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Assessing the Equity and Redistributive Effects of Taxation Reforms in Nigeria

Summary of Working Paper 130 by Henry C. Edeh

Introduction

Nigeria's annual economic growth averaged 7.1 per cent in the 2000s, but the 2014–15 oil shock and Covid-19 reversed this, with growth now averaging only 0.7 per cent. Living standards have fallen as population growth has outpaced economic growth. The poverty rate has risen from 35 per cent in 2010 to 41 per cent in 2019, and inequality has only declined slightly.

Changing the structure of fiscal taxation instruments could significantly impact growth, income distribution and poverty levels. The government has made some tax reforms, amending the Personal Income Tax (PIT) Act 1993 with acts in 2004 and 2011. The 2011 Act made changes in tax rates, tax bands, minimum rate and relief allowance: the tax rate for the lowest income earners was reduced from 7 to 5 per cent in the post-2011 scheme. The high earners' rate was reduced from 25 to 24 per cent. The lowest taxable income band, previously ₦20,000, increased to ₦300,000.[1] The highest band was raised from incomes above ₦120,000 to incomes in excess of ₦3,200,000. Low earners with no taxable income previously paid a minimum of 0.5 per cent, but now pay 1 per cent. The relief allowance with separated small amounts in the old scheme is now a lump sum of ₦200,000 and 20 plus 8 per cent of income in the new scheme. More recently, the VAT rate was changed from 5 per cent in the old scheme to 7.5 per cent in a new scheme. In considering these reforms, the policy questions are:

- Did the recent changes make PIT and VAT less or more progressive?
- What are the effects of PIT and VAT policy changes on inequality and poverty levels?

Data and methodology

The main data source is the Nigeria Living Standard Survey 2018/2019 produced by the National Bureau of Statistics (NBS).

It is nationally representative, with a sample of 22,110 households. Other data sources are macro datasets (comprising administrative data published by the Federal Inland Revenue Service) and national account data from the NBS and the Central Bank of Nigeria.

The study uses the 'simulation method' in calculating PIT and VAT from income and expenditure data. This assume that the economic burden of these taxes is borne by the income earner and the consumers in line with conventional tax incidence analyses. Informality in payment of PIT and VAT was accounted for by applying the tax rules on only formal labour incomes and applying effective VAT rates on taxable purchases. To measure the progressivity and redistributive effects of PIT and VAT reforms, the study utilised the Kakwani Indices and the simple static micro simulation approach respectively.

Main findings

The study finds income tax to have been progressive in the pre-2011 scheme, but to have turned regressive in the post-2011 scheme. The pre-2011 PIT marginally reduced inequality, but increased poverty. The post-2011 PIT reduced inequality and increased poverty, but by a smaller proportion. The newly introduced lump sum relief allowance accrued more to high-income than low-income taxpayers – confirming the post-2011 scheme's regressivity and marginal redistribution. However, in a new simulated scenario where the variable part of the relief allowance is reserved only for low-income taxpayers below a predefined income threshold, entirely excluding high-income taxpayers above or equal to this threshold, the current PIT scheme becomes progressive and largely redistributive. This is similar to a second scenario where the fixed part of the relief is given to all taxpayers plus the variable part multiplied by the predefined income threshold. As a result, the variable part does not grow beyond the predefined income level. The VAT was regressive in the pre-2020 and current reform schemes. VAT marginally increased both inequality and poverty in the pre-2020 scheme. Although the post-2020 VAT scheme slightly increased inequality, it significantly increased poverty.

"On the political side, it is clear that the richest taxpayers still enjoy a high degree of discretion in deciding how to comply, often due to their political power."

1 Nigerian Naira. The official exchange rate as of 1 January 2021 was 1 US Dollar ($) = 380 Nigeria Naira (₦).

Progressivity and redistributive effects of PIT in the pre- and post-2011 schemes

The pre-2011 scheme yields a positive Kakwani Index at national and regional levels, implying a progressive income tax, where the poor pay less and the rich pay more. The post-2011 scheme results in negative Kakwani Indices at national and regional levels, implying a regressive income tax. In terms of redistribution, the pre-2011 scheme reduced inequality by 0.001, but increased the poverty headcount by an average of 0.21 per cent.

The post-2011 scheme reduced inequality by a smaller average, 0.0 per cent, and marginally increased poverty by a rough average, 0.06 per cent. The regressivity and marginal redistributive effects of the post-2011 PIT scheme are mainly attributable to the lump sum relief accruing more to high-income than low-income taxpayers. This means high-income taxpayers enjoy a lower taxable income, relative to low-income taxpayers. However, in a new simulated scenario where an eligibility criterion is used to provide the variable part of the relief allowance to 'only' low-income taxpayers below a predefined income threshold, the post-2011 PIT becomes progressive, and inequality and poverty decline by larger amounts, -0.0053 and -2.00 respectively.

Progressivity and redistributive effects of VAT in the pre- and post-2020 schemes

The pre- and post-2020 VAT schemes yielded negative Kakwani Indices at national and regional levels, implying that they are regressive. In terms of redistribution, the pre-2020 VAT scheme increased the Gini coefficient and poverty, albeit by small points at national and regional levels. The post-2020 VAT scheme slightly increased inequality,

but significantly increased poverty. The estimated effects of the current VAT scheme are slightly higher than those of the previous scheme – attributable to the VAT increase from 5 to 7.5 per cent in early 2020.

Policy implications

- A well-regulated relief allowance (excluding high-income taxpayers from its variable part) will significantly improve the progressivity and redistributive effect of the income tax scheme.
- Well-targeted higher rates for relatively high-income earners will enhance the equity and redistributive potential of income tax policy.
- Differentiated VAT rates – higher rates on luxuries and lower rates on consumable items – will help achieve better fairness and redistribution.

"Better tax reform will enhance the equity and redistribution capacity of Nigeria's tax system."

Further reading

NLSS (2018/2019) *Nigeria Living Standard Survey*, http://microdata.worldbank.org/index.php/catalog/3827

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Credits

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