

The Relationship between Revenue Diversification and Government Spending In Cross River State

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Abstract: *In recent decades, revenue diversification has become a prevalent practice in state government finance. The trend of revenue diversification, according to the portfolio theory, has far-reaching implication for public financial management as it may change revenue stability, which has been an important policy objective for state government administrators. This study explores how revenue diversification affects government spending. The study adopted the survey design with data collected from both primary and secondary sources. After presenting and analyzing the collated data, the formulated hypothesis was tested using Regression model in SPSS 20. The result revealed that the diversification of public revenue reduces revenue fluctuation. It was thus recommended that to minimize revenue volatility, government should purposefully define a set of economic activities as tax base and create a tax portfolio with multiple revenue sources and low elasticity*

Keywords: *Revenue diversification, Government spending, Revenue stability, Tax base, Tax portfolio, Economic base.*

I. Introduction

For development and growth of any society, the provision of basic infrastructure is quite necessary. This perhaps explains why the government shows great concern for a medium through which funds can be made available to achieve their set goals for the society (Fagbemi et al, 2010). Government needs money to be able to execute its social obligations to the public and these social obligations include but not limited to the provision of infrastructure and social services. According to Murkur (2001), meeting the needs of the society calls for huge funds which an individual or society cannot contribute alone and one medium through which fund is derived is through taxation. Tax is a major source of government revenue all over the world. Government use tax proceeds to render their traditional functions, such as the provision of public goods, maintenance of law and order, defence against external aggression, regulation of trade and business to ensure social and economic maintenance. In Cross River State, apart from the federation statutory allocation, tax revenue has accounted for bulk of revenue needed for development purposes

In the study of the impact of public revenue on the development of any economy, a distinction has been drawn by several authors between external revenue and Internally Generated Revenue (IGR). While external revenue is revenue generated from outside the state, IGR is the revenue that state governments generate within the areas of their jurisdiction. The various sources of internal revenue available to state governments includes taxes, fines and fees, licenses, earnings & sales, rent on government property, interests and dividends, among others. The capacity of a state government to generate revenue internally is a crucial consideration for the creation of a state government. According to Babalola (2009), the provision of public schools, public health and public infrastructure require huge government spending, especially in these modern times. Also, state government incurs expenditure for the provision of adequate security, fulfills its commercial functions and administration. Therefore, the need for adequacy of revenue at all levels of government has become imperative, given the expenditure profile of government aimed at reducing poverty, generating employment, boosting growth and creating wealth. State governments now face more challenges in terms of struggling to be less dependent on the Federal government for financial resources. Though, the revenue allocation system mandates that a certain fraction of the Federation Account be allocated to state governments, these funds are not enough to meet expenditure requirements. This is because the size of the account is related to revenue from oil which is subject to fluctuations and the expenditures of state government far exceed available resources. The problem of lack of fiscal transparency as a result of mismanagement of funds, corruption, poor internal control and lackadaisical attitude to government work and property still abounds. The question that comes to mind is since the statutory allocation is has reduced because oil is de-emphasized in the economy what would be the lot of state governments? How would they survive fiscally?

The need for the government to provide social amenities, embark on developmental projects that would improve living standard of citizenry as well as meet its overhead or recurrent expenses

necessitate intensified revenue generation efforts both internally and externally. This effort will ensure the diversification of their revenue base which is the focus of this study.

1.1 Objectives of the Study

The objectives of this paper include the following:

- i. To highlight the diverse sources of revenue available to state government (externally and internally generated revenue)
- ii. To analyze the impact of revenue diversification on public revenue fluctuation in Cross River state.

1.2 Research Hypotheses

This paper formulates one hypothesis for testing

Ho: The diversification of public revenue does not reduce revenue fluctuation

1.3 Organization of the study

The rest of the paper is organized in four sections. The review of relevant literature on the subject matter is contained in section two, section three identifies the research methodology, and section four represents data presentation, analysis and discussion of finding while conclusion and recommendations are stated in section five.

II. Conceptual Review

Although the advantages of revenue diversification have been widely discussed in a variety of literature, the traditional debt management research and practice have a special emphasis on a closely related but different concept: economic base diversity.

Under the shadow of economic base diversification, the theoretical and empirical verification with respect to the effects of revenue diversification on revenue stability is still a key missing piece to the tax structure puzzle. An economic base refers to the composition of the economic structure of an area, namely, the variety of businesses and employers found in an area and their relative proportions. Clearly, each region has its own mix of industries which serves as economic drivers of the regional economy and the unique composition of industries could be partially attributed to the region's comparative advantages, such as natural resources and geographical advantages (Froeschle, 2005). The primary reason why economic base diversity has gained special attention is that government revenues rely on income, which is generated from a wide range of economic activities or an economic base. Large and random swings in economic activities can jeopardize a stable inflow of tax money (Loviscek & Crowley, 1990). Past research holds the view that "revenue variables are less important in bond ratings than the base from which the revenues are taken" (Hildreth & Miller, 2002). A similar view is also held by rating agencies. Standard & Poor's rating criteria (2005) perceives the strength of the local economy is a determining factor of revenue volatility and financial growth prospects, so economic base is a critical consideration in credit rating assessment.

High income level and a diverse economic base will better protect a region against economic changes and external shocks, and provide that region with superior debt-repayment capacity (Standard&Poor's, 2005). However, this paper suggests that a diverse economic base by itself does not ensure a government entity the strong ability or flexibility in managing all of its financial obligations. To be more specific, a diverse economic base helps to generate stable tax revenues only when acting with its compatible tax structure. The role of revenue structure, particularly its degree of diversification, which plays in determining revenue stability, has been largely understated in the existing literature.

To explain this, we first need to understand how a government uses the economic outputs to pay for public services. As we know, an economic base is the foundation for all sorts of revenues for a government. When policy-makers define the range of economic activities or tax base from which the government revenues are taken, they also assign the appropriate tax rate for each category of taxes. The tax revenues of a government are determined by the tax rate and the range of the tax base. In other words, the categories of taxes (tax base) and its relative proportion (tax rate) compose the tax or revenue structure of a government. With the influx of revenue, a government provides a wide range of public services. As such, a sound revenue structure is very important in that it helps to generate sustainable and adequate resources available to redistribute to the public by delivering a wide range of public services.

From the discussion thus far, we can see that, besides a strong economic base, the basic structure of a tax system also plays an important role in determining the stability and growth of government revenues. The analysis from Braun and Otsuka (1998) further confirms this view by showing that both tax structure and economic conditions have significant effects on the stability and growth of tax revenue flow. However, their study simply assumes that economic conditions affect revenue flow directly or indirectly through tax structure and it breaks down the tax structure by components. There are two main drawbacks associated with the analysis:

first, it does not consider the tax portfolio as a whole, which may bias the study by failing to account for the correlation between different taxes, and second, it fails to recognize the important interaction between economic base and tax structure in determining the revenue inflow. Put in other words, matching a given economy with a different tax structure can bring about significant changes in the levels of revenue growth and stability. Alternatively, applying similar tax structures to all regions with different economic conditions is also not a desirable strategy for governments with an objective of revenue stabilization.

2.1 The Concept of Revenue mobilization, diversification, volatility and stabilization

In corporate finance, risk means the market return is hard to predict or volatile over time. According to portfolio theory, diversification helps to reduce risk or variability, provided that different stocks in an investment portfolio do not move in exactly the same direction or the price changes of different stocks are less than perfectly correlated (Brealey; & Myers, 1991). There are two types of risks we need to distinguish: unique (unsystematic risk) and market risk (systematic risk). The unique risk stems from the adverse conditions that surround a particular company or industry. This risk can be eliminated by diversification. However, the market risk cannot be eliminated through diversification and it comes from the economy-wide perils which affect all businesses.

For a well-diversified portfolio, the only thing that matters is the risk that investors cannot get rid of – the non-diversifiable ones. Since a single security's contribution to the (market) risk of the whole portfolio depends on how sensitive the security is to the market movements (measured by beta), the risk of a well-diversified portfolio "equals the average beta of the securities included in the portfolio" (Brealey; & Myers, 1991). If the portfolio risk is driven by the betas of each different security, it implies that diversification cannot only eliminate the stand-alone risk, but also adjust the market risk of the portfolio by changing the combination of different securities.

In the context of government finance, the idea of revenue diversification is similar to investment diversification. We may consider the various revenue sources or tax bases as a government's investment portfolio and each tax as one of the securities in the portfolio. The variability of tax revenue is analogous to the concept of volatility in market returns in corporate finance. According to White (1983), revenue diversification in government finance relates to the correlation between two or more taxes. In order to reduce revenue fluctuation, a desirable tax structure should include taxes that are not perfectly correlated. In other words, the different tax revenues will not move in exactly the same direction and magnitude at the same time. In this way, when one tax shrinks for some reasons such as an economic downturn, the total loss of government revenue is minimized because other revenue sources have not experienced the same changes (White, 1983).

White's research clearly defines the unsystematic risk related to any single tax revenue and describes how diversification helps to minimize this stand-alone risk in public finance. As we know from portfolio theory, the stand-alone risk is less of a concern for a well-diversified portfolio. Investors tend to focus more on the market risk coming from the general economy, because different investment portfolios may vary in the market risk (beta) in terms of the market sensitivity or market risk of each asset included in the portfolio. As a result, investors can alter the risk of a portfolio by reshuffling the combination of assets. However, similar to White's study, the previous literature has uniformly assumed the instability is caused by random fluctuations without considering the fact that economic conditions can also cause changes to the tax base and thus the expected value of tax revenues (Bradley M. Braun & Otsuka, 1998). As a policy maker, one may need to go beyond the diversifiable risk and consider how to use different combinations of taxes to change the systematic risk, which is subject to the general economic condition.

In government finance, the degree of revenue variability is greatly determined by the income elasticity of tax revenues. The elasticity of each tax indicates that individual tax revenues have different degrees of sensitivity to the general economic condition by nature. In this sense, the income elasticity of a single tax's revenue is analogous to the concept of market risk or beta of each individual security in an investment portfolio.

According to previous research, corporate and individual income taxes have been generally classified as having high income elasticity, general sales taxes as medium and property and excise taxes as having low income elasticity. A larger share of total revenue from elastic taxes results in the total revenue being more susceptible to the short-run business cycle, which causes fluctuations in revenue streams (White, 1983). On the other hand, it is an often unstated assumption that an inelastic revenue system typically leads to a cyclically stable revenue system (Dye & Merriman, 2004). Therefore, by changing the tax structure to include taxes with low elasticity, the revenue risk subject to economic cycles can be reduced. The trade-off is that returns or revenue growth will not increase as much during periods of economic growth as it would for a tax structure with more elastic taxes.

To realize the goal of revenue stabilization, as one may argue, an alternative approach is using some forms of financial reserves, such as budget stabilization funds (rainy day funds). With rainy day funds, a government can still choose a revenue portfolio with high elasticity in that when the economy is experiencing

high growth, the higher surplus of revenue brought by the elastic tax structure can be set aside as financial reserves and used in lean years. Theoretically, revenue instability from economic fluctuations can be minimized through the stabilization function of slack resources.

However, only the rainy day funds with explicit rules and procedures of deposits and withdrawals could effectively help to increase savings and protect a state from the negative impacts of recessions (Hou, 2002). In practice, the funding mechanism of rainy day funds are largely subject to political involvement, and elected officials tend to prefer current spending to savings (Hou, 2002). Furthermore, states show great variation in terms of the procedures for disbursement (Joyce, 2001). The political and practical constraints of rainy day funds or other slack resources make it hard to be used as an independent fiscal device to achieve the goal of stabilization. Therefore, financial reserves could at most serve as a complement to revenue diversification to shield a government from revenue shocks during downswings.

In the practice of government finance, the actual effect of revenue diversification should be investigated separately in terms of nonsystematic and systematic risk. Given limited revenue choices, the nonsystematic risk can be lowered to some extent but can hardly be removed as it is in the investment portfolio. Also, the correlation between these revenue sources should be examined. For systematic risk, the key is how revenue diversification changes the elasticity or beta of the entire government revenue portfolio.

Revenue diversification can increase the overall elasticity or beta and reduce the revenue stability by having a combination of elastic taxes, though it may lead to revenue growth. Similarly, revenue diversification can also help to create a revenue portfolio with low elasticity with the appropriate tax selection. Therefore, the overall effect of revenue diversification is unclear without specific analysis on the nature and composition of the tax portfolio.

The unique mix of economic sectors in an area drives the regional economy and provides the government with possible tax revenue sources. Clearly, the fluctuations in a regional economy can influence the tax revenue streams. However, the perceived dominant influence of the economic base on revenue stability is a naive or over-simplified understanding of the way that revenue stability is determined in that it ignores the interaction between the economic base and the tax structure; it is this interaction that alters the revenue streams.

An economic base refers to the unique economic structure of a region, which can vary greatly in terms of its nature and composition. The industry composition determines the sources of economic outputs and hence the range of revenue options. More importantly, the composition of an economic base, e.g. the types of sectors and their relative shares, determines the nature of the economic base, which can be described by the economic instability of the region. When a regional economy experiences business cycles or random shocks, output and employment fluctuates around the trend as market demand for a regional product or service varies (Froeschle, 2005). This in turn affects government tax revenues. However, the varying nature of economic bases makes the economic activities in a region more or less subject to business cycles or other external fluctuations.

In the following text, the instability of an economic base is used to capture the economic impact of the external risk, which mainly includes nonsystematic risk caused by random shocks and systematic risk from business cycle to the economic base or tax bases. By reflecting the extent to which economic bases are affected by external risk, economic instability helps to classify different types of economic bases. Each economic sector or industry has different instability. The overall instability of an economic base is determined similarly to that of an investment portfolio by considering the instability of individual economic sectors. Therefore, the overall instability of an economic base differs in terms of the industry composition and the instability of individual sectors.

Revenue structure has an active influence on revenue volatility as well. Theoretically, to minimize revenue volatility, a government could purposefully define a set of economic activities as tax base and create a tax portfolio with multiple revenue sources and low elasticity. Since the nature of economic bases is different across jurisdictions, a tax portfolio that serves the goal of stability should be specifically tailored to the characteristics of each economic base and should vary across jurisdictions. Put another way, if we designate an equally well-diversified tax portfolio to a region ignoring the nature of its economic base, the effect of revenue diversification on revenue volatility can vary. Since the changes in economic bases are realized through a gradual process with uncertainty, from a short-run perspective it is meaningful to take the nature of an economic base as given and examine how the effects of revenue diversification on revenue stability change according to the unique nature of an economic base, particularly its instability.

Revenue diversification affects the nonsystematic risk of each tax portfolio in a similar way regardless the natures of economic bases. With a given economic base, a well-diversified tax structure can minimize the unsystematic or stand-alone financial risk and increase the stability of revenues. The unsystematic risks to tax receipts can be described as a catastrophic loss from any single tax revenue resulting from economic swings, legal or political actions (Suyderhoud, 1994) and other random events. Diversification cannot, however, eliminate the market risk or systematic risk caused by business cycles. To be more specific, when economic declines happen, some negative impacts will converge upon the whole economy and will be unavoidable, while

some revenue risk can be diversified away through the interaction of an economic base and its well-diversified tax structure. The key point here is that a vital economic base and a well-diversified revenue structure, including tax base and tax rate, must act together to lower the financial risk presented by tax revenue instability. Without an economic base with a variety of industries or sectors, it is meaningless to talk about diversifying revenues. On the other hand, even if a region has a mix of industries, the risk from a dramatic loss of individual revenue sources cannot be alleviated without diversification and balance in revenues. Therefore, both economic conditions and tax structure diversification are important in stabilizing tax inflows.

However, as discussed earlier, changing the structure of an economic base (e.g. degree of diversification) and further its nature (e.g. instability) is a long-term process and this study takes the nature of the economic base as given from a short-run perspective. In addition, sub-national governments are oftentimes constrained by limited revenue options, implying that stand-alone risks are hard to eliminate. Furthermore, there is no significant difference in revenue variety for each level of sub-national governments, which means most of these governments are subject to similar degrees of non-systematic risks. To better approach the problem of revenue volatility, attention should be focused on reducing the systematic risk by adjusting the relative shares of each revenue component.

The distinguishable effects of revenue diversification on revenue stability lie in the way it works on systematic risk, which surrounds all businesses or sectors in a region or even the entire country. Generally speaking, there are a variety of economic sectors located in a region and these sectors exhibit different vulnerability to the general economy. Economic base theory in regional science research usually divides economic sectors into two categories: population-serving sectors whose products meet the needs of the local communities, and export sectors, which target the export markets and generate additional employment and revenue for a region. According to economic base theory, it is the export sectors of a local economy that bring growth and expansion in terms of revenue and employment to the region (Froeschle, 2005).

However, regional business cycle theory, which is another school of thought in regional science that draws heavily from economic base theory, points out that export-oriented industries are more unstable and susceptible to economic fluctuations because these sectors are subject to “a high short-run income elasticity of demand for a region’s export” (Siegel & Johnson, 1995). If all the economic sectors are classified as stable or unstable sectors in terms of their sensitivity to cyclical changes or systematic risk, the regional business cycle theory suggests that regional differences in sensitivity to economic fluctuations can be attributed to a region’s composition of stable and unstable sectors.

After we recognize economic bases vary in terms of their sensitivity to cyclical fluctuations, it is important to examine how the effects of revenue diversification change when matched with different economic bases. Since the overall sensitivity of an economic base equals the weighted average sensitivity of individual sectors located in a region, if a given region has more unstable or export-oriented sectors in its industrial mix, the economic base is more sensitive with respect to changes in the general economy and employment and income are more prone to declines in demand and production caused by economic downturns. Suppose the local government defines a tax portfolio with the revenue share for each source similar to that of the industry sector mix in the region, the elasticity of the tax portfolio will be fairly high and the government will be more likely to suffer from the negative impacts of great revenue volatility. As a remedy, the government can adopt a diversified tax structure. A more balanced composition of tax revenues can lower the elasticity of the tax portfolio and improve the overall revenue stability by lessening the heavy reliance on elastic revenues generated from the unstable sectors of the area.

From the previous discussion, revenue diversification seems to be a laudable strategy to pursue, considering its perceived positive impacts on fiscal performance and its contribution to revenue stability (under a sensitive economic base). However, the optimum associated with revenue diversification under an insensitive economic base is far from obvious as revenue diversification can also hinder the revenue stabilization. When an economic base is dominated by stable sectors such as population-serving industries, it implies that the economic base is relatively stable or less responsive to the economic swings. In this case, the level of employment and income generated by the local industries is less volatile over time compared to the former case. If a great portion of the government’s tax revenue comes from stable industries, revenue volatility should be less of a concern. On the other hand, if an equally diversified tax structure is applied, the overall elasticity of the tax portfolio will increase as a result of lowering the proportion of relatively stable tax revenue from the inelastic industries. In this case, a naive pursuit of a balanced mix of many unstable small taxes may not be the desirable strategy to pursue because doing so would increase the volatility of overall revenue.

Table 1: Cross River State Government Revenue

	SOURCES	DESCRIPTION
1.	Taxes	These are compulsory levies imposed by the state government on individuals, institutions, corporate bodies, expenditures, etc, for which no direct benefits are received. Taxes/Levies Collectible by State Governments includes: Personal income tax: Pay-As-You-Earn (PAYE); Withholding tax (individuals only); Capital gains tax; Stamp duties (instruments executed by individuals); Pools betting, lotteries, gaming and casino taxes; Road taxes, etc. These constitute major sources of internal revenue to state governments.
2.	Charges & Fees	These are imposed on goods and services provided by the state government and they include tuition at state-owned colleges and universities, tolls and transportation charges, hospital charges, parks and recreation fees, solid waste charges, and other fees for the use of government services.
3.	License	These include money state governments charge individual for obtaining various types of licenses such as vehicle licenses and other certificates. Licenses have to be obtained to operate hotels, pool- betting, Casinos, etc.
4.	Earning & Sales	These include the incomes or profits which state governments derive from their investments or business ventures such as state owned hotels, transport business, production outfits, etc. They also include incomes government derive from the sale of government property such as land, houses, vehicles, equipment, etc.
5.	Rent on property	Most state governments also derive significant amount of revenue from rent paid by people who hire government property such as houses, land, etc.
6.	Interests and dividend	State governments also get revenue from interests on capital which they lend out to individuals, institutions or Local governments. They also receive dividends on state-owned shares and stocks.
7.	Fines	These include money imposed on law offenders/breakers in the state. Fines are paid in courts and they form part of government revenue.
8.	Miscellaneous	Apart from the sources of revenue mentioned above, state governments also get revenue from other means. These include agriculture, tourism, transportation, etc.

Source: Olusola, 2011

III. Research Methodology

This study employed the survey design with both primary and secondary data utilized. Primary data utilized self reporting Questionnaire on a drop and pick basis which was collected after the respondents filled it. 60 questionnaires were administered on the sampled respondents who were made of randomly selected from the entire population of the Cross River State Public Service Commission. The secondary data were sourced from published and unpublished materials including books, internet documents, journals, theses and dissertations, etc. The data obtained from the research instrument were analyzed using Regression model computed using SPSS.

IV. Analysis and findings

Ho: The diversification of public revenue does not reduce revenue fluctuation

Regression Analysis

Variables Entered/Removed^a

Model	Variables Entered	Variables Removed	Method
1	Revenue Diversification ^b		Enter

a. Dependent Variable: Revenue Fluctuation
 b. All requested variables entered.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.698 ^a	.488	.479	.628

a. Predictors: (Constant), Revenue Diversification

ANOVA^a

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	21.756	1	21.756	55.239	.000 ^b
	Residual	22.844	58	.394		
	Total	44.600	59			

a. Dependent Variable: Revenue Fluctuation
 b. Predictors: (Constant), Revenue Diversification

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.719	.357		4.819	.000
	Revenue Diversification	.615	.083	.698	7.432	.000

a. Dependent Variable: Revenue Fluctuation

V. Decision:

In the model summary, the value of R Square value is 0.488 which reveals that Public Revenue diversification alone accounts for over 49% reduction in revenue fluctuation. Meaning that other factors collectively account for 51% reduction in revenue fluctuation. This is statistically significant.

The ANOVA table shows an F-ratio of 55.239 and a p value of 0.000 showing that the model is valid. The coefficients reveal that the t-statistic value is 7.432 and a p value of 0.000. Therefore, since the p value is less than 0.05, the null hypothesis is rejected and the research hypothesis upheld that the diversification of public revenue reduces revenue fluctuation.

VI. Conclusion and Recommendation

Volatility of revenue is a major constraint in the management of the economy because it increases the difficulty of realistic and effective financial management, most critically in planning, budgeting and budget implementation. In the Nigerian experience, there has been the tendency to embark on new programs and projects and to increase the level of expenditure in times of increased revenue inflow (revenue-spend hypothesis) without due regard to whether or not such “windfalls” will last long enough to sustain the new commitments. The result is that when the revenue flows slow down government often resorts to deficit financing. The negative impact of revenue volatility is due not so much to the volatility of the inflow as to how the inflow is managed. Improved planning and budgeting systems and transparency and accountability in public expenditure management would reduce the leakages and feed increased output and productivity.

Stabilization of public expenditure and the need to pursue productive spending is strongly recommended in efforts to address the challenges of the global financial crisis. It is not how much spent but how well it is spent that can address economic leakages. Fiscal funds should be established for off-budget receipts and targeted at specific infrastructural development.

It is also been noted that public expenditure is relegated to a passive role and revenue continues to drive public expenditure growth pattern in Nigeria with attendant fiscal shocks. There must, therefore, be strong measures to enhance public expenditure management and implementation of policies to widen revenue bases in Cross River State.

This work has so far explained the theories of government revenue and expenditure by relevant scholars such as Wagner’s theory and Wiseman- peacock theory, as well as growth and development theories. According to Wagner, there are inherent tendencies for the activities of different layers of a government (such as central, state and local government) to increase both and extensively. The main thesis of Wiseman-Peacock theory is that government does not increase in a smooth and continuous manner, but in jerks or steep like fashion. And has pointed out the main reason for increase in government efficiency and expenditure is a stable and diversified mobilization of revenue from the various sources of government revenue which is either internally generated or externally generated.

The following recommendations are made:

To minimize revenue volatility, government could purposefully define a set of economic activities as tax base and create a tax portfolio with multiple revenue sources and low elasticity. It is suggested that a further study be carried out on revenue stabilization and its impact on government spending.

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