

Governance as a Transmission Mechanism: How Institutional Quality Shapes Fiscal Effectiveness in Nigeria

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Abstract — This study empirically examines how institutional quality moderates the relationship between fiscal policy and fiscal effectiveness in Nigeria from 1996 to 2024. The study employs annual time series data sourced from the Central Bank of Nigeria Statistical Bulletin and World Bank World Governance Indicators. Data were analyzed using Augmented Dickey-Fuller and Phillips-Perron unit root tests, Johansen cointegration, Vector Error Correction Model, Impulse Response Function, Variance Decomposition, Granger Causality, and an interaction regression model. Findings: The results reveal that all variables are integrated of order one $I(1)$ and cointegrated, indicating a long-run relationship. The VECM shows a negative and significant error correction term. The interaction term between fiscal policy and institutional quality is positive and statistically significant, confirming that strong institutional quality amplifies the effect of fiscal policy on economic growth. Impulse response shows that shocks to institutional quality have persistent positive effects on growth. Variance decomposition reveals that institutional quality and fiscal policy jointly explain over 35% of growth variation. Practical Implications: Fiscal reforms in Nigeria will be ineffective without corresponding governance reforms. Policy should focus on strengthening budget credibility, tax administration, and accountability institutions. This study provides direct empirical evidence of governance as a transmission mechanism in Nigeria, moving beyond treating it as a mere control variable.

Keywords— Institutional Quality, Fiscal Effectiveness, Fiscal Policy, Moderation, VECM, Nigeria.

I. INTRODUCTION

Fiscal policy remains one of the principal instruments for promoting growth, employment, and development in Nigeria (Central Bank of Nigeria [CBN], 2024). Through taxation, borrowing, and public expenditure, government attempts to influence macroeconomic outcomes. However, Nigeria's experience shows a disconnect between fiscal expansion and development outcomes. Despite rising government expenditure, challenges of poverty, unemployment, infrastructure deficit, and poor service delivery persist (OECD, 2023). This suggests that the effectiveness of fiscal policy is not determined by size alone, but by the quality of institutions that implement it. Drawing on Institutional Theory (North, 1990), this study argues that governance operates as a transmission mechanism. Institutional quality determines whether fiscal resources are converted into productive outcomes or lost to leakages and inefficiency. The main objective is to examine the moderating role of institutional quality on the relationship

between fiscal policy and fiscal effectiveness in Nigeria. Specifically, the study tests whether the impact of government expenditure on economic growth depends on the level of institutional quality.

II. LITERATURE REVIEW

1. Conceptual and Theoretical Review

Fiscal Effectiveness is the degree to which fiscal decisions achieve intended macroeconomic and social objectives (Siyanbola et al., 2025). Institutional Quality captures government effectiveness, control of corruption, rule of law, and accountability (World Bank, 2024). This study is anchored on Institutional Theory (North, 1990) which posits that institutions reduce transaction costs and uncertainty. It is also grounded in Endogenous Growth Theory (Barro, 1990) which emphasizes the role of government spending and institutional quality in growth. The transmission model

is:Fiscal Policy→Governance Institutions→Implementation→
Outcomes

2. Empirical Review and Research Gaps

The relationship between tax revenue composition and economic growth in Nigeria has generated considerable scholarly debate. The mixed findings in the literature can be attributed to differences in tax proxies, sample periods, estimation techniques, and the treatment of institutional factors (Obadiaru, 2024; Kawano et al., 2025). This section synthesizes key studies under three themes: direct taxes, indirect taxes, and institutional context.

Empirical Evidence on Direct Taxes and Growth

Studies on Company Income Tax [CIT] and Petroleum Profit Tax [PPT] present divergent results. A significant number of studies report a negative relationship between CIT and economic growth. Adegbite and Fakile (2024) using ARDL on data from 2000-2023 found that CIT had a significant negative effect on both FDI and GDP. This was attributed to high corporate tax rates that discourage investment and capital formation. Similarly, Nwankwo and Okeke (2023) using FMOLS and DOLS for 1990-2022, and Brown et al. (2022) in a panel of SSA countries, confirmed that CIT crowds out private investment and retards growth. Aliyu and Musa (2017) further tested the Laffer curve hypothesis and concluded that Nigeria is beyond the optimal CIT rate, implying that further increases reduce revenue and growth. However, some studies found positive effects. Balogun and Adeola (2018) reported that CIT positively influenced capital expenditure and GDP, but their study did not establish causality and used a short sample period. For PPT, the evidence is also mixed. Adefolake and Omodero (2023) and Adegbola et al. (2023) found that PPT has a positive and significant effect on GDP, supporting the resource channel of taxation. Conversely, Nwankwo and Okeke (2023) and Chukwu and Eze (2020) found that while PPT contributes positively in the short-run, its long-run effect is negative due to oil price volatility and Dutch disease effects. Ogundele and Adeyemi (2022) argued that over-reliance on PPT has crowded out non-oil sectors, thereby limiting diversification. This inconsistency suggests that the effect of PPT is context-dependent and may be conditioned by institutional factors.

Empirical Evidence on Indirect Taxes and Growth

The literature is more consistent regarding VAT. Majority of studies find that VAT has a positive and significant effect on economic growth. Adeyinka and Henry (2024), Major and Fente (2022), Wilson (2019), and Adefolake and Omodero (2023) all report that VAT is a stable revenue source that

promotes GDP growth. The theoretical justification is that VAT is less distortionary and has a broader base than direct taxes (Auerbach & Hines, 2019). However, Major and Fente (2022) noted a negative short-run effect of VAT due to administrative inefficiencies and compliance costs. Akintola et al. (2022) and Bakare and Adeyemi (2020) further showed that while VAT improves fiscal capacity and funds infrastructure, its growth effect is relatively weak because of leakages. For customs and excise duties [CED], findings are inconclusive. Ngwoke (2024) and Ocheni et al. (2020) found positive effects on GDP. In contrast, Omojolaibi and Obieke (2024) and Ezejiofor et al. (2020) found negative effects in the short-run, arguing that high tariffs distort trade and investment. International evidence from the World Bank (2018) and WTO (2018) also supports that excessive trade taxes reduce competitiveness.

The Role of Institutional Quality

A major limitation in the Nigerian literature is the neglect of institutional quality. Most studies such as Dabor et al. (2025), Chijuka and Izeke (2025), and Ogbonna and Appah (2017) estimated direct relationships without considering how governance affects tax effectiveness. International and recent Nigerian studies however suggest that institutions matter. Akitoby et al. (2022) and IMF (2025) found that the positive effect of tax revenue on growth is significant only in countries with above-average governance quality. Ibrahim (2024) and Siyanbola et al. (2025) argued that corruption and weak enforcement in Nigeria reduce the fiscal multiplier of tax revenue. The "resource curse" literature also emphasizes that in resource-dependent economies like Nigeria, weak institutions lead to rent-seeking and poor conversion of PPT to productive expenditure (Sachs & Warner, 2001; Ross, 2012). Despite this, no Nigerian study has directly tested CIT, PPT, and VAT with institutional quality as an explicit moderator using interaction terms.

Research Gaps

From the foregoing, three critical gaps emerge:

- **Methodological Gap:** Many studies relied on static OLS regression which cannot capture short-run and long-run dynamics (Joseph, 2023; Dabor et al., 2025). Few have applied VECM, IRF, and interaction models simultaneously.
- **Conceptual Gap:** Institutional quality has largely been omitted or treated as a control variable. Its moderating role in the tax-growth nexus remains underexplored in Nigeria.
- **Variable Gap:** Most studies use aggregate tax revenue or focus on one tax type. There is limited evidence on the simultaneous effect of CIT, PPT, and VAT with disaggregated analysis.

Contribution of the Present Study

This study addresses these gaps by: Using VECM to capture both short-run and long-run dynamics; Introducing institutional quality as a moderator through interaction terms CIT_IQ, PPT_IQ, and VAT_IQ; Covering a longer period 1996-2024 to capture major tax and governance reforms. Thus, this study provides more robust and policy-relevant evidence on how tax revenue composition affects growth in Nigeria.

III. METHODOLOGY

1. Research Design

This study adopts an ex-post facto research design using annual time series data covering the period 1996 to 2024. The choice

of this period is justified because it captures major fiscal and governance reforms in Nigeria, including the Fiscal Responsibility Act 2007, Treasury Single Account [TSA] 2015, and other public financial management reforms.

2. Sources of Data and Measurement of Variables

Data for the study were sourced from secondary sources. Macroeconomic and fiscal data were obtained from the Central Bank of Nigeria Statistical Bulletin, 2024 Edition. Governance data were sourced from the World Bank World Governance Indicators Database, 2024.

The variables and their measurement are presented in Table 1.

Table 1: Variable Description and Measurement

Category	Variable	Proxy	Measurement	Source	A Priori
Dependent Variable	Fiscal Effectiveness	GDPGR	GDP Growth Rate (%)	CBN	+
Independent Variables	Fiscal Policy	FEXP	Federal Government Expenditure as % of GDP	CBN	+
	Institutional Quality	IQ	Average of Government Effectiveness, Control of Corruption, and Rule of Law from WGI	World Bank	+
Interaction Term	Fiscal Policy × Institutional Quality	FEXP×IQ	Product of FEXP and IQ	Computed	+
Control Variables	Inflation	INF	Annual Inflation Rate (%)	CBN	–
	Investment	INV	Gross Capital Formation as % of GDP	CBN	+

Note: The Institutional Quality Index [IQ] was constructed by averaging the three World Governance Indicators following World Bank (2024).

4. Model Specification

To examine the moderating role of institutional quality, the study specifies an interaction model adapted from Barro (1990). The model is stated as:

$$GDPGR_t = \alpha_0 + \alpha_1 FEXP_t + \alpha_2 IQ_t + \alpha_3 (FEXP_t \times IQ_t) + \alpha_4 INF_t + \alpha_5 INV_t + \varepsilon_t$$

Where:

$GDPGR_t$ = GDP Growth Rate at time t.

$FEXP_t$ = Federal Government Expenditure as % of GDP.

IQ_t = Institutional Quality Index.

$FEXP_t \times IQ_t$ = Interaction term capturing the moderating effect.

INF_t = Inflation Rate.

INV_t = Gross Capital Formation.

ε_t = Error term.

A priori: $\alpha_1 > 0$, $\alpha_2 > 0$, $\alpha_3 > 0$. The coefficient α_3 is the key parameter of interest. A positive and significant α_3 implies that

institutional quality strengthens the effect of fiscal policy on growth.

5. Estimation Techniques

Given the time-series nature of the data, a number of econometric techniques were employed to examine both the short-run and long-run relationships among the variables. The analysis began with tests for stationarity using the Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) unit root tests. These tests were carried out to determine the order of integration of the variables and to prevent misleading results that may arise from spurious regression. Following the unit root tests, the Johansen cointegration test was used to examine whether a long-run relationship exists among Company Income Tax (CIT), Petroleum Profit Tax (PPT), Value Added Tax (VAT), Institutional Quality (IQ), and Economic Growth. Both the trace statistic and maximum eigenvalue statistic were considered in determining the number of cointegrating relationships among the variables. Since all the variables were found to be integrated of order one, I(1), and evidence of cointegration was established, the Vector Error Correction Model (VECM) was employed. The VECM was considered appropriate because it allows for the examination of both short-run changes and the long-run equilibrium relationship among the variables. The error correction term (ECT) was also examined to determine the speed at which short-run deviations are corrected and the system returns to its long-run equilibrium. A negative and statistically significant ECT indicates that adjustment towards equilibrium takes place following a deviation.

To further examine the dynamic relationships among the variables, Impulse Response Functions (IRF) and Variance Decomposition (VDC) were generated from the estimated VECM. The IRF was used to examine how economic growth responds to unexpected changes or shocks in CIT, PPT, VAT, and IQ over a ten-year period. On the other hand, the VDC was used to determine the extent to which shocks in each variable contribute to variations in economic growth over the forecast period. Finally, the Granger causality test was conducted within the VECM framework to establish the direction of causality among the variables. The test helped to determine whether changes in the different tax revenue components and institutional quality contain useful information for predicting economic growth in Nigeria.

All the econometric estimations and tests were conducted using EViews 12.

IV. RESULTS AND DISCUSSION

1. Unit Root and Cointegration Results

The Augmented Dickey Fuller and Phillips Perron tests were conducted at levels and first difference. The results are presented in Table 2.

Table 2: Unit Root Test Results

Variable	ADF Level	ADF 1st Diff.	PP Level	PP 1st Diff.	Order of Integration
GDPGR	-2.134	5.672***	-2.201	5.701***	I(1)
FEXP	-1.987	4.891***	-2.034	4.923***	I(1)
IQ	-1.765	5.234***	-1.812	5.289***	I(1)
INF	-2.301	6.102***	-2.345	6.134***	I(1)
INV	-1.901	5.445***	-1.956	5.478***	I(1)

Source: Author's Computation , 2026.

The results show that all variables are non-stationary at levels but stationary at first difference. Hence, they are integrated of order one I(1). Following this, the Johansen cointegration test was conducted. The trace statistic indicates the presence of one cointegrating equation at 5% level. This confirms the existence of a long-run relationship among fiscal policy, institutional quality and economic growth in Nigeria.

2. Vector Error Correction Model [VECM] Results

Given cointegration, a VECM was estimated. The results are shown in Table 3.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Error Correction Term (ECT)	-0.321	0.142	-2.261	0.032
D(FEXP)	0.187	0.098	1.908	0.067
D(IQ)	0.254**	0.121	2.099	0.045
D(INF)	-0.112	0.087	-1.287	0.209
D(INV)	0.165*	0.091	1.813	0.081
R-squared	0.682			

Source: Author's Computation, 2026.

The ECT is negative [-0.321] and statistically significant at 5%. This implies that about 32.1% of any disequilibrium in the

previous period is corrected in the current period. In the short run, both fiscal expenditure and institutional quality have positive effects on economic growth.

3. Moderation Effect: Interaction Model Results

To test moderation, the interaction model was estimated using OLS with robust standard errors. The results are presented in Table 4

Table 4: Moderation Effect Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.134	1.201	1.777	0.087
FEXP	0.093	0.112	0.830	0.414
IQ	0.156*	0.089	1.753	0.091
FEXP × IQ	0.184**	0.076	2.421	0.023
INF	-0.098	0.067	-1.463	0.156
INV	0.211**	0.091	2.319	0.029
R-squared	0.714			

Source: Author's Computation, 2026.

The key finding is the interaction term 'FEXP_IQ'. It is positive [0.184] and statistically significant at 5%. This confirms that institutional quality significantly moderates the relationship between fiscal policy and economic growth. Interpretation: At high levels of institutional quality, a 1% increase in government expenditure leads to a 0.42% increase in GDP growth. However, at low levels of institutional quality, the same 1% increase leads to only a 0.09% increase in growth. This provides empirical evidence that governance amplifies fiscal effectiveness in Nigeria.

4. Impulse Response and Variance Decomposition

The impulse response function shows that a one-standard-deviation shock to institutional quality produces a positive and persistent response in economic growth over a 10-year horizon. Variance decomposition results reveal that institutional quality and its interaction with fiscal policy jointly explain 38% of the variation in economic growth. Fiscal policy alone explains 14.7%, while institutional quality alone explains 21.3%.

5. Granger Causality Test

The Granger causality test indicates unidirectional causality running from institutional quality to economic growth. There is bidirectional causality between fiscal policy and economic growth. This suggests that governance drives growth, while growth and spending also influence each other.

6. Discussion of Findings

The findings support both Institutional Theory (North, 1990) and Endogenous Growth Theory (Barro, 1990). The significant positive interaction term is the major contribution of this study. It provides direct evidence that governance is not just a determinant, but a transmission mechanism. The results are consistent with Siyanbola et al. (2025) and Ibrahim (2024) who found that governance enhances fiscal outcomes in Nigeria. The implication is that increasing government spending without improving institutions will yield minimal growth impact. This explains why Nigeria's budget expansion over the years has not translated proportionately into development outcomes.

Why Fiscal Policy Underperforms in Nigeria

A fiscal stimulus assumes that public spending will generate demand, employment, investment, and improved services. In practice, the outcome depends on implementation quality. In Nigeria, capital spending may fail to produce strong growth if budget releases are delayed, procurement is noncompetitive, projects are selected for political rather than economic reasons, contractors receive payments without completing work, and monitoring agencies lack independence. Thus, the fiscal multiplier is institutionally conditioned. A naira spent under strong governance is more likely to produce infrastructure or services than the same naira spent in an environment characterized by weak controls and limited accountability. This explains why similar budget increases yield different outcomes across time and agencies.

V. CONCLUSION, RECOMMENDATION AND POLICY IMPLICATIONS

1. Conclusion

This study concludes that institutional quality significantly moderates the relationship between fiscal policy and fiscal effectiveness in Nigeria. Governance is not merely a background condition for fiscal policy. It is the transmission mechanism that determines whether fiscal resources produce meaningful outcomes (North, 1990). Strong institutions improve budget execution, revenue collection, expenditure efficiency, and accountability, while weak institutions create leakages, implementation failures, and limited fiscal multipliers. For Nigeria, fiscal effectiveness depends as much on institutional capacity and enforcement as on the size of the budget itself. Technical reforms such as the Treasury Single Account [TSA] and Government Integrated Financial Management Information System [GIFMIS] must be accompanied by autonomy, professional capacity, and enforcement.

2. Recommendations

Based on the empirical findings that institutional quality significantly moderates the fiscal policy–effectiveness relationship, the following recommendations are proposed:

Integrate Governance Reforms with Fiscal Policy

Technical financial reforms such as the Treasury Single Account [TSA], Integrated Personnel and Payroll Information System [IPPS], and Government Integrated Financial Management Information System [GIFMIS] must be strengthened with enforcement mechanisms. Digital platforms alone cannot prevent leakages if approval controls, sanctions, and political will are weak. Government should ensure that these systems are fully interoperable, regularly audited, and linked to consequences for violations. Fiscal policy and governance reforms should be implemented as a single package rather than in isolation.

Improve Budget Credibility through Realistic Forecasting and Timely Releases

The Ministry of Budget and National Planning, in collaboration with the CBN and NBS, should adopt conservative and evidence-based revenue projections. Over-optimistic forecasts of oil revenue lead to cash rationing, delayed capital releases, and abandoned projects. A Fiscal Responsibility Council should be empowered to independently scrutinize budget assumptions before approval. Furthermore, quarterly budget releases should be automated and tied to performance milestones to reduce political delays.

Strengthen Tax Administration through Digitalization and Risk-Based Audits

The Nigeria Revenue Service [NRS] formerly FIRS should accelerate the deployment of digital tax platforms for registration, filing, and payment. Taxpayer databases should be integrated with NIN, CAC, and banking systems to expand the tax base (Adegbite & Owolabi, 2025). The agency should shift from random audits to risk-based audits that target high-risk sectors and individuals. Taxpayer education and improved service delivery are also critical to build voluntary compliance and trust in the fiscal social contract.

Enhance Accountability through Independent Audits and Legislative Oversight

The Office of the Auditor-General of the Federation and the Public Accounts Committees of the National Assembly must be granted financial and administrative autonomy. Audit reports should be published within 6 months of the financial year and debated publicly. There should be mandatory implementation of audit queries with sanctions for non-compliance. Citizens

and civil society should also be engaged through participatory budgeting and access to procurement information to strengthen social accountability.

Increase Procurement Transparency and Contract Management

The Bureau of Public Procurement should maintain a public portal with details of all federal contracts above ₦50 million, including scope, contractor, amount, timeline, and completion status. Beneficial ownership information should be disclosed to prevent front companies. Project managers should be professionally certified and held liable for cost overruns and abandoned projects. This will reduce inflated contracts and improve value for money.

Strengthen Fiscal Discipline with Medium-Term Frameworks

Government should adhere strictly to the Medium-Term Expenditure Framework [MTEF] and Fiscal Strategy Paper. Borrowing should be tied to capital projects with clear revenue streams. The Debt Management Office should conduct debt sustainability analysis before new loans. Fiscal rules in the Fiscal Responsibility Act should be enforced with penalties for breaches to prevent politically motivated and unsustainable spending.

Improve Intergovernmental Coordination

There is need for a formal Fiscal Coordination Council comprising federal, state, and local governments. This will clarify expenditure responsibilities, harmonize tax policies, and improve data sharing. Revenue allocation should be linked to fiscal effort and transparency at subnational levels. Joint monitoring of federally funded projects at state and LGA levels will reduce duplication and improve implementation.

Adopt Performance-Based Budgeting and Monitoring

Budgeting should shift from input-based to output and outcome-based. Ministries should define clear KPIs before funds are released. The Budget Office should publish a quarterly “Budget Performance and Outcomes Report” that tracks not just how much was spent, but what was delivered in terms of schools built, patients treated, and roads completed. This will close the gap between appropriation and impact.

3. Policy Implications

Based on the findings, the following policy recommendations are made:

- **Integrate Fiscal and Governance Reforms:** Budget increases must be accompanied by anti-corruption and

transparency measures. Fiscal reforms cannot succeed in isolation.

- **Strengthen Budget Institutions:** This requires realistic revenue forecasts, timely releases, and clear links between plans and appropriations.
- **Improve Public Financial Management:** Commitment controls, cash management systems, transparent reporting, and credible audits should be prioritized.
- **Modernize Tax Administration:** The Federal Inland Revenue Service [FIRS] should adopt digital records, risk-based audits, and simpler taxpayer procedures (Adegbite & Owolabi, 2025).
- **Increase Procurement Transparency:** Government should publish contract data, beneficial ownership information, project locations, and implementation status.
- **Protect Oversight Institutions:** The Economic and Financial Crimes Commission [EFCC], Independent Corrupt Practices Commission [ICPC], auditors, legislators, and courts must operate independently.
- **Improve Intergovernmental Coordination:** Federal, state, and local government responsibilities should be clearly defined because many public services depend on their interaction.
- **Adopt Performance-Based Monitoring:** Budget releases should be linked to measurable outputs and outcomes.

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