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TAX INCENTIVES: TOOL FOR ATRRACTING FOREIGN DIRECT INVESTMENT IN NIGERIAN ECONOMY

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ABSTRACT

Globalization is knitting separate national economies into a single world economy. That is occurring as a result of rising trade and investment flows, greater labour mobility, and rapid transfers of technology. As economic integration increases, individuals and businesses gain greater freedom to take advantage of foreign economic opportunities. That, in turn, increases the sensitivity of investment and location decisions to taxation. Countries feel pressure to reduce tax rates to avoid driving away their tax bases. International "tax competition" is increasing as capital and labour mobility rises. Most countries in West Africa have pursued tax reforms to ensure that their economies remain attractive for investment. Having limited economic options the countries in the region have made tax competition a central part of their development strategy to attract and retain the companies in their countries. This paper reviews the debate about the effectiveness of tax incentives, examining two most-contested questions: Can tax incentives attract foreign investment? And what are the costs of using them?

KEYWORDS
Tax Incentives, Foreign Direct Investment, Development

INTRODUCTION

An agreed framework definition of foreign direct investment (FDI) exists in the literature. That is, FDI is an investment made to acquire a lasting management interest (normally 10% of voting stock) in a business enterprise operating in a country other than that of the investor defined according to residency (World Bank, 1996). Such investments may take the form of either "greenfield" investment (also called "mortar and brick" investment) or merger and acquisition (M&A), which entails the acquisition of existing interest rather than new investment. In corporate governance, ownership of at least 10% of the ordinary shares or voting stock is the criterion for the existence of a direct investment relationship. Ownership of less than 10% is recorded as portfolio investment. FDI comprises not only merger and acquisition and new investment, but also reinvested earnings, loans and similar capital transfer between parent companies and their affiliates. Countries could be both host to FDI projects in their own country and a participant in investment projects in other counties. A country's inward FDI position is made up of the hosted FDI projects, while outward FDI comprises those investment projects owned abroad. One of the most salient features of today's globalization drive is conscious encouragement of cross-border investments, especially by transnational corporations and firms (TNCs). Many countries and continents (especially developing) now see attracting FDI as an important element in their strategy for economic development. This is most probably because FDI is seen as an amalgamation of capital, technology, marketing and management.

THE CONCEPT OF FOREIGN DIRECT INVESTMENT

Renewed research interest in FDI stems from the change of perspectives among policy makers from "hostility" to "conscious encouragement", especially among developing countries. FDI had been seen as "parasitic" and retarding the development of domestic industries for export promotion until recently. However, Bende- Nabende, Ford and Slater (2002) submit that the wide externalities in respect of technology transfers, the development of human capital and the opening up of the economy to international forces, among other factors, have served to change the former image. Caves (1996) observes that the rationale for increased efforts to attract more FDI stems from the belief that FDI has several positive effects. Among these are productivity gains, technology transfers, the introduction of new processes, managerial skills and technical know-how in the domestic market, employee training, international production networks, and access to markets. Borensztein et al. (1998) see FDI as an important vehicle for the transfer of technology, contributing to growth in larger measure than domestic investment.

Findlay (1978) postulates that FDI increases the rate of technical progress in the host country through a "contagion" effect from the more advanced technology, management and practices used by foreign firms. On the basis of these assertions governments have often provided special incentives to foreign firms to set up companies in their countries. Carkovic and Levine (2002) note that the economic rationale for offering special incentives to attract FDI frequently derives from the belief that foreign investment produces externalities in the form of technology transfers and spillovers.

Curiously, the empirical evidence of these benefits both at the firm level and at the national level remains ambiguous. De Gregorio (2003), while contributing to the debate on the importance of FDI, notes that it may allow a country to bring in technologies and knowledge that are not readily available to domestic investors, and in this way increases productivity growth throughout the economy. FDI may also bring in expertise that the country does not possess, and foreign investors may have access to global markets.

Blomstrom et al. (1994) report that FDI exerts a positive effect on economic growth, but that there seems to be a threshold level of income above which FDI has positive effect on economic growth and below which it does not. The explanation was that only those countries that have reached a certain income level can absorb new technologies and benefit from technology diffusion, and thus reap the extra advantages that FDI can offer. Previous works suggest human capital as one of the reasons for the differential response to FDI at different levels of income. This is because it takes a well-educated population to understand and spread the benefits of new innovations to the whole economy. Borensztein et al. (1998) also found that the interaction of FDI and human capital had important effect on economic growth, and suggest that the differences in the technological absorptive ability may explain the variation in growth effects of FDI across countries. They suggest further that countries may need a minimum threshold stock of human capital in order to experience positive effects of FDI.

Balasubramanyan et al. (1996) report positive interaction between human capital and FDI. They had earlier found significant results supporting the assumption that FDI is more important for economic growth in export-promoting than import-substituting countries. This implies that the impact of FDI varies across countries and that trade policy can affect the role of FDI in economic growth. On its part, UNCTAD (1999) submits that FDI has either a positive or negative impact on output depending on the variables that are entered alongside it in the test equation. These variables include the initial per capita Gross Domestic Product (GDP), education attainment, domestic investment ratio, political instability, terms of trade, black market exchange rate premiums, and the state of financial development. Examining other variables that could explain the interaction between FDI and growth, Olofsdotter (1998) submits that the beneficiary effects of FDI are stronger in those countries with a higher level of institutional capability. He therefore emphasized the importance of bureaucratic efficiency in enabling FDI effects. The neoclassical economists argue that FDI influences economic growth by increasing the amount of capital per person. However, because of diminishing returns to capital, it does not influence long-run economic growth. Bengos and Sanchez-Robles (2003) assert that even though FDI is positively correlated with economic growth, host countries require minimum human capital, economic stability and liberalized markets in order to benefit from long-term FDI inflows.

FDI could be beneficial in the short term but not in the long term. Durham (2004), for example, failed to establish a positive relationship between FDI and growth, but instead suggests that the effects of FDI are contingent on the "absorptive capability" of host countries. Other than the capital augmenting element, some economists see FDI as having a direct impact on trade in goods and services (Markussen and Vernables, 1998). Trade theory expects FDI inflows to result in improved competitiveness of host countries' exports (Blomstrom and Kokko, 1998). The pace of technological change in the economy as a whole will depend on the innovative and social capabilities of the host country, together with the absorptive capacity of other enterprises in the country (Carkovic and Levine, 2002).

TAX INCENTIVES

Tax incentives are part of the tax system of developing countries and usually established by governments in order to grant foreign investors more attractive conditions to invest in their country. To achieve the gains of tax incentives for national development, developing countries must structure tax policies in a way so as to attract foreign investment, without creating a negative impact in the domestic economy and do not fall into a harmful tax competition against other countries.

WHAT FIRMS RESPOND?

The effectiveness of tax incentives is likely to vary depending on a firm's activity and its motivations for investing abroad. Growing evidence shows, for example, that tax incentives are a crucial factor for mobile firms and firms operating in multiple markets—such as banks, insurance companies, and Internet-related businesses— because these firms can better exploit different tax regimes across countries. Such strategies may explain the success of tax havens in attracting subsidiaries of global companies—and the spending by multinationals on economists and accountants to justify their transfer prices, designed to suit their tax needs. Similarly, tax rates generally have a greater effect on the investment decisions of export-oriented companies than on those seeking the domestic market or location-specific advantages, because such firms not only are more mobile but also operate in competitive markets with very slim margins.

The Nigerian Government has put in place a number of investment incentives for the stimulation of private sector investment from within and outside the country. While some of these incentives cover all sectors, other are limited to some specific sectors. The nature and application of these incentives have been considerably simplified. The incentives include: tax holidays, initial capital allowance, and free duty on equipment. (See Table 1 below)

TABLE 1: TAX INCENTIVES IN NIGERIA

Incentives	Oil and Gas	Agriculture	Solid Minerals	Energy	Telecommunication	Transport
Tax Holiday	5-7 Years	5-7 Years	5-7 Years	5-7 Years	5-7 Years	5-7 Years
Initial Capital Allowance	15%	100%	20%		30%	30%
Income Tax	30%	30%	20-30%	30%	30%	30%
Duty (Equipment)	Free	Free	Free	Free	Free	Free
VAT (Equipment)	Free	Free	Free	Free	Free	Free

Repayment of Foreign Loan (Tax Exempt) 5-7 Years 7 Years and above	70% 100%	70% 100%	70% 100%	70% 100%	70% 100%	70% 100%

SOURCE: NIPC (2009)

FACTS ABOUT FDI IN NIGERIA

Indeed, Sub-Saharan Africa (SSA) have not benefited much from the Foreign Direct Investment (FDI) boom for many reasons, ranging from negative image of the region, to poor infrastructure, corruption and foreign exchange shortages, an unfriendly macroeconomic policy environment, among others (Asiedu, 2005).

Nigeria is one of the few countries that have consistently benefited from the FDI inflow to Africa as reflected in Table 2. Nigeria's share of FDI inflow to Africa averaged around 20%, from 21.43% in 2000 to a low level of 13.02% in 2005, up to 24.45% in 2006. UNCTAD (2009) showed Nigeria as the continent's top FDI recipient.

TABLE 2: NIGERIA: NET FOREIGN DIRECT INVESTMENT INFLOW (US$ MILLION)

Year	World	Africa	% of World	Nigeria	% of Africa
1990-2000 (Annual Average)	492674	6890	1.39	1477	21.43
2005	973329	38222	3.92	4978	13.02
2006	1461074	57058	3.90	13956	24.45
2007	1978838	69170	3.49	12454	18.00
2008	1697353	87647	5.16	20279	23.13

SOURCE: UNCTAD (2009) FOREIGN DIRECT INVESTMENT DATABASE

Nigeria's vast oil and gas resources have proven a magnet for foreign investors, especially in times of rising oil prices. Though its accumulated stock of FDI is lower than Chile, Nigeria has experienced higher FDI inflows during the past five years, driven by a rising global demand for hydrocarbons. Given the prominence of the oil industry in Nigeria, the main source countries for FDI inflows are those that are host countries of the major oil Multinational Companies (MNC). The leading source country for FDI is the US through oil majors Chevron Texaco and ExxonMobil. The Netherlands through Shell, France through Total and Italy through ENI are the other leading investors in Nigeria. South Africa is the fifth largest source country. Apart from oil, other important destinations for foreign investors in Nigeria are the telecommunications, food and beverages and rubber product industries.

TABLE 3: INWARD FOREIGN DIRECT INVESTMENT IN G-15 COUNTRIES

	FDI Inward Stocks (2008)		**FDI Inflows ($Billions)**					
	($Billions)	**As % of GDP**	**2004**	**2005**	**2006**	**2007**	**2008**	Total **(2004-2008)**
Algeria	14.46	9.1	.88	1.08	1.79	1.66	2.64	8.05
Argentina	76.09	23	4.12	5.26	5.53	6.47	8.85	30.23
Brazil	287.70	18.3	18.14	15.06	18.82	34.58	45.05	131.65
Chile	100.99	59.6	7.17	6.98	7.29	12.57	16.78	50.79
Egypt	60.00	37	2.15	5.37	10.04	11.57	9.49	38.62
India	123.29	9.9	5.77	7.60	20.33	25.12	41.55	100.37
Indonesia	67.04	13.1	1.89	8.33	4.91	6.92	7.91	29.96
Iran	20.81	6	2.86	3.13	1.62	1.65	1.49	10.75
Jamaica	9.46	65.7	.60	.68	.88	.86	.78	3.80
Kenya	1.99	6.6	.04	.02	.05	.72	.09	.92
Malaysia	73.26	33	4.62	4.06	6.06	8.40	8.05	31.19
Mexico	294.68	27.1	23.65	21.92	19.31	27.27	21.95	114.10
Nigeria	83.07	29.5	2.12	4.97	13.95	12.45	20.27	53.76
Senegal	1.54	11.6	.07	.04	.22	.29	.70	1.32
Sri Lanka	4.28	4.28	.23	.27	.48	.60	.75	2.33
Venezuela	41.38	13	1.48	2.58	-.59	.64	1.71	5.82
Zimbabwe	1.54	70.4	.01	.10	.04	.06	.05	.26

SOURCE: WIR tables (UNCTAD, 2009)

INWARD FOREIGN DIRECT INVESTMENT IN GROUP OF FIFTEEN (G-15) COUNTRIES

Table 3 above shows the inward stock of FDI in G-15 countries as it stood in 2008. It shows that 13 out of 17 member countries have accumulated foreign investment of more than $10 billion. The top 10 G-15 countries in terms of FDI stock were (1) Mexico (2) Brazil (3) India (4) Chile, (5) Nigeria (6) Argentina (7) Malaysia (8) Indonesia (9) Egypt and (10) Venezuela. Table 3 also shows FDI inflows for five years from 2004-

2008. In terms of recent inflows, the top 10 G-15 recipients of foreign investments are (1) Brazil (2) Mexico (3) India (4) Nigeria (5) Chile (6) Egypt (7) Malaysia (8) Argentina (9) Indonesia (10) Iran.

A comparison of the stock and flow figures reveals a few interesting facts. Foreign investment in recent times has risen rapidly in Brazil and India (two of the so-called BRIC economies) and also in Nigeria and Egypt (driven probably by a combination of high oil and gas demand as well as economic reforms). By contrast, Mexico, Malaysia and Indonesia, have seen foreign investment flows fluctuating from year to year. The rate of growth of FDI in Chile and Argentina too has been relatively lower.

Prior to the early 1970s, foreign investment played a major role in the Nigerian economy. Until 1972, for example, much of the non-agricultural sector was controlled by large foreign owned trading companies that had a monopoly on the distribution of imported goods. Between 1963 and 1972 an average of 65% of total capital was in foreign hands (Jerome and Ogunkola, 2004).

The Nigeria Enterprise Promotion Decree (NEPD) was promulgated in 1972 to limit foreign equity participation in manufacturing and commercial sectors to a maximum of 60%. In 1977 a second indigenization decree was promulgated to further limit foreign equity participation in Nigeria business to 40%. Hence, between 1972 and 1995 official policy toward FDI was restrictive. The regulatory environment discouraged foreign participation resulting in an average flow of only 0.79% of GDP from 1973 to 1988 (Ayanwale, 2007). The adoption of the structural adjustment programme in 1986 initiated the process of termination of the hostile policies towards FDI. A new industrial policy was introduced in 1989 with the debt to equity conversion scheme as a component of portfolio investment. The Industrial Development Coordinating Committee (IDCC) was established in 1988 as a one-step agency for facilitating and attracting foreign investment flow.

This was followed in 1995 by the repeal of the Nigeria Enterprises Promotion Decree and its replacement with the Nigerian Investment Promotion Commission (NIPC) Decree 16 of 1995. The NIPC absorbed and replaced the IDCC and provided for a foreign investor to set up a business in Nigeria with 100% ownership. Upon provision of relevant documents, NIPC will approve the application within 14 days (as opposed to four weeks under IDCC) or advise the applicant otherwise. Furthermore, in consonance with the NIPC decree, the Foreign Exchange (Monitoring and Miscellaneous Provision) Decree 17 of 1995 was promulgated to enable foreigners to invest in enterprise in Nigeria or in money-market instruments with foreign capital that is legally brought into the country. The decree permits free regulation of dividends accruing from such investment or of capital in event of sale or liquidation. An export processing zone (EPZ) scheme adopted in 1999 allows interested persons to set up industries and businesses within demarcated zones, particularly with the objective of exporting the goods and services manufactured or produced within the zone.

SECTORAL ANALYSIS OF FOREIGN DIRECT INVESTMENT INFLOW IN NIGERIA

Agriculture, transport, building and construction remained the least attractive hosts of FDI in Nigeria if the report from the privatization programme is anything to go by (CBN, 2004). However, the transport and communication sector seem to have succeeded in attracting the interest of foreign investors, especially the telecommunication sector. Nigeria is currently described as the fastest growing mobile phone market in the world. Since 2001, when the mobile telecommunication operators were licensed, the rate of subscription has gone up and does not show any sign of abating; in fact, MTN (Nigeria) – the leading mobile phone operator – has acquired another line having oversubscribed the original line. The three major operators – MTN, Zain, and Globacom – are currently engaged in neck and neck competition that has forced the rates down and in the process fostered consumer satisfaction. But the effect of this development is yet to be translated to the rest of the economy. FDI in Nigeria has traditionally been concentrated in the extractive industries, but data reveal a diminishing attention to the mining and quarrying sector, from about 51% in 1970–1974 to 30.7% in 2000/01 (Ayanwale, 2007). The current sustained upward trend in the FDI inflow is due largely to the privatization and commercialization exercise of the government whereby public enterprises are put up for sale to the investing public. This exercise has attracted considerable inflows since 1999. For example, the deregulation of the telecommunication sector by granting licenses and tax holidays for global system for mobile communications (GSM) operators in 1999 caused the FDI in the telecommunications sector to increase from a mere US$50 million at the end of 1999 to about US$12.5 billion by the end of 2008 ((NCC 2009). The NIPC attributed over 75% of this increase to mobile telephone network investors.

ADVANTAGES OF TAX INCENTIVES

If properly designed and implemented, tax incentives may be a useful tool in attracting investments that would not have been made without the provision of tax benefits. As discussed below, new investment may bring substantial benefits, some of which are not easily quantifiable. A narrowly targeted tax incentive program may be successful in attracting specific projects or specific types of investors. That governments often choose tax incentives over other types of government action is not surprising. It is much easier to provide tax benefits than to correct deficiencies in the legal system or to dramatically improve the communications system in the country. Also, tax incentives do not require an actual expenditure of funds by the government. One alternative to using tax incentives is to provide for grants or cash subsidies to investors. Although tax incentives and cash grants may be similar economically, for political and other reasons, it is easier to provide tax benefits than to actually provide funds to investors.

DIFFERENT TYPES OF BENEFITS

Tax incentives may yield different type of benefits. The benefits from tax incentives for foreign investment follow the traditional list of benefits resulting from foreign direct investment; these include increased capital transfers, transfers of know-how and technology, increased employment, and assistance in improving conditions in less-developed areas. Foreign direct investment may generate substantial spillover effects. For example, the choice to locate a large manufacturing facility will not only result in increased investment and employment in that facility, but also at firms that supply and distribute the products from that facility. Economic growth will increase the spending power of the country's residents - that, intern, will increase demand for new goods and services. Increased investment may also increase government tax revenue either directly from taxes paid by the investor (for example, after the expiration of the tax holiday period) or indirectly through increased tax revenues received from employees, suppliers, and consumers.

One can provide a general description of the general type of benefits of additional investment resulting from tax incentives. It is difficult, however, to estimate the benefits resulting from tax incentives with any degree of certainty. Sometimes the benefits are hard to quantify. Other times the benefit accrues to persons other than the firm receiving the tax benefits.

DISADVANTAGES OF TAX INCENTIVES

DIFFERENT TYPES OF COSTS

In considering the costs of tax incentive regime, it may be useful to examine four different types of costs: (i) revenue costs; (ii) resource allocation costs; (iii) enforcement and compliance costs; and (iv) the costs associated with the corruption and lack of transparency.

REVENUE COSTS

The tax revenue losses from tax incentives come from two primary sources: first, foregone revenue from projects that would have been undertaken even if the investor did not receive any tax incentives; and, second, lost revenue from investors and activities that improperly claim incentives or shift income from related taxable firms to those firms qualifying for favorable tax treatment (Alex and Zolt, 2005).

Policy makers may wish to target tax incentives to achieve the greatest possible benefits for the lowest costs. The goal would be to offer tax incentives only to those investors who at the margin would invest elsewhere but for the tax incentives. Offering tax incentives to those investors' whose decisions to invest are not affected by the proposed tax benefit results in just a transfer to the investor from the host government without any gain. It is very difficult to determine on a project-by-project basis which projects were undertaken solely due to tax incentives. Similarly, it is hard to estimate for an economy as a whole what the levels of investment would be with or without a tax incentive regime.

For those projects that really would not have been undertaken without tax incentives, there is no real loss of tax revenue from those firms. Indeed, to the extent that the firms become regular taxpayers or to the extent that these operations generate other tax revenue (such as increased profits from suppliers or increased wage taxes from employees) there are revenue gains from those projects. An additional revenue cost of tax incentives results from erosion of the revenue base due to taxpayers abusing the tax incentive regimes to avoid paying taxes on non-qualifying activities or income. This can take many forms. Revenue losses can result where taxpayers disguise their operations to qualify for tax benefits. For example, if tax incentives are only available to foreign investors, local firms or individuals can use foreign corporations through which to route their local investments. Similarly, if tax benefits are available to only new firms, then taxpayers can reincorporate or set up many new related corporations to be treated as a new taxpayer under the tax incentive regime.

Other leakages occur where taxpayers use tax incentives to reduce the tax liability from non-qualified activities. For example, assume that a firm qualifies for a tax holiday because it is engaged in a type of activity that the government believes merits tax incentives. It may be difficult to monitor the firm's operation to ensure the firm does not engage in additional non-qualifying activities. Even where the activities are separated, it is very difficult to monitor related party transactions to make sure that income is not shifted from a taxable firm to a related firm that qualifies for a tax holiday (Alex and Zolt, 2005).

RESOURCE ALLOCATION COST

If tax incentives are successful, they will cause additional investment in sectors, regions or countries that would not otherwise have occurred. Sometimes this additional investment will correct for market failures. Other times, however, the tax incentives will cause allocation of resources that may result in too much investment in certain activities or too little investment in other non-tax favoured areas. It is difficult to determine the effects of tax provisions in developed countries where markets are relatively developed. It is more difficult to determine the consequences of tax provisions in developing countries where markets do not approach the competitive models. As such, where markets are imperfect, it is not clear whether providing tax incentives to correct market imperfections will make markets more competitive.

ENFORCEMENT AND COMPLIANCE COSTS

As with any tax provision, there are resource costs incurred by the government in enforcing the tax rules and by taxpayers in complying. The cost of enforcement relates to the initial grant of the incentive as well as the costs incurred in monitoring compliance with the qualification requirements and enforcing any recapture provisions on the termination or failure to continue to qualify.

The greater the complexity of the tax incentive regime, the higher the enforcement costs (as well as compliance costs) may be. Similarly, tax incentive schemes that have many beneficiaries are harder to enforce than narrowly targeted regimes. It is also difficult to get revenue authorities enthusiastic about spending resources to monitor tax incentive schemes. Revenue authorities seek to use their limited administrative resources to improve tax collection. The revenue authorities may prefer auditing fully taxable firms rather than those operating under a tax holiday arrangement. Tax incentives also impose administrative costs on taxpayers. The administrative costs will vary by type of incentive as well as the qualification process, monitoring and reporting requirements (Alex and Zolt, 2005).

OTHER COSTS

Since tax policy appears to have some effect on the location decisions of multinational firms, especially within regional markets, the concern is that countries may end up in a bidding war, favouring multinational firms at the expense of the state and the welfare of its citizens. Beyond the risk of a bidding war, tax incentives are likely to reduce fiscal revenue and create frequent opportunities for illicit behavior by companies and tax administrators. These issues have become crucial in developing countries, which face more severe budgetary constraints and corruption than do industrial countries. Tax incentives also have many other, less obvious costs. They can distort the allocation of resources by attracting investors looking exclusively for short term profits, especially in countries where the basic fundamentals (such as political and macroeconomic stability) are not yet in place.

CONCLUSION AND RECOMMENDATIONS

Tax incentives can play a useful role in encouraging both domestic and foreign investment. How useful, and at what cost, depends on how well the tax incentive programmes are designed, implemented, and monitored. Despite the fact that tax incentives are sometimes very attractive to investors, there are other factors that need to be addressed before implementing tax incentive provisions. Developing countries must first provide a safe investment climate; political and social stability; transparent, stable and predictable conditions; reduction of corruption; and a reliable legal structure and framework in order to provide guarantees to foreign investors along with other economic and tax benefits.

Harmful tax competition and many other negative consequences such as lower tax rates, the proliferation of tax havens, the erosion of the tax base and the distortion of the tax system in developing countries arise from the implementation of tax incentives and other benefits granted to attract more foreign investment. No easy answers exist to the questions of whether to use tax incentives and what form these tax incentives should take. There are, however, some clear guidelines that may improve the chances of success of tax incentive programs. First, the objectives of the tax incentive program should be clearly set forth. Second, the type of tax incentive program should be crafted to best fit the objective. Third, the government should estimate the anticipated costs and benefits of the incentive program in a manner similar to other types of tax expenditure analysis. Fourth, the incentive program should be designed to minimize the opportunities for corruption in the granting of incentive and for taxpayer abuse in exploiting the tax benefit. Fifth, the tax incentive regime should have a definite "sunset" provision to allow for a determination of the merits of the program. Finally, the government should be required at a specific time to assess the success and failure of each incentive program

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