MEMORANDUM ON THE POSITION OF THE REVENUE MOBILISATION ALLOCATION AND FISCAL COMMISSION ON FOUR (4) BILLS IN RESPECT OF THE TAX REFORM AND FISCAL POLICY BILL AT THE NATIONAL ASSEMBLY FOR DELIBERATION

1.0 Introduction

1.1 The Revenue Mobilisation Allocation and Fiscal Commission (RMAFC) acknowledges and appreciates the vision of His Excellency, Ahmed Bola Tinubu, GCFR, the President, Federal Republic of Nigeria in his transformational efforts under the Renewed Hope Agenda, particularly in advancing tax reforms to address Nigeria's fiscal challenges.

1.2 The Commission commends His Excellency for his innovative ideas and steadfast commitment to repositioning the revenue base of the country. The Commission as the revenue mobiliser for the three tiers of government, appreciates the submission of the four proposed bills, which reflect the President's visionary leadership in enhancing the nation's fiscal stability.

1.3 The proposed bills will significantly bolster the Commission’s efforts and the nation’s capacity for domestic revenue mobilization. They will help integrate untapped revenue sources, including contributions from the informal sector, into the tax net. Additionally, these reforms will enhance Nigeria's revenue-to-GDP ratio, positioning the country more favourably among nations with high fiscal performance.

1.4 The Commission therefore expresses its full support for the proposed legislation and is confident they will serve as a pivotal step toward elevating Nigeria's revenue generation and financing sustainable development.

1.5 However, the lingering debate over **derivation in Value Added Tax (VAT) allocation** has raised significant concerns, sparking heated arguments among stakeholders. This memorandum outlines the Commission’s position, emphasizing its constitutional mandate to ensure that VAT allocation adheres to the principles of fairness, justice, and equity, and highlighting why any arbitrary apportionment may be inappropriate and unconstitutional.

2.0 Background of Value Added Tax (VAT) in Nigeria

2.1 The history of **Value Added Tax (VAT)** in Nigeria began with its introduction in **1993**, following the promulgation of the **Value Added Tax Act No. 102 of 1993**, which came into effect on **January 1, 1994**. It replaced the **Sales Tax** system that had been in place since 1986 under the Federal Government's Decree No. 7 of 1986. The VAT was introduced to broaden the tax base, increase government revenue, and modernize Nigeria’s tax system.

2.2 It was structured as a consumption tax on the value added at every stage of production and distribution, with the burden ultimately borne by the final consumer. The Federal Inland Revenue Service (FIRS) was empowered to administer VAT while the consumption tax is within the jurisdiction of the state to collect and also the Federal Government.

2.3 The VAT rate was set at **5%** when it was first introduced. The tax covered goods and services, except for certain exempted items such as basic food items, medical services, and educational materials.

3.0 Amendments and Developments (1994-2018)

3.1 Over the years, amendments were made to the VAT Act to improve compliance and administration. Efforts to address challenges such as tax evasion, poor enforcement, and multiple taxation were introduced through capacity-building programmes and automation of VAT processes.

3.2 Increase in VAT Rate (2020)

3.3 In **January 2020**, the Federal Government increased the VAT rate from **5% to 7.5%**, following the enactment of the **Finance Act 2019**. This marked the first increase in VAT since its inception and was aimed at boosting non-oil revenue amid dwindling oil receipts.

4.0 Revenue Distribution and Controversies

4.1 VAT revenue is shared among the three tiers of government with **15% for the Federal Government, 50% for the States, and 35% for Local Governments**. Disputes arose regarding the collection and administration of VAT, particularly between the Federal Government and some States, such as Rivers and Lagos, which advocated for States to administer VAT within their jurisdictions.

4.2 This recent controversies and judicial interventions by Rivers and Lagos States have reignited debates over whether the Value Added Tax (VAT) formula should follow the derivation principle or remain a centrally administered consumption tax. These disputes, rooted in disagreements between federal and state governments, have sparked broader discussions on fiscal federalism, equity, and constitutional governance in Nigeria. Proponents of the derivation principle contend that VAT revenues should primarily benefit the states where taxable goods and services are consumed, while critics emphasize the importance of equitable redistribution to support weaker state economies and promote national cohesion.

4.3 This ongoing debate has brought the role of the Revenue Mobilisation Allocation and Fiscal Commission (RMAFC) into the spotlight. RMAFC plays a crucial role in Nigeria’s fiscal framework, ensuring an equitable revenue-sharing formula among the three tiers of government. Its constitutional mandate is vital for maintaining stability and fairness in the allocation of the nation’s resources.

4.4 Value Added Tax (VAT), introduced in 1993 to modernize Nigeria's tax system, has become a significant source of revenue. Originally established to replace the sales tax, VAT was designed to broaden the tax base and enhance non-oil revenue. Since its inception at a rate of 5%, the VAT rate was increased to 7.5% through the Finance Act of 2020. However, over the years, its administration and allocation have encountered various challenges, including inefficiencies in collection, tax evasion, and disputes over the centralization of VAT revenues.

4.5 Judicial Rulings (2021-2022)

4.6 In 2021, the Rivers State Government challenged the federal administration of VAT and passed a law to collect VAT locally. The Federal High Court in Port Harcourt ruled in favour of Rivers State, but the Court of Appeal granted a stay of execution, pending a decision by the Supreme Court.

4.7 Current Developments

4.8 Discussions on VAT reforms continue, with debates on central versus state administration and the implications for businesses and inter-state trade as well as VAT derivation principle. The ongoing arguments stem from differing interpretations of VAT’s allocation framework. Some states argue that VAT should primarily benefit the states where the taxable goods or services are produced or consumed, invoking principles of derivation while others emphasize that VAT, as a national consumption tax, should be shared equitably to support weaker economies and promote national cohesion. These divergent views threaten to undermine the spirit of fairness and cooperation enshrined in Nigeria's fiscal framework.

4.9 VAT remains a critical source of non-oil revenue, contributing significantly to Nigeria's fiscal sustainability. The controversies have prompted the Commission to clarify issues regarding to allocation of revenue as stipulated by the constitution of the Federal Republic of Nigeria. All these debates are rooted from the fiscal federalism and derivation. The Commission as empire arbiter intends to draw its position from the theoretical framework and concept of derivation vis –a-vis VAT derivation principle.

5.0 Fiscal Federalism Theory

The theory of fiscal federalism proponent by Musgrave, R. (1952) & Wallace E, O. (1972) advocates for **a balanced approach to resource distribution**, ensuring that all levels of government have adequate resources to fulfil their responsibilities. **By emphasizing equity and collaboration, fiscal federalism seeks to promote economic development while safeguarding national cohesion.** Applying this framework, VAT allocation must strike a balance between recognizing consumption patterns and supporting less economically developed states.

6.0 Concept of Derivation

Derivation in fiscal federalism refers to the principle where revenue generated from a specific resource or activity is allocated to the jurisdiction (state or region) where it originated. In Nigeria, this principle is constitutionally recognized, notably in the allocation of oil revenues where 13% of revenue derived from oil is returned to oil-producing states, though different from the VAT derivation. It aims to ensure fairness and economic equity by compensating resource-originating regions for their contributions to the national purse.

6.1 However, complexities arise in applying derivation principles to value-added taxes (VAT) due to the nature of VAT, which is consumption-based rather than origin-based.

6.2 Complexity in Ascertaining Taxpayer Residence for VAT

VAT is a tax levied on the consumption of goods and services. The final tax burden falls on the consumer, and the tax is remitted by businesses (agents of VAT collection) to the tax authorities. The complexity in determining the taxpayer's "residence" for derivation purposes arises when:

a. Goods are purchased in one location and consumed in another.
b. The seller and buyer operate across state boundaries.
c. VAT reporting systems do not track the end-use location effectively.

The above issues are presented in the scenario below:

Scenario: A Man from Kano Buys a Fuel Pump in Lagos for usage in kano state.

Scenario Outline:

- A business in Lagos sells a fuel pump to a customer from Kano.
- The Lagos business acts as a VAT collection agent, charging VAT on the sale.
- The customer transports the fuel pump to Kano for personal or business use.

6.3 Issues in Derivation:

1. **Point of Collection vs. Point of Consumption**:

    - The VAT is collected in Lagos, as the business selling the pump is registered there.
    - However, the pump is used in Kano, where the consumer resides, making Kano the point of consumption.

6.4 Allocation of VAT Revenue:

- Under Nigeria’s VAT system, collected VAT is pooled nationally and distributed based on a formula (50% derivation, 35% population, 15% equality).
- Lagos, as the point of collection, could argue for derivation rights.
- Kano, as the consumer's residence and point of use, could also claim derivation rights because it is a consumption tax which is borne by the final consumer.

6.5 Administrative and Legal Challenges:

VAT laws in Nigeria do not provide a clear mechanism to track goods post-sale to the end-use location. Without robust systems for monitoring consumption patterns, the allocation of VAT based on derivation becomes contentious.

7.0 Broader Implications

Systemic Issues:

- The existing VAT system prioritizes revenue pooling and formula-based distribution over strict derivation principles.
- Lack of digital infrastructure to trace goods and services from sale to consumption complicates accurate attribution.

8.0 Significance of VAT Revenue

VAT is a critical source of revenue for the three tiers of government in Nigeria, contributing substantially to the VAT pool Account. Unlike other taxes, VAT is a consumption tax where the burden is borne by the final consumer at the point of purchase. VAT is a centralized tax collected for redistribution across the Federation, making it crucial to allocate revenues equitably to all tiers of government.

8.2 The unique nature of VAT implies that its allocation must reflect principles of fairness, justice, and equity to ensure the harmonious functioning of the federation.

9.0 Nature of VAT and Challenges of Arbitrary Apportionment of VAT

Any attempt to apportion VAT revenues arbitrarily, whether vertically or horizontally, risks undermining the principles of equity for the following reasons:

i. **Consumption vs Production Dichotomy**
VAT is levied at the point of consumption, not production. A company may produce goods in one state but sell them in another. This consumption-driven nature means VAT revenues must be shared in a way that reflects this dynamic to prevent inequities among states and local governments.

ii. **Unity and Equity in Resource Sharing**

iii. Arbitrary percentages may alienate certain tiers of government or regions, creating divisions and eroding trust in the revenue-sharing process.

iv. **Legal and Constitutional Validity**
Only the RMAFC has the mandate to produce formulae for sharing revenues, including VAT. Any deviation from this constitutionally backed process is both inappropriate and potentially unconstitutional.

9.1 Dynamic in VAT Revenue Allocation

Given the dynamics, arbitrary apportioning of percentages for VAT allocation, whether vertically among the tiers of government or horizontally among states and local governments, is both impractical and unconstitutional. There might be Public perception of skewing the law to favour states with higher production or corporate presence, regardless of where consumption occurs. Ignoring the need to support less economically developed states and regions and undermining national unity and equity in revenue-sharing.

10.0 Constitutional Mandate of RMAFC

10.1 Section 162 (2) of the **1999 Constitution of the Federal Republic of Nigeria (as amended)** empowers the Revenue Mobilisation Allocation and Fiscal Commission to determine the formula for the equitable sharing of revenue among the three tiers of government. Ensure that such formula reflects the principles of fairness and justice. The **Constitution therefore made** RMAFC the **empire arbiter** in matters of revenue allocation for the three tiers of government.

10.2 The Constitution, being supreme, does not envisage that any other Act of Parliament such as the VAT Act could assume this responsibility. Any such attempt would contravene the Constitution. Therefore, the RMAFC remains the sole arbiter in producing allocation formulae that are **fair, just, and equitable** for the three tiers of Government. Any deviation from a formula crafted by the RMAFC risks violating constitutional provisions and undermining the Commission's role as the **impartial arbiter** of revenue allocation in Nigeria.

10.3 RMAFC's Formula: The Fair, Just, and Equitable Solution

Considering the constitutional mandates of the Commission to ensure, fair, just, and equitable allocation of revenue for the three tiers of government and to put the VAT derivation debate to rest, the Commission wishes to propose that:

i. **VAT Allocation and Derivation:** VAT allocation and derivation shall be based on a formula developed by the RMAFC, which considers VAT's unique nature as a consumption tax and ensures equitable distribution.
ii. **Avoidance of Arbitrary Percentages**: Any arbitrary vertical or horizontal apportionment of VAT revenue would fail to address the nuances of VAT collection and consumption.
iii. **Fair Distribution Mechanism**: The RMAFC's formula would ensure recognition of consumption patterns, not just production or company headquarters. Support for states with weaker economies to promote national cohesion and equitable benefits for all tiers of government without bias or favouritism.

10.4 Recommendations

1. **Empower RMAFC** to finalize a VAT allocation formula in line with its constitutional mandate, ensuring an equitable approach for all stakeholders.
2. **Constitutional Adherence**: Reinforce that VAT allocation is subject to the RMAFC's framework and not arbitrary determinations as stipulated in the VAT Act or the proposed bill which is threatening the unity of the country.
3. **Stakeholder Engagement**: Foster dialogue among the federal, state, and local governments to secure consensus on the RMAFC's proposed formula, reducing tensions and ensuring broad acceptance.
4. **Avoid Legislative Overreach**: Reinforce the constitutional mandate of the RMAFC and discourage any legislative or executive measures that undermine its authority.
5. **Adopt digital tracking systems**: Implement a system that tags VAT collections to end-user locations, using tools like electronic invoicing and transaction monitoring.
6. **Review VAT laws**: Amend legislation to clarify derivation rules for interstate transactions.

11.0 Conclusion

Distinguished Sir, VAT remains a critical revenue stream for all tiers of government, and its allocation must adhere to constitutional provisions to prevent inequities and national discord. By affirming the RMAFC's role in determining the VAT revenue-sharing formula, the legislators would have demonstrated commitment to constitutional governance and equitable fiscal management.

VAT is one of Nigeria’s major revenue sources, vital to the fiscal stability of all tiers of government. Resolving the derivation issue through a constitutionally grounded and equitable formula will enhance national unity, promote fairness, and reinforce trust in the revenue-sharing system.

12. Please, accept the assurances of our highest regard, Sir.

M. B. Shehu, OFR, Ph.D
Chairman