond.

In 2006 (latest available data), outstanding state bonds amounted to Nigerian naira (NGN) 24.5 billion (less than 3% of the 2006 gross statutory allocation). To the best of Standard & Poor's knowledge, all of these were floating-rate issues, with tenors of 3.5-7 years, and issued to fund development projects. Notwithstanding the lack of consolidated data, Standard & Poor's understands that state bond issuance was modest in 2007 and 2008, and that, therefore, total state bond issuance as a percent of gross statutory allocation was unlikely to have risen dramatically. In contrast with past trends, the State of Lagos plans to issue a significant amount of bonds (up to NGN 275 billion) in the coming years--a process that has already begun.

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Table 8

Nigerian States' Borrowing Limits--Domestic Bank Loans

To date, states have had virtually a free hand to contract domestic bank loans. However, we believe that outstanding domestic bank loans did not constitute a large debt burden at year-end 2007. In addition, the Debt Management Office is working with the states to define a framework of rules and guidelines for subsovereign domestic borrowing.

We see three main issues to watch out for concerning domestic bank loans: LRGs' exposure to banks, states' equity stakes in banks, and financial obligations arising from Public Private Partnerships (PPPs).

- On the first issue, available data from the Central Bank of Nigeria shows increasing, but not alarming, lending activity by banks to the states over the past five years. This is consistent with what we believe is a comfortable liquidity position for the states, due to abundant oil revenue proceeds and limited spending capacity. In general, states' borrowings are mainly short term and aimed at treasury management. According to the central bank, total outstanding net domestic credit to LRGs was NGN65 billion a month on average during 2007 (or 3% of total state revenues and 5% of net domestic credit). For local governments alone, central-bank data indicates very little bank lending in the past five years. There is, however, little data available. Subsovereign governments do not generally disclose aggregate information on total outstanding debt, including debt owed by parastatals and guarantees.

- A 2007 central-bank directive prevents states from holding more than a 10% equity interest in any bank. We believe that states have divested most of their holdings in the banking system.

- Finally, although Nigerian LRGs have already tried to establish PPPs--the best-known example being the Leki toll road project in Lagos--the PPP market is still under development and should not pose financial pressures in the short term.

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Weak Transparency And Disclosure

The federal government and a few reform-oriented states are emphasizing the concepts of due process and accountability in an attempt to improve transparency and disclosure throughout all government tiers.

In Nigeria, financial management is built on what we see as weak foundations, where the lack of information is the key problem. With some exceptions, past years' financial statistics may not be fully accurate owing to the absence of

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computerized systems to account for and record transactions, and standards that are lower than "best practice." In addition, accounts are not publicly available through the Internet.

To mitigate information flaws, we double check information with other available sources and make conservative assumptions. Particularly:

- For past budgetary performance, we contrast financial records produced by each state statistical office with external sources such as the state Auditor General and the Central Bank of Nigeria. We then conservatively adjust data whenever we find inconsistencies between surpluses after capital expenditures, and cash positions and debt borrowings.
- For oil revenue projections, we use Standard & Poor's oil price forecasts and make conservative assumptions regarding withdrawals from the Excess Crude Account.
- Whenever we face limited data, we also conservatively adjust--or make conservative assumptions regarding--all projected items, including IGR growth, updated liquidity positions, current debt levels and debt amortization, pension liabilities, and contingent liabilities linked to parastatals.

The Nigerian states' information deficits cloud our visibility over past and future performance, and explain why we would cap any ratings on the states at the 'B' category until they have successfully addressed these flaws.

While it is true that some states, such as Lagos, are making considerable efforts to address the transparency issue, financial management generally remains opaque, in our opinion. The lack of transparency results from a number of factors, including the absence of modernized computer systems, the need for better-qualified staff, shortcomings in record keeping, and weak monitoring of parastatals. We believe that these deficiencies stem, in part, from outmoded financial regulations and weaknesses in internal and external controls.

Information flaws cause, in turn, problems in several areas. Budgeting, accounting, and financial reporting fall short of international best practices. This results in analytical difficulties for market participants: The lack of information complicates the task of analyzing the debt sustainability of the Nigerian states as a whole. Weak data also hinders the setting of expenditure standards and equalization systems across the country, and reduces the efficiency of intergovernmental coordination.

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