

STATES & LOCAL FINANCE



The IGR Initiative

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TRACKABILITY IS THE NAME of the game in public sector revenue generation. That is why taxpayer databases play central roles in IGR expansion. The underground or shadow economy comprises economic activities outside tax administrations tracking radar. Such an enterprise can be legitimate or otherwise. The defining characteristic is its invisibility from the eyes of official record keepers. The success of hidden economic operations is principally why the compliance rates in most subnational governments are pretty low. As a result, the stronger the shadow economy's growth, the more the setback in subnational fiscal and economic performance. While this requires no further explanation, it is essential to emphasize the government's culpability in boosting the successful growth of shadow economies in Nigeria. Several studies show that the tax burden constitutes between 50% and 60% of the reasons for tax evasion for those in legitimate entrepreneurial activities. Yet other reasons such as the complexity of tax rules and poor tax education can constitute as high as 30%. According to IMF estimates, the underground economy in Nigeria is about 65% of the Nominal GDP. Without a doubt, conscious efforts that shrink the underground economy should improve subnational revenue prospects and the capacity for improved governance.

Hidden business enterprises are classifiable into two: illegal and lawful. Some examples of transactions considered illegal and often outside the purview of government for apparent reasons include trading on stolen goods and drugs, smuggling, illicit drug manufacturing and, in some countries, prostitution. Of course, some of these illegal transactions can exist without monetary exchanges. A good example is the barter trade on drugs and stolen goods. Generally, one would not expect the law to recognize and accept proceeds from criminal economic activities. However, some hitherto considered illegal or unacceptable activities due to their negative externalities can be regulated and taxed. Aside from the religious perspective, prostitution and the growing of drug-yielding plants can be subjected to rigorous regulation to check their potentially harmful effects on the society while government earns revenue from them.

At the other end of the shadow economy spectrum are substantial tax evasion and avoidance of otherwise legal activities, thus denying fiscal authorities revenue. These include unreported income from self-employment, fringe benefits, do-it-yourself work, barter-based trade, and numerous

informal sector activities. Successful tax evasion and avoidance reduce the cost of transacting at least by the size of the payable tax amount. Such advantages, particularly concerning cheap labour and materials, sustain the informal sector, the most significant component of the shadow economy. The government loses remarkably. Manifestations are evident in the bouts of budget deficits due to insufficient revenue earnings. The attendant implications are also high debt levels. It is also evident tax injustice at the market competition level. Those with lower cost advantages are usually more efficient and price competitive than others suffering higher tax burdens. Such market distortions affect the capacity of governments to attract investments. Generally, the shadow economy sabotages purposeful laws, regulations, governance and developmental objectives of the government.

Sadly, despite the enormous efforts by financial regulators, non-governmental organizations, the government, and commercial banks on expanded financial inclusion, the Nigerian economy is still substantially cash-based. The use of cash is one of the most efficient ways of hiding business and fraudulent transactions. It partially explains why corruption and public-sector fraud still thrive in the country. But, with the large size of the informal sector and a 70% below-the-poverty-line population, the use of cash has become increasingly ingrained. Underground economies also subsist to avoid the heavy fiscal burden from the system. Although Nigerians seemingly pay reasonably low tax rates compared to many other countries, they nevertheless pay heavily in other areas, such as the private provisioning of infrastructure that the government neglected to provide. For instance, Nigerians primarily provide their electric infrastructure and pay high transportation costs due to bad roads and the absence of a robust transportation system. Therefore, with huge costs already existing, hiding business operations becomes a strategy to avoid additional financial burdens that make entrepreneurial ventures uncompetitive.

Apart from paying taxes or levies, some administrative constraints can incentivize the undergrounding of some economic activities. For instance, government restrictions on business activities in residential areas mean that most home offices in the location may go underground. Generally, administrative and legal restrictions on economic activities without good options inevitably hide the same operation. The River State government outlawed large-scale artisanal mining because of the heavy toll on the environment. But the activity remains a signifi-

Underground businesses and subnational IGR expansion



cant source of employment and revenue within the state. Without a way out, such as instituting appropriate regulations across technology deployment in the sector and other operations, those conducting the business activities would continue to do so underground.

As a driver of underground economic growth, excessive taxation operates through four different mechanisms. The first is the size of the direct financial burden imposed on taxpayers. Unduly high tax rates and multiplicity of taxes and levies fall within this category. Again, while the pain may not be with the tax rate, the multiplicity of uncoordinated taxes and levies abounds. It is indeed a fact that most states and local governments in Nigeria have launched harmonization laws and codes to prevent double and multiple taxations. Yet the challenge remains unresolved, at least at the informal sector level. For instance, commercial drivers in virtually all the states of the Federation not only pay parking levies at the garage but must still pay a multiplicity of rates and levies, sometimes up to two times a day. The same applies to market women categories who practically pay usage fees and levies every day they operate. The second mechanism is through the government's abandonment of its governance responsibilities. When the government fails to provide basic infrastructure with previously paid tax revenue, taxpayers suffer a form of double taxation by providing such infrastructure alternatives at higher costs. The taxpayer, therefore, mentally aggregates the monetary value of previously paid but unused tax

and subsequent payments to provide for the unprovided facility. The third mechanism is governments inflating the system through unproductive debt expansions. The government's wastage, borrowing for consumption and monetary authority's ways and means [money printing] financing of the same end up creating significant inflation that is not different from direct taxes. The Nigerian governments and their political friends are guilty of these misdemeanours, which create substantial inflationary effects of financing those deliberately orchestrated inadequacies. Such an inflationary effect is interpretable as tax. The fourth mechanism is corruption which provides the base for the successful operations of the second and third.

Notwithstanding that the underground economy primarily thrives everywhere, its unduly large size in Nigeria is because our tax administrations do not have adequate data coverage of taxpayers. Those operating in the shadow economy abhor detecting their incomes and do everything possible to avoid declaring it. They succeed because tax administrations' taxpayer databases are not substantially matched with other databases to provide the much-needed insights into their incomes. The data acquisition process is also frustratingly sluggish. The question has always been, how have INEC's electoral voter database, customs and immigration database, school pupil's guardian database, the national identity number database, real estate property ownership database, motor registration database, and banks' customer databases helped uncover

hidden business operations? How much has the Joint Tax Board worked with tax administrations at other subnational levels to take advantage of adequately integrated and matched databases created from the aforementioned taxpayer data hubs? Reliance on financial inclusion as a way to tax the cash economy may never yield the size of the outcomes we expect unless we combine the same with sophisticated database intelligence.

Let us be frank. As much as we realize the urgency in drastically reducing the size of the underground economy, it is not as easy as merely having tax administrations put in place robust and well-integrated databases. Yet it must be done. But it must be accompanied by other equally essential desiderata such as inter-agency collaboration, an effective justice system and the rule of law, and the rejigging of our social norms of corruption and cronyism to shallow levels. Tax administrations cannot effectively deal with our porous borders and the attendant smuggling. Agencies such as the police, the customs, and the immigration services working together are best able to reduce the size of this underground activity. Similarly, the justice system and the rule of law are better able to prevent fraud and corruption, which are pillars for the growth and strength of illegal activity components of the shadow economy. Despite these apparent challenges, without proactively slowing down the rapid expansion of the underground economy, our government's finances would continue to grapple with deficits and unwarranted borrowing.

What are the ways forward? Six approaches can be suggested based on the ongoing discourse. The first is to relax some business regulations that push entrepreneurs into hiding. Regulations are like a two-edged sword that can save a life or result in death depending on their usage. It is the core duty of the tax administration to identify such regulations that aggravate the uncompetitiveness of businesses and help ensure that they are corrected, as not doing so affects compliance and the expansion of the hidden economy. Secondly, tax policies must be sensitive to the socio-economic conditions of the taxpayers or else they would find many ingenious ways of evading compliance. Many subnational governments seemingly turn their faces away when some private task forces collect unapproved levies through coercion from marketers, commercial vehicle owners, and other entrepreneurs, further adding to a range of legitimately collected levies and taxes. Such reprehensible government behaviour is abundant and only helps promote the shadow economy. The third is that all subnational governments must do everything to create a friendly business environment. The better the ease of doing business, the more likely taxpayer compliance is. Fourth, database interconnectivity and matching, as already described, is critical. Fifth is that government agencies must work together to curtail the quantum of illegal economic transactions such as smuggling and fraud. Finally, prioritizing the effective justice system and the rule of law is the most powerful key to unlocking hidden economies.