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# NEXUS BETWEEN TAXATION AND FOREIGN DIRECT INVESTMENT IN NIGERIA

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## **Abstract**

*This paper explored taxation and foreign direct investment (FDI) using the case of Nigeria with limited investigation. Taxation was proxy by company income tax (CITX) and value added tax (VATX), while FDI was proxy by FDI inflows. Data employed for the analyses were from 2000 to 2020 and obtained from Central Bank of Nigeria (CBN) Statistical Bulletins as well as World Development Indicators (WDI). Using time series econometric technique, the results revealed that CITX has a negative significant impact on FDI. Specifically, this implies that a rise in CITX rate leads to a decline in FDI inflow in Nigeria. We also find that value added tax (VATX) significantly improves FD investment in Nigeria. From the findings, it is recommended that policy makers in the area of corporate tax laws should enact laws that offer incentives to attract FDIs. More than this, government could technically rise the value added tax rate and spend the additional fund from it on human capital training and development for human effectiveness in companies.*

**Keywords:** Investment, Value Added Tax, Company Income Tax, Taxation, Foreign Direct Investment

**JEL Classification:** E22, H25

## **1. Introduction**

Almost all governments and institutions in developed, emerging, and developing nations are involved in attracting FDIs. This is very prevalent in developing countries in African. Attracting FDIs can result in the establishment of more jobs, more technological know-how, and, most crucially, economic growth, and development (Dakasku, Jelilov, Isik & Akyuz, 2020). The upshot of the economic gains will be an increase in net domestic income, distributed through wage taxation and profits from foreign-owned enterprise (Dakasku, Jelilov, Isik & Akyuz, 2020). FDI may have a spillover effect on domestic income due to the introduction of new technology and the improvement of human capital (Mallampally & Sauvart, 1999). Considering the potential benefits of FDI, policymakers have continued to reform their policies in the area of tax to attract FD investments (Ahmad, Ali, & Khan, 2020).

In every country, taxation is a critical weapon. It is an essential macroeconomic tool for the state to function with respect to revenue, access to infrastructure for its population, rules, and encouraging or discouraging investment, among other things (Ufoeze, Odimgbe, Ezeabalisi & Alajekwu, 2018). The term taxes are seen as a macro-economic instrument that governments utilize to produce money by Anyafor (1996). In the case of Nigeria, there have been high dependence on revenue from crude oil, but her crude oil earnings had been declining, due to drop in oil prices in the global market and decline in the crude oil

production because of the insurgence in the Niger Delta section of the country. According to Jones, Ihendinihu, and Nwaiwu (2015), this instability in oil price and production have place the country's foreign revenues in peril. This was backed up by a World Bank analysis from 2016 that warned that mono-product economies, especially those that rely on crude oil, will be sensitive to crude oil price volatility. Therefore, there is the need for alternative source of revenue or income for the economic, thus the emphasis on tax revenue in recent times.

Tax policies are fundamental in the final choice for an investor wishing to invest in another country (Justman et al., 2011). However, if a country's taxes are low, it becomes even more appealing to investors. Furthermore, if there are fiscal incentives for businesses, the size of the economy, its purchasing power, and other market-related factors can be compensated (Bucovetsky 2013). Therefore, each country would act accordingly to attract more foreign investors and to stimulate the inflow of foreign direct investments. Because it determines after-tax returns from investment, the burden of direct taxes influences the volume and location of foreign direct investment (FDI) (Okoi & Edame, 2013). Since the 1980s, there have been empirical evidence in Nigeria indicating there is a nexus between taxation and economic expansion or activity.

A review of several empirical studies between the period of 2010 and 2021 from continents in the world showed different results on the interaction between taxation and FDI. Furthermore, the review also revealed that most past studies were done in Asia especially in Malaysia, Laos, and India, while in Africa the studies were in Tunisia, Zambia, Ghana, and Nigeria, but most of the studies in Africa and Nigeria in particular employed petroleum profit tax and capital gain tax as taxation proxies. However, only the studies of Dibia and Onwuchekwa (2019); Ahmad, Ali, and Khan (2020); and Babatunde, Ibukun, and Oyeyemi (2017) employed the proxy of company income tax as taxation determinants of economic growth. In the literature reviewed we identified a gap in the scope of study; Bashir and Sam-Siso (2020) conducted their study using data from 1981-2018; Dakasku, Jelilov, Isik & Akyuz (2020) used data from 1986-2018; Andabai, Ikeora, and Anah (2019) used data from 1990-2017; and Ufoeze, Odimgbe, Ezeabalisi and Alajekwu, (2018) used data from 1986-2016, evidently, none of the studies used recent data making up to 2020. This study therefore seeks to address these research problems by first ensuring variables like value added tax and company income tax is included in our study. Secondly, the study employed the variable of foreign direct investment to measure investment.

The main objective of this study is to examine the effect of taxation on foreign direct investment in Nigeria. However, the specific objectives are to i) examine the effect of company income tax on foreign direct investment of Nigeria; and ii) investigate the effect of value added tax on foreign direct investment of Nigeria. The remaining part of this study is organized as follows. Section 2 provides the literature review and underpinning theory. Section 3 presents the methodology and section 4 the results and discussion of findings. This was closely followed by conclusion and recommendations in section 5.

## **2. Literature Review**

Foreign direct investment is described as the commitment or investment of resources into businesses or trade outside ones' home country. FDI is describe as an investment comprising of a long-term relationship which reflects a lasting business interest by The United Nations Conference on Trade and Development {UNCTD}, (1999). In the words of Mallampally and Sauvart (1999), FDIs is an investment by multi-national establishments in foreign nations

with the intention of asset control and management of production or business activities in host countries. FDI provides a channel for home countries to benefit from resources outside their countries' borders. Zarotiadis (2008), outlines three major justifications or explanations for how FDI happens and how it impacts trade flows. The first point is that FDI flows from foreign country that is (the country of origin) to the host country. This is because the country of origin has abundant capital to be invested in other countries. FDI investments are expected to have negative impact on trade flows since comparative advantages that drive trade are gone. The second point is that FDI flows because of comparative advantages in the host country. Here, trade flows is expected to rise because exports will rise. The third point is that FDI flows because firms select to enter foreign markets through export or FDI. Most countries chose FDI form of entry to export because of some factors such as trade barriers, cost of transportation, or the market size, and taxation policy of the host country.

Taxation is very essential for growth and development in any country. Adam (2001) says taxation is a major and essential source of revenue/income for governments in general and particularly in modern times. Aguolu (2004) stated that taxation is "a compulsory levy by the government through its agencies on the income, consumption (goods and services), and capital of its subjects". Taxation operates with principles, one of which is "the principles of Equity or Equality of Sacrifice". That is, the burden enforced by taxation are laid as equally as possible on all classes in the society. This principle ensures equal proportion of taxation on every income, meaning that in principle, everybody should pay the equal proportion of his/her income as tax. Again, the principle of taxation stresses that the payer of tax should know when and how much tax he/she has to pay (Adam, 2001). Components of taxation used in this study includes company income tax (CITX) and value added tax (VATX).

CITX is tax paid by incorporated entities/companies on their profits in Nigeria (Wooldridge, 2006). It also includes tax paid by non-resident companies doing business in Nigeria on their profits. It is paid by all limited liability companies in Nigeria. It is commonly called corporate tax. The law that enacted CITX is the Companies Income Tax Act (CITA) of 1979. It is the responsibility of the Federal Inland Revenue Service ('FIRS' or 'the Service') to administer and collect the taxes from companies. The tax is a major contributor to the income or revenue of the Service and the nation.

The tax system in operation in Nigeria does not operate in isolation from the tax system in other countries of the world. The Acts recognize that some foreign companies operate globally, and render profits on global basis, so the profits made by these foreign companies cannot be ignored. The CITA exempts the profit of the following from taxation, if the profit is not from a trade or business: organizations engaged in ecclesiastical like churches or mosques, charitable, or public educational activities, sporting activities among others. Theoretically, the expected relationship between CITX and FDI is negative because high corporate tax in the host country will discourage FDI inflows.

VATX by the VAT Decree 102 of 1993 was propagated in Nigeria and came into effect from December 1<sup>st</sup> in 1993 and real invoicing from January 1<sup>st</sup> in 1994. This Decree abolished Sales Tax Decree No. 7 of 1986. The administration and collection of VATX rest on the Federal Government through FIRS. VATX is levied on anybody (individual or corporate) that consumes or buys any taxable product or service in Nigeria. This is a type of tax that is imposed on consumers of any product or services that are taxable. The tax is collected by the seller when any taxable product or service is sold. Michael and Ben (2007) explore the causes and consequences of the spread of VAT in countries. From the study, it was revealed that

VAT has a significant impact on countries activities, however the impact was mixed. This suggests that some countries gain revenue or investment from VAT adoption, other countries do not. Theoretically, it is expected that VATX will impact FDI negatively because high VAT on goods and services in the host country will discourage FDI inflows.

Considering empirical studies in Nigeria, Gumo (2013) in his thesis studied tax incentives and FDI. Using the OLS method of analysis, the study reported that tax incentives has positive impact on FDI in Kenya. George and Bariyima (2015) studied the effect of tax incentives on FDI inflows in Nigeria using OLS and ECM models to examine the time series properties. The findings reveal that FDI's response to tax incentives negatively and it was significant at 5 percent. Wahab and Diji (2017) examine how tax drives investments in the oil and gas sector in Nigeria. Using tax optimization models, they reported that tax invariably affect Nigeria competitiveness for FDI. Davies, Siedschlag, and Studnicka (2018) examines corporate taxation and FDI in EU countries. Their finding reveals that corporate taxation positively influences foreign direct investments to EU countries from both other EU countries and non-EU countries. Shafiq, Hua, Bhatti, and Gillani (2021) examine taxation and FDI inflows in Pakistan. Using ARDL and ECM techniques for time series data for the period 1985 to 2020. The paper reports a run-long relationship between taxes and FDI's, showing that low taxes motivate foreign investor' to investment in the country. Similarly, the work of Appiah-Kubi, Malec, Phiri, Maitah, Gebeltová, Smutka, Blazek, Maitah, and Sirohi (2021) on tax incentives and FDI's studied 40 African countries with data from 2000 to 2018. The Random Effect estimator results revealed that FDI reacts to lower CITX and that tax concession is not significant to FDI inflows in Africa countries. From the review of empirical literature, there are few empirical studies that have considered the nexus between CITX and VATX components of taxation on FDI with current data in Nigeria, hence a major gap this study will fill in the literature.

The theory underpinning this study is the eclectic theory. Professor Dunning's eclectic theory is a synthesis of three different theories of direct foreign investments (O-L-I): "O" from Ownership advantages; "L" from Location; and "I" from Internalization. The eclectic theory demonstrates that OLI parameters differ from one company to another, and it depends on the host country's economic, political, and social characteristics to attract foreign direct investment (Denisia, 2010). As a result, this theory suggests that to attract enough foreign direct investments, governments must ensure that their economic policies which include taxes from foreign investments are favourable.

### **3. Methodology**

The research design is longitudinal. The data on proxies for taxation and foreign direct investments are derived from secondary sources of data. The data were gotten from CBN's Statistical Bulletin for 2020, as well as World Bank Database as of 2020. The period spans through market-based economic era when government fiscal policies were considered as the primary pillar of global economies. As a result, the data spans 2000 through 2020. The explanatory variables in this study include annual data on company income tax and value added tax, with the dependent variable being Foreign Direct Investment (Inflow) as a proxy for investment. Company income tax and value added tax have been employed as the independent variables in line with the studies of Bashir and Sam-Siso (2020) as well as those of Dakasku, Jelilov, Isik & Akyuz (2020). We first test for stationarity of the data before proceeding to test for cointegration using the Bound Test of Pesaran, Schuermann, and Weiner (2004). This technique calculates the impacts and uses a limits testing strategy to

determine whether the variables in the model have a long-term relationship. However, there is no long-term relationship between the variables which suggest there will be no need for any Error Correction Model. Hence, we employ the Vector Auto Regressive technique for our analysis which is justify following the study of Dibia and Onwuchekwa (2019). Furthermore, the econometric equation is express as:

$$\log(FDI)_t = \beta_0 + \beta_1 \log(FDI_t - FDI_{t-1}) + \beta_2 \log(CITX_t) + \beta_3 \log(VATX_t) + \beta_4 \log(CITX_t - CITX_{t-1}) + \beta_5 \log(VATX_t - VATX_{t-1}) + \varepsilon_t$$

**Where:**

- FDI = Foreign Direct Investment (Inflow)
- CITX = Company Income Tax
- VATX = Value Added Tax
- “t” = Time factor (2000 to 2020)
- e<sub>it</sub> = Error Term

Thus, we fail to reject the null hypothesis if the p-value of our regression estimates is greater than 5% and vice versa. Our *a priori* expectation is that an increase in CITX and VATX will decrease foreign direct investment inflows in Nigeria.

**4. Results and Discussion**

**Unit Root Test:** The Dickey Fuller Unit Root Tests is conducted to determine the stationarity or non-stationarity of each variable in the model. The results are presented in table 1.

**Table 1: Dickey Fuller (DF) Test for Stationarity**

<b>H<sub>0</sub>: There is no Stationarity</b>					
<i>At Levels-I(0)</i>		<b>Interpolated Dickey-Fuller Critical Values</b>			
<b>Variables</b>	<b>DF t-statistics</b>	<b>MacKinnon p-value</b>	<b>1%</b>	<b>5%</b>	<b>Decision</b>
FDI	-2.082	0.2517	-3.750	-3.000	Accept H <sub>0</sub>
CITX	-1.227	0.6621	-3.750	-3.000	Accept H <sub>0</sub>
VATX	-1.304	0.6273	-3.750	-3.000	Accept H <sub>0</sub>
<i>At 1<sup>st</sup> difference - I(1)</i>					
FDI	-5.105	0.0000	-3.750	-3.000	Reject H <sub>0</sub>
CITX	-3.310	0.0144	-3.750	-3.000	Reject H <sub>0</sub>
VATX	-5.060	0.0000	-3.750	-3.000	Reject H <sub>0</sub>

**Source: Researchers Computation (2022) from STATA’16 Output**

From the summary results in Table 1, it is revealed that the variables are only stationary at difference {I(1)} series. Therefore, there is need to test for the presence of long-run relationship among the variables in the model using the Johansen Co-integration test.

**Johansen Co-integration Test:** To determine the existence of long-run relationship or trend among the variables, a co-integration analysis is performed. In this case, the null hypothesis of no co-integration is tested. The results obtained is presented below:

**Table 2: Johansen Test for Cointegration**

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5%

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Maximum rank	Parms	LL	Eigen value	Trace statistics	Critical value
0	3	2.6035919	.	21.8457*	29.68
1	8	8.9522042	0.46999	9.1485	15.41
2	11	11.634172	0.23524	3.7845	3.76
3	12	13.526439	0.17240		
<b>5%</b>					
Maximum rank	Parms	LL	Eigen value	Trace statistics	Critical value
0	3	2.6035919	.	12.6972	20.97
1	8	8.9522042	0.46999	5.3639	14.07
2	11	11.634172	0.23524	3.7845	3.76
3	12	13.526439	0.17240		

**Source: Researchers Computation (2022) from STATA'16 Output**

The result of the Johansen co-integration test can be interpreted in parts. However, this study converge the focus towards three columns; maximum rank, trace statistics or max statistics, and critical values. Specifically, from the table above, at maximum rank zero, the trace statistic (21.85) is less than the critical values (29.68). Therefore the null hypothesis cannot be rejected. Also, this suggests that the time series variables employed in this study are not cointegrated. Similarly, for max statistics, the value (12.70) is less than the critical value of 20.97, thus suggesting a similar result that the null hypothesis cannot be rejected. Thus, as per maximum rank 0, the variables are not cointegrated. Following the above results, the study applies unrestricted VAR for the analysis.

**Table 3: VAR regression estimates**

logfdi	Coef.	Std. Err.	Z	P> z	[95% Conf. Interval]	logfdi
Logfdi						
L1	.0523951	.1932324	0.27	0.786	-.3263333	.4311236
L2	-.0229152	.1700055	-0.13	0.893	-.3561199	.3102896
L3	.9046772	.2012846	4.49	0.000	.5101667	1.299188
L4	-.1667865	.1930159	-0.86	0.388	-.5450907	.2115178
logcitx	-.3775309	-.102564	-3.68	0.000	-.5785525	-.176502
logvatx	-.0802935	.135948	-0.59	0.555	-.3467467	.1861598
_cons	3.527158	.9801804	3.60	0.000	1.60604	5.448276

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*Chi2=85.09*

*p>chi2 = 0.0000*

*R-Squared = 0.8335*

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**Source: Researchers Computation (2022) from STATA'16 Output**

In testing for the contribution of each of the explanatory variables on the dependent variable of concern, the VAR regression estimates of the relationship being analyzed are presented in table 3 above. The result reveals an  $R^2$  value of 0.8335 which indicates that about 83% of the variation in the dependent variable is being explained by the independent variables in the model. This also means that about 17% of the variation in the dependent variable is left unexplained but have been captured in the error term. The model goodness of fit as captured by the Wald statistics with the corresponding probability value 0.0000 which shows a 1% statistically significant level indicates that the entire model is fit and can be employed for discussion and policy recommendation.

#### **4.1 Discussion of Findings**

From the table above, we find that company income tax has a negative significant effect on foreign direct investment (FDI) in Nigeria. Specifically, the results implies that an increase in company income tax rate leads to a decrease FDI in Nigeria. We agree with the studies of Wahab and Diji (2017); Ordu (2016); George and Bariyima (2015); Gumo (2013); Fernando (2009); Coleman (2008) and Yakassi (2001). We do not agree with the findings of Agostini et al. (2003) and Abdiogluet al. (2016), which found that low labour costs in Nigeria and high turnover due to market opportunities, given the country's large population, had a positive impact for FDI. However, we find that value added tax insignificantly decrease FDI in Nigeria. Specifically, we opine that an increase in value added tax will insignificantly decrease FDI in Nigeria. However, it is possible that the structure of Nigeria's economy is responsible for this. Our findings go against those of Ugochukwu & Azuibike (2016), Okoli & Matthew (2015), Njoku (2015), Onwuchekwa & Aruwa (2014), Izedonmi & Okunbor (2014), and Chigbu (2014), which found that VAT had no influence on FDI.

#### **5. Conclusion and Recommendations**

Using annual data from 2000 to 2020, this study explored the impact of taxation on foreign direct investment in Nigeria. Taxation was proxied by company income tax and value added tax, while investment was proxied by foreign direct investment (inflow). Using time series econometric technique in line with related extant literature, the study discovered that company income tax has a negative significant effect on investment in Nigeria. Specifically, the results implies that an increase in company income tax rate leads to a decrease investment in Nigeria. Also, the findings reveals that value added tax insignificantly decrease investment in Nigeria. This means that an increase in value added tax will insignificantly decrease investment in Nigeria. This study's conclusions lead us to urge that policymakers in charge of corporation tax legislation devise strategies for enticing foreign direct investment. Investing in key infrastructure, particularly in the energy industry, can help lower overhead costs for investors. Increase the value added tax rate and invest it on human capital development in order to supply companies with the workforce they need. However, more research is needed to confirm whether VAT would have the detrimental impact on FDI that this analysis suggests it will.

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