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A Conceptual Analysis of Taxation as a Tool for Fiscal Stabilization in Nigeria

Raymond Effiok Thomas *

Temple Gate Polytechnic, Accounting, Aba, Abia State, Nigeria.

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Abstract

This paper describes the concept of the Nigeria's economy and fiscal policy by taxation and integration of recent academic publications until 2023. Previous studies have shown Nigeria's frequent macroeconomic instability, fiscal deficits, inflation, revenue fluctuations, oil dependency, and all the above factors have created an environment where the design of a tax-based stabilization policy is crucial. Thus, the paper aims to examine the extent to and the ways in which taxation in Nigeria affects fiscal stabilization and to explain how tax legislation have impact on macroeconomic variable and the major obstacles to the legislation's impact in Nigeria. Using the conceptual review method, the study collated and reviewed empirical and theoretical publications during the 2015 to 2023 period and examined fiscal policy theories, tax buoyancy, and public finance stabilization. The study found that taxation contributes to Nigeria's economy stabilization by affecting aggregate demand, broadening revenue base, and lessening fiscal instability. The researches indicate that revenue resilience and macroeconomic equilibrium are positively impacted by counter-cyclical tax measures, better tax management, and expanding the tax base. But challenges like systemic tax evasion, policy/institutional inconsistencies, administrative inefficiencies, and dependence on unstable oil revenue loosen the grip of tax measures. It ends by acknowledging that taxation, while remaining a tool of fiscal balance, requires considerable structural adjustment to fully function. The modernization of tax administrative systems, diversification of non-oil revenue, compliance automation, and taxation reengineering to achieve long-term fiscal sustainability are the most significant of these structural changes. In Nigeria, the research lays the groundwork for future empirical analysis of taxation and macroeconomic stability.

Keyword: Taxation; Fiscal; Stabilization; Public Finance; Redistribution

1. Introduction

The importance of taxation in modern public finances goes beyond funding public goods and services, as it also serves as a strategic tool in macro-fiscal management and facilitates the stabilization of economic output, inflation, income redistribution, and conditions for growth (Amah and James, 2018). In a country like Nigeria, which has a long history of oil revenues and large external shocks, the taxation potential is particularly valuable as a more predictable, buoyant and well-structured taxation system is able to limit fiscal vulnerability, minimise the necessity of pro-cyclical borrowing, and create the fiscal capacity for counter-cyclical spending (World Bank, 2022). However, the literature contains definitions and clarifications of taxation as a tool for fiscal stabilization and the constraints of such tool to support these functions in taxation which remain unclear and administrative, institutional, and behavioral weaknesses that blunt their efficacy remain contested. This conceptual review thus examines the mechanisms through which taxation can achieve stabilization in Nigeria, the theoretical and empirical discussions surrounding tax-related stabilization, and the practical obstacles that have constrained Nigeria's ability to use tax policy to smooth shocks and enhance macro-fiscal sustainability through tax.

* Corresponding author: Raymond Effiok Thomas

In principle, taxation can enable stabilization through various mechanisms. First, taxation can affect aggregate demand: When tax rates or tax bases are altered, disposable income and consumption change, thus giving fiscal authorities the ability to directly control demand and either fuel or mitigate inflationary overheating or recession (Adegbite, 2019). Secondly, taxation shapes automatic stabilizers: A broad, progressive tax system automatically counteracts the cycles as it collects more revenue during boom periods and less during bust periods. This reduces the need for discretionary counter-cyclical measures (Auerbach & Feenberg style, as formulated in macro-fiscal theory and applied in various country studies). Third, taxation provides revenue that is not volatile, which subsequently decreases the extent to which governments must rely on volatile external or short-term debt to finance deficits. This is crucial in a country like Nigeria, where the fiscal position is influenced by the volatility of oil fiscal revenue (World Bank, 2022). Such mechanisms demonstrate why, alongside sound management of public expenditure, integration of monetary policy makes scholars view tax systems as more than just revenue collection: as stabilizing systems in their own right (Amah & James, 2018; Adegbite, 2019).

Survey analyses of Nigeria document taxation stabilizing performance as mixed. Some studies document the view that taxation can cushion the economy from inflation. For example, Adegbite (2019) presented empirical findings indicating that alterations in tax policy have a significant, and in the short and long run, negative impact on inflation in Nigeria, implying that tax policy may be used as at an anti-inflation policy. However, other time-series analyses at the country level suggest that tax policy in the Nigeria context has not, over time, produced stabilizing results as tax policy is a narrow, fragmented, and structure-sensitive policy (Amah & James, 2018). Most importantly, the literature identifies conditions on which the stabilizing impact of taxation is dependent on the scope and progressivity of the tax base, quality of tax administration and compliance, and tax revenues being insulated from the opaque fiscal regime. When these conditions are absent, taxation may fail to stabilize the economy and, in some circumstances, may even exacerbate volatility through ad hoc tax hikes or poorly targeted tax cuts.

2. Literature review

2.1. Theoretical Perspectives on Taxation and Fiscal Stabilization

The theoretical basis regarding the use of taxation for disbursement in balancing payments derives from classical and contemporary public finance theories. Among classical economists, the understanding of taxation as a public revenue generator was the guiding thought, but with new macro-fiscal theories came an understanding of other such functions like revenue stabilization. Musgrave, in his theory of public finance, shows how governments through taxation achieve more than just allocation and redistribution of resources, but also aim at cyclically stabilizing the economy (Musgrave, 1959). Although Musgrave's theory is older, it is applied in contemporary taxation theories and continues to be useful for policy evaluation (Adegbite, 2019).

The stabilizing role of taxation is also recognized in the theory of Keynes, which posits that taxes are counter-cyclical instruments that can either control an inflationary economy by reducing aggregate demand or an economy that is in a recession by increasing aggregate activity (Auerbach, 2020). The theory proposes that a government's expenditure should be reduced during recessionary periods so as to allow the private sector to increase its investment and consumption. On the other hand, during a boom, the government should increase its expenditure through tax cuts to control inflation (Ojong and Owui, 2022). Thus, the theory shows that the taxation system can be used to achieve a desired national output.

An additional key line of inquiry relates to potential automatic stabilizers. When incomes rise, lower tiers of income, corporate, and value-added transactional taxation are triggered and when incomes fall, the tax deficit from such taxation equally reduces, enabling such tax regimes to dampen an economy's cycle without the need for government intervention (Auerbach & Feenberg, 2019). According to Adegbite (2019), such stabilizers are more efficient in systems where there is a broad and consistent tax base with little reliance on volatile sectors, such as the oil sector.

Deputing in Nigeria, theoretical discussions center on the degree to which the country's tax system could potentially stabilize such an economy, which is informally structured, has a narrow tax base, and is heavily reliant on oil. According to Amah and James (2018), there is little evidence to suggest Nigeria's tax structure possesses the automatic stabilizing qualities of advanced economies. In their reasoning, the economic impacts of tax progressivity seem to be weak, and so does the enforcement of tax provisions, with implications of restraints on the possibility of its tax system having a considerable counter-cyclical nature. In their conceptual framework, a broader range of factors beyond tax system design ought to be taken into consideration when determining the scope of tax stabilisation impacts, including institutional framework, political context, revenue collection structures, and administrative efficiency.

2.2. Empirical Perspectives on Taxation and Macroeconomic Stability in Nigeria

Numerous investigations have assessed whether the tax regimes in Nigeria have had any impact on fiscal and macroeconomic stability. One of the most referenced is Adebite (2019), who analyzed the impact of taxation on Nigerian inflation with the use of time series econometrics. His results show that there is a significant and negative effect of taxation on the inflation rate in the short and long run. This finding indicates that tax policies could serve as a moderation tool if used in a strategic manner, particularly as a control for the inflation rate.

Amah and James (2018) also present empirical data that taxation has control ramifications for macroeconomic stability. However, they argue that the control effect has been inconsistent, given Nigeria's over reliance on the oil sector. Their study indicates that even in the absence of oil, there is a stabilizing effect, but the revenue from petroleum is too volatile to warrant long run stabilization. This is comparable to the larger literature on economies that are dependent on resources, where the stabilization of fiscal policies is usually ineffective due to the volatility of prices on the commodities (World Bank, 2022).

Studies on Nigeria's fiscal framework show that tax revenue volatility negatively impacts economic growth and budgetary equilibrium. Idris and Yusuf (2020) argue that the tax revenue volatility creates fiscal deficits and negatively impacts expenditure flow leading to the tax policy's stabilizing function being weakened. Their study suggests broadening the non-oil tax revenue base in Nigeria to enhance stability.

Recent studies have built on this to look at the tax system's responsiveness to economic cycles. Ojong and Owui (2022) have shown that the elasticity of the tax system in Nigeria is low, indicating that tax revenues do not have a substantial response to related changes in economic activities. This low elasticity is said to reduce the automatic stabilizer effect hence, tending to a more pro-cyclical fiscal stance in Nigeria. There is an upward expenditure cut during economic booms and a downward cut in economic recession, the stabilizing tax system scenario is the opposite of this.

The empirical studies demonstrate that Nigeria's tax system has the potential to serve as a stabilizing instrument, however, this has not come to fruition because of highly structural weaknesses, administrative inefficiencies, and over-dependence on oil revenue.

2.3. Tax Administration, Informality and Fiscal Stabilization

A key sub-theme in the literature is the part tax administration and the informal economy play in shaping stabilization outcomes. Nigeria's informal economy is one of the largest in Africa, comprising over 50% GDP and more than 65% of employment (National Bureau of Statistics, 2021). The absence of formality severely limits tax policies from economically stabilizing the economy because a considerable amount of economic activity is out of reach of the tax net (Johnston, 2020).

Tax compliance studies, if there are administrative bottlenecks within the system, like multiple taxation, corruption, poor digitalization, lack of taxpayer education, it provides behavioural incentives to evade taxes (Olaoye & Adebayo, 2021). These tax barriers make the economic conditions voraciously volatile due to the unpredictable nature of effects these taxes have on the economy. For example, there is a tendency of a decrease in compliance to corporate taxes during economic downturns. Hence, the stabilizing effects of taxes are reduced significantly (Olaoye & Adebayo, 2021).

Yarima and Magaji (2022) state that Nigeria's fragmented tax structure incorporate federal, state and local tax authorities with overlapping/remanding roles which create revenue leakages and ambiguities which compromise stabilization. Their study suggests that Nigeria's tax system will remain ineffective as an instrument of fiscal stabilization absent of institutional reforms.

3. Methodology

This study is primarily secondary data and desk based and uses a conceptual research design policy and scholarly work to interrogate the role of taxation as tool of fiscal stabilization in Nigeria. A conceptual design is appropriate in this instance as the study intends not to collect/practice primary data and/or statistical estimation models but rather to synthesize a body of theory, frameworks, empirical findings and policy debates.

This review is based on primary peer reviewed journal articles, white and grey literature comprising institution and policy documents, and scholarly works that have been published until the year 2023. A systematic search on Google Scholar, JSTOR, and ResearchGate, as well as institutional repositories such as the World Bank, IMF and National Bureau

of Statistics (NBS) under the keywords taxation, fiscal stabilization, fiscal policy, automatic stabilizers, tax administration, non-oil revenue, and Nigeria, helped in the identification and retrieval of relevant literature.

Sources were selected based on three criteria:

- Relevance to taxation and fiscal stabilization in the Nigerian context.
- Credibility, prioritizing peer-reviewed articles, official publications and empirical studies.
- Timeliness, focusing on studies published between 2010 and 2023 to ensure contemporary relevance.

The methodology in focus engages in integrative literature, which helps in reviewing combination of theory, empirical evidence, and practical policy evaluations in order to form a holistic understanding of the topic under consideration. Information obtained from the selected documents was thematically organized into theory, empirical data, administration, revenue, and policies. This thematic synthesis helps to arrive at valuable ideas, conceptual interconnectedness, and conclusions concerning Nigeria's fiscal policy framework.

As the study is conceptual, primary data was not collected and therefore no statistical model was attempted. The emphasis is on interpretation, synthesis and critical examination of the existing literature to clarify what role taxation should play in fiscal stabilization in Nigeria, and what hinders its success.

4. Findings

The conceptual and empirical evidence reviewed tells us about the role of taxation in Nigeria as fiscal stabilizer, which, supposedly, should stabilize the macro economy and tells us the practical reasons, which, have not let stabilization work. These findings are presented in thematic form to capture the essence of the purpose of taxation and the macro-fiscal management in the economy of Nigeria..

4.1. Taxation Has Strong Theoretical Potential to Stabilize the Nigerian Economy

This literature argues that taxation should theoretically aid in fiscal stabilization concerning taxation's effect on aggregate demand, revenue stability, and through the effects of automatic fiscal stabilizers (in the case of recession, taxation revenue falls, increasing deficit spending). Auerbach, along with several other economists, grounded his theory in Keynesian economics and Musgrave's theory of public expenditure, in which he suggested that well-planned tax systems mitigate the effects of inflation, dampen economic cycles, and counter/cycle on economic depressions (Auerbach, 2020; Musgrave, 1959).

This theory is especially applicable to Nigeria, where studies have shown a direct correlation in the country between taxation, on the one hand, and inflation and consumption, on the other. To a large degree, inflation in Nigeria has been controlled when balanced policy measures are in place. This suggests, rather strongly, that taxation should be easily employed at stable rates as a vital instrument of Nigerian economic management (Adegbite 2019).

Yet, this theoretically strong justification has very weak practical applications in Nigeria. This is a function of the structural and institutional constraints that affect the country.

4.2. Nigeria's Current Tax Structure Is Not Sufficiently Broad or Progressive to Function as an Effective Stabilizer

The data also says that Nigeria has a very narrow and weakly progressive tax system that is largely in line with the revenue from the petroleum sector. This imbalance situation severely weakens the stabilizing potential. Amah and James (2018) and World Bank (2022) show that over 50 percent of revenue of the government is from oil, hence making the country's fiscal system vulnerable to the movements in the oil market.

This high degree of dependence minimizes the tax revenue flexibility to the changes of the revenue in a country. Nigeria's tax system does not stabilize the situation, instead, it increases the changes during oil "booms" and collapses during the oil price "crashes". This hyper-cyclical is something that most countries would wish to avoid and that would show us that Nigeria's tax system does not have the minimal flexibility that is found in countries with diversified tax systems. Moreover, the very limited progressivity of the personal and corporate income tax also means that the country's system has very limited automatic stabilizer effect.

4.3. Tax Administration Weaknesses Significantly Reduce the Predictability and Stability of Revenue Flows

Tax administration in Nigeria, as it stands is highly diffuse, and is challenged by structural duplications, corruption, and deficits in digital capacity. These features increase compliance costs and stimulate gross evasion (Olaoye & Adebayo, 2021).

There are many sources of revenue collection and each level of government (federal, state and local) have their own tax authorities. This creates a tax revenue structural imbalance and incoherence in policies, uneven/erratic legislation and tax compliance, and competing claims with other revenue objectives. This, as noted by Yarima and Magaji (2022) simply creates gaps in revenue and unpredictability, and in a straightforward manner, undermines any efforts aimed at fiscal stabilisation.

The absence of integrated digital tax systems and data collaboration across tax authorities results in considerable gaps in compliance by the private sector, including the majority of Nigeria's enterprises (the micro, small and medium enterprises or MSMEs). Lack of seamless tax administration systems fails to deliver to the expected results.

In conclusion, the government fails to perform counter-cyclical expenditure, or at the very least to budget with any degree of confidence, as a direct result of revenue administrative inefficiencies.

4.4. The Large Informal Sector Undermines the Effectiveness of Taxation for Stabilization

Every economy operates on some level of informality, but Nigeria's economic informality is on another level, so much so that it undermines the capacity of the taxation system to perform its capacity. Given that 65% of economic activities in Nigeria are informal, there is too much income and output that remain untaxed (NBS, 2021), which in turn, decreases the capacity of the system to generate revenue and the system's ability to deliver on taxes to the economy's activities in a given period.

Tax revenues in formalized economies become more predictable; however, that is not the case in Nigeria's economy. Johnston (2020) affirms that economies with a high level of informality and unassured tax revenues, undermines taxes as a stabilization tool. Nigeria's economy parlays a high level of informality. Thus, income taxes and VAT, as well as Corporate taxes, cannot exercised the attributes of countercyclical that is a characteristic feature in more formalized economies.

Without a doubt, Nigeria's high level of economic informality undermines taxation's ability to perform as a stabilization tool. Thus, it is only after Nigeria has undergone some degree of structural transformations and has been able to formalize its economy, that taxation can be expected to operate as a stabilization tool.

5. Conclusion

This conceptual analysis set out to establish how effective taxation is as a tool for fiscal stabilization in Nigeria. Evidence from theory and empirical studies and policy-based literature suggest that taxation has the theoretical potential to stabilize the macroeconomy, this potential is practically and considerably weak in Nigeria due to structural, administrative and institutional/systemic weaknesses.

The stabilizing role of taxation is a given in public finance and macroeconomics. It is within the Keynesian and Musgravian theories that taxation is perceived to be a counter cyclical tool that can stabilize inflation and aggregate demand as well as smooth growth in the output of an economy. Nigeria's fiscal experience, however, depicts a widening gap between theoretical fiscal-stabilizing mechanisms and empirical outcomes. It is the synthesis of theory and empirical evidence that suggests that taxation can be more effective in stabilizing the economy of Nigeria. A shift to a more flexible, responsive and technologically advanced system of tax collection and administration is critical for Nigeria to attain fiscal stability.

Recommendations

According to the recommendations provided in this research, the following actions should be taken in order to improve the impact of taxation in Nigeria's fiscal stabilization system:

- Expanding and diversifying non-oil taxation

It is suggested that the Nigerian government focus on the expansion of tax revenue by improving non-oil taxation sources such as value-added tax, personal income tax and corporate income tax. This can be done by removing some tax exemptions, bolstering tax enforcement activities, and formalizing the tax system to include the informal sector. A more diversified revenue base would decrease volatility and increase the stability of government revenue during downturns and fluctuations in the economy.

- Improving tax administration by digitalization

For stabilization to be achieved, tax administration restructuring is essential. The government should promote the use of new digital tax systems such as e-filing, unified taxpayer registries, digital payment systems, and automated systems for compliance verification and control. In terms of fiscal stabilization, digitalization is important to decrease tax revenue leakages, improve fiscal efficiency, and enhance the predictability of revenue..

- Formalize the Informal Sector to Increase Revenue Responsiveness

To implement a measure by which the informal economy can be taxable, one would have to know the best tax regimes for micro-taxations, what incentivizes them to register, the best education strategies for them, and the micro businesses simplification, formalization, and responsiveness of the revenue vis-a-vis economic cycles and the formalization will increase responsiveness.

Policy alignment between tax and spending must be different for the different types of stabilization, which is monetary. Coordination between FIRS, the Ministry of Finance, and the CBN of Nigeria will improve responses to instability, recession, and the shocks of exogenous events.

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