Increasing VAT Rate from 5 to 7.2%: Is Nigerian Economy ready for the Consequences?

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1. Introduction

Value-added Tax (VAT) is a flat-tax based on the increase in value of a product or service at each stage of production or distribution. It is paid by the final consumers and collected by the end retailer. As its name implies, value-added tax refers to fees placed on value-additions for goods and services at each stage of the production or distribution chain. VAT is passed down the supply chain by being included in sales prices until it reaches the final consumer. At each stage of the production or service, the seller collects a tax on behalf of the government from the buyer by adding the VAT fee above the price. If the buyer is not the final consumer, the tax can be transferred to the consumer by selling the value-added product at a higher price to the next buyer or consumer.

VAT was first introduced in Nigeria through Decree No 102 of 1993 and became effective on 1 January 1994. It replaced the Sales Tax, which was primarily a source of internally generated revenue for state governments. The Federal Inland Revenue Service was given the responsibility to administer it in all the 36 states in Nigeria and the FCT. This approach was criticised by state governments, as they argued that the centralisation of VAT administration usurped resources meant for States (Oyedockun, 2016). In trying to address this, there have been continuous amendments in VAT revenue sharing formula between the three tiers of government in Nigeria. From 1994 to 1995, VAT revenues in Nigeria were shared such that the Federal government retained 20% while state governments received 50% and local governments 30%. This formula was modified in 1995 to 50%

for the federal government, 30% for state governments, and 20% for local governments. The ensuing agitations and bickering over the division of powers and statutory rights and responsibilities of the different tiers of government led to yet another revision in 1997. This time, the formula was changed to 35%, 40% and 25% for federal, state and local governments respectively. Further agitations from sub-national governments led to the VAT (Amendment) Act, 2007, which led to the current formula that assigns 15% to the federal government, 50% to states, and 35% to local governments (Oriakhi and Ahuru, 2014).

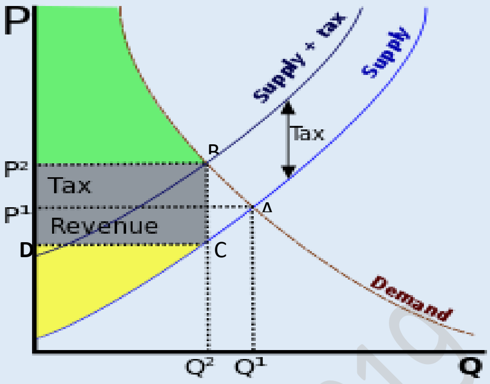
The average VAT collection in Nigeria since 2013 has been about N900 billion, shared among the Federal, State and the Local Governments in the ratio of 15:50:35 per cent formula, net of four per cent cost of collection to the Federal Inland Revenue Service. This amounted to around 1% of GDP for the period. This low VAT to GDP ratio is attributed to: Nigeria's low VAT rate of 5%, which has not changed since the establishment of VAT in 1993; a low c-efficiency ratio that is attributed to poor tax administration; and a large number of goods and services being exempted from VAT, resulting to only 40%-70% of consumer goods being taxed. In essence, a weak policy environment and administrative performance combined to translate to ineffective VAT collection -- revenues have stagnated since 2013 -- despite high growth in nominal consumption (16% per year since 2013).

Mindful of the low revenue from VAT and the fact that the Nigerian VAT rate is one of the lowest in the World, the Federal Executive Council proposed on the 11th of September 2019 a new Value Added Tax rate of 7.2% for the country, up from the current 5 per cent. Cosidering the fact that the government is in dire need of inreasing revenues and diversifying the economy to strenghthen its capacity to address growing resposnsibilities, including the proposed increase in minimium wage, the idea of increasing VAT may seem sound. Indeed, the Punch of 17th September, 2019 reported Bill Gates arguing that "Nigeria has one of the lowest domestic revenues at just six per cent of GDP compared to 15 per cent in some other countries". However, rather than the anticipated paliative effect, the increase in VAT rate is likely to have significant negative consequences on the Nigerian economy. This is despite the apparent attempt in the anouncement to suggest that "the existing VAT Act exempts the basic necessities such as food, medicines and education, which therefore minimises the impact on the poor and vulnerable segments of the Nigerian society from the burden thereof".

The Likely Impact of the VAT Rate Increase

Generally, taxes lead to resource reallocation from the payee (generally the producers or consumers) to the government. An important concern in introducing a new tax or increasing the rate of an existing one is the likelihood of losses in the consumer and producer surpluses (the deadweight loss) and other indirect effects of the resource reallocation. Basically, as being proposed, increase in VAT rates will trigger increase in prices, decreasing the real income of salary earners, thereby not only decreasing their purchasg power, but also their demand for goods and services and, hence, attendant productive activities.

As shown in the figure below, the economy was in equilibrium at point A, where demand and supply intersect before the introduction of tax, producing Q^1 output at P^1 price. If there is an introduction of tax or an increase in the rate, it will translate either to; increase in the cost of production and subsequent increase in the price level, if the goods involved lack high demand elasticity; or a decrease in supply (and production) if the goods involved have high demand elasticity. Whichever be the case, there will be a decrease in output/production, shifting the supply curve upwards by the amount of the tax increase. For the figure above, the economy will establish a new equilibrium at point B, suppling Q^2 output at P^2 price. The gain from the tax rate increase is the tax revenue depicted by the area shaded grey in the figure (P^2DCB), while the direct loss is the area P^2DCAB, giving a deadweight loss of BAC. This direct deadweight loss will be there for any increase in the VAT rate unless demand in the economy is perfectly inelastic.



The deadweight loss is just but one of many likely negative impacts of an increase in VAT rate. If the economy was in equilibrium before the tax increase, the decrease in production would mean the loss of employments and its chain effects, which will put the economy either in a non-equilibrium state or to a low-level equilibrium state. Theoretically, tax rate increase is an example of a contractionary fiscal policy, which will typically lead to decrease in peoples' real income and, thus, their consumption. Also, given that some producers in the country use mostly imported inputs, which will also be taxed at 100% value addition, their cost of production and final price of goods and services will be very high. Thus, if the revenue from the tax rate increase is not productively utilized, the likely negative effects are: decreases in real incomes; inflation; decreases in the purchasing power of wages and salaries; decreases in consumption; depreciation of Naira; decrease in demand; increase in unemployment and poverty; and decrease in national output.

Given the current economic situation in the country -- 1.94% year on year growth; 2.6% population growth rate; 23.1% unemployment; over 90 million (around 50%) of Nigeria living in extreme poverty; poor consumer demand; corruption and weak political leadership; and poor tax administration in the country -- one will ask, are we ready for these consequences? Can the earned revenue be enough and used judiciously to generate benefits that will outweigh these costs?

The answers to these questions are dependent on how the revenue from the tax will be generated and used. In the VAT sharing formula, 4% of the total revenue goes to the Federal Inland Revenue Service as the cost of collection. However, due to poor political leadership, high rate of corruption among the leaders and misuse of the public funds in the country, citizens do not have much confidence in the leaders, which increases the rate of tax aversion and avoidance. Coupled with poor tax administration, the above makes tax collection in the country so difficult that the cost of collecting tax may outweigh the revenue generated. Tax aversion and avoidance are commonplace due to endemic corruption and misuse -- a point underscored by Bill Gates: "the government needs to do more to gain the confidence of the people because the citizens could be discouraged from paying taxes if they see that taxes are not being properly utilised" (Punch of 17th Sept. 2019).

Furthermore, the deadweight loss and other negative impacts of a VAT rate increase can be reduced, eliminated or worsened depending on how the revenues generated from the tax is utilised. If the tax revenues are used to finance productive activities, they may go a long way in reducing or completely eliminating the deadweight loss, improving productivity, and generating employment. However, if the tax revenues are used to finance unproductive activities like debt financing, government consumption expenditure and importation of consumer goods, buying assets/investing in other countries, the deadweight loss of the tax and other negative impacts of the VAT increase may be made worse.

Recommendations

To ameliorate the expected negative impact of VAT rate increase, we recommend the following: First, government should convince citizens (by their actions) that revenue generated from tax will not be used for wasteful government consumption expenditures but rather, for productive activities as must be demonstrated through effective mangement of the revenues currently available.

Second, government should reform or significantly improve its tax administration to ensure an effiecinet tax system. For instance, there is a need to tighten movements around Nigeria's highly porous borders through more effective policing with a view to enhance security and generate more VAT revenues than might be gained from the proposed rate increase.

Third, there must be a drastic reduction in the administrative costs of running the Nigerian government, including unjustified high salaries paid to political leaders who reputedly receive the highest incomes and allowances in the world, which is a huge burden for a country with the highest number of extremely poor people in the world. By correcting this irony, the masses may be assuaged to willingly pay taxes.

It is only after ensuring that there is effective and efficient tax system, transparency, and good and accountable governance which foregrounds tax net increases and citizen welfare, should subsequent VAT rate increments be contemplated. Otherwise, it will be another version of paradox of thrift as more people will enter poverty, leading to a decrease in consumption and VAT revenue -- and social unrest and increased insecurity. Essentially, a VAT rate increase must be seen as a last resort!

References

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