GOVERNING LAGOS: Unlocking the Politics of Reform

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Taxation and the Social Contract

Few policy issues demonstrate how much Lagos has changed over the past fifteen years more clearly than taxation. Tax reform was motivated by a basic fiscal reality: Lagos State had few other sources of revenue and state leaders needed more resources to meet public demands. While expanded taxation is usually not considered a recipe for winning elections, in this case it appeared to be a political necessity. As the Lagos ruling party solidified its control over the city and set its sights on national political expansion and megacity projects, incentives increased to make improvements to the tax system. Implementing tax reforms relied on partnerships with private contractors, the creation of a technocratic bureaucratic enclave, and public outreach promoting the idea of a social contract between taxpayers and the state.

First Steps

Nigeria is Africa's largest oil producer, but most of its petroleum revenues are retained by the central government. The share of oil revenues that Lagos State receives is far from sufficient to run a city of its size. In 2002, the state government's personnel costs alone exceeded its statutory allocation from the federal government.[1] Lagos State cannot take out loans on capital markets indefinitely without proving it can repay them. Taxation is thus a crucial source of revenue for the state government.

Relative to other Nigerian states, Lagos has a significant tax base. As the country's commercial capital, it has a diversified economy and a critical mass of salaried staff employed by formal businesses that can be subject to income tax withholding. Personal income tax is the most important source of state government tax revenue, though Lagos State also collects taxes on property and certain other activities.[2]

Given this fiscal need and potential, why was tax reform not a central priority before 1999? Lagos certainly needed more funds in the 1990s, and its last military governor made some efforts to increase revenues through the use of a private tax consultant. Yet military leaders were concerned with maintaining order rather than increasing their popularity through effective service delivery. The military lacked legitimacy in Lagos, and multiple interviewees argued it could not have significantly expanded taxation without provoking strong societal opposition.

This threat calculus changed when political competition returned to Lagos. Tinubu and his party needed financial resources to prove they could deliver for their supporters. A former accountant, Tinubu recognized Lagos's untapped tax potential. Although taxation could be unpopular, the burden initially fell on formal businesses while Tinubu's political support relied more on the informal sector.

Tinubu made taxation an early priority and began a review of Lagos's tax processes shortly after his 1999 election. At that time, the state government lacked even basic capacity to efficiently collect or monitor tax payments. Taxes were paid in cash to revenue officials who gave out handwritten receipts, providing multiple opportunities for corruption. The finance ministry even lost track of the payments that made it

[1] Lagos Central Office of Statistics, *Digest of Statistics 2007*.

[2] The state government's tax powers are limited by Nigerian law. The national government sets income tax rates for all the states and has the exclusive right to collect certain important taxes, such as corporate taxes.

into state bank accounts. And many businesses were not paying at all. Poorly trained and resourced state revenue staff struggled to effectively audit businesses employing better-qualified accountants.

Faced with this situation, Tinubu's finance ministry first moved to shift tax collection from cash transactions toward electronic payments through banks. In 2000, the state government hired an external company, ALPHABETA Consulting (ABC), to manage its payment system in exchange for a commission on tax revenues. ABC developed software to monitor bank payments and to issue electronic receipts to taxpayers, helping ensure that more tax payments reached state coffers.[3]

Electronic payments reduced opportunities for fraud in the collection process but did little to ensure that taxpayers were paying their full liabilities. The Tinubu administration attempted to address this problem by hiring private auditors. Yet current and former revenue officials reported that this effort yielded disappointing results. State officials were unable to monitor whether these auditors were doing a good job or prevent them from cutting side deals with companies to lower their tax assessments.

The first Tinubu administration also had trouble convincing individuals and businesses that they had an obligation to pay taxes. Given Nigeria's heavy reliance on oil revenue, most Lagosians were not accustomed to seeing taxes as necessary to government functioning. Moreover, high levels of corruption contributed to widespread public skepticism about how this revenue would actually be used. Southwest Nigeria in particular has a history of strong opposition to taxation.[4] While Tinubu argued that taxation would enhance Lagos State's ability to provide public goods, the government had yet to demonstrate it could use revenues well—in part because it lacked the resources to make initial investments.

In addition, business people felt that the state government's tax enforcement efforts were unfair. One private sector representative noted that tax collection in the early 2000s was "like a war zone, you closed businesses, embarrassed customers," while another said the process was "crude and violent, the police and touts were mounting roadblocks, confiscating vehicles, and sealing factories without due process."

Despite these continuing problems, the shift to electronic payments and greater attention to enforcement led to substantial increases in tax revenues.

Institutionalizing Tax Reform

Beginning in Tinubu's second term, Lagos State embarked on more far-reaching tax reforms. This was partly a natural continuation of previous efforts, but the timing was also influenced by two important political considerations.

First, the state government faced an additional fiscal threat in 2004. Then president Obasanjo cut off federal funding for local governments in Lagos State due to a dispute with Tinubu over the creation of new local governments. Many scholars and other observers of Nigerian politics have presented this incident as the primary driver of tax reform in Lagos. Officials directly involved in tax policy, however, insisted that the local government crisis merely provided an additional impetus to an existing process. Tax efforts accelerated even after the funding issue was resolved, indicating that other motivations were also at stake.

[3] Olawale Edun, former Finance Commissioner, interview with author, Lagos, September 4, 2013.

[4] Jane Guyer, "Representation Without Taxation: An Essay on Democracy in Rural Nigeria, 1952–1990," *African Studies Review* 35, no. 1 (1992): 41–79; and Peter Lloyd, "The Development of Political Parties in Western Nigeria," *American Political Science Review* 49, no. 3 (1955): 693–707.

Second, after his 2003 reelection, Tinubu had good reason to believe he would have lasting influence in Lagos. This made institution building more feasible and meant Tinubu could expect to benefit in multiple ways from future improvements in tax collection.

Tax reform served the state governing party's—and Tinubu's—immediate political interests and national ambitions. As leaders of Nigeria's most prominent opposition state, Lagos politicians were eager to demonstrate that they could deliver more benefits to their constituents than the PDP, reinforcing incentives to raise revenues for public services.

Better functioning tax institutions also provide the state with resources that to some extent can be channeled at the governor's discretion. In addition, as will be discussed below, the use of private consultants in tax collection potentially opens up opportunities for more direct appropriation of revenue.

The turning point for Lagos tax institutions came in 2005, when the management of the existing internal revenue board was compulsorily retired and replaced with a new team led by Babatunde Fowler, a former bank executive. Tinubu immediately gave Fowler greater autonomy and supported a proposal to transform the revenue board into a new agency, the Lagos State Internal Revenue Service (LIRS). Tax officials explained that planning, professionalism, and staff morale rapidly improved under the new management.

LIRS came into full force in 2007, with Fowler as executive chairman. LIRS has been able to pay higher salaries and use greater flexibility in hiring and internal management than the ordinary civil service. As a result, it has been able to attract better-qualified staff and offer them improved training. This move is consistent with a trend across Anglophone Africa to create semiautonomous revenue agencies to professionalize tax collection.[5]

After taking office, Fashola built on Tinubu's reforms and made improving taxation a central focus of his administration. The governor saw robust revenue collection as critical to his broader vision of megacity transformation. Reforms to improve security, regulate transport, and manage the environment would not be possible without increased financing. The state government's crime policy, for instance, involves substantial resources for the Lagos State Security Trust Fund. This body provides the chronically underfunded federal police with basic crime-fighting tools like patrol vehicles and bulletproof vests, and it is widely credited with improving police effectiveness. Fashola's personal popularity has also relied in large part on his highly visible and costly infrastructure projects.

With strong support from the governor, LIRS steadily increased its outreach and monitoring capacities. Teams of revenue staff now regularly visit formal businesses and informal sector organizations to identify potential taxpayers, explain the tax payment process, and check for payment certificates. Audits have also increased markedly, with 1,500 in 2006, 4,000 in 2008, and over 6,000 in 2011.[6] LIRS continues to rely heavily on private auditors, but it has instituted external reviews to better monitor auditor quality and is building up its internal audit capacity.

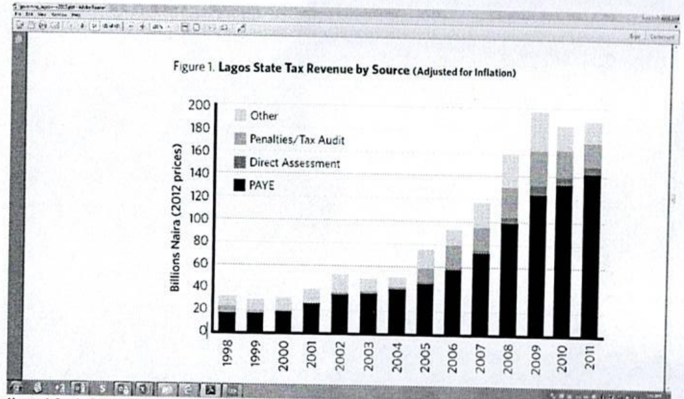
LIRS officials and private sector representatives emphasized that compliance relies on strong high-level political commitment to enforcement, including sealing delinquent businesses. Timothy Olawale of the private sector Nigeria Employers' Consultative Association, for example, noted that "noncompliance

[5] Mick Moore, *Revenue Reform and Statebuilding in Anglophone Africa*, IDS Working Paper vol. 2013, no. 428 (Brighton: Institute of Development Studies, 2013).

[6] Tunde Fowler, "Tax Assessment and Compliance in Nigeria," Presentation at Tax Retreat and Workshop for Ekiti State Board of Internal Revenue, Ikogosi Warm Spring, Ekiti, July 23–24, 2013.

is fishing in troubled waters, there are consequences...even with those that are politically connected, the government says, we provide services to the people and survive as institutions on this money, thus you have to pay."

These organizational reforms have been associated with significant jumps in tax collection. Chairman Fowler and LIRS audit officials reported that tax compliance among large companies is now over 80 percent, up from about 30–40 percent in 2005. In constant 2012 prices, tax revenue increased from about 49 billion Nigerian naira (around $310 million) in 2003 to ₦117 billion (about $746 million) in 2007 to ₦189 billion (roughly $1.2 billion) in 2011 (see figure 1).[7] Both revenues and tax audit penalties increased markedly after the 2005 management overhaul. The vast majority of tax revenues come from pay-as-you-earn (PAYE) personal income tax withholding from formal businesses.



Sources: Adjusted for inflation using the 2012 World Bank World Development Indicators Consumer Price Index. Data from the Lagos State Government Digest of Statistics 2007, Lagos State Government Digest of Statistics 2012, and Lagos state budgets 2007–2013. Data came from budgets two years ahead as next-year budgets did not have finalized revenue information. Tax revenues continued to increase after 2011, but more recent budgets were not available at the time of this research.

While LIRS's internal management capacity has greatly improved, ABC continues to manage the state's electronic tax payment system and receives an increasingly lucrative commission on tax revenues. This has fueled widespread rumors in Lagos that Tinubu himself either owns or profits from ABC,[8] though there is no concrete evidence of this. Still, the lack of transparency around ABC's contract has fostered suspicion; the company's commission is not public and does not appear in the state budget. In interviews,

[7] Adjusted for inflation using 2012 World Bank WDI Consumer Price Index; currency conversion based on WDI-reported official exchange rate in 2012 (156.81 naira to 1 dollar). Reflecting capacity shortcomings within the Board of Internal Revenue and the state government generally in the early 2000s, the pre-2006 revenue numbers are somewhat inconsistent between different official sources. The general trend is nevertheless clear.

[8] See, for example, Gboyega Akinsanmi, "Lagos Guber Candidates Vow to Cancel Alpha Beta Contracts," *ThisDay*, March 13, 2011, www.thisdaylive.com/articles/lagos-guber-candidates-vow-to-cancel-alpha-beta-contracts/87765; Seyi Olu Awofeso, "Lagos State Finances and Alpha Beta Ltd.," *Sahara Reporters*, February 3, 2013, http://saharareporters.com/2013/02/03/lagos-state-finances-and-alphabeta-ltd-seyi-olu-awofeso; and Momoh, "The Elections in Lagos State as a Political Monologue."

senior Lagos tax and finance officials did not provide convincing reasons why working with ABC remains necessary, with many referring to their contract as a political matter.

If the speculation around Tinubu's role in ABC is correct, the company would provide an important stream of revenue for his party-building efforts. The relationship would also give him a powerful incentive to continue to support current tax efforts.

Taxation as a Social Bargain

Bureaucratic reforms have greatly enhanced Lagos State's ability to keep track of tax revenues, identify taxpayers, and create a credible threat of enforcement. But the government nevertheless has scarce financial and human resources, and the logistical and political costs of attempting purely coercive tax collection would be very high.

Fashola and LIRS have made progress in encouraging greater tax compliance by presenting tax payment as a universal civic duty and part of a social contract between the state and its citizens. State revenue officials have also gained the cooperation of powerful business and informal sector associations in encouraging their members to pay taxes.

These efforts fit with what Margaret Levi has found in cross-national studies of taxation. She observes that "quasi-voluntary compliance" occurs when people choose to pay taxes but know noncompliance could bring penalties. According to Levi, this is most likely when taxpayers trust that the state will use the money to provide collective goods and believe that most other citizens are also paying taxes.[9]

Since taking office, Fashola has been more successful than Tinubu was in making the case that tax revenues will be used for public goods. He presents a more technocratic face of governance and has engaged in extensive outreach efforts. Early in his tenure, Fashola convened a tax stakeholder forum with representatives from the private sector as well as traditional and religious leaders, labor unions, civil society groups, and informal sector associations to discuss tax payment and address each group's expectations from government. These meetings coincided with the rollout of multiple infrastructure and transport projects, which gave the impression that Fashola was immediately delivering on his promises. Public works projects in Lagos display large signs urging people to pay their taxes.

Using tax revenue as well as loans, the government rapidly increased capital spending during Fashola's first term. Annual capital expenditures rose from about $600 million in 2006 to around $1.7 billion in 2011 (in inflation-adjusted 2012 dollars).[10] The state government's improvements to roads were particularly visible and popular. A 2009 survey of 2,000 Lagosians, for instance, found that respondents considered roads the most important issue requiring state government attention, and 83.9 percent were satisfied or very satisfied with the government's work on them.[11]

Public perceptions that the state government is doing its job well appear to have influenced individuals' readiness to pay taxes. A 2010 survey of 620 Lagosians with diverse socioeconomic backgrounds, for instance, found that receipt of public goods and satisfaction with state use of tax revenues were both significantly correlated with an expressed willingness to pay tax. Seventy-four percent of respondents said

[9] Margaret Levi, *Of Rule and Revenue* (Berkeley, Calif.: University of California Press, 1988).

[10] Adjusted for inflation using 2012 World Bank WDI Consumer Price Index; currency conversion based on WDI-reported official exchange rate in 2012 (156.81 naira to 1 dollar). Data is from Lagos Central Office of Statistics, *Digest of Statistics 2007*; and Lagos Bureau of Statistics, *Digest of Statistics 2012*.

[11] Etannibi Alemika and Shola Omotosho, *Criminal Victimization and Safety in Lagos State, Nigeria: 2009*, CLEEN Foundation Monograph Series no. 6. (Lagos: CLEEN Foundation, 2010).

they were somewhat or very satisfied with Fashola's use of tax revenues.[12] A national survey conducted by Cristina Bodea and Adrienne LeBas in 2010 further found that Lagosians expressed the highest support among urban residents in Nigeria for the statement that citizens should always pay their taxes.[13]

These general public sentiments decrease societal opposition to taxation, but they are not in themselves enough to guarantee individual compliance. Few people in any society pay taxes fully voluntarily. To address that issue, state officials have complemented their bureaucratic enforcement mechanisms with direct relationships with key social organizations.

Formal businesses are the most significant source of state tax revenue, and LIRS has greatly improved relations with the organized private sector under Fashola's tenure. While business representatives complained that they still pay a disproportionate share of taxes, they praised Fashola and LIRS for their willingness to listen to private sector concerns and for reining in illegal collection practices. The state government set up a Revenue Complaint and Information Unit in 2008 at Fashola's urging.

LIRS invites private sector association representatives to sit in on its meetings with noncompliant businesses and, according to some of those representatives, allows associations to intervene and mediate settlements before members have their premises sealed. Private sector groups in turn facilitate discussions between LIRS representatives and their members to explain tax policy and encourage compliance.

In addition, LIRS has reached out to the informal sector, where most Lagosians are employed. These workers are much more difficult to tax than salaried employees because the state cannot withhold taxes from their wages and in most cases has no clear way of calculating their tax liability. Informal workers also have lower incomes, and the administrative costs of taxing them can be higher than the potential revenues. State officials nevertheless see informal-sector taxation as a means of incorporating more people into the tax system, responding to formal sector complaints of being overtaxed, and sending a powerful message that everyone has a duty to contribute.

In order to make informal-sector taxation feasible, Lagos officials have relied heavily on ties with informal sector associations. This cooperative state-society relationship is especially clear with regard to the Lagos Market Men and Women Association. This organization brings together smaller associations of traders operating out of what are known as informal traditional markets (as opposed to modern shopping complexes). It is one of the most powerful and encompassing social organizations in Lagos and has served as a key source of grassroots support for the ruling party in Lagos since the 1960s.[14] These political ties are supplemented by personal ones. Former governor Tinubu's mother was the association's longtime leader in Lagos. After her death in 2013, she was replaced by Tinubu's daughter, a choice widely criticized as politically imposed.

Tax officials acknowledged that without the existence and cooperation of market associations, it would be very difficult to collect taxes from traders. When LIRS decided to attempt informal sector taxation, revenue officers focused their initial outreach on market leaders, negotiated the tax rate with them, and agreed to open tax offices within markets to make payment more convenient. Market leaders have in turn taken on much of the state's monitoring role, providing LIRS with lists of traders within their markets and keeping track of who has paid taxes.

[12] Etannibi Alemika, Nic Cheeseman, and Adrienne LeBas, "Raising Revenue to Reduce Poverty," Briefing Paper 16, Improving Institutions for Pro-Poor Growth, October 2011.

[13] Cristina Bodea and Adrienne LeBas, "The Origins of Voluntary Compliance: Attitudes Toward Taxation in Urban Nigeria," *British Journal of Political Science*, September 2014.

[14] Pauline Baker, *Urbanization and Political Change: The Politics of Lagos, 1917–1967* (Berkeley, Calif.: University of California Press, 1974); and Fourchard, "Lagos, Koolhaas and Partisan Politics in Nigeria," 40–56.

Reflecting the value of these ties, Kunle Oseni, the LIRS outreach director, said that his staff actively encourages markets without an association to form one, and that newly organized traders "realize now that they can talk to the government and the government needs them, especially during elections." Individual market associations can benefit in multiple ways from tapping into the Lagos Market Men and Women Association's close relationship with the state government, including through training programs and support in their power struggles with local governments.[15] LIRS staff also emphasize to market traders that tax revenues pay for new services such as health clinics and improved roads.

Lagos's experience resonates with Anuradha Joshi and Joseph Ayee's account of a similar associational taxation experiment in Ghana under former president Jerry Rawlings. In that system, the state partnered with the road transporters' union to collect taxes from members. The authors argue that informal sector taxation is more likely when informal workers are well organized and have institutionalized channels to negotiate with the state. In a potential warning sign for Lagos, however, the arrangement in Ghana fell apart after a new party without political ties to the union took power.[16]

[15] I am grateful to Shelby Grossman for this point.

[16] Anuradha Joshi and Joseph Ayee, "Associational Taxation: A Pathway Into the Informal Sector?" in *Taxation and State Building in Developing Countries: Capacity and Consent*, ed. Deborah Brautigam, Odd-Helge Fjeldstad, and Mick Moore (Cambridge: Cambridge University Press, 2008).