Tax Assignment and Revenue Sharing in Nigeria: Challenges and Options

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Assignment of taxes and revenue-sharing to different levels of government are politically divisive issues in Nigeria. Although these are not peculiar to the country, but they are unique because the federation has not been able to establish a widely acceptable system, despite the various fiscal commissions since 1946. The debate is the devolution of more taxes with high revenue yields to the state and local governments. The sub-national governments contend that, the currently assigned taxes are poor in terms of their bases and, therefore, revenues are not able to meet their expenditure expectations. Typical policy responses to these agitations by the Federal Government are minor adjustments in the revenue-sharing arrangements and the introduction of non-statutory transfers. Such measures have, however not assuaged the aspirations of the sub-national governments. Rather, the demand is a complete review of the sharing formula of the federally-collected revenue that could reduce to reasonable levels the existing vertical and horizontal fiscal imbalances. Similarly, some state governments are demanding for an increase in their shares of revenues derived from their jurisdictions. Specifically, the entrenchment of reasonable weights on derivation principle in the sharing of all revenue items is the most critical issue today. This paper build on the history as well as the current legal framework of tax assignment and revenue-sharing in Nigeria to identify the challenges while also drawing from the theoretical framework for policy options which will provide for a stable federal system in Nigeria. The paper recommended among others the strengthening of states internal revenue bases, adjustments on the vertical and horizontal revenue-sharing formula, effective compliance with the allocation of the mandatory 10% of states' internally generated revenue. The paper concludes that changes to the existing tax assignment and revenue-sharing arrangements will go a long way in protecting our nascent democracy.

Keywords: Federalism, Constitution, Inter-Governmental Fiscal Relations, Tax Assignments, Revenue-Sharing, Fiscal Imbalances

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I. Introduction

The federal system in Nigeria has evolved since 1946 and it is recognized by the constitutional division of administrative responsibilities and expenditure assignments to different levels of government. Each government is empowered by assignment of own taxes while that of the sub-national governments are complemented with statutory and non-statutory transfers from the federally- collected revenues by the Federal Government. However, tax assignment and revenue-sharing in the Federal Republic of Nigeria have witnessed periodic changes, following the recommendations of the different fiscal commissions established by the various regimes. For example, under the military governments, frequent changes of assignment of taxes and revenue-sharing formula through changes in decrees was a notable feature of the federal system in Nigeria. It is important to note that debates about tax assignment and revenue-sharing are not peculiar to Nigeria. Nonetheless, Nigeria's case is unique because the criteria for vertical and horizontal distribution of revenue so far used have not enjoyed wide acceptability.

Recently, agitations for a complete review of the assigned taxes to each level of government and the revenue-sharing criteria have become the main politically divisive issues. Specifically, some state governments are asking for the control of revenues of natural resources found in their domains. This has also, generated further debates that all non-oil revenue sources of the Federation Account should be shared on the basis of derivation. However, because of the wide gap in tax bases among the sub-governments and the need to achieve equal development across the country, the political actors at the centre are not pre-disposed to accede to some of these demands.

In this context, the debates suggest the need to review upwards the shares of the sub-national governments in terms of statutory transfers from the federally-collected revenue. Equally, the oil-rich states particularly and, the economically advantage states, are asking for an upward review of the weights attached to the sharing of not only revenues from natural resources but all non-oil revenue items. Similarly, current debates emphasize the need to review the horizontal–sharing indices which tend to favour the well established states (older states) and local governments to the disadvantage of the states and local governments with low per capita income. These debates are not limited to the fiscal relationships between the federal, state and local governments but also extend to the relationships between the states and their local

governments. The local governments in view of their fiscally-disadvantage positions in the federal system are also, demanding for a favourable revenue-sharing system from the revenues of state governments from assigned taxes and fees known as 'State Allocations' to complement transfers from the Federation Account and the VAT Pool Account, including assigned taxes and fees.

The objective of this paper, therefore, is to identify the challenges of tax assignment and revenue-sharing arrangements in Nigeria and proffer solutions. These policy options are aimed first, to accommodate the growing desires of some state governments wishing to acquire greater tax autonomy. Second, is to provide an overall transfer system that will ensure more funds to the sub-national governments to meet the Millennium Development Goals (MDGs) as well as achieve equalization effect across the state and local governments in the country. With this background, the rest of the paper is organized in four parts. Part two focuses on the theoretical framework on tax assignment and revenue-sharing in a federal system. Part three traces the evolution of tax assignment and revenue-sharing in Nigeria and evaluates the outcomes. Part four identifies the challenges and makes suggestions for new options. Part five summarizes and concludes the paper.

II Theoretical Expositions

II.1 Federalism and Assignment of Responsibilities

Federalism is defined as the amalgam of sub-units of national sovereign governments that operate independently under a constitutionally defined sphere of functional competence (Oates, 1972). It is a decentralization of responsibilities for expenditure and revenue to different levels of government that ensures that each government makes decisions and allocates resources according to its own priorities.

A number of economic arguments have been put forward to explain the adoption of fiscal federalism. One strand of the literature emphasized economies of scale in the provision of public goods, allocation and market efficiencies[1]. The other strand rests mainly on the idea that 'federal transfer system' could be seen as a risk-sharing mechanism against regional government's revenue shocks[2]. On the contrary, political arguments far enjoy higher considerations in the adoption of federalism. Thus, federalism is favoured when a country's population is not homogenous in terms of ethnic, linguistic, cultural, racial or other important national characteristics. It is

[1] Casella et all, 1990; Weber et all, 2001, Cremer, et all 1994, and Tanzi, 1995

[2] See Persson et.all 1996; IKein et all, 1998, and Ahmad E, et all; 2003.

used to induce the sub-units to remain in the federation while maintaining their different individual characteristics. In sum, it is generally believed that fiscal decentralization strengthens democracy by increasing interest in local politics.

II.2 Tax Assignment and Revenue Sharing in a Federal System

II.2.1 Tax Assignment

Tax assignment indicates the level of government that should be in control of a particular tax and how this should be administered. In public finance theory, there is no ideal system of tax assignment rather it varies from jurisdiction to jurisdiction, under three options namely: the assignment of all tax bases to sub-national governments only; the assignment of all tax bases to the central government only; and the assignment of tax bases to each level of government (Martinez-Vasquez et al, 1995).

It is generally recognized that both distributional and macroeconomic management considerations argue against the type of arrangement where all tax bases are assigned to the sub-national governments only (such as practiced in the former Yugoslavia). Under this system, the centre imposes surcharges on taxes collected by the sub-national governments. Nonetheless, this arrangement cannot facilitate income re-distribution through the tax system while it also deprives the central government any tax tool as fiscal policy instrument for macroeconomic management. The major advantage is that spending decisions are compatible with tax decisions and, therefore, it encourages tax competitions among the sub-national governments (Ter Minassian, 1997).

The assignment of all tax bases to the central government only is consistent with the pursuit of macroeconomic objectives, while it generates more revenues owing to economies of scale and prevents revenue losses and high costs of administration. This presupposes that the central government is obliged to transfer some of the revenue collected to the sub-national governments. However, this is most often critiqued because it separates spending authorities from revenue–raising responsibilities. Thus, the arrangement removes the links between the benefits derived from public expenditures and their prices (taxes). The third option, which is the most frequently observed, is the one which assigns own sources of revenue to each level of government with a combination of inter/intra-governmental transfers. However, the major problem with this system is the issue of overlapping of tax bases which means likely increase in the burden of the tax payers (Tanzi, 1995).

Generally, the implementation of assigned taxes to any level of government follows four methods, namely: independent legislation and administration, dual administration, surcharges on federal taxes and tax-sharing. Independent legislation and administration guarantees tax sovereignty, but sometimes inconsistent laws and administrative bottlenecks could create problems and increase the cost of administration. Dual administration means that both the centre and the units have legislative and administrative responsibilities. Tax sharing implies that the central government gives a fraction of revenue from some selected taxes collected from a sub-national government to the same government e.g. automobile taxes. Under this system, each sub-unit has latitude to choose their own rates. Surcharge implies that the lower levels of government may surcharge the central government for the taxes collected in its jurisdiction or vice-versa (Diaz-Cayeros and Mclure, 2000).

Three basic considerations which determine the type of taxes allocated to each level of government are: administrative efficiency; the objective of the tax and the mobility of the tax base (Shar, 1998). Following these broad principles, there is a general consensus in the public finance theory, on the types of taxes that should be assigned to the different levels of government (May, 1996).

- progressive re-distributive taxes are centralized e.g. personal income tax, corporate tax;
- taxes for economic stabilization are collected centrally e.g. import and export taxes;
- taxes on mobile factors of production are centralized e.g. capital gain taxes;
- residence-based taxes such as sales, excise and retail taxes can be decentralized;
- destination-based taxes are also subject to central collection -Value Added Tax;
- benefits tax/user charges are assigned to the level of government that provides the services such as toll fees, hospital and school fees, motor licenses etc.;
- taxes distributed on unequal basis to jurisdictions are administered by the central government e.g. taxes on natural resources; and
- tax on immobile factors of production such as land and buildings are assigned to the local jurisdictions e.g. property taxes are assigned to municipal councils.

II.3 Revenue–Sharing in a Federal System

Many federal systems attempt to achieve equity through revenue-sharing between the central and regions/local bodies and among the regions/local bodies. This reflects the fact that most times the high-yielding revenue types are assigned to the central government while substantial and growing expenditures are devolved to the sub-national governments, reflecting the presence of vertical fiscal imbalance. A vertical fiscal imbalance is measured by the extent to which a tier of governments' expenditures is financed by own assigned taxes (Marcelo et al, 2000). There is also the horizontal fiscal imbalance, since the revenue-raising capacities of each of the sub-national government vary and they face different costs, revenue-shocks and demand pressures as they attempt to meet their assigned expenditures. In this context, a horizontal fiscal imbalance is measured by the portion of which a sub-national governments' expenditures is financed by the assigned revenues compared to their counterparts. Thus, revenue-sharing in a federal system to a large extent is aimed at not only to re-distribute resources within the nation but also to effectively control the borrowing capacities of the regions/local councils (Broadway and Hobson, 1993)

Revenue-sharing in a federal system is implemented usually, through two main options, namely: a tax-to-tax sharing system or pooling the entire tax receipts before sharing. Tax-to-tax revenue sharing system (as practiced in Germany, Argentina, and Brazil) has some problems. The system could provide incentives for the central government to concentrate efforts more on those taxes that are either not shared or to a lesser degree shared and those, which can achieve its stabilization policies. When these happen, the entire national tax system may be distorted. For these problems, many federations are attracted to a sharing system whereby, the entire proceeds are paid into one account and the pooled resources distributed to all tiers of government through agreed vertical and horizontal sharing procedures.

The procedures for the distribution of central revenue among the tiers of government are enforced through approved laws or by the constitution, reflecting the formula/indices for both vertical and horizontal sharing procedures. Thus, the formula-based system provides for the predictability of revenue particularly, by the sub-national governments, which is an essential ingredient for budget planning. It also, removes the intensive lobbying associated with revenue-sharing when the formula/indices are not specified and also, erases the fear of domination by the minorities.

III Historical Background

III.1 Evolution of Tax Assignment and Revenue-Sharing Formula in Nigeria

Federalism was adopted in Nigeria in 1946, when the Richards Constitution came into existence, thus, recognizing the regional governments (North, West and East). The Phillipson Fiscal Commission (1946) assigned direct taxes (personal income tax), licenses and mining rents to the regions while taxes such as import and export duties, excise duties, company income taxes were assigned to the Federal Government. In recognition of the need to give the regions the right incentives for revenue mobilization, the principle of derivation was given high priority for the distribution of federally-collected revenue (Ahmad and Singh, 2003).

The adoption of the Macpherson Constitution in 1951 offered another opportunity to re-visit the issues of tax assignment and revenue–sharing in Nigeria. Thus, the Hicks-Phillipson Fiscal Commission (1951) was set up to review the existing tax assignment and revenue–sharing procedures. To broaden the revenue base of the regions, the commission recommended additional taxes, namely: sales tax on motor spirits, excise tax on tobacco, and entertainment tax. The recommended revenue-sharing formula adopted three principles: derivation, population and needs. Also, special grants for police and education were transferred to the regions. Each of the regions was satisfied with the new fiscal arrangements- the west was satisfied with the principle of derivation, the north with the principles of population and needs while the east liked the special grants.

In 1953, the Louis Chicks Fiscal Commission was established to fashion out new fiscal arrangements based on the Lyttleton Constitution of regional self-government. The Commission made a strong case for an upward review of the financial strength of the Federal Government. Against this backdrop, mining rents and royalties, and personal income taxes were brought under the purview of the Federal Government. The proceeds were shared between the federal and the regional governments. Derivation principle was again applied in the sharing of these resources but the major impediment was the difficulty experienced in establishing the statistical data for the distribution of these resources among the regions, hence, there were several complaints (Ashwe, 1986).

As the country approached independence, the Raisman Fiscal Commission (1958) reviewed the existing tax assignment and revenue-distribution. The Commission

expanded the regional tax base and subsequently, allowed them the full share of the proceeds from export taxes as well as excise duties and the Federal Government received the share attributable to consumption in Lagos. The marketing boards were, however, regionalized while the regions were empowered to fix producer's price, impose sales tax on the export commodities and retain the operational surpluses of the boards. In addition, the administration and retention of proceeds from personal income tax were reverted to the regional governments. It established the Distributable Pool Account (DPA) into which the shares of federally-collected revenue for the regions were deposited. Thus, the federally-collected revenue was 70 percent shared to the Federal Government while 30 percent was paid into the DPA. The proceeds of the DPA were distributed to the regions on the principles of derivation, population and needs using the formula of 40, 31, 24, and 5 percent for the Northern, Eastern, Western regions, and the Southern Cameroon, respectively (CBN, 2000).

Nigeria became a sovereign state in 1960; subsequently, the revenue-sharing formula of the proceeds of the DPA was adjusted in 1961, following the pulling out from the federation by the Southern Cameroon. The new adjustment allocated 42, 32.6, and 25.6 percent to the Northern, Eastern, and Western regions, respectively. A further adjustment was made in 1963, as a result of the creation of the Mid-Western region. Thus, the share of the Western region was divided between it and the Mid-Western region at a ratio of 18.9 and 6.3 percent for the Western and the Mid-Western regions, respectively. The Federal Government in 1964 commissioned the Binns Fiscal Commission with the mandate to recommend a widely acceptable tax assignment and revenue–sharing systems. Following those recommendations, the share of DPA from federally–collected revenue was increased to 35 percent while that of the Federal Government was reduced to 65 percent. Soon after, tensions were generated as the report of the Commission abandoned the principle of derivation and adopted internal revenue generation efforts, and needs. The tensions generated by the report later became a serious political crisis, culminating into a military intervention in 1966.

The military take-over laid to rest the confusion, as the Federal Military Government suspended the constitution and other related political activities. With decrees, the Federal Military Government made frequent adjustments to tax assignment and revenue-sharing formula. Thus, it retained most of the taxes such as company income tax, petroleum profit tax, and excise duties. Others were the sharing of excise duties on sale of tobacco and petroleum products and import duties on motor spirits equally between the federal and the DPA; export duties on the basis of 3:2 by the state of

origin and the DPA; and the introduction of uniform tax structure on personal income and sales taxes in 1975. The Federal Government replaced the regional marketing boards with commodity boards and, thus, assumed the control of the operations of the boards. In 1971, with Decree No.9, it retained all the off-shore oil revenue while Decree No. 6 (1975) channeled all revenues to be shared by the states through the DPA, except for the 20 percent of on-shore mining rents and royalties due to the states of origin on the principle of derivation ((Okunrounmu, 1996).

Following the transition program, the Aboyade Fiscal Committee (1977) was set up to review the fiscal arrangements in Nigeria. The committee renamed the DPA as 'Federation Account'; however, most of the recommendations were considered too technical and radically different from the past and, therefore, were rejected. The Okigbo Fiscal Commission (1980) was established by the new civilian administration. It accepted the earlier recommendation that all federally-collected revenue should be transferred into the Federation Account, except those classified as Federal Government independent revenue (Nigeria FR, 1980).

Since then, the revenue–sharing procedure has followed generally, the provisions of the 1981 Revenue Allocation Act, except for minor changes in the shares of the different tiers of government, including additional beneficiaries. Thus, between 1980 and1986, the share of the Federal Government was 55 percent, the state governments, 34.5 percent while that of the local governments increased from 8.0 percent in 1980 to 10.0 percent in 1986. In 1987, further amendments were made in the shares of the state governments from 34.5 percent in 1986 to 32.5 percent. This boosted the share of special funds, specifically, the Oil Mineral Producing Areas Development Commission (OMPADEC) and general ecology (Table 1).

Another amendment to the revenue-sharing formula was made by the Federal Military Government in 1990. Consequently, the federal and the state governments lost some percentages in their shares in favour of the local councils and special funds. The shares of the local councils and the special funds were raised to 15 and 5 percent, respectively. Further amendments in 1993, increased the shares of the local councils and special funds to 20 and 7.5 percent, respectively while that of the federal and state governments declined to 48.5 and 24.0 percent, respectively. These amendments came through the recommendations of a central finance commission established in 1989 namely: National Revenue Mobilization, Allocation and Fiscal Commission (NRMAFC). While the previous fiscal commissions were ad-hoc, the NRMAFC is a

permanent central fiscal commission of government. The 1993 amendment remained in force until 2002 when the Supreme Court judgment of April 2002 made some fundamental changes (Nigeria FR, 2002).

Transfers to states and local governments from the Federation Account used the following indices: population (30 %); land mass/terrain (10 %); equality of states (40 %); internal revenue generation efforts (10 %); and social development indicators (10%). The social development indices uses six factors namely: primary school enrollment (24% of 10 %); direct number of students enrolled in secondary schools (8% of 10%); and inverse number of students enrolled in secondary schools (8% of 10%); number of hospital beds (30% of 10 %); index of access to clean water (15% of 10%); and the quantity of rainfall (15% of 10%). However, there have been several complaints on the statistical data for the revenue transfers.

An assessment of the inter-governmental fiscal relationship at the state governments level showed that sharing of the state internally-generated between each state government and the local governments was also, institutionalized. Each state government was required by law to allocate 10.0 percent of its own internally-generated revenue from assigned taxes to the local governments in that state. The formula for the distribution of the allocation across the local governments varies from jurisdiction to jurisdiction.

An important change in tax assignment during the military interregnum was the replacement of states' sales tax with value-added tax (VAT) in 1994, while the Federal Government assumed the administrative responsibility. VAT proceeds are kept in the VAT Pool Account and shared among the three tiers of government. Initially, the Federal Government received only 20 percent of the VAT proceeds to cover administrative costs while state and local governments received 50 and 30 percent, respectively. In 1995, the Federal Government's share was increased to 50 percent while state and local governments received 30 and 20 percent, respectively. Again, the vertical distribution was adjusted in 1996 to 35, 40, and 25 percent to the Federal, State and Local Governments and later amended to 15, 50, and 35 percent to the Federal, State and Local Governments, respectively, in 2000. Transfers to states and local governments used the following indices: derivation (20%), Equity (50%) and Population (30%). Similarly, in 1995, the Federal Government through Decree No.7 introduced the education tax. It stipulates the purpose and the distribution procedure and established a National Trust Fund Board. The Board is entrusted with the

administration and disbursement of the proceeds while the Federal Inland Revenue Service (FIRS) is charged with the collection (Table 2).

Table 1: Federation Account's Revenue Allocation Formula (Per cent)

Years	Federal Govt.	Region/State Govt.	Local Govt.	Special Funds				
				FCT	Derivation	OMPADEC	Gen. Ecology	Statutory
1960	70.0	30.0	-	-	-	-		
1963-67	65.0	35.0	-	-	-	-		
1980	55.0	34.5	8.0	2.5	-	-		
1982	55.0	34.5	10.0	-	-	-		0.5
1987	55.0	32.5	10.0	-	-	1.5	1.0	-
1990	50.0	30.0	15.0	1.0	1.0	1.5	1.0	0.5
1993	48.5	24.0	20.0	1.0	1.0	3.0	2.0	0.5
1995-98	48.5	24.0	20.0	1.0	1.0	3.0	2.0	0.5
1999	48.5	24.0	20.0	1.0	1.0	3.0	2.0	0.5
2000-02	48.5	24.0	20.0	1.0	13.0	0.0	2.0	0.5

Notes:

1. 1960 to 1976 Local Governments were funded through the Regional Governments.
2. The 13 percent derivation is on mineral oil revenue only

Sources: Approved Budgets of the Government of the Federal Republic of Nigeria.

TABLE 2: VAT Revenue Allocation Formula (Percent)

	1994	1995	1996	1997	1998	1999-2004
Federal Government	20	50	35	35	25	15
State Governments & FCT	50	30	40	40	45	50
Local Governments	30	20	25	25	30	35
Total	100	100	100	100	100	100

Sources: Approved Budgets of the Government of the Federal Republic of Nigeria

III.2 Evaluation of Tax Assignment and Revenue–Sharing Performances in Nigeria

III.2.1 Tax Assignment Performance in Nigeria

Between 1948/49 and 1966/67 fiscal years, owing largely, to the favorable decentralization of taxes, particularly with those taxes having high revenue-yielding qualities to the regions, such as excise, export duties, etc., the regional governments generated more of their revenues that covered own expenditures from internal

sources. For instance, the share of internally-generated revenue by the regions in total income of the government sector increased from an average of 15.9 percent in 1948/49 to 41.0 percent in 1966/67 fiscal years. On the contrary, the share of the Federal Government revenue generated declined persistently, from an average of 84.2 to 59.0 percent during the same period.

Beginning from 1967/68 financial year, as a result of the military intervention and the subsequent adjustments in tax assignment, which concentrated all the high-yielding government revenue sources in the hands of the Federal Government, there was a general decline in the sub-national government shares of the total government income. Thus, the shares of the state and local governments' internally-generated revenue in total government income declined consistently from an average of 12.3 percent between 1967/68 and 1979/90 fiscal years to an average of 3.9 percent between 2000 and 2004. This was contrary to the extensive list of taxes and fees assigned to them but with generally small value of bases and relatively high administrative costs. Conversely, the shares of revenue generated by the Federal Government increased substantially to an average of 96.1 percent by 2000-2004 periods. Contrary to the proportion of the regional governments' revenues before the military intervention, from 1967/68 fiscal year, the sub-national governments became heavily reliant on the statutory transfers from the Federal Government (Table 3).

TABLE 3: Tax Decentralization in Nigeria

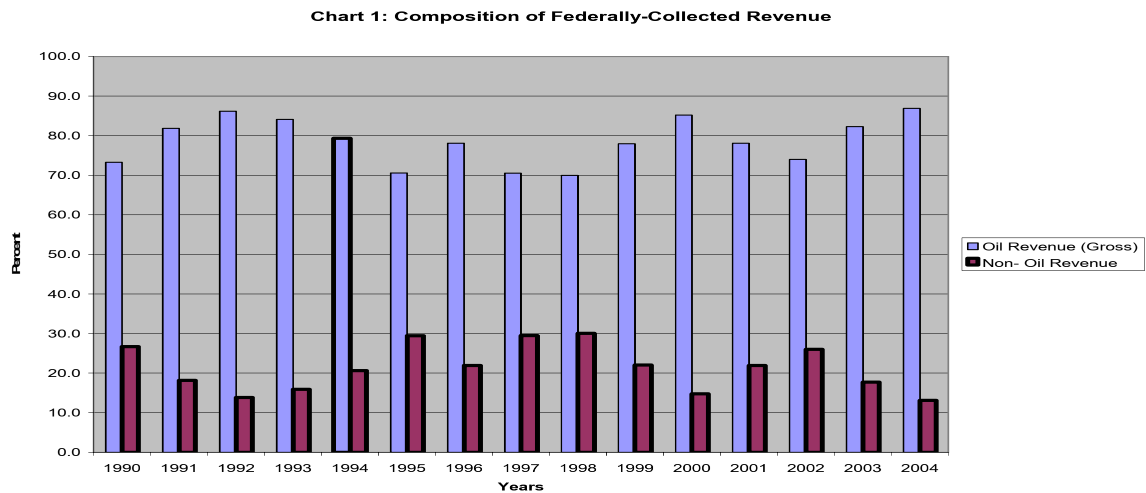
Commissions	Years	Federal	Regions/ States	Local Govts.
Phiiipson	1948/49-1951/52	84.2	15.9	n.a
Hicks-Phillipson'	1952/53-1953/54	72.5	27.5	n.a
Chicks	1954/55-1958/59	57.7	41.9	n.a
Raisman	1959/60-1963/64	62.1	38.1	n.a
Binns	1964/65-1966/67	59	41	n.a
Military Govts.	1967/68-1979/80	87.7	12.3	n.a
Civilian Govt.	1980-1983	99.2	0.8	n.a
Military Govts.	1984-1999	94.5	5.1	0.4
Civillian Govt.	2000-2004	96.1	3.4	0.5

Source: Derived from Government Budget Estimates and CBN Annual Reports

III.2.2. Revenue -Sharing Performances in Nigeria

Revenue-sharing from the Federation Account was financed mainly by oil revenues,

proceeds from company income tax, and customs and excise duties. Specifically, the oil revenue accounted for 78.5 percent of total federally-collected revenues between 1990 and 2004 while its share in total revenue by 2004 was 86.9 percent (Chart 1).



Source: Derived from CBN Annual Reports.

In contrast to the previous procedures in revenue-sharing, from 1989, first line charges were introduced by the Federal Government in the transfer of revenue from natural resources to the Federation Account. The composition of these special charges depended on the economic priorities of the Federal Government. First it was named 'stabilization fund' which was meant to cushion the negative impact of oil price variations in the international oil market. In other words, it served as national savings against likely revenue drought and was intended to maintain stability in government expenditures when oil price falls.

Beginning from 1990, several other charges were introduced against oil receipts (such as NNPC Priority Projects[3]; National Priority Projects; PTF[4], and External Debt Service Funds). These first line charges were deductions which serviced specific expenditures of the Federal Government. Ordinarily, these expenditures were supposed to be financed from the Federal Government shares of the national income. Subsequently, in addition to the stabilization fund, 'excess oil revenue' was introduced. This was charged against oil exports earnings, petroleum profit tax and oil royalty revenue while the modality for the charges was the difference between the budget price and the realized price. Like the stabilization fund, it was a compulsory

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[3] *NNPC refers to the Nigeria National Petroleum Corporation.*

[4] *PTF refers to the Petroleum Trust Fund which was created to handle infrastructural development arising from the gains associated with the increase in domestic pump prices of petroleum products.*

savings designed for macroeconomic management and was usually drawdown at regular intervals and shared among the tiers of government according to the existing revenue-sharing formula.

Thus, between 1989 and 2004, an average of 65.7 per cent of the federation account revenues was distributed while the balance of 34.3 percent was deductions to satisfy some specific Federal Government expenditures and/or served as national savings. Of this balance, deductions in respect of some Federal Government dedicated expenditures accounted for 21.0 percent while deductions as national savings were 13.2 percent of the total federation account revenues. The relative share of the Federal Government in the amount distributed (including special funds and other transfers unspecified) averaged 54.5 percent while allocations to the sub-national governments (state and local governments and allocations in respect of 13% derivation principle) accounted for 45.5 percent in the same periods.

A breakdown of the financial statement showed that between 1989 and 1993, the share of the proceeds of the revenue actually distributed was 58.8 percent. This increased to 59.9 percent during 1994 to 1999 periods and since 2000 it has increased further to 79.5 percent. This was attributed to the improved transparency in revenue-sharing by the civilian administration; implementation of the 13.0 % derivation and the landmark judgment of the Supreme Court in April 2002. Subsequently, the shares of the Federal Government in the amount distributed from the Federation Account declined from an average of 57.5 percent in 1989-1993 fiscal years to 56.4 and 49.3 percent in 1994-1999, and 2000-2004 periods, respectively. Conversely, the shares of the sub-national governments increased from 36.6 percent in 1989 to 52.6 percent in 2004. On the other hand, since the inception of VAT in 1994, the sub-national governments have enjoyed higher shares and accounted for 69.1 percent of the total proceeds in the VAT Pool Account (Table 4).

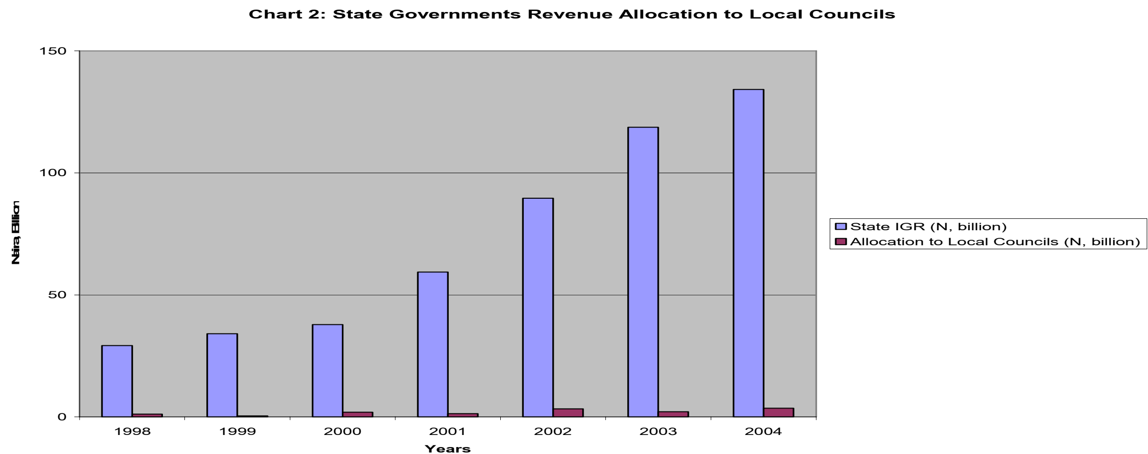
Another important assessment of the performance of revenue-sharing is the evaluation of the rate of compliance to the mandatory 10 % allocation by the state governments to the local governments. For example, between 1998 and 2004, an average of 2.9 percent of total internally-generated revenue by the state governments was allocated to the local councils across the country, indicating a shortfall of 7.3 percent. This showed that consistently, the state governments have not honored the required lawful obligations to the local councils (Chart 2).

However, there are variations of compliance across the state governments. The long-term implication of these variations is that the achievement of decentralization in different states will occur at different times and nationally, could be delayed. Nonetheless, recent actions of the Federal Government over withholding of local councils allocations from the distributable revenue in some states is another landmark in the fiscal relationships between the federal and state/local governments in Nigeria.

Table 4: Composition of the Distribution of Centrally-Collected Revenue

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
	In Billion Naira															
Federal Account Revenue	49.3	83.5	98	185.6	187.2	190.7	294.2	343.6	364.7	347.3	712.4	1478	1703	1478	1964	3249
Less:																
First Charge 2/	10.2	38	44	96.2	80.3	76.6	123.6	165	157.5	103	265.9	489	568.2	58.6	143	808.3
of which																
Stabilization/Excess Funds	10.2	21.3	21.6	47.5	24.4	5.1	18.6	35	35	0	93	291.5	179.5	12.4	143	808.3
Others	0	16.7	22.4	48.7	55.9	71.5	105	130	122.5	103	172.9	197.5	388.7	46.2	0	0
Federal Account: 3/	39.1	45.5	54	89.4	106.9	114.1	170.6	178.6	207.2	244.3	446.5	989.3	1135	1419	1821	2441
	In Percent															
Federally -Collected Rev.(net) 1/	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Less:																
First Charge 2/	20.7	45.5	44.9	51.8	42.9	40.2	42	48	43.2	29.7	37.3	33.1	33.4	4	7.3	24.9
of which																
Stabilization/Excess Funds	20.7	25.5	22	25.6	13	2.7	6.3	10.2	9.6	0	13.1	19.7	10.5	0.8	7.3	24.9
Others	0	20	22.9	26.2	29.9	37.5	35.7	37.8	33.6	29.7	24.3	13.4	22.8	3.1	0	0
Federal Account: 3/	79.3	54.5	55.1	48.2	57.1	59.8	58	52	56.8	70.3	62.7	66.9	66.6	96	92.7	75.1
of which																
Federal Government 4/	63.4	56.7	56.7	55.9	54.9	57.7	56	56	56	56.9	55.6	51.8	44.7	52	50.4	47.4
State,Local Govts.&Derivation 5/	36.6	43.3	43.3	44.1	45.1	42.3	44	44	44	43.1	44.4	48.2	55.3	48	49.6	52.6
	In Billion Naira															
VAT Pool Account 7/ (Naira Billion)	0	0	0	0	0	7.3	20.8	31	34	36.9	47.1	58.5	91.8	1.8.6	136.4	159.5
Distribution:																
Federal 8/	0	0	0	0	0	2	7.4	10.8	12.3	9.6	7.6	8.3	13.4	15.5	20	23.8
State	0	0	0	0	0	5	6.3	11.2	13.8	16	28.7	30.6	44.9	52.6	65.9	96.2
Local	0	0	0	0	0	0.3	3.6	4.6	6.8	9.2	9.6	13.9	20.1	18.7	39.6	46
	In Percent															
Distribution:																
Federal 8/	0	0	0	0	0	27.4	35.6	34.8	36.2	26	16.1	14.2	14.6	14.3	14.7	14.9
State	0	0	0	0	0	68.5	30.3	36.1	40.6	43.4	60.9	52.3	48.9	48.4	48.3	60.3
Local	0	0	0	0	0	4.1	17.3	14.8	20	24.9	20.4	23.8	21.9	17.2	29	28.8

Source: Derived from CBN Annual Reports.



Source: Derived from CBN Annual Reports.

IV Challenges of Tax Assignment and Revenue-Sharing in Nigeria

IV.1. Current Legal Framework for Fiscal Federalism in Nigeria

The fiscal chapter of the 1999 Constitution of the Federal Republic of Nigeria stipulates the inter-governmental fiscal relations. The constitution maintains an erstwhile division of functions between the various levels of government. However, the state governments, out of its own powers and responsibilities, assign certain functions and duties to the local councils while the constitution gives to the state legislatures the prerogative to create councils. In tandem, the constitution assigns to the Federal Government the power to legislate and collect revenues from company income tax, custom and excise, education tax, custom levies/surcharges, value-added tax and other independent revenue. The National Assembly also, legislates on matters concerning personal income tax but the state governments have administrative responsibilities and, therefore, retain the proceeds which they collect, except for personal income taxes of the personnel of the armed forces and residents of Abuja, FCT.

The constitution assigns to the state governments with the proceeds of the federal tax on motor vehicle licenses and other powers to set rates and retain proceeds on some other minor taxes including stamp duties, business registration fees and lease fees of state lands. Taxing power on properties is assigned to the local governments, in addition to some other minor taxes (Table 5).

Table 5: Nigeria's Tax Jurisdiction 1999

Federal Government	State Government	Local Government
1. Companies Income Tax	Personal Income tax (on residents of the State)	Tenement rate
2. Petroleum Profits Tax	Capital Gains Tax (on individuals only)	Shop and Kiosk Rates
3. Value Added Tax	Stamp Duties (on individual only	Liquor Licence Fees
4. Education tax (on Companies only)	Road taxes e.g. vehicle licenses	Slaughter slab fees
5. Capital Gains Tax (on Corporate Bodies and Abuja Resident	Betting and Gumming Taxes	Marriage, Birth and Death Registration Fees
6. Stamp Duties (on Corporate Bodies)	Business Premises and Registration levy	Street name Registration Fees (excluding state and capital)
7. With-holding Tax (on Companies)	Development levy (Max of N100 per annum on taxable individuals only)	Market/Motor Park Fees (excluding State-owned markets)
8. Personal Income tax (on personnel of the Armed Forces, Police, External Affairs Ministry and Residents of Abuja	Street Name Registration Fees (State Capital Only)	Domestic Animal Licence Fees
9. Mining rents and royalties	Right of Occupancy Fees (State capital only)	Bicycle, Trucks, Canoe, Wheelbarrow, Carts and Canoe Fees
10. Customs Duties (i.e. import Duties and Export Duties	Market fees (where market is financed by State Government)	Right of Occupancy fees (excluding State Capital)
11. Excise Duties	Miscellaneous revenues e.g. rents on property)	Cattle Tax
12. Miscellaneous revenues (e.g. Farming from Oil states. Rents on property etc –Largely Independent Revenue of the Federal Government.		Merriment fees
		Radio and TV license fees
		Vehicle Parking Fees
		Public Convenience, Sewage and refuse Disposal Fees
		Burial Ground and Religious places permit fees
		Signboard and Billboard Advertisement Permit Fees.

Source: Federal Ministry of Finance

The constitution mentions revenue sharing in Chapter 4, Part C, Section VI, and Paragraph 162. It establishes the "Federation Account" while it describes all federally-

collectible revenue except those classified as 'independent revenue' of the Federal Government as Federation Account revenues. The National Assembly makes laws for the distribution of the proceeds from that account. In addition, the 1999 Constitution maintains that not less than 13 percent of mineral revenues should be transferred to the states on the basis of derivation.

Third Schedule, Part N establishes the central finance commission - Revenue Mobilization, Allocation and Fiscal Commission (RMAFC), with a major change in the scope of the tasks compared with the past. Therefore, the commission is not only to concern itself with the distribution of the divisible revenue but to suggest ways of augmenting the revenue from other sources. In summary, it will examine the entire gamut of issues concerning tax assignment and revenue- sharing in the country.

The constitution provides for the establishment of the state finance commission known as the 'State Joint Local Government Accounts Committee'. It requires that allocations to the local councils from the Federation Account are to be paid in that same account while the States' Houses of Assembly make laws for the distribution across local councils. The constitution stipulates that each state government pays a specified percentage of its internally-generated revenue into the Joint Account. The National Assembly is assigned with the power to specify the percentage of the state allocation to the councils from own internal taxes and fees. However, the state legislatures make laws for the sharing of the state allocation among the local councils.

Current allocations from the Federation Account are: Federal Government (52.68 %); state governments (26.72%) and the local governments (20.60%). Indices for transfers to the states and local governments have remained the same as in the 1981 Revenue Allocation Act. It is important to note that the constitution made no mention of the VAT Pool Account and the Education Trust Fund. Rather it assumes that proceeds from the two sources form part of the Federation Account. In addition, the law makes it mandatory for the state governments to allocate 10% of its internally-generated revenue to the local councils. The sharing formula varies from state to state depending on the laws of the state legislatures (Nigeria, FR,2005).

IV.2 Challenges of Tax Assignment and Revenue Sharing in Nigeria

IV.2.1 Fiscal Imbalances- Vertical and Horizontal Fiscal Imbalances

Assessment of Vertical Fiscal Imbalance in Nigeria

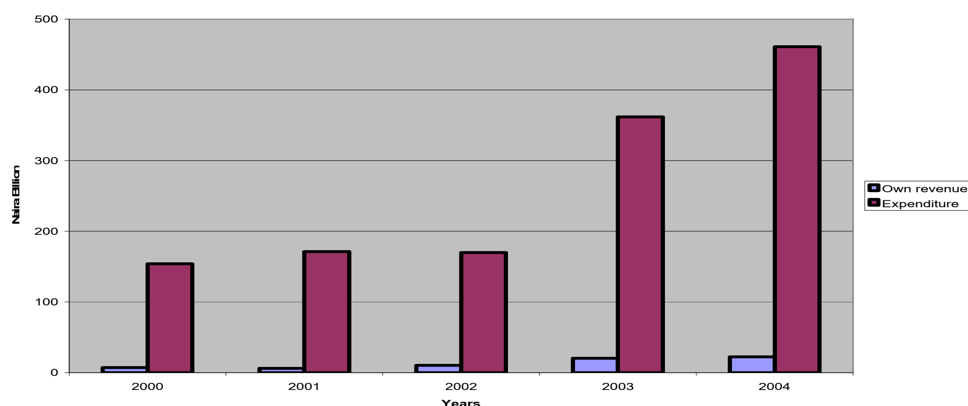
The Federal Government initially generates roughly about 96.1 percent of the total general government income. As a result a large vertical fiscal imbalance exists among the tiers of government. For instance, in 1980- 2004 periods, the state and local governments' internal revenues only financed 12.1 percent of their expenditures. In other words, about 87.9 percent of expenditures on the average were financed from statutory and non-statutory transfers from the Federal Government. However, a steady improvement was recorded between 2000 and 2004 periods. Thus, the sub-national government's total expenditure was financed to the tune of 9.9 percent from its own internal revenue sources compared with 1.5 percent during 1993-1999 financial years (Table 6).

Similarly, studies on local government finance point out that that level of government's internally-generated revenues are able to meet minuscule portion of the total expenditures, which is anywhere between 0.4 and 0.6 percent. In other words, the administration of local taxes is unsatisfactory, reflected in low collections of taxes and fees, and the inability of the local councils to periodically adjust the property values, tax rates, and user charges. The implication is a wide gap between revenue generated and expenditure, which explains a large vertical fiscal imbalance when compared with other levels of government (Chart 3).

Table 6: Assessment of Vertical Imbalances in Nigeria

Years	Expenditure			Own Revenue Generated		Vertical Fiscal Imbalance	
	General Govt.	Federal	Sub-National Govts.	Federal Govt.	Sub-National Govts.	Federal Govt.	Sub-National Govts.
	₦'Billion	₦'Billion	₦'Billion	₦'Billion	₦'Billion	%	%
1980	24.6	15	9.6	15.8	0.1	105.6	1
1981	26.2	11.4	14.7	15.3	0.1	134	0.7
1982	26.3	11.9	14.3	12.1	0.1	101.5	0.7
1983	24.5	9.6	14.9	11.1	0.1	115.2	0.7
1984	19.4	9.9	9.5	11.8	0.1	118.9	1.1
1985	20.9	13	7.9	15.9	1.6	121.9	20.2
1986	24	16.2	7.8	13	1.9	80.1	24.4
1987	33.1	22	11.1	25.5	2.2	115.8	19.8
1988	42.2	27.7	14.5	27.8	2.4	100.2	16.6
1989	58.4	41	17.4	51.3	1.9	125	10.9
1990	87.2	60.3	26.9	68.6	3.5	113.8	13
1991	102.8	66.6	36.2	81.6	3.9	122.6	10.8
1992	142.5	92.8	49.7	195.4	6.1	210.6	12.2
1993	254.9	191.2	63.7	198.4	6.7	103.8	10.5
1994	235.8	160.9	74.9	206	11.9	128	15.9
1995	349.1	248.8	100.3	480.7	18.7	193.2	18.6
1996	444.1	337.4	106.7	524.1	21	155.3	19.7
1997	550.8	428.2	122.6	591.5	29.5	138.1	24.1
1998	674.4	487.1	187.3	475.6	31.4	97.6	16.8
1999	1176	947.7	228.3	969.9	37.6	102.3	16.5
2000	1214.7	701.1	513.6	1945.2	43.9	277.5	8.5
2001	1786.4	1018	768.4	2276.8	68.3	223.6	8.9
2002	1912.5	1018.2	894.3	1799.9	100	176.8	11.2
2003	2509	1226	1283	2629.3	139	214.5	10.8
2004	2964.5	1377.3	1587.2	3941.3	156.6	286.2	9.9

Source : Derived from CBN Annual Reports



Source: Derived from CBN Annual Report, 2004.

Assessment of Horizontal Fiscal Imbalance in Nigeria

The wide disparities in tax bases available to each state produce large differences in internal revenue efforts across the state governments. This is attributed to the differences in resource endowments, expenditures, infrastructures and efficiency of tax administration among the states. Thus, it accounts for the large horizontal fiscal imbalance observed in the federation. The financial statements of the state governments showed that only Lagos State generated internal revenue that was able to cover an average of 48.4 percent of its expenditure (recurrent and capital expenditures) in 2001-2004. Of the remaining 35 states, only 9 had internal resources that covered 10 percent of total expenditures on the average in the same period while the rest had revenues that were only able to cover less than 10 percent of expenditures (Table 7).

The major challenge, therefore, is how to design a good inter-governmental transfer system that can reduce the vertical and horizontal fiscal disparities without a threat to secession or break-up being considered. A review of the constitutional responsibilities of the different levels of government with taxes assigned shows a great divergence. The assigned responsibilities to the state and local governments were mainly social services in nature requiring huge financial outlays (Table 8).

Analysis of the consolidated general government social sector expenditure showed that, on the average, the sub-national governments accounted for 61.3 percent of the total in 1998-2004. Apart from 1998 and 2002 fiscal years, the shares of the Federal Government expenditure on social services were lower than that of the sub-national governments in all other years under review (Table 9).

This reflects a huge burden on the sub-national governments if the country is to achieve the Millennium Development Goals (MDGs) by the year 2015. In summary, they will require additional resources either as statutory transfers from the federally-collectible revenue or they should be assigned with some of the high-yielding taxes.

Table 7: Assessment of Horizontal Fiscal Imbalance in Nigeria

	Internal Revenue (N'Billion)			Total Expenditure (N'Billion)			Horizontal Fiscal Imbalance (Percent)			
State	2001	2002	2003	2001	2002	2003	2001	2002	2003	Average
Abia	2.2	0.8	0.8	16.1	14.6	17.0	13.7	5.5	4.7	7.9
Adamawa	0.5	0.4	0.7	11.9	7.1	23.7	4.2	5.6	3.0	4.3
Akwa-Ibom	0.6	2.6	3.9	28.2	32.5	56.7	2.1	8.0	6.9	5.7
Anambra	0.6	1.6	2.4	10.8	26.2	23.7	5.6	6.1	10.1	7.3
Bauchi	0.9	0.7	0.7	13.3	11.9	13.4	6.8	5.9	5.2	6.0
Bayelsa	0.3	0.5	0.5	22.6	34.1	28.0	1.3	1.5	1.8	1.5
Benue	1.6	0.7	0.7	12.6	14.4	16.4	12.7	4.9	4.3	7.3
Borno	0.8	0.7	0.9	15.5	20.6	23.1	5.2	3.4	3.9	4.2
Cross River	0.8	2.2	1.2	14.0	21.6	14.5	5.7	10.2	8.3	8.1
Delta	8.2	6.0	6.3	57.2	63.0	67.2	14.3	9.5	9.4	11.1
Ebonyi	0.2	0.2	0.3	12.0	16.9	15.5	1.7	1.2	1.9	1.6
Edo	0.2	-	1.5	10.5	-	17.3	1.9	-	8.7	3.5
Ekiti	0.2	1.4	0.4	8.1	18.3	10.4	2.5	7.7	3.8	4.7
Enugu	2.2	1.4	1.9	11.8	12.3	17.7	18.6	11.4	10.7	13.3
Gombe	0.5	0.7	1.6	11.7	8.6	17.9	4.3	8.1	8.9	7.1
Imo	1.2	1.2	1.9	16.9	22.4	31.2	7.1	5.4	6.1	6.2
Jigawa	1.1	1.1	0.4	11.5	24.3	16.1	9.6	4.5	2.5	5.5
Kaduna	1.7	1.3	7.1	15.7	24.6	39.9	10.8	5.3	17.8	11.3
Kano	4.3	7.4	2.9	25.3	39.7	44.4	17.0	18.6	6.5	14.1
Katsina	1.1	2.4	1.1	13.6	18.6	12.4	8.1	12.9	8.9	10.0
Kebbi	0.2	0.7	0.5	9.8	14.7	7.6	2.0	4.8	6.6	4.5
Kogi	0.6	1.2	2.0	11.0	19.5	26.0	5.5	6.2	7.7	6.4
Kwara	1.5	0.6	2.2	13.3	16.5	17.7	11.3	3.6	12.4	9.1
Lagos	12.5	29.4	48.4	35.4	58.2	81.5	35.3	50.5	59.4	48.4
Nassarawa	0.9	0.3	0.8	11.3	9.8	13.2	8.0	3.1	6.1	5.7
Niger	0.5	-	0.6	10.7	-	14.8	4.7	-	4.1	2.9
Ogun	2.2	2.6	2.7	17.4	15.6	17.6	12.6	16.7	15.3	14.9
Ondo	1.1	1.1	3.1	21.2	20.1	38.8	5.2	5.2	8.0	6.2
Osun	1.8	2.3	2.0	11.5	18.9	14.2	15.7	12.2	14.1	14.0
Oyo	1.5	1.9	3.5	12.7	10.1	18.9	11.8	18.8	18.5	16.4
Plateau	0.7	1.8	3.2	13.1	19.9	24.4	5.3	4.0	13.1	7.5
Rivers	3.3	12.6	8.8	29.2	37.9	70.2	11.3	33.2	12.5	19.0
Sokoto	0.5	0.8	1.4	11.0	13.1	15.5	8.2	6.1	9.0	7.8
Traba	0.4	0.4	0.5	12.4	10.7	13.8	3.2	3.7	3.6	3.5
Yobe	0.3	0.5	0.5	12.9	11.5	16.0	2.3	4.3	3.1	3.3
Zamfara	0.9	1.2	1.4	10.1	12.2	15.1	8.9	9.8	9.3	9.3

For one thing, the current horizontal revenue–sharing formula favors those states that already have economic and social infrastructures in place. For example, the number of hospital beds and school enrolments are positively related to individual state's stage of development. Certainly, there is no basis for comparison in terms of the number of hospital beds and schools enrolment in Jigawa State with that of Kano State, from where the former was carved out. The revenue-sharing based on internally-generated revenue, population and land mass, again, tend to also favor the well-established states with good economic infrastructure, higher population, and bigger land areas.

Thus, apart from those state governments' allocations influenced by allocations under derivation principle on natural resources revenue, allocations to the well-established states are much higher than the fiscally–disadvantaged state governments. In a nutshell, the existing horizontal revenue-sharing indices cannot achieve the equalization effect across states and local governments as anticipated by the Federal Government. The overall effect is the increasing disparities and uneven development across states and local governments in the country (Chart 4).

Table 8: Assignments of Responsibilities in the 1999 Constitution

EXCLUSIVE LEGISLATIVE LIST	CONCURRENT LIST	RESIDUAL LIST*
Federal Government	State Governments	Local Governments
Accounts of the Federation	Allocation of revenue	Sewage Disposal
Arms, Ammunition, Defence and National Security	Antiquities and monuments	Environmental Sanitation
Aviation, Railways, Federal Trunk Roads and Maritime matters	Archives	Maintenance of Feeder Earth Roads
Immigration & Internal Affairs	Collection of taxes	Primary Education
Financial laws, and currency Issue & Exchange Control	Electoral Law	Payment of Salaries
Census, National Honour & Citizenship	Electric power	Market Stalls
Foreign Affairs and International Treaties	Exhibition of cinematograph films	Rural Health
Creation of States & regulation of political parties National and State elections	Industrial, commercial	Crafts and Small Scale Industries.
Mining & National Parks	Or agricultural development	
Labour, and Public service of the federation	Scientific and Technological Research Statistics	
Patents & trademarks	Trigonometrical, cadastral and topographical surveys	
Legal Proceeding between governments in the federation	University, Technological and Post Primary Education	
Establishment of federal agencies		
Telecommunications		
Public debt of the Federation		
Management of territorial waters		
Weights and Measures		
International trade and commerce		
Formulation, annulment and dissolution of manage		
Nuclear Energy		
Stamp Duties		

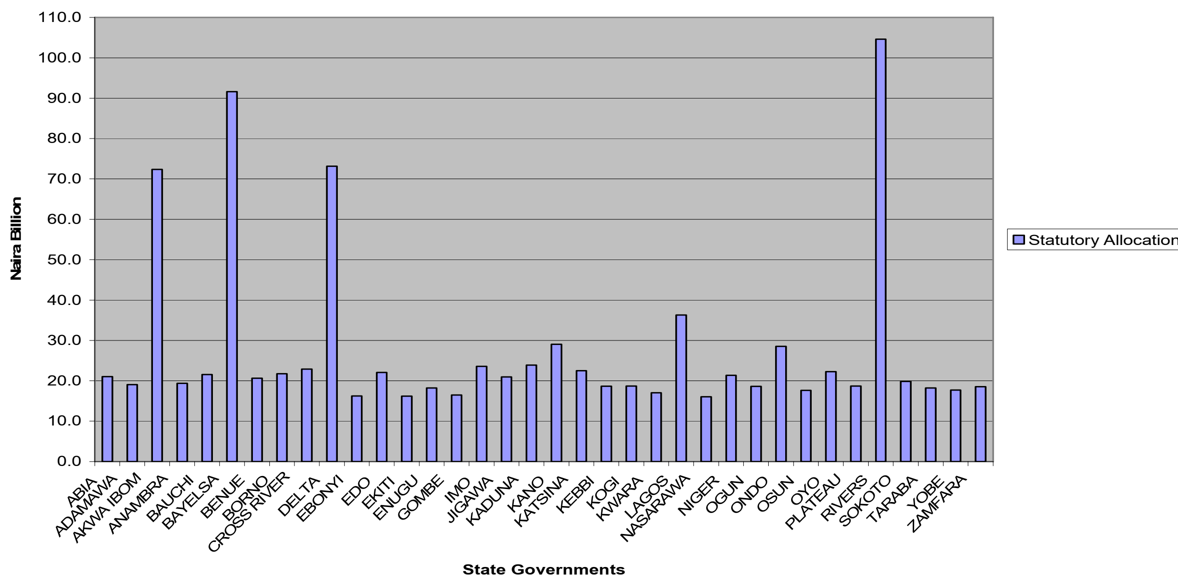
*Derived from the residual list for states.

Table 9: Social Sector Expenditure Profile in Nigeria

	1998	1999	2000	2001	2002	2003	2004
Capital Exp. On Soc. Service (N Billion)	44.7	51.2	77.7	176.3	416.1	491	497.6
Share of Federal Govt. (percent)	52.3	33.8	36	30.2	53.3	32.2	33.1
Share of State/Local Govt. (percent)	47.7	66.2	64	69.8	46.7	67.8	66.9

Sources: CBN Annual Reports

Chart 4: Total Statutory Allocations To State Govets. in 2005



Source: Federation Account Files January-December, 2005.

Against this backdrop, several agitations have emerged that must be addressed by the Federal Government for a stable federal system. These include:

- agitations on the control of exploitation of natural resources by the state governments as obtained before independence;
- agitations on the increase of the percentage share of the principle of derivation in the distribution of VAT proceeds;
- agitations against the use of number of local governments under the equality principle in the distribution of the shares of that tier of government from the proceeds of the Federation and VAT Pool Accounts. The arguments have been that there are wide gaps in revenue receipts among local councils by states. Thus, state governments with larger number of councils (mostly old states) receive more under the above mentioned principle compared with those states with smaller numbers of councils (new states);
- agitations on the non-distribution of other non-oil revenue sources of the Federation Account on the basis of derivation. The most important non-oil taxes except VAT include company income and customs and excise taxes. The formula for allocation of custom and excise duties, and company income tax did not give any weights to derivation;

- agitations for the inclusion of receipts of education and value–added taxes proceeds as part of the Federation Account, according to the intentions of the 1999 Constitution;
- suggestions that personal income tax administration and collection should be transferred to the Federal Government for better compliance and enhanced revenue;
- agitations by the state governments on the reviews of the vertical and horizontal revenue-sharing systems.

IV.2.2. Enforcing Compliance with the Law on Allocation of 10 percent Internally-Generated Revenue to the Councils by the State Governments.

Another major challenge of tax assignment and revenue-sharing in Nigeria is the enforcement of compliance by the state governments to allocate 10 percent of their internally-generated revenue to their local councils. The existence of vertical fiscal imbalance in respect of state governments and local governments, and horizontal imbalance across local governments has necessitated this constitutional requirement.

The local governments serve as the grassroots governments and, therefore, a lot of social services expenditure burden is placed on them. This will, therefore, require a substantial transfer of funds from the state governments to the local councils in addition to the statutory and non-statutory transfers from the Federal Government to enable them meet their expenditure expectations on the MDGs. Evidence has shown that the state governments over the years have continued to flout this requirement. Hence, the task before the Federal Government is on how to ensure compliance with the constitutional provision and the law

IV.2.3. Modality for the Sharing of Transfers from Federation Account to Local Councils by the State Governments

Recent developments point to the confusion emanating from the constitution in terms of the sharing of the allocations from the statutory accounts among the local governments in the states. Whereas the constitution grants the state legislatures the powers to make laws for the distribution of these transfers, the Federal Government is insisting that the transfers are exclusively, meant for those local councils created before the 1999 Constitution. This controversy emerged as a result of the unprecedented creation of local governments by the state governments. Meanwhile, the state governments are invoking their powers in the constitution to create local councils.

This impasse has resulted in most of the cases, the withholding of the shares of the councils from the centrally-distributable revenue in some of the states. The development, therefore, does not augur well for the good governance at the level of the councils and could delay the decentralization process. In this regard, the major challenge for the Federal Government is to find a permanent solution to this problem in the interest of the local government administration and finances.

IV.2.4. Establishment of a Good Statistical Base for the Horizontal Revenue-Sharing Across State and Local Governments

Good revenue-sharing arrangements without an acceptable statistical base for calculating the indices for each sub-national government, for the purpose of determining each government share, could also generate tension and confusion. This was a major impediment in the implementation of the fine recommendations of Louis Chicks Fiscal Commission of 1953. Thus, the current task before the Federal Government is on how to generate a good data for the horizontal distribution of federally-collectible revenue to the sub-national governments.

IV.3 Policy Options for Reforms of Tax Assignment and Revenue-Sharing Arrangements in Nigeria

IV.3.1. Increasing the Fiscal Capacities of the States and Local Governments

The current debate is that, sub-national governments in Nigeria, lack the financial capacities to carry out some of the assigned responsibilities and, therefore, the suggestion is to trim down these responsibilities. However, this will move Nigeria towards a unitary system of government. With this regard, the option is to improve the sub-national governments' fiscal capacities through partly, modifications of assigned taxes and introduction of other more reliable taxes as follows.

The introduction of state excise taxes on alcoholic beverages and tobacco products is a good example for new tax assignment to the state governments. This form of tax would be politically acceptable as a means of financing state governments' expenditures on health care services. The new tax system is expected to be a residence-based tax and does not eliminate excise tax by the Federal Government (such as practiced in Mexico)[5].

In particular, personal income taxes form a major component of tax assignment to

[5] See Walsh C., 1996 pg 115

the state governments. Evidence over the years has shown that yields from the personal income have been low. Consequently, in view of the performance of VAT compared with the former sales tax, there are new suggestions that the Federal Government should be encouraged to takeover the administration of personal income tax. However, we differ with this suggestion, rather we proffer that the powers to set rates, in addition to the existing administrative responsibilities should be transferred to the state governments. This will enable them to adjust rates, depending on their economic circumstances and revenue needs.

The constitution has recognized that property rate is intrinsically local in character and assigns it to the local governments. However, concerned with the stagnation in yields from the tax, we suggest a reform in this regard on the grounds of cost efficiency and higher compliance rate. Thus, the administration of property tax should be placed under the purview of the state governments while the proceeds should be given to the local councils, with a surcharge of not more than 10.0 percent to cover administrative costs. Thus, besides increasing revenue, it will also reduce tax evasion and avoidance. Another area in which the councils could increase their tax revenue is through entertainment tax on birthdays and burial ceremonies, taxes on advertisement in their localities, and cost recovery charges, such as tolls for use of local roads and other user charges. Again, more substantial taxes on fairs and markets or a local business license tax (as practiced in Germany) based on actual turnover could be pursued by the local councils to enhance their internal revenue base.

IV.3.2 Inclusion of the Education Tax and VAT in the Federation Account

One thing that has emerged clear with the coming into force of the 1999 Constitution is that the fate of the Education Trust Fund cannot be different from that of the Petroleum (special) Trust Fund. By extension education tax revenue is now part of the Federation Account Revenue and should be paid into that account. The VAT Pool Account should be abolished and merged with the Federation Account for simplicity and transparency as well as in conformity with the constitutional provisions.

IV.3.3 Review of the Vertical Distribution Formula

To further boost statutory transfers to the sub-national governments, the revenue-sharing formula should be reviewed. A notable feature of Nigeria's federal fiscal arrangements is the multiple channels of transfers from the Federal Government to the sub-national governments. Some are statutory transfers such as the Federation

Account and VAT revenues while others are plan transfers in the form of grants-in-aid. Plan transfers include transfers from education tax revenue and transfers in respect of Universal Basic Education (UBE), Basic Primary Healthcare and others. Therefore, considering the needs of the states and local councils to meet their different expenditure outlays, this paper considers a consolidated revenue transfers that is based on a tax-by-tax sharing system. However, the percentage allocation to each tier of government can be determined by proper bargaining, depending largely on the expenditure needs of each tier of government on social services, internal security and defense. We, therefore, suggest a sharing formula below:

Table 10: Suggested Vertical Distribution of Revenue in the Nigerian Federation (in percent)

	Federal	State	Local Councils	Derivation	Total
Oil Taxes & Revenue	52.5	32.5	15.0	20.0	100.0
Company Income Tax	50.0	50.0	-	5.0	100.0
Customs & Excise	50.5	30.0	19.5	5.0	100.0
Value -Added Tax	30.0	40.0	30.0	20.0	100.0
Education Tax	30.0	70.0	-	-	100.0
Average	42.6	44.5	12.9	-	100.0

The suggested vertical distribution in Table 10 is based on the following assumptions:

- that the funding of primary education should revert to the states while the federal and local councils participations are restricted to design and implementation, respectively. Basically, from experience over the years, the local councils lack the capacities to have this function assigned to them not only in terms of funding, but also administration;
- that the state governments' expenditure on social infrastructures will continue to rise and remain higher than that of the Federal Government;
- derivation should apply on a tax-by-tax basis and directly on the outstanding receipts before distribution. In view of this, derivation becomes a first charge on all revenue items except for education tax. This is mainly to serve as an incentive to state governments;
- this formula assumes the exclusion of special funds;
- the inclusion of education tax and VAT revenues in the federation account and the abolition of the individual taxes disbursement mechanisms;
- education tax should strictly be earmarked for the purpose except if abolished under the new tax reforms; and
- that the state governments should adjust regularly, the amount of state allocation to the councils.

The new options allocates to the Federal Government (42.6%), state governments (44.5 %), and local governments (12.9%) of total federally-collectible revenue. The objective here is to increase statutory transfers and decrease grants. This generally will remove the political-influence factors associated with federal grants in the inter-governmental transfers. Thus, the consolidation of all transfers as statutory revenue-sharing makes these transfers explicit and predictable.

IV.3.4 Review of the Horizontal Revenue-Sharing Formula

Revenue-sharing across the sub-national governments can be shared on a tax-by-tax basis, applying different weights and principles. The table below attempts to play down on most of the objections facilitating agitations in the horizontal revenue-sharing system. The suggested distribution profile did not recognize the principle of tax efforts while it de-emphasized the principle of geographic area (landmass/terrain). For instance, emphasis on equality principle is to help those disadvantaged sub-national governments with low per capita income compared with national standard to have more fund for infrastructural development, thereby, encouraging private investment to boost economic activities in their respective states and local councils. If the emphasis placed on the principles of equity is adopted it will achieve the equalization effect across the sub-national governments and reduce considerably the unintended advantages to the well-established states and local councils in the current distribution system.

Under the principle of social development factors, there is a recognition of the inverse of all the sub-factors and considerable weight given to them. It is believed that the implementation of this will encourage an even social development across the sub-national governments. These principles and the associated percentages are also, recommended for revenue distribution to local governments. However, the use of the number of local governments under equality of states should be abrogated since the power to create local governments has been reverted to the state governments.

Table 11: Suggested Horizontal Distribution of Revenue in Nigeria

Revenue Sources	Population	Landmass/ Terrain	Equality	Social Factor	Inverse of Social factor	Total
Oil Taxes & Revenue	20	5	60	5.5	9.5	100
Company Income Tax	10	10	60	10	10	100
Customs & Excise	30	0	60	5	5	100
Value Added Tax	25	0	60	7.5	7.5	100
Education Tax	0	0	40	30	30	100

IV.3.5 Compelling the State Governments to Allocate the Mandatory 10 % of their Internal Revenue to the Local Councils

The Federal Government should establish a standard format to enable it monitor this aspect of the constitution and stiff penalty stipulated in the law. For instance, it could be recommended that failure to comply, the fiscal commission should deduct the outstanding amounts from individual state government's share from the Federation Account. Thus, the States House of Assembly should endeavor to monitor the compliance of the law. In addition, the state finance commission should be properly constituted. Rather than allow the officials of the state's ministry of finance to dominate the committee, it should be made an independent body like the RMFAC. The objective of these reforms is to make the transfer system predictable, measurable and transparent. The proportion for distribution should be automatically adjustable to inflation. Although the criteria for distribution among the local councils need to vary from state to state because of differences in local situations, this should not be an impediment to the earlier achievement of decentralization in the country. Consequently, we suggest this framework below for adoption according to local conditions.

Table 12: Framework for Revenue-Sharing to LGs.

Criteria	Weights
Derivation	10%
Population	30%
Equality	30%
Own revenue efforts	10%
Geographic Area:	10%
Rural Area	-4%
Urban Area	-6%
Social Factors:	10%
Direct	-5%
Inverse	-5%

The principles underlying this framework, is that apart from the size of local governments represented by the population and geographical area (which are major determinants of the financial needs of the councils), revenue-sharing should be complemented by set of criteria, which measure efficiency by the revenue-generating efforts of local councils, and equity by the level of local income per capita. Thus, the equity principle favors the fiscally-disadvantaged councils while the former is an encouragement to those high revenue-generating councils for their efforts.

IV.3.6 Constitutional Amendment on the Distribution of Proceeds from the Federation Account

The Federal Government should pursue vigorously the amendment of the constitution in the area of the power of the state legislatures to create local councils. Thus, the National Assembly can be given the confirmation authority based on the available resources. The main implication of the excessive creation of councils is that, the available funds will be spent on mere administration rather than on economic and social infrastructures. Thus, there is the need to amend the chapter of the constitution dealing with the creation of local councils for a proper decentralization in Nigeria.

The Federal Government through the RMFAC should establish a good and acceptable statistical base for the purpose of revenue-sharing across the sub-national governments. This is in terms of derivation, population, and geographic area. This should also, be reviewed at regular intervals through independent surveys.

V Summary and Conclusion

The paper described the basis of tax assignment and revenue sharing in a federal system. The evolution of tax assignment and revenue-sharing arrangements in Nigeria were also discussed. The result of the review indicates that in the earlier periods of the Federation, fiscal decentralization was encouraged by granting high revenue-yielding taxes to the regions. However, with the coming of military rule in 1966 marked the beginning of the erosion of the taxing powers of the sub-national governments and the concentration of national financial resources in the hands of the Federal Government. Consequently, from 1967/68 fiscal year, a notable feature has been the growing vertical and horizontal fiscal imbalances in the Federation in terms of fiscal capacities of the various levels of government and across the federating units. These have generated debates threatening the existence of the nation and suggesting a likely break-up.

The introduction of democratic rule in 1999 has generated new issues namely: inadequate fiscal autonomy for the states and local governments, poor federation account distribution formula, lack of fairness in the distribution of non-oil federal taxes, the control of the exploitation of natural resources, etc. Options were proffered for reforms in the financial transactions and the fiscal relationships in the Federation. These suggestions include: the strengthening of state internal revenue bases through the introduction of state excise taxes on alcoholic beverages and tobacco products,

etc; adjustments on the vertical and horizontal revenue-sharing formula; adoption of a tax-by-tax sharing system; entrenchment of the derivation principle in the distribution of all revenues collected centrally; the transfer of education tax to the federation account and the merging of VAT revenue with the same account; effective compliance with the allocation of the mandatory 10 % of state governments' internally-generated revenue; the amendment of the constitution to reduce the powers of the state legislatures to create local governments; and the establishment of an acceptable statistical base for revenue distribution across state and local governments.

The paper concludes that changes to the existing tax assignment and revenue-sharing arrangements will go a long way in protecting our nascent democracy. It will also reduce agitations and tensions in the system while it will facilitate the stable provisions of public services across the sub-national governments.

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