Fiscal Federalism and Sub-National Development in Nigeria: Comparative Analysis of Revenue Allocation and Expenditure Efficiency

Isibor Areghan (PhD)
Dept. of Accounting, Finance,
and Taxation, Caleb University, Nigeria
isiborareghan@gmail.com;
Areghan.isibor@calebuniversity.edu.ng

Jude Idemudia Okoh PhD
Dept. of Business Administration,
University of Fairfax, Virginia, USA

Omoniyi Joseph Oluwadamilare
Department of Computer Science
Caleb University, Lagos
oluwadamilare.omoniyi@calebuniversity.edu.ng

Grace Omoniyi Oluwadamilare
olamigreat567@gmail.com

Kafidiya Olabisi
Covenant University, Nigeria
olabisikafidiya@gmail.com

Ogunfeyimi Ruth Inumidun
Dept. of Accounting, Finance,
and Taxation, Caleb University, Nigeria
ogunfeyimiruth@gmail.com

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Abstract
This work explores the complex interplay between fiscal federalism and sub-national development in Nigeria. It critically examines the historical evolution of Nigeria's fiscal federalism, the principles and challenges of its vertical and horizontal revenue allocation formulas, and their profound implications for the developmental capacities and expenditure efficiency of state and local governments. Drawing on data from the National Bureau of Statistics (NBS), Revenue Mobilization Allocation and Fiscal Commission (RMAFC), and various research reports, the study highlights the pervasive over-reliance of sub-national entities on federal allocations, particularly oil revenues, and the resulting fiscal imbalances. It discusses how this dependence, coupled with

issues of accountability and expenditure inefficiency, has led to uneven development across states in Nigeria and hampered effective service delivery at the grassroots. This study recommends that, reforming Nigeria's fiscal federalism to foster greater fiscal autonomy, will require, enhancement of revenue mobilization, improvement of expenditure efficiency, and promotion of equitable and sustainable development across all tiers of government.

Keywords: *Expenditure Efficiency, Derivation Principle. Fiscal Federalism, Revenue Allocation, Sub-National Development,*

1.1 Introduction

Fiscal federalism, the division of financial powers and responsibilities among different tiers of government, is a cornerstone of federal systems worldwide. It aims to optimize resource allocation, promote efficiency in public service delivery, and foster regional development by allowing sub-national governments to tailor policies to local needs and preferences (Oates, 1972). However, the actual practice of fiscal federalism varies significantly across countries, often shaped by historical, political, and economic contexts. Nigeria, with its complex federal structure comprising federal, 36 state, and 774 local governments, formally adopted federalism in 1954. This arrangement was intended to manage the country's vast ethnic, linguistic, and cultural diversity and ensure national cohesion. Over the decades, Nigeria's fiscal federalism has been significantly transformed, influenced largely by military rule, the discovery and dominance of oil revenue, and persistent agitations for resource control. The central challenge remains how to balance the fiscal autonomy of sub-national units with the need for national cohesion and macroeconomic stability, as this balance directly impacts the capacity of state and local governments to drive development and deliver essential services to their citizens.

1.2. Problem Statement

Despite its federal structure, Nigeria's fiscal federalism has been characterized by a highly centralized revenue system and an often-contentious revenue allocation formula. The disproportionate share of federally collected revenues accruing to the central government, coupled with the over-reliance on volatile oil revenues, has created significant fiscal imbalances and undermined the financial autonomy of state and local governments. This imbalance manifests in several critical issues: Firstly, Many Nigerian states and local governments are heavily dependent on allocations from the Federation Account, making them vulnerable to fluctuations in oil prices and federal fiscal policy. In 2023, 14 states derived at least 70% of their total revenue from Federation Account Allocation Committee (FAAC) receipts, and 32 states relied on FAAC for over 55% of their total income (BudgIT, 2024). Secondly, despite their constitutional responsibilities, many sub-national governments struggle to generate sufficient IGR, hindering their ability to fund local development initiatives and respond to citizens' needs. Even with allocated funds, concerns persist regarding the efficiency and effectiveness of public expenditure at the sub-national level, with reports often highlighting misapplication of funds, corruption, and a disconnect between spending and developmental outcomes (Eze et al., 2024). Thirdly, the current revenue allocation formula, while incorporating principles like population and equality, has been criticized for not adequately addressing the unique needs and developmental disparities across states, leading to significant imbalances in infrastructure, social services, and economic opportunities.

Besides, Local governments, constitutionally recognized as the third tier, often suffer from severe financial dependence on state governments due to the joint state-local government accounts system and undue interference, impeding grassroots development (Ali Yakubu, 2025).
These challenges collectively raise fundamental questions about the efficacy of Nigeria's fiscal federalism in promoting equitable and sustainable sub-national development.

2.1. Conceptual Framework of Fiscal Federalism

Fiscal federalism is a sub-field of public finance that examines the division of governmental functions and financial powers among different levels of government (Oates, 1972). The core idea is to achieve efficiency in public service provision by decentralizing functions whose benefits are localized, while centralizing those with nationwide benefits or significant externalities.

1. **Assignment of Functions:** Determining which tier of government is best suited to provide specific public goods and services (e.g., national defense at federal level, primary education at local level).

2. **Assignment of Tax Powers:** Allocating revenue-raising responsibilities to different tiers, ideally matching expenditure responsibilities.

3. **Intergovernmental Fiscal Transfers:** Mechanisms (e.g., grants, revenue sharing) to bridge the vertical fiscal imbalance (mismatch between revenue-raising capacity and expenditure needs) and horizontal fiscal imbalance (disparities among sub-national units).

a. Vertical Fiscal Imbalance: Occurs when the revenue-raising capacity of a particular tier of government does not match its expenditure responsibilities. In Nigeria, the federal government collects the majority of revenues, leading to a significant vertical imbalance where states and local governments are heavily reliant on federal transfers.

b. Horizontal Fiscal Imbalance: Refers to disparities in revenue-raising capacity or expenditure needs among sub-national governments at the same tier (e.g., among states). Revenue allocation formulas often attempt to address this through equalization principles.
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Horizontal Fiscal Imbalance refers to disparities in revenue-raising capacity or expenditure needs among sub-national governments at the same tier.

2.2. Fiscal Federalism Theory, the Decentralization Theorem (Oates, 1972):

This foundational theory argues that, for public goods whose benefits are spatially limited, a decentralized provision by sub-national governments is more efficient than centralized provision. This is because local governments are closer to the people, better understand their preferences, and can tailor services accordingly, leading to greater allocative efficiency.

2.3. Empirical Literature on Fiscal Federalism and Development

Global empirical studies yield mixed results on fiscal federalism and economic development:

1. **Positive Impacts**: Many studies support the idea that fiscal decentralization can lead to improved public service delivery, greater government efficiency, and enhanced economic growth, especially when strong institutions and accountability mechanisms are present.
2. **Negative Impacts/Challenges**: Conversely, some research points to potential pitfalls, such as macroeconomic instability from excessive sub-national borrowing, increased corruption at lower tiers due to weaker oversight, and widening regional disparities if equalization mechanisms are inadequate. The success of decentralization often hinges on institutional capacity, transparency, and accountability at sub-national levels.

2.4. Fiscal Federalism in Nigeria: A Review of Existing Studies

Numerous studies consistently highlight the contentious nature of Nigeria's fiscal federalism.

1. **Historical Contentiousness**: Revenue allocation has been a "most serious and intractable political issue" in Nigeria since colonial times.

2. **Centralization Trend**: The military era led to a significant centralization of fiscal powers, fostering a "fiscal centralism" rather than true federalism and weakening states and local governments.

3. **Oil Revenue Dominance**: The discovery of oil in the 1970s fundamentally shifted the focus from revenue generation by regions/states to revenue sharing from the Federation Account, fueling competition and reducing the incentive for sub-national governments to generate their own revenues.

4. **Impact on Development**: Studies show mixed results. Some find a positive and significant impact of revenue and expenditure decentralization on economic development in the long run. However, others note that despite increased revenue by different levels of government, GDP per capita growth has remained unstable, not always corroborating the argument that fiscal decentralization automatically brings development closer to the people.

5. **Local Government Financial Autonomy**: A recurring theme is the severe lack of financial autonomy for local governments, often due to state government interference in joint accounts and control over statutory allocations, severely impeding grassroots development.

6. **Expenditure Efficiency**: Studies often point to inefficiencies in public expenditure at state levels, with recurrent expenditures sometimes having a more significant positive effect on GDP than capital expenditures, raising concerns about unproductive capital projects.

3.0 Analytical Framework and Methodology

3.1. Analytical Framework / Methodology Overview

This study adopts a mixed-methods approach, primarily quantitative analysis of secondary data, complemented by qualitative insights from existing literature and policy documents. It employs descriptive and comparative research designs. It is descriptive in presenting the historical evolution and current state of fiscal federalism in Nigeria, including revenue allocation formulas and their implications and comparative in analyzing the fiscal capacities, revenue generation efforts, and developmental outcomes across different Nigerian states.

The analysis is guided by fiscal federalism theories, focusing on vertical and horizontal fiscal imbalances and the implications of resource dependence.

3.2. Data Collection and Sources

The study relies exclusively on secondary time-series and cross-sectional data from reputable national and international institutions. Sources include:

The Revenue Mobilization Allocation and Fiscal Commission (RMAFC) Provides detailed insights into the revenue allocation formulas, principles, and actual disbursements from the Federation Account. The National Bureau of Statistics (NBS) is a crucial source for Internally Generated Revenue (IGR) at State Level, State and Local Government Accounts (FAAC allocations) , and socio-economic indicators (e.g., poverty levels, education, health data) that serve as proxies for developmental outcomes. The Central Bank of Nigeria (CBN) provides data on federal government revenue (oil and non-oil), expenditure, and overall macroeconomic indicators. The Nigeria Extractive Industries Transparency Initiative (NEITI) provides detailed information on FAAC disbursements, including the impact of oil revenue and debt deductions on state allocations. The Think Tanks and Civil Society Organizations like BudgIT, also provide valuable analyses and visualizations of state finances and FAAC allocations.

3.3. Variables and Measurement

a. Dependent Variables (for sub-national development and expenditure efficiency):

1. **Developmental Outcomes**: Proxied by indicators such as Literacy Rate (state-level), Infant Mortality Rate (state-level), Access to Basic Infrastructure, and Expenditure on Education and Health (as % of state budget).
2. **Expenditure Efficiency**: Inferred by the **Ratio of Capital Expenditure to Total Expenditure** and the correlation between spending in key sectors and observed outcomes (e.g., education spending vs. literacy rates).

b. Independent Variables (for fiscal federalism aspects):

3. **Federal Allocation to States/LGs (FAAC_Share)**: Actual amounts received by states and local governments from the Federation Account.
4. **Internally Generated Revenue (IGR)**: Total IGR of each state/LGA.
5. **IGR as % of Total Revenue**: A key indicator of fiscal autonomy.
6. **Derivation Principle Share**: Amount received by oil-producing states based on the 13%

derivation principle.

7. **Horizontal Allocation Criteria**: Population, Equality of States Share, Land Mass/Terrain Share.
8. **Debt Deductions from FAAC**: Amounts deducted from states' FAAC allocations for foreign debts and other contractual obligations.

3.4. Data Analysis Techniques

The analysis involves a combination of descriptive, comparative, and potentially basic inferential statistics.

1. **Descriptive Statistics**: Used to analyze historical trends and patterns in vertical and horizontal revenue allocation. Includes compositional analysis to break down state and local government revenues into FAAC allocations and IGR components to highlight their dependence on federal transfers. Key ratios like IGR-to-Total Revenue for each state will be calculated.

2. **Comparative Analysis**: Used to compare the fiscal capacities (IGR performance, FAAC receipts), expenditure patterns (capital vs. recurrent, sectoral allocation), and developmental outcomes (e.g., literacy rates) across a selection of states, highlighting disparities and identifying states with more effective fiscal management. This includes comparing oil-producing states (benefiting from 13% derivation) versus non-oil-producing states.

3. **Basic Inferential Statistics**: If data permits, Correlation Analysis will examine relationships between fiscal variables (e.g., IGR growth) and developmental outcomes (e.g., improvements in literacy rates). Regression Analysis (Cross-sectional or Panel) may be used to explore the relationship between fiscal decentralization measures (e.g., IGR as % of total revenue) and developmental outcomes.

3.5. Econometric Model Specification (Example if using regression for impact analysis)

A simplified cross-sectional model could be considered to explore the impact of fiscal decentralization on development:

$$\text{DevOutcome}_i = \beta_0 + \beta_1 \left(\frac{\text{IGR}}{\text{TotalRevenue}}\right)_i + \beta_2 \left(\frac{\text{FAAC}}{\text{TotalRevenue}}\right)_i + \beta_3 \text{PopDensity}_i$$

Where:

1. DevOutcome_i, represents a developmental outcome for state (e.g., literacy rate, health index).
2. $\left(\frac{\text{IGR}}{\text{TotalRevenue}}\right)_i$ is the share of Internally Generated Revenue in total revenue for state, representing fiscal autonomy.
3. $\left(\frac{\text{FAAC}}{\text{TotalRevenue}}\right)_i$ is the share of FAAC allocation in total revenue for state, representing dependence.
4. PopDensity_i, and PovertyRate_i, and are control variables.
5. B_1 is expected to be **positive**, suggesting that greater fiscal autonomy leads to better developmental outcomes.
6. B_2 is expected to be **negative or insignificant**, suggesting that over-reliance on federal transfers

may not translate to effective development.

4.0 Historical Evolution, Current Structure, and Challenges of Fiscal Federalism in Nigeria

4.1. Historical Evolution of Fiscal Federalism in Nigeria

Nigeria's fiscal federalism has been marked by shifts between regional autonomy and central dominance.

1. **Colonial Era (Pre-1954)**: Fiscal commissions (e.g., Phillipson, Hicks-Phillipson) recommended revenue-sharing formulas, often emphasizing principles like derivation and needs, which fostered some regional fiscal autonomy.

2. **First Republic (1960-1966)**: Nigeria operated a quasi-federal system with strong regions. Derivation played a significant role in revenue allocation, particularly for regions with natural resources.

3. **Military Rule (1966-1999)**: The military fundamentally altered the federal structure, leading to a significant centralization of power and resources. The creation of more states and the increasing dominance of oil revenue shifted the focus to revenue sharing from the center, often adopting principles like population and equality of states at the expense of derivation. Local governments were also given a share of the Federation Account in 1976, which was further increased in 1992.

4. **Fourth Republic (1999-Present)**: The return to democratic rule established the three-tier structure. The Revenue Mobilization Allocation and Fiscal Commission (RMAFC) was constitutionally established to handle revenue matters. The 13% derivation principle for mineral-producing areas was reintroduced as a key concession to oil-producing states. However, the legacy of centralization and oil dominance ensures revenue allocation remains contentious.

4.2. Current Vertical and Horizontal Revenue Allocation Formulas

The system is governed by the 1999 Constitution and various Acts, with the RMAFC periodically reviewing formulas.

a. Vertical Revenue Allocation (Sharing among Tiers): The current vertical formula generally allocates:

1. **Federal Government**: Approximately **52.68%**.
2. **State Governments**: Approximately **26.72%**.
3. **Local Governments**: Approximately **20.60%**. This formula is criticized for giving an "unduly favoured" and "disproportionate share" to the Federal Government, which effectively controls over 56% of all revenues when special accounts are included.

b. Horizontal Revenue Allocation (Sharing among States and LGAs): This dictates how the shares allocated to states and local governments are distributed among themselves, guided by principles including:

1. **Equality of States**: Ensures a basic minimum share for each state, promoting equity.
2. **Population**: Acknowledges varying population sizes among states.
3. **Derivation Principle**: Mandates that at least 13% of revenues from natural resources

(primarily oil) be returned to the producing states. Oil-producing states often advocate for a higher percentage.

4. **Land Mass and Terrain**: Accounts for geographical size and difficult terrain that may necessitate higher costs for service provision.
5. **Internally Generated Revenue (IGR) Effort/Tax Effort**: Rewards states that demonstrate greater effort in mobilizing their own internal revenues.
6. **Social Development Factor/Needs**: Considers indicators like school enrollment or hospital enrollment.

4.3. Challenges of the Current Revenue Allocation System

The current system is fraught with challenges that undermine equitable sub-national development:

1. **Over-Centralization and Fiscal Imbalance**: The Federal Government's dominant share creates a significant vertical fiscal imbalance, fostering a "transfer trap" where sub-national governments become overly dependent on federal allocations and lack the motivation to generate their own revenues. In 2023, 14 states relied on FAAC for at least 70% of their total revenue.
2. **Over-reliance on Oil Revenue**: The Federation Account's heavy dependence on volatile crude oil revenues expose sub-national governments to significant fiscal shocks, making long-term planning difficult.
3. **Limited IGR Capacity**: Many sub-national governments have a weak IGR base due to a large informal sector, administrative inefficiencies, corruption in tax collection, and limited tax handles. Only Lagos and Ogun states collected more in taxes and other internal revenues than they received from the center in 2021. Lagos State is a notable exception, contributing N1.24 trillion (14.32%) to the cumulative subnational revenue in 2023.
4. **Contentious Derivation Principle**: The 13% derivation principle is constantly debated, with oil-producing states arguing for a higher percentage, leading to persistent agitations for "resource control" and political tension.
5. **Lack of Financial Autonomy for Local Governments**: Local governments often lack true financial autonomy as state governments interfere with their FAAC allocations through joint state-local government accounts, leading to diversion of funds and undermining grassroots development. While the Supreme Court has recently reinforced the autonomy of Local Governments, practical implementation remains a challenge.
6. **Inequity in Horizontal Allocation**: The weighting of horizontal allocation principles (population, equality, landmass) is often contentious, leading to perceptions of unfairness and potentially exacerbating regional disparities.

5.0 Policy Recommendations and Conclusion

5.1. Reaffirming the Need for Fiscal Federalism Reform

Nigeria's current practice of fiscal federalism, characterized by **over-centralization of revenue, contentious allocation formulas, and significant sub-national dependence**, has not optimally fostered equitable and sustainable development. The existing fiscal arrangements have contributed to fiscal imbalances, expenditure inefficiencies, and widening developmental disparities across states and local governments. A comprehensive and politically courageous reform of Nigeria's fiscal federalism is imperative to unlock the developmental potential of its sub-national units and ensure a more prosperous and equitable nation.

5.2. Policy Recommendations for Enhanced Sub-National Development and Expenditure Efficiency

5.2.1. Review and Reform of the Revenue Allocation Formula:

1. **Increase Sub-National Shares**: Adjust the vertical revenue allocation formula to grant a larger share of the Federation Account to state and local governments, commensurate with their expenditure responsibilities and proximity to the populace.
2. **Enhance Derivation Principle**: Review the 13% derivation principle to potentially increase it or ensure greater direct benefit to host communities, provided there are robust accountability mechanisms.
3. **Review Horizontal Allocation Criteria**: Re-evaluate the weighting of horizontal allocation criteria to ensure they more effectively promote fiscal equalization and address developmental needs.

5.2.2. Strengthening Internally Generated Revenue (IGR) Capacity:

1. **Broaden State and Local Tax Bases**: Empower states and local governments with more diverse and productive tax handles.
2. **Improve Tax Administration**: Invest in technology, data analytics, and human capacity development for state and local revenue authorities to improve tax collection efficiency and curb evasion.
3. **Formalize the Informal Sector**: Implement policies to gradually formalize the large informal sector, bringing more economic activities into the tax net.
4. **Fiscal Incentives**: Introduce incentives for states and local governments that demonstrate significant improvements in IGR mobilization.

5.2.3. Enhancing Fiscal Autonomy and Accountability at Local Government Level:

1. **Abolish Joint Accounts**: Strictly enforce the Supreme Court's pronouncement on local government autonomy by ensuring direct disbursement of FAAC allocations to local government accounts, bypassing state control.
2. **Strengthen Local Government Financial Management**: Implement robust financial management systems, including budgeting, accounting, and auditing, at the local government level.
3. **Promote Local Accountability**: Foster greater citizen participation and oversight in local government budgeting and expenditure processes.

5.2.4. Improving Expenditure Efficiency and Transparency:

1. **Performance-Based Budgeting**: Introduce and rigorously implement performance-based budgeting frameworks at state and local levels, linking budgetary allocations to measurable outcomes and developmental targets.
2. **Strengthen Public Procurement Processes**: Enhance transparency, competitiveness, and accountability in public procurement to reduce corruption and ensure value for money.
3. **Robust Monitoring and Evaluation (M&E)**: Establish independent and effective M&E mechanisms for capital projects and public service delivery at the sub-national level to ensure efficient utilization of funds.

4. **Fiscal Responsibility Legislation**: Strengthen and enforce fiscal responsibility laws at the state level, setting clear limits on borrowing, debt accumulation, and mandating fiscal transparency.

5.2.5. Economic Diversification and Human Capital Development:

1. **Diversify State Economies**: Encourage states to develop comparative advantages in non-oil sectors (agriculture, manufacturing, services, technology) to reduce their reliance on federal allocations and create sustainable IGR sources.
2. **Invest in Human Capital**: Prioritize and efficiently fund education, healthcare, and skills development at the state and local levels, as human capital is fundamental to long-term economic growth and IGR potential.

5.3. Conclusion

Nigeria's fiscal federalism has operated largely as a centralized system, characterized by significant vertical and horizontal imbalances and heavy reliance on oil revenues. This has led to widespread dependence on federal transfers, limited fiscal autonomy, and often inefficient public expenditure at sub-national levels, resulting in uneven development and sub-optimal service delivery. Reforming Nigeria's fiscal federalism is a critical imperative for national cohesion, equitable development, and sustainable economic growth. Success requires a courageous political commitment to decentralize revenue powers, empower sub-national governments with greater fiscal autonomy, strengthen their IGR capacities, and enforce rigorous accountability and efficiency in public expenditure. By fostering a truly functional fiscal federalism, Nigeria can unlock the immense potential of its diverse sub-national units.

5.4. Areas for Future Research

1. A detailed empirical analysis of the impact of IGR performance on specific developmental indicators (e.g., primary school completion rates, access to potable water) across Nigerian states using panel data.
2. A qualitative study on the political economy of revenue allocation reforms in Nigeria, exploring the vested interests and institutional barriers to implementing a more equitable and efficient system.
3. An investigation into successful IGR strategies and expenditure efficiency models adopted by high-performing states (e.g., Lagos, Rivers) and their replicability in other states.
4. A comprehensive analysis of the fiscal implications of local government autonomy following recent judicial pronouncements, including challenges in revenue generation and financial management at the grassroots.
5. A comparative study of Nigeria's fiscal federalism with other diverse federal systems (e.g., India, Brazil, Canada) to draw lessons on best practices in revenue allocation, equalization, and sub-national fiscal discipline.

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