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Impact of Tax Revenue on Foreign Direct Investment in Nigeria

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Abstract: *This Study examined the impact of tax revenue on foreign Direct Investment in Nigeria; using time series data from 1981 to 2017. Data for the study was sourced from the Central Bank of Nigeria Statistical Bulletin and the National Bureau of Statistics and analysed using the Ordinary Least Square (OLS) technique. The results show that: Tax Revenue has long run relationship with Foreign Direct investment in Nigeria. Company income tax and Personal income tax have negative impact on Foreign Direct investment in the long run, while Value added tax and Custom and excise duty have positive relationship with Foreign Direct investment in the long run. Based on findings, the following recommendations were made; provision of infrastructures by the government, elimination of multiple taxes as well as simplifying tax laws and adjusting tax rates to encourage investments.*

Keywords: *Tax Revenue, Company Income Tax, Personal Income Tax, Value added tax, Custom and excise duty, Foreign Direct investment, Nigeria.*

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I. Introduction

Taxes constitute a major source of revenue to governments in both the developed and developing countries. Even after the discovery of oil in Nigeria, tax revenue still remained a major source of revenue to successive governments over the years. For example the proportion of tax revenue to total revenue was 26% in 2010, 52% in 2016 and 44% in 2017 (CBN, 2017). According to Chigbu, Akujiobi & Ebimobowei (2012), the economic history of both developed and developing countries reveals that taxation is an important weapon or instrument in the hand of government not only to generate revenue but also to create fiscal goals that influence the direction of investments and taming the consumption and production of certain goods and services. This position has led to several revisions or amendments to the nation's tax laws over the years including the promulgation of the Value Added tax and the Education tax acts in 1993 and 1994 respectively and the recent Personal income tax amendment act 2011. The amendments which form the basis of government's fiscal policy were aimed at encouraging production through increased investment and consumption spending and the redressing of external disequilibrium.

Despite the fiscal policy measures undertaken by the government over the years, the objective of stabilising the economy is yet to be achieved. The inflow of foreign direct investments has shown minimal improvements; from 0.91 percent in 1981, it rose to 10.83 percent in 1994 and then down to 5.05 and 0.9 percent in 2009 and 2017 respectively (CBN, 2017).

Foreign Direct Investment is increasingly being recognised as an important factor in the economic development of countries. Besides bringing capital, it facilitates the transfer of technology, organisational and managerial practices and skill as well as access to international markets.

Recent Studies have turned to investigate the effect of tax revenue on foreign direct investment; for instance, among the studies conducted in Europe, Sato (2012) and Gedik (2013) found strong negative relationship between Tax revenue and Foreign direct investment while Wolff (2006) showed no significant effect. Among the Studies conducted in developing countries, for instance, Klemm & Parys(2009) found significant negative relationship between tax revenue and foreign direct investment; Babatunde & Adepeju(2014) found a positive relationship while Kinda (2014), found no such relationship . Other studies like, Peters & Kiabel (2015), Akinwunmi, Olotu & Adegbie (2017) and Saidu (2015), all carried out in Nigeria, showed that tax revenue is negatively related to foreign direct investment. Thuita (2017), found that tax incentives greatly influence the attraction and retention of foreign direct investments. Demooij & Ederveen (2001) posited that a substantial variation across studies existed.

The results exhibited significant variations across countries. Even among the studies carried out in Nigeria there are still some significant variations. Some of these Studies failed to adopt robust methodologies in carrying out the analysis of research data. Also most of the studies were conducted in Europe and other developed economies that differ significantly from the Nigerian context. Unfortunately, policy makers seemed to have applied the conclusions from these studies in the Nigeria context. This could be argued to contribute in

exacerbating the existing macroeconomic contradictions. Given the importance of foreign direct investment to the development of Nigeria's economy there is surely a need for more about how different taxes influence the inflow of foreign direct investments in Nigeria.

This study therefore seeks to evaluate the impact of tax revenue on Foreign Direct investment in Nigeria. The remainder of this paper is organised as follows, Section 11 discusses the literature on tax revenue and foreign direct investment. Section 111 lays out the analytical framework and econometric methodology. Section 1V reports the results while section V concludes.

II. Review of Related Literature

2.1 Theoretical Framework

The main theory adopted in this Study is drawn from Dunning (1993) which suggested that the main factors that drive FDI inflows have been the need to secure market access, the opportunities presented by large scale privatization processes and the degree of political and economic stability.

The eclectic paradigm of Dunning, also known as OLI, proposes that the undertaking of FDI is determined by the realization of three groups of advantages of ownership which arise from the firm's size and access to markets and resources, the firm's ability to coordinate complementary activities like manufacturing and distribution and the ability to exploit differences between countries. Then locational advantages which include differences in country natural endowments, transport costs, macroeconomic stability, cultural factors and government regulations. And also the internationalisation incentives which arises from exploiting imperfections in external markets. These include the reduction of uncertainty and transaction costs in order to generate knowledge more efficiently and the reduction of state generated imperfections such as tariffs, foreign exchange controls and subsidies.

Host country policies are viewed from the perspective of macroeconomic stability and taxation policies. Macroeconomic stability is measured using inflation rate and exchange rate separately, tax incentive policy through effective tax and average tax rates. Dunning (1981) does not give a detailed account of the various channels by which taxation might influence OLI conditions and FDI decisions. Perhaps, a host country's tax system may be an important factor in an investor's assessment of host country *location advantages*, where two main considerations could be the "direct effect" of host country taxation on the after-tax hurdle rate of return on investment, and the "budget effect" which recognises the basic role of tax in funding government programmes (*e.g.* infrastructure development, education) which, by lowering costs of accessing factors in the host country, help create an attractive location for FDI. In addition to this observation, the OLI framework emphasises the relevance of a number of key decision margins driving FDI decisions and thus FDI flows. In particular, the framework identifies export sales and licensing arrangements as alternative options to FDI. Thus the framework highlights the need to account for considerations, including relevant tax aspects (*e.g.* tax relief for exports) relevant to the costs of relying on these alternatives, when assessing theoretically or empirically the relative importance of tax amongst other factors influencing FDI.

There is some evidence that tax incentive may affect net foreign direct Investments via its effect on both inward investment and outward investment. But in the case of inward investment there is a positive relationship between taxation and investment only if tax rates on retained earnings are considered (Leibfritz, Thornton & Bibbee, 1997). There exists still another channel through which home country taxation can influence the firm's FDI decisions. To the extent that domestic investment and foreign investment are alternative methods of serving the same objective (e,g. producing the same good), the size of FDI can be affected by the substitutability between investment locations. The magnitude of FDI, therefore, may be affected not just by the effective tax rate on the FDI income but also by the effective tax rate on the income from the same type of investment in the home country (Jun, 1994). Taxes potentially affect the international location of investment by influencing its relative net profitability in different locations. Since foreign direct investment (FDI) inevitably involves the question of overlapping tax jurisdictions, the tax treatment of foreign source income in the home country is always an important concern for multinational firms.

FDI will be affected by more than just tax factors. Various other factors will influence the profitability of doing business abroad. Research and development is an important source of comparative advantages with which a multinational may expand its activities across national boundaries. Exchange rates may influence the firm's FDI decision by affecting the competitiveness position of the host country. (Jun, 1994).

2.2 Empirical Review

Wolff (2006), estimated the effect of taxes on foreign direct investment (FDI) flows and on three sub-components of these flows for the countries of the enlarged European Union. The model in the spirit of gravity equations robustly explains FDI flows between the 25 member states. Results showed that the different sub components of FDI should and indeed do react differently to taxes. After controlling for unobserved country characteristics and common time effects, the top statutory corporate tax rate of both source and host country,

turn insignificant for total FDI and Investment into equity. However, high source country taxes clearly increased the probability of firms to re-invest profits abroad and lower the percentage of debt financed FDI. This might reflect profit reallocation to avoid taxes.

Babatunde & Adepeju (2012), Investigated the determinant factors of FDI and analysed whether or not some selected factors such as tax incentives, availability of natural resources, macroeconomic stability, market size, openness to trade, infrastructural development and political risk have an impact on FDI in the oil and gas sector. Secondary data was collected and analysed and Karl Pearson coefficient of correlation 'r' statistical method was employed in the analysis. The results showed that tax incentives, availability of natural resources and openness to trade significantly influences FDI in the Nigerian oil and gas sector. No significance however was found of market size, macroeconomic stability, infrastructural development and political risk on FDI.

Demooij & Ederveen (2001), reviewed the empirical literature on the impact of company taxes on the allocation of foreign direct investment. The Study makes the outcomes of 25 empirical studies comparable by computing the tax rate elasticity under a uniform definition. The mean value of the tax rate elasticity in the literature is around 3.3, i.e. a 1% point reduction in the host-country tax rate raises foreign direct investment in that country by 3.3%.

Gedik (2013), investigated the factors that determined foreign direct investment inflows in the framework of fiscal, economic, political and institutional dimensions. The factors that affect FDI are investigated for the 11 OECD countries for the period 1995-2008, by using Dynamic Panel Data Model and GMM Estimation Technique. Results indicated that FDI does not prefer high tax environments. High tax rates are evaluated as a cost component for foreign investors.

Desai, Foley & Hines (2004), examined the impact of indirect taxes on FDI by American multinational firms, using affiliate-level data that permit the introduction of controls for parent companies and affiliate industries. Results indicated that taxes other than income taxes are sizable, positively correlated with direct tax rates and strongly associated with foreign investment and production patterns. The evidence indicated that direct and indirect taxes have comparable and independent effects on asset allocation by American multinational firms, after controlling for common parent and industry effects. Both types of taxes are costly and therefore associated with reduced FDI and output by American firms.

Sato (2012), examined the effect of corporate income tax on foreign direct investment, based on a panel of bilateral foreign direct investment flows among 30 OECD countries over 1985- 2007. The Study further addressed the dynamic panel data analysis (System GMM), through the expansion of the static panel data analysis. Results indicated that the current scale of foreign direct investment is influenced by the investment level of the previous period. These Studies also implied that the impact of corporate tax on foreign investment is significantly negative.

Kinda (2014), used manufacturing and service firm-level data for 30 sub-Saharan African (SSA) countries, to show that taxation is not a significant driver for the location of foreign firms in SSA, while other investment climate factors, such as infrastructure, human capital and institutions are . By analyzing disaggregated FDI data, the Study established that while there is considerable contrast in behaviour between vertical FDI (foreign firms producing for export) and horizontal FDI (foreign firms producing for local markets) taxation is not a key determinant for either type of FDI. Horizontal FDI is attracted to areas with higher trade regulations, highlighting interest in protected markets. Furthermore horizontal FDI is affected more by financing and human capital constraints and less by infrastructure and institutional constraints, than is vertical FDI.

Akinwunmi, Olotu & Adegbie (2017) examine the relationship between multiple taxes and Foreign Direct Investment inflow in Nigeria for the period 1996 to 2015. The study adopted the ex-post facto research design and secondary data used was collected from the Central Bank of Nigeria Statistical bulletins and the National bureau of statistics. The Ordinary Least Square technique was used in estimating the time series data collected. Findings show a significant inverse relationship between multiple taxes and Foreign Direct Investment (FDI) in Nigeria.

Peters & Kiabel (2015) examine the influence of tax incentives in the decision of an investor to locate FDI in Nigeria. Data were drawn from annual statistical bulletin of the Central Bank of Nigeria and the World Bank Development Indicators Database. The work employs a model of multiple regressions using static Error Correction Modelling (ECM) to determine the time series properties of tax incentives captured by annual tax revenue as a percentage of Gross Domestic Product (GDP) and FDI. The result showed that FDI response to tax incentives is significantly negative, that is, increase in tax incentives does not bring about a corresponding increase in FDI.

Saidu (2015) examined the relationship between corporate taxation and foreign direct investment in Nigeria from 1970-1980. The data sourced from the CBN statistical bulletin, National Bureau of Statistics and the World Bank was analyzed using the Ordinary Least square technique. The result showed negative significant relationship between Company income tax rate and FDI whilst exchange rate and FDI indicated negative

insignificant relationship. However, GDP was positively insignificantly related with FDI whilst inflation had positive significant relationship with FDI.

Ioan-Alin & Păun (2013) test if the economic development of a country represented in consum ption (measured in VAT income for the country) and production (measured in the change in Corporate Income Tax) would create an increase in Foreign Direct Investments. Based on a series of models of multiple regressions, the study tests if the FDI is influenced by income obtained through Corporate Income Tax and Value Added Tax. The results show that an increase in VAT income for the state would create a decrease in the level of FDI. Also, an increase in taxation (increase of CIT level) would determine a decrease of FDI in Romania.

Effiok ,Tapang.& Eton (2013) focus on the impact of tax policy and incentives on Foreign Direct Investment (FDI) and economic growth in Nigeria. Data were collected through questionnaire and analyzed using the ordinary least square techniques. The study revealed that tax rates have a significant positive relationship to FDI and economic growth.

Thuita (2017) investigates tax incentives and how they influence Foreign Direct

Investments. A sample size of 72 employees of the firms operating in the Export Processing Zones(EPZs) of Kenya was selected for the study using stratified sampling method for the firms and purposive method for the respondents. The study utilized descriptive survey design using self administered questionnaires to solicit information from sampled senior staff of selected firms. The study found that the use of tax holiday greatly influences the attraction and retention of Foreign Direct Investments. Arguably, the manufacturing sector seems greatly favored by the tax incentives compared to other sectors due to extended capital allowances.

III. Methodology

3.1 Data and Variable Description

This Study was based on secondary data. A sample of annual observations on time series covering the period from 1981 to 2017 was employed. Series are in current domestic currency. Most series were collected from the Central Bank of Nigeria Statistical Bulletin (various editions) while the others were obtained from the Bureau of National Statistics.

3.2 Model specification

The specification of the econometric model adopted in this study, including control variables and the classification of taxes, builds on theoretical propositions.

The final regressors are;

- Foreign direct investment as the dependent variable.

The explanatory variables include:

- Gross domestic product (Real GDP per capita)
- Exchange rate (Real effective exchange rate):
- Personal Income Tax: The personal income tax is collected mainly at the state level, and represents taxes on income or profits of individuals and unincorporated bodies.
- Company Income Tax: Represents taxes on profits of incorporated business organizations.
- Value Added Tax: This is collected at the federal level
- Customs and Excise duty: This is also collected at the federal level.

FDI = f (GDP, EXR, VAT, PIT, CIT, CED).

The equation from the model becomes

$$LnFDI = a + a_1 LnRGDP_t + a_2 LnREXR_t + a_3 LnVAT_t + a_4 LnPIT_t + a_5 LnCIT_t + a_6 LnCED_t + \in_t \quad (1)$$

Where:

FDI = Foreign direct investment
RGDP = Real Gross domestic product
REXR = Real Exchange rate
VAT= Value added tax
PIT = Personal Income Tax
CIT = Company Income Tax
CED = Customs and Excise duty
$\in_t$ = Random error term
a = Constant
a_1, a_2, a_3. a_4, a_5 and a_6 are the coefficients of the regression equation.

3.3 Estimation Procedures

- The characteristics of the time series data used in the analysis are first evaluated. The summary statistics of the various variables are estimated. Thereafter, the stationarity properties of the employed data are examined by carrying out the Augmented Dickey-Fuller test. Maximum eigen-value test of Johansen co integration are carried out based on the assumption of linear deterministic trend. The long run impact analyses are estimated for the model, using the Ordinary Least Square (OLS) estimation technique, with the
- E-view Statistical package.

IV. Results and Discussion

4.1 Statistical Properties of the Variables

The characteristics of the time series data used in the analysis is presented in Table 4.1

Table 4.1 Summary Statistics of the Variables Employed

	CED	CIT	FDI	PIT	REXR	RGDP	VAT
Mean	155.4919	262.8043	368.1511	215.1670	151.9638	32749.95	222.6057
Median	87.90000	46.20000	111.3000	34.10000	100.0000	22449.41	47.10000
Maximum	438.3000	1215.057	1360.300	1133.620	546.3100	69023.93	972.3480
Minimum	1.616000	0.403000	0.264000	0.040000	49.73000	13779.26	0.000000
Std. Dev.	161.1318	381.4705	447.0497	310.7398	123.5277	18889.20	304.0557
Skewness	0.615439	1.288717	0.876217	1.341864	1.799527	0.801592	1.154168
Kurtosis	1.870860	3.207411	2.239036	3.606851	5.379257	2.141006	2.840077
Jarque-Bera	4.301279	10.30787	5.627221	11.67144	28.69667	5.099938	8.254072
Probability	0.116410	0.005777	0.059988	0.002921	0.000001	0.078084	0.016131
Observations	37	37	37	37	37	37	37

Source: Author's Computation

4.2 Correlation Analysis

The correlation matrix of the variables employed in this Study is presented in Table 4.2. The table presents all possible bivariate combinations of all the employed variables. The result as presented in Table 4.2 showed that most of the variables employed are highly correlated. The directions of the correlation for some are positive, while negative for some variables.

Table 4.2 Correlation Matrix

	CED	CIT	FDI	PIT	REXR	RGDP	VAT
CED	1.000000	0.925342	0.918057	0.906322	-0.364376	0.979511	0.948301
CIT	0.925342	1.000000	0.851135	0.978382	-0.243065	0.964622	0.990670
FDI	0.918057	0.851135	1.000000	0.847365	-0.319900	0.908736	0.896405
PIT	0.906322	0.978382	0.847365	1.000000	-0.249601	0.951388	0.974508
REXR	-0.364376	-0.243065	-0.319900	-0.249601	1.000000	-0.360059	-0.265567
RGDP	0.979511	0.964622	0.908736	0.951388	-0.360059	1.000000	0.973720
VAT	0.948301	0.990670	0.896405	0.974508	-0.265567	0.973720	1.000000

4.3 Unit Root/ Stationarity Test

The results of the unit root tests as presented in Table 4.3 indicated that all the variables are stationary at after first difference while only the LRGDP is stationary at after second difference.

Table 4.2 The Unit Root Test Results for the Selected Variables

VARIABLES		AUGMENTED DICKEY-FULLER TEST	CONCLUSION
LCED	Level	0.327141	1(1)
	1st Difference	-4.922153	
LCIT	Level	1.654638	1(1)
	1st Difference	-4.642476	
LFDI	Level	-0.283250	1(1)
	1st Difference	-4.014514	
LPIT	Level	1.992202	1(1)
	1st Difference	-4.274724	
LREXR	Level	-2.879622	1(1)
	1st Difference	-4.535838	
LRGDP	Level	0.114975	1(2)
	2nd Difference	-5.327991	
LVAT	Level	1.795079	1(1)
	1st Difference	-3.651374	

4.4 Tests for Co-integration

Table 4.4 illustrates the outcome of the co-integration test for the LFDI model. There are four co-integrating relations among the variables in the LFDI model as indicated by the Max-Eigen Statistic. This implies that there are long run relations among the variables employed in the LFDI model.

Table 4.4 Test of Co-integration among LFDI, LRGDP, LREXR, LTVAT, LPIT, LCIT and LCED

Eigenvalue	Likelihood Ratio	5 Percent Critical Value	1 Percent Critical Value	Hypothesized No. of CE(s)
0.970069	293.9363	124.24	133.57	None **
0.859427	171.1263	94.15	103.18	At most 1 **
0.675183	102.4552	68.52	76.07	At most 2 **
0.627661	63.09793	47.21	54.46	At most 3 **
0.322593	28.51963	29.68	35.65	At most 4
0.250339	14.88771	15.41	20.04	At most 5
0.128229	4.803011	3.76	6.65	At most 6 *

*(**) denotes rejection of the hypothesis at 5%(1%) significance level
L.R. test indicates 4 co integrating equation(s) at 5% significance level

4.5 Estimated Results of the LFDI Model

The results of the model estimation as presented in the table 4.5 show that LFDI has inverse relationship with LPIT and LCIT while LCED, LVAT, LRGDP and LREXR have positive relationship with LFDI. Only two of the explanatory variables included in the LFDI model, namely LVAT and LCIT are significant. As indicated by the coefficient of Adjusted R^2, only 88.3 per cent of the variations in the LFDI are captured by the exogenous variables included in the LFDI model. The coefficient of the F-statistic for the LFDI model suggests that the model is statistically significant.

Table 4.5 Estimated Results of the LFDI Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-333.7928	215.4624	-1.549193	0.1318
RGDP	0.018153	0.011518	1.576019	0.1255
REXR	0.143092	0.245469	0.582935	0.5643
CIT	-2.332413	0.599551	-3.890263	0.0005
PIT	-0.073955	0.424074	-0.174393	0.8627
CED	0.010811	0.973249	0.011108	0.9912
VAT	3.202501	0.804354	3.981456	0.0004
R-squared	0.902896	Mean dependent var		368.1511
Adjusted R-squared	0.883476	S.D. dependent var		447.0497
S.E. of regression	152.6033	Akaike info criterion		13.06222
Sum squared resid	698633.4	Schwarz criterion		13.36699
Log likelihood	-234.6511	F-statistic		46.49141
Durbin-Watson stat	1.327434	Prob(F-statistic)		0.000000

4.6 **Discussions**

Findings indicate a significant negative relationship between Company Income tax and Foreign Direct Investments and also a non significant negative relationship between Personal income tax and foreign direct investment. This means that higher Company Income and Personal income tax rates lead to lower foreign direct investment inflow. This is in line with theory. Taxes potentially affect the international location of investment by influencing its relative net profitability in different locations.

Furthermore Value added tax and Customs and excise duty show positive relationships with foreign direct investment. Value added tax and Customs and excise duty are indirect taxes that are borne by the final consumers and therefore do not adversely affect the investor's decision to invest in any jurisdiction.

V. Conclusions

This study examined the effect of tax revenue on Foreign Direct Investment in Nigeria using aggregate time series data for the period 1981 to 2017. Data collected was analysed using the Ordinary Least Square (OLS) technique. The results of the estimates showed that Tax Revenue has long run impact on Foreign Direct investment in Nigeria; Company income tax and Personal income tax have negative impact on Foreign Direct

Investments while Value added tax and Customs and excise duty are positively related to Foreign Direct Investment. The Study thus concluded that it is imperious for the government to factor in taxation when formulating policies that are meant to stimulate Foreign Direct Investment in the Nigerian economy.

VI. Recommendations

i. Government should use tax revenue to provide basic infrastructures such as stable power supply, good road networks etc. This would lower the cost of doing business in the country thereby positively impacting business investment.. This will lead to higher domestic investment and result in higher economic growth.
ii. The strategy of Government will be to reduce the rate of Companies Income Tax to 20% or less to encourage investments, increase tax compliance and attract investments into the country.
iii. Government should simplify tax laws for clarity and regularly update such laws to keep them in line with developments in the Nigerian economy
iv. Streamlining and harmonising taxes across the federation would increase Nigeria's productive output. Strict enforcement of the taxes and levies approved list for collection Act No 21 of 1998 is also necessary.

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