

STATES & LOCAL FINANCE



The IGR Initiative

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IN PROVIDING FAVOURABLE deviations from the extant and the general operational tax policies, governments usually expect specific actions or investments in return from the benefiting taxpayers. Theoretically speaking, the idea of tax incentives is sometimes comparable to price discounts aimed at spurring more than proportional quantity demand increases. Yet, it is deployable by governments to achieve more than mere transactional expansion or increased compliance. Tax incentives as a central tax policy tool play fundamental roles in managing negative externalities. Most governments provide tax incentives in line with their developmental priorities and to correct short-term economic maladjustments. In Nigeria, at least five anticipated impact areas dominate the design of tax incentives. These include the facilitation of business formation and entrepreneurial growth, increase in employment opportunities, the attraction of foreign investments, compensation for inadequate infrastructure and promotion of exports. The Nigerian ten-year road infrastructure tax credit [RITC] scheme is a good example. The scheme encourages companies able and willing to undertake road infrastructure construction and maintenance to do so as they can recover the entire construction and road maintenance costs as tax credits over an agreed time. To encourage new business formation, newly registered businesses in Nigeria now enjoy an eighteen-month tax holiday. For instance, pioneer status incentives in the ICT sector include a three-year tax holiday from the initial stage and the non-deduction of a 10% withholding tax from shareholders' dividends.

COVID-19 pandemic triggered a festival of tax waivers and discounts from several state governments. The objective was to reduce the financial burden on taxpayers during the pandemic up till 2021 in many cases. Reliefs granted taxpayers covered most areas where state and local governments have tax collection jurisdictions. Examples include the Pay As You Earn, all other forms of personal income, direct taxes, capital gains tax, property taxes, land registration and certificates of occupancy fees. But beyond the COVID-19 tax incentives are a range of relief windows that sub nationals can utilize for the benefit of taxpayers. These cover tax credits allowable against taxes payable on income derived from abroad, consolidated relief allowance, tax exemption where income is less than N30,000.00, and conditional exemptions of dividends from tax, among others.

Although policymakers in sub-Saharan Africa often mainstream tax incentives as critical to business success, many studies disprove it. Investment decisions in

sub-Saharan Africa may not have much to do with government tax incentives. Of course, there is absolutely no doubt that entrepreneurs in Nigeria would rate such factors as access to finance, electricity, good roads, access to foreign exchange and favourable exchange rates far more in importance than tax incentives. They would prefer that the government prudently spends collected taxes to provide these public goods rather than their efforts to compensate for their absence through tax incentives. But Nigerian government, through the Nigerian Investment Promotion Council and the Federal Inland Revenue Service, has unleashed a large stream of tax incentives in recent years to promote private investment. Consequently, the government deliberately forfeit critically needed financial resources that it ought to deploy to create the right environment for improved entrepreneurial activities in the delusive thinking that such large-scale revenue losses would spur positive investment responses. It does not also appear as though these government agencies have conducted rigorous cost-benefit and sensitivity analyses to support the faith placed in the capacity of tax incentives to drive enhanced economic growth prospects.

There are at least three criteria for determining the desirability of tax incentives and their design. The first is the goal effectiveness criterion which presupposes that a tax incentive must be consistent with the country's developmental priorities. Let us assume that entrepreneurial profitability and attendant growth in employment represent such priorities and expected economic outcomes. Therefore, a prospective tax incentive would only make sense if these 'economic priority representations' are positively sensitive [elastic] to the tax incentive stimuli. For instance, reducing the tax rate should ideally trigger a more than proportionate increase in entrepreneurial profitability and employment. The second criterion is the size of net benefits, which should exceed a prior established performance threshold. The two suppositions in this criterion are determining future costs and benefits of implementing a tax incentive and comparing the resulting net benefits against a pre-defined performance threshold. Needless to reiterate, there is no need to design and implement proposed tax incentives that do not satisfy this condition. Again, Nigerian tax authorities rarely consider this criterion in their tax incentives design and launch. The third criterion is tracking and monitoring effectiveness. A good tax incentive must have a clear and measurable goal implying that there must be a logical link between the tax incentives and the desired economic outcomes. Again, there must be clearly defined performance indicators to

Who cares about tax incentives?



gauge how well the tax incentives facilitate achieving those desired economic outcomes.

We can test the engagements of these three criteria in the recent avalanche of tax incentives by many subnational governments in response to the effect of the COVID-19 pandemic on businesses. These relief measures seem to have substantially satisfied the goal effectiveness criteria. The primary objective and the expected economic outcome was to reduce the cost of doing business during the pandemic. However, virtually all the state governments failed to satisfy the second and third desiderata to implement tax incentives. To date, no subnational government claims to have any information on the responsiveness of business prosperity before or after the launch and implementation of the COVID-19 tax relief measures. None also put in place any parameters for gauging the success of the tax policy changes on the expected economic outcomes. The state government also did not monitor and track the performance of these relief measures.

While tax incentives may have further supported the growth of Asian and European economies and upheld by policymakers as a magic wand for stimulating consumption and entrepreneurial activities, such promises are hardly the reality in Nigeria. Tax incentives often create several windows for abusive avoidance schemes. A good example is the mutation of domestic firms into foreign investors, where the goal of the tax incentive is to promote such. Similarly, existing firms may transition into new entities to qualify for such incentives as tax holidays. But it is not only the taxpayers who abuse these incentives. Corruption prone governments may leverage this window to obfuscate fiscal records further. An undocumented survey of several tax administrations in Nigeria revealed that they could not determine how much their governments spent or lost on the recently retired COVID-19 tax relief to businesses.

Again, many thriving businesses in Nigeria already factor in highly challenging environments such as poor electricity supply, logistics, distributional infrastructure, and foreign-exchange supply difficulties in their operating models. Therefore, tax incentives are unlikely to improve their viability

significantly. Consequently, such tax incentives only burgeon the actual revenue costs to the government. Unfortunately, the government must offset these inefficient revenue forfeitures with fiscal adjustments, either as increased taxes from other sources, public sector borrowing or the sacrifice of critical spending on public goods. Furthermore, by diverting administrative resources from revenue collection, tax incentives, when not stimulating entrepreneurial growth as desired, depletes the revenue per unit of resource costs to tax administrations. Worse still, when it is preferential and selective, such incentives quickly undermine compliance by creating a sense of inequity and discrimination against taxpayers.

Let us review three of the many tax incentives cases of abuse. The first is when domestic firms restructure as foreign investors. Often, tax incentives are the only element in the portfolio of fiscal incentives targeting foreign investors. For instance, some state governments offer free or subsidized land in designated industrial areas in addition to tax holidays for foreign investors willing to set up their manufacturing concerns in the state. In some reported instances, existing firms register a similar operation as a shelf company overseas. They package the newly registered overseas company to acquire the domestic one while using same to negotiate with the government as a foreign investor. Once the deal is signed, the domestic company transfers some of its nonfunctional assets to the new location, construct a few blocks of buildings, and finally secures the free land offered by the government. Another abusive format is for existing firms to transition into new entities to qualify for tax incentives. One good example is with the eighteen-month tax holidays for new firms. Assume that a company named Jay limited registers with the corporate affairs commission and automatically qualifies for an eighteen-month tax holiday. Upon the expiration of the tax holiday of eighteen months, the company can register a new company with the name Jayx limited without altering its logo and physical address, which means that customers will not know that it is a new company in the eyes of the law. With this tax avoidance strategy, the business in question can continue to enjoy an

other round of eighteen-month tax holidays as long as it can register as a new operation. Burying non-qualifying activities into qualifying activities is also a popular way of abusing tax incentives. Let us consider a hypothetical situation where maize growers receive tax relief to boost maize production. A company primarily involved in Maize farming can use it to disguise its importation of maize and would receive unapproved tax exemption in its reports.

The legislature can play a critical role in helping sub-national governments make the most out of their tax incentives by pressuring tax administrations to effectively track, monitor, and report progress on the target goal. Significant success in this respect will require the legislature to embark on a regular rigorous examination of incentive targets, processes, costs, and outcomes. But none of these deliverables is assessable without consciously collecting data about them. Legislators, therefore, have a duty to mandate tax administrations to keep all relevant data for tax incentive targets, costs, and outcomes. They may also set up legislative hearing activities on these evaluations.

These analyses are not to play down the effectiveness of tax incentives in driving economic prosperity. Abundant evidence shows that policymakers in developed countries take maximum advantage of tax incentives' capacity to elicit taxpayer compliance and drive far-reaching target outcomes. These successes remain possible in environments with adequate compliance with the required conditions for tax incentive design and implementation effectiveness. On the contrary, tax incentives in sub-Saharan Africa have not satisfactorily delivered on desirable outcomes. Instead, it has created windows for several waves of tax avoidance and incentives abuse and corruption. Therefore, tax administrations must continuously engage with the heads of sub nationals to heed the conditions that must precede the design of tax incentives if it is to be fruitful.

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