THE INTERPLAY BETWEEN TAX INCENTIVES AND FOREIGN DIRECT INVESTMENT IN NIGERIA

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Abstract

The purpose of this study was to examine the relationship between tax incentives and Foreign Direct Investments in Nigeria. This study adopted an ex-post facto research design and data was gathered from CBN statistical bulletin and annual reports of the Federal Inland Revenue Service for the period of 33 years (1991 to 2023). The Eviews 11.0 econometric software was used to analyse the data that was gathered from the various sources. The results revealed a significant negative impact of Customs and Excise Incentives (D(CED)) on Foreign Direct Investment (FDI) underscores the importance of streamlining administrative processes to reduce the complexities and burdens these incentives may impose on investors. Conversely, the insignificant impacts of Value Added Tax Incentives (D(PPT)) and Company Income Tax Incentives (D(CIT,2)) suggest that these measures alone are insufficient to drive FDI, thereby highlighting the necessity of a holistic approach that integrates these incentives with broader economic strategies. The authors recommended, among others, that, a simplified customs procedure to mitigate perceived complexities and enhance the attractiveness of these incentives to potential investors.

Keywords: *Foreign Direct Investment, Privilege Zones. Tax deferrals, Tax Incentives, Tax Subsidies.*

Introduction

According to the Governor of the Central Bank of Nigerian (CBN), Yemi Cardoso, Foreign Direct Investment increased by 237 percent in first quarter of 2024 compared to the same period in 2023 amid the CBN policy interventions. According to the foreign portfolio investment data published by the Nigerian Exchange Limited, NGXs research department total foreign inflows of N93.37 Billion against a foreign outflow of N119.81 Billion. The total net outflows for the quarter was N26.44 Billion, underscoring a trend of foreign investors withdrawing more funds than they bring into Nigeria equity market. The constant inflow of foreign direct investment (FDI) into one country or another is related to the inflow of benefits such as technical know-how and human resources. As a result, the Nigerian government, through the competent authority, has over the years engaged in a number of economic reforms of which the tax incentive is foremost. These incentives are given to investors (multi-national, international and local) to make the local economy more investment friendly. Variants of tax incentives that have been adopted in Nigeria come in the form of tax holidays (pioneer certificate), capital allowances in respect of investment in machinery, construction and loss of transport facilities, import duty relief, authorized user scheme under which import duties have been refunded to approved undertakings, importing goods for export production and oil exploration relief (Adegbite & Akande, 2017).

In Nigeria, company income tax benefits have been successfully used to mitigate tax fraud or tax evasion (Oyetunde, 2008). Reduced corporate income tax policies that have been used by countries to encourage technology-intensive investment include a cut in the marginal tax rate, tax breaks, tax-free returns, tax deduction from the minimum tax levy, flat rate and forward-paying losses. Over the years,

efforts have been focused on oil revenue instead of tax revenue. In an attempt to thoroughly break the age-long jinx of the country's counter-productive overdependence on its mono-product (oil), tax policy measures that include certain tax benefits have been introduced with a view to enhancing FDI in a number of other sectors of interest. This tax benefits are either cost-based or profit-based. Cost-based incentives are ultimately aimed at lowering costs for international buyers, while profit-based incentives help to reduce the proportion of income charged as taxes (Institute for Fiscal Studies (IFS), 2018). Mixed findings from existing research may have been attributed to dissimilar databases, measurement methods and time horizons. This in addition to different measures of variables studied can also be a reason for the mixed findings, which serves as further motivation for this study.

Research Questions

The following research questions were raised to guide the study.

Research Question 1: What is the relationship between tax holiday and foreign direct investment in Nigeria?

Research Question 2: What is the relationship between company tax incentives and foreign direct investment in Nigeria?

Research Question 3: What is the relationship between petroleum profit tax incentives and foreign direct investment in Nigeria?

Research Question 4: What is the relationship between value added tax incentives and foreign direct investment in Nigeria?

Research Question 5: What is the relationship between customs and excise duties incentives on foreign direct investment in Nigeria?

Research Hypotheses

The following research hypotheses were formed to guide the study.

Research Hypothesis 1: Tax holiday does not significantly associate with foreign direct investment in Nigeria.

Research Hypothesis 2: Company tax incentives does not significantly associate with foreign direct investment in Nigeria.

Research Hypothesis 3: Petroleum profit tax incentives does not significantly associate with foreign direct investment in Nigeria.

Research Hypothesis 4: Value added tax incentives does not significantly associate with foreign direct investment in Nigeria.

Research Hypothesis 5: Customs and excise duties incentives does not significantly associate with foreign direct investment.

Literature Review

Foreign Direct Investment

Foreign Direct Investment is characterized as a cross-border acquisition of financial or physical assets by foreign entities or governments with some controlling rights on the part of the investor. These foreign direct investors can be individuals, corporate entities or a government (Odiase, 2006). Similarly, the FDI may be viewed as an investment that imbues leverage over ownership of a company located in a country other than that of an investor (lexicon.ft.com). These meanings mean that FDI is characterized as international controlling ownership, which implies the external flow of financial, human and real resources from outside the world (Olaniyi et al., 2018). According to Ndagi (2016), FDI is when a foreign investor acquires at least 10% of the shareholding and voting rights of a foreign company. This point adds insight to the question of managing ownership. The purchase of a minimum shareholding shares of 10% is considered to be considerable and this allows the international investor a long-term management stake in the investor.

Tax Incentives

Tax incentive may be defined as a careful reduction in or total removal of tax liability granted by the government in order to encourage a particular economic unit to act in some desirable ways. The desirable ways maybe to invest more, employ more, export more, sell more, consume less, import less and pollute less and so on (Sanni, 2017). Fletcher (2002) describes tax incentives as any tax provision given to an eligible investment project which represents a beneficial departure from the provisions applicable to investment projects in general. Thuita (2017) notes that various studies of foreign investors have shown that tax benefits are not the most important element in the choosing of investment destinations, but there are tax policies that can influence the amount and position of FDI, as higher tax rates limit post-tax returns (Morisset & Neda, 2001).

There are well accepted reasons favouring the use of tax incentives as an acquisition mechanism. Bruce (2004) argues that tax incentives boost economic returns and are justified by the beneficial benefits of investment, including the simplicity with which they are directed towards a single target market, the ease with which they are fine-tuned and their openness to capitalism. Furthermore, they are required in order to compete in other tax jurisdictions as they compensate for other inadequacies in the investment climate. Morisset and Neda (2001) argued that tax incentives are still commonly used by developed countries, especially those that consider themselves to be in tough competition with FDIs, as they are located close to other countries with an equally desirable investment environment.

Company Income Tax incentives and Foreign Direct Investment

In Nigeria, company income tax benefits have been successfully used to mitigate tax fraud or tax evasion (Oyetunde, 2008). Reduced corporate income tax policies that have been used by countries to encourage technology-intensive investment include a cut in the marginal tax rate, tax breaks, tax-free returns, tax deduction from the minimum tax levy, flat rate and forward-paying losses. Companies with a turnover of fewer than 25 million are charged no tax (minimum tax), while lN 50 million and below at a minimum rate of 20%. Some of the government's efforts to create a favourable environment for foreign direct investment in Nigeria are such that loans granted to Nigerian companies can be exempt from tax if the necessary conditions are met, Nigerian companies with a minimum of 25% foreign capital and, in their first four years of operation, exempt from the payment of minimum tax, tax holidays granted to Nigerian companies (Olaleye, Riro & Memba, 2016). Fakile and Adegbile (2011) argue that a low corporate tax rate is part of the structure of developed countries and is typically set up by governments to give foreign companies more favourable conditions to invest in their countries.

Petroleum Profit Tax Incentives and Foreign Direct Investment

Kyari (2020) examines whether the Nigerian oil tax incentive package is sufficient for attracting foreign direct investment. Data was obtained via a five-point Likert questionnaire and analysed using descriptive statistics and the Kruskal-Wallis technique. The study found, among other things, that Nigeria's oil tax incentive program is adequate in number and suitable in mix to draw foreign direct investment. This study concluded that Nigeria's oil tax incentive package is appropriate for attracting foreign direct investment. Likewise, the report suggests that the tax incentives are adequate in number and acceptable in mix to draw foreign direct investment to the nation's oil and gas industry.

Customs and Excise Duties and Foreign Direct Investment

George and Bariyima (2015) investigated how tax incentives impact on the inflows of FDI to Nigeria. The result of multiple regression and error correction model employed showed that FDI's response to tax incentives is negatively significant. Adepeju and Adepeju (2012) conducted a study on the impact of tax incentives on FDI inflows to the Nigerian oil and gas sector. The result of the Karl Pearson correlation statistics suggested that tax incentives significantly impact on FDI inflows to the sector. Fakile and Adegbile (2011) assessed the effectiveness of tax incentives as a tool to attracting FDI in the Nigerian economy and found that tax incentives play a useful role in encouraging both domestic and foreign investment. Apparent lack of consensus among these studies as well as narrowness of a large number of them calls for this study. Specifically, various tax incentives in company's income tax, VAT,

custom and excise duties, petroleum profit tax were combined in this study against large number of previous studies that did not take cognizance of these. Maghori (2014) studied the determinants of FDI in Nigeria. The study made use of time series from 1970 to 2010. Utilizing the Error Correction Modeling (ECM) technique, the results show that the major determinant of foreign capital inflow in the economy is the ratio of external debt to Gross Domestic Product both in the short run and long run. However, some factors such as the size of the national income, the degree of openness to trade, the existing stock of foreign capital in the previous period, inflation rate and exchange rate are well maintained through to the long run.

Tax holiday and Foreign Direct Investment

Thuita (2017) investigated the relation between tax benefits, tax holidays in particular and capital deductions, and how they affect the attractiveness and preservation of foreign direct investment. A sample size of 72 workers of companies working under EPZs was chosen for the analysis using a stratified system for the businesses and a method for the respondents. The research used a descriptive survey design using self-directed questionnaires to request information from the sampled senior firm of the Export Processing Zones. The study showed that the use of tax holidays has a significant impact on the attraction and preservation of foreign direct investment. The industrial industry is likely to be favoured by tax advantages relative to other industries due to increased capital allowances. The report concludes that tax benefits should be increased to boost the growth and development of global director investors and that the government should be able to expand tax holidays beyond 10 years for companies based on the money injected over the long term.

Etim, Mfon and Ofonime (2019) explored the use of effective tax policy measures to encourage foreign direct investment. Thus, a 19-year empiric investigation (1999-2017) was undertaken to determine the impact of cost-based and profit-based tax benefits on FDI in Nigeria. In accordance with the ex-post-facto analysis design adopted for the report, secondary data were obtained from the CBN Bulletins and the World Bank Database. Multiple regression methods have been used to analyse the three models that have been formulated. The results showed that while cost-based tax incentives had a comparatively stronger impact on FDI (R2 of.230) compared to profit-based tax incentives (R2 of.045), there was no substantial association between cost-based tax incentives, profit-based tax incentives and FDI in Nigeria.

Value added tax incentives and Foreign Direct Investment

Adegbite and Akande (2017a) investigated the effect of VAT on private investment in Nigeria through the use of Pearson Product Moment Correlation and Multiple Regression techniques. The study revealed a positive relationship between private investment and VAT in Nigeria. Amuka and Ezeudeka (2017) conducted an investigation to determine if the implementation of a tax incentive scheme would result in a major shift in the trend of FDI flow in the Nigerian non-oil market. Companies' payroll tax and pension allowances were known as tax incentives. Secondary data has been used for the analysis. Ordinary least square econometric regression was used for data analysis. The results of the study showed that the implementation of a scheme of tax incentives changes the trend of FDI flows in the market. This means that tax incentives may be seen as a genuine method for drawing FDI to the non-oil market.

Method

Research Design

An ex-post facto research design was used to achieve the purpose of the study. The justification for this design is that the independent variables are grouped using a particular trait or feature (tax incentives) and are compared to a dependent variable. Furthermore, the relationship between tax incentives and foreign direct investment is after the fact and as such, this research design is suitable for this present study.

Population and Sampling Procedure

The population of the study spans from the CBN data 1991 to 2023. The population includes the numerous tax incentives identified in the study. The sampling method adopted was the convenience sampling technique to select a sample of 33 years from the population. The choice of this period is to cover the period of major economic reforms such as the Structural Adjustment Programme (SAP), the National Economic Empowerment Development (NEED) as well as the availability of data.

Data Collection Procedure

The source of data for the study is secondary source. The secondary data will be sourced from Central Bank of Nigeria (CBN) Statistical Bulletin and Annual report of Federal Inland Revenue Service. Also, the CBN publications on monetary policy, surveillance activities and operations will also be used to collect data for the study.

Data Analysis

This study employed the use of the error correction model. The justification for this model is that it is a time series regression model that is used to establish equilibrium both in the long and short run of the time series. The Eviews 11.0 econometric software was used to analyse the data that was gathered from the various sources. It is vital to note that time series data are subject to errors due to possible fluctuations in the variables; as such, a number of tests will be carried out to account for these errors.

Result

Table 1: Mean and Standard Deviations on the Levels of the Study Variables.

	FDI	PPT	CIT	CED	TH
Mean	1.617501	5.623142	4.730988	5.070074	0.545455
Median	1.450318	6.073205	4.708421	5.330996	1.000000
Maximum	5.790847	6.505329	5.983875	5.437526	1.000000
Minimum	0.331651	2.215638	3.476687	3.936564	0.000000
Std. Dev.	1.184418	0.990365	0.781665	0.464618	0.505650
Skewness	1.902984	-1.625019	0.034811	-1.262613	-0.182574
Kurtosis	7.048416	5.627552	1.715082	3.152052	1.033333
Jarque-Bera	42.45321	24.01682	2.276809	8.799840	5.501528
Probability	0.000000	0.000006	0.320330	0.012278	0.063879

Note. FDI = foreign direct investment, CITI = company income tax incentive, TH = tax holiday, VATI = value added tax incentive, CEI = customs and excise incentive.

The descriptive statistics for Foreign Direct Investment (FDI) and various tax incentives reveal key characteristics and distributions of these variables. The mean FDI value is 1.617501, indicating the average level of foreign investment, with a median of 1.450318, suggesting that half the observations are below this value. The FDI values range from a minimum of 0.331651 to a maximum of 5.790847, with a standard deviation of 1.184418, reflecting moderate variability. The positive skewness (1.902984) indicates that FDI distribution is skewed to the right, with a few high values pulling the mean upwards, while the high kurtosis (7.048416) suggests a leptokurtic distribution with more frequent extreme values.

For Company Income Tax Incentive (CITI), the mean is 4.730988, with a median close to this at 4.708421, implying a relatively symmetric distribution around the central values. The CITI values show less variability (standard deviation of 0.781665) compared to FDI. The negative skewness (-1.625019) indicates a left-skewed distribution, where lower values are more common, while the kurtosis of 5.627552 points to a leptokurtic distribution with fatter tails. This can be interpreted as the majority of CITI values clustering around the mean with some significant low outliers.

Customs and Excise Incentive (CED) and Tax Holiday (TH) also show distinct patterns. CED has a mean of 5.070074, a relatively narrow range (standard deviation of 0.464618), and negative skewness (-1.262613), indicating more frequent lower values. Its kurtosis (3.152052) is close to normal, suggesting a more moderate tail distribution. The tax holiday has a mean of 0.545455 anda high standard deviation (0.505650), indicating substantial variation with a minimum of 0 and a maximum of 1. Its skewness (-0.182574) is near zero, indicating a fairly symmetric distribution, and the kurtosis (1.033333) suggests a flatter distribution than normal. The Jarque-Bera test results, with significant probabilities for FDI, CITI, and CED, confirm that these distributions deviate from normality, while TH is closer to normality with a less significant p-value.

Table 2: Pearson's Correlation between and among the Study Variables.

	FDI	PPT	CIT	CED	TH
FDI	1.000000				
PPT	-0.159537	1.000000			
CIT	0.113001	0.450122	1.000000		
CED	-0.350897	0.764364	0.556399	1.000000	
TH	-0.215701	0.735535	0.411879	0.726233	1.000000

Note. FDI = foreign direct investment, PPT = Petroleum Profit tax, CIT = Company income tax, CED = Customs and Excise Incentive, TH = Ta holidays.

The correlation analysis examines the relationships between Foreign Direct Investment (FDI) and various tax incentives: Value Added Tax Incentive (PPT), Company Income Tax Incentive (CIT), Customs and Excise Incentive (CED), and Tax Holiday (TH). The correlation coefficient ranges from -1 to 1, where values closer to 1 indicate a strong positive relationship, values closer to -1 indicate a strong negative relationship, and values around 0 suggest no linear relationship. The correlation between FDI and the tax incentives shows mixed relationships. FDI has a weak negative correlation with PPT (-0.159537) and TH (-0.215701), with p-values of 0.3752 and 0.2280, respectively, indicating that these correlations are not statistically significant. The correlation between FDI and CED is moderately negative (-0.350897) with a p-value of 0.0453, suggesting a statistically significant relationship where higher customs and excise incentives might be associated with lower FDI. FDI's correlation with CIT is weakly positive (0.113001) but not statistically significant, with a p-value of 0.5312. Among the tax incentives themselves, there are stronger correlations. PPT shows a strong positive correlation with CED (0.764364) and TH (0.735535), both highly significant with p-values of 0.0000. CIT is positively correlated with PPT (0.450122), CED (0.556399), and TH (0.411879), all significant, suggesting that these tax incentives tend to increase together. CED and TH also have a strong positive correlation (0.726233), indicating that these incentives are likely to be used in conjunction. Overall, the analysis highlights significant relationships between the tax incentives but mixed and mostly insignificant correlations between FDI and the individual tax incentives.

Table 3: Model Summary of Regression Analyses on the Study Variables.

Variable	Coefficient	Std. Error	t-Statistic	P-Value
C	0.947635	0.490871	1.930520	0.0654
D(PPT)	0.041582	0.262383	0.158477	0.8754
D(CIT,2)	0.065921	0.290032	0.227288	0.8221
D(CED)	-8.837428	4.050264	-2.181939	0.0391
D(CED,2)	2.714749	2.853795	0.951277	0.3509
TH	-0.937945	0.522472	-1.795205	0.0852
ECM(-1)	-0.683634	0.202322	-3.378940	0.0025
R-squared	0.467140	Mean dependent var		-0.036086

Adjusted R-squared	0.333925	S.D. dependent var	1.200112
S.E. of regression	0.979453	Akaike info criterion	2.992035
Sum squared resid	23.02388	Schwarz criterion	3.315838
Log likelihood	-39.37654	Hannan-Quinn criter.	3.097587
F-statistic	3.506657	Durbin-Watson stat	1.989892
Prob(F-statistic)	0.012381		

The regression analysis evaluates the impact of various tax incentives on the changes in Foreign Direct Investment (FDI)) using a sample of 31 observations from 1992 to 2022. The constant term (C) has a coefficient of 0.947635, which is marginally insignificant at the 5% significance level (p-value of 0.0654) but could be considered significant at the 10% level, suggesting a potential base level effect on D (FDI). The change in Customs and Excise Incentive (D (CED)) has a coefficient of -8.837428 and a p-value of 0.0391. This indicates a statistically significant negative relationship with changes in Foreign Direct Investment (D(FDI)). Specifically, for every unit increase in D(CED), D(FDI) decreases by approximately 8.837428 units, holding all other factors constant. The p-value of 0.0391 suggests this relationship is significant at the 5% level, implying a reliable negative impact of customs and excise incentives on foreign direct investment. This counterintuitive result might reflect that higher customs and excise incentives could be seen as additional costs or complexities, potentially deterring foreign investors.

The first difference of the Value Added Tax Incentive (D(PPT)) has a coefficient of 0.041582 and a p-value of 0.8754. The coefficient is positive, suggesting a very slight increase in D(FDI) with an increase in D(PPT); however, the high p-value indicates that this relationship is not statistically significant. In practical terms, this means that changes in value-added tax incentives do not have a discernible impact on changes in foreign direct investment within the studied sample. The lack of significance might be due to various factors, including the potential that VAT incentives are not a primary consideration for foreign investors. The second difference of the Company Income Tax Incentive (D(CIT,2)) shows a coefficient of 0.065921 and a p-value of 0.8221. The positive coefficient suggests a slight increase in D(FDI) with an increase in D(CIT,2), but similar to D(PPT), the high p-value indicates no statistically significant relationship. Therefore, the change in company income tax incentives, when considering the second difference, does not appear to significantly influence foreign direct investment. This result suggests that alterations in company income tax incentives might not be immediately impactful or that other factors overshadow their influence on FDI decisions

Discussion

The findings from the regression analysis reveal significant insights into the impact of tax incentives on Foreign Direct Investment (FDI). The most notable result is the negative and statistically significant coefficient for the change in Customs and Excise Incentive (D(CED)), with a coefficient of -8.837428 and a p-value of 0.0391. This suggests that higher customs and excise incentives are associated with a decrease in FDI. The negative impact may arise because such incentives could increase the operational complexity and compliance burden for foreign investors, making the investment environment less attractive. Policymakers should consider this implication when designing tax policies, possibly streamlining customs procedures or reducing the associated compliance costs to enhance the attractiveness of these incentives.

Conversely, the first difference of the Value Added Tax Incentive (D(PPT)) and the second difference of the Company Income Tax Incentive (D(CIT,2)) did not show significant effects on D(FDI), with p-values of 0.8754 and 0.8221, respectively. This lack of significance implies that adjustments in VAT and company income tax incentives might not be strong determinants of FDI decisions. For policymakers, this indicates that while VAT and corporate tax incentives are commonly used tools to attract foreign investment, their impact may be limited or overshadowed by other factors such as market size, labor costs, infrastructure quality, and political stability. Therefore, it may be beneficial to complement these incentives with other strategic measures to enhance the investment climate.

Conclusion

The regression analysis of tax incentives and their impact on Foreign Direct Investment (FDI) yields significant insights with critical implications for policy formulation. The key finding of a significant negative impact of Customs and Excise Incentives (D(CED)) on FDI underscores the importance of streamlining administrative processes to reduce the complexities and burdens these incentives may impose on investors. Conversely, the insignificant impacts of Value Added Tax Incentives (D(PPT)) and Company Income Tax Incentives (D(CIT,2)) suggest that these measures alone are insufficient to drive FDI, highlighting the necessity of a holistic approach that integrates these incentives with broader economic strategies. The analysis also emphasizes the importance of long-term stability and consistency in tax policies, as indicated by the significant error correction term (ECM (-1)). This highlights the need for policies that not only attract immediate investments but also sustain investor confidence through predictable and stable regulatory environments. Diversifying incentive programs to cater to specific sectors and enhancing governance frameworks further support a conducive investment climate. In conclusion, while tax incentives remain a vital tool for attracting FDI, their design and implementation must be meticulously calibrated to avoid unintended negative consequences and to align with the country's strategic economic goals. Policymakers should adopt a comprehensive and data-driven approach, ensuring that tax incentives are part of a broader, stable, and predictable policy framework that effectively addresses the multifaceted needs of investors. By doing so, countries can enhance their attractiveness to foreign investors, fostering sustainable economic growth and development.

Recommendations

The following recommendations are made:

1. Simplifying customs procedures can mitigate perceived complexities and enhance the attractiveness of these incentives to potential investors.
2. There is the need to maintain a stable and predictable tax policy environment to build investor confidence. Transparent tax regulations and consistent application of incentives are crucial for long-term investment planning and decision-making.
3. Continual review and adjustment of tax incentives should align with strategic economic goals and market dynamics to sustain investor trust and commitment.
4. There is the need to strengthen institutional capabilities and governance frameworks responsible for administering and monitoring incentive programs. Efficient administration, backed by robust capacity-building initiatives, enhances regulatory compliance and investor confidence in the incentives regime.

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