

STATES & LOCAL FINANCE



The IGR Initiative

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IN 2021, IN ONE OF THE STATES in Southeast Nigeria, most taxpayers in three local government areas paid up to N1,000 as transport fares to file tax returns between N300 and N650. This tax compliance cost experience is not unique relative to what obtains across many parts of the country, particularly at the subnational level. However, this case warranted urgent attention, which unfortunately never happened until our intervention. In fact, at many local government levels, many low-income taxpayers incur transportation costs, public relations spending, and payments to someone knowledgeable enough to explain their tax obligations and how to fulfil them that is equal to the tax amount. Unfortunately, tax administrations in the second and third-tier governments scantily pay considerable attention to this factor, which is crucial in improving tax compliance and IGR expansion.

Tax compliance costs, like tax returns, deplete the residual income available to taxpaying individuals and businesses. And since residual or disposable income is a reasonably good measure of available choice-making and welfare-improving capacity, tax compliance costs capable of depleting them are avoided. Rational human behaviour is pro-welfare maximization with a considerable aversion to the contrary. In economically challenging times, for instance, higher compliance costs worsen the hardship and often result in equally elevated levels of non-compliance. Many taxpayers would consider this unfair. Consider, for instance, a situation where the tax laws are complex to understand, requiring the support of paid tax professionals to explain them adequately. The additional monitoring costs and the stress and anxieties welling up in the process make it even more challenging. Such invariably leads to lower levels of compliance.

Five categories of compliance costs are identifiable. Costs incurred using external resources to facilitate compliance with tax obligations are classifiable as external compliance costs. Examples include payments to professional advisors and tax experts. It differs from the costs of time and money spent by individual taxpayers directly or in putting together relevant documents and information for use by tax professionals to comply with tax payment obligations. Usually, compliance costs, which are generally classifiable as internal, comprise costs of complying with such taxes as the Pay as You Earn or goods and services tax. Whether a compliance cost is external or internal, it will most likely be denominated as monetary/fiscal, time, or psychological costs.

While monetary costs comprise financial expenditures and other incidental costs to fulfil tax payment obligations, time costs refer majorly to the hours spent on such activities as tax record-keeping, preparation, completing and filing tax returns. Anxiety and stress regarding managing complex tax concerns and fulfilling expected obligations are classifiable as psychological costs.

Businesses and individual taxpayers have no choice regarding whether they should comply with tax laws and consequent payments. They must therefore bear the burden of compliance. The costlier the costs of complying, the more it increases the effective tax burden borne by taxpayers. Several factors influence the incurrance of compliance costs. By far, the most influential is the complexity of tax laws, including the number of such laws, frequencies of change, and the ease of understanding them. Often, tax laws become complex owing to tax administrations' efforts to prevent or minimize high levels of tax evasion and avoidance. This situation is commonplace in most state and local government tax rules and policies and contributes considerably to worsening non-compliance levels, primarily in the informal sector. The second driver is customer friendliness in internal revenue services.

Ideally, such customer focus ensures that taxpayers receive regular and proper education to understand how to correctly complete tax forms, conduct error-free self-assessment, and file returns appropriately. Customer-centric tax administrations also readily address taxpayer concerns, minimizing repeat visits and making dependable and not opaque administrative statements and suggestions. The third driver is the level of technological awareness of the taxpayer on the one hand and the digitalization of compliance processes by tax administrations on the other hand. The easier it is for taxpayers to use computers and other digital devices for self-assessment, completing e-tax forms, and e-file returns, the lower the tax compliance costs provided that the tax administrations digitalized these processes. Careful record-keeping and auditing requiring the use of experts such as bookkeeping, financial account audits and other critical documentation required for assessing compliance obligations constitute the fourth driver of the compliance burden.

The taxpayer compliance costs model is, therefore, formalized as the totality of monetary spending by taxpayers and all imputed costs of time and resources spent to fulfil their tax obligations less

Compliance costs and subnational IGR expansion



all benefits [managerial, cash flow and tax deductibility] and tax liability reductions due to planning. The subtraction of tax compliance benefits from gross compliance costs equals net compliance costs.

A substantial percentage of scholars generally believe that compliance costs are regressive. Regressivity means that the share of compliance costs decreases as the income of the taxpayer increases and vice versa. For instance, although large business organizations have higher compliance costs in absolute terms, their tax compliance costs become smaller with revenue expansions compared to smaller low-income enterprises and taxpayers. Economies of scale favouring large businesses more than smaller ones account for this regressivity. One of the fundamental weaknesses of the regressivity of tax compliance costs is the perceived violation of the principle of equity in taxation. Adam Smith suggested that a sound tax system should be fair with proportionality in the associated burden. But regressivity suggests that small and micro businesses are more likely to withstand the worst of compliance costs than larger firms, even though the latter may experience more politically inspired problems. For instance, a 2014 study by Emmanuel Eragbhe and Kennedy Prince Modugu titled "Tax Compliance Costs of Small and Medium Scale Enterprises in Nigeria" and published in the International Journal of Accounting and Taxation revealed that while smaller SMEs had an average total cost of compliance of N219,601 per annum, larger SMEs had an average of N123,047. Their work also showed that the value-added tax contributed the highest share of compliance costs at 33%.

A somewhat related 2011 study by Nihal Pitigala and Monbert Hoppe titled "Impact of Multiple Taxation and Competitiveness in Nigeria" published as Note #16 in Africa Trade Policy Notes found that average companies' pre-tax compliance costs in Nigeria were 11%, while the overall tax burden was 42%. Although the data is seriously dated, it does not appear that these findings have consid-

erably changed, particularly at subnational government levels. The findings showed that Lagos, Anambra, Enugu, and Ogun state's pre-tax compliance costs for the same period were 10%, 13%, 12% and 7%, respectively. Apart from the enormous private investment attraction disadvantages and losses relative to other countries, high tax compliance costs also incentivize bribery and unofficial payments accounting for approximately 6% of pre-tax profits.

Bribery is a particular instrument for managing burdensome compliance costs. The more onerous compliance costs become, the more the incentives to illicitly induce tax officers to reduce them, with severe implications on the size of collectable revenue. Bribing tax officers to give a wrong but favourable taxpayer assessment can provide substantial relief from multiple taxes and high tax rates. Such bribes send a misleading signal of compliance while depriving tax authorities of massive collectable amounts. A variant of this unlawful incentive is typically found with tax collection contractors, mainly where there is manual receipting of payments. Although contractors usually should legitimately receive a fraction of the collected amount, by depleting the monetary value of their tax bases for calculating the returns, they can earn far more than the legitimate fee as bribes while seriously reducing government revenue. Therefore, tax policy designs must factor in compliance cost considerations; otherwise, the government would incur substantial losses due to bribes and other forms of corruption.

Besides the bribery effects on revenue performance, compliance costs also devastate corporate profitability. Poor profitability performance constrains the size of contributions of businesses to economic growth. This situation is particularly true for small businesses. The choice to comply with tax payments means the incurrance of other costs, including financial auditing for tax purposes, efforts to understand tax rules and policies, documentation required for tax information and assess-

ment, completion and filing of tax returns and the engagement of tax professionals to ensure the legitimate minimization of the burden. Albeit not proven by either convention or research, a sound tax system should have no more than 0.1% pre-tax business profit as a tax compliance cost. The greater the percentage share of compliance costs relative to this unofficial benchmark, the less of a good tax system it is. Although newly registered businesses in Nigeria enjoy an 18-month tax holiday, most suffer early mortality due to these weighty burdens.

By eliminating or considerably minimizing tax compliance costs, substantial economic resources would be freed up and deployed in more productive entrepreneurial activity areas. The most crucial step in this process is simplifying tax rules and policies. Subnational tax administrations need to conduct requisite survey research to determine the areas in the tax rules and compliance processes that taxpayers find complex, unwieldy, and difficult to understand. Based on the research outcomes, tax authorities would implement a relevant tax simplification program. Additionally, reducing the number of rules and tax filings required for compliance is equally crucial. Secondly, future tax policy designs must adequately consider the compliance cost implications before rollout. Process digitalization [e-filing] may help reduce compliance costs. However, tax authorities must ensure that taxpayers do not encounter additional costs for learning and adapting to the new digitalized system. Solid tax education substantially reduces the learning curve and associated capital costs necessary for such technology adaptation. Another approach to minimizing tax compliance costs is the integration of the processes of business compliance within the internal processes and functions used in interacting with customers and employees. That way, it reduces the cost of outsourcing professional services necessary for compliance and internalizing the same.

Finally, the minimization of tax compliance costs may fail to optimize the goal of taxation in some instances. For instance, consider using a tax to discourage certain activities such as narcotics consumption. On the contrary, objectives such as this require compliance cost maximization. Most importantly, tax reforms focusing on managing compliance costs should pay close attention to the underlying tax objectives. In situations where the objective tilts more in favour of revenue generation rather than curbing certain activities, reducing taxation's burden becomes more imperative.

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