Tax Bites

How to fix Nigeria's broken VAT system

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I have shared my views on several platforms regarding the ongoing VAT controversy. This note summarises the salient issues and my viewpoints to facilitate informed conversation and provide a complete picture for ease of reference.

Historical context

VAT stands for Value Added Tax. It is a tax payable on the supply of goods and services at different stages of product supply and service delivery value chain. The burden of the tax ultimately falls on the final consumer.

The concept of VAT was first developed by a German economist in the 18th Century but first adopted by France in 1954. So, VAT is relatively a new tax compared to other taxes like income tax with some accounts attributing its first introduction to Egypt as far back 10 AD, or stamp duty which was first introduced in Spain in 1637.

Different countries operating a federal system of government have different structures of VAT. Brazil has both a federal VAT and state sales and service tax with lower rates applicable to inter-state transactions. Canada has combined federal GST and provincial sales taxes. The US operates only sales tax at states level excluding inter-state and international trade.

VAT has so far been adopted in over 150 countries worldwide. It is referred to as Goods and Services Tax (GST) in some countries. It can be differentiated from 'Sales Tax' which is imposed at every point of consumption without an input credit mechanism. Let's use a cake as an example assuming a consumption tax rate of 10% as illustrated below:

Value chain	Selling price	VAT at 10%	Sales Tax at 10%
Supplier of flour, egg, fat & sugar	1,000	100	100
Cake manufacturer (added value of 500)	1,500	50 (150 less 100 input VAT)	150
Cake distributor/retailer (added value of 300)	1,800	30 (180 less 150 input VAT)	180
Total consumption tax		**180**	**430**

Under a VAT system, the final consumer only pays 10% on the final value resulting in a total cost of **1,980** (1,800+180) compared to **2,230** (1,800+430) under a sales tax system due to the cascading effect of sales tax without any mechanism for input tax claim.

Nigeria's VAT facts and figures

1. VAT was introduced in Nigeria via Decree 102 of 1993 and implementation began in 1994. It replaced the sales tax introduced via Decree 7 of 1986. Since introduction almost 3 decades ago, VAT has become the fastest growing tax revenue head in Nigeria displacing PPT (N1.52 trillion) and CIT (N1.41 trillion) in 2020 to claim the top spot at N1.53 trillion.
2. The 1999 Constitution does not mention VAT, Sales or Consumption Tax even though the VAT law predates the 1999 constitution. The omission means it is considered a residual item which falls within the remit of state to legislate on based on S.4(7) of the 1999 Constitution.
3. The VAT act has been amended several times with key changes such as clear definition of exempt items, exemption threshold for small businesses with annual turnover not exceeding N25m, requirement for foreign suppliers to charge VAT, self-charging of VAT, exclusion of rent, land and building from the scope of VAT, etc
4. Over 500 food items are exempted from the national VAT including bread, cereal, fish, milk, fruits, yam and water. In addition, education books and materials, tuition, medical services, shared passenger transport, commercial air travel, and rent are exempted.
5. VAT collection in 2020 was N1.53 trillion out of which about 51% represented import VAT and international services. The top contributing sectors are professional services & telecoms 10.6%, other manufacturing 10.07%, commercial & trading 5.06%, breweries, bottling & beverages 3.90%, transport & haulage 2.84%.
6. Alcohol which is banned in some states contributed less than 3% of total VAT collection
7. Some big sectors contribute very little to VAT revenue due to the nature of their operations e.g. banks & financial institutions contributed 1.62% (because VAT is only charged on a small component of their income such as fees & commission but not on interest or premium), oil marketing contributed only 0.63% given that VAT is not charged on petroleum products.
8. In line with S.40 of the VAT Act, revenue is shared 15% to Federal Government, 50% to States & FCT, and 35% to Local Governments. The principle of derivation of not less than 20% is reflected in the distribution to states and LGs. Although not stated in the VAT Act, other factors used in the distribution are equality 50% and population 30%. There is a 4% cost of collection for FIRS and 2% for NCS in the case of import VAT.
9. States with the highest derivation are Lagos (50.5%), FCT (13.2%), Oyo (2.9%), Rivers (2.7%), and Kano (1.4%). The bottom 32 states contributed only 7% with the bottom 3 being Abia (0.08%), Osun (0.07%), and Zamfara (0.06%). On the other hand, amounts shared by the top states & their LGs are Lagos (14.7%), Kano (3.8%), Oyo (3.2%), Rivers (2.7%) and FCT (2.5%). The bottom 3 states shared Osun (2%), Abia (1.6%), and Zamfara (1.6%).
10. In the early years of VAT introduction, filing and payments were made based on branch locations. This practice was complicated especially with respect to offsetting of input against output VAT. A central system of filing was therefore introduced about a decade ago. This means VAT is currently filed and remitted centrally by companies based on their head office locations. This gives rise to what I call the "Headquarters Effect". For instance, all the Telcos, Banks, big manufacturing companies, top professional firms etc with head offices in Lagos remit their VAT to FIRS offices in Lagos. This artificially inflates the VAT attributed to Lagos while reducing the VAT revenue attributed to other states. Other major states may suffer the HQ effect to some extent e.g. PH Electricity Disco based in Rivers but serving other states.

Implications of a States' VAT regime

1. If states enact their VAT or Sales tax laws, the guaranteed winners will be the federal government in respect of import VAT and international transactions (whether retained by FG only or paid into the Federation account and shared), and the FCT. States that may either lose or gain are Lagos and Rivers due to HQ effect and subject to collection efficiency. Lagos also has to deal with granting input VAT at 7.5% on items sourced by businesses outside the state against the lower output VAT rate of 6%. All other states and 774 local governments will be worse-off, all things being equal.
2. The positions of all states will be negatively impacted by lack of capacity to collect, difficulty in auditing compliance, and higher cost of collection which may be up to 15% especially in states where consultants and other forms of agency structures are used for tax collection
3. States that have existing consumption tax such as Lagos, Edo and others would have to repeal those laws when introducing VAT or sales tax as to do otherwise would amount to legislating double taxation.
4. Small businesses with turnover not more than N25m that are exempt under the national VAT would have to comply with VAT under the states VAT laws.
5. Penalties for failure to register is as high as N50,000 for the first month and N100,000 for each subsequent month while the fine for failure to keep records to ascertain the correct VAT is up to N250,000. This penalty regime will weigh heavily on businesses especially SMEs such as barbers, hairdressers, tailors, shoemakers, plumbers, bus and taxi drivers, makeup artists, restaurant owners, etc. This further increases the risk of such businesses being harassed and extorted in many states especially those employing tugs to enforce tax compliance
6. People will pay more, but government will collect less due to inefficiency of collection and leakages. There will be higher cost of goods and services arising from input VAT claim and refund complications in addition to items which are not exempted under the states VAT law such as rent, tuition, processed foods such as amala, suya, jollof rice, and ogbono soup. In addition, there will be incidence of double taxation due to likely conflicts between origination and destination principle in different states. Worse still when the reality of inability to implement VAT hits home many states will inevitably introduce sales tax with its cascading effect.
7. Nigeria's ease of doing business and paying taxes will deteriorate in view of the multiple VAT compliance and Nigeria's tax to GDP ratio will decline.
8. Tax practitioners including lawyers and accountants will benefit as the states VAT regime will create multiple fee opportunities to assist taxpayers comply.
9. Local governments will be worse off. Effectively between states and LGs, the VAT revenue split under the national VAT is 59% to 41%. However, states are prescribing lower rates for LGs e.g. Rivers 30%, Lagos 25%.
10. FIRS will lose cost of collection on VAT revenue within states and may have to improve its operational efficiency to sustain current capacity or seek additional funding from the National Assembly which will reduce revenue accruing for sharing to all level of government.

Conclusions and recommendations

The connotation that the current VAT controversy will improve fiscal federalism is superficial. Out of the top 7 taxes in Nigeria, 3 accrue entirely to states & local governments (personal income tax, property taxes, and stamp duties) while the remaining 4 (companies income tax, petroleum profits tax, VAT, import & excise duties) are shared to states & LGs at rates ranging from 43.32% from the federation account to 85% from the VAT pool. This is equivalent to 5 of the top 7 taxes accounting for over 95% of tax revenue in Nigeria accruing to states & local governments. In the US, both the federal and state governments collect personal income tax while sales tax is only collected by states. Land which is a country's most valuable natural resource is about one-third federally owned in the US while states own less than 10%, the rest are owned by private landowners, tribal authorities and counties. In Nigeria, land is owned almost entirely by states while personal income tax, the top revenue yielding tax head in the world, accounting for about 38% of tax revenue in South Africa, up to 41% in the US and over 30% global average, is entirely collectible by Nigerian states on their residents.

So, efforts aimed at addressing the current challenges need to be redirected. It is not a clash between states and federal government (amending the constitution is squarely within the purview of the National and States Assemblies). It is also not a North vs South context, the 32 states that will suffer financially cut across all regions. And the impact of certain states sharing VAT from alcohol and spirits which are prohibited within their territories is exaggerated given that such products account for less than 3% of VAT revenue.

Below are my thoughts on the way forward:

1. **Put people first** – any outcome that negatively impacts the majority of Nigerians is not the right solution just as we cannot claim to empower the subnational by weakening at least 32 states and all 774 local governments.
2. **Address inequity** - the current VAT revenue sharing formula among states is not equitable. This inequity should be addressed by allocating any domestic VAT collected from each state entirely to the respective state. Only VAT collected on imports, international services and inter-state transactions should be paid into the VAT pool and shared based on derivation. This will address the current controversy without creating new problems.
3. **Give accelerated hearing** – this is an issue of utmost national importance and should be accorded the urgency that it deserves by the judiciary and all key stakeholders. The uncertainty created is counter productive for business and tax revenue generation.
4. **Redesign the VAT structure** - regardless of the outcome of the ongoing court case, a more suitable VAT regime should be developed for Nigeria and clearly spelt out in the constitution. By extension, the tax system is overdue for a holistic review.
5. **Avoid reversing progress** – even if states are to collect consumption tax going forward, adopting the very old VAT law as we have seen with Rivers and Lagos state is a setback especially with respect to lack of exemption for small businesses, limited scope of exempt items, not addressing the digital economy and business reorganisation. The fact that a state has the legal right to enact a VAT law does not mean it should do so in a hurry. Sufficient time should be dedicated to consultation, stakeholder engagement, capacity building and administrative readiness before enacting the law with a minimum commencement of 3 months after enactment in line with the 2017 National Tax Policy. A model legislation may in fact be developed by the Joint Tax Board.
6. **Grow the pie and optimise existing taxes** – beyond ensuring equity in sharing the cake, everybody wins when we grow the pie. Creating a conducive business environment to stimulate the economy and creating employment will inevitably lead to more tax revenue for all levels of government. Examples include land reforms, unlocking dead assets and removing impediments to the ease of doing business.

Nigeria's tax system is in a bad shape, which is set to get worse with the recent developments. To find the right solutions we must correctly define and properly situate the underlying issues to avoid misdirected prescriptions or "cobra effect" where the solution designed to solve a problem ends up making it worse.

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