

# **Government Budgeting and Economic Development in Iraq. By Dr. Jasim Al-Ali**

## **Abstract**

The bulk of revenue that is generated in the Iraqi Economy is from oil export. The oil sector is an enclave sector with very little interaction with other areas of the economy. Government Budgeting is the only medium by which development in the oil sector can be used to promote other areas of the economy. This demands a greater emphasis of the role of budgeting, as an important instrument for economic development. The aim of the paper is to discuss and explain this, however the success of such budget approach will be contingent upon; clarity of accountability relationship, good governance, high skill capacity and environment stability.

## **Introduction**

The dominant role that revenue generated in the oil sector plays in financing government activities in Iraq is well recognised. No other significant alternative financial resource exists. The nature of the oil sector is, however, an enclave sector, characterised by weak forward (production) as well as backward (consumption) linkages with the rest of the economy, making the role of the oil sector for inducing or leading the overall development process in Iraq neither direct nor spontaneous.

Given this factor, a need has arisen for an alternative means which can be used to compensate for this lack of strong interaction between the oil and non-oil parts of the economy.

One way to achieve this is by employing the government budget as a medium to spread the development which has taken place in the oil sector across other sectors of the economy. As such, the government budget is thus seen to play a dual role. Firstly, as a means by which developments in the oil sector are directed to induce and facilitate the development of other sectors in the economy and secondly, as an instrument for economic stabilisation and development policies. Both these roles cannot be successfully carried out unless two conditions are met. One of these conditions is the willingness of government to transmit the oil sector development into other sectors by making the revenue gained from oil exports available for the financing of the development of other sectors. In other words, increasing budget allocation. This condition, although it is necessary, is not in itself sufficient unless such willingness is matched by the ability to spend in an efficient and productive way, i.e. proper and well thought out methods of allocation.

The broad objective of this study is to examine the effectiveness of government budgetary policy during the past years and to establish how the two conditions, that is the willingness to spend and the ability to spend efficiently and productively, can be met.

The process of evaluation and assessment of the role that public (government) expenditure plays should be carried out by means of measuring the impact of the different structure of this expenditure both at an aggregate national level, i.e. aggregate investment, consumption, output, etc. and also at the sectoral level.

The value of such an analysis will be appreciated more when the decision making process of the plan and the budget are both taken into consideration and moreover, the consequences of this dichotomy on the achievement of the intended objectives, are analysed. Thus, a

secondary (practical) objective which is hoped to be achieved from this paper is the provision of a tool that can be used in order to promote harmonisation between both planning and budgetary decisions which is vital for the realisation of long term objectives.

### **The Structure of Public Finance in the Iraqi Economy**

Over the twentieth century as a whole the change in government expenditures has been dramatic in all countries and Iraq is no exception to this phenomenon.

The State has absorbed a steadily increasing share of national output. The search for an explanation to this phenomenon has caused considerable debate among economists and has shed considerable light on this question (Musgrave 1969). Explanations arrived at in these studies are not only important in this respect but they are also important because their indications of changing public attitudes toward government expenditure and government intervention in the economy.

In Iraq, the bulk of government revenues are raised through oil revenue rather than anything else. Taxation, as a fiscal instrument and a vital source of government income, is negligible in the country's economy. From these considerations it can be said that public finance in Iraq differs from that of other countries. There exist different characteristics, different problems and, therefore, different solutions are needed.

This, of course, does not mean that the theory of public finance in general cannot offer some principles which would apply to all countries, including Iraq, but this rather limits the scope of the analysis regarding the theory application to the country's public financing activities.

Before looking to the Iraqi public sector, the theory of public expenditure growth may be briefly reviewed. An inevitable starting point is Wagner's law of "expanding state activity" which was formulated at the end of the nineteenth century. This law stated that with rising per capita income in industrialising countries, the relative share of the public sector in national output will rise. Wagner offers three reasons for this: first, with industrialisation there would be increased need for the administrative and protective functions of the State. Second, the cultural and welfare functions of the State will expand, especially those connected with education and income distribution. Finally with the change in technology following on from industrialisation and the increasing capital requirement of many industries, the State will intervene to protect consumers from private monopolies and, therefore, the direct investment role of the government will expand. Wagner did not see war and defence as playing a role in the expansion of public expenditure. War and defence expenditures in some countries at least, proved to be one of the important causes of the growth of public expenditure in this century (Bird 1971).

Wagner's law is broadly supported by the empirical evidence of public sector growth. However, some of his propositions have to be modified to make them in line with actual facts. Current knowledge suggests that there are a variety of reasons for the phenomena of public sector growth, which can be summarised as follows (Groenewegen 1970):

a) The effect of economic growth on public sector outlays as proposed by Wagner's law, plus the need for growth in defence spending as a product of industrialisation either because of the rising significance of the protective function of the State or, as the pressure for territorial and market expansion, safeguard foreign investment, trade routes, the supply of essential

materials etc.

b) The high income elasticity of demand for public goods at a certain stage of development. Musgrave, in his study of fiscal systems, found variation in the income elasticity of demand for public goods in three ranges of per capita income levels. At a low level of per capita income associated generally with pre-industrial society in developing countries, demand for public goods was generally very low because almost all income is devoted to satisfy basic needs. When per capita income starts to rise a demand for goods supplied by the public sector becomes more important (Musgrave 1969). Hence public sector outlays expand at a rate faster than that of private sectors. Finally, at the high level of per capita income associated with developed countries, public sector growth will slow down until public and private expenditure grow almost at the same rate.

C) Productivity differential between public sector and private sector (the productivity lag). When productivity of the resources used in the public sector grow slower than that of similar resources employed in the private sector then there is greater relative need for inputs to produce a given output in the public sector. This tends to increase overtime.

d) The displacement effect and the concentration process. In their research of British government expenditure growth, Peacock and Wiseman noted changes in the rate of growth of public expenditures which they associated with wars (Peacock and Wiseman 1967). What was important in this context was not the rise in expenditure during the war years but rather the fact that post-war expenditure levels did not return to their pre-war level but remained significantly above them. War expenditure appeared to have what they called a “Displacement Effect”.

Peacock and Wiseman study points to a further characteristic of public expenditure growth in the UK that is the concentration process. The consequent desire for greater uniformity and standardisation of services like planning the war economy, anti-cyclical action after the 1930 Depression and improved transportation and communication, for example, required central government intervention through the provision of equalisation grants to remedy the different standard of public services in various parts of the country. Although the concentration process may be explained by many factors it at least, in part, is associated with the displacement effect.

### **Government Budgetary and Economic Policy**

Nowadays modern government claims to be a welfare state and its functions are ever-increasing. In such circumstances a budget is a significant instrument of planning, publicising, executing and reviewing the government economic policy. The budget has a wide-spread ramification throughout the national economy, because firstly, at present, budgetary policy is conducted much more deliberately and secondly, the size of the budget in relation to the rest of the economy has grown so much that the powerful role of the budget in affecting the rest of the economy has been greatly enhanced.

The economic policy through budgetary action is effective in controlling and regulating the total volume of economic activity, the general price level and private expenditures. These measures may be regarded as indirect but these indirect measures have direct effects too. An increase in income tax rate, for example, designed to restrict the consumer expenditure in order to check inflationary conditions, is an indirect measure of controlling economic

activity. However this will directly affect the expenditure on particular commodities. According to Hansen, the budget is often spoken of as a mean of economic policy, but in fact the budget covers several economic policy measures parameters - which the State and other public authorities can use in economic policy (Hansen 1958).

A government, before adopting budgetary measures of economic policy, should identify what measures will result in certain consequences and also, if certain results are to be achieved, what steps must be taken. This, of course, is a difficult task, because in modern society, economic systems are highly integrated, sensitive and closely inter-dependent. Therefore, an effect of any particular measure cannot be easily identified (Williams 1963). However, by using certain modern techniques the impact of a similar group can be identified. The objectives or goals of economic policy for a particular country can be determined only with reference to its stage of development.

The government should see whether it is an advanced, developing or an underdeveloped Country and whether its economy is agricultural or industrial. Similarly note should be taken in regard of its social ideology, its circumstances and the nature of the economy.

Musgrave states that there are three objectives of economic policy achieved through government budgeting. They are (Musgrave 1959):

- (i) To secure adjustment in the allocation of resources;
- (ii) To secure adjustment in the distribution of income and wealth;
- (iii) To secure economic stabilisation.

Due, on the same issue, states that the primary objective of economic policy is the maintenance of a reasonably stable rate of economic growth without developing substantial unemployment on the one hand or of upward or downward movement in the general price level on the other (Due 1959).

To sum up the discussion, the major ends of government are to achieve economic stability, full employment and price stability. Some economists also stress upon national security, social security, economic and social progress and political stability (Boulding 1955). The latter is an important objective to all countries because without it, economic stability cannot be achieved.

One way to understand the growth of the public sector in Iraq is an appraisal of the existence, strength and reliability of the various linkage effects of the petroleum sector (Hirschman 1977). In this regard major conclusions drawn from studies of other oil exporting, developing countries are of interest (Pearson 1970; Harris 1971; Al-Ali 1988).

First, most studies in which staple theory were expanded to the petroleum sector suggest that the petroleum industry has tended to be relatively deficient in spread effects associated with production and consumption linkages. Obviously, failure of petroleum to create production linkages was a direct result of the technology used in it, which is highly capital and skill intensive. Hence, in a developing country like Iraq, petroleum industry input requirements were highly divergent from domestic factor supply. On the other hand, the failure of the oil industry to raise or generate consumption linkage could be due to its low labour demand as a

result of its technology.

The second conclusion regarding the examination of linkages in the petroleum sector is that fiscal linkages in an export oriented economy are by far the most important means through which developments in the petroleum Sector are transmitted to the rest of the economy.

The third conclusion is that the difference between production and consumption linkages on the one hand and fiscal linkages on the other is vital to the understanding of the unique problem the sector has in transmitting its growth to the rest of the economy. Production as well as consumption linkages, success or failure is worked out through the market mechanism while the success of fiscal linkage depends primarily on the governments' ability and willingness to participate in the income originated in the petroleum industry. More importantly, this willingness and ability to acquire income must be matched by the ability to invest productively.

An assessment of export-led growth in petroleum economies suggests that, from the perspective of the staple theory approach, Iraq has to rely primarily on fiscal linkage. This means that government has to play the leading role in initiating development. This role could be direct or indirect and that is what should have happen during the past years. Therefore, to understand the important role played by the government budget in the process of economic development in Iraq, is to study the impact of fiscal linkages associated with the oil industry on the domestic economy, fiscal linkage was defined by Pearson as 'inter-sectoral effect associated with government expenditures of incremental revenues collected from expansion of a given industry' (Pearson 1970). As such fiscal linkages are induced externally, an increase in an industry's contribution to government revenue could be the result of either the external effect of an expansion of the given industry, or a sizeable increase in the price of the exported commodity (as is the case for petroleum exporting countries currently) or both. The financial proceeds invested (channelled) into the domestic economy (fiscal linkage) is the result of an increase in government expenditures due to increases in its revenues from oil.

Inter-sectoral impact associated with increased government expenditure in Iraq can be categorised as follows: first, direct government investment in the economy in a form of infrastructure as well as direct productive activities through State enterprises; second, indirect investment to support private sector activities such as: industrial estates, research and development as well as grants, subsidies and interest free (or low cost) credit etc and third, the distributional aspect of government expenditures. This could be looked at as supplementary to the inter-sectoral flows. These come in different forms such as tax relief, indirect subsidies, or the government wage bill which has an enormous impact on private consumption.

Fiscal linkages of petroleum exports can effectively offset or compensate for the weakness of the industry's other linkages (ie production and consumption linkages), especially when the role of government expenditure is enhanced by careful planning of the budget's allocation, its functions and constituents. It is in this context that the role of the Iraqi government budget should be looked at and analysed. Government, through the budget, should consider proper utilisation of economic resources and, because the problem of economic growth requires proper participation between private sector and government economy in the total available productive resources, government should use the budget to support the private sector in order to play its role in the economy. In Iraq as in any other country, problems of development and steady economic growth require a steady increase in total investment, private as well as

public. In order to maintain total investment activities, public investment has to be increased and incentives need to be extended by government to encourage private investment. As such, Iraqi budgetary policy during the period should have the following objectives:

- a) To increase the rate of investment not by checking actual and potential consumption through higher taxation but through direct and indirect government investment as well as assisting private investment;
- b) To channel the flow of investment into fields judged to be most desirable from the point of view of society;
- c) To regulate the purchasing power in accordance with the overall pattern specified in the development plans;
- d) To modify the inequality in income distribution in a manner which is consistent with the best long- run interest of the population;
- e) To check the rise in prices by subsidising the prices of certain essential goods and services.

In general, the overall objective of the budget is to plan and direct the resources available to government in order to ensure that the spread effect of oil industry fiscal linkage is effectively used to compensate for the weaknesses of production and consumption linkages associated with the petroleum sector in such a way that the process of economic diversification and socio-economic development are ensured.

Measuring the impact of a change in one or more determinants in national income has been the subject of much examination in economic literature. In recent years, there has been an impressive increase in modelling for economic impacts. Economic multipliers are estimated through a variety of models. These can be classified in three main types:

1. General equilibrium model

These are Keynesian in nature and evolved around national income identity (Peacock 1965; Gramlich 1968; Leuthold and Due 1970; Stone 1988; Goldberger 1989). The estimation in all these studies have usually been made through macro-econometric models that deal with the aggregate concept. Most of these studies do not disaggregate the government sector so that the multiplier delivered from these is independent of the sector to which the increase/decrease in government expenditure is directed. As far as the impact of government expenditure is concerned, it is important when a decision regarding a choice of expenditure programme is made. The programme that is to be used should be the one with the most favourable impact on the rest of the economy. This effect cannot be achieved through an aggregate model nor through a partial equilibrium model.

2. Input – output model

These have the ability to avoid aggregation and take into account the detailed analysis of impact on a micro (sectoral) basis. One of the earliest studies was initiated by Peacock and Stewart (1958). Their study centred on the United Kingdom and used open Leontief input – output system to estimate the direct and indirect impact of

government purchases on different sector incomes. Two subsequent studies were undertaken for the US economy. The first, (Leontief and Hoffenberg 1961) focused on dividing the US economy into 57 producing sectors and identified 8 military and non-military final demand elements. This enabled their study to estimate the effect of a reduction in defence expenditure on the producing sectors. Kokat (1966) further examined this subject by improving upon the methodology adopted in the Leontief and Hoffenberg study, by relaxing the fixed proportionality between final demand elements and the producing sectors. These two studies were concerned with the investigation of structural problem which may arise when a substantial shift in specific expenditure has taken place.

Roskamp's article (1969, 1971) could be regarded as the first comprehensive study in this area. Using a 55 sector input-output model for West Germany, he estimated the impact of an increase in the volume of government expenditure without a change in their composition. Jones and Kubursi (1973) adopt a single target methodology as opposed to multiple target approach as postulated by Roskamp. The model arrives at optimal composition of government expenditure according to their functional classification as opposed to the sectoral classification which earlier studies have adopted. There is an added advantage with the functional classification as the optimal programme composition can be directly arrived at, therefore the difficulty of translating sectoral composition of expenditure into different expenditure programmes will be eliminated (Al-Ali 1988).

Studies cited above attempt to measure the total impact (direct, indirect and induced) of a given changes in any final demand component (namely Government expenditure in this case) on sectoral output.

### 3. *The hybrid model*

The hybrid model combines elements of macro-econometric and input – output techniques (Morishima and Nosse 1972; Forsell 1975; Dahlberg and Jacobsson 1977). Through utilising a consumption function, these studies accomplish by linking input - output with the Keynesian model.

## **Characteristics of the Iraqi Economy**

From what has been discussed in the previous section impact studies, of a somewhat relevant type, provide us with a systematic way in attempting to measure the impact of any exogenous variables in an economy. In a country like Iraq, the environment in which the analyses are to be carried out is, however, somewhat different from what we have seen in the previous studies. These differences can be summarised as follows:

1. Government assumes direct ownership of the major financial resource generating facilities, namely oil production and export facilities.
2. Oil revenue received directly by government produces in the first instance, merely a rise in government bank deposit. It is only when government injects them into the domestic income stream that the impact of this revenue is generated.

3. It follows from (2) that government expenditure is the main financial linkage between the oil sector and the rest of the economy. Under the existing arrangement oil revenues are automatically neutralised and do not have any effect on the economy until they are disbursed through government budgets. This exogenous nature of oil revenue and the institutional arrangement of revenue receipts and their utilisation makes the Iraqi economy different from other primary commodity exporting countries. In these countries production facilities are in the hands of the private sector, in which case the problems of monetary stabilisation which do arise are confronted. In the case of Iraqi, however, government can manipulate its expenditures to prevent such problems from happening.

4) Leakage in the form of taxes is negligible if it exists at all.

Such specific characteristics of the Iraqi economy will influence, to a large extent, the structure of models that can be developed.

This paper argues that given the important role of the government budget and the size of its impact on the macro and micro levels of the economy, one might expect that during the last period and, as a result of the large sums spent by government, that the outcome could have been one of a high rate of growth and real structural development. That such an outcome could not only be achieved but could also be sustained in the future without very much reliance on a similar high level of future government expenditure.

The current economic situation is mainly a consequence of past undue spending policies. During the past period budgets have always deviated from plan in such a way that actual expenditure far exceed its planned level and, in many instances, was different from the planned structure. The concentration on high consumption is one example of such a deviation from the planned sectoral and functional structure of spending. Such changes could influence the private sector's attitude by investing heavily in areas like trade and so on. This could lead to an increase in the supply of such activities to a level higher than the market required and negatively influence investment in industrial and other productive projects.

The failure to achieve improvements in the economy is partly related to the current unstable environment. However the most important factors are related to the weakness and vagueness of the administrative arrangement of government organisation and the process of budgetary planning and control system such as:

1. Lack of clarification and delineating the responsibility of the central and local government. This stems from the confusion between federal and decentralised structure of the state organisation. This will lead to a distortion in the authorisation and accountability arrangement that is necessary for good performance;
2. Weak and limited skill capacity to plan and manage the economic resources by linking budgeting to development planning;
3. Government budgeting during the previous years have done very little to add to the development of the different aspects of the economy. There seems to be very little that has been done to achieve any improvement in the economy. This is because policies of allocation during the previous years were biased towards short-term rather than a long-term strategic framework;

4. Budget expenditures include a large proportion allocated to purposes which neither serve to promote investment nor consumption, but rather to provide an ad hoc assistance used to create a pseudo-structural change. The existence of which may hinder the achievement of the required real and sustainable structural transformation;
5. The experience of the previous years shows that budget allocation decisions are made without due regard to the planned target. This, in itself, is a serious point since this lack of harmony often causes hesitation in the market as to which aspiration to follow- that of the plan or that of the budget;
6. The allocations made during the past period were made without the knowledge of either the nature or the size of the interaction between the different categories of expenditure (type or function) and the various sectors in the economy. This has resulted in a disparity between both the level of expenditure and the level of sectoral development requirement;
7. The state of the limited skill capacity of the economy indicates that a higher level of expenditure is not necessarily always desirable. On the contrary, it may create a situation where unnecessary projects are undertaken irrespective of their economic or social viability;
8. Government expenditure levels of the past period have created a pattern of activities which has relied heavily for its implementation and operation on the importation of material. This, apart from social side effects, has left its mark on the characteristic and magnitude of the Iraqi development. Through keeping development within the capacity of indigenous resources, especially manpower, with some degree of foreign supply, the process could evolve smoothly without experience of the past. Moreover, it would have reduced the leakage out of the economy by reducing the size of imports.

### **The way forward**

Based on what has been shown in this study and the current economic conditions in Iraq, a number of suggestions could be made to improve the situation and to mitigate some of the consequences brought about by the misdirection of government expenditure, owing to the inadequate planning of public finances. These suggestions could be summarised as follows:

- The most important cause for the problem of the decline in economic structural development and activity is the lack of effective allocation of government expenditure and the inability of private sector to offset this effect. In order to prevent a further deepening of the problem some adjustment in the size and the composition (pattern of allocation) of the budget may be warranted. Measures to that effect may take one of two forms: rationalisation of expenditure or mobilisation of additional skills to reshape the economic management of the country.
- Rationalisation of expenditures would comprise a restructuring and prioritising of public expenditure. This could mean the elimination of unproductive and wasteful spending, a reduction of unnecessary subsidies on various goods and services and a review of the enormous amount of government expenditure on public administration. In addition, an elaborate cost-benefit analysis or value for money audit may be undertaken to ensure the optimal spending policy.

- While economic efficiency is an appropriate criteria for resource allocation, in spending money to maximise the benefits to and from the private sector a higher weighting should be given to those sectors which have long-term prospects, strategic importance and wider linkages in the economy, i.e. those having the maximum impact/multiplier.
- Government should adopt a declared stable budgetary policy. This is most important from the point of view of the private sector since it eliminates speculation and reduces uncertainty in private sector planning. Such an adjustment would be more effective if carried out within the long term development planning framework.
- Measures to raise additional government revenue so as to reduce the effects of uncertain oil revenues and increase budget allocations could include a wide range of tax and non-tax measures. The latter may be the easiest for government to administer, at least in the short-run. All that needs to be done is to rationalise subsidies and put a price on goods and services which are currently provided by government either free of charge or being heavily subsidised. Of course, tax and non-tax measures have to be studied and evaluated in the light of the government's commitment to raising the standard of living.

The essence of the new situation is that, despite (and because of) the inefficiency in government expenditures more is now required from the private sector, as a parallel force shaping the economy than ever before. The most adequate measure is, therefore, for the government to improve the efficiency and effectiveness of its support to this sector. To this end, several steps could be taken.

First, new incentive schemes for the private sector are needed in order to make it more sensitive to the scale of private commitment, to the marketing risk involved and also, to the developmental priorities. Most of these are possible and can be administered easily. Technically they require a recalibration of the existing system of incentives together with the appropriate priority ranking for the nature of activities concerned.

Second, for domestic developments a sector by sector review of private investment intentions, market potential, technology transfer requirement and financing possibilities will have to be carried out as a joint government/private sector exercise. Special attention should be given to those sectors (or activities) which promise a growth potential and substantial linkage effects such as those sectors with high impacts shown in this study or an extension of them, e.g. agricultural processing and secondary petro-chemicals etc.

Thirdly, a serious problem facing businesses is the lack of adequate information on the local market to enable the decision maker to take the correct decision. Businesses wishing to enter into new fields have difficulty in identifying, for example, the size of government purchases of various goods and services, future prospects for government spending in areas of relevance and other market information. Often such information is available but is not made public because of the misplaced emphasis on confidentiality. An adequate policy should, therefore, be derived regarding the process of making public information more of value and of relevance to the making of sound decision and judgements.

### **Final remarks**

A framework of budget preparation and implementation such as the one suggested above will no doubt require certain requirements, some of which are structural and relate to the

organisation arrangement of government agencies involved in the budgetary system. This calls for a delineation of responsibility and authorisation between central and local government. Other requirements are operational and relate to the skill capacity of government officials. For this to end, capacity enhancing programmes should be undertaken and utilise the skills of Iraqi development experts who are involved with International organisations such as World Bank, IMF, UNDP etc, rather than foreign consultants who have no real understanding for the socio-economic and cultural environment of Iraq. Government will need to initiate a strong regulatory framework that nurtures good governance to avoid the abuse of public office for private gain. In order for this to be achieved, strong external accountability and control systems are required to deter such malpractice which was, beside environment uncertainty, the cause for not achieving the intended objectives.

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