

# **IMPACT OF VALUE ADDED TAX ON ECONOMIC GROWTH OF NIGERIA**

**BY**

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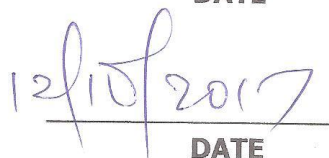
### CERTIFICATION


We certify that this project was carried out by **Nchor Edwin Ereshie** for the award of Masters Degree in Business Administration (MBA) in Financial Management Technology, School Management (SMAT) Federal University of Technology, Owerri under our supervision and guidance.

  
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## **DEDICATION**

This thesis is dedicated to my mother, **Mrs. Janeth AgboNchor** and my wife **Mrs. SarayaNchor**.

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## **ABSTRACT**

This research examined the impact of value added tax (VAT) on economic growth of Nigeria. The aim of this study is to examine the contributions of the VAT in the economic growth of Nigeria. Data used in this study was mainly from secondary source principally the Central Bank of Nigeria and the Bureau of Statistics. The study employed a time series data for a twenty year period 1995 – 2014. The data was analyzed using the regression statistical model. The model assisted in testing the statistical significance of the variables under study. At the end of the analysis, we found that VAT has positive and significant impact on economic growth in Nigeria. We also found that value added tax has a Positive impact on federally collected revenue. We thus conclude that the value added tax has influences the pattern of federal collected revenue and the economic growth of Nigeria. Based on these findings, we recommend that there is the need for policy impact assessment before tax policy is carried out in Nigeria.

**Key Words:** Value Added tax, Economic Growth, Gross Domestic Product, Economic Development, Tax Planning, Tax Exemption.



## **CHAPTER ONE**

### **INTRODUCTION**

#### **1.1 BACKGROUND OF THE STUDY**

In any country, well articulated economic policies influences a whole range of economic activities embarked upon in such country. Such policies includes fiscal policy, which refers to the raising of revenue through taxation and deciding on the level and pattern of expenditure of a country for the purpose of influencing economic activities or attaining some desirable macroeconomic goals. Such fiscal policy goal s can be used for allocation, stabilization and distribution effect of a country.

In Nigeria, the Federal Ministry of Finance has the responsibility of formulating and executing fiscal policy based on the state of the economy. In this regard, the fiscal policy goals are the gross national product (GNP), prices, employment, incomes, the exchange rate stability, the inflationary rates.

The role of fiscal policy in ensuring the securing stability and growth of an economy is of fundamental importance. Perhaps the impact of fiscal policy upon capacity output is through its effects on savings and capital stock. Capital formation raises productivity. The larger the share of incomes saved and invested, the higher the level of output. By influencing this aggregate share, fiscal policy has an important impact upon economic growth. However economic growth has its cost. When the share of incomes, which is currently used for capital formation, is increased, consumption will be reduced. The policy problem is therefore one of choosing between present and future consumption. The terms on which this choice can be made have been the subject of much controversy analysis during the past decade. Here our concern is with the immediate question of how savings and investment in the private sector are affected by fiscal measures. The effects of tax policy upon savings in the private sector matter a lot because they effect bear on the division of resources and the consumption output.

The effects of taxation refer to all the changes in the economy as a result of the tax imposition. The presence of tax distorts the pattern of production, consumption, investment, employment in the macro-economy. These distortions are collectively viewed as the effects of taxation. Here, the effects are examined on the macro-aggregate level (the economy as a whole).

The introduction of the value added tax as a fiscal tool in Nigeria came from the report of the study group set up by the federal government in 1991 to review the entire tax system. VAT was proposed and a committee was set up to carry out feasibility studies on its implementation. It however became operational in January 1994. VAT is a consumption tax imposed on certain categories of goods and service. Since is a consumption tax, it is relatively easy to administer and difficult to evade. VAT has become a major source of government revenue. VAT is believed to encourage economic growth through its positive impact on savings and investment while at the same time discourages excess consumption.

Indeed, the central problem of tax policy in developing countries is how to obtain necessary revenue while at the same time provide the basis for correcting the inequality in the distribution of income, but without interfering unduly with private savings and investment.

Economic growth has been simply defined as the increase in the economy's output overtime. The best measure is the gross national product (GNP). While development is generally thought of as involving more than a command of income, it also includes an accumulation of physical and human capital.

Nigeria operates a federal system of government, with a Federal Government, State and Local governments. In such a multilevel system, fiscal responsibilities are rested in both the central and lower level government – Federal, state and Local. This gives rise to Fiscal Federation. Okigbo (1965) refers to fiscal federalism as

the existence in one country of more than one level of government, each with different expenditure responsibilities and taxing powers. In essence, the study inquired at a macro level, the effect of value added tax (VAT) on economic development in Nigeria.

## **1.2 STATEMENT OF THE PROBLEM**

The central problem of tax policy in developing countries centre around how to obtain necessary revenue to finance growth while at the same time providing some correction for a of inequality in the distribution of income, but without interfering unduly with private savings and investment.

At the structural level, it has argued that the tax provisions do not adequately reflect the peculiar socio-economic character, goals and problems of the nation. On the other hand, at the administrative level, it is argued that the machinery and procedures followed in implementing the tax system are inadequate, and hence account for the consistent low yield of some taxes and inner group inequities. Any change in tax law is usually designed in adhoc manner and is based on expediency rather than on long-term studies. Since small taxpayers are numerous in developing countries and administrative facilities so limited, the treatment of small taxpayers required special attention.

The difficulty of imposition of taxes has led most developing countries to omit all but a few services from taxes. Administrative constraints are the main reasons why VAT that prevails in developing countries is usually very different from the broad-based and neutral tax.

The informal structure of the economy in many developing countries and the financial limitation, creates difficulty in generating reliable statistics. The lack of data prevents policy makers from assessing the potential impact of the tax system.

From the discussions above, this study seeks to provide answers to the following questions.

- Is there any relationship between values Added Tax and Gross Domestic Product.
- Is there any relationship between Value Added Tax and Federally Collected Revenue.
- Is there any relationship between a Value Added Tax, Federally Collected Revenue and Inflation in Nigeria.

### **1.3 OBJECTIVES OF THE STUDY**

The major objective of this study is to examine empirically the relationship between Value Added Tax and economic growth in Nigeria.

The objectives pursued in the study include:

- Investigation of the relationship between Valued Added Tax and Federally collected Revenue in Nigeria.
- Investigation of the relationship between Gross Domestic Product and Value Added Tax, Federally Collected Revenue and Inflation in Nigeria.

### **1.4 STATEMENT OF THE HYPOTHESES**

The following hypotheses shall form the major focus of this study.

HO<sub>1</sub> There is no relationship between Value Added Tax, Federally collected Revenue, Inflation and Gross Domestic Product

HO<sub>2</sub> There is no relationship between Value Added Tax and Economic Growth of Nigeria.

HO<sub>3</sub> There is no relationship between Value Added Tax and Federally Collected Revenue.

## **1.5 SIGNIFICANCE OF THE STUDY**

The gains of VAT to the economy need not be overemphasized. It is certain that one of the objectives of VAT is to reduce consumption so as to increase savings and investment, which leads to economic growth. The study sought to examine the effects of VAT on economic growth in Nigeria and to provide a basis for suggesting ways of minimizing the adverse effects, while consolidating on the beneficial aspect. It is hoped that the insights to be gained from this research will consequently serve as aid to future policy formulations in order to arrive at a well-articulated and optimally beneficial policy to the economy.

This research is intended not only to fill the gap of academic research in this subject, but also to serve as a basis for further research on VAT.

## **1.6 SCOPE OF THE STUDY**

The study was not restricted to any state in Nigeria in particular because of the national perspectives of the study. For effective analysis, this research covers the period 1995 – 2014. This duration captured the major periods of fiscal reforms in Nigeria and the changes in the fiscal relations in the country

## **1.7 LIMITATIONS OF THE STUDY**

In carrying out this study, the researcher anticipated a number of difficulties, which actually manifested. They include finance, inadequate information, time and the uncooperative attitude of relevant authorities and institutions these issued placed limit on the coverage of this study but did not hindered or hampered the successful completion of this work. The effective strategies we put in place ensured that these limitations were resolved in a way that we achieved our objectives.

## **1.8 ORGANIZATION OF THE STUDY**

This study is organized into five chapters. We presented the background of the study, the statement of the problem, the objectives of the study, the hypotheses, the scope and limitation in the first chapter of the study.

Chapter two is the literature review, while chapter three contains the methodology used in the study. In chapter four, we presented the data for the analysis, the analysis and the discussion of findings. Chapter five contain the summary of finding the conclusion and the recommendations of the study.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1. CONCEPTUAL FRAME WORK**

Value added tax (VAT) originated in the developed countries of Europe and Latin American. However, over the past 25 years VAT has been adopted by a vast number of developing countries. A recent IMF study concludes that VAT is an effective method to raise revenues and modernize the overall tax system – but this requires that the tax be well designed and implemented (Ebrill 2002).

The rapid rise of value added tax was the most dramatic and probably most important. The development of taxation in the later part of the twentieth century VAT was barely known outside theoretical discussions. It is a key component of the tax system in over 120 countries, raising about one-fourth of the world's tax revenue.

##### **2.1.1 WHAT IS VAT?**

According To Onuwuchekwa and Suleman (2014) Value Added Tax is a consumption tax (of a good or service) levied at each stage of the consumption (of a good or service) and borne by the final consumer of the product or service. It is a tax levied on sales or commodities at every stage of production. Its defining feature is that it credits taxes paid by the enterprise on their material inputs against the taxes they must levy on their sales. Unlike retail sales tax under which tax is collected only at the point of sales to the

final consumer, revenue is collected throughout the production process.

### **2.1.2 EVOLUTION OF VALUE ADDED TAX IN NIGERIA**

According to the Federal Inland Revenue Service (FIRS), VAT originated in Nigeria as a result of the report of a study group set up by the federal government in 1991 to review the entire tax system. According to Anyanwu (1997), based on the recommendations of the study group, the government decided to adopt the Modified Value Added Tax (MVAT) in principle with a lead period of 2 years during which necessary machinery will be set in motion for the introduction of scheme. Consequently, the government approved as follows:

- a. In order to avoid a multiplicity of tax structures, MVAT when introduced will replace sales tax in its entirety
- b. MVAT will have a single rate.
- c. MVAT will cover manufactures and importers level in respect of goods.
- d. MVAT will cover professional services excluding medical and pharmaceutical service; and
- e. MVAT legislation will pay special attention to state-federal fiscal relationship.

The preparatory action programme includes, registration of companies to be covered by MVAT, design and production of necessary forms, education of participants and preparation of relevant legislation. The federal government therefore decided to abolish the sales tax and introduced the VAT system by virtue of



decrees 102 of 1993, which took effect from first January 1994. The VAT is a consumption tax on economic operations including import except those exempted as per the provision of the degree. The system attracts a flat rate of 5% and initially covered items of good and 24 items of service. The tax is collected on behalf of the government by businesses and organizations, which have registered with the Federal Inland Revenue Services (FIRS) for VAT service. These businesses and organizations can claim credit for this tax (called input tax) when goods are sold and services rendered. VAT returns also have to be rendered monthly to the FIRS by these registered agents. The 5% VAT is also called the output tax less the input tax and is equivalent to the VAT paid by the final consumer of the product that will be collected by the government.

### **2.1.3 OBJECTIVES OF THE ADDED TAX**

- The major objectives of VAT according to Nwezeaku (2005):
- Are to eliminate or minimize the distortions to private savings and investment resulting from taxation by improving transparency and predictability and shifting its incidence towards expenditure rather income.
  - To achieve grater fiscal flexibility in order to develop expenditure that can be maintained in the tax fluctuation in oil revenue by broadening the statutory base for taxation and its effective coverage.

- To distribute the burden of taxation more evenly across different goods and services through a broader coverage to avoid multiple taxation.
- To consolidate and modernize the tax system in order to provide the base for strong revenue growth and flexible management in the economy.
- To shift taxation towards consumption rather than income.
- To reduce dependence on oil revenue.
- To develop an approach to taxing luxury on consumption relatively higher and minimizing the impact on essential goods and services consumed by the low-income group.

#### **2.1.4 SERVICES EXEMPTED**

The VAT decree as enacted in 1993 excludes government agencies and parastatals from collecting VAT for government. This is because the taxable person in section 42 has been defined to exclude "public authority acting in that capacity. By decree 31 however, government agencies and parastatals have been brought into the decree. By Decree 31 of 1996, non-resident person doing business in Nigeria are able to include VAT on their invoice. The VAT is however to be withheld by the Local Company, government agency or persons doing business with them.

All exports are zero-rated implying that exporters do not collect Vat on export but they can claim credit for VAT paid on their inputs, on the other hand, all imports are VAT able, whether raw materials or finished goods. Moreover, VAT on imports is calculated on the total cost, insurance and freight (CIP) plus

custom duties and all other charges on imported goods, amounts expressed in foreign currency are converted into naira using exchange rate adopted by the Nigeria customs service (NCS). Between January 1994 and August 1995, the Nigeria custom Service used the exchange rates prevailing on the date the goods were cleared from the port. In this connection, it is recalled that by the beginning of 1995, when the exchange rates depreciated by over 70% in the autonomous foreign exchange market (AFM), the organized private sector put enormous pressure on government to review this procedure for computing VAT liability on imports so that by August, the Nigerian Customs Service was directed to use 65% of the prevailing exchange rate on the date of clearance of imports to determine the VAT liability on all categories of imports.

#### **2.1.5 FEATURES OF THE VALUE ADDED TAX IN NIGERIA**

The following are the major features of Nigerian VAT

- Value added tax is based on consumption of vatiable goods and services. It is a tax on spending. Therefore, the tax is borne by the final consumer of goods and services
- The tax is a single rate of 5% which makes it easier to administer.
- The tax adopts the input-output tax mechanism, which makes it self-policing. Although, it is multiple tax, it is expected to have a single effect on consumer price and should not add more than specified price consumer price no matter the number of stages at which the tax is paid. In essence, it is the official view that the VAT should not be cascading what so ever since the liability of a taxable organization is the difference between VAT on output and

VAT on inputs. In other words, the credit method of collection should eliminate any cascading effects.

- The tax is collected on behalf of the government by businesses and organizations, which have registered with the Federal Inland Revenue Service (FIRS).
- Records and Accounts have to be kept. VAT was introduced to replace sales tax which had been in operation under federal government decree No. 7 of 1986 but was operated on the basis of residence. VAT returns (and payments) are normally made monthly to local VAT office on or before 14<sup>th</sup> day of the month, following that in which the supply was made. 5% VAT (called output tax) is included in the price of all goods and services supplied by registered persons.
- A business or organization which has registered for VAT is classified as a registered person. Such persons will pay 5% VAT on goods and services are supplied to reducers.
- The tax is relatively simple to administer and difficult to evade.

## **2.2 ADVANTAGES AND DISADVANTAGES OF VAT**

Nwezeaku (2015), summarized the advantages and disadvantages of Valued Added Tax as follows:

### **ADVANTAGES**

- i. VAT is a low rate tax with high yield. As a broad based tax, the wide coverage of VAT results in increased revenue for the government.
- ii. Low tax evasion rate. As a consumption tax, VAT is more difficult to evade. It is however subject to tax avoidance.

- iii. Reduction in the weight of tax/impact the tax incidence on the tax unit. The VAT system is embedded/added in the selling price and the tax burden is not felt by the consumer.
- iv. VAT rate is uniform and makes no distinction between various types of goods, although this places unprofitable businesses at a disadvantage since they will pay the same tax with profitable ones.
- v. It encourages economic growth. VAT discourages excessive consumption thereby encouraging savings, which translates to higher productivity and investments.
- vi. Flexibility: The Vat rate is more flexible than many tax systems. Here, government can take advantage of its flexibility to adjust the rate as may be desired for either an increase or decrease or stability in revenues accruing to government.

## **DISADVANTAGES**

In spite of the many advantages of VAT, there are still some disadvantages. These include:

- i. Increased paper work: Administration of VAT requires enormous paper work and adequate record keeping.
- ii. Increased administrative cost: To administer VAT, a high number of tax officials and administrative staff officials are required which increases the cost of its administration and collection. VATable persons and organization will also experience increased costs.
- iii. It is regressive: The tax burden under Vat is regressive since the uniform rate does not give any consideration to either unprofitable business or higher income bracket vatiable persons. Specifically, it results in a fall in the proportion of consumption to income.

### 2.1.7 TYPES OF VALUE ADDED TAXES

Musgrave and Musgrave (1986) contend that there are three major types of value added tax: GNP Type, income type and consumption type. In the same vein, should (1969) Identify four possible types of value added tax. They include production VAT on GNP types, income type and wage type.

- a. Production VAT or GNP type:** Here the tax base for any firm is sales minus materials other than capital goods. Only the value of non-capital purchases from the other firm is deducted such that for the economy as a whole value becomes equal to the GNP (if there is external trade).
- b. Consumption VAT:** The tax base is the sum of wages, profits and depreciation less investment. The firm is thus allowed to deduct from the gross Value of firms, but also the capital equipment purchased leaving, as remainder, consumption.
- c. Income type VAT:** This form is here is allowed to deduct the full value of its non-capital – purchases from other forms. The tax base (total sales minus materials depreciation for each firm such that from the economy as a whole, the tax base in the absence of external trade) is the NNP. They have the greatest appeal to government.
- d. Wage – Type VAT:** The firm here is allowed to deduct the net earnings from its capital in order to arrive at the tax base. If income is defined as the sum of wages, profits and interests than after the deduction of profit, interest what is left is wages hence the name, wage – type VAT. It has the least appeal.

## **2.2 ECONOMIC EFFECTS OF TAXATION**

The effects of taxation refer to all the changes in the economy consequent upon tax imposition. The presence of distortions in the patterns of production, consumption, investment, employment and other similar patterns for good or for bad and these distortions are collectively viewed as the effects of taxation.

Aboyade (1985); Due (1974); Ugo (1962); and Waweru (1980) examine the effects of taxation either generally, nationally or cross-country. Heavy direct taxation on income, especially if progressive can have serious disincentive effect on the willingness to work, since it makes overtime appear to be very much more heavily taxed than the rest of one's income. Thus, taxation can be a deterrent to work. On the other hand, indirect taxes on commodities may actually increase the desire to work in order to earn extra amount necessary to pay for these commodities.

Taxation too can act as a deterrent to savings, since it is equivalent to a reduction of incomes, though it may not always have this effect in the case of people saving for a particular purpose. Taxation of profits is regarded by some economists notably Ricardo, as taxation of enterprise and therefore likely to check inflation, may have the opposite effect, the rise in resulting from the taxes stimulating the inflationary spiral and leading to demand for wage increase.

Certain taxes on commodities, such as purchase taxes can have directional effects by reducing demand for particular commodities and therefore, their production, and so causing a diversion of economic resource from the production of the taxes goods to the production of the things. Ugo (1962), show that consumption tax induces greater saving than income tax. Furthermore, it does not distort the pattern of investment. In this respect, it creates a more favourable atmosphere for the development of new industries. However, Ugo found from empirical studies, the disincentive effect of high income tax on the supply of labour are negligible, but lamented that there is no empirical evidence in the case of the consumption tax, but assumes as being obvious that a tax cannot induce people of reduce their hours of work. In his view, the superiority of the consumption tax as a stabilizer both during a depression and inflation seems uncontested. A conclusion was reached that it seems consumption tax is more adequate for economic growth. Whoever, since analysis was partial, he considers such a conclusion, as rash.

While examining the effects of direct taxation on development in poor economics with special reference to Kenya, Wa'weru (1980) has views opposed to Ricardo (1777). David Ricardo in his work on the "principles of political economy and taxation" consistently maintained that all taxes have the effect of reducing an economy's power to accumulate the necessary growth was the entrepreneur in whatever field of economic activity. To tax a farmer is to reduce his incentive to work hard and produce food to feed the thousands



of displaced peasants now turned into an urban or rural proletariat. To tax an entrepreneur in commerce or industry is to kill his business moral. To tax worker's wage entails not only considerable personal suffering but also creating the basis for demands for the higher wages which in turn would affect the employer's capacity to save and the incentive to be more enterprising.

Wa'weru (1980), in the context of Kenya and other poor developing economics, views taxation as not politically expedient but as an engine for generating the necessary impetus for government to provide social goods, which are usually consumed by private.

According to Wa'weru, funds to government through taxation in Kenya have been effectively utilized not only in the funding of social overhead, but also in direct capital formation both in the public and private to increase private savings and the rate of capital formation. However, in the case of taxation of individuals in Kenya, there were, for example, generous concessions available to individuals who added to the loan used to acquire houses or other property, which added to the capital stock of the country. Moreover, there are concessions in the case of individuals who paid premiums for life assurance policies. These measures were in Wa'weru view, designed in Kenya to encourage savings.

Thus, Kenya's income Tax Act 1973 was a formal recognition that direct taxation plays a bigger role in securing desired modes of economic behaviour by both individuals and business enterprises. However, in the case of corporate business taxation in Kenya, there were serious problem, which mainly emanated from the incompatibility of heavy reliance on foreign companies and business was ruled out if greater inflows of foreign private capital were to be expected. These loopholes were fully exploited by foreign enterprise with tacit approval of the country's leadership.

Much of the issue above can be summarized using the framework by Due (1963) who examined the effects of taxation in terms of its impact on the following:

- a. Purchasing power effect
  - b. Tax payer behavior
  - c. Income distribution
  - d. Resource allocation and
  - e. National income.
- 
- i. **Purchasing power effect:** Personal income tax extracts purchasing power direct from individuals either before it reaches their hands or shortly after they receive it. Company income tax absorbs the funds directly from the business enterprise and the taxes reduce dividends; the final effects is much the same as the personal income tax. Sales or excise tax including VAT tends to

shift forward to the consumer and thus extract from the purchaser in the form of an addition to the prices he pays.

- ii. **Behavioural effect:** The collection of taxes on various commodities may result in modification of behaviour, by affecting the incentive for various actions. A personal income tax, for example, may alter the willingness of persons to work and thus may alter labour supply. It may lessen the willingness to undertake business development and expansion. It can trigger-off capital flight from developing countries, because some goods are made relatively more expensive compared to others. Similarly, excise duties and taxes including VAT, if applied to factor inputs, may affect choice of production techniques.
- iii. **Income Distribution Effect:** As a result if the extensive use of income taxes, the opulent are made to pay substantially more for the governmental services than are the lower income groups. The net effect is that the poor receives considerably greater real income and the wealthy receives less than would have been the case if the production of government services were in the private rather than in the public sector.
- iv. **Resource Allocation Effect:** Taxation has some effects upon the relative supply of various factors. Taxes, which penalize risky undertakings, lessen the investor's willingness to venture into such business areas. These modifications in factor supplies will affect factor prices and thus the relative output of various commodities.

The taxation system alters the saving consumption ratio and thus the relative output of consumption and capital goods. The provision of tax-funded governmental services reduces the output of goods which are substitutes for the governmental services and increases the output of goods, which are complementary to the services. For example, the NIPOST Express Mail effects the survival of private courier services; the availability of government colleges influences willingness of the voluntary agencies to provide educational services. If there is less Police services then private security guard companies would enjoy a greater boom.

- v. **National Income Effect:** Government expenditure and taxes exert some impact upon the level of national income both real and in monetary terms. This happens in two ways: (a). by altering the supply of factors and (b) by affecting the level of spending thereby extending the attainment of full employment as well as the general price level (Due: 1963) Taxes withdraw money from the circular flow of national income in just the same way as savings and imports. If the government taxes firms, part of the money received by firms is not available to be passed on to households. If the government taxes households, part of the income earned by households is not available to be passed back to firms.

Some of the taxes, however, find its way back to the circular flow of national income if the government subsequently spends it on goods and services in the form of factor services obtained from households. If on the other hand, the government refused to

spend the tax-money but simply accumulates it as a reserve against some future expected expenditure, it will remain outside the flow (Lipsey, 1972). Anyanwu (1997), examined the effects of taxation on the aggregate level, that is, the aggregate effects of taxation on the economy as a whole. He identified four principal categories of the effects, viz: effects on production and growth, effects on distribution, effect on economic stabilization, and effects on inflationary pressure.

1. Effects of taxation on production and growth may be analyzed with reference to:
  - a. Capacity to work, save and invest, and
  - b. The will to work, save and invest.

An alternative manner of analyzing these affects is to split them into:

- a. A shift in the allocation of existing productive resources and
- b. A changes in the supply of these productive resource and use them as manifestation of the capacity (and will) to work, save and invest. This latter approach is adopted.

- i. **Allocation effects of Taxes:** The government could ensure to the judicious set of indirect taxes on a selective basis for realizing a desired shift from the existing allocation e.g. selective commodity taxation taking cognizance of the elasticity of demand and supply. Goods with higher elasticity of demand (or supply) would be affected more and those with lower elasticity of demand or supply) would be affected less by a given tax rate. This is because, the allocation effects of indirect taxes.

Taxation of earnings from investment tends to reduce the supply of savings and investment in general. Government uses tax concessions and penal taxes to divert investment from low priority to high priority industries while differential taxation is used to influence the location of industries. At the same time a progressive income tax causes a shift in labour from agreeable into more agreeable employments. The allocative effect of a tax on capital depends on its form and coverage.

- ii. **Effect of taxation on supply of resources.** When savings are taxed, investors will naturally come across smaller amounts of savings and the overall level of investment will decline (unless it is counter balanced by other forces such as community or government savings). When the government taxes earnings from investment, it might become a problem for firms to raise adequate resources in the capital market.

In addition, when retained profits are taxed, firms fail to depend on their internal resources for expansion, but resort to borrowing if they can obtain such loans. Thus, the total capacity to invest is likely to decrease if retained profits are taxed. Thus, taxation must discriminate between different types of industries, taxing those in low priority and exempting or taxing highly those belonging to high priority list. Specifically, it is observed that indirect taxes on commodities reduce the purchasing power of current income; income taxes reduce savings and hence investment, expenditure

taxes are pro-savings, while capital taxes discourage savings supply.

### **Effects of taxation on distribution of income and wealth.**

Market economics are characterized by great deal of income inequalities through the institutions of private property and inheritance. Taxation has the object of reducing this income and wealth inequalities, which incidentally conflict with increasing production and economic growth objectives.

In developing nations, object poverty exists among the masses and this must be reduced. At the same time there must be adequate production and growth through which the egalitarian objectives of the government can be attained, otherwise the exercise amounts to the distribution of poverty.

However, without total political and economic revolution in a nation, a quick redistribution of income and wealth is not a possibility for it will be time-consuming just embarking on progressive income tax, wealth tax, gift tax expenditure tax etc. in this case, a proper degree of redistribution will only be a long-run thing. This emanates from the fact that the use of taxation to reduce income and wealth inequalities has a lot of limitations. Direct taxation with its progressive rate, cover only a small fraction of the population, while being susceptible to massive evasion. Indirect taxes, on the other hand, despite their selective coverage and differential rates are regressive, inflationary and thus

exacerbate inequalities. In addition, in the long run other forces may counter balance measures to reduce income inequalities.

To effectively redistribute income and wealth, taxation should be sufficiently administered step so as to practically mop off income beyond a certain height, while tax evasion should be made impossible. Steep taxes designed to reduce wealth and economic power concentration must be available and effectively implemented. In doing this, steep rates on gifts, unearned increments and capital gains will be effective since they do not act as disincentive to work, save and invest. Wealth and inheritance on the other hand, should attract mild rates so as to avoid their effects on savings as an incentive device.

### **Effect of taxation on Economic Stabilization**

To Kenyes, there is no inherent tendency for the market economy to stabilize itself, hence the need for government action particularly in the short-run. It is also in this sense that Lerner introduced the concept of functional finance where taxation and expenditure are used to correct market incompatibilities between demand and supply. Therefore, progressive taxation should be used in neutralizing the fluctuations in income, output, employment, price and the like in the economic system.

The poor, with high MPC (Marginal Propensity to Consume) should not be taxed heavily to maintain a firm base of aggregate consumption in the economic. With depression, the tax liability of



the richer sections should fall rapidly thus, leaving a relatively larger proportion of purchasing power in private hands.

### **Effects of taxation on inflationary pressure**

During inflationary periods, direct tax should increase and thus excess purchasing power is affected. Here, however, there should be selective selection of indirect taxes taking cognizance of the elasticity and high supply elasticity will not fuel the inflationary flame with increased taxation. If the reverse is the case inflationary spiral results.

In addition, luxuries should attract higher taxes than necessities; custom duties should also be manipulated appropriately to ensure the domestic economy from externally originated trade cycles (Anyanwu, 1993). Most of the issues raised above by Anyanwu have been examined by Due (1993) and others.

## **2.3 PROBLEMS OF TAX PLANNING, ADMINISTRATION AND COLLECTION IN NIGERIA**

Anyanwu (1997), opined that tax policy planning and coordination of tax administration in Nigeria involves many agencies at various levels of government. This is because the efficacy of the tax system is not just a matter of appropriate laws but depends on the efficiency and integrity of tax administration (Kaldor, 1970).

For any tax, to be administered successfully it must be appropriate to the government, the economic and social institutions in which

the tax is imposed. Thus, successful tax administration depends upon the following requisites.

- a. Acceptance by a majority of the taxpayers. Otherwise the tax will degenerate into an erratic system of collecting tribute from the powerful part of the community. There will, of course, always be a minority who are reluctant and defiant about paying taxes, and who must be dealt with and if necessary, penalized. But no government machinery can search out and penalize more than a small fraction of the community, and if tax avoidance is wholesale then government actions and institutions must of necessity breakdown.
- b. A body of workable concept beginning with the definition of what is to be taxed.
- c. Manpower-a team of human resource capable of understanding and interpretation of the tax to the taxpayers, and enforcing it without fear or favour and
- d. Adequate administrative tools including records, maps, machines etc.

It is against this background that criticism of the Nigerian tax administration has focused on two main aspects, viz: the tax structure and its administration. As the structural level, it has been argued that the tax provisions do not adequately reflect the peculiar socio-economic character, goals and problems of the nation. On the other hand, at the administrative level, it is also argued that the machinery and procedures followed in

implementing the tax system is inadequate and hence account for the consistent low yield of some taxes and intergroup inequities (Anao, 1988). Specifically, in Nigeria, tax policy planning is not clearly assigned to a specific unit, either at the ministerial level, or at the lower levels. In some cases, the so-called research units/divisions attached to the minister or to the Heads of revenue departments devote their time to solving day-to-day problems rather than to long-term studies. Moreover, the tax statistics that are collected are usually inadequate to allow a sound evaluation of the current tax arrangement notwithstanding the existing data processing capabilities in the country.

In spite of the reforms following the recommendations of the Tax Force on Tax Administration, one is still dismayed by the fact that the number of tax agencies in the country follows the pattern of our colonial heritage. For instance, customs and excise duties are administered by a separate agency-the customs services while income taxes are entrusted to another agency-the FBIR. Other revenues for example, motor vehicle licenses/taxes, land taxes, etc are left to the attention of other authorities that collect those charges as a subsidiary function. This practice calls for proper rationalization.

In terms of assessment and collection of taxes, which are undertaken together by the appropriate agencies, one must say that it promotes co-ordination between the agencies involved, thus eliminating massive tax arrears. However, its main weakness is

that it encourages dishonesty and or corruption. This implies that some methods should be used to encourage officials to be honest. Any change in tax laws is usually designed in adhoc manner and is based on expediency.

It is also important to note that the attempt of revenue departments in the country in fighting excessive centralization is, in itself, a measure of their efficiency. This is exemplified in the establishment of regional and/or state offices, in accordance with availability of staff and geographic distribution of revenue potential.

Confusion and lack of uniformity have resulted from the proliferation of taxes and tax laws. This proliferation of taxes involve different or supplementary rates and separate returns, indicate a pressing need In the country for a single code of tax laws and regulations that contains all the required information. Currently, the recruitment and retention of qualified staff members constitute serious problems in Nigerian. Low salaries, lack of training and under-staffing of many categories of staff have been major factors in creating this situation. In some cases, staff turnover is high and vacancy rate sometimes reach alarming proportions.

According to the findings of Ndekwa, (1988) vacancies account for about 35-40 percent of approved establishments of tax authorities and available evidence indicate that existing tax officials are

unduly overstretched. None of the tax authorities has a comprehensive training programme on a continuing basis for the tax personnel at all levels. Also, apart from the poor conditions of service and poor prospect of advancement, the salary scale is inadequate (especially under conditions of galloping Inflation) to attract highly qualified and relevant tax personnel. Thus, vacancies continue to occur as a result of resignations arising largely from frustration and lack of job satisfaction and motivation. Physical facilities in Nigeria are inadequate and not conducive to efficient working conditions, staff morale, or taxpayers, respect for the tax service. In addition, equipment is often not readily available, and shortages of calculators, motor vehicles and stationary have created frequent delays in operations. It is not therefore surprising that it was found that tax departments which provide about 90 percent of the recurrent revenue to finance government services and supplies development projects and programmes are grossly ill equipped for their operations, not only in terms of the number and quality of tax personnel employed but also in terms of accommodation, furnishing, budgetary allocations, equipment and vehicles.

There are severe difficulties in identifying and locating Individual taxpayers in Nigeria. In most cases, there are considerable differences between the number of taxpayers registered by tax departments and the number of persons with business licenses issued by other public agencies. The existence of tax arrears is also a sure sign of the ineffectiveness of the tax administration.

Noncompliance of public enterprise, for Instance, has been widely tolerated and has often been justified by the existence of unpaid government debts. This situation calls for appropriate procedures.

The tax clearance certificates demanded by the authorities on certain occasions, though helpful in some respects, have been inefficiently executed and are characterized by delays and inconveniences in obtaining them, owing to the inability of the tax administration to perform the necessary checks within a reasonable time, quite apart from encouraging and institutionalizing corruption and forgeries. This situation should be reviewed since it tends to generate considerable ill-will on the taxpayers part.

In Nigeria, the litigation system is not always organized for an effective and speedy disposal of tax cases. The administrative review process is not properly developed. Furthermore, defective drafting of tax laws is room for to frivolous objections by taxpayers, which has been justified on the grounds that it provides protection for taxpayers against arbitrary administration, creates an unwieldy system due to local prejudices and domination by local cliques. It is recognized that tax statistics provide basic data for the formulation of economic and fiscal policies. They are also an important tool for managing the revenue departments. However, in Nigeria, the statistics collected, both at the local state and national levels, are generally inadequate, and in many cases unreliable and inconsistent. They are also not fully utilized when

they are available. In addition, such statistics are not conceived together with research, planning, programming, while the collection process is usually rather slow. It is not reviewed frequently with a view to deciding whether changes are needed. On the question of taxpayer education, the low level of literacy, the technical nature of tax procedures, and the lack of trained staff constitute major difficulties in establishing the desired level of efficiency in tax administration in Nigeria.

Corruption and dishonesty have been a danger to tax departments in Nigeria. Poor salaries, lack of adequate internal auditing, poor supervision and disciplinary measures are principal factors in enhancing efficiency.

We must emphasize that the tax policy till date, in Nigeria, has been used largely to generate maximum revenue for the government in contrast to either optimally allocate resources or redistribute income is yet to be emphasized. It is not surprising therefore, that each tax authority in the country has concentrated on the manipulation of the tax rates and tax base than on the improvement of tax administration in spite of the several recommendations of statutory bodies and economists on the matter.

There is abundant evidence to show the existence of large-scale tax evasion arising from weak tax administration in the country. Such tax evasion takes the form of income under-declaration, refusal to complete tax return forms, illegal bunkering, smuggling,

fraud, inflation of deductible expenses etc. Effective tax collecting machinery presupposes, among other things, that proper and correct tax assessment has been effected. A major cause of incorrect assessment is tax evasion; and unless and until it has been minimized or eliminated, the tax administration will continue to leave much to be desired. Tax evasion is an attempt to escape tax liability (wholly or partially) by breaking the tax law. It is essentially a criminal act since it is achieved principally by making false declarations such as underreporting income or over-reporting reliefs and allowances. It is important to distinguish tax evasion from tax avoidance. The latter is an attempt to escape tax liability by circumventing the law not by breaking it. Thus, even though the tax evader and the tax avoider have a similar objective (namely to escape tax liability), their means to the end differ. The tax evader is a criminal, but the tax avoider is just a smart taxpayer who exploits loopholes in the tax laws (and related laws) to reduce his tax liability.

It is clear from the above comparison that not much can be done by the tax administration about tax avoidance as long as the law continues to provide various loopholes for the smart taxpayer to exploit. Indeed, the tax administration by and large is not to blame for successful tax avoidance by contrast; tax evasion is due principally to administrative ineffectiveness. One of the ultimate tests of administrative effectiveness therefore is to know the extent to which the tax administration can prevent tax evasion. An understanding of the determinants of tax evasion is therefore



necessary for formulating and implementing an effective counter-evasion policy. Failure on the part of receiving agents and employees of relevant tax department to pay in the actual amount of tax collected into the treasury as required by the represent a worrying feature of tax collections in Nigeria. Oftentimes, money collected is not paid in at all.

There is currently no adequate machinery for effective remittance of dividends and rents to the relevant tax authority especially as the exercise involves numerous persons in each of the thirty-six states of the country. The concentration of the responsibility of tax assessment and its revision on the same tax officials creates room for abuse of office and corruption, thus rendering tax administration ineffective. Another serious problem affecting taxation in Nigeria is the hostility of taxpayers to tax collectors. Oftentimes, questions as to what taxpayers money is been used for is asked tax collector. This is because the taxpayers expect that the government ought to provide social goods from tax revenue collected. When government on its part fails to provide these social goods, taxpayers become either reluctant or discouraged to pay their taxes. It has been noted that taxpayers' anger are visited on tax collectors. The major activities in VAT administration are identifying taxpayers, processing returns, controlling collections, making refunds, avoiding taxpayers and levying penalties. On the part of administration, it is a prior task to identify the taxpayers. In this connection, preparation of a single master file, based on unique tax identification number (Tin) is crucial and this ensures

that each taxpayer's account contains all the relevant tax and payment for the taxpayer alone. On account of the requirements of VAT, the even functioning of VAT perilously depends upon complete records. To minimize the likely amount of high compliance costs, however, sellers are expected to maintain sufficient details to have information on the following aspects. These include particulars of invoices, giving details of tax on sales and credit on purchases, details of accounts giving information of all purchases and sales and interaction between invoices, purchases and sales accounts with the taxation return form.

The other part of VAT administration is assessment on VAT execution. This includes identifying taxpayers and tax evaders as well as the registered and unregistered taxpayers among the business community. It follows that the concerned tax authorities would take legal measures against people who do not comply with the VAT law, for example, on those who conceal invoices and engage in illicit business transactions. It is not only the authorities who should be responsible in the assessment of VAT but the consumers themselves have a key role to play.

The human resources element is essential in VAT administration. Training personnel very low in most developing economics and this has forced them, for instance to organize their VAT activities under existing tax administrative structures. Consumers need to make sure that businesses that levy the tax are registered with the VAT administration as evidenced by a registration certificate which is

expected to be posted visibly on the establishments premises. They should receive receipt for the goods and services they purchased and also ensure that the receipt clearly indicates the VAT registration number and the taxable items.

They key decisions that must be made before introducing a VAT, relate to the choice of organization to administer the tax and the organizational changes required. Nearly all developing countries that apply a VAT through retail stages have assigned its administration to the same organization that administer income taxation, which usually also administered the taxes that the VAT replaced.

Weak tax administration stems from a number of factors: overly complex and outdated tax laws and procedures, weak or outdated operating and management information systems, poorly trained staff, low remuneration packages for the civil service poor infrastructure and equipment, corruption and political interference in tax administration and fiscal fraud. Poor revenue from tax can be characterized as being low amounts of tax revenue as a result of low amounts of per capital income, the subsistence nature of their economy poorly structured tax systems and weak tax administration.

Firstly, most workers in these countries are typically employed in agriculture or in small, informal enterprises and this means the possibility of regular or fixed wages is rare as they receive cash

payments (i.e off the books) that further mean difficulty to calculate the base for an income tax. Related to this, most of the workers do not make transactions in large stores. The role played by income taxes and consumer taxes is limited and creates little possibility for the government to achieve high tax levels. Secondly, it is difficult to create an efficient tax administration without well trained staff, when money is lacking to pay good wages to tax officials and to computerize the operation (or even to provide efficient telephone and mail services), and when taxpayers have limited ability to keep accounting records. Thirdly, informal economic structures in many developing countries and finance limitations, statistical and tax offices create difficulty in generating reliable statistics.

This lack of data prevents policy makers from assessing the potential impact of major changes to the tax system. As a result, marginal changes are often preferred over major structural changes, even when the latter are clearly preferable. This perpetuates inefficient tax structures. Finally, income tends to be unevenly distributed in developing countries. Although raising high tax revenue in this situation ideally calls for the rich to be taxed more heavily than the poor, the economic and political power of rich taxpayers often allows them to prevent fiscal reforms that would increase their tax burdens. This explains personal income and property taxes and why their tax system rarely achieves satisfactory levels progressively (in other words where the rich pay proportionally more taxes). The whole tax system is faced with

such problems as unsatisfactory level of educated/informed taxpayers, there is high cost of tax compliance, extensive evasion overzealous and corrupt tax officials and extremely narrow tax base in many of the countries, it frequently suffers from being incomplete in one aspect on another. Many important sectors, notably services, the wholesale and retail sectors have been left out of the VAT net, or the credit mechanism is excessively restrictive (that is there are denials or delays in providing proper credits for VAT on inputs), especially, when it comes to capital goods.

Administrative considerations have greatly influenced the structure of the VAT. Because a single rate VAT is easier to administer than a multiple rate VAT, the former has been applied. The complexity of administering full exemptions (zero rating) has led to restrict them to exports. Small taxpayers have been dealt with by exempting those with gross sales below a certain threshold or by rating them under a simplified system. Because of the difficulty involved in taxing services, the VAT is imposed on selected services only. Insufficiency of resources leads administrations to concentrate those enforcement efforts on large taxpayers, which can encourage non-compliance among taxpayers.

The other problem commonly observed is that some of the taxpayers refuse to honour their debt obligations to the VAT service, while others submit their VAT returns without payments. There is also deliberate submission of nil returns, non-issuance of

VAT invoices and entertainment providers and lotto operators refuse to use the VAT coupons.

Experience with VAT implementation in many countries shows that refund of credit has been a big problem. It has been a source of tension between authorities and the business sector and, in some countries, has led to the complex administrative measures that have significantly undermined the functioning of the VAT system.

A key feature of the invoice-credit form of VAT is that some business will pay more VAT on their purchases than they collect on the taxable sales they make, and so should be able to reclaim the difference from the tax authorities. This is particularly true of exporters whose export sales are zero-rated. It is also true of business-particularly new enterprises that make large purchase relative to current sales. Refunds can be substantial. In many countries, VAT collections. Forty percent of the survey respondents repay a third or more of gross VAT collections in refunds. Countries with refund levels below 20 percent are mostly in African, Asia and Latin America (Harrison & Krelove 2005).

In theory, VAT refunds should be paid promptly following receipt by the tax authority of a VAT return giving rise to excess credit. That is the practice of most developed countries, where refunds are generally paid within four weeks of a refund claim being made. The situation is different in developing and transitional countries, however, where it often takes several months, and sometimes

more than a year, to process refunds claims. In export-oriented countries such practices can seriously undermine the competitiveness of the export sector.

The prevalence of fraudulent claims is often cited by tax officials as a major reason for delaying payment of refunds. Often, less advance tax administration pursue time-consuming and labour intensive processes to certify claims before approving refunds, resulting in backlogs of refund requests and considerable disquiet among business taxpayers who have been deprived of their working capital. In contrast, the most effective and efficient tax administrations tackle refund-related fraud as part of a broader VAT compliance strategy based on risk management principles and generally limit pre-refund verification checks to perceived high-risk claims.

Delays in processing refunds also occur when state budgets are under pressure and when tax collection targets are not being met. This often happens when tax authorities and finance ministries do anticipate refund levels, and do not set aside sufficient funds to meet legitimate refund claims when they occur. Administration with more sophisticated forecasting and budgeting capabilities have been able to predict refund levels with a fair degree of precision, given that a pattern of refund claims to develop within countries overtime. When tax authorities deny payment of legitimate refund claims, the nature of the VAT is effectively altered, in part, from a tax on final consumption to a tax on production. To avoid this happening, VAT

policy makers often advocate that the same tight statutory timetable imposed on persons on persons paying VAT should also apply to tax authorities in refunding VAT, it is of little surprise; therefore the 90 percent of the countries that responded to the survey reported that their tax authorities are bounded by law to making within a prescribed timeframe, generally 30 days. Some countries (around 40% of those surveyed) go further, with their laws providing for interest to be paid on late refunds – this recognizes that excess credits not returned promptly to the taxpayers tantamount to funds loaned to the government.

At the same time policy makers acknowledge that safeguards need to be in place to tackle fraudsters who take advantage of regimes providing prompt VAT refunds. Safeguard range from providing tax officials with statutory power to conduct audits and verification checks, to measure such as requiring security or bank guarantee from traders who see refunds. In 60% of the surveyed countries, mandatory carry forward period of excess VAT credits are also imposed, generally for non-exports, to limit the number of refund claims.

Notwithstanding the preponderance of statutory time limits for making refunds, experience is that these are often insufficient in guaranteeing that timely refunds will be made in practice. Many examples exists where tax authorities do not meet processing deadlines, and while this is more likely to be the case in developing countries and transitional countries, it is not confined to the. It is not



uncommon for business enterprises in advanced economics, also to complain about the tie taken by tax administration to refund amounts due to them.

Finally, in response to increased demands by the business community for improved services from tax administrator, there has been a growing trend to introduce fast track refund processing for taxpayers with proven records of good compliance. There are in some cases technical reasons that prevent some transactions from being brought into tax. It is not easy, for example to allocate the value added in the provision of financial services between buyer and seller in such a way as to ensure proper functioning of the credit mechanism. And the cost of administration and compliance may warrant excluding some perfectly honest traders from the VAT. But none compliance is clearly one key reason for incompleteness of coverage. The rate and coverage of tax differ significantly in developing countries. Experience in developing countries shows that an important requirement for successful VAT administration is that the tax be structured so as to minimize problems of implementation. Some of the structural features of VAT that affects the ease of administration are the number of rates, the scope of exemption and zero rating, and the treatment of small enterprises. Multiple rate has added to cost of small administration, reduced rates increase compliance cost for small firms. This European experience teaches the advantages of a single rate VAT, or at least a very simplified rate structure.

In an effort to mitigate regressivity some developing countries have adopted vat with more than one rate. In some instance a VAT originally enacted with a single rate was later transformed into multiple VAT rate. Developing countries with multiple rate VATs tend to obtain a smaller fraction of their VAT receipt from the higher rate than estimates of the tax base would suggest. This is true when the high rates apply to luxury goods, where the temptation to evade is high. They argue the scant administrative resources available in developing countries cannot cope with enforcement.

Some critics say that high rates tends to distort resources allocated because they help inefficient enterprises to continue operating by charging VAT on their sales and failing to pay the tax to the government. Experience shows that neither high nor low VAT rates are enforceable in developing countries without effective administration. Scarce administrative resources must be aimed at carefully chosen objectives to ensure an appropriate compliance level, especially, when the standard rate for short-term revenue needs.

Experience in both industrial and developing countries suggest that a VAT imposed at low rates may not be worth the administrative and compliance costs involved in the switch to the VAT (Gills et al 1990). The most comprehensive government survey of VAT options for the US concluded VAT is not a tax to impose at low rates, because of the additional investment in tax administration that would be required before and during the first few years of operation of the tax.

Many developing countries (like many OECD countries) have adopted two or more VAT rates. Multiple rates are politically attractive because they ostensibly though not necessarily efficient serve an equity objective, but the administrative equity concerns through multiple VAT rates may be high in developing than in developed countries (Gill et al, 1990) exemptions complicate the administration of VAT. Additional record keeping is required to segregate taxable from exempt sales and in practice the distinction between what is exempt and what is taxed is often tenuous or arbitrary. The fact that exemptions complicate VAT administration has not deterred developing countries from exempting basic and non-basic commodities. Adding to the number of refund will divert administrative resources from enforcement of the VAT.

The difficulty of implementing workable self-assessment systems under which taxpayers declare and pay taxes on the basis of their own calculations, subject to the possibility of later audit by the tax authorities. Also worthy of note is the issue of tax revenue instability. Due (1963) states with respect to export duties that it should be noted that the revenues are unstable. Prest (1962) notes that the problem of revenue instability is linked with the repercussions of the inherent economic instability of under developed countries on the finance of government and further emphasized that "the fact remains that the public finances of under developed countries are liable to experience short-term distortion. These may take the form of reduction in the proceeds of taxes levied on the profits of exporters, or taxes on the exports themselves, and in so far as smaller exports

lead to a reduction in the imports, this may also cut government revenues severely if it is highly dependent as so often is the case, on import duties.

Idachaba (1975) provides statistical evidence on tax revenue instability in Nigeria over the periods 1934-57 and 1959-70 and concluded that a country like Nigeria which until recently derived most of its public revenue from taxes on production and international trade (export and import duties) tends to experience relatively high instability in revenue. He went further to disclose that most states depend on the federal government for more than 50 percent of their annual revenue. This implies that fluctuations in federal government's revenue get transmitted to the state Government rather directly. This would imply that state governments should diversity their internal revenue base to offset fluctuations in revenue from federal resources.

## **2.15 VALUE ADDED TAX AS A TOOL FOR POVERTY REDUCTION**

Is VAT inherently regressive or is it a powerful instrument for poverty alleviation? It is commonly believed that VAT adversely affects the distribution of real income. But rather than any one tax, it is the system as a whole, taken in conjunction with public spending policies that affects poverty and fairness. In theory, a regressive tax could be the best way to finance pro-poor spending which more than offsets any anti poor effects of the tax itself. The question of course, is how the situation plays out in practice in most developing countries (Nigerian Tax News 2002).

Studies of tax in developing countries are still few, but there is growing evidence that VAT is not an especially regressive tax. For example, studies for Cote d'ivoire, Guinea, Madagascar and Tanzania all show that the poor pay less than their share of total consumption as their share of total VAT revenues. Notably VAT proves more progressive than the trade taxes it often replaced. Many of those perceive VAT as particularly regressive are likely to be implicitly comparing it to a progressive personal income tax- a comparison of little relevance given the great difficulties that developing countries experience in administering an effective personal income tax (Ebril 2002). More generally, few taxes are often far better equity objectives. Expenditure policies are often a far better means of achieving these aims, though the capacity for using targeted spending measures is very limited in many low income countries, while the scope for pursuing distributional objectives on the spending side should not be taken for granted, experience has clearly demonstrated that the first function of tax action must normally be to raise needed revenue with as little distorting of economic activities as possible (Nigerian Tax News 2002).

## **2.4 KEY ISSUES IN FISCAL FEDERALISM**

Fiscal federalism presupposes a decentralized fiscal system. A fiscal system is the institutional framework or arrangement of a place for making political and economic decisions which include budgetary and debt decision, etc in an economy (Nnamocha, 2002).

Currently, Nigeria operates a fiscal system of government, with a federal government, 36 state governments and 774 local governments. In such a multi-level system, fiscal responsibilities are vested in both the central and lower level governments- the federal, state and local. This gives rise to a decentralized fiscal system of fiscal federalism. Federalism is seen as a series of legal and administrative processes varying degree of real authority and jurisdictional autonomy. This implies the coexistence of both national and sub-national governments which perform the economic functions required by the people of the society or an association of two or more levels/tiers of government within a country (Anyanwu, 1997).

Fiscal federalism refers to the existence in one country of more than one level of government, each with different expenditure responsibilities and taxing powers. Thus, under fiscal federalism, any one individual is subject to the influence of the fiscal operations of different tiers of government. It is the division of fiscal powers between or among sovereign levels of government in a federation that we refer to fiscal federalism. (Herber, 1979). This is akin to what Broadway (1979) referred to as economics of multilevel or federal system of government when he opined that the public sector is stratified into more than one level of government, each having a different set of expenditure responsibility and taxing powers.

In discussing fiscal federalism, it is generally assumed that the method of taking collective decisions is predetermined and that it is relatively efficient. This means that is governments due to the

incentives of vote maximizing or whatever, tend to take resource allocation decisions. Thus, in this way the distinction between the positive theory of fiscal federalism and normative theory tends to become blurred since governments are treated as if they behave optimally irrespective of aberrations in our political economy.

It is important to note that fiscal federalism and inter-government fiscal relations are often used interchangeably. Inter government fiscal relations refer to the fiscal transactions and coordinating arrangements among the various tiers of government in a federation (Musgrave and Musgrave, 1980). The nature of intergovernmental fiscal relations constitutes an extremely relevant consideration for the attainment of fiscal rationality within a decentralized political structure. Intergovernmental fiscal relations assume two principal dimensions: (a) budgetary influence between levels of government, which is known as the area of “vertical” intergovernmental fiscal relations and (b) budgetary influence between different government units at the same level, which is known as the area of “horizontal” intergovernmental fiscal relations. The later type of interrelationship is possible only at the state and local government where more than one unit of government exists.

**The objectives of fiscal relations in a federation are to;**

- Ensure correspondence between sub-national expenditure responsibilities and their financial resources (including transfers from central government) so that functions assigned to sub-national governments can be effectively carried out.

- Increase the autonomy of sub-national government by incorporating incentives for them to mobilize revenue of their own.
- Ensure that the macro-economic management policies of central government are not undermined or compromised.
- Give expenditure discretion to sub-national government in appropriate areas in order to increase the efficiency of public spending and improve accountability of sub-national officials to their constituents in the provision of sub-nationals services.
- Incorporate intergovernmental transfers that are administratively simple, transparent and based on objective, stable, non-negotiated criteria.
- Minimize administrative costs and, thereby, economize on scarce.
- Provide equalization payments to offset the differences in fiscal capacity among states and among local governments so as to ensure that poorer sub-national governments can offer a sufficient amount of key public services.
- Incorporate mechanisms to support public infrastructure development and its appropriate financing and
- Support the emergency of a government role that is consistent with market – oriented reform (Akindele and Olaope 2002)

Fiscal decentralization entails the process of reassigning expenditure functions and tax revenue to the lower tiers of government who are free to take decisions and allocate resources according to its own priorities in its own area of jurisdiction. The central argument for decentralization is based on the premises that it allows a closer match



between the preferences of the population and the bundle of public goods and services chosen by the government (Nnanna 2000).

Decentralization of responsibilities to lower levels of government will ensure improved and efficient allocation of resources for the provision of local public goods and services that mostly represent the aspiration of people at that level. However, the degree of decentralization in fiscal system is determined by the extent of independent decision-making by the constituent governments in the provision of both public and economic services. In spite of the advantages of fiscal decentralization, the practice in most federations including Nigeria has been fiscal centralism-thus, a fiscal arrangement that is characterized by excessive concentration of fiscal power at the highest level may negate fundamental principles of federalism and may be a camouflage for defector unitary system of government.

Zhurauskaya (2002) argues that inefficient inter-governmental relations are possible importance reason why Russia lags behind other countries in economic growth. In particular, the structure of revenue sharing between regions and local governments affects government's incentives to foster business growth and to provide public goods efficiently.

Montinola et al (1995) also argued that the Chinese fiscal reforms of early 1983 up till 1994, which gave more incentives to local governments to pursue local economic growth, provided the basis for China's remarkable economic performance. This reform induces a

strong positive relationship between local revenue and economic prosperity for all provinces and cities, thus providing local officials with incentives to foster that prosperity.

## **2.17 JUSTIFICATION OF FISCAL FEDERALISM IN NIGERIA**

Weak fiscal capacity: the present fiscal arrangement is characterized by weak fiscal capacity of the state and local government. An assignment of the current expenditure assignment, tax assignment and revenue sharing formula points to the need for policy reforms. The existing expenditure assessment appropriated all the economically and financially viable functions to the federal government while states and local government are given functions with high investment and low outlays. For instance, solid mineral developments lie with the Federal Government, while responsibilities of primary education, town planning and urban and rural water lies with the state governments. For each tier to execute the responsibilities assigned to it, it accesses funds through assigned tax bases. However, internally generated revenue of state and local governments compared with their shared revenue is very low. For instance, between 1991 and 2002, internally generated revenue of state governments averaged 6.8 percent. The low internal revenue base resulted from the types of taxes assigned, which unfortunately have low yields, and high cost of administration. Examples of such taxes include property and personal income taxes.

Over dependence of states and local government on federal government, the weak fiscal capacity analyzed above has often

resulted in over dependence of states and local governments on the federation account and value added tax revenues to execute their programmes. The low internally generated revenue coupled with lower shares from the federation account and VAT accounts explains their inability to provide and maintain social services.

The concentration of two much funds at the centre has engendered the struggle for control of power at the centre that tends to overheat the polity, and which may lead to the disintegration of the country if necessary precautions are not taken to address the issues.

Agitation for Resource Control by oil producing states: as a result of the neglect of the oil producing areas, especially, during past military regimes led to the agitation for resource control under the present democratic dispensation. This agitation is legitimate because equity requires that externalities associated with oil exploration should be compensated. Before the military intervention in 1966, the region was assigned the full retention of mining rights and royalties with a federal tax of 30 percent payable to the distributable pool account and was later adjusted to 35 percent in 1957. When the military government transferred to itself the legislation and administration of mining rents and royalties, the situation changed. This period began the neglect of the oil producing states, as no fund was made available for the development of the area. However, the 1999 constitution has made provisions for 13 percent of oil revenues for the development of the oil producing states. The belief is that the

allocation to the oil producing states will be reviewed from time to time depending on oil revenue situation.

The present fiscal management has also resulted in large-scale mismanagement and misallocation of resources. This factor accounts for the several uncompleted government projects especially during the military regime, high fiscal deficits and huge external debt. It has been observed that the local government authorities spend the bulk of their resources on recurrent expenditure as the chairman and other officials undertake frequent overseas trips under the pretext of studying local government operations in the industrialized world. Such expenditure has serious implications for the balance of payment.

The issue of poor expenditure management and rising poverty incidence in Nigeria can be attributed to many factors:

- i. Poor alignment of the rolling plan and development plan programmes with the capital expenditure programme in the annual budget (Okunrounmu, 2002).
- ii. Many capital expenditure programmes are hurriedly embarked upon the abandoned.
- iii. As a result of poor inter government fiscal relations; the federal government and the lower tiers of government are not judiciously using the available financial resources.
- iv. Uncoordinated private and public sector roles in the provision of private goods.
- v. The Issue of corruption in expenditure management is largely responsible for the poor social services delivery and

inevitably low economic performance and poor resource allocation.

## **2.5 VERTICAL AND HORIZONTAL FISCAL IMBALANCE**

Vertical fiscal imbalance refers to fiscal imbalance between the central government and other tiers of government, emanating from inequitable tax assignment and expenditure responsibilities to the three tiers of government, while the horizontal fiscal imbalance relates to the imbalance between one state and the other or between the local government councils in the federation. Inter government transfers are needed to balance the budget at the sub-national levels in situations where the national government retains the major tax bases and when key public services that touch the majority of the populace are carried out by sub-national governments. The rationale behind decentralized spending function relates to the superior capability of the local government to deliver public goods and services better attuned to local demands and needs as well as the increased political control by local citizens, while the rationale behind relatively centralized taxation relates to the economies of scale and the mobility of tax bases. Oates (1972) classic work on fiscal federalism also suggests that jurisdictions should be designed, and the assignment of public expenditure should be carried out, in such a way that services are provided by the jurisdiction representing the smallest possible area over which the benefits are distributed.

The net fiscal benefits measured by the gap between fiscal capacity and fiscal need are often caused by uncontrollable factors and therefore should be addressed by central government transfers. An effective transfer system therefore should satisfy the following criteria.

- **Revenue adequacy:** The sub-national authorities should have sufficient resources with the transfer, to undertake the designated responsibilities.
- **Local tax effort and expenditure control:** ensuring sufficient tax efforts by local authorities. The transfer system should not encourage fiscal deficit or sub optimal fiscal efforts.
- **Equity:** Transfers should vary directly with local fiscal needs and inversely with local fiscal capacity.
- **Transparency and stability:** The sharing formulas should be announced and each locality should be able to forecast its own total revenue(including transfers) in order to prepare its budget and the formula should be sufficiently stable to allow long term planning at the local levels

## **2.6 EVOLUTION OF FISCAL FEDERALISM IN NIGERIA**

The concept of fiscal federalism was first introduced in Nigeria in 1946, following the adoption of the Richard's Constitution. The period 1947-52 marked the beginning of the recognition of sub-national government during which financial responsibilities were developed at the three regions, north, west and east. Each of the regions had a constitution, which governed the fiscal relations

between the regions and their provinces. At present, Nigeria has a central government, 36 states and 774 local government councils.

The need to bring governance closer to the people informed the creation of additional states, the first being in 1963. Thereafter, the number has risen steadily, until the present 36 states, created in 1996.

Vincent (2002), enumerated the existence of the following fiscal arrangement before the military took over power in 1966.

- The regions were assigned the proceeds from export and excise taxes while the federal government received the share attributable to Lagos area.
- Marketing boards were regionalized and their respective regions retained their operational surpluses.
- Regions were empowered to fix producer prices and also impose tax on the products of marketing boards.
- Regions were assigned the full retention of mining rents and royalties with federal tax of 30 percent payable to the distributive pool account (DPA) and were later adjusted to 35 percent in 1957.
- Regions were allowed to administer and retain income tax on income not above N700 per annum.
- The federal government determined the relationship between the region and the provinces.

The implication of these measure were an increase in regional revenue from 7.7 percent in 1946/49 to 41.6 percent in 1966/67 while the share of the central government declined from 82.3 percent to 58.4 percent in the same period.

The military intervention in 1966 brought new changes as the federal constitution of 1963 was suspended. The federal government took over state and local government's functions for a variety of reasons. Consequently, new tax measures were introduced as follows:

- The transfer of legislation and administration of mining revenue and royalties to the federal government.
- Centralization of the marketing boards, while all taxes, surpluses and fixing of producer prices were administered by the federal government.
- Right to revenue emanating from company income tax, import, export, petroleum profit tax (PPT), excise taxes and mining royalties and rent were vested in the center.
- Replacement of sales tax with value added tax (VAT) in 1994 and subsequently transferred to federal government for the purposes of regulation and administration, while the proceeds are paid into the VAT account for distribution among the tiers of government. Subsequently, the revenue potentials of the states were eroded, and internally generated revenue declined while that of the local councils between 1996 and 1999 averaged 6.7 percent of total expenditure.



## **2.7 ASSIGNMENT OF REVENUE TAXING POWERS IN NIGERIA.**

Ideally, each tier of government should be assigned revenue/tax sources commensurate with its responsibilities. However, it is important to reconcile considerations of efficiency (minimization of resource cost) with equity which entail light that certain principles become imperative. Progressive redistributive taxes should be central while lower level taxes should be cyclically stable; tax bases distributed equally between jurisdictions should be centralized, taxes on factors of production are best administered at the centre; residence based taxes such as sales of consumption goods to consumer or excises are suited for states; taxes on completely immobile factors are best suited for local level; and benefits taxes and user charges might be appropriately used at all levels(Musgrave, 1959 in Anyanwu,1997).

It is also important, in assigning tax revenue powers to distinguish between those revenue powers which are exercisable by one level of government and the revenues from which accrue to the level of government alone ("Independent revenue") and those exercisable by the level of government, but the revenues which accrue to that level of government and other levels of government. The latter refers to revenues that are subject to intergovernmental sharing which today makes up the federation account.

All the major sources of revenue, petroleum profit tax, import duties excise duties, VAT mining rents and royalties and

companies income tax, come under the jurisdiction of the federal government with the exception tax (at the local government level) whose potentials are yet to be fully tapped. The state and local governments have jurisdiction over minor and poor-yielding revenue sources such as entertainment tax, motor vehicles and drivers licenses and fees and motor park dues. State government's independent revenue as a proportion of the federal and state government averaged about 6.6% between 1970 and 1993. This led to serious over-dependence of lower levels of government on the federal government finances.

In Nigeria, non-correspondence has recently followed a clearly discernible pattern, with the federal level of government enjoying a greater ability to raise revenues to meet its functional expenditure obligations than state and local government. The combination of military rule, civil war and an arrangement whereby all the proceeds from oil goes to the federal government exclusively reversed the situation in the early 1960s when there was substantial revenue and expenditure decentralization. Today, what exists is a situation in which all fiscal resources are centralized at the federal level, which is then transferred to the states and local government joint account respectively. This situation has recently been compounded by shifts in fiscal responsibilities from the federal to the other levels of governments. Especially the local government (primary education and primary health care for example) Anyanwu,1997).

## **2.8 REVENUE ALLOCATION IN NIGERIA**

Generally, revenue allocation refers to the redistribution of fiscal capacity between the various levels of government or the disposition of fiscal responsibilities between tiers of government. Narrowly conceptualized, revenue allocation is seen as the transfer of financial resources from one level of government to another which arises because of the revenue advantage which the former has over the latter, mostly as a result of the powers conferred on it over tax revenues (Mbanefoh and Anayanwu, 1990). Thus, in a federation like Nigeria revenue among the various governments, that is federal, state and local governments, and horizontally, between the component elements of each lower tier of government was influenced by the recommendations set up by the federal government. These included Raisman commission (1957), Binns Commission (1964), Dina Commission (1968), Aboyade Technical Committee (1977) and Okigbo Commission (1980). In 1989 permanent commissions known as National Revenue Mobilization Allocation and Fiscal Commission (NRMFC) was set up.

The history of revenue sharing started in 1957 when Raisman commission recommended the establishment of distributable pool account (DPA) where 30 percent of import duties, mining rents and royalties were to be paid for the purpose of sharing to the regions. This was however, adjusted to 35 percent in 1964.

Between 1957 and 1963, the revenue sharing formula was adjusted at various times. In 1957 the formula was 40:31:24 and 5 percent for the Northern, Eastern, Western and Southern

Cameroon respectively. This was adjusted in 1961 to 42:32:6:25:6 for Northern, Eastern and West respectively, following the withdrawal of Southern Cameroon. Further adjustment was made in 1964 after the creation of mid-western Nigeria. The formula was 42:30:20 and 8 percent for the North, East and mid-West.

The Abayode Technical Committee on Revenue was set up in 1977. The recommendations of the committee represented a break from the past, as it recommended that all federally collected revenues without distinction should be paid into the federation account. The proceeds of the account were to be shared among the federal government, states and for the first time local government councils in order to 60, 30 and 10 percent respectively. It also created a special grant account (3 percent from the federal government share) to be administered by the federal military government share) to be administered by the federal military government for the benefit of mineral producing areas in need of rehabilitation from emergencies and disaster.

In 1980, the Okigbo commission recommended that all federally collected revenue should be paid into a federation account. It recommended that the federation account should be shared as follows: federal government (53%), state governments (30%), local governments (10%) and special funds(7%). It further recommended that the 7 percent of federation account should be applied as follows:

- Initial development of the federal capital territory (2.5%)
- Special problems of the mineral producing areas(2%)

- Ecological and similar problems such as soil erosion, desert encroachment, flood control etc.(1%)
- Revenue equalization fund(1%)
- The government accepted the recommendations but the Supreme Court later declared it ultra-virus. The statutory share of the federal government declined from 55 percent in 1980 to 50 percent in 1990 and 48.5 percent in 1993. Similarly, the share of local governments increased progressively from 8 percent in 1980 to 15 percent in 1990 and 20 percent in 1993.

However, the Babangida regime introduced the deduction of first charges in 1989 for external debt service, dedicated accounts; such as joint venture companies (JVC) cash calls, NNPC priority Projects and excess crude oil earnings. These charges further increased the total revenue available to the federal government, hence perpetuating over centralization of resources at the centre.

The Principle that have guided the sharing of resources among the three tiers of government include derivation, needs, even development, equality of states, land mass and population. The horizontal distribution formula had remained stable since 1981, except for the increase in derivation principle for mineral revenue to 13 percent in 1999.

## **2.9 REVENUE ALLOCATION FORMULA AND PRINCIPLES**

Revenue allocation is based on three main arguments; “balancing” equalization”, “Promotional”. These are meant to attain two broad objectives, efficiency and equity. However, to attain these objectives, appropriate revenue allocation formula and principles must be devised.

Indeed, due to the problems of non-correspondence/vertical fiscal imbalance (incongruence between the responsibilities assigned to the various levels of government and the revenue power/sources assigned to them) and equalization/horizontal fiscal imbalance (differences in the per capital distribution of income and wealth as well as in the volume of sales transaction has emerge as one way out not only to enhance economic growth and development but also to promote efficiency, equity and national unity and minimize intergovernmental tensions. In essence, the existence of federalism, embodying many governmental units necessitates revenue sharing and what is shared depends on the availability and amount of revenues as well as on the formulae and principles.

Such formula refers to the system of weights or relative weights (percentages) assigned to the inter-governmental sharing. On the other hand, the revenue allocation principles refer to the rules or factor applied the basis or general law to guide, or to be applied in revenue allocation among states and local government. This must be distinguished from the “Criteria” or standard by which to judge the allocation in relation to the attainment or otherwise of the efficiency and equity criteria (Anyanwu, 1993).

## **2.10 SHARING OF VAT REVENUE**

Beginning in 1994, the governments of Nigeria have been sharing the revenue from value added tax in VAT pool account. The formula for this sharing has changed many times and stands at 25% and 30% for federal, state and local governments. This compares with the 1997 formula of 35%, 40% and 25% for federal, state and local governments. VAT revenue has had the effect of increasing the revenue levels of governments since its introduction.

## **2.11 ECONOMIC DEVELOPMENT**

Economic development is the study of how countries develop, why some have failed, and what policies or strategies would be most successful in encouraging development and economic growth. The degree of development is measured by GNP per capita. Each country's GNP per capita is converted to American dollars at the current exchange rate. Then all the countries are ranked and compared in terms of GNP per capita.

Development is generally thought of as involving more than a command of income. It also includes an accumulation of physical and human capital. Just as development is associated with urbanization, it is also associated with capital accumulation. This capital accumulation is through heavy industries, which is capital intensive and produces capital goods almost exclusively.

## 2.12 PRECONDITIONS FOR DEVELOPMENT

According to Walter Restow in Henderson and Roole (1991), there are preconditions for a country today to “take off”. By this term he meant to move from a low level of development to sustained industrialization and economic growth. His focus was on market economies, where he thought development would occur much as it did in industrial nations in the past without significant government intervention. He presented four preconditions that provided a general setting in which development can occur.

- a. **A budding middle class of entrepreneurs:** An entrepreneurial class with enough capital to start small business and willingness to undertake those risks is needed. These entrepreneurs will adapt existing technologies and use available material and worker skills to produce those goods that will be demanded in that country. For this class to function, it must be well educated, probably urbanized, and have financial resources. From the above, there is the need to embrace tax policies that encourages savings and investment.
- b. **Literate work force:** Much of the work force must be literate. To work and function in modern factories, most workers must be able to read and write so that they can operate and repair machines, keep inventories and fill orders. To learn a skilled or semi skill occupation, they must be able to read and understand written materials. Literacy is also an important factor that affects how a country will adopt new techniques and ideas.



- c. **Adequate infrastructure investment:** An infrastructure of transport, Communications, and utilities must exist to facilitate economic interaction within the country. Goods must be trucked or shipped by rail across regions. This requires telephone and communication services. Electricity and water supply must be reliable.
- d. **An appropriate institutional environment:** The institutional environment must be conducive to growth. Foremost is an effective rule of law, which ensures that contracts can be enforced. If a contract for loan repayment, delivery of materials, for the sharing of profit in a partnership, and so on, is broken, legal resource must be available, otherwise, the contract is meaningless and business relations and ventures are sharply restricted, and deals are the made only with a family or a circle of acquaintances. Political stability and social order are also an important part of the environment needed for development. Fear of government extortion or instability greatly reduces the ability to grow and willingness to invest and take risks. If the preconditions are met in some fashion, development is impeded, at least to some extent.

## **2.13 THEORETICAL FRAME WORK**

There many theories of economic development and growth. However, only a few are discussed in this study. They include Herrod-Domar model, structure-change theory, the linear stages of growth model, neo-Marxist theory and the Neo-classical theory.

### **2.13.1 HARROD-DOMAR MODEL**

The Harrod-Dommar model delineates a functional economic relationship in which the growth rate of gross domestic product ( $g$ ) depends positively on the national savings ratio ( $s$ ) and inversely on the national capital/output ratio ( $K$ ) so that is written as  $g = S/K$ . the equation takes its name from a synthesis of analysis of growth by the British economist every Domar. The Harrod model countries in economic planning with a target growth rate, and information on the capital output ratio, the required saving rate can be calculated.

### **2.13.2 STRUCTURAL CHANGE THEORY**

Although its influence has declined considerably, the structuralist school of development economics has had a lasting impact on debates regarding development, especially with respect to Latin America and other regions with similar problems.

The structuralists focus on the mechanism by which “underdeveloped” economies transform their domestic economics from a traditional subsistence agricultural base into a modern economy. A modern economy is defined as one in which most of the population is urban and the bulk of the country’s output is in the form of manufactured products or services. Under this model, the ultimate question becomes how to expand the modern economy while contracting the indigenous traditional economy of the country or region. The object of development is the structural transforming of underdeveloped economics so as to permit a

process of self-sustained economic growth. This may only be achieved by eliminating the under developed country's reliance on foreign demand for its primary exports (raw materials) as the backbone fueling economic growth.

Economic growth must be fueled through an expansion of internal industrial sector. The structuralists school emerged in Latin America in 1940s. In the latter part of the nineteenth century and the beginning of the twentieth century Latin American countries were exporters of raw materials. Classical economics held that the region had a comparative advantage in raw materials, meaning they could produce raw materials more efficiently than other regions. As such they concentrate on expanding such exports.

By the 1940s Latin American economies began to attack this notion. They argued that export led growth led growth of raw materials was no longer a feasible path to economic development. This was because the prices of primary exports were declining, while the price of manufacture products was increasing. In addition, the supply of manufactured goods was increasing. In addition, the supply of manufactured goods was due to World War II. All of these factors created large disruptions for the economies of developing countries. Given the low price being paid for exports of primary products, developing countries were unable to make enough money to pay for all of the important factor inputs they needed, including high-priced manufactured products.

Many Latin American economists believed that the situation would not improve following the conclusion of the war. They cited two

reasons in support of this conclusion. First, they noted that the advances in technology, which lowered the production costs of manufacture goods, were not resulting in lower priced import if such goods. Structuralists argued that the fruits of those advances were being retained by the industrialized nations in the form of increased profits for the manufacture and higher wages for the workers. Given these “structural” impediments in the world economy, the structuralist argued that economic development has to be pursued through an expansion of the domestic industrial sector.

Second, structuralist economists warned that, given the United States role as the world’s new industrial leader, the demand for new raw materials was going to diminish because the United States would be willing to buy raw materials abroad only if it was cheaper than extracting them at home. But this scenario was unlikely because the post-war global economy differed substantially from the situation during the previous century. At that time, Great Britain, was the pre-eminent economic power, but it has few natural resources. In order to feed its industries, Britain had to import raw materials. This gave providers of raw materials more bargaining power, power that developing countries would no longer have in the post-war world.

Structuralists also argued that focusing on overall economic growth members was a necessary but not sufficient step in pursuing economic development. An underdeveloped economy is defined as one in which the technological levels of one or more

sectors of the economy fall below the technological level of the most advanced sector, especially if technology exist that will enable these sectors to be more productive. To the structuralists, development had to include the expansion of new technology and methods of production in order to eliminate the gap between the most advance sectors of the economy and those that lagged.

Thus the structuralists measured development by the number of economic sectors using the most advanced levels of technology. The goal was to have an economy in which the total output would be divided equally among all of the country's economic sectors. The existing scenario in which the bulk of the output was derived from the primary product sector was unacceptable. Economic development could only be achieved through the expansion of those sectors of the economy, which up to that point has neglected.

In addressing to cause of underdevelopment, structuralists economists focused on the evolution of economic relationships between developing countries were brought into international economy to serve two purposes: (I) to supply cheap raw material (ii) to purchase finished manufactured goods from industrialized economics. This gave rise to "achieve" economics in developing countries that expanded the primary product export sector at the expense of the industrial sector.

The structural relationship in the international economics led to a dual economic structure in developing countries, where a modern economy (the export sector) coexisted with a backward and

underdeveloped one. The modern sector was maintained not through internal innovation and advancement but by purchasing new technology from developed countries. As long as dualism persisted, that is growth would be dependent on the industrial countries. Structuralists argued that economic growth has stem from internal demands.

The structuralist argued that the structural change needed to being about economic development could only be achieved by State intervention. For example, government-imposed tariffs on imports were designed to stimulate the internal market by protecting new industries within the country. A tariff was viewed as a way to even the playing field between a manufacturer in an industrialized country and one in a developing nation. The former tended to have better access to capital and technology as well as a more productive workforce. These factors enabled manufactures in industrialized countries to produce a given product faster and cheaper than “infant industries” in developing countries.

A tariff is a tax that government of the importing country placed on importation products. The tax is designed to make the imported product more expensive than the domestic product, thereby making the later more attractive to the consumer of the product because it is cheaper, in theory, the structuralists thought tariffs could be lowered or eliminated when the domestic industry had reached the level of development that enables it to complete without the government –imposed protection.

Another important component of the structuralists approach was state owned enterprises. The structuralists believed that, giving the underdeveloped capital markets in developing countries, only the state could generate and manage the sizable needed to industrialize. Other policies that were recommended were fiscal (taxes and government spending) and monetary (money supply and interest rates) in nature.

In sum, all of these known collectively as "Import substitution" were geared at encouraging the country to industrialize. Thus, the structuralists accepted the notion that development was to be achieved through capitalism. But they were not convinced that the market alone could achieve the type of thriving capitalism that industrialized countries were enjoying.

Governments of developing countries had to actively promote industrialization through government regulation of the economy. While the structuralists made significant contributions to our knowledge of the process of development, their prescriptions were not successful in many cases. Countries that adopted the import-substitution model of development began to notice in the 1960s that government led initiatives to industrialize could not effectively create the most important phase of industrialization relating to heavy machinery and plant installation. Moreover, the heavy involvement of the state in the market created inefficiencies that eventually caused major internal and external economic problems. And the drive to industrialize led, ironically, to increased dualism in

developing countries as the gap between the rich and poor widened.

Structural change approaches to development economics have faced criticism for their emphasis on urban development at the expenses of rural development which can lead to a substantial rise in inequality between internal regions of the country. The two-sector surplus model, which was developed in the 1950s, has been further criticized for its underlying assumption that predominantly agrarian societies suffer from a surplus of labour. Actual empirical studies have shown labour to urban areas can result in a collapse of the agricultural sector. The pattern of development approach has been criticized for lacking a theoretical framework.

## **THE LINEAR-STAGES OF GROWTH MODEL**

The industrialized nations did not pay much attention to the problems facing developing countries until the late 1940s and early 1950s, they approached the problems of the third world only after they had finished rebuilding much of western Europe. Following World War II, most of the economics of Western Europe were devastated.

The Marshall plan for economic reconstruction made possible an amazing and repaid revival of industrial Europe. Europe's success in rapid re-industrialization was to every influential in how policy makes in industrialized countries approached the economic problems of developing countries. The views discussed in this part all share the proposition that economic growth could only be



achieved through industrialization. It was also accepted that the constraints were mostly internal. In particular, growth was restricted by local institutions and social attitudes, especially those that negatively affected the rate of savings and investment. This view contrasted with the structuralists' view that developing countries' economic problems were due in large to external factors.

The key to development was simple; implementation of a program providing for massive injection of capital coupled with public sector intervention designed to accelerate the pace of economic development, this would compensate for the lack of internal after all, had worked very well in Western Europe via the Marshall plan.

In this part, we look at Rostow's stages of growth model of development. This is not to say that Rostow's model was the only one or the best. It was, however, the model that achieved dominance in this strand of development economics. Rostow argued that advanced countries have all passed through a series of stages. He designated the stages as follows: (1) The traditional society (2) The preconditions to take-off, (3) the take-off (4) The drive to maturity, and (5) The age of high mass-consumption.

In his view, the advanced countries have passed the stage of take-off and achieved self-sustaining growth. The developing economies were either in the "preconditions" or "traditional" stage. All that these societies had to do in order to take-off (to reach self-sustaining growth) was to follow a certain set of rules of development. Rostow defined take-off as a period when the degree of productive economic activity level reaches a critical level

and produces changes, which lead to a massive and progressive structural transformation of the economy and society. The take-off stage could only be reached if there criteria were satisfied. First, the country had to increase its investment rate, with investment amounting to no less than 10 percent of the national income. This requirement could be satisfied either through investment of country's own savings or through foreign aid or foreign investments second, the country has to develop one or more substantial manufacturing sectors with a high rate of growth. Third, a political, social and institutional framework had to exist or be created to promote the expansion of the new modern sector.

Under this theory, economic growth was measured by a rising per capita income. Unlike the structuralists, Rostow was not concerned whether the product was evenly divided among all economic sector. Thus, again unlike the structuralists, Rostow equated economic growth with economic development.

To stimulate growth, the country had to increase savings and investment. Given the low savings rates in developing countries, the government was responsible under this theory for creating a class of people with a propensity to saved. The government also had to ensure that people who saved more would obtain a greater share of the national income otherwise: national income would be consumed rather than invested.

It is easy to see why this model was so widely accepted. If justified massive transfer of capital and technology from the north (industrialized countries) to the south (developing countries). At

the same time, it provided a rationale for the massive concentrations of wealth that existed in developing countries.

Despite its appeal, the Rostow model is seriously flawed. The linear-stage of growth model blamed developing countries' stagnation on internal factors, namely a lack of internal savings and investment. The model assumed that if these components were injected into developing countries through direct foreign investment or aid, economic growth would naturally follow. This assumption was based, in part, on the success of the Marshall plan in Europe. Thus, the model assumed that but for the low savings and investment rates, developing countries and Europe were the same for purposes of development. They were not. While post-world war 1 Europe lost its infrastructure and industrial bases, social structures i.e. skilled labour and a competent managerial sector, it had a stable civil and criminal legal framework experienced in handling the many problems associated with capitalism. Developing countries' levels of human resources could not compare to those of Europe.

Consequently economic aid and foreign investment were not enough to industrialize the region. If sustained growth was to be achieved in developing countries, the society itself had to be restructured. The linear-stages of growth model focused only on the symptoms of an ailing economic society that saved very little and invested even less.

## **NEO-MARXIST THEORY**

One of the most controversial schools of development economics in the 1960s and 1970s focused on neo-Marxist theory. Neo-Marxist economics accepted Marxist philosophy in principle but argued that it had to be modified if it was to be applicable to developing countries. They argued that Marx did not have sufficient information to develop a theory dealing with underdevelopment. Armed with observations that Marx could not possibly have made, neo-Marxists made important theoretical departments from orthodox Marxist doctrine. We will cover only two here.

First, neo-Marxists broadened the scope of orthodox Marxist doctrine by looking at exploitation among nations. Marx's doctrine of surplus value stated that the worker was being robbed by the capitalist class. The worker was being robbed by the value of the product, which his labour produced. The difference was expropriated by the capitalists the private owners of the factories and machines. The neo-Marxists gave this theory an international dimension based on the behaviour of nations. Hence they concluded that industrialized countries historically extracted surplus value from developed countries paid very low prices for the primary products imported from developing countries, transformed them into finished products and sold them back to developing countries at very high prices. This resulted in chronic poverty and misery in developing countries. Second, neo-Marxists took issue with the orthodox Marxist theory that a social revolution is possible

only after a country has undergone a capitalist transformation. This orthodox position would mean that such a revolution could not occur in developing countries until industrialization flourished. Neo-Marxists argued, however that passing through the industrialization stage was impossible for many developing countries, given the theorists' observations that developing countries were stuck in a state of underdevelopment and unequal exchange with advanced capitalist nations.

The path to industrialization was difficult and even impossible to follow because, as we have just noted, developing countries were bought into the capitalist international economy as producers of cheap raw materials. Thus, foreign capital flowed to and modernized only one sector of developing economies—the primary product sector. The by-product of this process was the destruction of indigenous industry either directly or through neglect. Neo-Marxists argued that foreign capitalists had no interest in developing local industries. And the local capitalists were happy as long as they could extract surplus capital was either invested abroad or consumed via the purchase of luxury goods from abroad of course. All of these factors contributed to static economics in developing countries, which meant that capitalism could not be achieved.

Consequently, Neo-Marxists called upon the masses to engage in a socialist revolution which would wait for the arrival of industrialization. The revolution would place the surplus value in the hands of the workers, who invest in socialist development;

neo- Marxist theory was an important and provocative contribution to development economics, primarily because it questioned many assumptions supporting development theory based on capitalism.

Nevertheless, the theory was subject to a great deal of criticism, especially the neo-Marxist based "dependency theory" which held that developing countries development was dependent on, and thwarted by, advanced capitalists countries. Classically trained economists argued that heading neo-Marxist calls for self-sufficient development would lead to economic stagnation in developing countries. Pointing to empirical evidence, Marxist economists claimed the neo-Marxists incorrectly concluded that developing countries could not attain the capitalist mode that Marx deemed necessary for a socialist revolution. Others noted that neo-Marxist theory failed to explain patterns of specialization in developing countries, others believed neo-Marxist theory was too idealistic to be useful

## **THE NEOCLASSICAL THEORY**

Neoclassical theory experienced resurgence in the 1980s, it is not coincidental that, during this same period, the governments of most of the industrialized nations were governed by conservative political parties.

Neoclassical economic theory dismissed neo-Marxist theory as flawed and unrealistic. It also rejected structuralists claim that developing countries problems were due to structural impediments

in the international economy and that domestic structural flaws required significant state intervention in the economy. To neoclassical economist, economic stagnation in developing countries was a by-product of poorly designed economic policies and excessive state interference in the economy. They argued that in order to stimulate the domestic economy and promote the creation of an efficient market, developing countries governments had to eliminate market restrictions and limit government intervention. This was to be accomplished through the privatization of state owned enterprises, promotion of free trade, reduction or elimination of restrictions on foreign investment, and a reduction or elimination of government regulation affecting the market.

These reform measures collectively were called "the Washington in sum, market forces, not government intervention in the economy, would bring about development in stagnating economics.

This framework became the basis for the massive economic changes that occurred in Latin America after the onset of the debt crisis in the early 1980s and for the equally profound transformation of socialist economics after the fall of the Soviet Union.

In other words, these theories are claiming that an unobstructed free market is the best means of inducing rapid and successful development. Competitive free markets unrestrained by excessive government regulation are seen as being able to naturally ensure the allocation of resources occurs with the greatest efficiency

possible and the economic growth is raised and stabilized. It is important to note that there are several different approaches within the neoclassical theory, each with subtle, but important, differences in their views regarding the extent to which the market should be left unregulated. These different on neoclassical theory are the free market approach, public choice theory, and market friendly approach. Of the three, both the free-market approach and public-choice theory content the market should be totally free, meaning that any intervention by the government is necessarily bas. Public-choice theory is arguably the more radical of the two with its view, closely associated with libertarianism that governments themselves are rarely good and therefore should be as minimal as possible. The market friendly approach, unlike the other two, is a more recent development and is often associated with the World Bank. This approach still advocates free markets but recognizes that there are many imperfections in the markets of many developing nations and thus argues that some government intervention is an effective means of fixing such imperfections.

## **2.14 EMPIRICAL STUDIES**

Izedonmi & Okunbor (2014) used 17 year time series data to assess the role of value added tax on the economic growth of Nigeria. Using both simple regression analysis and descriptive statistical methods, they found that VAT revenues and total revenues accounted for as much as 92 percent significant



variations in GDP in Nigeria. They also found a positive and insignificant correlation between VAT revenue and GDP.

Onwuchekwa and Suleman (2014), on the other hand examined the effects of value added tax on the economic growth of Nigeria. The study made use of the ordinary least square method in analyzing data for a period of 20 years. The result show that VAT significantly contributes to total revenue of government and to the economic growth of Nigeria.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 RESEARCH DESIGN**

The research methodology here refers to the method employed in gathering and analyzing data used in the study. This was clearly stated as to enhance test of the hypotheses prescribed for the study.

#### **3.2 DATA COLLECTION**

The data for this study was collected using secondary sources. Information from the secondary source includes review of previous studies and findings on the subject matter from test books, magazines and journals. Specifically we collected data on VAT and Gross Domestic Product (GDP) in Nigeria, Federally collected revenue and inflation in Nigeria, over a period of 20 years, ie 1995-2014.

#### **3.3 DATA ANALYSIS**

The techniques for the analysis of the effect of VAT on the overall economy centre on time service analysis. The variables collected were tabulated, while the regression and correlation analysis were adopted to test for significance in the hypothesis formulated for the study.

##### **3.3.1 REGRESSION ANALYSIS**

Regression analysis is a statistical tool for the investigation of relationship between two or more variables. Usually, the investigation seeks to ascertain the casual effect of one variable

upon the other. To explore such issues, the investigator assembled data on the underlying variable of interest and employed regression to estimate the quantitative effect of the casual variables upon the variables that they influence. The investigator also typically assessed the “statistical significance” of the estimated relationship. This is the degree of confidence that the relationship is close to the estimated relationship between variables, measures it and makes prediction about values of one variable from given values of the other(s) (Nworuh 2001). This study uses the simple and multiple regression models for data analysis.

Regression analysis with a simple explanatory variable is termed “simple regression”. The task of regression analysis to produce an estimate of these two parameter a and b, based upon the information contained in the data set. Linearity assumption is common in regression studies but is by no means essential to the application of the technique and be relaxed where the investigator has no reason to suppose “apriori” that the relationship between the dependent variable and independent variable can be expressed as:

$$Y = a + bx + e$$

Where y is the dependent variable

a, b are known parameters to be estimated

e is the random term (Noise component) and comprises of factors that are unobservable, or at least unobserved.

The method of least square is used to find the a and b parameters.

The multiple regression is statistically stated as follows:

$$Y = x_1 + x_2 + x_3 + \dots + x_n + e$$

### 3.3.3 CORRELATION ANALYSIS

This refers to the techniques used in measuring the closeness of the relationship between variables or among variables. The degree of the relationship between three or more variables is called multiple correlations. Correlation may be positive or negative. We have a positive or direct correlation if two related variable change in the same direction. i.e. they tend to increase or decrease together, when the two related variables change in opposite directions, i.e x increase correlation.

**DECISION RULE:** Any correlation coefficient from .50 and above is considered strong positive any value below. .50 is considered as weak positive. .50 and above is considered weak negative relationship.

#### T-STATIC

T-statistic is used for hypotheses testing. The hypotheses testing with a regression coefficient, seeks to formulate a null hypotheses and then decide whether to accept or reject it. The underlying assumption that the variable x and y has a joint normal distribution can be shown that when  $p = 0$ .

**DECISION RULE:**  $H_0$  is accepted at the 5% significant level: If  $(t) 0.05 (n-2)$  ie if the t calculated is less than the table value of otherwise the null hypothesis is rejected in favour of the alternative,  $H_A$ .

### 3.3.4 COEFFICIENT OF DETERMINATION

This coefficient of determination expressed as  $R^2$ , is a number indicating the proportion of the variation in the dependent variable, which is explained by the independent variable (s). In effect, it tells us how the regression equation fits the data.

Total variation = explained variation + unexplained variation.

**DECISION RULE:** When r2 is .50 and above, the relationship is said to be strong and significant and good for policy decisions.

### 3.4 MODEL SPECIFICATION

The study employed a time series data for the period 1995 – 2014 a period of twenty years.

The models for this study are specified ad follows

$$GDP = X_0 + X_1 \text{ VAT} + FCR + IFL + et \dots\dots\dots (1)$$

Where GDP, Gross Domestic Product,

VAT = Value Added Tax

Inf = Inflation rates

FCR = Federally Collected Revenue

et = error term

$$GDP = X_0 + X_1 \text{ VAT} + et \dots\dots\dots (2)$$

$$FCR = X_0 + \text{VAT} + et \dots\dots\dots (3)$$

The models above could be restated in the logarithm form as follows:

$$\text{LOG GDP: } \log X_0 + X_1 \text{ Log } X_1 \text{ Vat} + \text{Log } X_2 \text{ FCR} + \text{Log } X_3 \text{ Inf.} + et \dots\dots (1)$$

$$\text{Log GDP} = \text{Log}X_0 + X_1 \log X_1 \text{ VAT} + et \dots\dots\dots(2)$$

$$\text{Log GDP} = \text{Log}X_0 + x_1 \text{ VAT log}$$

$$\text{Log FCR} = \text{Log}X_0 + \text{Log } X_1 \text{ VAT} + et \dots\dots\dots(2)$$

## CHAPTER FOUR

### DATA PRESENTATION, ANALYSIS AND DISCUSSION

The chapter focuses on the presentation of the data for the analysis, the analysis of the data and the discussion of findings of the study.

#### 4.1 DATA PRESENTATION

The data for the analysis of the hypotheses of this study is presented in Table 4.1 below. The Data is for a 20 year period i.e. 1995 – 2014.

The data show the real GDP in Millions, the Value Added Tax for the same period, the Federally Collected Revenue in Millions and the rate of inflation in percentages.

Table 4.1 Data for Analysis of the Models

	Real GDP (N million)	VAT (NM)	FCR N Million	INFG%
1995	181,401.4	20,761	459,981	51.6
1996	293, 745.38	31,00	523, 597	14.3
1997	302022.48	34,00	582,811	10.2
1998	310, 890.05	36,900	463,609	11.9
1999	312,183.48	47,100	949,188	10.2
2000	329.178.74	58,500	1,906,160	14,5
2001	356.994.26	91,800	2,231.600	16.5
2002	433,203.51	108,600	1,731,838	12.1
2003	477,532.98	136,400	2,575,096	23.8

2004	527,576.04	159,500	3,920,500	10
2005	561,931.39	178,100	5,547,500	11.6
2006	595,821.61	232,700	59,651,002	8.5
2007	634,251.14	312,600	5,715,600	6.6
2008	672,202.55	401,700	7,866,590	15.1
2009	718, 977.33	481,400	4,844,692	13.9
2010	776,332.21	564,890	7,303,672	11.8
2011	834,000.83	659,160	4,623,000	10.3
2012	888,892.99	710,560	5,007,000	10.3
2013	642,631.00	795,600	4,864,200	14
2014	528,587	900	4,724,150	15

Source: Centre Bank of Nigeria, Statistical Bulletin Various Issues.  
National Bureau of Statistics.

## 4.2 THE RESULTS OF THE ANALYSIS

The results of the analysis is shown in Tables 4.2 below:

Table 4.2: Analyses of the characteristics of the variables

	LNGDP	LN VAT	INF	LNFCR
Mean	13.10112	11.99599	14.72500	14.74913
Median	13.17701	12.03485	12.0500	14.97156
Maximum	13.69773	13.58685	51.60000	17.90402
Std. Dev	0.383389	1.198168	9.391647	1.240739
Skewness	-0.618143	1.682015	13.27166	3.214250
Jarque-Bera	1.619730	1.597015	122.8008	0.580704
Probability	0.444918	0.450000	0.000000	0.748000
Observations	20	20	20	20

Source: E views Result

We used the mean and standard deviation to describe the behavior of the variables. We then use the Jarque-Bera statistic to explain the normality of the variables. At 0.05 level of significance, LnGPD, LnVAT and LnFCR are normally distributed because their P. values are above 0.05. However, the INF does not have normal distribution. This implies that the inflation rate in Nigeria is not stable.

**TABLE 4.3 CORRECTION MATRIX**

	LNGDP	LN VAT	INF	LNFCR
LNGDP	1.000000			
LN VAT	0.951124	1.000000		
INF	-0.363135	-0.382436	1.000000	
LNFCR	0.727460	0.741751	-0.346054	1.000000

Source E views Results.



The result of the correlation matrix was used to test for multicollinearity. The decision rule is to accept any coefficient above 0.7 as strong correlation. The presence of strong correlation implies colinearity. It signals presence of multicollinearity. In the results on Table 4.2 above, there is only one strong correlation in the explanatory (independent) variables. Thus, we conclude that there is no multicollinearity in the models.

#### 4.2.1 Model Estimation

$$\text{LnGDP} = X_0 + x_1 \text{LnVAT} + \text{Inf} + \text{LnFCR} + e_t$$

Dependent Variable: LNGDP

Method: Least Squares

Date: 09/16/16 Time: 14:12

Sample observations: 20

Table 4.4 test of model Estimation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LN VAT	0.293139	0.037376	7.842894	0.000
INF	0.000177	0.003409	0.051801	0.9593
LNFCR	0.015273	0.035546	0.429662	0.6732
C	9.356767	0.403780	23.17295	0.0000

R-Squared	0.905726	Mean dependent var	13.10112
Adjusted R-squared	0.888050	S.D. dependent var	0.383389
S.E. of regression	0.128278	Akaike info criterion	-1.092374
Sum squared residue	0.263285	Schwarz criterion	-0.893228
Log likelihood	14.92374	Hanna –Quinn criter.	-1.053499
F-statistic	51.23932	Durbin- Watson stat	0.752771
Prob. (F-statistic)	0.000000		

$$\text{LnFCR} = X_0 + X_1 \text{LnVAT} + e_t$$

Dependent Variable: LNFCR

Method: Least Squares  
Date: 09/16 /16 Time: 14:30  
Sample: 1995-2014  
No of observations: 20

Variable	Coefficient	Std.Error	t-Statistic	Prob
LN VAT	0.768106	0.163696	4.692260	0.0002
C	5.534942	1.972983	2.805367	0.0117
<hr/>				
R-squared	0.550195	Mean dependent var	14.74913	
Adjusted R-squared	0.525205	S.D.dependent var	1.240739	
S.E. of regression	0.854935	Akaike info criterion	2.619058	
Sum squared residue	13.15646	Schwarz criterion	2.718631	
Log likelihood	-24.19058	Hanna –Quinn criter	2.638495	
F-statistic	22.01731	Durbin- Watson stat	2.481126	
Prob. (F-statistic)	0.000182			

Source: E views Analysis

### 4.3 Test of Hypotheses

Three hypotheses were specified for this study. These hypotheses covered the scope of the research.

#### 4.3.1 Test of Hypothesis one

##### **Hypothesis one States as follows:**

There is no relationship between Value Added Tax, Federally Collected Revenue, Inflation and Gross Domestic Product.

##### **The Model for equation one is stated as follows:**

Analyses of Model 1

$$\text{LnGDP} = X_0 + X_1 \text{LnVAT} + \text{LnFCR} + e_t$$

Dependent Variable: LNGDP

Table 4.5 Test of Model 2

Variable	Coefficient	Std. Error	t.Statistic	Prob.
LN VAT	0.293139	0.037376	7.842894	0.0000
INF	0.000177	0.003409	0.051801	0.9593
LNFCR	0.015273	0.035546	0.429662	0.6732
C	9.356767	0.403780	23.17295	0.0000
R-squared	0.905726			
Adjusted R-squared	0.888050			
F-statistic	51.23932	Durbin-Watson	0.752771	
Prob. (F-statistic)	0.000000			

\* Significant at 1%: \*\*\* significant at 5%:

The coefficient of determination (R-Squared) is 0.91 which means that about 91% of changes in the dependent variable (economic growth) can be explained by the explanatory variable (VAT, INF, and FCR). The F-statistics is 51.23932 with a probability value of 0.000000. Since the p. value is less than 0.05 level of significance, we conclude that all the explanatory variables have overall significant effect on the dependent variable (economic growth).

The Durbin Watson statistics is 0.752771. Since the Durbin Watson is less than 2, we can conclude that there is autocorrelation in the model.

The result of the individual coefficients is explained using the equation from model result, thus:

$$\text{LnGDP} = 9.356767 + 0.293139\text{LnVAT} + 0.000177\text{INF} + 0.015273\text{LnFCR}$$

Based on the results, all the explanatory variables (VAT, INF and FCR) have relationship with GDP but only VAT have significant effect.

The implication is that Inflation and Federally Collected Revenues do not have significant effect on GDP. This is because the P values for Inflation

(0.9593) and Federally Collected Revenue (0.6732) are greater than the 0.05 level of Significance.

Thus although these variable have a relationship with GDP, they do not have significant effects.

#### 4.3.2 Test of Hypothesis two

Hypothesis two states as follows:

There is no relationship between Value Added Tax and Federally Collected Revenue in Nigeria.

#### ANALYSIS of Model 11

$$\text{LnFCR} = X_0 + X_1 \text{LnVAT} + e_t$$

Dependent Variable: LNFCR

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LN VAT	0.768106	0.163696	4.692260	0.0002
C	5.534942	1.972983	2.805367	0.0117
R-squared	0.550195			
Adjusted R-squared	0.525205			
F-statistic	22.01731	Durbin-Watson	0.752771	
Prob. (F-statistic)	0.000182			

\* Significant at 1%: \*\*\* significant at 5%:

The coefficient of determination (R-Squared) is 0.55 which means that about 55% of changes in the dependent variable (FCR) and be explained by VAT proceeds. The F-statistics is 22.01731 with a probability value of 0.000182. Since the p. value is less than 0.05 level of significance, we conclude that VAT has overall significant effect on FCR. The result of the coefficient of VAT (0.768106) Significant at 0.05% confirms the result.

$$\text{FCR} = 0.534942* + 0.768106 \text{LnVAT}*$$

The Durbin Watson statistics is 2.481126. Since the Durbin Watson is than 2, we can conclude that there is no autocorrelation in the model.

### **4.3.3 Test of Hypothesis Three**

**Hypothesis Three States as follows:**

There is no relationship between Value Added Tax and Economic Growth of Nigeria.

The test of the Hypothesis is as shown in the analysis shown in Table 4.5. From the analysis, the value for the T-Statistic is 7.842894 with a probability value of 0.0000. The P value is less than the 0.05 level of Significance. Here the T-Statistic is greater than the P-value. Thus the VAT has a significant effect on economic growth.

## **4. DISCUSSION OF FINDINGS**

The study shows a positive and significant relation between domestic product (GDP) and value Added tax in Nigeria. It has been argued that VAT encourages savings by discouraging excessive consumption thereby encouraging investment (capital formation) which leads to economic growth. In the same vein, VAT revenue leads to an increase in government revenue and government expenditure. Government is able to invest in infrastructure that will aid in production of goods and services.

According to Musgrave and Musgrave (1980), perhaps the major impact of fiscal policy on capacity is through its effect on savings and on capital formation. He concludes by arguing that capital formation raises productivity, and this economic growth.

Musgrave and Musgrave, further opined that a fundamental requirement of economic development is an adequate rate of capital formation relative to that of population expansion. It may be in the form of investment in the public or the private sectors. Particularly, in the early stages of development, the public sector investment is of critical importance in the form of social infrastructure, (power, communication, port facilities etc).

Furthermore, capital formation includes investment in human resources in the form of education and training as well as in physical assets. Consumption tax induces greater savings than the income tax. Furthermore, it does not distort the pattern of investment, in this respect; it is more favourable for development of new industries. The superiority of the consumption tax as a stabilizer both during a depression and in inflation seems obvious. Thus consumption tax is more adequate tax to enhance economic growth.

Taxation is not only politically expedient but as an engine for generating the necessary development at capital. Taxation is for government to be able to provide social services, which are usually consumed by private investors. Expenditure will increase GDP since it contributes to current demand.

However, there is also a negative effect since increased public expenditure needs to be financed through taxes or by borrowing. Increased taxes will lower disposable income and private consumption may fall accordingly. Public expenditure may also have a crowding out effect on private investments. This is because resources that could have been invested in the private sector, for instance, go to the government sector instead. Public expenditure also has a positive effect on interest rates, which influences investments. When it effects public investments, they are devoted to roads, railways, buildings like schools and hospitals. Government investments are expenditure on the core functions and therefore they are expected to have a positive effect on the economic growth of the country.

The expansion of a country's economic and socio-economic infrastructure is a prerequisite for sustainable growth and development. In this regard, that government and public corporations play an invaluable role in facilitating and propelling the investment process by creating a conducive and investor friendly environment, and the provision of the necessary economic infrastructure, which will lead to the crowding in of increased private sector fixed investment to enhance the country's productive capacity.

Gross fixed capital formation has a crucial effect on economic growth and development. Such investment includes capital spending on the expansion and maintenance of economic infrastructure such as roads, rail networks, port and labour facilities, electricity supply, as well as telecommunication services. A rapid increase in fixed investment broadens a country's economic base and provides a robust base for future economic activities, increased levels of production capacity as well as the associated wealth creation. It is in this regard that government can play a catalytic role, resulting in expanding a country's economic role, with the benefits of expanding a country's economic infrastructure manifesting themselves in the long term and being a precondition for an accelerated growth trajectory.

Public spending in recent years is characterized by insufficient spending on infrastructure development and/or its maintenance, resulting in increased inefficiencies. Such inefficiencies consequently translated into increased operational cost for the private sector.

The traditional (neoclassical) model contends that increased taxation as well as increased savings and investment, only have transitory effects on the rate of growth. The steady state equilibrium has no role for changing economic policies. The classical theories ensure that the broad concept of reproducible capital (technology), endogenous growth theory affect long-run growth, via its impact on investment in machines, skills and technology. To the extent that capital and labour deter such investments they induce growth. Similarly, public expenditure finance these programmes, or induces by taxes required to finance these programmes, or that reduces incentives to save and accumulate capital in other ways.

Economic growth is created over the long run by a labour force which possesses the incentive to work and produce and by entrepreneurs who have incentives to invest in capital stock. Through excessive spending government negatively affects the long-run economic growth rate of the

economy. Government spending reduces labour force participation, increases unemployment and reduces productivity.

The IMF has a bias towards expenditure reductions rather than tax increase, particularly for advanced economics with already high tax burdens. The above supports the view that economic growth will be higher if government spending is lower.



## **CHAPTER FIVE**

### **SUMMARY OF FINDINGS CODUSION AND RECOMMENDATIONS**

#### **5.1 SUMMARY OF FINDINGS**

This Study sought to establish a functional relationship between VAT and Gross Domestic Products (GDP).

1. In testing for the hypotheses prescribed for the study, we employed the use of correlation and regression analysis. The analyses show that there is a very strong and positive association between VAT and Gross Domestic Product (GDP).
2. We also found that the value Added Tax has significant relationship Federally Collected revenue. We also found that there is a strong relationship between Gross Domestic product and other explanatory variables Consisting of Federally Collected revenue, Value Added Tax and Inflection

#### **5.2. CONCLUSION**

This study shown that value Added Tax impacts significantly on the economic growth of the Nigeria economy. We found that VAT has a strong relationship with federally collected revenues and affects government spending to a lager extent. Government expenditure has an important role is stimulation growth in the Nigeria. Change in VAT revenues to the federal, State and local governments have direct effects on the pattern of expenditure of these units and thus the growth rate of the natural economy.

We can thus conclude that the lack of synchronization between the expenditure pattern of government and VAT revenues constitutes a major limitations to the growth of the national economy.

## **5.2 RECOMMENDATIONS**

Based on the findings from the study we made the following recommendations:

1. To broaden the tax base and to bring VAT administration closer to the taxpayer, new local VAT offices should be established all over the country.
2. The government should strengthen tax administration to ensure more efficient tax collection, through training of staff, awareness campaigns and computerization of customs tariff.
3. Government on its part should use VAT proceeds to improve on the standard of living of the populace and improve on infrastructures such as transport, power, communication and information technology so as to strengthen the productive capacity and motivate taxpayers in paying their taxes.
4. Since taxation with representation "is now the global trend we recommend that stakeholders, be involved in VAT rate increase by widespread enlightenment campaign, so as to foster high rate of compliance. Thus, government should always consider taxpayers and other key stakeholder' interest in fiscal policy formulation and to achieve improved tax compliance rate in the country.
5. VAT rate increases should be compensated with palliatives for the taxpayers. Such palliatives include reduction in the personal tax burden.
6. Prosecution of corrupt tax officials and tax payers that default on tax payment should be intensified.
7. Government should be made to cut down unnecessary expenditure rather than increase tax rate.

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