The Nigerian Economic Society

N E S

FISCAL FEDERALISM AND NIGERIA'S ECONOMIC DEVELOPMENT

Selected Papers Presented at the 1999 Annual Conference

21

POTENTIALS OF VAT AND STATE FINANCES: A Case Study of Cross River State

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ABSTRACT

This paper discusses the potentials of value added tax (VAT) in strengthening the finances of Cross River State. The paper examines VAT and its relevance to total revenue and gross domestic product (GDP) of the nation. An analysis of Cross River State VAT Directorate shows that VAT has greatly helped the state's revenue generation profile. The paper then concludes by recognizing the need for the potentials of VAT to be exploited so that more revenue can be generated for the socio-economic growth and development of the state.

1. Introduction

ONE of the recurrent problems of the three-tier structure of government in Nigeria is dwindling revenue generation as characterized by yearly budget deficits and insufficient funds for economic growth and development. This economic reasoning emphasizes the revenue need of government and indicates that apart from strengthening the existing sources of revenue, it is also necessary for government to diversify its revenue base in order to meet its constitutional responsibilities.

The financial capacity of any government depends, among other things, on its revenue base, the fiscal resources available to it and the way these resources are generated and utilized. It is, therefore, the duty of government to adequately mobilize potential revenue across the country to prevent economic stagnation. This mobilization involves the adoption of economically and politically acceptable taxes that would ensure easy administration, accounting, verification, auditing and investigation, based on the equity, neutrality and other attributes of a good tax. In light of the prevailing economic situation, the adoption of any indirect tax should involve a critical assessment of the efficiency of such a tax. It would be quite unrealistic to adopt any indirect tax with an adverse variance in fiscal revenue (the excess of the optimum level of revenue over the actual revenue). The problem of adverse variance in fiscal revenue can be caused by factors like tax evasion, avoidance, concession and other tax deliquencies. Any indirect tax that would minimize the adverse variance with wider coverage is considered appropriate in the context of revenue generation.

Consumption taxes have a wider coverage since the causes of adverse variance can be adequately controlled under proper administration. The revenue generated from consumption taxes can help boost the financial base of any economy. This, however, involves exploiting the potentials and adopting the type of consumption tax that will recognize the taxpayers as utility-minimizing individuals and safeguarding their tax-evading behaviour. The best way of selecting the type of consumption tax to use is to conduct a feasibility study to determine the system that would be most efficient and sustainable. The selection of the consumption tax to be adopted involves a critical analysis of the incidence, base and distribution sequence of all the taxes with a view to identifying the best option. The essential considerations in choosing a consumption tax option from other tax options include assessing the adminis- trative feasibility of each tax, and determining its relative revenue potentials, its degree of voluntary compliance, its relative neutrality, its equity potential for regressivity, and the efficiency of data matching. Based on these criteria, one can easily see the underlying reasons why government replaced the retail sales tax (RST) with value added tax (VAT) as consumption tax. VAT is inherently more comprehensive and superior to RST and has a better self-evolving revenue generation capacity due to its multi-stage nature.

The full recognition of the potential value of VAT in revenue generation explains its adoption into the Nigerian tax system. The purpose of this paper, therefore, is to examine the potentials of VAT in revenue generation with reference to Cross River State.

It is hoped that the paper would give an adequate picture of VAT with regard to revenue generation and expansion. In pursuance of this, the paper is organized into six sections. Following this introduction, section 2 contains a theoretical background of VAT and its initiation in Nigeria. Section 3 deals with its performance in Nigeria while section 4 highlights its performance in

Cross River State. Section 5 offers some suggestions on how to improve the VAT collection machinery while the last section contains some concluding remarks.

2. Theoretical Background

2.1 The concept of VAT

VAT is a tax on the supply of goods and services which is borne by the final consumer but collected at each stage of the pro- duction and distribution chain. The above definition, as contained in the United Kingdom Statement of Standard Accounting Practice (SSAP) No. 5 (cited in Ogundele 1996) points out three major characteristics of VAT, namely, that it is a consumption tax; it is a multi-stage tax, and it is borne by the final consumer. Basically, therefore, the calculation of VAT centres on the *value added* which has been defined by Ogundele (1996) as the amount of value a firm contributes to a good or service by applying its own factors of production. It, therefore, means that value added is the summation of the returns to factors of production in a given period, that is, summation of rent, wages, interest and profit.

Historically, the adoption of VAT as a dependable tax is traceable to the success it acheived in France. With a favourable experience in the adminis-tration of VAT in France, five other original member states of the European Commmunity (EC) endorsed it under the treaty of Rome signed in January, 1957. Since then, many countries have adopted it either due to necessity or as a means of improving their lean financial capacity. Again, since it is a consumption tax, it is relatively easy to administer and difficult to evade. The VAT yield is a fairly accurate measurement of the growth of an economy since purchasing power (which determines yield) increases with economic growth and development. Based on the principles of neutrality, regressivity, equity and ease of administration, VAT has performed quite commendably.

VAT eliminates the cascading effects (the heterogenous turnover) of retail sales tax through its refund or credit mechanism. Furthermore, Tait (1991) considers VAT to be non-distortionary under the theory of neutrality, provided there are few exemptions and little zero rating. It has also been described as an efficient and neutral tax which does not distort savings and investment behaviour. It is necessary to briefly examine the negative reports of the impact of VAT on welfare so as to maintain a balanced discourse of the true essence of this valuable source of revenue.

The major causes of trepidation and apprehension towards VAT are its tendency to induce inflation, inequality and regressivity. However, on the contrary, various studies have dismissed such arguments. Tait (1988) confirms that the introduction of VAT, or change in VAT rate is not inflationary; the change might lead to a once- and- for- all shift in prices, but not to accelerated price changes. Furthermore, it has been shown that the VAT structure involves some degree of progressivity (not regressivity) with the urban sector in Cote d'Ivoire. Therefore, since VAT is not meant to be used as a weapon for short-term demand management and finetunning of the economy, it should be strengthened so as to generate revenue that will enable government to help the poor in more effective ways. The long-term effect of this will overshadow the sceeming adverse socio-economic consequences of its introduction.

2.2 Initiation of VAT in Nigeria

VAT has become a veritable source of revenue in many developing countries. In Sub-Saharan Africa, it has been introduced in several countries including Benin, Cote d'Ivoire, Guinea, Kenya, Madagascar, Mauritius, Niger, Senegal, Togo and, lately, Nigeria. Its adoption in Nigeria can be traced to the report of the committee set up by the federal government in 1991 to review the entire tax system with a view to expanding the financial base for revenue generation. This became necessary because sales tax could not guarantee wider and better tax admministration as many states were resentful of its uniform nature due to differences in their political orientation. The rationale behind the adoption of VAT in Nigeria can be summarized as the need to achieve:

- simplification of indirect tax system;
- enhancement of tax neutrality in international trade;
- reduction in tax evasion;
- expansion of the tax base; and
- promotion of investment.

These points are further amplified by Nwokedi (1996) who argues that a consumption tax, such as VAT, is increasingly being favoured as a tax base over income and allied items. Naiyeju (1997) further supports the introduction of VAT in Nigeria as an instrument for the balance of payments engineering, by encouraging exports through zero-rating of export goods.

VAT was adopted in Nigeria in 1994 and prospective VAT payers – manufacturers, wholesalers, importers and suppliers of taxable goods and services – were required by Decree No. 102 of 1993 to register with the Federal Inland Revenue Services (FIRS) which centrally administers VAT in the country. VAT is a gross-product type of tax imposed on the destination principle. At the moment, there are seventeen categories of goods and twenty-four

categories of services that attract VAT. The goods and services exempted by the decree are purely those that bother on people's welfare and whose requirements are necessary for improving human development. These include medical and pharmaceutical products, basic food items, educational materials, agricultural services and equipment, etc. However, there is much confusion over which goods or services should be in the exemption list. Furthermore, Nigeria adopts the same 5 per cent VAT charges on all goods and services, either domestic or imported; and imposes a zero-rate on export commodities with a view to encouraging favourable balance of trade. It would seem, however, that the benefits of VAT outweigh its demerits. What is only required is a measure of commitment and transparency in the mobilization and allocation of VAT proceeds. At the moment, the proceeds are shared among the three-tiers of government as shown in Table 1 below:

Table 1. Sharing Formula of VAT from 1994-1998

Years	FIRS	FGN	States	Local Govt
1994	20% of gross proceeds	—	80% of the proceeds	—
1995 (Jan-March)	—	50% of the proceeds	25% of the proceeds	25% of the proceeds
1995 (April-Dec)	—	40%	35%	25%
1996-1998	—	35%	40%	25%

Source: The states' share is to be distributed between them on the basis of 50 per cent equality; 30 per cent population; and 20 per cent derivation

3. VAT in Nigeria: The Performance So Far

An important factor which has led to the success of VAT administration in Nigeria is that it can be structured to minimize problems of implemen- tation. The framework of VAT in Nigeria appears to permit a comprehensive approach to the taxation of goods and services that hitherto were not taxed under the retail sales tax (RST).

For VAT to guarantee better revenue generation, it must be carried out with adequate training, publicity and provision of adequate facilities. The first year of VAT implementation in Nigeria recorded little success as a proper foundation for its take-off had not been laid and the level of public awareness was still quite low. Although the feasibility study carried out by government favoured the adoption of VAT, the enthusiasm of FIRS and the urgency with which government pursued its implementation blurred the shortcomings during the first year. However, the VAT proceeds in 1994 showed quite remarkable improvement over the previous years' levels and represented over 390 per cent of the total retail sales tax collected in the country between 1986 and 1992. This impressive performance justified the shift from retail sales taxes (RST) to the value added tax (VAT). Available records have confirmed the improved performance of VAT since its inception though there are areas where its revenue yield can still be increased.

Table 2 shows the proceeds from VAT as a percentage of total revenue and gross domestic product of the nation over the years. The table shows that if carefully and judiciously administered, VAT will significantly improve the revenue base of all the three tiers of governments in Nigeria.

Tables 2a and 2b show that VAT proceeds have been on the increase. Since its inception in 1994 up to 1996, the percentage increment in VAT revenue has been about 327 per cent, which shows very promising prospects. Similarly, the contribution of VAT to non-oil revenue has also been positive (see Table 3). From the table, we can observe that there is a continuous increase in VAT contribution to non-oil revenue of the federal government. The increase was over 68 per cent between 1994 and 1996. Furthermore, in comparing VAT with other federal taxes, Table 4 and Figure 1 reveal the relative importance of VAT.

Both Table 4 and Figure 1 show the significant contribution of VAT to the federal tax performance. Between 1994 and 1997, VAT proceeds increased by over 337.5 per cent as against 115.4 per cent and 52.38 per cent for company

Table 2a. VAT Revenue, Total Revenue and GDP

Years	Total Revenue (N'million)	VAT (₦million)	GDP (₦million)
1994	201,910.8	7,260.8	911,068.01
1995	459,987.3	20,761.0	1,960,685.58
1996	520,190.0	31,000.0	2,331,923.99

Source: FOS (1997).

Table 2b. VAT Revenue as a Percentage of Total Revenue and GDP

Year	% of VAT to Total Revenue	% of VAT to GDP
1994	3.59	0.80
1995	4.51	1.06
1996	5.96	1.33

Source: Derived from Table 2(a)

Table 3. Contribution of VAT to Non-oil Revenue

Year	Non-oil Revenue (million)	VAT Revenue (million)	VAT percentage of non-oil Revenue (%)
1994	100,439.7	7,260.8	7.24
1995	215.085.0	20,761.0	9.65
1996	254,190.0	31,000.0	12.19

Source: FOS (1997).

Table 4. VAT and other Federal Taxes, 1994-1996

Tax	Revenue Collection (₦'billion)			
	1994	1995	1996	1997
Value added tax	8.0	21	32	35
Customs and excise duties	18	39	–	–
Company income tax	13	21	23	28
Petroleum profit tax & royalty	42	57	48	64

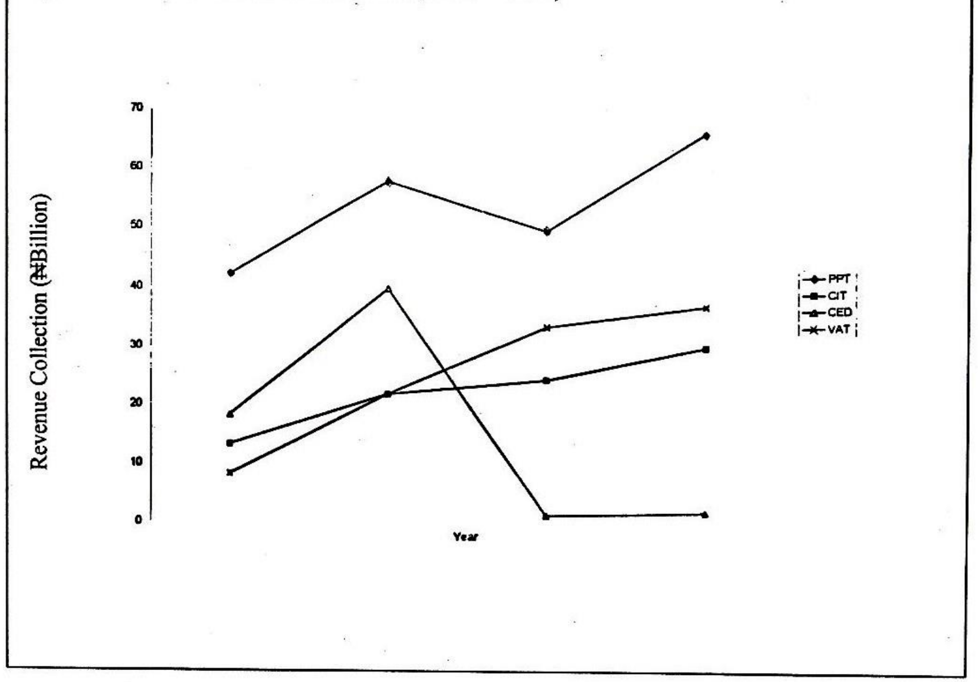
Source: FOS (1997)

income tax and petroleum profit tax and royalty, respectively. We can also observe that the revenue productivity of VAT was higher in 1994 and 1995 than in 1996 and 1997. In conclusion, we can say that VAT contribution to the revenue base of the federal government is commendable and its trend has been progressive.

Judging, therefore, from the foregoing performance, one can say that the contribution of VAT could have improved if all the categories of goods and services which attract VAT had been covered. The 1996 VAT value is derived from 21.89 per cent of 58,665 identified VAT-paying establishments, and if the 78.11 per cent of unregistered establishments had been registered by FIRS, the 1996 VAT proceeds would have probably tripled. The same goes for other years. Therefore, there are future possibilities of better VAT generation as even the actual VAT revenue between 1994 and 1996 exceeded the projected amount for the period. Total VAT revenue for 1994, 1995 and 1996 were estimated at ₦600 million, ₦900 million, and ₦15,000 million, respectively, which were lower than the actual VAT revenue for the period (see Table 2a). The performance of VAT has so far shown the high potentials of the tax for revenue generation in the country, given proper administration.

When considering the negative impact of VAT on Nigeria, the movement of the consumer price index (which shows inflation rate) should be noted. In 1994 when VAT was introduced, the inflation rate rose from 54 per cent to 57

Figure 1. Federal Tax Performance (1994 – 1997)



per cent then went up further to 72 per cent in 1995. But in 1996, it fell significantly to 44.6 per cent. Therefore, we can say that CPI trend shifted up considerably due to the effects of other factors besides VAT. This situation hypothesized a "shift plus acceleration situation" postulated by Alan Tait. It, therefore, implies that the introduction of VAT has not led to inflation as it was feared.

4. The Performance of VAT in Cross River State

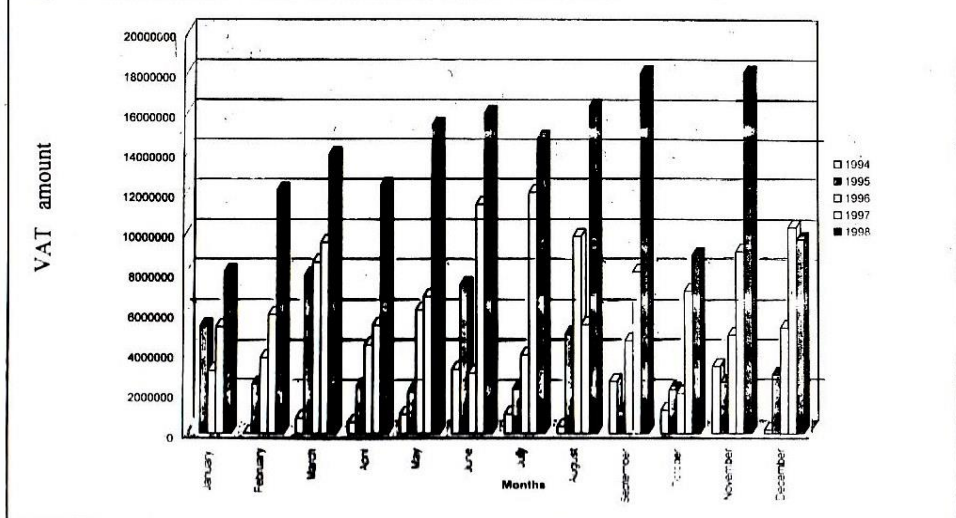
The Calabar VAT zonal office commenced operations in February, 1994, and since then, a lot of activities have been going on to improve revenue generation in the state. Cross River State is noted to be a "civil service state", which implies that large-scale manufacturing and service-oriented establishments that could generate high VAT revenue are few. The few small-scale enterprises in the state constitute a great proportion of VAT-paying establishments. Therefore, how to treat these small-scale enterprises is a crucial problem in terms of administrative bottlenecks and setting of tax thresholds. In other words, the cost/benefit ratio is phenomally high and

control over deliquency difficult. This is the primary motivation for the study of VAT administration in Cross River State.

In 1996, about 239 establishments (31 per cent) out of the 771 identified establishments registered with the Calabar VAT office. The number increased to about 1,289 in 1998, though the total number of establishments identified by the State Ministry of Commerce and Industry and their activity groups or form of organizations could not be ascertained. The increase in the number of VAT-paying establishments is concomitant with higher revenue profile over the years. Figure 2 shows the revenue profile and level of performance of Calabar VAT from 1994 to 1998. The monthly analysis of each year does not reveal any particular trend, there is, therefore, no consistent lean or peak month for VAT but equal propensity for VAT derivation in every month. But, on average, the months of April through September yield higher revenue every year. A yearly analysis shows that there has been a remarkable improvement in VAT derivation since inception: from a lean amount of ₦15.15 million in 1994 to an impressive amount of about ₦163.44 million in 1998, showing an over 951 per cent increment.

For a rather more detailed analysis of the VAT revenue profile of Calabar, performance can be measured in light of expected VAT revenue each accounting year. The VAT Directorate normally undertakes a prior assessment of VAT-paying establishments and projects the revenue that it is likely to derive under ideal situations. It is, therefore, left for the directorate to meet or

Figure 2. Revenue Profile for Calabar VAT. 1994-1998



exceed the target for its generation effort to be successful. Table 5 shows the expected and actual VAT revenue between 1994 and 1998 and the level of variance.

It can be observed from the table that in all the years except 1997, some proportion of collectable VAT revenue remained uncollected. Specifically, the percentage of deficit to expected was much higher in 1994 and 1995. The situation in 1997 showed a positive profile and a better performance. In addition, even though there was a downturn in 1998, the deficit was not substantial. Since the level of performance is measured by the level of variance in fiscal revenue, it becomes imperative to know whether there was any significant difference between expected and actual VAT revenue collected within the period. This involves statistical testing of the null hypothesis, < tcal (0.0636) ttab (4.604) @ P<0.01). The inferential test shows that there is no significant difference between actual and targeted VAT revenue: hence, there is better performance.

It is, however, necessary to be cautious in drawing such an overwhelming inference. adequate feasibility study undertaken to actually ascertain the potential of VAT revenue in the state. Moreso, because of the problems encountered in tax collection, the actual performance of the directorate is still questionable. The inability of the VAT Directorate to register all its potential customers also indicates that VAT potentials in the state have not been adequately exploited. However, with the increasing revenue profile and the seemingly high performance level, one can say that VAT is an efficient tax system and a potential one for better revenue generation, even in Cross River State where there are predominately small-scale enterprises.

4.1 VAT revenue and Cross River State finance

Decree No. 102 of 1993 which established VAT centralized its administration under the jurisdiction of the federal government and shares its proceeds among

Table 5. Expected and Actural VAT Revenue for CRS, 1994-1998

Years	Actural VAT Revenue	Expected VAT Revenue	Variance	% of Expected
1994	15,550,574.49	20,000,000	–4449425.51	–22.25
1995	43,244,222.05	49,224,000	–5979777.95	–12.15
1996	59,416,655.46	64,625,000	–5208344.54	–8.06
1997	96,263,969.60	74,700,000	21563969.6	28.87
1998	163,445,635.30	180,000,000	–16554364.7	–9.19

Source: Compiled from Calabar VAT Office, 1999.

the three tiers of government, based on a sharing formula. Since the introduction of the tax regime till this moment, there have been series of adjustments in the sharing formula, partly arising in response to criticisms and protests by states (see Table 1 for the sharing formula). At the moment, the Federal Capital Territory (FCT) gets 10 per cent of the states' allocation.

Cross River State has benefited from VAT since its inception and a summary of this is shown in Table 6. The table shows the level of VAT revenue allocated to Cross River State and the percentage contribution of VAT and internally generated revenue to the total revenue of the state across the years. In actual amount, the proportion of VAT revenue to the total revenue of Cross River State has been on the increase. From ₦117.4 million in 1994, it rose to ₦226.3 million, showing an increase of over 126 per cent. However, when we compare the VAT revenue allocated to the state with the internally generated VAT revenue, one can observe that the state benefitted more from the allocation than from its internally generated resources (see Table 7)

According to Table 7, the formula used in allocating VAT revenue to the three tiers of government favoured Cross River State and brings out the importance of VAT revenue to Cross River State revenue profile over the years. In 1994, the state got over 657 per cent more than what it generated internally and over 176 per cent in 1997. In essence, the state has benefited

Table 6. Summary of CRS Finance (₦'million)

Years	Statutory Allocation	VAT Allocation	Internally Generated	Others	Total	% of VAT to Total	% of Internally Generated to Local
1994	794.9	117.4	181.3	14.0	1,107.6	10.50	16.37
1995	1,248.9	146.8	338.5	6.0	1,740.2	8.44	19.45
1996	1,114.8	284.3	330.6	10.50	1,746.0	16.28	18.93
1997	1,305.6	266.3	376.0	179.6	2,127.5	12.52	17.67

Source: FOS (1997)

Table 7. Summary of VAT Revenue Generated and VAT Revenue Allocation to CRS

Years	Total VAT Revenue Generated	VAT Revenue Allocation (₦'million)
1994	15,500,574.49	117.4
1995	43,244,222.05	146.8
1996	59,416,655.46	284.3
1997	96,263,969.60	266.3

Source: Derived from Tables 5 and 6

from the operation of VAT and still stands to benefit more within the paradigm of fiscal federalism. It, therefore, follows that even though internally generated revenue is important in the finances of Cross River State, the revenue significance of VAT is of equally high magnitude. Since the state stands a great chance of benefitting from VAT, there is the need to create an enabling economic, social and political environment for new establishments, especially large-scale enterprises, while also strengthening existing ones.

5. Improving VAT Collection Machinery

Since the importance of VAT to the revenue base of the three tiers of governments in Nigeria cannot be overemphasized, there is, therefore, an urgent need for proper administration of VAT so as to make the collection machinery yield optimal proceeds. On the administrative side, efforts to enforce correct payment from the small firms should be carried out. These involve efficient administration, proper auditing, issuing of registration certificates, distribution of return forms and recording of payments. Furthermore, the VAT directorate should liaise with state ministries of commerce and industry to identify all existing establishments that have not registered with the directorate. Moreso, as pointed out by Due (1987), farmers and small firms should be treated differently under VAT. This could be in form of having a different lower VAT rate for them and organizing enlightenment programmes for them through extension services. Adequate training and provision of infrastructure for the field staff of the VAT directorate should also be ensured. In a nutshell, every means through which adverse variance in fiscal revenue can be checked should be put in place and adequately enforced.

7. Concluding Remarks

The success or failure of any government depends, among other things, on its revenue base and how well its fiscal resources are managed. This becomes more necessary in view of its constitutional responsibilities to the people.

Multiplication of sources of revenue and improvement of strategies for revenue generation ensure better fiscal resources for any government.

As a result of the foregoing discussion, and taking the need for economic development into consideration, there is a clear indication that the importance of VAT will continue to be felt and its relevance in national and state development sustained. Even in a state like Cross River where most enterprises are small-scale, VAT proceeds are still commendable. Therefore, on the fiscal horizons, *ceteris paribus*, VAT will continue to play a major role

in economic development and its growth trend will continue to accelerate, especially if Nigeria's economy stabilizes in the near future.

The success of VAT as a better replacement for retail sales tax would only be sustained if it is administered efficiently and correct renditions are made of the collected revenue. This will be possible when all the drawbacks are adequately eliminated and both the state and local governments assist by creating enabling environments since they benefit most from its proceeds.

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