OPTIMISING INTERNALLY GENERATED REVENUE IN NIGERIA

LEAP: High-Level Policy Dialogue

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Contents

'Where large gaps between theory and policy remain, the difficult question is whether policymakers need to learn more from theorists, or the other way around.'[1]

EXECUTIVE SUMMARY

This paper has been commissioned by LEAP to *'provide a contextual study of factors linked to effective internally generated tax development'* in line with LEAP's objective to promote the generation and use of evidence on key public sector reform policy questions. It was prepared by Professor Nic Cheeseman, Birmingham University & Dr Olly Owen, Oxford University, with support from the LEAP team. It extends earlier analysis by DFID on non-oil taxation in Nigeria. This paper underpins deliberation within PERL about how to work with Nigerian partners to push forward the internally generated revenue (IGR) agenda rapidly and effectively, and it contributes to the development and delivery of action plans to tackle blockages in IGR generation (see PERL Year 1 Implementation Plan). It complements ARC's Scoping Notes submitted to DFID earlier in June.

The paper starts from the premise that there are indeed many practical and rapid options for moving forward and that by understanding the broader context better it will be possible to address the blockages to change as well as design and implement policies that contribute positively to key social and business objectives (and do not increase poverty or act as a brake on growth). It draws attention to potential measures to motivate reform, to create win-win outcomes, to factor-in administrative considerations, to build public support, to build social contracts and a sense of citizenship, and ways to tackle poverty. It provides some initial practical pointers on the means of building legitimacy. It offers guidance on how to take into state economic specificities.

Low oil prices and difficult economic conditions have turned the spotlight on Nigeria's relatively low level of IGR at both federal and state levels. Previous research and analysis has outlined the scale and importance of the economic and fiscal challenge. It is universally accepted that there is a fiscal imperative in Nigeria to increase levels of internally generated revenue (IGR) at least administrative cost. What is not articulated so clearly is that there is a governance imperative to increase the type and levels of IGR to start to build a social contract between the state and the citizen. There is a social welfare imperative to avoid implementing a regressive tax system that would harm the poorest and the most vulnerable in society. There is a service delivery imperative to implement a tax system that supports improved service delivery and encourages accountability. And there is an economic growth imperative to improve the business environment, or at least not to damage it further.

At the present time, the main focus of Nigeria's development partners has been on encouraging and supporting governments to respond to the fiscal imperative. This paper aims to set out the case for broadening the focus, responding directly to concerns set out in DFID's earlier discussion paper. The need to broaden the focus is not only based on governance, social welfare and business militates but also on the practical need to address the barriers to reform that are preventing progress, and will continue to do so unless they are explicitly factored into dialogue and policy, and into programme design.

This position paper draws on examples from across the continent and more broadly to outline the specific challenges that Nigeria faces when seeking to raise revenue, and explain how they can be overcome. It is a starting point not an end point, and provides guidance on the next steps which stakeholders could take to develop this policy area effectively in line with PERL's strategic ambition.[2]

Centrally, the paper begins by emphasising that revenue should not be seen as a goal for its own sake, but because government wishes to demonstrate the role it can perform in improving the lives of citizens in the long

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[1] *N. Gregory Mankiw, Matthew Weinzierl, and Danny Yagan, 'Optimal Taxation in Theory and Practice', Journal of Economic Perspectives, 2009. (The authors note that both possibilities have historical precedents.)*
[2] *As laid out in the position statement on* PERL's Approach To Internal Revenue*, 2016 which emphasises 'mutually reinforcing relationships between internal revenue generation and service delivery, the business climate, accountability and poverty reduction'.*

run.[3] Taxation only works if it is implemented in step with visible service delivery and development. Further, increasing IGR in a way that does not increase poverty depends on the instruments used and the specific economic conditions in a given state. Because Nigerian states vary greatly in terms of economic base, level of urbanization, size of the private sector, level of formal employment, the extent and causes of poverty, and so on, the ability of a state to raise IGR in a productive way must be assessed on a case-by-case basis. To do this successfully it is essential to understand that revenue policy is not just a matter of increasing collection levels, but also involves economic analysis, political judgement, governmental capacity and targeted communications. Bringing in new taxes can prompt the creation of new social contracts around accountability, responsiveness, tax burden and performance. However, this is not done automatically, or on a blank slate, so successful tax policy needs to engage with the interest groups and public understandings underpinning the status quo. Political will and legitimacy in the eyes of the public are key factors.

Key points

- Raising revenue is not always a simple win for the political system or the economy. The debate therefore needs to shift from a focus on revenue maximization to revenue optimization.
- Raising IGR is more feasible where the formal sector is strong and revenue can be generated through PAYE, but this is not the case for the majority of states.
- Efforts to raise IGR must be preceded by a broader review of the economic and social situation to ensure that raising taxes will not harm economic activity and push people into poverty.
- Opponents of reform can be brought on board by allowing them to share the benefits of additional revenue, & using public expenditure to meet their needs.
- Legitimising taxation requires a combination of public relations work which engages with public attitudes, and leading by example – tax increases are most effective when they come after improvements in governance, not before.
- Under certain conditions growing IGR can help to increase demands for accountability as citizens realise that it is their money that is being well/poorly used by their leaders, but governments must keep their end of the bargain by providing services.
- In Nigeria, revenue policy involves a number of overlapping actors which may vary according to local context (as identified by PERL, 2017)[4] so successful policy work needs to engaged with them in a networked manner.

Next steps are set out at the end of the paper.

[3] *The standard economic theory of optimal taxation posits that a tax system should be chosen to maximize a social welfare function subject to a set of constraints (Mankiw, 2009)*

[4] PERL/ARC draft report: Executive Summary: Scoping and Gap Analysis of Tax/Internally Generated Revenue Administration Reforms, February 2017.

Introduction

This paper - a LEAP 'deliverable' - has been commissioned to '*provide a contextual study of factors linked to effective internally generated tax development*'[5] , in line with LEAP's objective to promote the generation and use of evidence on key public sector reform policy questions. It extends the discussion started in DFID's discussion paper 'Non-Oil Taxation in Nigeria'[6]. This paper provides analysis to underpin deliberation within PERL about how to work with Nigerian partners to push forward the IGR agenda rapidly and effectively and contributes to the development and delivery of action plans to tackle blockages in IGR generation (see PERL Year 1 Implementation Plan). It complements ARC's Scoping Notes submitted to DFID earlier in June.

A version of this paper will be circulated to active development partners including the Bill and Melinda Gates Foundation, the World Bank and the IMF, and a version will also be prepared to contribute to the Nigerian discourse on the Fiscal Sustainability Plan and to promote policy debate on the Plan. Key stakeholders in the debate include the Federal Ministry of Finance, the NGF, the NEC and the Community of Practice of Budget and Planning Commissioners.

The paper highlights some key concepts to guide the discussion on what is required for effective IGR development taking into account specific features of the Nigerian political economy context. It provides evidence from Nigeria and comparator countries on which types of IGR policies have proven effectives and where risks arise.

The paper proposes next steps to drive the agenda forward.

Optimising revenue, not maximizing revenue

Tax optimisation involves considerations not only of maximising revenue, but also of its sustainability, political feasibility and wider impact. While it is tempting to recommend that all sub-national governments should seek to maximize internally generated revenue (IGR), doing so without first conducting a broader analysis could lead to a number of negative externalities.7 And while the fiscal imperative in Nigeria to increase levels of internally generated revenue (IGR) is well understood, the barriers to doing this have not been explored.

The need to understand the potential for generating negative externalities and the need to understand the blockages to reform both point to the need to extend the traditional analysis of technical, theoretical feasibility. The starting point must be a recognition that tax policy impinges on a whole range of political issues and policy domains. There is a governance imperative to increase the type and levels of IGR to start to build a social contract between the state and the citizen. There is a social welfare imperative to avoid implementing a regressive tax system that would harm the poorest and the most vulnerable in society. There is a service delivery imperative to implement a tax system that supports improved service delivery and encourages accountability. And there is an economic growth imperative to improve the business environment, or at least not to damage it further.

At the present time, the main focus of Nigeria's development partners has been on responding to the fiscal imperative. This paper aims to set out the case for broadening the focus, responding directly to concerns set out in DFID's earlier discussion paper, to achieve a faster and deeper response.

Issues of wider political economy shape what IGR policies are feasible or desirable. According to Di John, 'The process of tax collection is one of the most powerful lenses in political economy to assess the distribution of power and the legitimacy of the state and powerful interest groups in civil society. The collection of tax not only requires substantial coercive power, but more importantly requires a state to be legitimate since the vast majority of tax is collected when there is high level of voluntary compliance.' 8 This paper is not first and foremost about the political economy of taxation, which will be the subject of the next LEAP paper, but is more directly concerned with economic and social policy militates, including service delivery, and it does consider the politics of taxation.

[5] LEAP Approved Work Plan
[6] 'Non-Oil Taxation in Nigeria – Discussion Paper' DFID Nigeria with GEMS3, SPARC and FEPAR, August 2015 (Not for Public Dissemination)
[7] Wane, Waly, 'The optimal income tax when poverty is a public 'bad'. 'Journal of Public Economics, 2001
[8] Di John, Jonathan 'The Political Economy of Taxation and Resource Mobilisation in Sub-Saharan Africa' in 'The Political Economy of Africa', Ed Vishnu Padayachee, Routledge, 2010

However, it is important to note here that there has been no recent analysis in Nigeria of 'willingness to pay' or the effectiveness of coercive tax power (although there is good analysis of the strategies adopted by Lagos State to improve legitimacy, address the requirements of specific interest groups, and to secure compliance). In the absence of such analysis it is possible to hypothesise - based on a significant degree of casual empiricism - that willingness to pay is extremely low and that coercive power is weak and as such any attempt to increase the level or reach of existing instruments, or to extend the array of instruments, would be met with low levels of compliance indeed.

Viewed from the vantage point of 'willingness to tax', it is generally accepted that, 'taxation is the main nexus that binds state officials with interest groups and citizens. Not only can taxation enhance government accountability, it also provides a focal point around which interest groups can mobilise to support, resist, and even propose tax policies.'9 Taxation is as constitutive of interest group formation as it is of state formation. For this reason, political elites used to distributing oil-rents with extremely limited accountability may be expected to resist strenuously measures to increase taxation that would both build interest groups and build state capacity that could threaten their degrees of freedom. Thus, charting a course through this difficult terrain will be no easy matter, which is why the next paper will address these political economy challenges in more depth in order to determine how to construct pathways.

Tax policy is also economic policy; it incentivises certain activities and discourages others. Most notably, failing to ascertain the broader economic social and economic impact of tax increases may lead to the following outcomes:

- **Poverty**. Increasing or enforcing PAYE tax on those in the formal sector with very low incomes may push individuals and families below the poverty line.[10] Similarly, if the taxation of the informal sector results in falling economic activity and higher unemployment, it is likely to increase the poverty rate over time.
- **Sustainability**: Aggressive efforts to maximise revenue may (or may not) bring in larger amounts in the short-term but to be sustainable they need to also be seen as fair, legitimate and payable and not undermine other governance relationships.[11]
- **Economic development:** Tax policy is also a tool which encourages or discourages certain types of behaviour, and it does so whether intentionally or not, so that tax planners need to consider wider socio-economic effects.
- **Enabling environment for business:** The wider business environment is affected not just by the level of taxes but by their relative administrative burden.
- **Informal entrepreneurship**. Formalizing and taxing the informal sector – for example around markets – is one way to increase revenue streams. However, given the tight margins within which many informal entrepreneurs operate, there is a significant risk that substantial tax increases will put some traders out of business, increasing unemployment.[12]
- **Competitiveness**. Tourism and consumption taxes are often one of the main sources of revenue available to sub-national governments, but raising levies in this area may render a particular town or city uncompetitive,[13] and so harm the tourist industry in the long-run.

It is therefore better to think of optimizing IGR, rather than maximising it. Plans to increase sub-national revenue generation must take into account the capacity of different constituencies to pay more tax, as well as the spending needs of the state and the political settlement on which effective administration rests.

Examples: Recent research in Punjab, Pakistan[14] illustrated that property tax collection policy could have been developed to collect greater amounts, but that a systematic convention had emerged which centred instead on the sustainability of collection and maintaining an established stable power relationship between different levels of government.

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[9] Ibid
[10] Lustig, Nora, Carola, Pessino, and John, Scott. 'The impact of taxes and social spending on inequality and poverty in Argentina, Bolivia, Brazil, Mexico, Peru, and Uruguay: Introduction to the special issue', Public Finance Review, 2014.
[11] Prichard, Wilson 'Taxation, Responsiveness and Accountability in Sub-Saharan Africa: The Dynamics of Tax Bargaining', Cambridge University Press, 2015.
[12] Guha-Khasnobis, Basudeb, and Elinor Ostrom 'Linking the formal and informal economy: concepts and policies', Oxford University Press, 2006.
[13] Begg, Iain 'Cities and competitiveness', Urban studies, 1999.
[14] Piracha, Mujtaba, and Mick Moore, 'Revenue-Maximising or Revenue-Sacrificing Government? Property Tax in Pakistan', The Journal of Development Studies, 2016.

Motivating reform

Raising internally generated revenue is often unpopular with both the public and business elites. As a result, plans to increase the collection of local taxes are often abandoned before they are effectively implemented. Academic and policy research has identified four main drivers that encourage sub-national leaders to pursue reform. The more drivers are present, the more likely transformative change becomes:

- **Budget constraints**. As in Nigeria, a sudden loss of resources can encourage sub-national political leaders to look for alternative sources of income, such as IGR.[15] This may take the form of the withdrawal of central government transfers, falling oil prices, or general economic decline.
- **Political competition**. When an opposition party at the national level wins elections at the sub-national level, political competition can lead state/local governments to try to become more financially self-sufficient in order to assert their political and economic independence.[16] It may also encourage sub-national elites to perform particularly well in this area so that they are better placed to mount a challenge for national power. This is the recent story in Lagos.
- **Ideological commitments**. Many of the most successful examples of IGR reform have come when local political elites were committed to ideological goals that entailed state building.[17] These projects are not 'ideological' in the sense of a left-right spectrum, but rather in terms of the deeper commitment of leaders to an overriding goal such as coping with rising urbanization or building a city or state that they can be proud of.
- **Incentive alignment**. Governments are unlikely to pursue IGR if doing so disproportionately disadvantages their core supporters, and their ability to retain their political networks and their grip on power.[18] Persuading sub-national leaders to enact potentially unpopular policies therefore depends on whether it is possible to find win-win scenarios that offer political as well as policy benefits.

Examples: In both the Western Cape in South Africa[19] and Lagos in Nigeria opposition parties have used their control of regional governments as an opportunity to demonstrate their capacity to manage the economy and public services effectively. As part of this process they have been motivated to collect and to increase IGR to build infrastructure and fund new projects, which in turn enabled them to expand their political support base.

Creating win-win outcomes

A number of barriers to raising IGR exist in most towns, cities or states. These typically include reluctant business elites, influential members of the middle class, and in some cases the wider public themselves. The strength of these barriers, and the limited capacity of many states to enforce taxation, means that the successful implementation of IGR reform requires finding creative ways to bring these groups on board by generating win-win outcomes.

- **Revenue streams**. Raising tax revenues can enable governments to meet their policy goals, but can also create funds that can be diverted for activities that can seem to be political patronage.[20] This can be unpalatable for donors and many civil society organizations because it may involve clientelism and corruption, but it is clear that sub-national elites have a stronger motivation to invest in controversial reforms when they stand to gain politically and personally. All governments use tax policy to maintain political support to some extent;[21] how far this is legitimate varies a lot between countries.[22] For example in many countries side-payments (such as tax credits) compensate tax-paying allies enabling reformist governments to stay in power.
- **Business elites**. Businesses are often reluctant to pay higher taxes – for example property taxes – because they already pay for services they believe the government should provide, such as electricity, security, and road maintenance. As a result, they often seek to undermine the effective collection of property taxes, which is

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[15] *Drazen, Allan, and Vittorio Grilli, 'The benefits of crises for economic reforms', National Bureau of Economic Research, 1990.*
[16] Cheeseman, Nic and Dianne de Gramont, 'Managing a mega-city: learning the lessons from Lagos', Oxford Review of Economic Policy, (forthcoming)
[17] de Gramont, Diane, 'Beyond Magic Bullets in Governance Reform', Carnegie Endowment for Peace, 2014
[18] de Gramont, Diane, 'Governing Lagos: Unlocking the politics of reform', Carnegie Endowment for Peace, 2015
[19] Schrire, Robert, 'The realities of opposition in South Africa: Legitimacy, strategies and consequences', Democratization, 2001
[20] *Cheeseman, Nic and Dianne de Grammont, 'Managing a mega-city'.*
[21] Khemani, Stuti, 'Political cycles in a developing economy: effect of elections in the Indian states', Journal of development Economics, 2004
[22] Bates, Robert H.' Markets and States in Tropical Africa: The Political Basis of Agricultural Policies: With a New Preface'. University of California Press, 2005.

problematic as this is one of the few revenue raising opportunities open to sub-national governments that do not enjoy a large formal sector. One effective strategy to secure the support of business elites for tax collection/increases has been to ring-fence any additional revenue raised in a special fund that can then be used to improve business conditions in the area, enabling them to make more money and hence pay their taxes.[23]

- **Crime**. Many wealthier citizens complain that they should not be required to pay tax because they send their children to private schools and use private health services, and so do not benefit from government expenditure.[24] Thus, some sub-national political leaders have sought to use some of the revenues available to them to increase security – even though this may not be a constitutional responsibility – in order to demonstrate to members of the middle class that paying taxes can help the government to respond better to some of the most pressing challenges that they face.[25]

Examples: The Central Business District of Cape Town, which includes the well-known waterfront restaurants and businesses, is now a thriving success. However, this was not always true – in the past, business interests were undermined by poor infrastructure and high crime. One of the main barriers to changing this situation was that businesses were reluctant to pay more tax, having been dissatisfied with previous government performance. They were persuaded to change their minds by the promise that if they paid higher than normal rates as part of a newly created Central City Improvement District, the funds would be ring-fenced to provide extra cleaning, security, and social programmes to make the CBD more "business friendly".[26]

Administration and regulation

Tax options depend on collection and enforcement capacity. Bringing in revenue from new areas of economic life also involves regulating them, creating new systems and practices but also new information, new norms and new relationships with publics.

- **Accountability:** Accountability links and social contracts are not always linear and do not always take the form envisaged by policymakers.
- **Side-effects:** Tax reforms may produce other socio-economic goods as by-products, such as better-defined rights.
- **Regulating competing demands:** Taxing an area of socio-economic life effectively also entails protecting taxpayers from competing and informal demands. For the same reason, state and federal taxes should be compatible, rather than overlapping.
- **Simplification:** Many states lack capacity to administer tax in complex ways, and so opt for blanket charges in the form of licences or presumptive taxes.
- **Overlap:** Nearly all local governments rely on revenue from petty fees and licences, but this can lead to proliferation and to multiple taxation.
- **Linkages with organised groups:** Some states have created tax administration capacity indirectly, by partnering with associations representing economic sectors – however this creates particular governmental alliances.

Examples: Recent research on property tax in Lagos shows that reform of the Land Use Charge has been used by publics to strengthen the security of property rights, as some taxpayers value tax receipt documentation in enabling them to build up a record of continuous presence in a context of insecure property rights. Lagos State has also had to justify its tax collection by dealing with the competing issue of informal property taxes, enacting a 'Land-Grabbers Law' to regulate demands for informal payments.[27] Linkages with organised groups bring capacity benefits but also risks: One forestry-rich state in Nigeria allied with chainsaw operators to collect association membership fees and taxes due at the same time. This maximised reach and enforcement for both, but created a close relationship which may have implications for government's freedom of action and independence in other areas of policy-making.

[23] *Attwell, William, 'Cape Town Lessons and Property Tax', Seminar Paper, Nairobi, 2015.*
[24] *This was a common complaint raised by members of the Lagosian middle class with Cheeseman in discussions during four years of research. A similar point was often raised as a source of concern by representatives of the Lagos State Government.*
[25] *Burbidge, Dominic,'Emerging Diversity in Security Practices in Kenya's Devolved Constitution', African Centre for the Constructive Resolution of Disputes, 2017*
[26] *Attwell, William, 2015*
[27] *Goodfellow, T. & Owen, O. ICTD working paper, forthcoming.*

Building public support for taxation

Given public scepticism towards taxation, both as a result of its colonial roots and high levels of post-colonial corruption, it is essential that efforts to collect greater IGR be preceded by awareness campaigns to demonstrate the value of tax payment. In many countries, citizens systematically underestimate the proportion of tax revenues that are spent on providing services, and it is essential to correct this misperception. Current best practice suggests that this should include at least four components:

- **Messaging**. The limited provision of public services and poor quality of public relations in many developing countries means that citizens are not explicitly aware of the connection between tax payment and the funding of services that they rely on. Clever advertising – through newspapers, radio jingles, and social media – can demonstrate this connection, laying the foundation for a social contract (figure 1).[28]
- **Branding**. One reason that citizens underestimate government spending is that they are not sufficiently aware of government programs and their funding streams.[29] This problem can be overcome through the effective branding of new infrastructure to reinforce the point that it was only possible as a result of tax revenues.[30]
- **Participation**. Public participation in the budget process (as supported by ECP) should be enabled through consultative "town hall" meetings throughout the process, in addition to stakeholder meetings with key interest groups and civil society.[31] This can build a sense of public ownership of the budget, and hence legitimate tax collection.
- **Transparency**. In order for the other three strategies to be credible, the collection of taxes must be seen to be transparent. This means two things. First, taxes should be professionally collected without recourse to extortion. Second, the accounting of tax revenue should be open and made accessible to the public, for example via the Internet and the publication of "people's budgets".[32] Such strategies may encompass related concerns such as the cost of governance and wasteful or unaccountable spending.

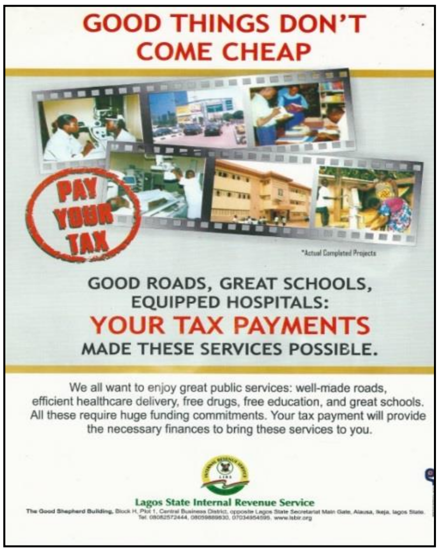


Figure 1: Lagos State Government tax advert

Examples: A panel survey conducted over three years in Lagos has demonstrated that the combination of effective public relations work including "tax roadshows" and the provision of public services by the State government increased public support for tax payment.[33] Partly as a result, Lagos has proved to be one of the most successful sub-national governments in the world at raising IGR over the past decade.

[28] Bodea, Cristina, and Adrienne LeBas, 'The origins of voluntary compliance: attitudes toward taxation in urban Nigeria', British Journal of Political Science, 2016

[29] *A panel survey conducted in Lagos by Cheeseman found that it was common for less well informed citizens to believe that the government spends less than 10% of the budget on public services.*

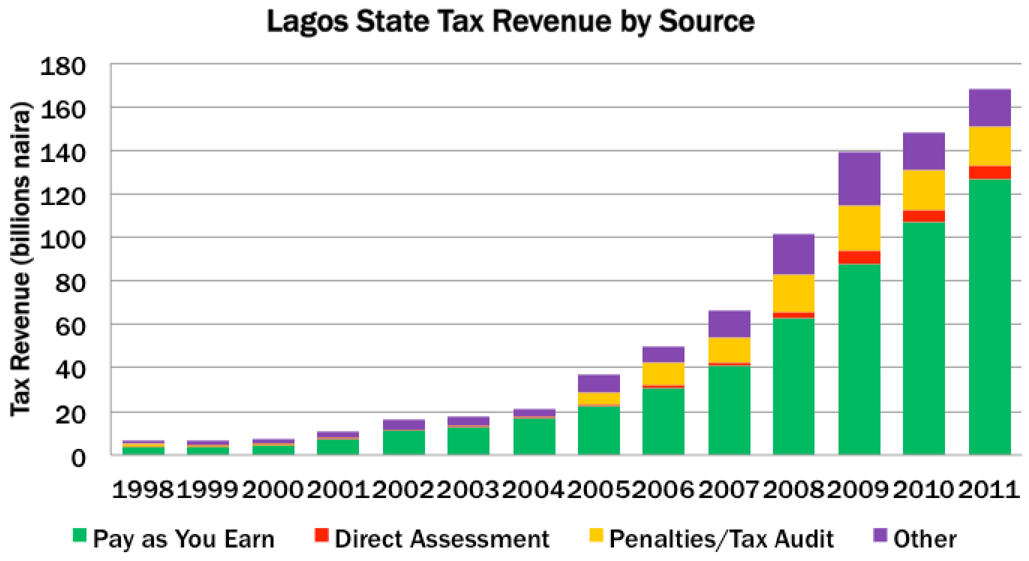
[30] *Gatt, Leah, 'The Impact of Direct Taxation on State Society Relations in Nigeria', African Studies Masters dissertation, University of Oxford, 2012*

[31] Burbidge, Dominic and Nic Cheeseman, 'Public Participation, Legitimacy, and Revenue Generation in Kenya', Conference paper commissioned by the National Treasury of the Republic of Kenya for an internal report on county governments and revenue generation, Naivasha, Kenya, 2015. Public participation is a legal requirement of the budget process in Kenya under the 2010 constitution. Papa, Robert O. 'Factors influencing public participation in project development in Busia county Kenya', Dissertation, University of Nairobi, 2016

[32] *In Lagos, simplified budgets were released in a bid to more effectively communicate how tax revenue is used by the state. Ajanaku, Idowu, 'Lagos and the 2016 people's budget', The Guardian (Nigeria), 3 January 2016*

[33] *Cheeseman, Nic and Dianne de Grammont, 'Managing a mega-city'.*

Figure 2: Increase in Lagos State Revenue 1998-2011



Social contracts and citizenship

Establishing a social contract through taxation can help to create a virtuous cycle, in which taxation leads to greater demand for accountability and higher spending on public services, which in turn generates public support for higher rates of taxation, which can lead to stronger demands for accountability and better quality public services, and so on.[34] There is a strong relationship between tax and citizenship which needs to be considered in policy formulation – tax policy is not implemented in a vacuum – publics have pre-existing ideas of their obligations and rights through which they filter their understandings of tax policy. Survey evidence has demonstrated that citizens – including the very poor – are often willing to pay more taxes in return for better services. However, constructing an effective social contract requires governments to fulfil their side of the bargain.[35] This includes:

- **Inclusive taxation**. 'Tax morale' – public support for the broader tax system – can be undermined if it is widely known that certain individuals or groups do not have to pay tax as a result of their political connections. It is therefore important that senior political figures and their associates lead the way by paying tax and publicly demonstrating that they have done so.[36]
- **Sustaining services**. Academic research has found that one of the most effective factors in building public support for tax payment is the provision of public services, knowledge of government reforms, and evidence of action against corruption.[37] But it is not enough to provide short-term services, or poor quality ones: generating a sustainable social contract requires the consistent provision of quality services.

Examples: A number of studies have found that people who pay higher levels of taxation are more likely to demand accountable government,[38] and to be critical of corruption. At the same time, Prichard's work in Ghana[39] finds that the type of accountability demands that evolve vary across time and context, and are shaped by the type of tax that is levied. In general, sales taxes, which are often hidden, are expected to have less impact on citizens than income tax, which is more visible.

However, social contracts are not written on a blank slate, as there are pre-existing forms of social contract underpinning the status quo. In some cases, citizens are used to a system of "taxation without representation"

[34] Tilly, Charles. 'Democracy, Social Change and Economies in Transition', National Academy Press, Washington DC, 1998; Tilly, Charles, and Willem Pieter Blockmans. 'Cities and the Rise of States in Europe, AD 1000 to 1800', Westview Press, 1994.
[35] *Cheeseman, Nic and Dianne de Grammont, 'Managing a mega-city'.*
[36] Bird, Richard M., Jorge Martinez-Vazquez, and Benno Torgler. 'Tax effort in developing countries and high income countries: The impact of corruption, voice and accountability', Economic Analysis and Policy, 2008.
[37] *Cheeseman, Nic and Dianne de Grammont, 'Managing a mega-city'.*
[38] *Bodea, Cristina, and Adrienne LeBas. 'The origins of voluntary compliance: attitudes toward taxation in urban Nigeria', British Journal of Political Science, 2016*
[39] Prichard, Wilson, 'The politics of taxation and implications for accountability in Ghana 1981–2008', IDS Working Papers, 2009

and see tax as an extractive and illegitimate burden.[40] In others, public understandings around tax can include pre-existing notions of rights or political relationships[41] and policymakers need to understand these and engage with them in order to avoid politically costly mistakes and unworkable policy. In particular these include:

- **Partisan taxation**. Tax burdens and social contracts may be conditioned by non-programmatic factors such as partisan alliances with sections of the voting public. Social contracts around tax can be patterned on pre-existing notions of political allegiance between particular socioeconomic groups, parties and personalities.[42]
- **Entitlement and exemption**. Some groups associated with government have developed a tacit idea of social contract based on their exception from the rules which govern revenue collection from other non-state sectors. This needs to be renegotiated through careful collective bargaining and targeted communications.

Examples: Research from Meagher[43] suggests that tax collection policies relating to the informal sector in several northern Nigerian cities may have had an effect of transferring value and government spending between areas dominated by migrant citizens on one hand to longer-established communities on the other. Research by Gatt and Owen (forthcoming) in Lagos indicates that informal-sector taxpayers modelled their understandings of tax payment participation and accountability on their accustomed roles in electoral and political mobilisation.

Reducing poverty

There is nothing inherently poverty-reducing about internally generated revenue. Indeed, by increasing the tax burden, IGR can reduce the money that citizens have to live on or invest in their businesses, pushing them into poverty. There are a number of factors that shape the poverty reducing potential of IGR.

- **Progressive tax collection**. IGR can be increased in many ways. One of the easiest is by increasing sales taxes, which tends to have a regressive effect and can hurt the poor.[44] Similar, raising taxes on the informal sector is likely – on its own at least – to hurt the economic position of women and marginalized communities. By contrast, PAYE taxes, if higher earners pay more people under a certain cut off point pay nothing, tend to have a progressive effect,[45] which makes it easier to combine IGR with poverty reduction. It is important to note that the capacity to raise IGR in a way that is poverty neutral will vary on a case-by-case basis.
- **Property tax and wealth:** To avoid undue burdens on wage-earners, forms of progressive tax which capture value created outside that system need to be developed. Property taxes can tax wealth at points where it is spent and stored as well as earned.[46]
- **Informal sectors:** There is a balance to be struck between getting informal-sector operators into a tax net on one hand, and administering punitive or retrogressive tax burdens on the other; informal-sector business associations can often provide a valuable link in evolving good policy and administering it.[47]
- **Redistributive expenditure**. Like anything that increases government revenue – aid, an oil windfall, GDP growth – higher IGR will do little to reduce poverty unless it is spent in a way that redistributes wealth throughout society. This will be the case if the government uses additional IGR to invest in education, health, and public transport or other strategies to reduce inequality.[48] It may not be the case if IGR is used to increase public sector pay or undertake large infrastructure projects that do not increase GDP.
- **Reproducing existing problems:** Not all revenue reform is progressive;[49] and tax collection is potentially open to diversion in a similar manner to spending. The use of politically savvy solutions such as tax consultants can be a win-win but only if managed correctly.

Examples: Ongoing research in North-Central Nigeria[50] shows that presumptive taxation is being propounded as the solution to informal-sector taxation. However setting levels is done with recourse to very limited available

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[40] Bernstein, Thomas P., and Xiaobo Lü, 'Taxation without representation in contemporary rural China'. Vol. 37. Cambridge University Press, 2003.
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[48] Seekings, Jeremy, and Nicoli Nattrass, 'Class, distribution and redistribution in post-apartheid South Africa', Transformation: critical perspectives on Southern Africa, 2002
[49] Di John, Jonathan, 2010
[50] *Owen, O, ibid*

information, and there is little or no evidence to show the sustainability of the presumptive tax targets or their impacts on local economies. If wrongly targeted, this can lead to evasion and failure. One North-Central state under its previous administration hired tax consultants but set their targets at a lower rate than the public servants were already collecting. The sole effect was to privatise a public revenue stream and enable value-extraction for the politically connected. Property tax can capture wealth obtained in a variety of ways. However the ability to do this depends on political will and confidence as well as economic geography and social makeup, as a recent comparison of four cities in Sierra Leone suggests.[51]

Taxes and governmental legitimacy

The issue of taxation can define whether a public feels that government is acting in their interest or in an extractive, oppressive or unjust manner and this can have profound effects on the capacity and sustainability of an administration. Ultimately, the political will of a state to implement tax policies can depend on the legitimacy on which the government is perceived to have, and this may define the tax options available to a government. This is in contrast to conventional theories which suggest that legitimacy and democratic accountability emerge as a result of tax bargaining – instead research[52] suggests these factors may be a prerequisites for a successful process.

- **'Felt' tax burdens.** The issue of 'felt' or salient taxes is a different issue to the overall amount charged but is often even more politically significant.
- **Exploitation.** Taxes which are felt to punish publics for their own efforts to make life liveable are not popular and can lower tax morale and thus cause policy to fail.
- **Legitimacy.** Publics are more likely to accept new taxation propositions from governments they feel have legitimacy in the first place and who enjoy broad public consensus.
- **Perceived value.** The workings of government at a local level are often very visible to publics, so failures in service delivery, waste, late salaries and lack of capital development all impede tax morale and collection efforts.

Examples: As public sector efforts at service provision have not kept pace with population growth, many Nigerians self-provide essential services such as water and power. In many cases they do this at the same time as paying fees for government-provided services. Yet there is at least one state in Nigeria presently which charges a tax on boreholes, potentially generating feelings of unfairness as burdens are increased on citizens who are providing their own essential services. Elections also directly affect tax options – one state in North-West Nigeria under a previous administration rejected offers to develop IGR collection as political leaders felt elections had been so contested and rancorous that it would be better not to risk public criticism.

State context and its implications

The capacity of states to increase IGR will depend on the nature of their economies, the proportion of their economies that are formalised, the type of industry and agriculture that is practiced, the size and distribution of the population, the level of trade with other states and the outside world, and the amount of IGR already being collected. Indeed, it is hard to overstate the variation in state GDP and IGR (figure 3).[53]

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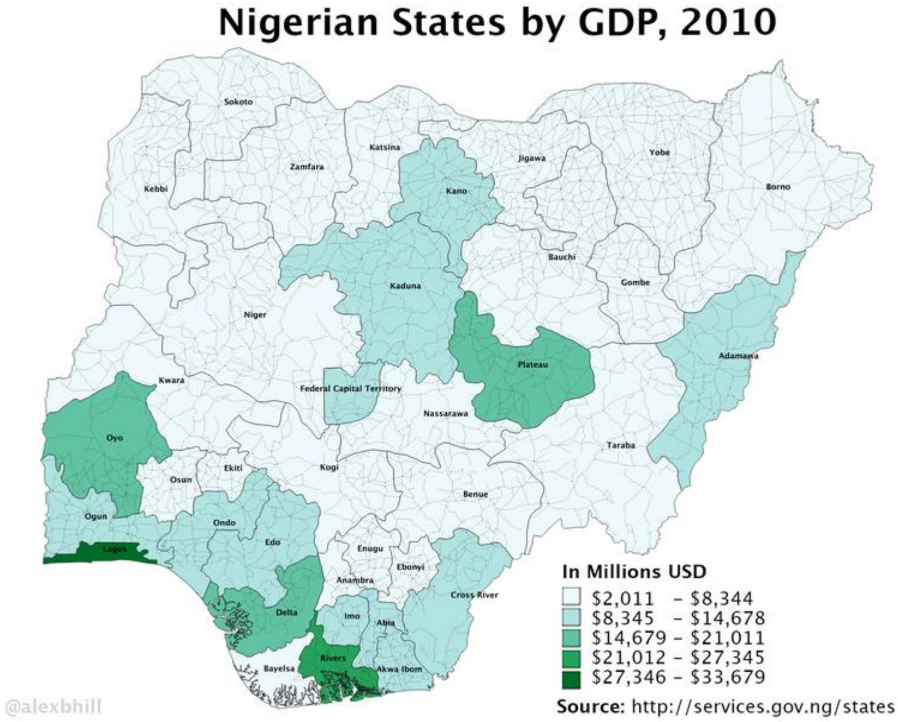
[51] Jibao, Samuel S., and Wilson Prichard, 'The political economy of property tax in Africa: Explaining reform outcomes in Sierra Leone', African Affairs, 2015

[52] Owen, O, ibid

[53] Nigerian Governors' Forum Secretariat, 'Fiscal sustainability of states', Discussion Paper prepared by the Nigeria Governors' Forum Secretariat in partnership with DFID's Learning Evidence and Advocacy Partnership, 2017

Figure 3: State level GDP, 2010



When designing an IGR policy for a given state, it is important to take into account the following factors:

- **GDP**. Though a very crude measure of economic activity, states with very low levels of GDP are unlikely to be able to significantly increase IGR unless there is a large informal sector that can profitably be formalised without aggravating poverty. At the other end of the spectrum, states that already do a good job of collecting IGR and have already increased their GDP considerably, such as Lagos, may also find that there is less scope to make further improvements. In the middle are states with a medium-sized but precarious formal private sector in which ability to realise taxation depends on the state of the local economy.
- **The formal economy**. Many of the IGR gains achieved in Lagos State have come about as a result of the effective collection of PAYE (figure 2). In turn, this was made possible by the existence of a sizeable formal sector. Other states with a much smaller formal sector are likely to struggle to achieve the same gains and will be more reliant on other forms of taxation such as VAT. However, the larger the size of the informal sector, the harder it is likely to be to tax sales, and even when this is possible the effects may be regressive.
- **VAT baseline**. Levels of VAT collection vary considerably across Nigeria ~~as a result of~~because of historical patterns and the decision of individual state governments.[54] Those states that do not currently invest in VAT collection could potentially secure easy gains through this route, but only if the financial and political costs of collecting VAT would outweigh the 85% of VAT revenue that would return to the state. Collecting VAT for the first time has a similar effect to the introduction of a new tax, and may be deemed politically unfeasible by some state governments as they move towards the next election campaign.
- **Trade.** States with a small formal sector and little scope to collect VAT may be tempted to boost government coffers by levying forms of ‘trade tax’ on the movement of goods, using their control of business permits, and inspection levies. This is potentially an attractive option to local political elites, as it offers a point at which to capture value derived from sectors such as agricultural produce and livestock when transported, and as some of those paying the levies may be based outside of the state. However, the cumulative effect of such taxes – if raised across the country – would be to significantly increase the cost of doing business, which would likely increase the cost of goods to Nigerian buyers and undermine the competitiveness of Nigerian traders.
- **Multiple taxation.** The issue of multiple taxation at the state level has been a significant barrier to trade and business. A 2011 World Bank study on the impact of state level taxes on business showed wide differences between states:

[54] *Nigerian Governors’ Forum Secretariat, 2017*

Figure 4: Impact of state level taxes on business

	Average	Lagos	Anambra	Enugu	Ogun
Direct tax burden	31%	24%	34%	52%	17%
Double Taxation	8%	6%	9%	12%	4%
Mobile fees and levies	10%	12%	11%	12%	6%
Compliance Costs	11%	10%	13%	12%	7%
Total tax burden	**42%**	**34%**	**47%**	**64%**	**24%**

[55]

These various taxes and levies were estimated to total around 42% of pre-tax profits. Both the taxes themselves and the administrative cost of compliance have had a negative impact on businesses. Moreover, traders looking to work across state boundaries faced high costs which resulted in lower inter-state trade and isolation of productivity. The result of this has been vertical trade creation - items have typically been produced in one location instead of different elements produced in areas where they have a competitive advantage then joined together. The impact on small traders has typically been higher than for larger businesses which could absorb some of the additional costs. It has also resulted in a decrease in the international competitiveness of Nigerian businesses and limited their ability to get into the supply chain, especially for lower-value goods which developing economies often export.

- **Coordination.** The government has moved to address the issue of double taxation, for example the debate and court cases over Federal VAT and state-level Sales Tax; while the Joint Tax Board exists as an ongoing forum for coordinating discussions. The National Economic Council created a committee to review the issue of multiple taxation on manufacturers. As a result of the committee recommendations, tax responsibility was clarified. The 2015 Schedule increased the number of official taxes and levies from 39 to 61, recognising some state level taxes and levies as legitimate[56]. There may be further changes as the 2017 Nigerian Tax Policy specifically identifies the need to use taxes to create a 'competitive edge'[57].

Conclusions

The conclusion of this paper is that policymakers should be promoting a strategy of IGR optimisation rather than maximisation. This depends on numerous factors including the impact of IGR on poverty, economic incentives, the investment climate and competitiveness, as well as the level of administrative capacity in government. IGR policy must also be guided by considerations about the political context, and the extent to which changes in IGR policy will strengthen or undermine government legitimacy and the social contract between government and citizens. All of these factors vary enormously between Nigerian states and between levels of government, indicating that IGR policy must be carefully adapted according to the local context. This paper has explored how contextual factors affect IGR development in broad terms, but there is still much to learn about how these factors vary between states.

This paper has also emphasised the need to give careful attention to managing the process of delivering IGR reforms, including issues of sequencing, messaging to citizens and bringing political opponents on board. This demonstrates that effective IGR development is not only a technical challenge, but depends critically on being able to think and work in politically smart ways.

Next Steps

As noted earlier, this paper will be used within PERL to strengthen its approach to tackling blockages in IGR. It will be used to work with Nigerian partners to push forward the IGR agenda rapidly and in this respect it complements ARC's Scoping Notes submitted to DFID earlier in June.

It would be helpful to have a consensus among key development partners on the critical elements of the agenda, and in this context a version of this paper will be circulated to active development partners including the Bill and Melinda Gates Foundation (BMGF), the World Bank and the IMF, for discussion. We have already had initial discussion with the BMGF (who support a substantial part of the NGF's work programme in this area) and the World Bank, and the Bank has asked to us to prepare a paper on the political economy of taxation that will analyse the blockages to reform. This would complement the ARC and ECP agendas very effectively to build synergy within PERL. The paper will look at the political economy challenges set out in this paper in more depth

[55] *'The Impact of MultipleTaxation on Competitiveness in Nigeria', World Bank*
[56] *https://www.linkedin.com/pulse/ over-view taxes levies approved list collection, abdulrazaq*
[57] *http://pwcnigeria.typepad.com/files/fec-approved-ntp feb-1-2017*

in order to determine how to construct pathways for change. The paper will also look at the complementary policies and reforms that are required to build legitimacy including improving the efficiency - the productivity - of public expenditure, and reducing leakages, patronage and corruption that are frequently associated in the publics' mind with government expenditure programmes.

A version of the paper will also be prepared to contribute to the Nigerian discourse on the Fiscal Sustainability Plan and to promote policy debate on the Plan. Key stakeholders in the debate include the Federal Ministry of Finance, the NGF, the OVP and the NEC, the Special Adviser to the President on Economic Matters, and the Community of Practice of Budget and Planning Commissioners.

We intend to undertake two case studies at state level on how to put the agenda mapped out in this paper into practice and these will be done immediately after the political economy analysis.

We will undertake a review of how development agencies have been able to be effective in supporting effective IGR strategies in Nigeria and elsewhere.

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