Tax Incentives and Firm Profitability of Nigerian Manufacturing Industry

Raji MojeedGbolagade, Doctoral Research Scholar & Lecturer in the Department of Accountancy, The Polytechnic, Ibadan, Ibadan, Oyo State, Nigeria

ABSTRACT

The paper is concerned with an investigation of the impact of tax incentives on firms' profitability of Nigerian manufacturing industry. The main objective of this study is to investigate the relationship between tax incentives viz: capital allowance, tax holidays and tax deduction with a view to determining its impact on performance. The studies are anchored on Tax Discrimination and Tax competition theories. The population of this study comprised twenty-seven (27) consumer goods sub-sector of manufacturing industries whose shares are quoted on Nigerian Stock Exchange. The sampling techniques used are the judgmental and convenience because of availability of data. Data were obtained from secondary source covering the periods of 2006 – 2015. The method of data analysis utilized was the pooled OLS, static panel using the fixed effect. The fixed effect model explores the relationship between the predictor and the outcome variables within an entity. The findings from this study showed that tax incentives have a positive effect on ROCE with P-value of 3.533% < 5%, hence statistically significant at 5%, R^2 of 20%. In conclusion, the way in which tax incentives are organized differs among countries, depending on the economic and political contexts. Therefore recommend that, government should provide adequate tax incentives in the real sector and particularly manufacturing sub-sector. Tax incentives would enhance the emergence of new enterprises or re-activation existing ones, thereby reducing profit tax which would have been earned from them, but ultimately encouraging production to curb the nuisance of unemployment, youth agitation and over-reliance on the government for a means or source of revenue.

Keywords

Tax incentives, Firm Profitability, Quoted Manufacturing Industries and Nigeria Stock Exchange

INTRODUCTION

There is transformed interest in the role of industrial policy in promoting investment and growth. Industrial policies are type of discerning involvement or government policy that endeavor to modify the formation of production toward sectors that are anticipated to offer better projection for trade and industry growth. Industrial policy can assist to tackle market and harmonization failure in the investment and growth process. Tax incentives can be seen as part of industrial policy. Tax as an instrument of fiscal policy is used by the government to encourage certain sectors of the economy, which are construed as essential for economic growth and development. The various ways through which these economic activities are stimulated are referred to as tax incentives.

Tax incentive, concisely is the use of government spending and tax policies to influence the level of national income. Zee, Stostsky and Ley (2000) opined that tax incentives exerted great influence in attracting new investments in order to encourage trade and industry growth in countries like Korea and Singapore where tax incentives are part of a wider policy to attract investment and encourage quick industrialization.

Clark (2000) posited that the effectual use of tax incentive to encourage investment decision is slowed down by some factors, which may be political or economic. For instance, a country like Nigeria, characterized by social insecurity and dysfunctional legal system may act in retort poorly to the effective use of tax incentive to smooth the progress of investment decision. In the same vein, Markusen and Katherine (2007) opined that eh effective use of tax incentive to encourage business decision is corruption. Corruption is a common feature of the developing economies and it is apparent in several forms. This means that the effective use of tax incentives to stimulate trade and industry growth is tied to sound social-economic and political factors.

As part of the efforts of provide an enabling environment that is conducive to the growth and development of industries, inflow of Foreign Direct Investment (FDI), safeguard existing investments from iniquitous competition, and stimulate the expansion of domestic production capacity; the Federal Government of Nigeria has urbanized a package of incentives for various sectors of the economy. These incentives, we hope, would help revive the economy, accelerate growth and development, and reduce poverty. Ola (1991) posited that most manufacturing industries in Nigeria are suffering from business reduction and profitability determinations; some are struggling very hard to retain their financial performance.

Tax reform is simply the sequence of action taken by Nigeria's government to promote the tax system. It is not a work of fiction, as Nigeria has embarked on a sequence of tax reforms. The several tax reforms were designed to broaden the tax base, reduce the tax burden on taxpayers, restore the confidence of the taxpayer on the tax system, and promote voluntary compliance on the part of the taxpayer. Odusola (2006) posited that the tax reform of 2004 under the leadership of IfuekoOmoigieOkauru marked a landmark enhancement in tax administration in Nigeria. The achievements and improvement made were surpassed in the history of tax administration in Nigeria. The tax reforms of 2004 constitute an integral part of the National Economic Empowerment and Development Strategies (NEEDS). In addition, positive recommendations were made by the reduction of company income tax from 30 percent to 20 percent to manufacturing industries. The intensification of NIPC to enable it serves as an agency for clearing all the requirements for investment in the country. The tariff composition they reformed with a view to boosting local invention. Tax incentives serve as an instrument for taxations systems and used to influence trade and industry activity.

Viewed from this perspective, the Federal Government of Nigeria has urbanized a package of incentives for various sectors of the economy. These incentives, we hope, would help revive the economy, accelerate growth and development, and reduce Poverty.

To ease understanding, the paper is structured as follows: Section 1 is the introduction; Section 2 focuses on theoretical underpinning and conceptual issues, while Section 3 addresses methodology and data analysis. Section 4 concludes the paper and presents the recommendations.

OBJECTIVES OF THE STUDY

To investigate the relationship between tax incentives and firm profitability with a view the determining its impact on firm profitability.

RESEARCH HYPOTHESIS

Tax incentives do not significantly affect firm profitability.

REVIEW OF RELATED LITERATURE

Conceptual Review

Tax incentives under the Nigerian tax law

Somorin (2015) observed that Nigeria has always put in place policies to attract investment in order to endorse sustainable development. Tax incentives are available to encourage both local and foreign investors under various statutes, but because of some bottlenecks contiguous to the statutes, some investors are not aware of the dispensation of the germane documentations which might be of assistance in doing business.

Types of Tax Incentives

Wikipedia (2008) enumerated several tax incentives and benefits, few among which are:

Reduced Corporate Income Tax Rates Imf, Oecd and World Bank (2011) reiterated that countries may provide exemptions from or reduced rates of, Corporate income or Profit tax to particular types of activity. Some countries provide a reduced rate of tax types of investment. For instance in Ireland, there is reduced rate for manufacturing industries. Other countries like China and Malaysia reduced tax rate for investment in particular locations or regions.

Tax Holidays

Wells and Allen (2001); House and Shapire (2008) and Unctad (1998 & 2002) asserted that, in developing countries such as United State of America, tax holidays are by far the most common form of tax incentives for investment. A tax holiday may take the form of a complete exemption from profits tax of a reduced rate of tax. The exemption or reduction is granted for a limited period.

Capital Allowance

According to Morisset and Purnia (2003) capital allowance is granted to the industry for unerring and using qualifying capital expenditure during a year of assessment for the purpose of deriving its income. Different rates are used for the qualifying capital expenditure. For example, in Nigeria, the amount of capital allowance to be enjoyed in a year of assessment is generally restricted to a percentage (at percent 66 $\frac{2}{3}$%) of the assessable profits. The agro-allied industry, which is engaged in the trade or business of manufacturing, is not affected by this restriction (NIPC, 2016; FMITI, 2011).

Zones

Zeng (2015); The Economist (2015) and Artana (2015) are of the opinion that countries use two types of special zones to magnetize investments; (i) duty-free zones, enjoying exclusion from customs duties; and (ii) special economic zones, in which investors enjoy other tax rights not granted in other parts of the host country. When put into practice, investors in duty-free zones often receive other tax rights (Especially in export processing zones) and special economic zones sometimes enjoy customs rights. Duty-free zones and export processing zones (EPZs) are anticipated to make possible the trans-scupment of goods, and the dispensation of imported materials or mechanism for export. By distinction, special economic zone are anticipated to promote economic activity within a selected area, and are not constrained to exporting. They consequently should not be given favourable customs handling.

Return on Capital Employed (ROCE)

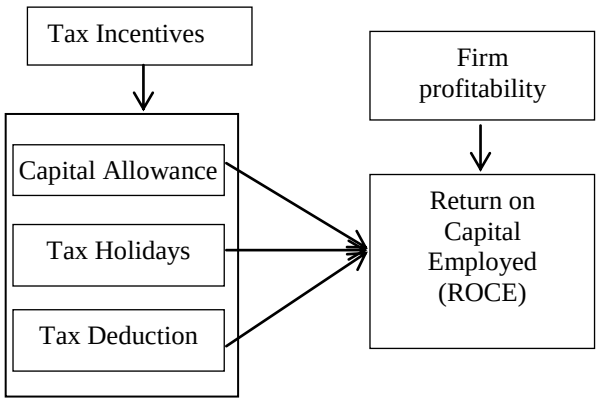
Udeh, Abiahu and Tambou (2017:56) asserted that

"ROCE is one of the several profitability ratios used to evaluate a company's performance. It is designed to show how efficiency a company makes use of its available capital, by looking at the net profit generated in relation to every amount of capital utilized by the company. This ratio does not concern itself with external investment or the earnings from such investment. It seeks to ascertain the level of profit made by the firm as a going concern".

It is expressed as:

(Profit before interest and taxes-income from external investment) / (Share Capital)

CONCEPTUAL MODEL



Source: Raji (2017: 28)

THEORETICAL FRAMEWORK

Taxation is a product of theorist. Theories examined in this study are as follows:

Theory of Tax Competition

Wikipedia (2017), tax competition, a form of regulatory competition, exists when governments are encouraged to lower fiscal burdens to either encourage the inflow of productive resources or discourage the evacuation of those resources. Often, this means a governmental strategy of attracting foreign direct investment and high value individual resources by minimizing the overall taxation level or special tax preferences creating a comparative advantage.

Brill and Hassett (2017) argued that tax competition is beneficial in raising total tax ingestion due to low corporate tax rates inspiring economic growth. They argued that tax competition is generally detrimental because it distorts investment decisions, reduces the efficiency of capital allocation and undermines democracy by forcing governments into modifying tax systems. It also tends to increase intricacy in national and international tax systems, as governments persistently modify tax system to take account of the aggressive tax environment.

Theory of Tax Discrimination

Glaeser (2001), which stated that government imposes different tax velocity based on regions and investments, developed tax discrimination theory. The tax velocity is for firms to be located in a meticulous location. The government applies tax discrimination to encourage development in the rural areas. Tax holidays and low

velocity are given to investors to locate their businesses in less developed areas of the major cities and towns.

According to Manson (2006), tax discrimination subjects the residents and non-residents to different tax regimes in the same jurisdiction. The resident taxpayers are usually taxable on all of his or her global income, whereas a non-resident is taxable on income derived in the host state. Manson (2006) stated that the European Court of Justice argued that tax discrimination promotes economic effectiveness and amalgamation of the theory based on economic analysis of maximizing the apparent gains of tax evasion, encouraged by the common market.

Methodology and Data Analysis

An ex-post research design was adopted in this study. The population comprised of 27 consumer goods manufacturing industries listed on the Nigerian Stock Exchange (NSE) as at 31 December, 2015 (NSEFactbook publication, 2015). A sample of 5 companies that enjoyed tax holidays incentive were selected. The main criterion for selection was that, it was found in their annual reports and accounts for the period covered for this study.

Measurement of Firm Financial Performance

Researcher employed ROCE as a Proxy for firm profitability, particularly in valuing performing (e.g. Raji, 2017; Udeh, Abiahu&Tambou, 2017), Graham, (2003) submitted that a good ROCE is a level that exceeds the WACC for the business. Shyma (2013) show that the ROCE metric has an important influence on the valuation multiple that a firm enjoys. It is calculated thus:

Variable	Measurement
Return on Capital Employed (ROCE)	$\frac{EBIT}{TA - CL}$

Source: Researcher's Compilation (2017).

Where:

EBIT: Earnings before interest and taxes

TA: The book value of the total assets of the firm.

CL: The book value of the current liabilities of the firm.

Method of Data Analysis

The study utilized pooled OLS, using the fixed effect as the method of data analysis, having presented the descriptive statistics and correlation matrix.

A-priori expectation

Apriori expectation are expected to be greater than zero and positively signed.

Model specification

The model for this study is in line with prior studies (Raji, 2017) and is as specified below: ROCE = f(CA, TH, TD)

In econometric form, this model is re-written as:

$$ROCE = \alpha_i + \beta_i \log CA_{it} + \beta_2 \log TH_{it} + \beta_3 \log TD_{it} + \mu_{it}$$

Where

CA = Capital allowance

TH = Tax holidays

TD = Tax Deduction

β = the coefficient of the explanatory variables

α = intercept for the model

i = cross-sectional variables from 1, 2, …. 5

t = time-series variables from 1, 2, 3, ….10

Analysis of Data

Table 1: Analysis of Data

Descriptive Statistics

Statistics	ROCE	CA	TH	TD
Mean	13.39	6.12	2.35	3.08
Median	24.39	6.43	0.00	4.73
Maximum	174.18	7.09	6.87	6.66
Minimum	-249.17	3.98	0.00	0.00
Standard deviation	70.00	0.85	2.93	2.85
Observation	50	50	50	50

Source: Researcher's Computation (2017)

From the descriptive statistics of the variables as shown in Table 1 above, it is observed that the return on Capital Employed (ROCE) for the sample has a positive of 174.18% and a negative value of 259.17%. The implication of this result is that some firms were performing better than the other. A quick review of the capital allowance, tax holidays and tax deductions have mean ratios of 6.12%, 2.35% and 3.08% respectively. This

implies that majority of the firms sampled receive meager on capital allowance, receive lower tax holidays and pay lower taxes to the government.

In addition, the minimum values for tax deductions, tax holidays and capital allowance were 0% for both tax deductions and tax holidays meaning that the government do not take tax in some years for some of the sampled firms, however, for capital allowance the minimum value stood at 3.78% implying that some firms capital allowance was to the tune of 3.98%. Also, the maximum values for tax deductions, tax holidays and capital allowance stood at 6.66%, 6.87% and 7.09% respectively. The implication of this result is the allowances and deductions given to the sampled firm differ. The standard deviation which is used to measure the level of volatility, shows that degree of volatility for the sampled firms return on capital employed is very high, this suggests that the rate at which the return on capital employed can change is high and this amount to about 70%. However, the degree of change for tax deductions, tax holidays and capital allowance is low and this in the range of 0.85 to 2.93%.

Table 2: Correlation matrix

Variable	ROCE	TD	TH	CA
ROCE	1.00			
TD	0.21	1.00		
TH	=0.19	-0.88	1.00	
CA	0.11	-0.20	0.23	1.00

Source: Researcher's Computation (2017) using the stata 11.0 statistical software package

The result shows that there is a positive association between return on capital employed and tax deductions and capital allowance and it ranges from 11% to 21%. This implies that when the return on capital employed increases (decreases) both the tax deductions and tax holidays increases in the return on capital employed would lead to a decrease in tax holiday.

Also, there is a negative association between tax deductions and tax holiday on one hand and tax deduction and capital allowance with the tax holidays and capital allowance at 88% and 20% respectively. Finally, a positive association of 23% between tax holidays and capital allowance. The implication of this result is that when tax holidays increase (decreases), the capital allowance also increases (decreases).

Parameter estimate for Model

Variable	Coefficient	Std. error	t-stat	Prob
C	-2.082	1.257	-1.66	0.105
CA	.5786	.2041	2.83	0.007
TH	-0.0850	.05996	-1.42	0.164
TD	-.00969	.06208	-0.16	0.877
R2	0.20			
F-stat	3.533*			
Prob (F-stat)	0.0227			
Obs.	50			
Cross section	10			

Source: Author's Computations from Regression Results (2017)

Key: CA = Capital allowance, TH = Tax Holidays, TD = Tax Deduction

The empirical evidence obtained suggests that the coefficients of tax deduction and tax holidays are negative and that of capital allowance is positive. This implies that there is an inverse relationship between tax deduction and return on capital employed on one hand, and tax holidays and return on capital employed on the other. In addition there is a direct relationship between capital allowance and return on capital employed. This is inconformity with the a-priori expectation and it is statistically significant at 5%. This implies that capital allowance is a significant factor influencing return on capital employed of the sampled firms. The R^2 of 0.20 is low and it shows that tax incentives (capital allowance, tax holidays and tax deductions explain about 20 percent changes in ROCE, while the remaining percent are the other factors affecting ROCE.

CONCLUSION

Tax incentives have become a popular discussion. The widely held view that tax incentives determines firm profitability and protects the interests of shareholders has led to increasing global attention. This paper studies tax incentives (capital allowance, tax holidays and tax deductions variables and firms' profitability variable (ROCE).

RECOMMENDATIONS

Based on the findings and conclusion of this study, manufacturing in Nigeria significantly needs government attention to continue to play its role as wealth and employment generator. Government as a matter of urgency should provide adequate tax incentives in the real sector and particular manufacturing sub-sector. Tax

incentives will enhance the emergence of new enterprises or re-activation of existing ones, thereby reducing profit tax which will have been earned from them, but ultimately encouraging production to curb the nuisance of unemployment, youth agitation and over-reliance on government for a means or source of revenue.

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