EFFECT OF FISCAL POLICY ON PRIVATE CONSUMPTION IN NIGERIA (1981 – 2011)

ISIAQ OLASUNKANMI OSENI

B. Sc. (Economics) O.O.U., M.Sc. (Economics) Ife

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CERTIFICATION

I certify that this work was carried out by **Oseni Isiaq Olasunkanmi**, under my supervision in the Department of Economics, Obafemi Awolowo University, Ile-Ife, Nigeria.

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Prof. P. A Olomola Date

Supervisor

………………………………………….. ……………………………………………

Prof. P. A Olomola Date

Head of Department of Economics

Obafemi Awolowo University, Ile-Ife, Nigeria

AUTHORISATION

AUTHOR: Isiaq Olasunkanmi Oseni

TITLE: Effect of Fiscal Policy on Private Consumption in Nigeria (1981-2011)

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DEDICATION

This little contribution of mine is dedicated to Almighty God, my able supervisor- Prof. P. A Olomola and all other well wishers.

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ABSTRACT

The study examined the trend and pattern of fiscal policy variables and private consumption; established the existence of Ricardian Equivalence Hypothesis using Nigerian data; analyzed the relationship between government debt and private consumption; determined the impact of fiscal policy shocks on private consumption and investigated the effects of anticipated and unanticipated fiscal policy shocks on private consumption. This was with a view to providing information for announcement and post implementation effects of changes in fiscal policy variables on private consumption in Nigeria between 1981 and 2011.

Secondary data were used for the study. Quarterly time series data on the Government Revenue, Government Expenditure, Government Debt, Interest Rates and Private Consumption from 1981:1 to 2011:4 were collected from Central Bank of Nigeria (CBN) Statistical Bulletin for various years (2008 – 2011) while data on Total Wealth, Disposable Income and Distortionary taxes were collected from World Development Indication, 2011. Data collected were analyzed using descriptive statistics and econometric techniques.

The results of the trend and pattern analysis showed that there were cyclical movement between fiscal policy variables and private consumption in Nigeria for the periods of study. The results on the existence of Ricardian Equivalence Hypothesis in Nigeria indicated that only government expenditure confirmed the existence of Ricardian Equivalence Hypothesis in Nigeria ($\beta = -0.1598$, $p<0.05$) while other variables like distortionary taxes ($\beta = 0.3837$, $p<0.05$ instead of $\beta = 0$, $p<0.05$); disposable income ($\beta = 0.0244$, $p>0.05$ instead of $\beta \neq 0$, $p<0.05$); government debt ($\beta = -0.3881$, $p<0.05$ instead of $\beta = -0$, $p<0.05$) and total wealth ($\beta = 0.0793$,

p<0.05 instead β = 0, p<0.05) showed that Ricardian Equivalence Hypothesis did not hold in Nigeria. The study also showed that government debt (β = -0.1208, p<0.05) had negative and significant effect on private consumption in Nigeria. The SVAR results revealed that government revenue shock (β = -0.97, p<0.05) and government spending shock (β = -0.36, p<0.05) had negative and significant impacts on private consumption while government debt shock (β = -0.38, p>0.05) had positive and insignificant effect on private consumption. Finally, the study also revealed that the coefficients of anticipated fiscal policy shocks (ε_t^{ag}= 1.6313, p<0.05; ε_t^{ab}= 0.1730, p<0.1 and ε_t^{atr}= -0.4003, p>0.05) had significant impacts on private consumption while the coefficients of unanticipated fiscal policy shocks (ε_t^{ug}= 9.81E-07, p<0.05; ε_t^{ub}= -2.33E-07, p<0.05 and ε_t^{utr}= -7.50E-08, p>0.05) had no significant effect on private consumption in Nigeria.

The study concluded that the existence of REH in Nigeria was inconclusive. Also the announcement of government policies had immediate effect on private consumption while the implementation period had no effect on private consumption.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

One of the tenets of macroeconomics is how fiscal policy can be effective in stimulating aggregate demand and reviving a stagnant private consumption. Effective fiscal policies provide a stable macro environment for investment and increased productivity. Fiscal policy involves the deliberate actions of government in spending money and levying taxes with a view to influencing macro-economic variables to attain a desired direction. This includes sustainable economic growth via increase in aggregate demand, high employment creation and low inflation (Abata et al, 2012). Increase in government spending or a reduction in taxes tend to pull the consumption level (most especially private consumption) out of a recession; while reduced spending or increased taxes slow down a boom (Dornbusch and Fischer, 1990).

Evidently, the achievement of sustainable increase or decrease in private consumption through fiscal policy in Nigeria has remained unclear. Despite the substantial increases in government expenditure from 1980s to 2011, private consumption has not grown with the expected rates, Abata et al (2012). The deprived performance of fiscal policy has been apparently blamed on the problems of policy inconsistencies, high level of corruption, wasteful spending, poor policy implementation and lack of feedback mechanism from implemented policies between 1985 and 2005 (Omitogun and Ayinla, 2007; Abata et al 2012). In the debate on economic policy, fiscal policy is predominantly viewed as an instrument to mitigate short-run fluctuations in private consumption and employment. By varying government spending or taxation, fiscal policy aims at altering aggregate demand in order to move the present level of private consumption closer to potential level, (Eggertsson et al, 2010; Christiano, Eichenbaum and Rebelo, 2011).

Fiscal policy also entails how the creation of public debt affects the private sector (Omitogun and Ayinla, 2007). This aspect is particularly vital when evaluating stabilization policies with a notion to affect aggregate demand. The Keynesian perspective on this issue is that, for a given path of government consumption, by decreasing taxes today, the private sector will increase its spending, and thus aggregate consumption increases. To this end, the private consumption today is determined by today's disposable income; hence with a tax cut, both disposable income and private consumption will increase. This conclusion implies that households regard their holding of government bonds as net wealth, i.e. the households do not discount any part of the future tax increases that are necessary to repay the public debt. A similar conclusion of the effects of debt policy is obtained in neoclassical models of the Yaari-Blanchard type (see Blanchard, 1985; and Buiter et al, 2002), where new households enter the economy in the future, and thus a part of the tax burden is evaded by the households that are presently part of the economy. In this type of model, households discount only a part of future tax payments, and thus a tax cut today increases private consumption, but by a smaller amount than in a Keynesian model.

The Ricardian equivalence hypothesis (REH) stands in sharp contrast to the conventional view by arguing that government deficit financing merely generates the private saving necessary to absorb the additional government debt, leaving national saving and private consumption unaltered. In other words, Ricardian equivalence holds that an increase in the government deficit will be exactly offset by an increase in private sector savings. Furthermore, as national saving does not change, the real interest rate need not rise in a closed economy to maintain the balance between national saving and investment and hence, there is no effect on investment as well as private consumption either. In an open economy, there would be no effect on the current account balance because private saving rises enough to avoid the need to borrow from abroad. Therefore, budget deficits would not cause current account deficits.

These conclusions are formally based on Barro's (1974) seminal paper. By introducing rational behaviour and fiscal expectations into a forward-looking permanent income-life cycle consumption model, it showed that inter-temporally maximizing rational consumers will not view government debt as a part of their net wealth if they accurately anticipate the future tax liability of that debt. Instead, rational consumers would realize that the public debt created now by government borrowing must be repaid in the future by an increase in taxes. Hence, a lowering of taxes today will merely induce consumers to increase saving in order to avoid a sharp decline in their future disposable income and consumption due to higher taxes. Private consumption thus remains unchanged provided that the present value of government expenditures is not affected by the choice of budget deficits and surpluses, i.e. by the timing of taxes. If this is a correct representation of consumer behaviour, the Ricardian equivalence proposition leads to a quite drastic policy implications: since a deficit-financed tax cut has no effect on aggregate consumer demand, even in the short run, attempts to stabilize the economy are doomed to be futile.

Also, there has emerged a third line of reasoning called the non- Keynesian view, which stresses the importance of the current fiscal policy in shaping consumers' expectations about the future policy mix. Specifically, if the level of government debt affects consumers' expectations on the future path of government budget variables, expansionary fiscal policy today in association with a high government debt to GDP ratio and large budget deficit may have a contractionary effect on private consumption and aggregate demand. For example, Sutherland (1995) shows that if a high level of government debt signals an imminent need for fiscal stabilization, forward-looking rational consumers anticipate the eventual consequences of accumulating government debt and decrease their consumption in response