STATES & LOCAL FINANCE

The IGR Initiative

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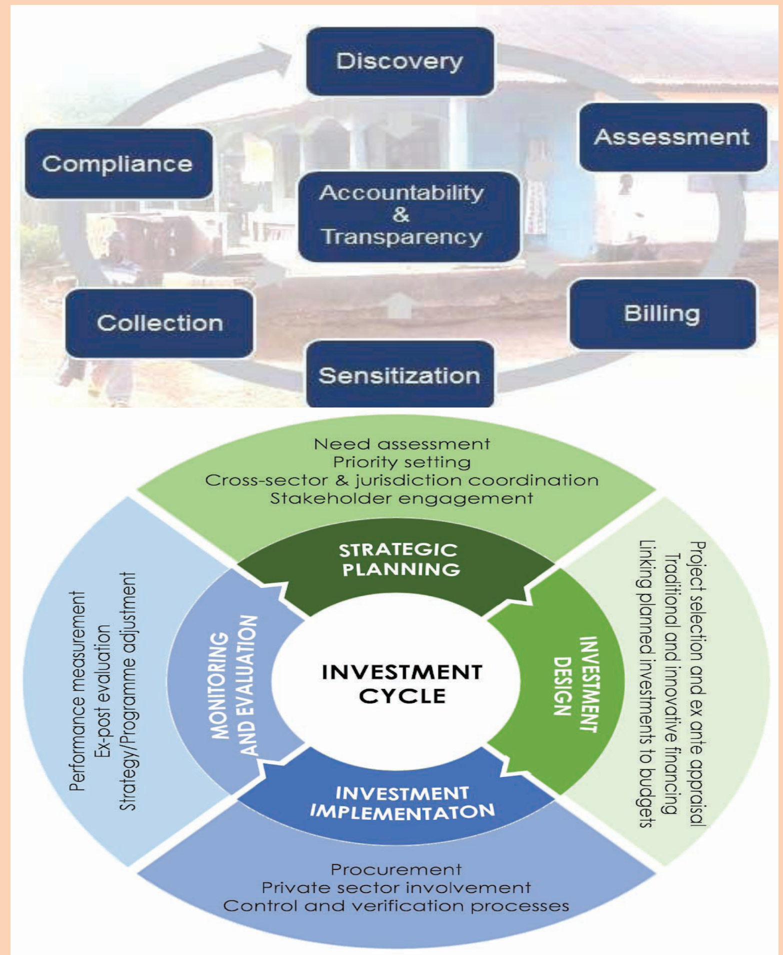
Landmines to avoid in subnational IGR expansion



FOR OBVIOUS REASONS, SUBNATIONAL GOVERNMENTS ARE OBSESSED with maximising internally generated revenue. The more, the merrier. In an overly simplified conceptualization, the thinking is that more IGR affords the government an enhanced capacity to provide good governance. But government income growth comes at various costs to the government and the citizens. The presence of trade-offs means that the government must balance available options and choices it makes to grow its revenue. Therefore, the government must simultaneously marry its concerns on increasing its revenue with simultaneously minimising the associated costs. That is the revenue optimization challenge summary: simultaneously maximising the desired objective and minimising the undesirable constraints and their effects. Subnational governments must therefore optimise the IGR expansion process by paying attention to and avoiding landmines that may attenuate the growth benefits. The critical questions are: at what point is IGR expansion harmful to the state and local government economy? Beyond what point is it no longer necessary to impose more fiscal burdens on the citizens to raise more revenue? In the absence of statutory allocation from the centre, state and local governments' paternalistic roles in providing essential public goods may mainly require changes in tax policies, such as upward reviews in tax rates and tax bases.

The effects of subnational IGR expansion are categorizable into immediate and long-run effects. The former is usually directly connected and changes almost in tandem with the expansion. A good example is the cost of collection. While sustaining continuous growth in the IGR without incurring marginal collection cost increases is virtually impossible, there must be a threshold beyond which it becomes inefficient. Subnational governments must therefore work out such optimal collection cost thresholds for various tax types, fees and levies. Sadly, this is rarely the case, as a growing convention is for state governments to allow the IRS to retain 10 percent of collected revenue to cover their costs. The weakness of this approach is that, on the one hand, it gives room for fraud where the actual costs of the collection fall far below 10 percent. On the other hand, it leads to underfunding revenue mobilisation efforts where the costs are higher than 10 percent. Collection costs cannot be uniform across states and time. Sometimes it may be higher and lower in other periods, much lower than before. A compelling collection cost optimization process would require selecting and adopting the most efficient least-cost approach from a number (between 4 and 6) of robustly designed collection strategy scenarios. Each collection scenario will have clear financial implications, logistics and functional strategy accompaniments to guide choice-making. The delineation of the collection strategy can also be spatial along senatorial district lines.

The long-run effects comprise the varied impacts of changes in applicable levies, fees and fines, licences, and the role of tax policy on government spending, tax reliefs and incentives, taxpayer income, poverty levels, service delivery and resource wastage, resource allocation and competitiveness of businesses. In practical terms, the list is much longer. Let us start with reliefs and incentives. One of the ways that subnational governments enhance citizens' compliance is usually by unrolling some tax relief and other fiscal incentives. Subnational governments must more accurately determine the optimal point beyond which such incentives result in substantial revenue losses. Sometimes, such well-intended reliefs also create opportunities for crony patronage. Corrupt public officials know too well and can assist their cronies in subverting compliance using relief and incentive windows even when the beneficiaries are not eligible. But again, such a relief and incentive window creates opportunities through which powerful interest groups also avoid tax payments, albeit legitimately.

Regardless of whether it is regressive or progressive, all taxes reduce the returns on earnings. The effects are more pronounced in indirect taxes, usually linked to production and consumption, because there is no distinction among the taxpayers based on the ability to pay. The rich and the poor pay the same amount, which is essentially unfair as those with higher purchasing power pay much lower proportionate to their income. For a country with 63 percent of its citizens multidimensionally poor, over 33 percent unemployment rate, and a 22.8 percent underemployment rate, there is a need to rein in the tax approach to IGR expansion considerably. That would help minimise the aggravation of the conditions, underscoring the grave inequality conditions. Agreed, achieving tax equity in indirect taxes can be challenging. An acceptable option is to consider the population of the poor in determining applicable tax and other non-tax rates and substantially discriminate based on the types of goods produced and consumed. Consistent with tax equity's ability-to-pay principle, commodities majorly consumed and used by the poor should attract lower rates than those majorly within the choice portfolio of the rich. This situation is similar concerning direct taxes. Reconcile some subnational governments' aggressive upward adjustments in the tax policy with the wages of citizens, particularly those in the public service, which are considerably sticky or, at best, increasing at a terrible snail rate. It is incontestable that apart from cities like Lagos, Abuja, and Port Harcourt, salary adjustments in most other states take a long while.

The most critical landmines to watch in the journey of IGR growth revolve around service delivery, good governance, and accountability. Virtually all the governors and chairpersons of local government areas recognize that earning the trust of their citizens depends considerably on the provision of good governance. Unfortunately, while many do not seem bothered, given their glaringly low performance on this factor, many deploy public deception tactics to work around it. Consider, for instance, that a state government locates an ultramodern primary school in a community with a deficient population of people of school age and a high population of the elderly. It also built a customary court in a nearby neighbourhood with a dense population of children of school age but lacking reasonable learning infrastructure. Notwithstanding that the government had provided some public utilities for these two communities, they are nevertheless a poorly optimised and colossal waste of public resources.

Fiscal programme optimisation is central to the provision of good governance. Governments must understand and base their expenditures on critical priorities and equitable balance across essential demographics such as senatorial zones, religion, and gender, depending on what matters most to the state. Such prioritisation is rarely the case, even when there is a willingness to make these provisions. Regardless of the size of spending, as long as citizens do not perceive that the government meets their needs, it becomes challenging to elicit their trust and willingness to comply with tax payments. A good example is Enugu State, with a large population of civil servants who have not received the minimum wage of N30,000. Yet, there is no functional water supply source for its citizens, particularly those in the urban areas who also spend up to N28,000 per household to have water. On average, it costs N14,000 to purchase a thousand litres of tanker-supplied water. A family of four uses at least two such supplies per month. Sadly, as it is in water provision, so is the governance failure in other areas. Most Nigerians are at home with this kind of scenario which also challenges the government's wisdom in seeking citizens' compliance in its IGR expansion expeditions.

Another area to watch is the potential of IGR expansion strategies to distort the allocation of investable resources, killing the incentives for innovation and competitiveness. Positive rate changes, the multiplicity of taxes and levies and even the manner of tax collection always affect the return on earnings. Several studies have shown that high marginal tax rates can weaken investment incentives. Suppose the tax policy odds are against some specific sectors more than others. In that case, entrepreneurs will likely shift to other industries or geographical areas (for instance, another state) with higher earnings returns. They may also considerably whittle down the scale of investments, affecting employment, output, and innovation. These demoralising investment policies substantially kill competition and competitiveness that should have driven the state to higher levels of IGR in the medium to long term. Notwithstanding that subnational governments do not collect corporate income tax, many have a multiplicity of levies and fees targeting many aspects of the corporate organisations' strategic value chain and overall existence. High personal income taxes and subnational government-orchestrated high living costs can significantly discourage work and savings even if we ignore the effect on corporate organisations. It is important to clarify that when the government fails in its responsibility to provide essential public goods, leaving the same in the hands of private providers, the costs of living inevitably go up.

Revenue forecasting upon which state and local governments base their expenditure programmes is equally a potential landmine, mainly when the estimates are problematically optimistic. A lot of subnational government budget's underperformance is attributable to such forecast errors. But that is more than where the problem lies. The government runs into unplanned deficits primarily financed through borrowing. So, progressive governments must pay adequate attention to the existing capacity for revenue forecasting to ensure that it does not run into unwarranted deficits. Economic theories speak eloquently about the crowding out effect of fiscal deficits on private investments, its inflationary consequences, and the channelling of state and local governments' scarce resources on interest payments. On the whole, chronic unplanned budget deficits resulting in equally incidental debt exposure have the potential of significantly ruining the subnational economy and subjugating the future of the state or local government in long-term debt repayment bondage.

Finally, in planning for independent revenue growth, the government must distinguish between distortionary fiscal policy changes and non-distortionary tax increases with benign effects on investment, competition, and competitiveness. The key here is to painstakingly determine the degree of impact of per unit change of the tax rate, levies and fees on different industries operating within the state and on different income categories. Such careful investigation reveals the optimization points or ceiling beyond which the government would not impose an additional fiscal burden on the citizens or their businesses. The impact of taxable assets or income increases, like the rates and levies, deserves substantial attention. Additionally, it is essential to know how much proposed fiscal policy changes affect the poor or can push more citizens below the poverty line. Ultimately, decision-makers must know when to shift from taxing income to property or consumption in a way that does not jeopardise citizens' well-being.

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