Fiscal/Monetary Policy and Economic Growth in Nigeria: 
A Theoretical Exploration

Dr. Abata, Matthew Adeolu  
Department Of Accounting And Finance, Faculty Of Management Sciences, Lagos State University, Ojo, Lagos, Nigeria

Dr. Kehinde, James Sunday  
Department Of Accounting And Finance, Faculty Of Management Sciences, Lagos State University, Ojo, Lagos, Nigeria

Mrs Bolarinwa, Sehilat Abike  
Department Of Accounting And Finance, Faculty Of Management Sciences, Lagos State University, Ojo, Lagos, Nigeria

Abstract

This paper assesses how fiscal and monetary policies influence economic growth and development in Nigeria. The paper argues that curbing the fiscal indiscipline of Government will take much more than enshrining fiscal policy rules in our statute books. This is because the statute books are replete with dormant rules and regulation. It notes that there exist a mild long-run equilibrium relationship between economic growth and fiscal policy variables in Nigeria. The paper suggest that for any meaningful progress towards fiscal prudence on the part of Government to occur, some powerful pro-stability stakeholders strong enough to challenge government fiscal recklessness will need to emerge.

Introduction

The Nigerian economy has been plagued with several challenges over the years. In spite of many, and frequently changing, fiscal, monetary and other macro-economic policies, Nigeria has not been able to harness her economic potentials for rapid economic development (Ogbole, 2010). According to Adeoye (2006), the debate on the effectiveness of fiscal policy as a tool for promoting growth and development remains inconclusive, given the conflicting results of current studies.

Over the last decade, the growth impact of fiscal policy has generated large volume of both theoretical and empirical literature. However, most of these studies paid more attention to developed economies and the inclusion of developing countries in case of cross-country studies were mainly to generate enough degrees of freedom in the course of statistical analysis (Aregbeyen, 2007).
Fiscal and monetary policies are inextricably linked in macro-economic management; developments in one sector directly affect developments in the other. Undoubtedly, fiscal policy is central to the health of any economy, as government’s power to tax and to spend affects the disposable income of citizens and corporations, as well as the general business climate.

Monetarist strongly believes that monetary policy exact greater impact on economic activity as unanticipated change in the stock of money affects output and growth i.e., the stock of money must increase unexpectedly for central bank to promote economic growth. In fact, they are of opinion that an increase in government spending would crowd out private sector and such can outweigh any short-term benefits of an expansionary fiscal policy (Adefeso and Mobolaji, 2011). On the other hand, the concept of liquidity trap which is a situation in which real interest rates cannot be reduced by any action of the monetary authorities was introduced by Keynesian economics. Hence, at liquidity trap an increase in the money supply would not stimulate economic growth because of the downward pressure of investment owing to insensitivity of interest rate to money supply. John Maynard Keynes recommends fiscal policy by stimulating aggregate demand in order to curtail unemployment and reducing it in order to control inflation. While there are several studies on this debates between Keynesian and Monetarist in the developed countries, only fragmented evidence have been provided on this issues in the case of Nigeria (Adefeso and Mobolaji, 2011).

Today, monetary and fiscal policies are both commonly accorded prominent roles in the pursuit of macroeconomic stabilization in developing countries, but the relative importance of these policies has been a serious debate between the Keynesians and the monetarists. The monetarists believe that monetary policy exert greater impact on economic activity while the Keynesian believe that fiscal policy rather than the monetary policy exert greater influence on economic activity. Despite their demonstrated efficacy in other economies as policies that exert influence on economic activities, both policies have not been sufficiently or adequately used in Nigeria (Ajisafe and Folorunsho, 2002). The objective of this paper is to review the practice of monetary and fiscal policies in Nigeria

**Conceptualizing Fiscal Policy**

The term fiscal policy has conventionally been associated with the use of taxation and public expenditure to influence the level of economic activities. The implementation of fiscal policy is essentially routed through government’s budget. The budget is, therefore, more than a plan for administering the government sector. It (budget) both reflects and shapes a country’s economic life. In fact, the most important aspect of a public budget is its use as a tool in the management of a nation’s economy (Omitogun and Ayinla, 2007).

Fiscal policy deals with government deliberate actions in spending money and levying taxes with a view to influencing macro-economic variables in a desired direction. This includes sustainable economic growth, high employment creation and low inflation (Microsoft Corporation, 2004). Thus, fiscal policy aims at stabilizing the economy. Increases in government
spending or a reduction in taxes tend to pull the economy out of a recession; while reduced spending or increased taxes slow down a boom (Dornbusch and Fischer, 1990).

Fiscal policy involves the use of government spending, taxation and borrowing to influence the pattern of economic activities and also the level and growth of aggregate demand, output and employment. Fiscal policy entails government’s management of the economy through the manipulation of its income and spending power to achieve certain desired macroeconomic objectives (goals) amongst which is economic growth (Medee and Nembee, 2011). Olawunmi and Tajudeen (2007) opine that fiscal policy has conventionally been associated with the use of taxation and public expenditure to influence the level of economic activities. They further said the implementation of fiscal policy is essentially routed through government’s budget. Fiscal policy as mostly to achieve macroeconomic policy; it is to reconcile the changes which government modifies in taxation and expenditure, programmes or to regulate the full employment price and total demand to be used through instruments such as government expenditures, taxation and debt management (Hottz-Eakin, Lovely and Tosin, 2009). As noted by Anyanwu (1993), the objective of fiscal policy is to promote economic conditions conducive to business growth while ensuring that any such government actions are consistent with economic stability.

From the foregoing, it is clear that if fiscal policy is used with circumspection and synchronized with other measures, it will likely smoothen out business cycles and lead to economic growth and stability.

In principle fiscal dominance occurs when fiscal policy is set exogenously to monetary policy in an environment where there is a limit to the amount of government debt that can be held by the public. Hence if the inter-temporal budget constraint must be satisfied, fiscal deficits would have to be magnetized, sooner or later. In fact when the size of the financial system is small relative to the size of the fiscal deficits, a central bank may have no choice but to magnetize the deficits. Thus… in countries with shallow financial systems, monetary policy is the reverse side of the coin of fiscal policy and can only play an accommodative role. In such low income countries, government securities markets are underdeveloped and central banks do not hold sufficient amounts of tangible securities and the central bank’s lack of suitable and adequate instruments of monetary control constitutes one of the factors that induce fiscal dominance.… Where fiscal dominance applies, the country’s economic policy is only as good as its fiscal policy and institutionalized central bank independence may not necessarily bring about an independent monetary policy (Oyejide, 2003).

**Monetary Policy**

Monetary policy is concerned with discretionary control of money supply by the monetary authorities (Central Bank with Central Government) in order to achieve stated or desired economic goals. Governments try to control the money supply because most governments believe that its rate of growth has an effect on the rate of inflation. Hence monetary policy
comprises those government actions designed to influence the behaviour of the monetary sector.

Monetary Policy is the deliberate use of monetary instruments (direct and indirect) at the disposal of monetary authorities such as central bank in order to achieve macroeconomic stability. Monetary Policy is essentially the tool for executing the mandate of monetary and price stability. Monetary policy is essentially a programme of action undertaken by the monetary authorities generally the central bank, to control and regulate the supply of money with the public and the flow of credit with a view to achieving predetermined macroeconomic goals (Dwivedi, 2005).

Monetary policy as one of the tools of controlling money supply in an economy of a nation by the monetary authorities in order to achieve a desirable economic growth. Monetary policies are effective only when economies are characterized by well developed money and financial markets like developed economies of the world. This is where a deliberate change in monetary variable influences the movement of many other variables in the monetary sector.

Monetary policy consists of a Government’s formal efforts to manage the money in its economy in order to realize specific economic goals. Three basic kinds of monetary policy decisions can be made about:

a) The amount of money in circulation;

b) The level of interest rate

c) The functions of credit markets and the banking system (Ogunjimi, 1997).

The combination of these measures is designed to regulate the value, supply and cost of money in an economy, in line with the level of economic activity. Excess supply of money will result in an excess demand for goods and services, prices will rise and balance of payments will deteriorate. The challenge of monetary policy management rest wholly on monetary authorities which has over the years been committed to its effective control. The performance of monetary policy has improved greatly in recent times- inflation has remained at moderate levels accompanied by high growth of domestic output. To sustain the efforts, there is need for appropriate collaboration with the fiscal authorities as well as the development of confidence in inter-bank market and the necessary financial market infrastructure is still relevant.

**Economic Growth**

Economic growth has long been considered an important goal of economic policy with a substantial body of research dedicated to explaining how this goal can be achieved (Fadare, 2010). Economic growth has received much attention among scholars. According to Khorravi and Karimi (2010), classical studies estimate that economic growth is largely linked to labour and capital as factors of production. The emergence of the endogenous growth theory has encouraged specialists to question the role of other factors in explaining the economic growth phenomenon (Bogdanov, 2010).
Economic growth represents the expansion of a country’s potential GDP or output. For instance, if the social rate of return on investment exceeds the private return, then tax policies that encourage can raise the growth rate and levels of utility. Growth models that incorporate public services, the optimal tax policy lingers on the characteristic of services (Olopade and Olopade, 2010). Economic growth has provided insight into why state growth at different rates over time; and this influence government in her choice of tax rates and expenditure levels that will influence the growth rates.

**Fiscal Policy And Economic Growth**

The impact of fiscal policy on growth has generated large volume of empirical studies with mixed findings using cross sectional, time series and panel data. Fiscal policy is generally believed to be associated with growth, or more precisely, it is held that appropriate fiscal measures in particular circumstances can be used to stimulate economic growth and development (Khosravi and Karimi, 2010).

The role of economic policy in the achievement of macroeconomic objectives has been extensively dealt with in Keynesian analysis of an activist macroeconomic policy. The Keynesian analysis leads to the conclusion that demand management policies can and should be used to improve macroeconomic performance. An activist macroeconomic policy involves setting monetary and fiscal variables in each time period at the values which are thought necessary to achieve the government’s objectives. A basic premise of Keynesian economics is that the private sector is inherently unstable. It is subject to frequent and quantitatively important disturbances in the components of aggregate demand. It is the task of counter cyclical or stabilization policies to offset these private sector disturbances and so keep real output close to its market – clearing equilibrium time path (Omitogun and Ayinla, 2007).

Dar Atui and Amirkhalkhali (2002) conducted investigation on the endogenous growth model of fiscal policy and concluded that in the endogenous growth model of fiscal policy (government expenditure and income) is very crucial in predicting future economic growth. Abduliah (2000) analyzed the relationship between government expenditure and economic growth and found that the size of government expenditure is very important in determining the performance of the economy. He further advised that, government should not only support and encourage the private sector to accelerate economic growth, but should also increase its budgetary provision on infrastructure, social and economic activities.

Nijkamp and Poot (2002) also conducted a meta-analysis of past empirical studies of fiscal policy and growth and found that in a sample of 41 studies, 29% indicate a negative relationship between fiscal policy and growth, 17% a positive one, and 54% an inconclusive relationship. Khosravi and Karimi (2010) maintains that fiscal policy is generally believed to be associated with growth, or precisely, it is held that appropriate fiscal measures in particular circumstances can be used to stimulate economic development and growth.
Gregoriou and Ghosh (2007) investigated the impact of government expenditure on economic growth using panel data and discovered that countries with large government expenditure in term of budgetary provisions tend to experience higher economic growth, but the effect varies from one country to another.

Mansouri (2008) studied the relationship between fiscal policy and economic growth in Egypt, Morocco and Tunisia. The spans of data for each country are: 1970-2002 for Morocco, 1972-2002 for Tunisia and 1975-2002 for Egypt. The empirical results showed that 1 percent increase in public spending raised the real GDP by 1.26 percent in Morocco, 1.15 percent in Tunisia and 0.56 percent in Egypt. The results also indicated existence of long-run relationships for all the three countries. Chowdhury (1986) in his study of monetary and fiscal impacts on economic activity in Bangladesh was also of the opinion that fiscal rather than monetary action had greater influence on economic activities.

In Nigeria, Ekpo (1994) studied the contributions of public expenditure to economic growth in Nigeria over the periods 1960 to 1992. The findings from the study provided support for fiscal policy-led growth through crowding-in private investment resulting from government expenditure on infrastructure. Nurudeen and Usman (2010) analyzed the impact of government expenditure on economic growth in Nigeria over the period 1970 – 2008. The paper revealed that government total capital expenditure, total recurrent expenditures and expenditure on education have negative effect on economic growth while expenditures on health, transport and communication are growth enhancing. On the other hand, Oyinlola (1993), studied the impact of budgetary expenditure on the defense sector on economic development of Nigeria and discovered that defense expenditure exert significance positive influence on economic growth.

**Fiscal And Monetary Policy In Nigeria**

Literature abounds on the relative effectiveness of monetary and fiscal policy in developed and developing countries of the world. However, there has been contrasting opinions on which of the two policies exert greater influence on economic activity (Ajisafe and Folorunsho. 2002). Fiscal policy is thought to stifle economic growth by distorting the effect of tax and inefficient government spending. Therefore, in the light of the above, the question that comes to fore is what has been the effect of fiscal policy on economic growth in Nigeria.

Fiscal policy consists of the manipulation of government finances by raising or lowering taxes or levels of spending to promote economic stability and growth. This role of government sector in economic management is performed through the formulation and implementation of economic policy generally and fiscal policy in particular. It is designed to achieve the objective of price stability, growth, balance of payments equilibrium, full employment, mobilization of resources and investment. These objectives have influenced government’s economic policy design and development efforts in Nigeria since independence.
Different opinions have indeed continued to emerge on how fiscal policy can affect economic activities. The genesis of these controversies has been traced to the theoretical exposition of the different schools of thought namely: the Classical; the Keynesian; and the Neo-classical schools of thought. To the Classical school of thought, fiscal deficits incessantly financed by debt crowds-out private investment and by extension lowering the level of economic growth.

As summarized by Tchokote (2001), the classical economists believe that debt issued by the public has no effect on the private sector savings. To them, a deficit financed by increasing the supply of securities, ceteris paribus reduces its price and raises real interest rates and this crowds out private investment. In sum, excessive deficit can lead to poor economic performance.

As observed by Omitogun and Ayinla (2007), the Keynesian school of thought postulates a positive relationship between deficit financing and investment and consequently on economic growth. This school of thought sees fiscal policy as a tool of overcoming fluctuations in the economy. As put by Tchokote (2001) this school regards deficit financing as an important tool to achieve a level of aggregate demand consistent with full employment. When debt is used to finance government expenditures, consumers’ income will be increased. Given that resources are not fully utilized, crowding-out of private investment by high interest rates would not occur.

The position of the Keynesian school of thought on the possible effects of fiscal deficits on economic activities has been challenged by the Neo-classical school of thought on the premise that the former school ignores the significance of how fiscal deficits are financed on the effect of this policy variable on macroeconomic performance. The Neoclassical school postulates that the manner in which deficits are financed is capable of influencing the level of consumption and investment and by extension affect economic growth.

In Nigeria, the result of government role in economic activities and the achievements in economic performance in Nigeria have been mixed. The economy experienced growth in real output in some years and declines in others. But the overall picture is low scoring for the country’s development efforts. The economic crisis from the 1980s and early 1990s brought out vividly the distinction between growth and development. The objectives of monetary and fiscal policies in Nigeria are wide-ranging. These include increase in Gross Domestic Product growth rate, reduction in the rates of inflation and unemployment, improvement in the balance of payments, accumulation of financial savings and external reserves as well as stability in Naira exchange rate. The policy as well as instruments applied to attain these objectives, however, have until recently been far from adequate. Undue reliance has been placed on fiscal policy rather than monetary policy in Nigeria (Darrat, 1984).

Fiscal policy is considered an important variable which may determine changes in national income in developing countries like Nigeria. In order to stimulate the economic growth by means of fiscal policy, the country has more instruments. These according to Ebimobowei (2010) include; the financing of direct investments which the private sector would not provide an adequate quantities; the efficient supply of certain public services which are necessary to ensure the basic conditions to display the economic activity and long term investments; and the
financing of public activities so as to minimize the distortions to come up with the decisions to spend and invest properly in the private sector.

Ajayi (1974) emphasized that in developing economy in which Nigeria is a typical example, the emphasis is always on fiscal policy rather than monetary policy. In his work, he estimated the variables of monetary and fiscal policies using ordinary least square (OLS) technique and found out that monetary influences are much larger and more predictable than fiscal influences. This result was confirmed with the use of beta coefficients that changes in monetary action were greater than that of fiscal action. In essence, greater reliance should be placed on monetary actions.

Monetary and fiscal policies play a key role in the promotion of the main government objective of promoting the welfare of its citizens. Familoni (1989) argued that before monetary policy can produce desired result as maintained by the classical economist, highly integrated and monetized economy and regular information network system are indispensable. He, however, lamented that the Nigerian economy lacks the fundamental, flexibilities (in respect to interest rate, treasury certificates, etc.) which could have aided a much more effective use of monetary policy. He therefore, denounced the classical preference of monetary policy over fiscal policy on the basis of their empirical evidence and predicted that it would only work for a developed economy and suggest where necessary the mixture of both policies for better performance in a developing economy like Nigeria.

As noted by Ajisafe and Folorunso (2002), the monetary rather than fiscal policy exerts a great impact on economic activity in Nigeria and that the emphasis on fiscal action of the government has led to greater distortion in the economy. Fiscal policy in Nigeria has been heavily influenced by oil-driven volatility impacting both revenue and expenditure. Since 1970, both revenue and expenditure have been very volatile while increasing over time.

In periods with high oil prices, such as in 1979-82, 1991-92, and more recently in 2000-02, revenue and expenditure have increased sharply. This has typically been followed by the scaling back of expenditure as oil prices subsequently decline, though at times with a lag. The implications of such boom-bust fiscal policies include the transmission of oil volatility to the rest of the economy as well as disruptions to the stable provision of government services. This has added to the failure over the years of public spending. Neither facilitating the diversification and growth of the non-oil sector nor reducing poverty (Baunsgaard, 2003). Given the above scenario, especially the dominance of fiscal policies, it is not surprising that enormous confusion has reigned over the conduct of monetary policies in the country all in the attempt to engender economic growth.

Under ideal and perfectly competitive situations, economic policies for growth or stabilization should be employed in such a way as to equate the marginal productivity of government investment to that of private investment. This has to be so because the equilibrium situation in national income determination implies that resource employed in government investment activities should be as productive as in any alternative employment. The implication of
government investment should be equal to the gross rate of interest at which the private investment is undertaken (Olaniyan, 1997). However, a cursory examination of the structure of selected macroeconomic indicators of performance of fiscal policy revealed that the Nigerian situation has been far from ideal.

Fiscal policy in Nigeria has been extremely pro-cyclical with expenditures racking out of control on the upswing of the oil price cycle. This has contributed to the observed deficit bias in the conduct of fiscal policy. One option is to put in place a fiscal policy rule. A fiscal policy rule makes sense in Nigeria, given the complete absence of a tradition of fiscal discipline. Because a fiscal rule commits government to a certain level of conduct in fiscal and budgetary management, it will help begin to build government credibility in fiscal management and over time, promote strong fiscal discipline across all tiers of government. A rule, based on oil prices, will also help address the issue of the vulnerability of all tiers of government to oil price swings and reduce the pro-cyclicality in the budget. This will allow savings to build up financial assets in periods with high oil prices that can be used to finance the desired expenditure programmes when oil prices are low (Kwakwa, 2003).

Phillips (1997) critically analyses the Nigerian fiscal policy between 1960 and 1997 with a view to suggesting workable ways for the effective implementation of Vision 2010. He observes that budget deficits have been an abiding feature in Nigeria for decades. He notes that expect for the period 1971 to 1974, and 1979, there has been an overall deficit in the federal Government budgets each year since 1960 to date. The chronic budget deficits and their financing largely by borrowing, he asserts, have resulted in excessive money supply, worsened inflationary pressures, and complicated macroeconomic instability, resulting in negative impact on external balance, investment, employment and growth. He, however, contends that fiscal policy will be an effective tool for moving Nigeria towards the desired state in 2010 only if it is substantially cured of the chronic budget deficit syndrome it has suffered for decades.

As noted by Babangida (1993), the lack of fiscal discipline is the bane of our economy. In spite of realized revenues being above budgetary estimates, extra budgetary expenditure has been rising so fast and resulting in ever bigger deficit ....To say the least, this is a sobering revelation and we must all ensure that the deficit is not only minimized but eventually eliminated.... The practice of financing the fiscal deficit through the banking system, especially the Central Bank’s Ways and Means facility, results in rapid growth of domestic liquidity, which in turn, exerts immense pressures on prices, interest rates and exchange rate of the Naira. As an illustration, between 1988 and 1991, an average of 77 percent of the overall deficit was financed by the CBN while in 1992 the deficit had been largely financed by the CBN. As a direct consequence, the monetary and credit aggregates have been exceeding prescribed targets in recent years.

Folorunsho and Abiola (2000) examine the long –run determinants of inflation in Nigeria between 1970 and 1998, using the econometric methods of co integration and error correction mechanism. They find that inflation in Nigeria could be caused by the level of income, money supply, and public sector balance. The results also indicate that in the long –run, exchange rate, money supply, income and fiscal balance determine the inflation spiral in Nigeria. The study,
therefore, concludes that a reduction in fiscal deficits, an increase in domestic production and a stable exchange rate should be pursued as means of controlling inflation in Nigeria.

According to Baunsgard (2003), experience in Nigeria illustrates the difficulties of implementing fiscal policy in an environment with highly volatile revenue flows. Over the years, there have been a strong deficit bias and procyclically in fiscal policy, driven largely by oil prices 1991-1992 and 2000-2002, revenue and expenditure have increased sharply. This as typically seen followed the scaling back of expenditures as oil prices substantially decline, though at times with a lag. The implications of such boom-burst fiscal policies include transmission of oil-price volatility to the stable provision of government services. This has added to the failure over neither the years of public spending, facilitating the diversification nor growth of the economy. There is no doubt that the failure of government fiscal policies, rather than the failure of monetary policies, is the main reason why most of the past developmental programmes undertaken by the Government has come to naught (Ezeoha and Uche, 2010).

Despite the lofty place of fiscal policy in the management of the economy, the Nigerian economy is yet to come on the path of sound growth and development. The behaviour of fiscal policy in Nigeria has followed unsteady pattern, assessing the significance of the policy; therefore, in the actualization of sustainable economic growth is imperative more so that the country is working towards achieving the millennium development goals.

Conclusion And Policy Implications

This study is a theoretical investigation of the impact of fiscal policy variables on economic growth in Nigeria. Fiscal policy involves the use of government spending, taxation and borrowing to influence both the pattern of economic activity and also the level and growth of aggregate demand, output and employment. The achievement of economic growth through fiscal policy in Nigeria has remained a mirage. Nigerian is one of the developing nations had lost a decade of (10) ten years’ decades of developing her economy but failed. It seems that no economic principles can improve the lot except a change of culture, improve on discipline, transparency and do away with corruption.

Evidently, the achievement of sustainable economic growth through fiscal policy in Nigeria has remained a mirage. Despite the substantial increases in government expenditure over the years, the rate of economic growth has been very low and sluggish. The poor performance of fiscal policy has been ostensibly blamed on the problems of policy inconsistencies, high level of corruption, wasteful spending, poor policy implementation and lack of feedback mechanism for implemented policies (Omitogun and Ayinla, 2007). This study revealed that the effect of monetary policy on economic growth in Nigeria is much stronger than that of fiscal policy. This study therefore, recommends monetary policy for the purpose of economic stabilization.

Fiscal policy should give priority attention to capital and public investments by making them of higher proportion in gross government expenditure, thereby creating more jobs and enhancing the quality of public spending and the attainment of sustainable growth and development. To
put the Nigerian economy along the path of sustainable growth and development, the
government must put a stop to the unproductive foreign borrowing, wasteful spending and
uncontrolled money supply and embark upon specific policies aimed at achieving increased and
sustained productivity in all sectors of the economy. In general, until macroeconomic policies
are effectively implemented and particularly geared towards enhancing the overall productivity
of the economy only then can their potential beneficial effects be appreciably felt in the
country (Omitogun and Ayinla, 2007).

Emphasis should be on the development of basic infrastructure (example, transportation,
energy and communication). Human capital development should be a priority. Government
fiscal policy should refocus and redirect government expenditure towards production of goods
and services so as to enhance GDP growth (Ogbole, et al, 2011).

Government economic policies should focus on diversification of the economy to enhance the
performance of the non-oil sector, so as to create more jobs in this sector. The government
should avoid unnecessary borrowings and ensure that existing debts are properly serviced as at
when due. The government should ensure that policy inconsistency are minimized and policy
reversals are properly checked for both short and long run effects on the economy.
Government should fight the problem of corruption because without a reduction of the level of
corruption in the country, fiscal policy components will not achieve the required level of
economic growth in Nigeria.

There is need for an improvement in government expenditure on health, education and
economic services, as components of productive expenditure, to boost economic growth. What
Nigeria needs is a fiscal policy rule, which would commit the government to a certain level of
conduct in fiscal and budgetary management.

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