

# Impact of Multiple-Taxation on Competitiveness in Nigeria

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## Introduction

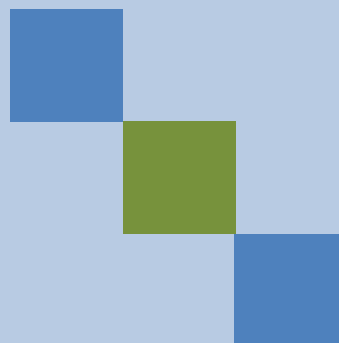
Nigeria is Africa's most populous country and second largest economy after South Africa. By virtue of its size, improved economic management and strong economic growth in Nigeria would generate substantial prospects for growth and spillovers for the whole West African region. But the challenges facing the country are formidable—despite its oil wealth and sustained economic growth during the last decade, more than half of its population still lives in poverty. Given the low employment capacity in the oil sector, economic diversification is important for sustainable growth, job creation, and poverty reduction.<sup>1</sup> However, Nigerian firms, the engine of growth and diversification, continue to face

<sup>1</sup> Export Diversification and Economic Growth. In R. Newfarmer, W. Shaw, & P. Walkenhorst, *Breaking into New Markets: Emerging Lesson for Export Diversification* (pp. 55-80). Washington, DC: World Bank.



## Africa Trade Policy Notes

### Note #16



a challenging business environment. In addition to continuing scant electricity supply, multiple-taxation is one of the major impediments to doing business in Nigeria (FIAS, 2008, DFID, 2008).<sup>2</sup>

The Nigerian Federation comprises three tiers of government—the federal government, 36 State governments and the Federal Capital Territory, and 774 local governments. The exact number of ‘taxes’ levied on businesses seems to vary significantly between various states and local governments throughout Nigeria and “businesses may be subject to as many as 100 different taxes, charges, fees and levies, and in some instances taxed for the same

<sup>2</sup>Multiple-taxation is often referred to when same asset or event is taxed multiple times by different jurisdictions in a federal system. We extend the definition to include and ‘nuisance taxes’ as they can exacerbate the burden through administrative costs to both the government and businesses.

event or asset” that are levied by the three tiers of government (FIAS, 2008). In an environment where trade taxes, surcharges and a plethora of other levies add to the operational and transaction costs of businesses, their arbitrary implementation heightens the uncertainty to Nigerian enterprises and further increases the cost of doing business. The impact of multiple-taxation on competitiveness, and therefore external integration, can be profound; in addition the multitude of taxes on the transportation of producer and consumer goods in particular impairs the integration of internal markets and the establishment of a fully integrated economic space within Nigeria, implying much broader economic and social impacts, including on poverty levels. By impairing the integration of the national market, these mobile levies also reduce competition between companies located in different States in Nigeria. Such increased competition could bring down prices for consumer goods produced by these companies and increase efficiency.

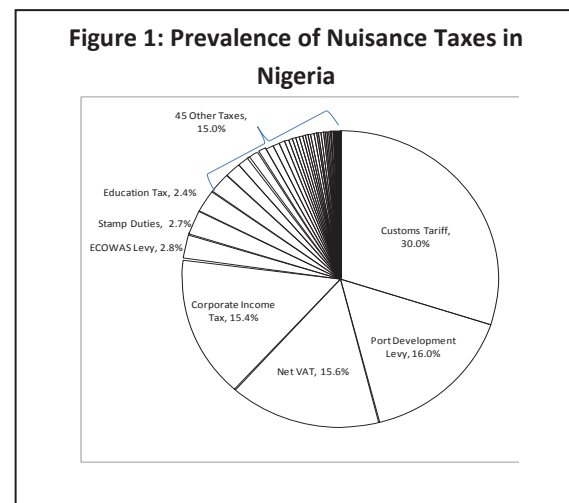
This Note is based on a study of the effect of multiple levels of taxation at different jurisdictions (federal, state and local as well as Ministries, Departments and other Authorities) on enterprises, especially traders, in Nigeria.<sup>3</sup> It focuses on medium-size enterprises in selected states and municipalities within those states. The study demonstrates the degree to which multiple-taxation burdens businesses and traders, reducing their ability to compete domestically with imported products and to compete successfully in export markets.

<sup>3</sup> The States chosen were Lagos, Ogun and Anambra.

Multiple taxation is understood to include both incidences of *double-taxation*, whereby the same asset or event is taxed multiple times by different jurisdictions, and the *multiplicity* of small “nuisance taxes”. By auditing the burden of multiple taxes, fees and levies at each jurisdiction and on the transportation of goods and people, and assessing the associated administrative costs at enterprise level, the current study demonstrates the real burden of taxation, fulfilling a vacuum acknowledged by recent studies.<sup>4</sup>

### Multiple-Taxation: Findings

The firm-level findings suggest that the current system of taxation is characterized by a high incidence of ‘nuisance taxes’, on mobility of goods and people across states and the prevalence of double taxation. The direct burden of official taxation on firms in



Nigeria is compounded by the administrative burden to comply with these taxes which is significantly higher than competitors. While our findings are based

<sup>4</sup> The FIAS (2008), DFID (2008), and CIPE (2010) studies on taxation in Nigeria primarily focused on its direct burden.

on primary data collection focusing on a few locations and using a small sample, we are confident that the findings are representative of reality as they are supported by anecdotal evidence.

**Direct tax burden is comparable to SSA counterparts but variation is high across states.** On average, firms paid around 31 percent of their pre-tax profits on taxes, corresponding to Doing Business findings. This is comparable to other Sub-Saharan African countries,<sup>5</sup> but the burden varies strongly by State. Firms in Ogun, and Lagos paid around 17 and 23 percent respectively, while they paid as much as 51 percent of pre-tax profit in taxes in Enugu (see Table 1). This is partly a composition effect—traders in Lagos are relatively larger in terms of turnover. Despite being subjected to a relatively higher number of tax events, traders in Lagos were also more knowledgeable of the tax system and better able to challenge any policy perceived to be offensive and injurious to their interests.

**Table 1: Summary of Tax Costs in Nigeria, by State**

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

<sup>5</sup> World Bank’s Doing Business survey revealed Nigerian businesses on average paid around 32 percent in pretax on profits, compared to 41 percent in Ghana, 49 percent in Kenya, 31 percent in Rwanda and 30 percent in South Africa.

**Presence of high ‘nuisance taxes’:** In the aggregate, firms pay the overwhelming share of taxes to the federal government (about 87 percent of the total tax burden), and only a relatively small share of taxes are collected at the state, local and MDA levels in the form of numerous smaller taxes that, at less than one percent of total tax revenues, are tantamount to “nuisance taxes” (Figure 1). The administrative burden of collecting nuisance taxes by different jurisdictions and classifications often tends to outweigh any benefit both to the private sector and to tax authorities- especially when the tax system is plagued with weaknesses in assessment including lack of understanding of the tax payer rights and by the government appointed agents as well as private assessors appointed on their behalf, as found in Nigeria (FIAS, 2008, CIPE 2010).

**Small traders are penalized even more:** Sector analysis suggests that the agriculture sector comprises relatively smaller firms within the sample, but they paid relatively higher incidence of pre-tax profits around 54 percent, which is indicative of the regressive impact of taxes. Manufacturing enterprises paid around 43 percent. Firms active in the services sector were exposed to only limited imports of goods and had to pay few import taxes. This created a lower overall burden of around 34 percent as immobile factors and assets make up the majority of such firms’ operations; and those tend to escape the portion of the tax net penalizing cross-border (and internal) movements, such as transport and vehicle tax, radio tax, road tax and haulage fees.

***And taxes on mobility are particularly high:*** Traders with mobile factors (inputs or outputs) are subjected to road related taxes and/or levies, which accounted for approximately 10 percent of their pretax profits on average, and as much as 24 percent of the pretax profits of some firms. Most traders incurred road taxes through the transportation of inputs or finished goods from and to the main entry or exit points in Nigeria (Lagos primarily) to factory or outlet—implying additional costs to exporting, reducing margins of locally produced goods and making them less competitive in world markets. However, these mobile fees are levied indiscriminately on goods transport within Nigeria and therefore also substantially affect domestic trade. These mobile fees include mobile advertising fees for marked vehicles, radio levies, and other (in)formal payments at road blocks along main and secondary roads.

***Compliance costs are high:*** Compliance costs consist of costs of filing and complying with taxes, resources spent on external tax consultants, and “gifts and unofficial payments” to government appointed “tax consultants and other officials”. Compliance costs account for an average 11 percent of an enterprise’s pre-tax profits, implying that the total tax and related administrative burden is around 42 percent on average for medium sized firms, a measure that was not captured in previous studies. This relatively high cost of tax compliance places Nigerian firms at a distinct disadvantage compared to other

countries.<sup>6</sup> “Gifts and unofficial payments” to the authorities and tax consultants account for around 6 percent of pre-tax profits,<sup>7</sup> half of which are incurred when complying with high trade-related taxes (customs duty and obtaining duty drawback). The plethora of taxes and documentary requirements along transport corridors and at the border leaves substantial room for arbitrariness, creates opportunities for rent-seeking, and increases direct costs to companies. While duties and VAT are refundable, traders face long delays in receiving refunds from the Federal government, exacting additional costs on firms in the short-run.

***High tariffs, non-tariff levies and charges increase the cost of importing:*** Finally, Nigeria applies import duties similar to those of other West African countries with which it is negotiating a Common External Tariff. However, its highest tariff exceeds that of other countries in the region substantially at 35% and Nigeria argues that its neighbours should also adopt this high tariff band as part of the CET. In addition, Nigeria levies a number of product specific levies (including excise levies on alcohol

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<sup>6</sup> In Doing Business Rankings Nigeria ranked 178th of the 183 countries and the worst among all Sub-Saharan African countries, with a staggering 938 hours of an average medium sized company devoted per annum to complying with taxes at the 4 tiers of government (equivalent to roughly =40 days = 120 working days = 24 staff weeks).

<sup>7</sup> Lack of information on taxpayer rights and responsibilities, lax enforcement of the law, and rampant illegality in use of unofficial “tax consultants” to assess and collect taxes on a commission basis on behalf of local and state governments are all attributed to this outcome.

and tobacco) ranging from 5 to 100 percent of the import value, and resulting in tariff-like duties of 5 to 135 percent. Only 118 product lines are duty free. In addition to these high tariffs, Nigeria also continues to apply import bans on 218 categories of agricultural and non-agricultural goods (at HS four-digit level), though a limited number of products is currently (February 2011) being removed from this list. This translates into roughly 10% of tariff lines at the 6-digit level. Moreover, Nigeria applies a variety of para-tariffs on imports, such as a 7 percent Port Development Levy on the duties payable, a one percent Comprehensive Import Supervision Scheme [CISS], or a 0.5 percent National Import Supervision Scheme (NISS). A consignment with 35 percent duty would translate into to nearly 46 percent ad valorem duty once other taxes and fees are paid.<sup>8</sup> A number of other charges, often duplicating what has been rendered under the administration, clearance and port handling, are allegedly being charged, magnifying the effect of trade taxes.

### **Implications of Multiple-taxation in Nigeria**

The foregoing results reveal new insights on multiple-taxation in Nigeria, complementing previous studies. The first is the overall magnitude of the burden. The recent CIPE study (2010) estimates that all tiers of tax cost firms on average about 40 percent of *production costs*. The World Bank (2008)

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<sup>8</sup> In principle VAT portion does not create a wedge between domestic and international goods they are applied to both goods the nominal protection would be thus be about 38.7 percent.

reported an *average effective tax* rate of business in Nigeria approximately 33 percent and a *marginal effective tax* of approximately 40 percent. The current study, based on firm-level data, highlights that associated administrative costs amplify the tax burden substantially, accounting for as much as 42 percent of pre-tax profits of traders and businesses in Nigeria. These costs, which seem to be even higher for smaller and more remote enterprises, place firms at a distinct disadvantage compared to competitors in the international market. This high tax burden occurs in an environment where the State fails to deliver reliable access to electricity in exchange, and where security concerns abound.

High taxation levels and compliance costs have significant implications for Nigerian businesses, reducing incentives to expand production, leading to higher prices, and distorting factor incomes. As firms take investment decisions based on long-run returns to capital, the costs of multiple-taxation reduce the size of the capital stock and aggregate output in the economy and discourage investment in productivity-enhancing measures. This ultimately leads to lower returns to human capital and lower job creation. Addressing the issue of multiple taxation and nuisance taxes would increase expected returns to entrepreneurs and would encourage capital accumulation, investment, and job creation.

***The presence of mobile fees and levies extracts a punitive measure on traders across local and state boundaries, preventing the development of cross-state value-chains and causing the segmentation***

*of the national territory into smaller economic sub-units.* Critically, an internal common market such as a federation only functions efficiently if all resources (labor, capital, goods, and services) are free to move from one jurisdiction to another without policy or physical impediments. This likely to be an important factor to the absence of vertically specialized production sharing within Nigeria, whereby different steps of the production process are located in areas that have a competitive advantage in the special tasks required. Moreover, it is regressive as these barriers to intra-national movements have an “isolating” effect on small traders and businesses in remote regions (mostly rural), and the households they support—this aspect has not been emphasized adequately in previous literature, and may suggest a broader socio-economic impact of the current system of taxation on the ability of Nigeria to promote inclusive, trade-led growth.

In addition, the segmentation of markets resulting from artificially high transport costs limits the potential for different States to compete for investors by simplifying and improving the business climate, as investors will tend to locate close to their markets. Likewise, the artificial barriers between States limit competition among companies across Nigeria which could lead to lower consumer prices.

*Compounded by high trade taxes, this geographic segmentation also prevents the integration of Nigerian enterprises into international supply chains,* where low and high income countries are specializing in tasks based on respective comparative

advantages. In tandem with low quality and high costs logistics services, the tax-related barriers to an efficient internal market stifle domestic linkages that could exploit vertical linkages in international markets, limiting the prospects for export growth and diversification.

High trade taxes—specifically the higher tariff bands and import prohibitions—raise domestic prices for protected goods and distort both consumption and production by altering the relationship between domestic and world market prices. Where imports represent essential inputs into final goods production (for domestic sale or export), such barriers increase the costs for businesses and make them less competitive on world markets. High import taxation also distorts the incentives to invest in export activities and therefore reduce the export base. Reforming trade taxes and in particular replacing import bans with tariffs would reduce incentives to smuggle. The overall welfare benefit is likely to far outweigh the cost to producers who have thrived behind protection.

*From the government’s point of view, our analysis suggests that the three tiers of government are overexploiting the existing tax base.* Taxing a specific tax base will lead to increasing revenues up to a specific point, after which the overall tax revenue will decline because companies go out of business, or evasion increases significantly. The results of the exercise suggest that the government could likely generate higher tax revenues with lower compound tax rates.

The low tax compliance level in Nigeria is likely to be due to the high compliance

costs, limited transparency, as well as the incidence of double taxation. The high incidence of “gifts and unofficial payments” reflects this lack of transparency. Firm-level interviews validated the apparent lack of information on taxpayer rights and responsibilities. Moreover, the high tax incidence and the associated administrative burden encourage informality to reduce visibility to tax authorities (as reported in World Bank, 2007, and numerous anecdotal accounts).

The high prevalence of informal enterprises in the Nigerian economy, in turn, discourages efficiency gains from the economies of scale that are required to compete domestically or internationally, lowering returns to human and physical capital. Consequently, reforming taxes and reducing the burden could lead to an expansion of scale and greater economic efficiency. This is particularly important as trade in the global market place dominated by competition with China for standard industrial goods is characterized by small margins. In such circumstances, even small additional costs due to policy barriers such as taxes or other structural impediments can impede firms that could otherwise efficiently produce from competing in an infinite global market altogether. This means that small additional costs can have an enormous impact on the performance of otherwise competitive companies. It is likely that multiple-taxation, nuisance taxes, and the high administrative burden in Nigeria are major factors in the poor performance of manufacturing businesses, which has resulted in a high number of reported closures in recent years.

## **Conclusion and Guidance on Reform**

The design and application of Nigeria’s federal tax system represents a significant impediment to formalize and grow a business, and to compete in international markets. Our findings suggest that the direct tax burden may not be insurmountable relative to SSA counterparts and that double-taxation is a relatively small share of the overall burden. However, the multiplicity of taxation, and the administrative burden created by the uncoordinated and lax enforcement mechanisms across different levels of jurisprudence has given rise to significant costs, particularly penalizing smaller and more remote businesses. The large amount and magnitude of taxes on mobile factors lead to the economic isolation of distant areas, prevents the establishment of national supply chains, and reduces competition among companies located in different States within Nigeria, as well as competition among States for investors through improvements in the investment climate.

The following provides key recommendations and guidelines for these reforms, based on international best practices and lessons learned, to inform future tax reform efforts:

***Eliminate “nuisance taxes” and align tax bases.*** To reduce the multiplicity problem and therefore the administrative costs they create, the federal government should enter into a dialogue with the other tiers of government to reduce the overall number of taxes – without necessarily reducing the amount of tax revenue collected. Taxes could be regrouped at the municipal level

and levied consistently. This would also increase transparency, provide greater legitimacy to taxes that businesses have to pay and prevent opportunities for collecting additional “taxes” by illegal tax collectors. Similar reforms have been undertaken in

government. The aim would be to eliminate the incidence of multiplicity of taxation by clarifying relevant legal texts and strict assignment of tax bases, or harmonization of key tax policies across levels of government to guard against over-taxation and to lower

### **Box 1: Tax Reform to Reduce the Multiplicity of Taxes**

Prior to the 1990s, the Russian Federation was characterized by a system of complexity that resulted in levies and charges at different levels of government, which amounted to approximately 100 different taxes. Reforms initiated to deal with tax avoidance began with a reduction of the corporate tax rate from 35 percent to 24 percent and a flat-rate small business tax. Other tax reforms included replacing separate taxes for pensions, social insurance, medical insurance and unemployment with a unified, lower social insurance tax rate; and eliminating most small nuisance taxes and tax privileges. Between 2001 and 2003, income tax revenues under the flat tax system increased by 28 percent in the first year after reform and by more than 80 percent within three years after reform as compliance increased and economic growth expanded the tax base.

The main elements of reform initiated by Tanzania in 2003 were the abolition of “nuisance taxes”, the flat rate development levy and of business license fees for enterprises below a certain size, and capping the latter for larger enterprises. According to a Poverty and Social Impact Analysis of the World Bank (2006), Tanzanian businesses recorded a 14 percent decrease in tax burden overall. Within this, medium businesses recorded 11 percent less tax, and small businesses 36 percent less tax. The reforms were particularly beneficial in remote regions where many firms have seen a reduction of 28 percent in total taxes paid. All councils were enterprising in replacing income lost from the development levy and market dues by intensifying collection of taxes that remained on the permitted schedule.

In the Hashemite Kingdom of Jordan, the tax regime comprised a complex array of taxes and fees on commercial activities, including hundreds of nuisance taxes, many disguised as fees that were promulgated through dozens of laws and different government agencies. In an attempt to reduce the burden on the private sector and reduce the administrative costs to the Government of Jordan, in 2009, embarked on an ambitious fiscal reform program to eliminate such nuisance taxes and unify them through a flat corporate income tax regime. A temporary tax law entered into force in January 2010 unifying several categories of taxes making Jordan more attractive for foreign investment.

Russia, Tanzania, and Jordan, where tax revenues actually increased as a result of these simplifications (see box 1).

Ideally, the government should undertake a top-down reform from the Federal level that reduces and clarifies responsibilities of tax authorities at lower levels of government, while addressing the issue of revenue distribution among the three tiers of

the administrative and compliance costs associated with the implementation of multiple taxes. The Russian Federation, Tanzania, and Jordan, all provide example of eradicating multiple taxes through rapid and comprehensive reform programs.

Alternatively, the federal government could initiate pilot reforms of “willing” State and Local jurisdictions with the aim of revenue



neutrality, increased transparency, and simplicity. Such an approach could be supported by disbursement of funds from the federal government towards the state level and municipal level to cover any ‘shortfall’ of revenues.<sup>9</sup> Alternatively, simplification and the introduction of single municipality taxes could help in reducing the number of taxes, while keeping revenue constant. Demonstrating beneficial effects could then lead to be replication through a gradual approach to roll out reform across the rest of States. Such an approach would also permit reform-minded States to compete for investors and businesses through the simplicity and transparency of their tax systems.

***Eliminate mobile levies.*** To achieve competition among states for investors through improvements in the business climate or simplifications in the tax system, however, it will be critical that the federal government, in collaboration with the state governments, enforce a single economic space in Nigeria by abolishing all kinds of fees and levies on mobile factors and removing roadblocks on internal traffic. Such a measure would likely meet substantial resistance from municipal governments and related lobby groups that are currently benefiting from these arrangements and close coordination with the States. Starting strict enforcement of such policies on selected priority corridors first could help create strong support from civil society that could create a counterweight to vested interests of a limited

number of beneficiaries that nevertheless seem to be very well connected politically.

***Improve transparency in the tax system.*** A well understood tax system eliminates the chances of corruption and harassment by tax officials and consequently of non-compliance by tax payers. A critical step would be to *publicize the tax payer rights* and responsibilities. Specifically, there is a need to provide adequate awareness to taxpayers on the list of approved taxes at the federal, state, and municipal level to check arbitrariness in assessment by properly defining the tax base, tax rate and other aspects of tax administration – and *to establish an independent yet powerful complaint body that taxpayers could turn to when treated in violation of their rights.*

***These reforms would increase economic efficiency and reduce inequalities in the tax burden between states and between small and large enterprises. They would also make enforcement simpler.*** Eliminating double taxation of specific tax bases, reducing the total number of taxes paid, increasing transparency as to how and what to pay, and facilitating procedures for filing taxes, will be essential to reducing the high compliance costs in terms of man hours that were identified by our study. Streamlining and simplifying the tax system would reduce the regressive nature of the current tax system that puts additional burden on agricultural companies, small companies, and companies in remote areas of Nigeria. It would directly benefit those companies that are the potential engine of growth and are likely to create the largest number of jobs, particularly the small- and medium-sized

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<sup>9</sup> The methodology for calculating such shortfalls would have to be agreed beforehand.

companies. Additional efforts could be undertaken to reduce trade-related compliance costs by simplifying and making payments more transparent. Given the delays in obtaining duty and VAT refunds, the introduction of alternative systems by the Federal government, such as suspension schemes, could bring down companies' capital costs of funds that are currently tied up in federal accounts.

***Realign trade taxes and barriers.*** The current structure of Nigeria's import regime distorts economic activity and reduces the competitiveness of Nigerian firms, both at home and abroad. Removing the import bans on the remaining products and taking the lead in agreeing to a regional common external tariff within ECOWAS are key issues the Federal government should pursue. Agreeing to a CET close to the current CET of UEMOA, without a large list of products to be included under the 35% tariff band, would ultimately be in Nigeria's interest as these reforms would reduce the distortionary effects of the current tariff policy, reduce the scope for corruption and

waste and increase Nigeria's standing and political leverage in the region. Fiscal revenue losses resulting from tariff reform could be addressed by specific compensation mechanisms that have been used elsewhere. For example, the EU has compensated Burundi and Rwanda through a trust fund for revenue losses incurred when acceding to the CET of the East African Community.

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