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An econometric analysis of the impact of taxation on domestic investment in Nigeria

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Abstract
This study sought to investigate the relationship between government tax revenue and domestic investment in Nigeria using annual time series data spanning the period 1980-2017. The study employs the ARDL bounds testing approach to examine the long and short run relationship between the variables of interest. The bounds test suggested that the variables in the model are bound together in the long run. The associated Error Correction Model was also significant confirming the existence of long-run relationships. The empirical results showed that Personal Income Tax have a significant positive effect on domestic investment in both the short and long run, Value Added Tax has a significant negative impact in the long run only while Company Income Tax has a significant positive influence on domestic investment in the short run only. For the control variables, Interest Rate and FDI both parade evidences of a significant negative impact on domestic investment in both the short and long run while Stock Market Capitalization had a significant positive effect on domestic investment in the long run only. The study therefore recommends improvement of the infrastructural base, political and macro-economic stability and provision of credit facilities to domestic investors at low interest rate.

Keywords: tax revenue, domestic investment, bounds testing, co-integration, gross fixed capital formation, structural break, Nigeria

1. Introduction

Taxation in developing countries is a strategic tool that makes it possible to finance the provision of public goods such as infrastructure, education, health and justice, which are essential for growth. But beyond that, taxation affects individual savings, work and education decisions, production, job creation, investment and business innovation, as well as the choice of savings instruments and assets by investors (OECD, 2009). All the decisions are affected not only by the level of taxes, but also by the way in which different fiscal instruments are designed and combined to generate government revenue (Gbato, 2017). Taxation is an essential component of economic policies for a country to sustain and strengthen its economic growth and global competitiveness (Macek, 2014). It provides countries with stable and predictable fiscal environment, thus enabling them to accumulate funds to finance their social and physical infrastructural needs (Wisdom and Bernard, 2015).
The need for tax payment has been a phenomenon of global significance as it affects every economy irrespective of national differences (Ojong *et al*., 2016). The volume of collectible taxes has a direct relationship with the level of economic activities of a nation. Government use tax revenue to carry out their traditional functions such as the provision of public goods and services, maintenance of law and order, defence against external aggression and regulation of trade and business to ensure social and economic maintenance (Odhiambo & Olushola, 2018). For this objective to be achieved, government must put in place a good and functional system of tax administration (Udeh, 2015). Effective tax revenue mobilisation reduces an economy's dependence on external flows which have been found to be highly volatile. Taxation also allow government greater flexibility in designing and controlling their development agenda, conditions states to improve their domestic economic policy environment, thus creating a conducive environment for the much-needed foreign direct investment and strengthen the bonds of accountability between government and the citizens.
Investment is generally classified into four major components: the private domestic investment, public domestic investment, foreign direct investment and the portfolio

investment. Private domestic investment refers to gross fixed capital formation plus net changes in the level of inventories whereas public investment includes investments by government and public enterprises on social and economic infrastructures, real estate and tangible assets. The combination of private domestic investment and public domestic investment is normally referred to as gross fixed capital formation to distinguish them from their counterpart foreign investment. The foreign investment when it is on tangible asset is referred to as foreign direct investment. It is called portfolio investment when it is on shares, bonds, securities, etc (Osinubi & Amaghionyeodiwe, 2010) [12]. Sustainable and rapid economic growth of an economy depends significantly on the size and rate of investment whether they are domestic or foreign direct investment along with increased amount of capital and changes in technology (Jeza *et al*, 2017). However, many developing countries including Nigeria suffer from low domestic saving levels leading to huge gap between savings and investment. In fact, domestic savings and investment in Nigeria are not in long-run equilibrium, necessitating large capital flow into the country. In both the developed and developing economies, tax policy is an important instrument used by countries to attract foreign capital. Tax incentives, by lowering the cost of doing business improve the location advantage of an economy and thus can be expected to attract FDI inflows (Jeza & Hassen, 2016) [9].

It is a common knowledge even to the cursory observer of the African continent that there are very few countries with the economic potentials of Nigeria. The country is richly endowed with abundance of human and natural resources. With a population of over 198 million people and a GDP of over US$ 420 billion, Nigeria has an internal market that has no rival within the African continent (Deloitte, 2018) [4]. The country has vast arable land with complementing conditions that support agricultural activities. Nigeria is endowed with Africa's second largest oil reserves. In addition to its large oil and gas deposits, Nigeria is endowed in commercial quantities with about 37 solid mineral types that have barely been harnessed, for a wide range of industries such as construction, pharmaceuticals, food processing and other forms of manufacturing (Sanusi 2010). Despite the huge resource base of Nigeria, the country has not been able to achieve a high level of economic growth nor has it been able to attract Foreign Direct Investment (FDI) commensurate with its economic potentials (Deloitte, 2018) [4].

After ranking consistently among the top three destinations of FDI between 2004 and 2014, capital inflow into Nigeria has been dwindling and has fallen by 34% during the period (Obi, 2018). The broad issue is that, most increase in economic growth of the host countries by FDI always affects the size of the host country's domestic investment. This concern emanates from the fact that FDI inflow reduces output, employment as well as worsens the balance of payment position of most developing countries. This is because the benefits of those FDI are not automatically accruing to the host countries but rather crowding out domestic investment by forcing local competitors out of the market (Alfa & Garba, 2012). Nigerian macroeconomic indicators show the pitiable performance of domestic investment in Nigeria for the period 1986 to 2010 as the economy continues to face a variety of problems (CBN, 2016). These problems include low level of savings and

investment, high interest rate, high level of unemployment, poor infrastructure leading to high cost of doing business, inefficiencies in the capital and money market and different measures of uncertainties (political, social and economic) (Victor & Dickson, 2013). Thus, the impact of domestic investment on growth has been low and less significant in raising the level of output.

The 2008/2009 global financial and economic crisis provided useful lessons for countries on the need to direct more attention to domestic resources mobilisation efforts through increasing tax revenues and shift away from over-dependence on external financial flows and export revenues (Odhiambo & Olushola, 2018). The crisis had serious implication for many countries in Sub-Saharan African which, to a very large extent, depend on the flow of aids, FDI, overseas development assistance and portfolio investments into the region for development (Ekpo, 2016). The influx of these flows became dwindled in the wake of the financial crisis thus portending that foreign capital or other assistance as it were, may not be a sustainable source of economic growth. It is upon this premise that this study is designed to investigate the short and long-run effects of various taxes on domestic investment in Nigeria using time series data from 1980-2017. Following this introduction, section two reviews relevant conceptual and theoretical literature while section three discusses the research methodology used in the study. The empirical results and discussions are presented in section four while section five concludes the study and offers some recommendations based on the findings.

2. Theoretical and conceptual framework
2.1 Theoretical framework
The theoretical foundation of this study is anchored on the Laffer's curve theory of taxation, the accelerator, the neo-classical and Tobin's Q theories of investment summarized below.

2.1.1 The Laffer's curve theory of taxation
The Laffer curve theory of taxation shows the relationship between government revenue raised by taxation and all possible rate of taxation. It considers the amount of tax revenue raised at the extreme tax rates of zero percent and 100 percent. This theory is of the opinion that a 100% tax rate raises no revenue in the same way that 0% tax rate raise no revenue. This is because, at 100% tax rate, there is no longer the incentive for a rational taxpayer to earn any income. Thus, the revenue raised will be 100% of nothing. It therefore, follows that there must exist at least one rate in between where tax revenue would be at maximum. This theory believes that increasing tax rate beyond a certain point will become counter-productive for raising further tax revenue because of diminishing returns (Ekwe & Azubike, 2018) [2]. Laffer in 1979 argues that the more money taken from a business in the form of taxes, the less money it must invest in the business. A business is more likely to find ways to protect its capital from taxation or to relocate all or part of its operations overseas. Investors are less likely to risk their own capital if a larger percentage of their profits are taken in tax. When workers see increasing portion of their wages taken due to increased efforts on their part, they will lose the incentive to work harder. For every type of tax, there is a threshold rate above which the incentive to produce more diminishes, thereby reducing the amount of revenue the government receives (Karier, 1997).

2.1.2 The accelerator theory of investment

The simple version of this theory expresses change in capital stock as a multiplier function of change in output. The theory suggests that as demand or income increases in an economy, so does the investment make by firms. It suggests that when demand levels result in excess demand, firms have 2 choices of how to meet demand (Geda, 2014). It is either to raise prices to cause demand to drop or to increase investment to match demand. The theory proposes that most companies choose to increase production thus increase their profits. The theory further explains how this growth attracts more investors, which in turn accelerates growth.

2.1.3 Jorgensen's neo-classical/user cost of capital theory of investment

The basic reasoning behind the user cost of capital theory, introduced by Jorgensen (1963) and Hall and Jorgensen (1967), is that a firm weighs the costs and benefits of investment and invests when the benefits exceeds the cost. (Vartia, 2004). The theory is based on the neo-classical theory of optimal capital accumulation which is determined by the relative prices of factors of production. The model attempts to evaluate the benefit and cost of owing capital. Based on Keynes original approach, the model attempts to relate the level of investment with Marginal Product of Capital (MPK), the interest rate (r) and the tax rule (t) affecting firms.

So investment = f (MPK, r, t).

2.1.4 Tobin's Q theory of investment

Tobin noted a link between fluctuation in investment and fluctuation in stock market. Stock/ share prices in stock market tend to be high when firms have many opportunities (as it entails high investment and high returns to shareholders). So, stock prices show the incentive to invest. Tobin, therefore, proposed that firms based their investment decision on the following ratio, called Tobin Q. Q = market value of installed capital/ Replacement cost of installed capital. According to Tobin, if Q >1, the stock market value of installed capital is more than its replacement cost; managers can raise the market value of their firms' stock by buying more capital. If Q < 1, managers will not replace capital as it wears out.

2.2 Conceptual framework

Kajola (2006) defines tax as a compulsory payment made by individuals and organizations to the government in accordance with pre-determined criteria for which no direct or specific benefit is received by the taxpayer. The motive of tax is to finance the activities of public sector to achieve economic and social goals in the country. Nzotta (2007) noted that taxes have allocation, distributional and stabilisation functions. The allocation function of taxes entails the determination of the pattern of production, the goods that should be produced, who produces them, the relationship between the private and the public sectors and the point of social balance between the two sectors. The distribution function of taxes relates to the way effective demand for economic goods is divided among individuals in the society while stabilisation function of taxes seeks to attain a high level of employment, a reasonable level of price stability, an appropriate rate of economic growth with allowances for effects on trade and the balance of payments. From the theoretical framework, Domestic Investment is captured as the Gross Fixed Capital Formation (GFCF), the determinants of investment include the Marginal Product of

Capital which measures the marginal receipts or benefits obtained from the use of capital in production. This determinant of investment was not captured in the empirical model of this study because of measurement difficulty. Interest rate which measures the real cost of capital from the User Cost theory was captured in the empirical model as Nominal Interest Rate (INTR). Taxes levied by government and tax incentives are two important tax elements which also influences the rental cost of capital. The higher the tax rate, the higher the rental cost of capital while tax incentives reduce the rental cost of capital. Tax rule in the theoretical framework is captured in the study by disaggregating the various taxes in the empirical model. The average Q is captured in the empirical model as Stock Market Capitalization while FDI inflow is included in the empirical model to test if FDI inflow has a crowding in or crowding out effect on domestic investment in Nigeria. The econometric analysis performed in this study builds on a multivariate set-up, allowing for key control variables to intermediate the nexus between tax revenue and investment growth. Such a rich environment can overcome variable omission bias, thus allowing for efficient estimates of the test statistics.

3. Research methodology
3.1 Research design

This study adopted the quantitative method and descriptive research design to provide empirical solution to the research problems using already existing data. Descriptive research designs help provide answers to the questions of who, what, when, where and how associated with a research problem. A descriptive study cannot conclusively ascertain answers to why. It is used to obtain information concerning the status of the phenomena and to describe "what exists" with respect to variables (William, 2006).

3.2 Nature and Sources of data

The data for this study which are purely secondary were extracted from various reports of the Federal Inland Revenue Service (FIRS), Central Bank of Nigeria (CBN) Statistical Bulletin, National Bureau of Statistics (NBS) and the World Development Indicators using the desk survey approach. This is because the study is country specific and the estimation of the empirical model requires the use of time series data. All variables were taken on annual basis as obtained from their various sources in nominal terms and in rates.

3.3 Specification of the empirical model

The model designed to capture the effect of tax revenue shocks on domestic investment in Nigeria draws from Nwokoye & Rolle (2014) and Jeza (2016) [9]. The model specification leans very closely on the user cost of capital and Tobin's Q theories of investment regarding the relationship between taxation and investment. The dependent variable of the model is Gross Fixed Capital Formation (GFCF) while Petroleum Profit Tax (PPT), Company Income Tax (CIT), Personal Income Tax (PIT), Value Added Tax (VAT) and Customs and Excise Duties (CED) used as proxy for tax rule and control variables such as Nominal Interest Rate (INTR), Stock Market Capitalization (SMC) and Foreign Direct Investment inflow (FDI) were used as the independent variables. From the foregoing, the variables used in the specification of the empirical model are specified in a linear form as follows:

Δ $GFCF_t = \beta_0 + \beta_1 PPT_t + \beta_2 CIT_t + \beta_3 PIT_t + \beta_4 VAT_t + \beta_5 CED_t + \beta_6 INTR_t + \beta_7 SMC_t + \beta_8 FDI_t + \mu_t$ ....Eqn 1

Where:
β_0 = intercept β_1, β_2, β_3, β_4, β_5, β_6, β_7 and β_8 = Regression coefficients to be estimated.
t = time trend μ = the random or error term

A priori expectations
The theoretical expectations about the signs of the coefficients of β_1, β_2, β_3, β_4, β_5, β_6 and β_8 could be positive or negative. That is, β_1, β_2, β_3, β_4, β_5, β_6 and β_8 = > or < 0 while β_7 is expected to be positive, that is, $\beta_7 > 0$. This theoretical expectation follows naturally from the analysis of the various investment theories discussed in the theoretical framework.

3.4 Estimation procedure
The study uses the Auto-Regressive Distributed Lag (ARDL) co-integration test popularly known as bounds test procedure, jointly developed by Pesaran *et al.* (2001), to empirically analyse the short and long run impact of tax revenue shocks on domestic investment in Nigeria. The ARDL is utilized in this study mainly because it allows for variables integrated of order zero and order one, I(0) and I(1) respectively, to be utilized in the same model without the risk of generating spurious regressions (Pesaran *et al*, 2001). The ARDL bounds test is also robust for finite samples, even in the presence of phenomena of shocks and regime shifts. In addition, different optimal lags can be used for different variables as they enter the model, which is not applicable in the standard co-integration test. To use this approach, the study first ensure that none of the variables in the model are I(2), as such data will invalidate the methodology. Second, formulate an "unrestricted Error Correction Model (ECM) for all general and specific objectives. Following these, estimate the equation and ensure the errors of each model are serially independent and stable. Then perform a "Bounds test" to see if there is evidence of a long run relationship between the variables and if the outcome is positive, then the study estimates a long run "levels model', as well as a separate "unrestricted" ECM.

4. Results and Discussions
4.1 Unit root test
Prior to investigating co-integration, researchers effect unit root test on the series under study to examine the stationarity properties of time series variables. The conventional method of Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) unit root tests were adopted to ascertain the stationarity properties of the study variables. The results of the ADF and PP unit root tests are presented in table 1.

Table 1: Augmented dickey fuller and phillips-perron tests for unit root with constant

Variables	ADF test statistic	Prob. Value	Order of Integration	PP test Statistic	Prob. Value	Order of Integration	Remarks
GFCF	-5.5151	0.0000***	I(1)	-12.0046	0.0000***	I(1)	S
LogPPT	-4.7956	0.0000***	I(1)	-5.8202	0.0000***	I(1)	S
LogCIT	-6.7949	0.0000***	I(1)	-6.6363	0.0000***	I(1)	S
LogPIT	-6.4892	0.0000***	I(1)	-6.4381	0.0000***	I(1)	S
LogVAT	-4.0145	0.0055***	I(0)	-4.0145	0.0055***	I(0)	S
LogCED	-6.0569	0.0000***	I(1)	-6.0568	0.0000***	I(1)	S
INTR	-3.7015	0.0083***	I(0)	-7.7198	0.0000***	I(1)	S
SMC	-2.9734	0.0471**	I(0)	-3.9609	0.0042***	I(1)	S
FDI	-3.6645	0.0000***	I(0)	-12.7211	0.0000***	I(0)	S

Source: Author's computation from E-views 9.5. Note: (*) significant at the 10%, (**) significant at the 5%, (***) significant at the 1% and S = stationary.

Table 1 indicated that VAT, INTR, SMC and FDI are stationary at levels with constant only while the other variables were stationary only after first difference. The PP test results showed that VAT and FDI were stationary at levels with the others achieving stationarity only after first difference. The variables included in the model are thus a mixture of I(1) and I(0) series, therefore necessitating the need for the ARDL bound testing technique to co-integration.

4.3 Bounds test to co-integration
The bounds test results and the estimated F-statistic displayed in table 3 indicates the presence of a long run relationship amongst the variables. The decision rule is based on the F-statistics (7.204803) that is above the upper bound critical values of 4.1, 3.39 and 3.06 at 1%, 5% and 10% level respectively. As such we reject the null hypothesis of no long run relationship and conclude that a long run relationship exists between the study variables.

Table 3: ARDL Bounds Test Results

Test Statistic	Critical Value	Significance Level	I(0	I(1)
F- Statistics	7.204803	1%	2..79	4.1
K	8	2.5%	2.48	3.70
		5%	2.22	3.39
		10%	1.95	3.06

Source: Author's Computation using E-views 10

4.4 Estimation results of long and short-run elasticities
Having established the presence of a long run relationship between the variables in the model, we therefore proceed to estimate the long and short run co-integrating relationship and the results obtained are tabulated in table 4. The long run results demonstrate that Personal Income Tax has a long run positive effect on domestic investment and is significant at 10%. In other words, an increase in PIT is expected to increase domestic investment in Nigeria ceteris paribus. The result is in line with Nwokoye & Rolle (2015) [11], Adejare & Usman (2017) who established a significant positive

relationship between PIT and GFCF. The results further portray a negative long run relationship between Value Added Tax and domestic investment that is significant at 10% level. This implies that an increase in VAT is expected to decrease domestic investment in Nigeria ceteris paribus. This is in line with Jeza *et al.* (2016) [9], Edame & Okoi (2014) [5] and Vartia (2006) who reported that investment respond negatively to an increase in personal income tax and company income tax rate. Petroleum Profit Tax, Company Income Tax, Customs and Excise Duties all displayed signs of negative effect on domestic investment that were not statistically significant because of the high rate of these taxes and the multiplicity of taxes in the Nigerian fiscal landscape.

Table 4: Long run co-integration results

Variables	Coefficients	Std. Error	t-Statistic	Probability
LogPPT	-0.078004	0.356581	-0.218755	0.8323
LogCIT	-0.606922	2.112266	-0.287332	0.7812
LogPIT	1.178925	0.620971	1.898518	0.0942
LogVAT	-5.607889	2.891354	-1.939537	0.0884
LogCED	-1.922588	1.212701	-1.585378	0.1515
INTR	-0.113460	0.051799	-2.190394	0.0599
SMC	0.199377	0.041572	4.795940	0.0014
FDI	-1.878089	0.716062	-2.622804	0.0305

R^2 = 0.994691, F-Statistic=107.0667 Prob(F-Statistic) = 0.000000 DW stat = 3.316802
***Source*:** Author's Computation using E-Views 9.5

The results also parade a significant influence of all the control variables on domestic investment. Foreign Direct Investment inflow and Nominal Interest Rate show signs of a negative influence on domestic investment and were significant at 1% and 10% respectively. These evidences are in line with Adekunle & Aderemi (2012) [1], Victor Dickson (2013) who found a significant negative impact of INTR and FDI on GFCF. Lower interest rate induces economic agents to undertake investment activities while FDI show evidence of displacing or crowding-out domestic investment in Nigeria. Stock Market Capitalization exhibited a positive effect on domestic investment that was significant at 1% level. The results of the short run dynamic coefficients are contained in table 5.

Table 5: Short run co-integration results

Variable	Coefficient	Std. Error	t-Statistic	Probability
D(LogPPT)	-0.276961	0.471080	-0.587927	0.5728
D(LogCIT)	4.573313	1.589847	2.876574	0.0206
D(LogPIT)	1.945049	0.565409	3.440077	0.0088
D(LogVAT)	-3.103351	1.697475	-1.828217	0.1049
D(LogCED)	-3.213646	1.028618	-3.124238	0.0141
D(INTR)	-0.472992	0.062427	-7.576749	0.0001
D(SMC)	0.047992	0.026449	1.814512	0.1071
D(FDI)	-1.279046	0330562	-3.869306	0.0047
Constant	195.803798	19.717838	9.930267	0.0000
CointEq(-1)	-1.710143	0.172183	-9.932108	0.0000

***Source*:** Author's computation using E-Views 9.5

The short run dynamic results show that Personal Income and Company Income Tax have a positive short run impact on domestic investment and were significant at 1% and 5% level respectively while Customs and Excise Duties exhibited a negative impact on domestic investment that was significant at 1% level. For the control variables, Nominal Interest Rate and Foreign Direct Investment show evidences of a negative short run effect on domestic investment and are both significant at 1% level. The coefficient of the ECM (-1), that is, the co-integration equation (CointEq) is -1.710143 and affirms the existence of a long run relationship among the variables. The coefficient of co-integration Equation (cointEq -1) which shows the speed of adjustment indicate that it takes 1.71 years to correct the short run deviations from long run equilibrium. This indicates a 1.71 years degree of convergence with the long run equilibrium.

4.5 Short-run econometric diagnostics tests
The results of the short-run diagnostics test are contained in table 6. The Breusch-Godfrey Serial Correlation LM test with a p-value of the F-statistic of 0.7228 which is greater than 0.05 implies that there is no serial correlation in the residuals of the model. The Breusch-Pagan-Godfrey test with a p-values of the F-statistic of 0.6826 which is greater than 0.05 indicates that our model does not suffer from heteroscedasticity. The results of the Jarque-Bera test shows that the p-value of 0.527771 is greater than 0.05 which implies that the residuals are normally distributed. An inspection of the CUSUM and the CUSUMSQ graphs (Figures 1 and 2) from the recursive estimate of the model reveals that there is stability and no systematic change is detected in the coefficient at 5% significant level. We therefore conclude that this model is well specified as it passes both the residual and stability diagnostic tests.

Table 6: Short-run Diagnostics Tests Results

Test	Null Hypothesis	F-Statistic	Prob. Value
Breusch Godfrey	No Serial Auto-correlation	0.507967	0.7228
Breusch-Pagan-Godfrey	No Heteroskedasticity	0.734729	0.6826
Jarque-Bera	There is Normal Distribution	1.278185	0.527771

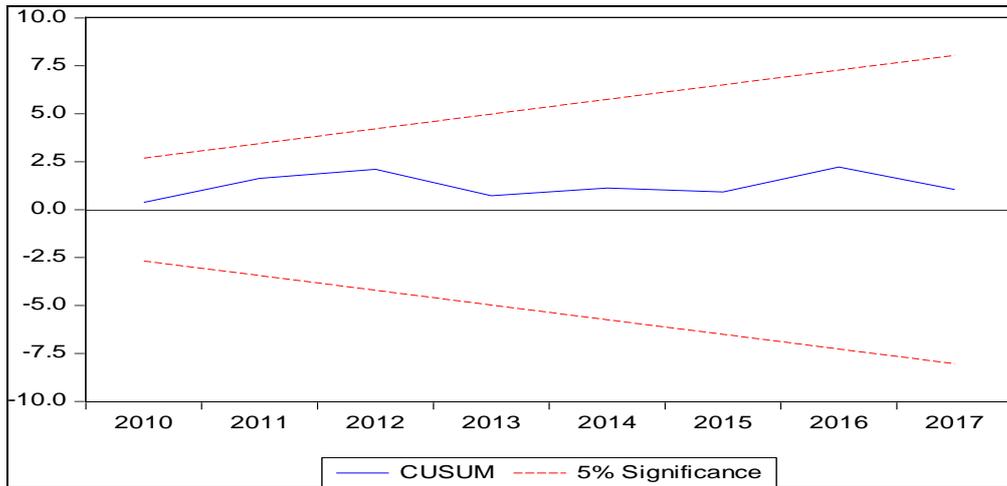*Source*: Author's Computation using E-Views 10.
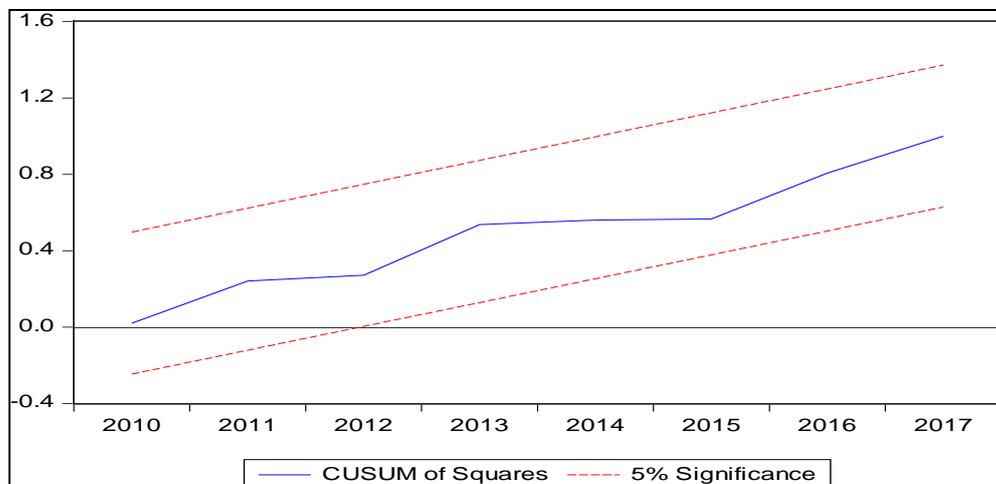

Fig 1: Stability Test, (CUSUM)

Fig 2: Stability Test (CUSUM of Squares)

5. Conclusion and Recommendations

The objective of this study was to empirically investigate the impact of tax revenue shocks on domestic investment in Nigeria using time series data for the period 1980-2017. The ARDL bounds test results recognized the existence of a long run relationship between tax revenue and domestic investment in Nigeria in the study period. The empirical results confirmed that Personal Income Tax have a significant positive effect on domestic investment both in the short and long run, Value Added Tax has a negative impact on domestic investment in the long run only. Company Income Tax has a positive influence on domestic investment in the short run only while Customs and Excise Duties has a negative short run impact on domestic investment. For the control variables included in the model, Nominal Interest Rate and Foreign Direct Investment both parade evidence of a significant negative impact on domestic investment in both the short and long run while Stock Market Capitalization displayed evidence of a positive effect on domestic investment in the long run only.

The coefficient of co-integration equation revealed that it takes 1.71 years to correct the short run deviations from long run equilibrium.

The findings of this study have implications for the government and the public. With increasing globalisation, the importance of optimally designed growth-friendly taxation policies has been emphasized by the enhanced international mobility of capital in search of lower tax burden and modest production cost to ensure competitiveness. Lower corporate tax serves as an incentive for investors to invest, create jobs and employees pay personal income tax from their earnings. However, lower corporate tax is not enough to promote investment. Businesses are more interested in policy stability, availability of social and physical infrastructure and the creation of a conducive business environment. The study therefore recommends the provision of basic social and infrastructural facilities to reduce the cost of doing business in Nigeria, better mobilization of domestic savings and the accessibility of such funds by domestic investors at single

digit interest rate, reorganization of the tax system to effectively address the problem of multiple taxation and high company income tax rate, political and macroeconomic stability that gives investors a certain level of predictability to be able to assess risks and determine what to invest in and creating an enabling environment for businesses that guarantee security of lives, property and investment.

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