Enhancing Tax Collection Efficiency and Compliance in Nigeria: The role of behavioural economics

Eustace Uzor argues that incorporating insights from behavioural economics into the operation of the Federal Inland Revenue Service (FIRS) could transform tax collection in Nigeria.

Nigeria recently increased efforts to raise tax revenues, given the permanently low oil prices. However, despite earlier tax reforms, tax revenue has remained rather low, at a tax to GDP ratio of 6.1 per cent. So far, reforms have focused on strengthening traditional mechanisms for tax compliance and collection, without incorporating insights from behavioural economics that can cost-effectively improve compliance and raise revenue.

Since social factors influence taxpayers’ decisions, the Federal Inland Revenue Service (FIRS) should incorporate behavioural factors such as social recognition and peer behaviour to encourage improved voluntary tax compliance. A small-team of behavioural economists and cognitive psychologists can be hired and embedded within the Compliance and Enforcement Group (CEG) of FIRS to operationalise its implementation.

Nigeria’s huge tax gap, currently estimated at 14 per cent of GDP, highlights the country’s low tax performance. Various tax policy reforms have been carried out to increase tax revenue from improved compliance and collection efforts. These reforms are encapsulated in the FIRS Establishment Act of 2007 which significantly increased its autonomy over key drivers of its organisational performance. Notably, the Act increased its fiscal autonomy from the Ministry of Finance and granted it independence in human management resource decisions. These reforms have improved the capacity of FIRS to improve tax administration, and therefore its ability to collect taxes. For instance, a tax-audit of large tax paying units conducted in 2007 generated tax arrears of US$260 million. However, at 1.5 per cent of GDP (2013), Nigeria’s tax revenue is clearly one of the lowest in the sub-Saharan Africa (SSA), significantly lower than the region’s average of 15.8 per cent.

The foregoing analysis points to the need for more cost-effective tax collection mechanisms in Nigeria. Improving VAT collection efficiency and compliance is one area where such improvements
can be made. At 5 per cent, Nigeria has one of the lowest VAT rates in the world, well below the regional ECOWAS requirement of 10 per cent. Notwithstanding the low rate, data from IMF reveals that VAT collection efficiency, measured by C-efficiency ratio, is low, at 29 per cent. Unsurprisingly, weak compliance accounts for 42 per cent of this inefficiency.

Beyond increasing the VAT rate to 10 per cent (as recently proposed by IMF and the World Bank) and tightening enforcement measures, how else can VAT revenue in Nigeria be increased cost-effectively? An increasing body of evidence show that incorporating behavioural dimensions to tax administration procedures can significantly improve VAT compliance rates. This innovative mechanism overcomes institutional limitations such as weak performance incentives for tax officials, limited administrative capacity, corruption, and high rate of informality in countries such as Nigeria. Preliminary findings from an ongoing study of VAT payment behaviour by firms in Bangladesh show that the promise of sharing a firms’ tax compliance behaviour with similar firms elicits positive behavioural response, increasing compliance rates and collection efficiency.

An increasing evidence-base also show that framing tax compliance letters differently induces dissimilar responses from taxpayers. (For instance, by using different messages in letters to improve tax payments in Guatemala – a country with low tax revenue (10 per cent of GDP); UK’s Behavioural Insights Team (BIT) showed that the best performing letters highlighted that 64.5 per cent of taxpayers had paid their taxes. In this instance, using behavioural insights quadrupled tax received on each letter, with a negligible cost liability.

The successful use of behavioural insights to improve tax revenue collection is explained by the fact that in real-life scenarios ordinary individuals are inconsistent in their judgement and decision-making. It is common knowledge that the actions of individuals are considerably influenced by social norms and preferences, the choice of others, as well as inherent biases (ie, the tendency to be much more averse to losses than gains of equivalent value).

Given this deviation from standard economic theory – rational choice model, behavioural economics can be used to nudge citizens and firms towards socially desirable behaviour like paying taxes, without constraining their choices or changing their incentives. The critical role played by social recognition, societal status, and peer influence in Nigeria provides a rich context to extract more tax revenue (including VAT) using tools from behavioural economics.

Two interrelated policy recommendations are proposed. First, FIRS should integrate and institutionalise the use of behavioural economics in its operational procedures, particularly VAT collection. Second, a small team with expertise in behavioural economics and cognitive psychology should be hired and granted autonomy to lead the process. The ongoing economic recession provides the right institutional and political atmosphere to implement this tax policy reform.

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The views expressed in this post are those of the author and in no way reflect those of the Africa at LSE blog or the London School of Economics and Political Science.