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TAXATION, REVENUE ALLOCATION AND FISCAL FEDERALISM IN NIGERIA: ISSUES, CHALLENGES AND POLICY OPTIONS**

ABSTRACT: *Taxation is one of the most important and easy sources of revenue to any government, as the government possesses inherent power to impose taxes and levies. Nigeria tax system has been weak due largely to inadequate data of the tax base and heavy reliance on oil revenue. With the volatility in oil prices and excruciating impacts of the recent global financial crisis, taxation deserves more attention now than ever before in Nigeria. One issue that is critical to domestic resource mobilization and utilization is the issue of fiscal federalism. Nigeria operates three tiers of government; Federal, State and Local Governments with separate revenue, expenditure, and assigned responsibilities each. However, all decisions*

including resources are controlled from the centre and the vertical revenue allocations tilt more towards the direction of federal government, contrary to the tenets of federalism the country is practicing. Both vertical and horizontal revenue in Nigeria is engulfed in controversy.

The paper presents key issues, trend and challenges of taxation and fiscal federalism in Nigeria. In addition, the paper highlights a number of suggestions that would stimulate increase in tax revenue and guarantee fiscal assignment acceptable to the federal and sub-national government

KEY WORDS: *Taxation, Revenue Allocation, Fiscal Federalism*

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1. INTRODUCTION

The choice of whether a country becomes unitary system, confederation or a federation is a political decision. This political decision once made, have implications for political government, fiscal management and economic development as well as the attainment of social stability (Okunroumu, 1996). According to Aigbokhan (1997), and Olowonmi (2000) the most feasible option of achieving an efficient public sector is fiscal decentralization. A very important goal of any government is efficient allocation of resources and efficient distribution of national wealth (Afolabi, 1999). Nigeria, after about 50 years of independent is still engulfed in the problem of how to share centrally generated revenue among the Local Governments, States and Federal Government. Another problem is how the revenue apportioned to the Local Governments and States can be shared among these aforementioned tiers of government.

The volatility of oil production and revenue due to conflict in the Niger Delta Region plus the excruciating impact of the recent global financial crisis- with drop in commodity prices (including oil prices), aid flows and FDI respectively- makes it important to look deeper into alternative sources of development finance particularly taxation. Taxation is not only an effective tool to reduce Nigeria's dependence on oil revenue but also dependence on aid from developing partners. With a population of about 150 million people, Nigeria has tremendous tax potentials that can guarantee reliable and uninterrupted revenue to government. Efficient and robust taxation system is the cornerstone to attaining the Nigeria's ambition of becoming one of the most rapidly developing economies the world by 2020.

This paper examines the twin issue of taxation and fiscal federalism in Nigeria. The paper took a cursory look at the topic during the pre and post independent period. Section one, is introductory section. The other parts of the paper are arranged as follows. Section two, examines Nigeria's Tax System. While section three, contains a discussion on the Nigeria's fiscal federalism, section four highlights expenditure assignment and revenue allocation in Nigeria. Section five examines the challenges facing revenue allocation in Nigeria. Finally, section six contains the study conclusion and policy recommendation.

2. NIGERIA'S TAX SYSTEM

2.1 Tax Type and Tax Jurisdiction

The assignments of fiscal instrument in Nigeria were guided by constitutional provision. The federal constitution gave the federal government exclusive power to collect levies like customs and excise, company tax, education tax and mining rents, VAT etc. All these revenues (with the exception of education tax) are paid into the federation account for distribution among the three tiers of government in line with national constitution. The states and local governments are left with the powers to collect other fees. The main types of tax revenue for the federal and sub-national government are listed in Table 1. Nigeria's local governments have autonomy to perform their functions in line with the constitution. However, the autonomy of local governments is not absolute. They retain their functions and fiscal relations with states and federal government.

Table 1 Nigeria's Federal, State and Local Tax Jurisdiction and Assignment

Tax	Legal Jurisdiction	Collection	Retention
Import duties	Federal	Federal	Federation Account
Excise duties	Federal	Federal	Federation Account
Export duties	Federal	Federal	Federation Account
Mining rents & royalty	Federal	Federal	Federation Account
Petroleum profits tax	Federal	Federal	Federation Account
Capital gains tax	Federal	State	State
Personal income tax (other than listed in 8)	Federal	State	State
Personal income tax: armed & police forces, external affairs officers, non-residents, residents of the Federal Capital Territory	Federal	Federal	Federal
Value added tax (Sales tax before 1994) ²	Federal	Federal / State	Federal / State

Company tax	Federal	Federal	Federation Account
Stamp duties	Federal	State	State
Gift tax	Federal	State	State
Property tax and ratings	State	State/local	State/local
Licenses and fees	Local	Local	Local
Motor park dues	Local	Local	Local
Motor vehicle	State	Local	Local
Capital transfer tax (CTT)	Federal	State	State
Pools betting and other betting taxes	State	State	State
Entertainment tax	State	State	State
Land registration and survey fees	State	State	State
<i>Market and trading license and fees</i>	State	Local	Local

Source: (Anyanwu, 1995; Jimoh, 2003; Federal Republic of Nigeria Constitutions, 1963, 1979 and 1999)

Although the tax types have remained virtually unchanged since independence, a number of changes had occurred with respect to who has right to revenues. For example, before 1959, regional governments have rights to 100% of mining rents and royalties but with production and exportation of oil in 1958, and following Raisman Commission recommendations, in 1959, this was to be distributed as follows: mineral region (50%), Federal (20%) and Distributable Pool Account, DPA, (30%). In addition, sales tax, to which states (or regions) hitherto had 100% right, was replaced by VAT in 1994 (Jimoh, 2003).

2.2 Taxation and Revenue Structure in Nigeria

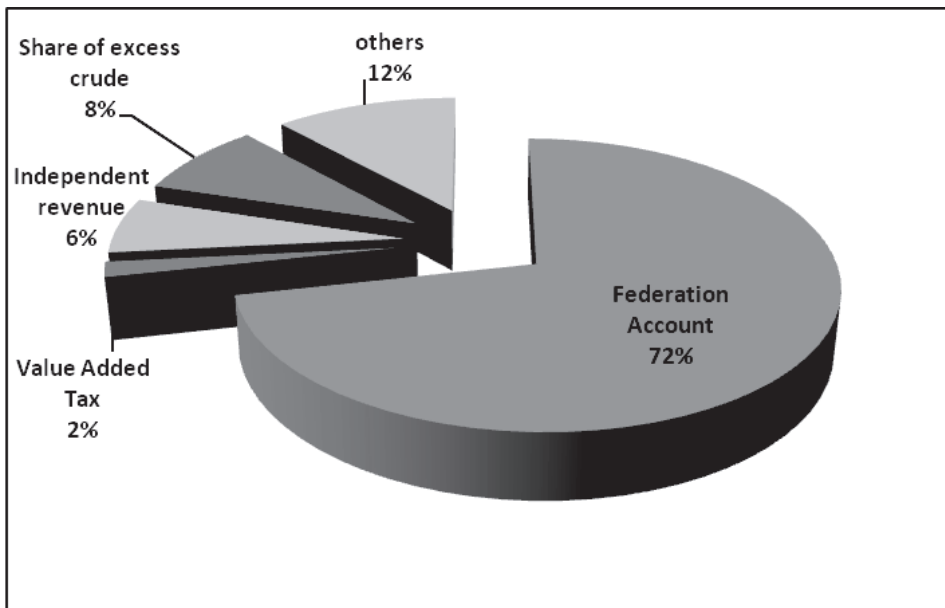
Over the last three decades, the sources of public revenue in Nigeria are proceeds from the sale of crude oil, taxes, levies, fines, tolls, penalties and charges. Oil revenues are the main source of public revenue, accounting for about 80% to 85% of the total (AfDB, UNECA, and OECD 2010). In the period 2001–09, oil revenues averaged 27% of GDP while tax revenues averaged 6.4%. Oil revenues have been volatile, ranging from 35.6% in 2001 to 19.6% in 2009 when oil prices dropped as a result of the global recession. In Africa, Nigeria like Algeria, Angola, Equatorial Guinea and Libya rely almost entirely on one single type of tax, unlike Kenya, South Africa and Mauritania which show a relatively balanced mix of different types of taxes.

The lion share of total Nigerian revenues is collected and retained by the federal government. For instance, between 1980 and 2008, about 93.9% of the

total Nigerian government revenues were collected by the federal government. This is not unexpected as the federal government is solely responsible for the collection of mining rights and royalties, petroleum profit tax (Nigeria’s major revenue source) and share VAT collection with state government. This implies that the local and state governments put together, collect less than 7% of Nigeria’s government revenues.

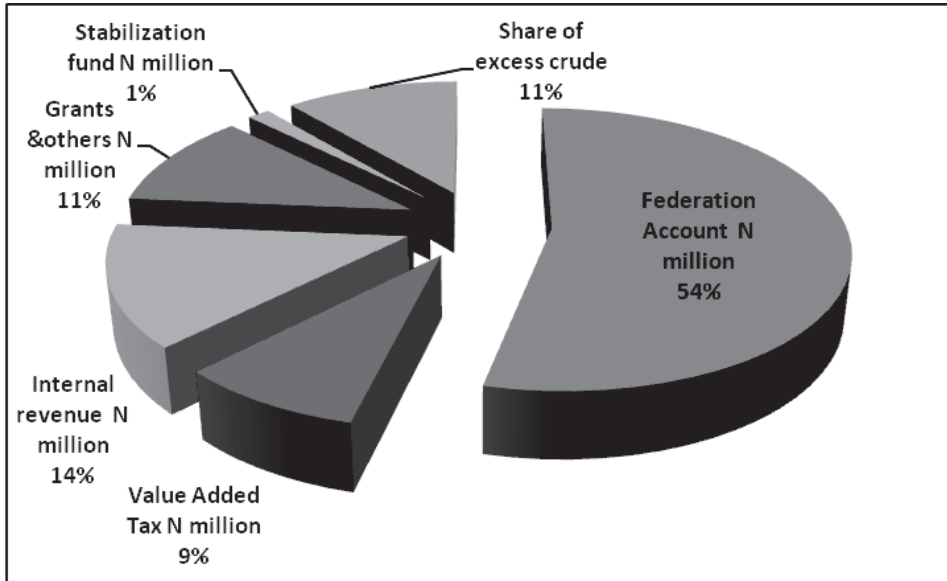
The revenue profiles of the three tiers of government for the period 2003-2008 are depicted in figures 1, 2 and 3 respectively. The bulk of the federal government revenue (over 70%) is from the federation account. In fact, federal government generates only about 6% independent revenue between 2003 and 2008. Similarly, internal generated revenue (IGR) efforts of states at 14% in the same period are generally very weak. State governments rely mainly on federal allocation, grants and proceed from excess crude account as their major sources of funding. Also, the structure of local government revenue follows the same trend exhibited by federal and states government. This weak drive for internally generated revenue by the three tiers of government is not conducive for economic growth and prosperity.

Figure 1. Revenue Structure of the Federal Government, 2003-2008



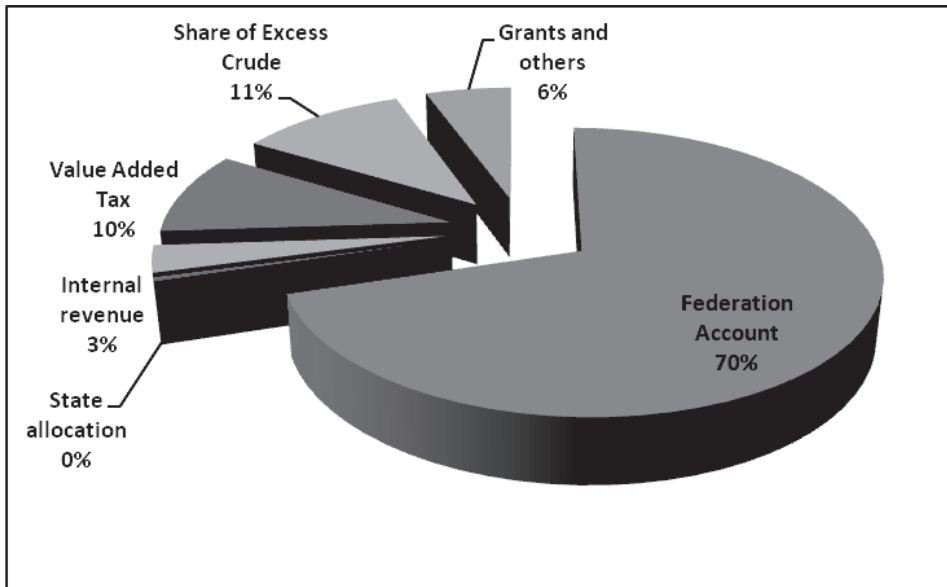
Sources: CBN: Statistical Bulletin and Annual Report and Statement of Account (various issues).

Figure 2. Revenue Structure of State Government, 2003-2008



Sources: CBN: Statistical Bulletin and Annual Report and Statement of Account (various issues).

Figure 3. Revenue Structure of Local Government in Nigeria, 2003-2008



Sources: CBN: Statistical Bulletin and Annual Report and Statement of Account (various issues).

Tax administration and revenue collection functions are performed by different institutions at the three tiers of government. At the federal level, Federal Ministry of Finance; the Federal Inland Revenue Service and the Nigeria Customs Service are responsible for the administration of tax laws and revenue collection. The Joint Tax Board is responsible for harmonising the relationship between tax authorities at the federal and state levels. The National Revenue Mobilisation, Allocation and Fiscal Commission propose the remuneration of political and judicial office-holders, and also advise on the allocation of revenues among the three tiers of government. The state's Board of Internal Revenue and Ministry of Finance are responsible for tax administration at the state level. The revenue committee for local governments and Finance and Supply Department are responsible for tax matters at the local government level.

Efficiency and effectiveness of Nigeria's tax system over the years has been faced with a number of challenges. These challenges include:

- (i) Tax Administration and administrative challenges; these include inadequate personnel and institutional capacity to administer taxes effectively. The use of poorly trained staff with inadequate technical and administrative competences is not uncommon especially at the local government level.
- (ii) Compliance challenges; The failure of employers to keep accurate records and remit all personal income tax (PIT) to relevant authorities remains a challenge in spite penalties and the payment of all tax arrears by defaulters. Also some business concerns keep different versions of record at times all certified by auditors. The correct version is different from the version for the tax authority. There is yet another robust version for the bank showing a buoyant business. Also, most tax-payers have limited ability of to keep accurate accounts and are ignorant on their tax responsibilities.
- (iii) Lack of reliable statistics on the various taxpayers is a major hindrance for the identification and assessment of taxpayers. This lack of data limits follow up to enforce collection.
- (iv) Lack of equality especially in PIT is major problem of taxation in Nigeria. Self-employed outnumber paid workers and they earn as much as four times that of the formal sector employees, the bulk of PIT is paid by employees whose salaries are deducted at source (Mamud, 2008).
- (v) There are over 500 different taxes and levies imposed by various tiers of government in Nigeria instead of only those approved by Taxes and Levies (Approved list of Collection) Act. The multiplicity of tax-imposing and tax-collecting structures drives up the cost of doing business and destroys investor confidence. In fact, the World Bank *Doing Business* Report, 2010, ranked

Nigeria 132nd out of 183 countries with regard to the ease of paying taxes. Multiple taxation partly accounts for this low ranking (AfDB, UNECA, and OECD 2010). Multiple taxation is more common in the Local Government Councils.

- (vi) Fraud and Corruption on the part of tax-collecting institutions is an issue that needs to be addressed. Revenue Collectors still engage in fraudulent practices, in spite of the various control measures and the presence of Independent Corrupt Practice Commission (ICPC), and the Economic and Financial crime Commission (EFCC).

In order to address the above challenges the federal government has adopted several measures. In 1986, following the introduction of the structural adjustment programme (SAP), tax reform undertaken includes, reviewing custom and excise duties, continuing with the reduction of company and income taxes, expanding the range of tax exemptions and rebates, introducing capital allowance, expanding the duty drawback scheme and manufacturing-in-bond scheme, abolishing excise duty (Mamud 2008). In 2002, the federal government of Nigeria inaugurated a Study Group (the SG) to review all aspects of the Nigerian Tax System and administration. The SG report and recommendations was further reviewed by a Working Group (the WG) inaugurated in 2004.

Most of the legislation presented by government to the National Assembly as recommended by the SG and WG has been signed into laws. These include; Bill for an Act to establish the FIRS as an autonomous Service, Bill for an Act to amend the Companies Income Tax Act and Bill for an Act to amend the Petroleum Profit Tax. Following the recommendation of the WG, a new National Tax Policy (NTP) was approved by the Federal Government of Nigeria in January 2010, to provide a set of rules and guidelines that will regulate all stakeholders such as taxpayers, regulators, tax practitioners and legislator. The policy is also expected to uphold the application of fiscal federalism in the generation and expenditure of revenue by governments at all levels as stipulated by the Nigerian constitution. The policy will become fully operational following the passage into law by the National Assembly (Oji,2010).

Key highlights of the draft tax policy include: Avoidance of multiple taxation by the various tiers of government on income, property, imports, production and turnover; encourage the use of career tax administrators to collect tax as against the use of ad-hoc consultant or agents; more emphasis on direct taxation than indirect taxation coupled with an increase in the rate of VAT; reduction in

companies' income tax from 30% to 20% and the top rate for PIT from 25% to 17.5%.

The proposed National tax policy though a major improvement over the existing strategic document still has some short comings. For example, the issue of non-compliance of employers to register their employees and to remit such taxes to relevant authorities was not properly addressed in the new national tax policy. Besides, the policy is not very clear on how the challenge of multiplicity of taxes can be tackled by the three tiers of government. Nigeria's active workforce is predominantly in the informal sector where collection of taxes is a critical challenge. The modalities for widening the tax base to effectively capture most of the informal sector and other potential tax payers needs to be given more consideration before the document is finally signed into law. Moreover, the greatest challenge of the new policy to a federal state like Nigeria is the ambiguity in tax jurisdiction. According to Sanni O. (2010), some state governments, like Lagos State not only faulted the new policy on the ground that all State Houses of Assembly powers will be usurped from legislating on tax matters but also raise objection to why the Federal Government is given the responsibility to charge fees like PIT and land use tax.

3. INTERGOVERNMENTAL FISCAL RELATIONS (FISCAL FEDERALISM)

Globally, there are only 24 of the world's 193 countries including four African countries namely Comoros, Nigeria, Ethiopia and South Africa with clear federal constitutions. Other countries outside Africa that operates federal political systems includes America, Canada, Switzerland, Germany, Australia, India, Argentina, Brazil and Belgium. Iraq, Sudan, Sri Lanka and the Democratic Republic of Congo (DRC) are either considering the option or are in transition to a federal system.

Fiscal Federalism is the inter-government fiscal relation as enshrined in a federal constitution provided for the functional responsibilities to be performed by the multi –levels of government and the financial resources that can be raised for provision of collective goods and services. Therefore, fiscal federalism recognizes that two or three government and not one central government must perform the role of the state in economic management, each level with different expenditure responsibilities and taxing powers. The federal system of administration is unique in that it allows both a centralized and decentralized collective choice. Fiscal federation places the economy at a higher utility level than a centralized system.

(Okigbo, 1965; Anyanwu, 1996; Okunrounmu, 1996; Olusoji and Magbagbeola, 1997; Devarajan, 2000; Inegbedion and Omoregie (2006); Buettner and Wildasin, 2007; and Freinkman, 2007).

Tella (1999) identifies two types of federalism namely, the dual federalism and the cooperative federalism. For the dual federalism, the constitution created two separate and independent tiers of government with their own clearly defined areas of responsibilities. In such a system, it is inevitable that a certain level of tension and competition would exist. Cooperative federalism, on the other hand, simply refers to making federalism work through cooperation between the various levels of government. It emphasizes the partnership between the different levels of government providing effective public services for the nation. This type of federalism is practiced in the United States of America and Germany. Nigeria too has been practicing cooperative federalism since the military incursion of 1966.

In the strong central government approach, the federal government retains the lion share of revenue and the state/ local governments have smaller share out of the federation account. In the decentralized approach, the federal government retains a lower share, with states and local governments having a larger share out of the federation account (Likita, 1999). On the other hand, confederation is a loose form of federalism that allows citizen from each region to maintain their primary allegiance to the region to which they belong. Confederation allows each region to retain and utilize revenue generated from within its jurisdiction (Okoh, 2004). Earlier, Mbanefoh (1993) argues that, it may be practically impossible to satisfactorily balance the financial resources of a segment of a federation with the functions which it is expected to perform. This imbalance (Okeke 2004) concluded should not be regarded as result of federalism, but as a result of the disturbances of the equilibrium which ordinarily would allow the segments of the federation to carry out developmental programs that could be undertaken with the available internal resources.

Nigeria was incorporated in 1914 with the amalgamation of the two British protectorates of Northern and Southern Nigeria and the Crown Colony of Lagos into a single entity. The concept of fiscal federalism was first introduced in Nigeria in 1946 with the formation of a federation of three regions by splitting of the Southern Province to create the Eastern and Western Regions, and the Northern Region which was a continuation of the Northern Province, following the adopting of the Richards Constitution. Each of the three regions (East, West and North) has its own revenue base with a relatively weak federal government

(Barkan *et al*, 2001; Vincent, 2002). The Nigerian federal system metamorphosed thereafter from a two-tiered federal arrangement initially comprising three unequal political and administrative regions to the current three tiered federal system of 36 states, one Federal Capital Territory and 774 Local Governments.

Before the military took over government in 1966, the regions were powerful and autonomous, especially as they generated most of their revenue from independent sources. Nowadays, the sub-national governments are totally dependent on federally collected revenues (Barkan *et al*, 2001; Mfor, 2009). According to Nwabuese (1983), true federalism presupposes that the national and regional governments should stand to each other in a relation of meaningful independence resting upon a balanced division of powers and resources. Conversely, most analysts including Vincent (2002) are of the opinion that Nigeria stopped operating a truly federal system of government in January 1966 in favour a unitary system of government. In July 2010, the Nigeria's 1999 constitution was amended. Unfortunately, expected changes especially the issues "true federalism" were not made.

One thing that can make or mar the corporate existence of Nigeria is the status of oil producing states. The way and form of allocating funds to oil producing areas from the federation account is very controversial. The establishment of the defunct Oil and Mineral Producing Areas Development Commission (OMPADEC), Niger Delta Development Commission (that replaced OMPADEC in 1999) and the recently established ministry of Niger Delta in 2008, has not fully resolve the agitation for more shares of national revenue by oil producing areas in the Niger Delta nor ameliorate the deplorable conditions in their area.

Government established federation account in order to disburse the funds to the bonafide beneficiaries (Federal, State and Local Governments) in line with the constitution and approved revenue allocation formula. The disbursement of this fund is done by the Federation Account Allocation Committee (FAAC). FAAC made up of Minister of States for Finance (Chair), Accountant general of the Federation, Commissioners of Finance of the 36 states of the federation and representatives of other institutions meets monthly. The Revenue Mobilization Allocation and Fiscal Commission (RMAFC) established in 1989 is constitutionally charged with the responsibility of ensuring that this disbursement exercise is accurate, fair and transparent (RMAFC, 2003).

4. EXPENDITURE ASSIGNMENT AND REVENUE ALLOCATION IN NIGERIA

4.1 Expenditure Assignment

All the constitution of the Federal Republic of Nigeria allocated function to be performed by each level of government. The 1963 Federal Constitution allocated the functions to be performed by the federal and regional government under two main headings. That is, the exclusive federal and concurrent legislative list. In 1963 constitution, the local government was treated implicitly as part of the regional governments. The 1979, 1989 and 1999 federal constitution identified functions of each level of the federation. These functions are:

- (i) Exclusive list: These are function to be performed solely by the federal government. These functions include: external affairs, issue of legal tender currency, police, defense accounts of government of the federation etc.
- (ii) Concurrent legislative list: These are those to be performed by federal and state/ regional governments. These include census, higher education, industrial development prisons, National Parks and Antiquities etc.
- (iii) Functions of Local Government: The functions and roles of the local government are listed in the fourth schedule of the 1979, 1989 and 1999 federal constitutions. The main functions of local governments are provision of public goods, cemetery, refuse disposal public convenience, naming of roads, streets and house numbering, licensing, regulation and control of the sale of liquor, collection of rate, radio and television license etc.

However, under the military administration, the functions of each tier of government are not clearly defined. The function of each level of government depends on the Head of State and Commander-in-chief of the Armed forces. The military governments rely on decrees and various ad-hoc provisions to assign responsibilities. Even under the civilian dispensation, the local governments are still subject to varying degrees of state oversight and control, even though their functions are specified in the Fourth Schedule. The local government authorities (LGAs) can exercise their authority only in accordance with enabling legislation passed by the states.

Furthermore, most of the powers accorded to the states in the Second Schedule of the 1999 constitution are exercised concurrently with the federal government. However, there is the confusion over which tier of government, federal or state, is best equipped to deal with various areas of policy. At the moment, the federal and states government complement each other in the area of

provision of health and education. In practice, the functions on the concurrent list lead to wasteful duplication and inter-unit competition which hinder the effective functioning of the federal structure (Barkan *et al*, 2001; UNDP, 2009).

4.2 Revenue Sharing Arrangements in Nigeria

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. Revenue sharing arrangement is at two levels: One, the vertical allocation- among federal, state and local councils- two, horizontal allocation, among the states and the local governments. Revenue allocation is meant to attain two broad objectives, namely, efficiency and equity. Revenue allocation, in Nigeria commenced under the Richard Constitution of 1946. Thereafter, there were over nine fiscal commissions, six military decrees and one act of parliament to design appropriate tax assignment and revenue allocation formulae including: the Hicks-Phillipson Commission (1951), Chick's Commission (1953), Raisman Commission of 1958, Binns Commission (1964) Dina Commission (1968), Aboyade Technical Committee (1972), Okigbo Commission (1980) and Danjuma Commission 1988 (Salami, 2007). The recommendations of all the commissions were all based on the need to have equitable and balanced horizontal and vertical allocation for the country.

Nigeria's fiscal arrangement has been guided by the country's constitution. For example, Section 162(1) of the constitution states that the federation shall maintain a special account to be called the "Federation Account" into which are paid all revenues collected by the government of the federation. All funds standing to the credit of the Federation Account must be distributed among the federal, the state governments and the local government councils on such term and manner prescribed by the National Assembly. Proceeds from the PIT of members of the armed forces, the Nigerian Police Force and the External Affairs Ministry and residents of the Federal Capital Territory, Abuja are, few exceptions of revenue not paid into the federation account in line with the constitution. The allocation formula is guided by certain allocation principles like population (and population density), equality of states, internal revenue generation, and land-mass and principle of derivation.

Since 1989 when the National Revenue Mobilization, Allocation and Fiscal Commission was established, revenue allocation among states/local governments has been based on the following principles: equality, population, social development, internally generated revenue and land mass/terrain. The

importance attached to each of these principles is reflected in the weight given to each principle.

The principles represent the factors that govern the application of revenue allocation such as population, derivation, Landmass, national interest. The formula refers to their relative weight attached to each principle.

Derivation principle. The principle believes that revenue in the federation account should be allocated on the basis of each state's contribution to total revenue. That is, all revenue which can be identified as having come from, or can be attributed to, a particular region or state should be allocated to it (Phillips, 1971). This principle was attacked because it makes rich states richer since the more developed states will contribute more to the federation account, starving needy states of developmental funds. It can therefore, leads to greater disparity among states and the consequent instability within the country.

Principle of need. The principle advocated that states are not equally endowed with resources, some states are more populated and developed than others, and therefore, more resources should be given to the less developed states to bridge the gap in development.

Principle of National Interest. The principle is based on the importance attached to developing all states to increase progress and sense of belonging. It will promote national unity by sharing the revenue in the federation account equally among States. This formula was to strike a balance between equity, and needs of national economic/ political growth leading to stability.

Principle of Independent Revenues. This principle advocates that states can introduce or charge revenue yielding taxes within the state as long as it is a stable source of revenue but must conform with the principles of taxation within the economy and take into consideration national interest.

4.3.1 Vertical allocation of federally collected revenues

The Federal Government retains some of the federally collected revenues as its independent revenues and balance of the federally collected revenues is to be paid into the Federation Account for distribution among tiers of government in accordance with an agreed formula. Before independence, the regional government allocation was more than that of the Federal Government. The sharing formula in 1958 as recommended by Raisman commission was 40:60 in

favor of region. Thereafter and up till today, federal government is allocated the highest share of the federally collected revenues.

However, the Federal Government's share has been on the decline in favor of lower tiers of government. In 1992 the vertical allocation was changed to 48.5%, 24% and 20% for federal, state and local government respectively. Special funds accounted for 7.5 %. The current vertical allocation (without the special funds) with effect from 2002 is 52.68%, 26.72% and 20.60% for federal, state and local government respectively. Anderson (2007) observed that at less than 53% of total government spending (after all transfers to the states), Nigeria is more decentralized than in Brazil, Malaysia and Venezuela. On the other hand, some federations are still more decentralized than Nigeria like Belgium, Canada, Germany and Switzerland, where the federal government accounts for between 30 and 40% of direct government spending.

The derivation account phased out by the Military regime was re-established in 1999. The account was as high as 50 % in 1958. Presently, the derivation account is 13 % of the revenues obtained from oil produced on-shore, that is on the land areas of each of the nine oil producing states, namely; Abia, Akwa Ibom, Bayelsa, Cross River, Delta, Edo, Rivers, Imo, Ondo. Nigeria is perhaps the only known federation that applies derivation principle to federal oil revenues. India and Russia for example make minor special transfers to the producing states. While countries like Mexico, Brazil, Australia, and the United States have no derivation principle (Anderson, 2007). The Federation Account excludes the derivation account. It also excludes the various federal government dedicated account that has first charge AFEM Surplus Account, Petroleum Trust Funds, National Priority Project Funds, External Service Funds, NNPC Joint Venture Payment Account, Educational Tax Funds are increasing. Consequent upon making provisions for all these funds and the derivation account, the balance of the total federally collected revenues paid into the federation account in 2008 is less than 60% , down from over 90% in 1970 (Table 3).

Table 3. Federation Account as a Percentage of Federally–Collected Revenue

Year	Total federally collected revenue ₦ million	Federation Account ₦ million	Federation Account as Percentage of Federally Collected Revenue
1970	634	582	92
1975	5,515	5,294	96
1980	15,234	14,747	97
1985	15,050	13,750	91
1990	98,102	68,064	96
1995	459,987	170,523	38
2000	1,906,159	1,262,468	66
2005	5,597,500	3,203,300	57
2006	6,061,000	3,315,100	55
2007	5,715,600	3,878,500	68
2008	7,866,600	4,552,800	58

Sources: CBN: Statistical Bulletin and Annual Report and Statement of Account (various Issues)

VAT introduced in 1994 to replace the Sales Tax also has a first charge to federally collected revenues and are paid into a special fund called the VAT Pool Account and subsequently shared among the three levels of government. The lion share of the VAT allocation formula goes to the federal government. Currently, the federal government is allocated (40%), state governments (35%) and Local governments (25%)¹.

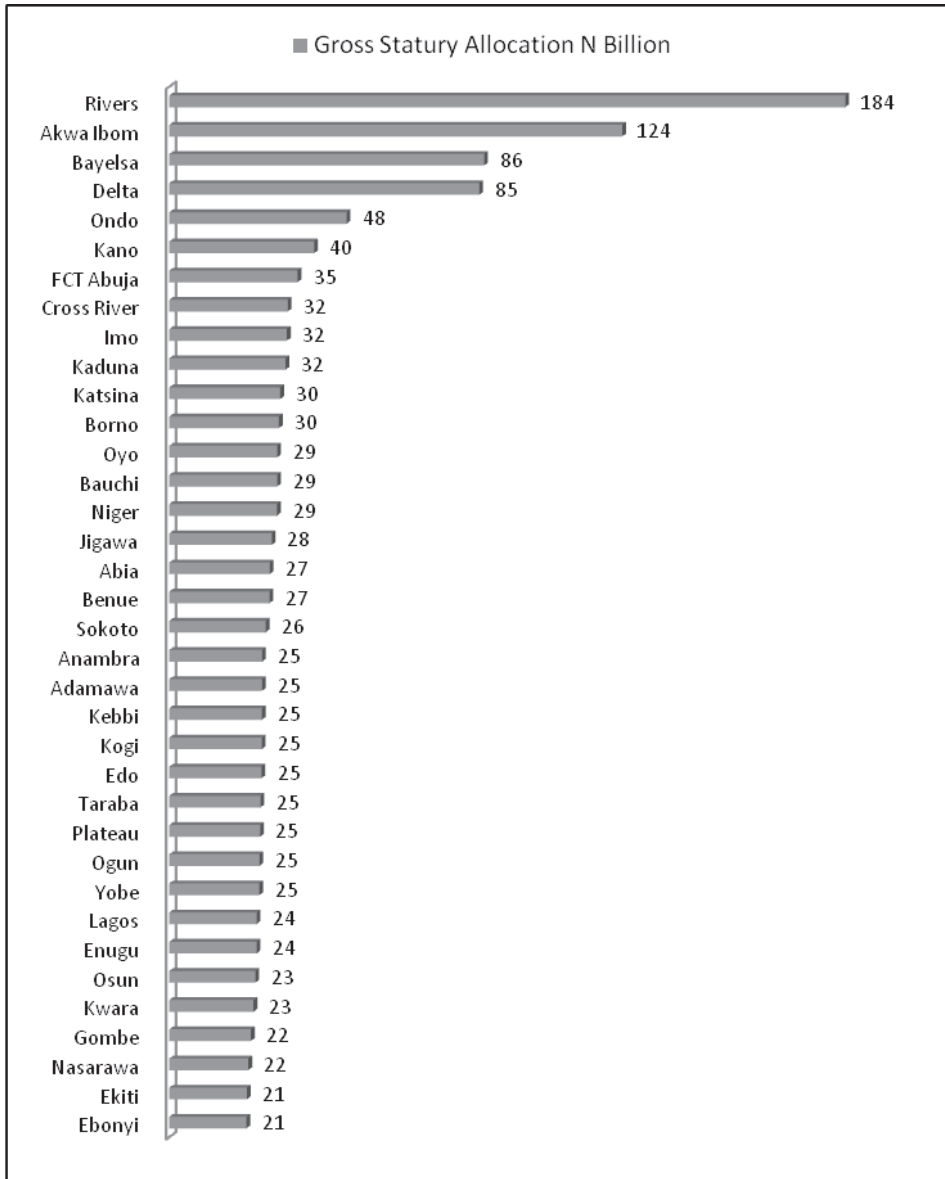
4.3.2 Horizontal Allocation among federating States and local governments

Horizontal allocation among state and local government councils in Nigeria favored states with large land areas, large number of councils, high population and in some instances derivation principle. Prior to 1964, derivation was given the greatest weight 50% in horizontal revenue allocation. The balance was shared among the region based on the principle of equality of state (50%) and population (50%). Between 1964 and 1976, there was no derivation, the principle of equality of state and population were still given equal weights of 50 % in the allocation of revenues among the states. Between 1977 and 1981, equal access to development

¹ See section 2.2 for the share of VAT in revenue generated by the federal and sub-national government

opportunities has a weight of 25 %, national minimum standard 22 %, absorptive capacity 20 %, independent revenue efforts 18 % and fiscal efficiency 15 %.

Figure 4. Federal Allocation Among States 2008 N Billion



Sources: CBN Annual Report and Statement of Account 2008

Between 1982 and 1998, equality of states has a weight of 40 %, population 30 %, independent revenue efforts 10 %, land mass and terrain 10 % and social development 10 %. From 1999, equality of state had the highest weight of 40 % under horizontal allocation among the states. This is followed by population, 30 %. The balance of 30 % is being shared by social development factor, 10 %; land mass, 10 % and internal revenue effort 10 % respectively. Annex 2 highlights the horizontal allocation in Nigeria from 1969 to date. For the distribution of VAT proceeds among states and local governments the indices are derivation (20 %), equality (50 %) and population (30 %). The horizontal distribution formula had remained stable since 1981, except, for the increase in derivation principle for mineral revenue to 13 % in 1999 to the following Nigeria's nine oil-producing. As a result, Rivers, Akwa Ibom, Delta, Bayelsa and Ondo, all oil producing states received the highest amount from the federation account in 2008 (See figure 4). This has been the trend for the past 8 years. However, the revenues allocated to oil producing areas over the years are not sufficient to remedy the negative externalities of oil production let alone grant them access to equal opportunities for development with other states of Nigeria. Therefore, the persistent restiveness in the oil producing areas for sometimes now (Vincent, 2002; Jimoh, 2003).

5. CHALLENGES OF FISCAL FEDERALISM AND REVENUE ALLOCATION IN NIGERIA

The current revenue allocation formula allocates more funds to the federal government at the detriment of the states and local government. Secondly, the system discourages states to strive for an increased Internally Generated Revenue (IGR). This is because most states wait for allocation from the federation account without much effort at getting an increased level of IGR. Furthermore, the allocation to the LGAs are reallocated in most states by a committee namely, State Joint Allocation Committee (JAC). This is unconstitutional and an aberration that needs to be discouraged.

Besides, the fiscal system in Nigeria grants minimal fiscal autonomy to the sub-national governments in terms of revenue assignment as the major taxes such as company income tax, VAT, custom and excise duties, tax on petroleum products and education tax, are assigned to the federal government. The sub-national governments lack financial autonomy especially during the military regimes. The Military incursion into governance in Nigeria distorts the built-in mechanism in the constitution to address fiscal management problems.

With the advent of democratic dispensation in 1999 the situation has improved. For example, Barkan *et al*, (2001) discovered that local governments in few states of the federation such as Ogun, Nasarawa, Delta and Rivers States are now provided with complete or near complete financial autonomy. They no longer require prior approval of any contract, whatever its size, from any organ or functionary of the State Government provided that the project had received the prior approval of the Legislative Arm of the Local Government during the normal process of the annual budget exercise. Though a high degree of financial dependency on central government stifles federalism, it is important to note that an effective federal system does not require that sub-national governments have complete financial autonomy. In practice, fiscal imbalances also feature in most federations as in Brazil and Australia (See Boxes 1 and 2).

Box 1: Brazil Federation

Brazil first adopted federal constitutions in 1889. A revolution in 1930 reduced the autonomy of Brazil's states. That regime was overthrown by the military in 1945 and the federal system was reinstalled, along with an electoral system that included competitive nation-wide parties for the first time in the history of the republic. The military regime that took power in 1964 kept an emasculated form of the federal system, but democracy returned in 1985 and the new federal government allowed direct elections for the state governments. The 27 states (including a Federal District) and 5,559 municipalities of Brazil have significant powers under its Constitution, which was produced by a constitutional assembly in 1988. Three orders of government are recognized: central, state and municipal; and a process of fiscal and political decentralization was ushered in with the new constitution.

The division of revenues from Brazil's state value added tax (VAT) and revenues from offshore oil resources among the three tiers of government is a challenge. The major challenge of the Brazilian government is to achieve consensus among Brazil's constituent units on the sharing of wealth with the aim of reducing regional inequalities. Brazil's federal VAT is fully creditable against the state VAT, with complex technical and Administrative problems relating to different VATs in different states and overlapping tax bases. The major concern of the Brazilian government includes increasing revenue autonomy and decreasing transfer dependency. However, vertical gap of sub-national governments is bridged by equalization transfer.

Box 2: Australia Federation

Australia which became a federation in 1901 currently has 6 States and 2 territories and approximately 774 local governments. The national government tax jurisdiction covers income taxes on individuals and businesses, sales tax, excise taxes, and taxes on international trade, which are Commonwealth taxes. The States' taxes include taxes on payrolls, financial and capital transactions, gambling, insurance, and motor vehicles. Local governments tax immovable property. There vertical and horizontal fiscal imbalance in Australia as the states depend upon transfers from the central government to finance their own expenditure responsibilities. Government put in place inter-governmental transfers to sub-national government through equalization arrangements to deal with these vertical and horizontal fiscal imbalances between the states through specific grants, specific purpose payments and block grants from the federal to states and local governments. Tax system in Australia also includes a federal VAT levied throughout the country, which is distributed to the states through an equalization grant. Key issues of concern in Australia's federal system are reorganization of Australia's hospital funding and health care system and amendments to the Goods and Services Tax, among others.

Another area of concern is the use of land mass and population for computing horizontal revenue allocation formulae. This principle is biased in favor of states with wide land mass and thin population. The equality principle may not be appropriate in Nigeria as the states differ in terms of resources endowment, existing capital formation, e.tc.

6. CONCLUSIONS AND POLICY RECOMMENDATIONS

This paper has examined the issue of taxation and fiscal federalism in Nigeria. Nigeria's expenditure assignment, tax jurisdiction and revenue allocation is disproportionately in favor of federal government despite the recent tax reforms and constitutional amendments. Each level of government should be made to be autonomous. The local government should not be made to depend on state and federal government. The State Joint Allocation Committee should be abolished. The internal revenue sources of local and state government have not been fully exploited. Therefore, concerted effort should be made to boost the internal revenue of the local and state government.

A review of the current revenue sharing formulae to give weight to each tier of government based on the function they perform is imperative. Conflicts, waste

and inefficiencies as a result of duplication of services such as primary and secondary education, primary and secondary healthcare services, and water and sanitation services provided by the sub-national government as well as federal government needs to be eliminated especially with the adoption of a cooperative approach to governance. As recommended by Carling (2006), the problems of vertical imbalance can also be corrected from either the expenditure side—by substantially narrowing the states’ expenditure responsibilities to fit their limited revenue bases—or from the revenue side—by substantially broadening the states’ revenue autonomy and reducing their dependence on commonwealth grants/federal allocation

The persistent agitation for resource control especially by Niger Delta needs to be given urgent attention. Furthermore, government commitment to high level of technical training and capacity building of tax and revenue officials and constant public enlightenment will increase compliance and boost taxation drive by the three tiers of government. As stipulated in the tax proposed tax policy, the use of tax consultants should be discouraged. Tax consultant may only be used in circumstances where there is deficiency in technical skills and required manpower. Finally, for the new tax policy to have a significant impact on the revenue and economic development of Nigeria, the endemic corruption and leakages in the tax administration should be eliminated.

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**ANNEX 1:
VERTICAL ALLOCATION OF THE FEDERATION ACCOUNT, 1981 – TILL DATE**

Recipients	1960-1962	1963-1966	1981 Act	1984 Jan.	1990	Jan. 1992	June 1992	June	2002 till Date*
1. Statutory Allocation Formula (%)									
(i) Federal Government	70	65	55%	55%	50%	50%	48.5%	48.5%	52.68
(ii) State Government	30	35	30.5%	32.5%	30%	25%	24%	24%	26.72
(iii) Local Government			10%	10%	15%	20%	20%	20%	20.60
(iv) Special Funds			4.5	2.5%	5%	5%	7.5%	7.5%	-
(a) Federal Capital Territory					1%	1%	1%	1%	-
(b) Stabilization					0.5%	0.5%	0.5%	0.5%	-
(c) Savings					0%	0%	0%	0%	-
(d) Derivation			2%	2% ^b	1%	1%	1%	1%	-
(e) Dev of oil mineral producing areas			1.5%	1.5%	1.5%	1.5%	3%	3%	-
(f) General cology			1%	1%	1%	1%	2%	2%	-
Total			100%	100%	100%	100%	100%	100%	100%
2. Value Added Tax									
Federal								80	40
State								20	35
Local Govt								0	25

* Without the special funds

Source: (Anyanwu, 1995; Jimoh, 2003; RMAFC database)

**ANNEX 2:
HORIZONTAL REVENUE ALLOCATION FORMULAE (AMONG STATES)
IN NIGERIA (%)**

Criteria .	1969-76	1976-1981	From 1982	January 1990	1999-todate
(i) Minimum Responsibilities of Government (Equality of States)	50.0	-	40.0	40.0	40.0
(ii) Population	50.0	-	40.0	30.0	30.0
Equal access to Dev. Opportunities	-	25.0	-	-	-
Nat'nal min. standard for Nat'nal Integration	-	22.0	-	-	-
Absorptive capability	-	20.0	-	-	-
Fiscal efficiency	-	15.0	-	-	-
(iii) Social Development Factor	-	-	15.0	10.0	10.0
(a) Primary school enrolment of which					
-direct enrolment	-	-	11.25	-	-
-inverse enrolment	-	-	3.75	-	-
(b) Education	-	-	-	4.0	4.0
(c) Health	-	-	-	3.0	3.0
(d) Water	-	-	-	3.0	3.0
(iv) Landmass and Terrain	-	-	-	10.0	
(v) Internal Revenue Effort	-	18.0	5.0	10.0	20.0
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: (Anyanwu, 1995; Jimoh, 2003; RMAFC databases)