STATES & LOCAL FINANCE

The IGR Initiative

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Measuring the impact of tax policy changes on businesses and citizens

IGR PURSUITS CAN CREATE the same effects as a two-edged sword. On the one hand, they provide the firepower for good governance and citizens' well-being. Government revenue generally provides requisite funding for critical institutions to design and implement sound policies and the rule of law. They also underlie the availability of infrastructure supporting businesses and citizens' welfare. IGR expansion can lead to economic inconveniences and hardship despite these glowing benefits. In Nigeria, with a multidimensional poverty headcount ratio of about 63 percent, tax increases may worsen the country's socioeconomic condition. Apart from the adverse effects on the disposable incomes of the already poor majority, it also depletes enterprises' revenue and profitability prospects because of the leftward shift in citizens' earnings. Ultimately, with all things being equal, IGR receipts will also take a hit as the noncompliance level may increase. Subnational governments can reverse this potentially destructive vicious cycle through deliberate optimization programming. The programming prioritizes citizens' welfare maximization and fiscal burden minimization in its tax policies. But the only way to determine the extent of growth of citizens' welfare and the reduction of their fiscal burden is to measure the effect of tax policies on them. During the recent COVID-19 pandemic, many state governments unrolled several tax incentives to cushion business impacts. However, it is unclear whether any state governments based the design of their incentives on any impact analysis or whether there was a progressive assessment to gauge the degree of success of the scheme.

Considering the severe inadequacies of entrepreneurship-supporting public goods in our environment, subnational governments, in making tax policy decisions, must ensure that rates and bases do not cross the threshold where they discourage investment and business activities. Reducing business profitability and demotivating investments are inconsistent with sound tax policy in a progressive society mainly because they frustrate the creation of jobs and expansion in economic activities. Consider this actual scenario of a tax notice served to a three-month-old hospital in one of the states in southeast Nigeria. The hospital received a notice of harmonized assessment for 2023 from five agencies: the waste management agency, tourism and infrastructure development, commerce and industry, the estate internal revenue service and local government. The state IRS presented the notice requiring the three-month-old clinic to pay N140,000.00 sanitation fee, N100,000.00 infrastructure development levy, N10,000.00 renewal fee for business premises, N5,000.00 for social services stabilization and N350,000.00 as withholding tax on directors fees/personal income tax. The local government presented the clinic with N100,000.00 tenement bill, N50,000.00 for an operational permit, N10,000.00 for capitation, and N30,000.00 for radio and television licenses. Of course, it is worth emphasizing that aside from these bills, some other agencies, such as advertising management agencies, will still add to them. Unarguably, this tax notice for a three-month-old business is a considerable disincentive.

Therefore, subnational governments must consider how tax laws and policies affect business survival and prosperity. The regulatory environment component of the ease of doing business indicators measures the magnitude of the impact of these laws and government policies on entrepreneurial competitiveness. The 2021 report examined four subcomponents: paying taxes, starting a business, enforcing contracts and land, and property acquisition and development. As we already know, governments design and implement laws in these areas to generate various forms of revenue. So how they go about it considerably redefines the environment in which businesses succeed or fail. For instance, in the paying taxes indicator, which gauges the clarity of tax policies and its communication among agencies to eliminate multiple taxations, the average national performance was 5.37 points on a 10-point scale. 5.37 out of 10 points is not an impressive score by any standard and shows how much the complexity of tax policies and poor communication has affected business success. The average score on starting a business indicator, which gauges performance on the processes and requirements to satisfy before starting a business, was 5.49 on a 10-point scale. Again, this is not a good score. For instance, it takes approximately 20 days to receive a tax clearance certificate after filing. In Yobe State, achieving the same thing took about 149 days in 2021.

These insights justify the need to measure tax policies' impact on citizens' welfare and business profitability. But there are a lot more reasons. Recall the famous cliché, "what is not measured cannot be controlled". Therefore, if we are to manage whatever adverse impacts that tax policies can throw up, then we must be able to collect relevant data on them and develop appropriate models showing how they feed into business profitability prospects and citizens' welfare. We should also be able to determine the points beyond which tax policy changes and begins to create more problems. But even to develop the behavioural model, we must identify all critical variables and how they interact to create the modelled behaviour. Secondly, a robust understanding of how tax policies impact business profitability and citizens' welfare will also show the size or magnitude of impacts, how variables interact to create beneficial and adverse consequences and, generally, chain effects. For instance, it is not enough to say that increasing the tax rate would reduce the taxpayers' incomes. It would be more satisfying to know the size of the reduction in income and other parameters that are likely to be affected by the decrease in earnings. Thirdly, such knowledge is equally helpful in planning the capacity of the IRS and other revenue-generating and collecting institutions for exploiting identified IGR expansion opportunities.

Subnational governments that are keen on standing their design and implementation of tax and revenue expansion policies on their understanding of the impact on citizens and business prospects can utilise several available approaches. This essay will enumerate four such methods.

The first is reliance on published indicators such as the already discussed ease of doing business scores. The challenge with this approach is the risk of discontinuity and the chances of it not covering other areas of interest to the concerned state or local government. Before now, the World Bank produced these indicators covering subnational governments in several countries. They discontinued production after the 2018 report. In 2021, the Nigerian government developed and released the current and latest edition. Interested subnational governments can work with suitable consultants to create theirs. The advantage of creating theirs is that they can better contextualise the reports to their unique circumstances and determine and manage the reporting frequency. The more frequently they track the impact of the subnational government's IGR expansion activities and policies on the prosperity of businesses, the better they can understand the phenomena. Policymakers and implementers could appreciate changes in the trends and magnitudes better. They can deduce significant connections between these and other crucial elements, which might aid in better tuning their policies.

Another approach is to determine how sensitive the net present value [NPV] and the internal rate of return [IRR] of randomly selected businesses are to changes in the tax rates for various tax types. This approach leverages typical business viability modelling to quantify changes in business prosperity due to changes in tax policy. The investigator collects solidly developed cash flow statements projected over five years across selected target sectors for the best results. The sampling ideally should be proportional to the size of people and businesses operating in each of the target sectors and subsectors. For instance, in a state where more than 70 percent of its population works in the mining sector, it will make more sense that 70 percent of the sampled firms should also be from the industry. There should also be proportional representation across enterprise sizes: large, micro, small, and medium. Therefore, investigators will use robustly referenced financial spreadsheet models to determine firms' net present values, internal rate of returns, and the relative rates of change as tax rates charged on such businesses change. The aggregate of these changes for different sectors, industries, and the entire state economy will give a clearer picture of how tax policies generally affect business profitability and prosperity.

The third approach is the experimental method which has a powerful place in impact evaluations. In this context, the experimental impact analysis uses randomised controlled trials (RCTs) to measure the intended or unintended effects of tax policy changes on target outcomes such as citizens' standard of living and the profitability of business enterprises. RCTs are experiments randomly assigning participants [citizens and businesses] to either a treatment or control group. The treatment group complies with the tax policy changes, while the control group does not. The control group is a "counterfactual" measuring the impact of tax policies on those complying with them. The counterfactual analysis enables the consultant to attribute cause and effect between interventions and outcomes. The counterfactual analysis estimates what would have happened to citizens' well-being and business prosperity without the tax laws. And the impact is calculated by comparing counterfactual outcomes to those observed under the treatment group. It is important to note that having a control group in some circumstances might be difficult. In such cases, a non-experimental before and after effect might suffice.

One other approach is to estimate the Laffer curve. The Laffer curve suggests a relationship between tax rates and the amount of tax revenue governments collect. The theory states that when tax rates are too high, people will work less and invest less, resulting in lower tax revenue. Conversely, when tax rates are too low, people will work more and invest more, resulting in higher tax revenue. Based on this theory, the consultant or researcher can collect cross-sectional data on people's perceptions and likely responses to hypothetical tax rates. With the data, the consultant or researcher can develop a Laffer curve showing various intersection points and determine the threshold beyond which the subnational government starts losing revenue.

Finally, the way forward is that governors, local government chairpersons, and the legislature must conduct tax policy impact assessments before proceeding with any tax policy review, new policy formulation and implementation. It is hypocritical to claim to serve the citizens' interests without making policies based on a thoroughly conducted assessment of their impacts on their well-being and the prosperity of the businesses. They must also build staff capacity to regularly conduct such evaluations to guide policy formulation.

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