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TAX INCENTIVES AND FOREIGN DIRECT INVESTMENT IN NIGERIA

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ABSTRACT

This study examines the impact of tax incentives on Foreign Direct Investment in Nigeria, focusing on tax holidays, reduction in company income tax (CIT) rates, and capital allowances. Despite the Nigerian government's efforts to attract FDI through fiscal measures, the desired level of foreign investment has yet to be fully realized. The study addresses gaps in existing literature by empirically analyzing the effectiveness of specific tax incentives in influencing foreign investment decisions. Data were collected from 150 respondents and analyzed using chi-square test to determine the relationship between tax incentives and FDI. Findings indicate that tax holidays and CIT rate reductions significantly influence FDI inflows, with investors viewing these incentives as critical in reducing operational costs and enhancing profitability. Although, capital allowances also showed a positive impact, responses were mixed, suggesting that other factors may play a role in investment decisions. The study concludes that while tax incentives are effective, holistic approaches which include improvements in infrastructure, business climate and regulatory frameworks would further enhance Nigeria attractiveness for FDI. The study recommends for policy improvements broadening of incentives and robust evaluation framework are provided to optimize the role of tax incentives in fostering economic growth.

Keywords: Tax Incentives, Foreign Direct Investment, Tax Holidays, Company income tax reduction, capital allowances.

1. Introduction

Governments and agencies in several countries, including both developed and emerging nations, have shown a keen interest in attracting foreign direct investment since the past few years. This is a prevalent occurrence in African nations. Eiya and Okaiwele (2019) argued that attracting

foreign direct investment leads to a rise in net domestic income, which can be distributed through wage taxation and the earnings of foreign-owned enterprises. FDI might potentially provide spillover effects on domestic income due to the introduction of new technology and the enhancement of human capital. Recognizing the potential advantages that Foreign Direct Investment (FDI) might provide, policymakers have consistently revised their tax laws to make them sufficiently attractive for investment. Taxation plays essential role in any country, regardless of its level of development. it is a macroeconomic instrument essential for a nation to generate money and provide amenities and infrastructure for its population, regulate economic activities, and influence investment decisions (Adegbite & Akande, 2017). According to Anyafor (2018) and Uwuigbe, Eluyela, Uwuigbe, Obarakpo and Falola (2020), taxation is a macroeconomic tool employed by governments to produce money. It is referred to as a compulsory tax, which individuals, businesses, and organisations must comply with or suffer legal consequences, as government officials at the state or federal level have been authorised to take legal action against those who fail to comply. Tax policies have a crucial role in the ultimate decision of an investor who wants to invest in a different country (Justman, 2017). Nevertheless, when a nation's tax rates are low, it becomes increasingly attractive to potential investors. Moreover, the presence of fiscal incentives for firms can help offset the impact of other market-related elements, such as the size of the economy and its purchasing power (Bucovetsky, 2018). Consequently, each nation would respond in a manner designed to entice further international investors and encourage the influx of foreign direct investments. The impact of direct taxes on after-tax profits from investment affects both the amount and the location of foreign direct investment (FDI) (Okoi & Edame, 2018). The continuous inflow of foreign direct investment (FDI) into a country is often linked to benefits such as technological advancement and human capital development. To enhance FDI, the Nigerian government, through relevant authorities, has implemented a series of economic reforms, with tax incentives being a significant component. Despite these efforts, Nigeria has not achieved the desired level of foreign investment (Olaniyi, et.al,2018). While tax incentives are theoretically designed to attract FDI, there is a need to empirically evaluate their effectiveness in the Nigerian context. Although the efficacy of tax incentives for attracting FDI is debatable, governments of developing countries, including Nigeria, continue to offer these incentives to expatriates to encourage investment in their domestic economies (Olaniyi, et.al,2018). Existing studies on this subject have yielded mixed results, potentially due to differences in datasets, estimation techniques, and time horizons. These studies also suffer from limited scope and a lack of current relevance. This study is motivated by the need to address these gaps and to specifically assess the impact of various tax incentives on FDI inflows into Nigeria. The specific objectives of this study therefore are:

- i. To examine the relationship between Tax holidays and Foreign Direct Investment in Nigeria.
- ii. To determine the relationship between Reductions in Company income tax (CIT) Rate and foreign direct investment in Nigeria.
- iii. To examine the relationship between Capital Allowance and Foreign Direct Investment in Nigeria.

2. Literature Review

2.1 Conceptual Review

Concept of Foreign Direct Investment

Foreign investment refers to the transfer of capital from one country to another in exchange for significant stakes in domestic companies or other domestic assets (Alfar, 2016). Foreign investment typically implies that foreigners take an active role in management as part of their investment. Foreign investment in a country is regarded as a source of future economic growth and a good sign. According to Ledyeva and Linden (2018), there are four categories of foreign investment. These are foreign portfolio investment, foreign direct investment, commercial loans, and official flows.

Concept of Taxation

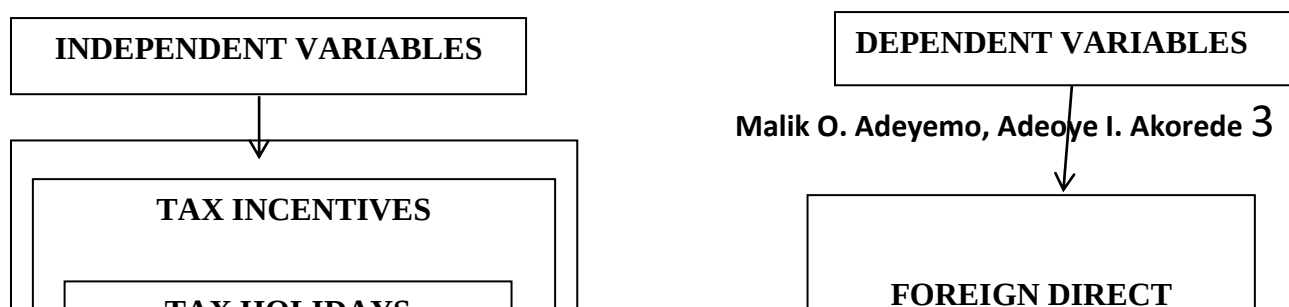
Taxation can be characterized as a corresponding commitment from people and property, demanded by the state, by the ethicalness of its sway for the help of the legislature and every single open need. Taxes are levied by the government so that citizens are taken care of and provided with the basic needs, most of which can only be provided by the government. Not only that, but taxation is seen as a two-way relationship between the government and its citizens, which means that for the government to be able to make or provide the necessary goods and services for its people, they have to fulfill their own patriotic responsibilities by paying their taxes (Ekpung & Wilfred, 2020).

Tax incentive Schemes

Tax incentives are a crucial tool in stimulating investment, fostering economic growth, and promoting development in various sectors of the economy. Tax holidays, which provide temporary exemptions from specific taxes, such as corporate income tax, aim to reduce the initial tax burden on new investments, allowing companies to establish themselves and become profitable before being subject to regular tax rates (Abeler & Jäger, 2015). In Nigeria, for instance, the pioneer status incentives offer a tax holiday for up to five years to new industries (Orkaido, 2022). Reductions in Company Income Tax (CIT) rates are another form of tax incentive that involves lowering the corporate income tax rate for specific sectors, industries, or regions to encourage investment. By reducing the CIT rate, governments aim to increase after-tax returns on investment, making the country more attractive to both domestic and foreign investors (Maffini et al., 2019). In Nigeria, reduced CIT rates are provided for companies engaged in agricultural production or export-oriented industries. Capital allowances, which allow businesses to claim deductions on their taxable income for investments made in certain assets like machinery, buildings, or equipment, aim to reduce the effective cost of acquiring capital assets, encouraging businesses to invest in productivity-enhancing equipment and infrastructure (Kuria et al., 2017). In Nigeria, examples include accelerated depreciation and investment allowances for qualifying capital expenditures. Custom and excise duties tax incentives involve reducing or exempting import and export duties on specific goods, materials, or equipment to lower the cost of importing essential goods and equipment needed for production, thereby encouraging investment in sectors reliant on imported inputs (Edin et al., 2015). In Nigeria, exemptions from import duties on agricultural equipment and machinery are common.

Conceptual Framework

The conceptual model of this study shows the relationship between the dependent and independent variables with their proxies.



Source: Research's Content

2.2 Theoretical Review

Tax Competition Theory

The theory was proposed by Oats in 1972 and proposes that in order to encourage the inflow of valuable resources and reduce the outflow of production resources, governments deliberately reduce economic burdens. Therefore, Kiburi, Mirie, Okiro, and Ruigu (2017) suggests that the tax competition theory may be used to understand governments efforts to reduce economic burdens in order to bring in more foreign investments such as skilled and qualified human capital and financial investments into the country. Consequently, this theory suggests that in ensuring that enough foreign direct investments are attracted to a country, the governments try to ensure that their tax policies in place in terms of the tax rates and the taxes collected from foreign investments are favorable enough to attract new and retain the existing foreign investments in the country. Leaning on the tax completion theory and adapting the model of Akinwunmi et al. (2017), we expect a functional relationship between taxes and FDI in the form;

$$FDIt = f(taxes)$$

Options-Based Theory of Investment

The real option theory of investment sees FDI as a representation of portfolio of options. Accordingly, investment opportunities are viewed as option-rights. In making investment decisions, the investor pays a price (the cost of setting up the project) in the immediate period or future for a return value in the asset (Chen and Funke, 2003). The possibility of a suboptimal investment due to irrational investment decisions, which are not properly aligned with the user cost of capital, arises. The key components of the user cost of capital, according to Phillipon (2007) are the price of capital relative to the output, tax treatment of capital purchases and capital income (i.e., tax rate and depreciation expenditures). It relates firms' investment opportunities to the various expenditures that are necessary to bring about the investment. The greater the expenditures, the higher the cost of investment and the lower the return on investment.

2.3 Empirical Review

Hassan (2022) investigates the nexus between tax and foreign direct investment (FDI) in Nigeria, over the period 1986-2020. Employing the dynamic system GMM estimation technique, the findings show that a high tax regime has a destabilizing effect on FDI inflows. Lagged FDI (a measure of agglomeration effects, relating current FDI to past FDI inflows) is positively and significantly related to FDI. Growth rate of real GDP (a measure of economic size) is positively and significantly related to FDI. It is also evident that infrastructure has a positive but weak impact on FDI. Timothy (2021) specifically looked at the impact of direct tax components like petroleum profit tax, corporate income tax, education tax, and personal income tax on foreign direct investment in Nigeria. The study revealed a positive relationship between petroleum profit tax (PPT), companies' income tax (CIT), and personal income tax (PIT) on foreign direct investment to gross domestic product ratio (FDI_GDP). However, the outcome of the relationship was not statistically significant. Education tax had a negative relationship with FDI_GDP. The outcome was statistically significant. Also, Onome, Anthony and Akhigbodemhe (2020) investigate the proposition that tax policies enacted by military and democratic regimes differ on the influence the foreign direct investments. Panel data between 1983 and 2017 were obtained from the databases of the World Bank, Central Bank of Nigeria and the Federal Inland Revenue Services. The study revealed that tax variables during the military regime exerted more explanatory power of 79% compared to the civilian administration of 66% with respect to the impact of corporate taxes on FDI. The effect of company income tax on FDI was more pronounced during the military regime than in the civilian regime. FDI had a higher degree of convergence during the military regime compared to civilian rule, and this is vital for policy assessments and comparison. Onakoya and Afintinni (2016) explored the cointegration relationship between tax revenue and economic growth in Nigeria from 1980 to 2013. The findings indicated a long-run, but not a short-run, relationship between taxation and economic growth in Nigeria. The results revealed a significant positive relationship at the 5% level between petroleum profit tax, company income tax, and economic growth, but a negative relationship between economic growth and customs and excise duties. However, the tax components were collectively insignificant in impacting Nigeria's economic growth.

3. Methodology

Research Design

This study adopted a descriptive research design. Descriptive research was chosen because it provides an accurate portrayal of characteristics of a particular individual, situation, or group (Creswell, 2014).

Population and Sample

The population for this study comprises three primary groups: foreign direct investors, government officials, and tax experts. Foreign direct investors are individuals and entities that have made investments in Lagos, Nigeria. Government officials are from relevant governmental bodies such as the Nigerian Investment Promotion Commission (NIPC) and the Federal Inland Revenue Service (FIRS). Tax experts include professionals specializing in tax law and policy, such as accountants, tax consultants, and academic researchers.

The sample size was determined based on the total population, ensuring statistical significance and representativeness. Stratified sampling involves dividing the population into strata (foreign investors, government officials, and tax experts) and then conducting random sampling within each stratum to select participants. However, one hundred and fifty (150) respondents were sampled for this study.

Research Instrument: a structured questionnaire was utilised for the purpose of collecting primary data.

Validity and Reliability of the Instrument: To ensure the validity of the research instrument, content validity was adopted. The reliability of the instrument was ascertained using Cronbach's alpha to measure the internal consistency of the questionnaire items.

Data Analysis Technique

The data collected from the questionnaires was analyzed using both descriptive and inferential statistical techniques. Descriptive statistics, including frequency count, percentage, mean and standard deviation was used to summarize the data. Inferential statistics, such as chi-square, was employed to test the hypotheses and determine the relationships between variables. The Statistical Package for the Social Sciences (SPSS) software was used for data analysis.

4.0 Results

4.1 Data Presentation

Table 1: Demographic information of respondents

Variables	Frequency	Percentage (%)
Gender		
Male	96	64.0
Female	54	36.0
Age Range		
18 - 21 years	18	12.0
22 - 30 years	31	20.7
31 - 40 years	50	33.3
41 - 50 years	29	19.3
51 years and above	22	14.7
Educational Level		
Primary	18	12.0
Secondary	25	16.7
Tertiary	63	42.0
Postgraduate	44	29.3
Profession		
Foreign Direct Investor	66	44.0
Government Official	43	28.7
Tax Expert	41	27.3
Experience		
Less than 1 year	55	36.7
1-3 years	48	32.0
3-5 years	47	31.3
Organization Size		

Small (1-50 employees)	44	29.3
Medium (51-200 employees)	50	33.3
Large (201+ employees)	56	37.3
Sector of Organization		
Manufacturing	82	54.7
Services	30	20.0
Agriculture	18	12.0
Technology	20	13.3
Familiarity with Tax Incentives		
Not familiar	10	6.7
Somewhat familiar	42	28.0
Familiar	44	29.3
Very familiar	54	36.0
Total	150	100.0

Source: Field Survey 2024

4.2 Hypotheses Testing

H₀₁: There is no significant relationship between Tax holidays and Foreign Direct Investment in Nigeria

Table 2: Result of Hypothesis One

Option	Observed value	Expected value	Df	Chi-Square value (χ^2)	Asymp. Sig.	Remark
Strongly Disagreed	12	30.0	4	62.067 ^a	0.000	H ₀ Rejected
Disagreed	18	30.0				
Neutral	13	30.0				
Agreed	54	30.0				
Strongly Agreed	53	30.0				
Total	150					

Source: Researcher's Field Survey, 2024.

Table 2 indicate that the majority of respondents believe that tax holidays have a substantial impact on their investment decisions, as reflected in the strong deviations in the "Agreed" and "Strongly Agreed" categories. This suggests that tax holidays are an important factor in attracting foreign direct investment in Nigeria. The result also shows that p-value of 0.000 is less than the

common significance level (0.05), therefore the null hypothesis (H_0) is rejected. This indicates that there is a significant relationship between Tax holidays and Foreign Direct Investment in Nigeria.

H₀₂: There is no significant relationship between Reductions in Company income tax (CIT) Rate and foreign direct investment in Nigeria

Table 3: Test of Hypothesis Two

Option	Observed value	Expected value	Df	Chi-Square value (χ^2)	Asymp. Sig.	Remark
Strongly Disagreed	6	30.0	4	115.533 ^a	0.000	H ₀ Rejected
Disagreed	31	30.0				
Neutral	4	30.0				
Agreed	77	30.0				
Strongly Agreed	32	30.0				
Total	150					

Source: Researcher's Field Survey, 2024.

Table 3 suggest that a large number of respondents believe that reductions in the CIT rate are a crucial factor influencing their decision to invest in Nigeria, as seen in the significant number of respondents who "Agreed" that the CIT rate reduction has a positive impact on investment decisions. Thus, the reduction of the CIT rate can be seen as an important policy tool for encouraging foreign direct investment in the country. The result also shows that the p-value of 0.000 is less than the typical significance level (0.05). Therefore, the null hypothesis (H_0) is rejected. Thus, there is a significant relationship between Reductions in Company income tax (CIT) Rate and foreign direct investment in Nigeria.

H₀₃: There is no significant relationship between Capital Allowance and Foreign Direct Investment in Nigeria.

Table 4: Test of Hypothesis Three

Option	Observed value	Expected value	Df	Chi-Square value (χ^2)	Asymp. Sig.	Remark
Strongly Disagreed	25	30.0	4	21.333 ^a	0.000	H ₀ Rejected
Disagreed	44	30.0				
Neutral	37	30.0				
Agreed	33	30.0				
Strongly Agreed	11	30.0				

Total	150					
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Source: Researcher's Field Survey, 2024.

Tables 4 indicate that the provision of capital allowances has a significant influence on the decision to invest in Nigeria. However, a large proportion of respondents appear to "Disagree" or remain "Neutral" on the influence of capital allowances, which may indicate mixed opinions or a perception that other factors are also important in investment decisions. Nonetheless, capital allowances are still recognized as a significant factor in investment decisions by the statistical test. The result shows that the p-value of 0.000 is less than the typical significance level (0.05). Therefore, the null hypothesis (H_0) is rejected. Thus, it is conclude that there is significant relationship between Capital Allowance and Foreign Direct Investment in Nigeria.

4.3 Discussion of findings

The analysis of the impact of tax incentives on foreign direct investment (FDI) in Nigeria reveals a complex relationship characterized by both recognition of the incentives' potential and a hesitance to attribute significant weight to them in initial investment decisions. While a substantial majority of investors (81.3%) view the tax incentive framework as attractive, only 22.6% believe these incentives significantly influence their investment choices. This discrepancy is further illustrated by a low mean score of 2.46 regarding the impact of tax incentives on investment decisions, suggesting that while investors acknowledge the benefits, they may prioritize other factors when making initial commitments. However, the incentives appear to have a more pronounced effect on operational activities and the likelihood of further investment, with mean scores of 3.61 and 3.46, respectively. This indicates that tax incentives may play a crucial role in enhancing business operations once investments are established, aligning with findings from Appiah-Kubi et al., (2021) that emphasize the positive relationship between tax holidays and FDI inflows in African economies. The hypothesis tests conducted further emphasize the significance of tax holidays and reductions in corporate income tax (CIT) rates, which were found to have a substantial positive impact on investment decisions. The rejection of the null hypotheses, supported by highly significant p-values (0.000), highlights the effectiveness of these fiscal measures in attracting and sustaining foreign investment in Nigeria. This is consistent with the findings of Etim et al., (2019) who noted that lower corporate income tax rates and extended tax holidays are effective in drawing FDI. Moreover, while capital allowances received mixed reviews from respondents, the statistical analysis still indicated a significant relationship with FDI, suggesting that investors may consider a range of factors beyond tax incentives when making investment decisions. This aligns with the observations of Amuka & Ezeudeka, (2017) who noted that tax incentives positively affect FDI flows, albeit with varying perceptions among investors. In conclusion, the findings suggest that while tax incentives are recognized as attractive by a majority of investors, once investments are made, these incentives significantly enhance operational activities and the likelihood of further investments. The effectiveness of specific incentives, particularly tax holidays and CIT reductions, is supported by empirical evidence, indicating their importance in the broader strategy to attract and retain foreign direct investment in Nigeria.

5.0 Conclusion and Recommendations

Based on the findings, it is evident that tax incentives, particularly tax holidays and reductions in CIT rates, have a significant and positive impact on foreign direct investment inflows into Nigeria. These incentives are viewed by foreign investors as important in reducing the cost of doing business and improving profitability, thereby making Nigeria a more attractive destination for FDI. However, the relatively low agreement on the overall impact of tax incentives on investment decisions indicates that while they are effective in expanding operations, they may not be the sole determinants of FDI inflows. Capital allowances also play a role but are less consistently viewed as crucial by investors. Despite the positive influence of tax incentives, it is clear that other factors, such as infrastructure, ease of doing business, and political stability, are also important in determining the level of FDI that Nigeria can attract (Etim et al., 2019). Hence, tax incentives alone may not be sufficient to fully realize Nigeria's potential as a destination for foreign investment. Stemming from the findings, the following recommendations are proffered:

1. **Enhancement of the Tax Incentive Framework:** The Nigerian government should continue to improve the current tax incentive structure, making it more targeted and transparent. In particular, adjustments should be made to align the framework with investor needs and expectations, ensuring that tax holidays and CIT rate reductions are easily accessible and efficiently administered.
2. **Broaden the Scope of Incentives:** While tax holidays and CIT rate reductions have shown significant effectiveness, the government should explore enhancing other forms of incentives such as capital allowances and customs/excise duty waivers. This diversification may help attract a broader range of foreign investors with different operational needs.

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