AN EXAMINATION OF NIGERIAN INCOME TAX INCENTIVES POLICIES: PROBLEMS AND PROSPECTS

Iya, Mohammed Alhaji*

Abstract

The current macroeconomic thinking is that the lower the number of taxes in the fiscal system the less the effect of taxation on business and individual earnings. The method applied in this research is doctrinal. The taxation of consumption rather than income may, for instance, be considered an incentive by people who believe that taxpayers find it more difficult to bear their income tax burden, or that direct taxes exert a harsher incidence on the tax base. An incentive is created when the government deliberately manipulates the tax system to the advantage of a potential taxable person, or adopts tax policies that favour the taxpayer. Tax incentives is that, it did not take cognizance of the custom, religion and culture of the taxpayers particularly on personal reliefs in respect of the number of children which it covers. The tax law ought to be amended to cover the above mentioned lacuna. In spite of the forcefulness of the argument of critics of benign taxation, tax incentives remain a popular means of mobilising and allocating resources, and of stabilising the effects of market forces on production and consumption. What is therefore required is that, governments must forge a coherent mechanism for designing and monitoring the package of incentives. In designing tax incentive, some factors may be considered: sensitivity, long term, monetary balancing, investment incentive etc.

Keywords: Incentive; Income; Finance; Government; Monetary; Tax.

1. Introduction

Applied to taxation, the term 'incentive' is both generic and contentious. It encompasses all the measures adopted by government to motivate taxpayers to respond favourably to their tax obligations. It includes adjustments to tax policy aimed at lessening the effects of taxation on an industry, a group of persons or the provision of certain services. Such measures may subsume the adoption of benign low tax rates; the effective dissemination of fiscal information by tax authorities; or the non-imposition of taxes at all! The taxation of consumption rather than income may, for instance, be considered an incentive by people who believe that taxpayers find it more difficult to bear their income tax burden, or that direct taxes exert a harsher incidence on the tax base. In short, an incentive is created when the

* LL.B, BL, LL.M, M.Sc, FIFIA, FEC, FFC, Department of Shariah and Civil Law, Yobe State University, Damaturu, Yobe State, faisaliyaj@gmail.com, 08033729719.

government deliberately manipulates the tax system to the advantage of a potential taxable person, or adopts tax policies that favour the taxpayer.

2. Nature and Types of Tax Incentives

Yet it can be asserted that it is the following measures that are commonly referred to as tax incentives in current public finance discourse:

i. tax holidays;
ii. reliefs and allowances;
iii. tax credits;
iv. deferments and write-offs
v. low tax rates;
vi. exemptions; and
vii. tax cuts or tariff reduction.

2.1 Tax Holidays, Reliefs and Allowances

For instance, any organization that enjoys a pioneer status as provided by the Industrial, Development (Income Tax Relief) Act is granted a tax holiday during which its income and holders' dividends will be tax-free. Reliefs are usually short-run fiscal measures and may be in the form of lower taxes or increase in allowances.

In the fiscal budget of 1996, the Federal Government of Nigeria increased children's allowance to N1,500 per child, raised tax-free allowance to N10,000 and also excluded from the tax net profits of companies providing services to manufacturers of export goods, among other incentives.

2.2 Reduction in the number of effective Taxes

Current macroeconomic thinking is that the lower the number of taxes in the fiscal system the less the effect of taxation on business and individual earnings. Consequently, a reduction in the number of effective taxes is considered an incentive. In the same vain, the granting of tax credit, which is usually set off against a taxpayer's liability, serves as incentive since it helps reduce the cost of financing business investment.

2.3 Tax Credits

In the Nigerian Value Added Tax (VAT) system, for instance, exports are zero-rated and exporters as well as producers of export goods are entitled to a refund of their input tax.[1] The revised (1991) Memorandum of Understanding (MOU) between the Nigerian government and oil-producing companies provides for an offset against the companies' Petroleum Profit

[1] Section 17 VAT Act, 1993 (as amended in 1996 No 31 and in 1998 No.18).

Tax (PPT) liability in the form of an addition bonus when addition to oil and condensate exceeds production for that year.[2]

2.4 Tax Deferments, Write-offs

Due to cultural, political, economic or humanitarian factors, certain potential taxable persons or income earners or items may be exempted from tax; for example, schools, non-profit-making organisation and religious bodies are exempted from income tax in nearly all countries including Nigeria.[3]

2.5 Low Tax Rates

Finally, in a democracy tax cuts are commonly turned into a political football in parliaments and in the market of public Opinion, the press. When rate cuts are administered on high-rate mass-market taxes or presumably punitive levies, they can have a dramatic effect on prices and consumption but when the affected taxes are already Ineffective, rate cuts are practically otiose.

3. Attractions under the Tax Incentives Measures

Most nations acknowledge the need for tax inclusive; and the provision of incentives appears as recurrent variables in most tax reforms in both developed and developing economies. Indeed, what Adam Smith designates as the four canons of taxation - equity, certainty, convenience and administrative efficiency which are not just the qualities of a good tax system but the goals of incentives without which a fiscal system may be both unproductive and punitive.[4]

The adoption of an incentive including tax cuts and the imposition of little or no tax on income from dividends and interest may well be a matter of social, political or cultural influences. Besides the claim that the provision of incentives enhances the workings of taxation as Smith has implicitly proclaimed, there are currently a welter of possible reasons for incentives in all countries.

3.1 Social Development

Depending on the goals of government, a tax incentive can be introduced to increase the level of employment through the encouragement of the growth of industries and commerce. A long-run attraction of incentives is that they can even be used to promote literacy by, for instance, exempting educational materials from tax as in the Nigerian VAT system.[5]

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[2] Section 56 PPTA 1990.

[3] See sections 19, 33 and 3" Schedule of PITA 1993.

[4] Adam Smith; Wealth of Nations (Published 1914) Sweet & Maxwell, London pp.1-30.

[5] Section 3 VAT Act 1993

3.2 Investment

Tax incentives can be used to induce investment and widen the profit margins of companies through a reduction in various tax liabilities. The Nigerian government granted an investment allowance of 15% for the replacement of worn-out plants and machinery with effect from January 1996e. This is one way of manipulating the tax system to stimulate economic growth by reducing the cost of financing business operations.

3.3 Special Sectors

Where government is desirous of stimulating the growth of certain industries, it can grant selective tax incentives to investors in such areas. For instance, the Nigerian government provided tax holiday of three years to investors in the mining of solid minerals all in an attempt to diversify the nation's natural resources production.[6] Investors in Nigeria's oil and gas downstream sector enjoy a three-year tax holiday beginning from the date of commencement of operations.[7] Similarly, having found that it has not been a significant computer-manufacturing nation, Australia introduced in 1995 some key incentives to attract the siting of the regional headquarters of multinational computer companies in the country. The inducements include exemption of computer equipment from sales tax; and the deductibility of start-up capital in the taxation of such companies.[8]

3.4 Tax Revenue

The fiscal productivity of government tax effort can be enhanced through the provision of tax incentives that will improve the response of the tax base. This is achievable in two ways. One, incentives such as tax cuts can induce taxpayers to be more tax compliant by making tax evasion and avoidance unattractive. Two, incentives such as capital allowances, relief and low tax rates or the non-taxation of dividends and interest on deposits and loans, can spur people to capital formation, thus encouraging the growth of enterprises and the tax base.

The tax history of the United States illustrates the effects of incentives on tax revenue. Under President Hoover, the US slashed tax rates five times in the 1920s.[9] Rather than contract government revenue, the measure raised the number of effective taxpayers and tripled tax receipts. Similarly, President, F. Kennedy's tax cuts which started in 1962 contributed so much to enhancing the level of industrial and commercial activities that, as some tax experts have said, federal tax revenue rose by about 50% from the pre-tax-cut[10]

[6] The 1995 Fiscal Budget Statement of Federal Republic of Nigeria.
[7] Ibid.
[8] The Australian Finance Gazette, 1995.
[9] President Hoover 1920 Tax Reforms (U.S.A white paper 1920).
[10] U.S.A Income Tax Bill of 1962.

3.5 Inflation

Tax incentives are potent weapons in sustaining the purchasing power of consumers in an inflationary economy. This explains why the devaluation of the CFA Franc about three years ago prompted tax cuts, the granting of tax holidays and widespread tax reductions in Francophone West Africa.[11] In Togo, import duties on educational materials and petroleum products were slashed 50% and the turnover tax abolished.[12] In Senegal, the five-rate VAT was reformed through a reduction in the number of rates; while in Cote d'ivoire the standard VAT rate was reduced from 25% to 20% and the 30% VAT on luxury items scrapped.[13]

Where high tax rates are identified as contributive to general inflation, a reduction in taxes can have a spiral of effects. The introduction of a high-rate VAT to Ghana in 1995 instigated a widespread hike in prices that government attempted to tackle by reducing the tax rate from 17.5% to 15% (although that did not solve all the country's VAT-induced problems).[14]

3.6 Production and Consumption

In addition to promoting inflation, punitive taxes and high tax rates act as disincentive to production and consumption, thus reducing the speed of economic growth. It is this assumption that has driven the Nigerian government to continue to adjust the bands on the rates of personal and corporate taxes, and also to reduce import duties of many export-oriented raw materials.[15] Where a country runs a progressive tax system, the tendency is that, taxes could discourage people from aspiring to work more or produce additional units of goods and services. The higher the marginal tax on extra earnings, the greater the need to stimulate production and consumption through tax incentives. On the personal taxation level, the thinking is that lower tax will increase disposable income and raise the volume of consumption and savings, thus providing resources for capital formation. On the corporate taxation level, low company taxes and a reduction in, say, import duties on imported raw materials or mass market goods can stimulate domestic demand and promote economic growth.

In the 1996/97 budget, Malawi pursued economic growth through massive tax cuts. and reduction in excise duty on non-luxury passenger cars by 10%.21 Similarly, in 1994 Italy announced that its economic recovery programme would be based chiefly on increase in tax

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[11] The Magazine: 'African Economy' of August 12th, 2003 pp10-18.
[12] Ibid, p.14.
[13] Ibid, p.17.
[14] Ibid, p.18.
[15] See the various Federal Budget Statements from 2000-2007 respectively.

incentives which it said would boost industrial performance, create more job opportunities and cause the listing of more companies on the stock exchange.[16]

3.7 Protectionism

A nation's scale of tax incentives can be discriminatorily structured to favour certain industries or the production and consumption of certain goods to the exclusion of other industries or goods with which the favoured ones are n competitive demand. It is in this way that tax incentives can be manipulated to protect local industries or particular sectors, or to encourage the consumption or distribution of goods. The US, for instance, provides rather meagre incentives for the importation of Japanese automobile products in order to protect its vehicle manufacturing companies.[17] The 35% duty rebate granted on imports into Nigeria in August 1995 did not include items such as confectioneries, perfumes, electronics, wines and alcoholic drinks as a way of discouraging the importation of such luxury items.[18]

3.8 International Trade

Most countries employ tax incentives to strengthen their position in international trade, to stem capital flight and to attract foreign investments. A nation may grant tax concessions to its citizens and companies that operate abroad or trade with foreign countries and repatriate their incomes; for example, Nigeria's 1996 fiscal policy exempts company's foreign earnings from tax and grants a concessionary tax rate to proceeds of foreign earnings by individuals.[19] Exports are similarly less taxed by many countries including Nigeria in order to encourage participation in international trade and commerce. Tax treaties as well as the establishment of tax-free export processing tones with all the appurtenances of tax concessions and holidays are the climax of the manipulation of incentives to promote foreign trade.

4. Problems and Prospects

One serious criticism against tax incentives is that, it did not take cognizance of the custom, religion and culture of the taxpayers particularly on personal reliefs in respect of the number of children which it covers. For instance, the Personal Income Tax Act, 1993 provided reliefs and allowances to only four children.[20] In Nigeria, some religions and cultures allow the practice of polygamy where the taxpayer can have four or more wives and many children but,

[16] The 1994 Italy Economic Recovery Program.
[17] U.S.A. 2000 Federal Fiscal Budget.
[18] Nigeda Fiscal Budget 1995.
[19] Nigeria Fiscal Budget, 1996.
[20] Section 33(3) b, PITA, 1993.

the personal income tax recognized one man and one wife with only four children entitled to child allowance.[21] The tax law ought to be amended to cover the above mentioned lacuna.

Also, tax incentives are arguable to the amount of money expended on the up-bringing of a child. In the present case, the child requiring succour and nurturing may be an infant industry, a political constituency, or an income earner. In other words, the provision of tax incentives is some kind of opportunity cost: the society pays for the provision of tax incentives.

Renowned economist[22] has specified the following as the possible Cost borne by government and citizens to offer special incentives:

i. A sacrifice of revenue;
ii. Risk of uneconomic increases in wages;
iii. Administrative difficulties;
iv. Socio-political discord.

When a government cut taxes or exempts certain persons or items from tax, it contracts its own source of livelihood, finance. Yet nothing can be more pronounced in the symbiosis of government-taxpayer relations than the granting of incentives.

From the tax-payer viewpoint, the payment of any form of tax is a sacrifice towards maintaining government which in turn has the duty of, creating and maintaining public goods and services - hospitals, roads, the police, telecommunications, schools, prisons, etc. From the government angle, granting tax incentives is similarly a sort of sacrifice of revenue towards assisting taxpayers to continue to support government either financially or morally.

The logic of the sacrifice of revenue that incentives denote is that the fiscal gap will be compensated from the long - run by a growth in the tax capacity of the favoured tax base, or will be filled in the short run by revenue from other taxes, government enterprises or borrowings, or by reliance on surplus revenue in the kitty.

To fulfil his political campaign, US President, Ronald Reagan began in 1981 the implementation of what his economists called Economic Recovery Tax Act (ERTA)[23] which cut across the board for both personal and corporate tax. Reagan's defence of (ERTA) was that the programme would stimulate growth so much that taxpayers would be more productive, and, therefore, government revenue would swell. In fact, the government had calculated that the programme would so succeed that there would be surplus revenue to

[21] Ibid.
[22] Prof. Richard G. 'Government, Revenue and the Citizen'(Oxford University Press), 1998. pp23-30.
[23] Economic Recovery Tax Act, 1981.

finance its huge defence build-up and, as Senator Bill Bradley phrased it, to "balance the budget.[24]

ERTA proved to be an excellent instance of how not to provide tax incentives for it neither assisted in curing America's persistent budget deficits (indeed, deficits rose to an average of $490 billion annually) nor aided the taxpayers and the economy that had fallen into doldrums. Yet it cost the US about $800 billion in tax revenues.[25]

The truth is that where the revenue sacrifice is not adequately compensated for, tax incentives easily run governments into budget deficits especially where public revenue is dominated by taxes. For financial considerations, it is better not to cut taxes than (as the Reagan experiment in the US showed) to over-cut them.

A tax system that aspires to buoyancy may do well with a reduction in the number of nuisance levies than with a reduction in the rate or number of effective taxes. Early 1996 the highest rate of income tax in Nigeria was further reduced to 25% from 30% because the government felt the loss in revenue as a result of income tax cuts would be made up for by increasing revenue from consumption taxation. On the other hand, the abrogation of the capital transfer tax by the government, in 1996 would make no impact on tax revenue or on the level of tax compliance because, for decades, capital transfer tax had been unofficially dead.[26]

Implicit in the cost implications of tax incentives is that incentives tend to complicate the tax system, to increase the required dosage of tax effort and, therefore, to place an extra cost on tax administration. For instance, tax allowances, deductions and credits do inflict loopholes on the tax system which clever taxpayers may exploit. It may cost tax administration some extra funding to detect and investigate such practices; without additional finance, tax administration gathers the dust of inefficiency and ineffectiveness. Tax incentives can therefore widen the scope for corrupting the tax system.

It can be inferred that not all target beneficiaries of tax incentives do actually enjoy them; that is, tax incentives can easily be wasted. Tax incentives may help a company increase its profitability, but they cannot create profits for any organization. For instance, an organization that records no taxable income or that incurs no tax liability can hardly benefit from tax credits or accelerated depreciation allowance. In Nigeria, crude oil producers pay no corporate tax on their oil profit, that is, on the balance after deducting oil allowances.

[24] Times Magazine 28th November, 1981.
[25] Ibid, p.16.
[26] General Sani Abacha abrogated the Capital Transfer Tax Act 1990 in his 1996 budget broadcast.

Contractors are allowed to reimburse themselves for their capital investment and operating cost.[27] But, sure, an oil company that, for whatever reasons, produces no oil will not enjoy such tax incentives. This raises the question of equity in the provision of incentives.

By increasing the liquidity of established companies, the director of the Fiscal Affairs Department of I.M.F, Vito Tanzi, argues that tax incentives "may facilitate their development but normally, will not help very much the potential enterprises or the individuals who do not have funds for the fixed initial investment."[28] Citing a study that showed that for decades capital accumulation was not a problem to investors in South Korea in spite of the low level of capital incentives, Tanzi therefore warns nations that tax incentives can lead to inefficiency in resource allocation.

Perhaps the most obvious demerit of incentives is that they can lead to erosion of the tax base. It can even be asserted that tax incentives are chronic kind of official erosion of the statutory tax base; this poses a danger to compliance (especially on the long run) where incentives have inadvertently turned into subsidies. By carrying with them the disadvantages of tax expenditure, tax incentives can be equated to a kind of subsidy which, in many countries including Nigeria, has been identified as a source of inefficiency and unproductivity of enterprises

Moreover, not all tax incentives are solely economically motivated. A government can cut taxes or propose tax reductions in the hope of optimizing its popularity. In the run-up to his election as French President, Jacques Chirac promised to cut taxes to attract investment and ease the burden of financing the bureaucracy.[29] Realizing on assuming office that the tax problem of France is not a dearth of incentives but the existence of large-scale tax evasion, President Chirac has since backpedalled from his promise.[30] In 1980, Ronald Reagan urged the American electorate to vote for him on the grounds that he hoped to allay their tax burden and improve the quality of life through tax reductions.[31] As earlier stated, Reagan's package of tax incentives did not work.[32] This is the main ways politicians tend to reserve for tax incentives: project the attractions of an incentives-reeking tax system in order to gain political favour. To cap it, the provision of tax incentives may sometime be instigated by influential business groups whose main interest is profit accumulation.

[27] Section 12 Petroleum Profit Tax Act, 1990.
[28] Nigerian Tax News Vol.ii No.1 1996.
[29] Times magazine 6 June, 2003.
[30] Ibid, p.20.
[31] Times Magazine of 12 August, 1981.
[32] Ibid, p.24.

The grant of tax incentives can even be an imposition on government or a limitation to sovereignty. When a nation joins a common market, it subscribes to the harmonization of its fiscal policies with those of other member nations of the community. Community policy aimed at harmonizing taxes often involves a variety of tax incentives including low tax rates, tax cuts and even the non-imposition of certain taxes. The ECOWAS Treaty for instance, calls on member-states to "reduce and ultimately eliminate customs duties."[33] Similarly, the EEC Seventh Directive for VAT bars the member-countries from imposing VAT at a rate higher than 5% on works of art in order to avoid the double taxation of such items. It is the objective of GATT to remove obstacles to trade including trade-distorting taxes and tariffs. Yet it often happens that tax incentives that are thus internationally imposed on a government may not reflect the domestic needs of the particular country.

5. Conclusion and Recommendations

In spite of the forcefulness of the argument of critics of benign taxation, tax incentives remain a popular means of mobilising and allocating resources, and of stabilising the effects of market forces on production and consumption. What is therefore required is that, governments must forge a coherent mechanism for designing and monitoring the package of incentives. In designing tax incentive, the following factors may be considered:

i. **Selectivity**: Tax incentives need to be selective and targeted at a specified limited class of beneficiaries. This will reduce the tendency to misallocate resources and the cost of administering incentives.

ii. **Long-term objectives**: It may be better if tax incentives are employed to pursue mainly long-term national objectives such as the development of Nigeria's technology-based industries like iron and steel, petrochemicals. Liquefied gas project, etc. The tax deferment (VAT on imports) recently granted the new Aluminum Smelter Company of Nigeria (ALSCON), Ikot Abasi, by the Federal Government is for this reason justifiable.[34]

iii. **Monetary balancing**: Where incentives are aimed at countering the effects of inflation or at fostering capital formation, government must ensure that there is monetary discipline in terms of keeping accurate data on any financial expenditures.

iv. **Investment incentives**: For tax incentives to be effective, they should be programmed into a broader package of investment incentives which may include the provision of credit incentives, good government, efficient communications facility, etc. Tax

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[33] Article 13(1) of ECOWAS Treaty.

34 The GUARDIAN Newspaper Friday 14, 2005.

incentives will not inoculate an economy against depression where the requisite social infrastructure is lacking.

v. **Expansion of Tax base**: Governments contemplating tax cuts, reliefs and allowances will need to counter balance the possible loss of revenue with a simultaneous expansion of the base of effective taxes.

vi. **Timing**: Tax holidays, reliefs and credits should have a limited lifespan. It may be better if, ¡n designing tax policies, incentives are considered along with other elements such as the tax structure, the base, the rate, etc. The legal basis of a tax should provide for incentives. Above all, incentives may not be granted except when growth indices are prevalent when there is anticipated economic growth. Granting tax cuts or tax credits to potential foreign investors in an unstable political system will attract little or no foreign investment. On the other hand, (selective) tax reductions may be adopted to forestall an anticipated capital flight or economic depression.

vii. **Communication**: Tax authorities should not merely provide tax incentives; they should ensure that target beneficiaries are aware of the incentives and take full advantage of them. A tax payer assistance programme should be designed to help potential tax payers derive maximum benefit from incentives, especially from short-run fiscal policies.

viii. **Surveillance**: Incentives succeed where there are measures to monitor compliance and to counter evasion and avoidance or to check taxpayers who may take undue advantage of loop holes to further contract their tax liability, incentives that are found to be too costly or ineffective should be cancelled.

ix. **Low Tax Rate**: Constant adjustment to policies can create the impression that an economy is unstable. It is therefore expedient to keep taxes at low rates rather than periodically manipulate taxes to provide incentives that many potential beneficiaries may not even be aware of. If the philosophy of tax havens is anything to go by, the greatest incentives that a government can offer is to levy a very limited number of taxes at the lowest possible rates.