

## **Re-Investment Allowance, Investment Tax Credit, and the Reality of Corporate Cash Flow in Nigeria**

John Ohaka PhD<sup>1</sup>, Daibi W Dagogo PhD<sup>2</sup>.

*Department of Accountancy Rivers State University of Science and Technology, Port Harcourt Nigeria*

*Department of Banking and Finance Rivers State University of Science and Technology, Port Harcourt Nigeria*

---

**Abstract:** *This study examines the influences of tax incentives on cash flow of manufacturing corporations in Nigeria. To do this, research questions were raised, hypotheses were formulated, sixty (60) quoted manufacturing companies in Nigeria constituted the sample of this study and secondary data from Nigeria Stock Exchange fact book were complemented with ordinal data collected via questionnaire. The stated hypotheses were statistically tested with paired t-test of two means from the same sample. T-test was eventually used because of the ordinal data, which might not satisfy the condition of normal distribution. Our findings revealed that tax incentives significantly increased the mean cash flows from financing, investing and operating activities of Nigerian manufacturing corporations. It was therefore recommended that Nigerian government should provide adequate tax incentives for manufacturers in Nigeria, if vision of becoming one of the top twenty nations by the year 2020 must be realized.*

**Keywords:** *Fiscal policy, Tax Incentives, re-investment allowance, cash flow, investment tax credit*

---

### **I. Introduction**

The need to grow the private sector has often received significant attention in Nigeria's development agenda by succeeding administrations in the past forty years. The principal policy instruments in the pursuance of this objective have always been through fiscal and monetary policies. With fiscal policy, the key policy tool to drive this agenda as contained in the nation's specific national policy documents is the granting of tax incentives, as this strategy has always been an important aspect of Nigeria's industrial policies. This is not peculiar to Nigeria. For instance, in the years following the end of the Second World War, the British government made use of initial investment allowance to influence investment decisions in private firms (Bird, 2000). Remarkably, the proliferation of tax incentive measures in many countries is an evidence of the increasing importance of applying not only fiscal policies but particularly tax incentives in achieving targeted rate of economic growth and restructuring aimed at stimulating a given sector towards a desirable national interest. Tax incentive according to Adedotun (2001) is the reduction in the effective tax burden on the favoured activity as against that currently imposed upon it in the hope that the reduction in government revenue due to tax forgone will be compensated by an expected expansion of the national economy and ultimately by a resulting increase in total revenue from such broadened economic basis. Tax incentive according to Auerbach and Hines (1988), can take the form of a tax holiday, capital allowance, tax payers right of election, re-investment allowance, investment tax credit proportionate to the amount of capital investment, accelerated depreciation or an interest subsidy, export processing zone, etc. In whatever form they are granted, they are supposed to generate more current investments that lead to higher future production. It is therefore advisable to look at the relative merits and demerits of a given incentive base on equity and efficiency. In the face of unfriendly business environment particularly for start-up, and the devastating effect of rapid technological changes today, many manufacturing companies experience highly volatile cash flow situations that predict insolvency. This is in spite of the ongoing incentive schemes available to these manufacturers aimed at dousing both financial and operating risks of doing business in Nigeria. This has led to stagnated performance of many manufacturing companies as observed from key performance indicators such as profitability, cash flow, liquidity, market growth, and employment. Many others have simply collapsed, thus, causing disincentive to invest, and demand for higher return on investment, as is characterized by average return on equity and cost of debt capital. Accordingly, the absence of foreseeable improvement in the indicators listed above even as recently as the reports of 2013 showed a great concern not only to practitioners but also to the academic world, and this reflected in the rise in the number of researches around this area.

In other words, it is time to review the effect of fiscal policy measures on corporate financial performance with particular interest in cash flow. Studies on application of incentive in both developed and developing countries, showing positive results with respect to productivity, growth and other non-financial measures have been articulated by Ola, (1991) Andic, (1998), Dagogo (2014b) and Adedotun,(2001). In Nigeria, in view of the new tax reform policy on incentives, many corporations have decried its dysfunctional nature and argued that it is rather too counter-productive. It therefore represents a dilemma where policy aimed

at improving the lot of manufacturers eventually becomes the woe of the same system it is designed for, while the regulatory bodies acclaim themselves of succeeding tax regime. One therefore wonders why a segment of the economy celebrate the tax reform and another, perhaps a more responsive sector, is drained as a result of the same reform. This paper therefore provides an empirical analysis of the existence of tax incentive dilemma on account of the poor financial performance, with particular interest in cash flow, of manufacturing companies in Nigeria.

## **II. Statement Of Problem**

The major industrial policy strategy that cuts across different industrialization eras and policy instruments has always been investment subsidies involving grants and tax-based incentives. The use of investment subsidies is justified by the existence of market failures in the financial market. Some firms would not have sufficient access to credit to undertake investment projects because of market failures. Moreover, the risk and uncertainty involved in the investment projects may hinder some firms from realizing their projects, especially during periods of economic instability. In addition to failure of information, public goods, incomplete markets, externalities, failure of competition and macroeconomic disturbances tax can cause market failure and may provide the rationale or scope for government intervention for the realization of investment projects (Zee et al, 2002). The investment climate is tensed with multiplicity of taxes imposed by the public sector on the organized private sector. Often, in addition to the prescribed taxes as contained in the constitution of the Federal Republic of Nigeria, there are situation of double taxation and excessive arrogation of power by the local government authorities that breaches normal course of justice. A search through the literature seems to indicate that tax incentives package had no significant impact on the investment and production decision of business firms in Nigeria. As Philips (2004) observed, the list of existing incentive may appear long, but there is likely no evidence of their critical significance in the investment and production decision of business firms in Nigeria. Yet, some writers are of the opinion that tax incentive is an albatross. For instance, Aluko (2001) has argued that the current trend in development planning is to discourage too many tax incentives as it sends wrong signals to the investors who become suspicious of the real intentions of the host country. The questions to be asked here are: why would a country that is in a hurry to develop and progress not collect all the taxes it can and use same to develop infrastructure that makes the country more attractive for more investors? What is the relevance of tax incentives when manufacturing firms still go bust or declare losses in spite of the seeming advantages of tax incentives (Klemm, 2004)? This study finds explanations to these phenomena by examining the influence of tax incentives on cash flow of manufacturing firms in Nigeria.

## **III. Research Questions**

The following specific questions are stated to guide the research process: (a) Is there any significant effect of tax incentive on cash flow from financing activities of Nigerian manufacturing companies? (b) Is there any significant effect of tax incentive on cash flow from investing activities of Nigerian manufacturing companies? (c) Is there any significant effect of tax incentive on cash flow from operating activities of Nigerian manufacturing companies?

## **IV. Literature Review**

### **4.1 Re-investment allowance**

The review begins with the essence of re-investment allowance in corporate tax management. Re-investment allowance is an incentive given to already existing manufacturing companies that incur capital expenditure for purposes of approved expansion of production capacity, modernization of production facilities and diversification into related products. Auerhach and Hines (1988) observed that, re-investment allowance is an allowance available to a company which has been in operation for upward of twelve months and had incurred capital expenditure on a factory, plant or machinery for the purpose of acquiring or retaining qualifying project.

It is aimed at encouraging re-investment of profits. The allowance is available as a percentage of the expenditure incurred on the qualifying projects and its deduction is restricted to a percentage of the statutory income. Suffice to say that the quantum of the deduction varies depending on some pre-conditions to be satisfied. Bird (2000) named these pre-conditions as follows: (1) the activity engaged, (2) the geographical location where the expenditure is incurred, and (3) whether a certain level of production or process efficiency (PE) was achieved. Olatundun (2008) argued that the re-investment allowance is in the form of an allowance involving 60 percent of qualifying capital expenditure incurred by the companies for several years. The allowance can be utilized to offset 70 percent of the statutory income in the year of the assessment. Toaze (2001) observed that in promoted areas, 100 percent of statutory income may be offset. While in non-promoted areas, 100 percent of statutory income can be offset if the company attains a productivity level exceeding the level determined by government. But any unabsorbed allowance may be carried forward to the following years until it is fully utilized. In view of the aforesaid, it is important to note the importance of reinvestment allowance as a dimension of tax incentive is a means of encouraging manufacturing companies to expand and then contribute to the growth of the economy. Other than re-investment allowance, investment tax credit is also one

of the major types of tax incentives offered to investors/companies, we therefore look at this dimensions in the context of this study.

#### **4.2 Investment Tax Credit**

Investment tax credits are earned when qualified buildings or equipments are purchased for use in the firm (Ohaka, & Agundu, 2012; Shah, 2005; Klemm, 2004). The investment tax credits can be applied against federal income tax. Andic (1998) viewed investment tax credit as a tax credit that permits companies or individuals to deduct a specified percentage of certain investment costs from their tax liability in addition to the normal allowances for depreciation. Though, investment tax credits are similar to investment allowance but differ from accelerated depreciation, they were both adopted by US government in 1962 in order to protect domestic businesses from foreign competition but have since been applied toward the support of various forms of desirable economic development. Investment tax credit according to Zee et al (2002) is directed toward new manufacturing plant and equipment purchased for first time use in manufacturing or processing.

He further reiterated that corporations earn 10 percent non-refundable tax credit which can be applied against corporate income tax in Manitoba, Canada, in the year earned with unused credits available for a ten-year carry forward and a three year carry-back. Andic (1998) argued that investment tax credit in the manufacturing firms extends the definition of qualified property to include used building, machinery and equipment as well as new equipments. In spite of this argument, many countries including Nigeria limited the investment tax credits to new equipment and building only, because according to Ougi and Zodrow (2006) investment tax credits are only earned in the year that the property was actually acquired, and only applies to new properties. Suffice to say that properties acquired are eligible at a rate of 10 percent of the capital cost of the properties. It is pertinent to remember that the capital cost of an item must be reduced by grants received on that purchase before calculating investment tax credits. Investment tax credits earned in any particular year must be used to reduce federal income tax due in first year. Any remaining credits can be applied against federal income tax paid in previous years, and then any remaining credit can then be applied against federal tax in future years. For instance, investment tax credit earned in previous year can be carried forward ten years and carried back three years. Bloom et al (2002) posited that failure to use the tax credits within the ten years of earning them will result in the loss of the credits. As such, any unused investment tax credits earned in previous years can be used to reduce federal income, tax for the year, if not enough credit were generated during the current tax year, but credit earned this year are added to unused credits from previous years to create an investment tax credit pool. Auerbach and Hines (1988) concluded that 40 percent of unused investment tax credits generated in a tax year can be claimed in the year that the investment tax credits were actually earned. This incentive is granted for the purpose of enhancing performance of the firm and economic growth.

#### **4.3. Measuring Financial Performance**

According to Ohaka & Agundu (2012) measures of financial performance take a variety of forms. These measures differ from each other on several dimensions, and many issues concern the choice of which particular financial measures to employ. For example, measures may be absolute (profit/sales), return-based (profit/capital, profit/equity), internal (profit/sales), external (market value of the firm), a level for a single period (one year), mean or growth rate or variability (measures of central tendency and dispersion). With the use of mean, deviation or trend, they introduced firm survival as one of the indicators of the effect of tax incentives, which was considered to be a very important stimulus to industrial development (Andic, 1999). This is a simple and effective way of improving the commercial profitability of and cash flow from investments such that incentives are made available to companies within the exemption period. Dagogo (2014a) evaluated seven factor determinants of cash flow to ascertain the most critical of them all. Basically, all were related to tax incentives. Andic (1999) further argued that tax incentives help to increase the profit prospects of a new venture and enables a firm to recover its capital costs more quickly. That notwithstanding, the costs recovered would eventually lead to reduced risks of investment, a quick build-up of the firm's assets and capital for re-investment. Investment tax credit is earned when qualifying new buildings and equipment are purchased by a manufacturing firm. The credit could be used to off-set government tax in the future, thereby reducing the cost of capital and offsetting federal tax. This eventually impacts on the cash flow of the firm that is used to evaluate growth potentials of any organization. Hence, Auerbach and Hines (1988) concluded that tax incentive is granted for the purpose of enhancing business performance of the companies.

From the foregoing above, the following hypotheses, stated in null form, were drawn to elicit the impact of tax incentives in the financial performance of manufacturing firms: (a) There is no significant effect of tax incentive on cash flow from investing activities of Nigerian manufacturing companies (b) There is no significant effect of tax incentive on cash flow from operating activities of Nigerian manufacturing companies (c) There is no significant effect of tax incentive on cash flow from financing activities of Nigerian manufacturing companies Tax incentives are often used to achieve medium term development objectives, which

may also be affected by other factors (Klemm, 2009; Ohaka & Idoniboye, 2010). Thus, without a study of this nature it will be difficult to demonstrate how tax incentive translates into economic growth. Adedokun (2001) argued that ultimately, the benefit of incentives should be assessed in terms of financial performance, as this will culminate in higher investment and growth. Re-investment allowance according to Auerbach and Hines (1988) is the percentage of the expenditure incurred on the qualifying projects. He stressed further that the allowance is aimed at encouraging reinvestment of profits. In support, Toaze (2001) stated that reinvestment allowance could be used to offset 100 percent income of the manufacturing firms. This will eventually help to boost the financial status of the firm and thence increase investment and growth.

### V. Research Methods

The sample of this study consisted of sixty (60) quoted manufacturing companies whose data were retrieved from Nigerian Stock Exchange Fact book of 2013. In addition, ordinal data were collected using structured questionnaire. The questionnaire was a 5-point Likert scale, designed as follows: Strongly Agreed (SA), Agreed (A), Indifferent (I), Disagreed (D), and Strongly Disagreed (DA). In testing the stated hypotheses, the paired test-of-two-means from one sample inferential statistical tool was employed with t-test. This was preferred because the data might not be normally distributed as they are ordinal in nature. The procedure involved the pairing of the pre- and post-tax incentive means of the same 60 manufacturing companies. This simply implied that the sample and sample size remained the same. But we expected to observe changes in the paired means as a result of tax incentives. We further expected that for *t* to be significant, p-value should be less or equal to 0.05, i.e.  $p \leq 0.05$ , and that negative value of *t* implied that pre-tax incentive mean is greater than post tax incentive means, and a positive *t* value implied a greater post tax incentive than pre-tax incentive.

### VI. Empirical Analysis and Results

This section focused on data analysis and results as shown in the tables below.

**Table 1: Paired T-Test of two means from one-sample involving pre and post-tax incentive cash flow from financing activities**

Mean difference	Paired Differences				t	df	Sig.(2-tailed)
	Std. Dev.	S E of mean	95% conf. interval of the difference				
			Lower	Upper			
125.328	167.018	20.217	72.613	159.613	5.584	59	.000

Source SPSS Windows Output

The results presented in table 1 above revealed a t-value of 5.584 and a p-value of 0.000. Since *t* value is positive and the corresponding p-value is less than 0.05, it implied that the mean cash flow from financing activities did not merely or nominally increase among the 60 companies studied during the 2013 tax period, but this increase was also statistically significant at 100 percent level of significance as observed above.

**Table 2: Paired T-Test of two means from one-sample involving pre- and post-tax incentive cash flow from investing activities**

Mean difference	Paired Differences				t	df	Sig.(2-tailed)
	Std. Dev.	S E of mean	95% conf. interval of the difference				
			Lower	Upper			
238.080	618.425	87.516	66.843	403.316	2.849	59	.005

Source SPSS Windows Output

Again, the results shown in table 2 above indicated a t-value of 2.849 and a p-value of 0.005. Similarly, *t* value is positive and the corresponding p-value is less than our benchmark of 0.05. There is strong and significant statistical evidence that the mean cash flow from financing activities rose among the 60 companies studied during the 2013 tax period.

**Table 3: Paired T-Test of two means from one-sample involving pre and post-tax incentive cash flow from operating activities**

Mean difference	Paired Differences				t	df	Sig.(2-tailed)
	Std. Dev.	S E of mean	95% conf. interval of the difference				
			Lower	Upper			
48.170	71019971.3	22.074	405.850	980.657	2.339	59	0.027

Source SPSS Windows Output

Finally, the results contained in table 3 above revealed a t-value of 2.339 and a p-value of 0.027. Since t value is positive and the corresponding p-value is less than 0.05, it implied that the mean cash flow from operating activities was not a notional increase among the 60 companies studied during the 2013 tax period. This increase was also statistically significant at 97.3 percent level of significance as deduced from table 3 above.

### **VII. Discussion Of Findings**

The result of our analysis indicated that tax incentives make a significant difference on financing, investing and operating cash flow activities of Nigerian companies. These findings provide valuable support to existing literature. Andic (1999) asserted that tax incentives not only stimulate investment and economic growth, but also impact the financial performance of firms. Ohaka & Agundu (2012) revealed that capital allowance gives room for firms to lay claims to certain financial cut that could be diversified or used on the firm to enhance productivity that could yield economic growth and financial performance in terms of profitability, return on investment and return on equity. Andic (1999) equally lent credence to these findings. His studies revealed that tax incentive increase the profit prospects of a new venture and enables a firm to recover its capital cost more quickly. Our contribution therefore is our ability to extend previous empirical findings by confirming the effect of tax incentives on cash flow.

### **VIII. Conclusion And Recommendations**

In this study, it was ascertained that tax liabilities on manufacturing firms inhibit their financial performance. In other words, tax incentives are factors that accelerate corporate cash flows. Based on the findings generated from this study, it was concluded that tax incentives create positive and significant difference on corporate cash flow. It is therefore recommended that government should provide adequate tax incentives in the real sector and particularly manufacturing sub-sector if our dream of achieving vision 20 2020 is to be realized.

### **References**

- [1]. Adedotun, P. (2001). Reforming Nigeria's incentives system. Quarterly Journal of Administration (University of Ife), 4 (7) 421-426.
- [2]. Aluko, S.A. (2001). Tax incentives for industrial development in Nigeria. Presented at UN Industrial Organization conference. (Unpublished): 55-60.
- [3]. Andic, A (2005). Fiscal incentives for investment and innovation. Oxford University Press: 125.
- [4]. Auerbach, A.J. & Hines, J. R. (1988). Investment incentives and frequent tax reforms. American Economic Review, 78 (2), 211-16.
- [5]. Bird, R.M. & Krugman, P. (2004). Agglomeration, integration and tax harmonization. European Economic Review. 48, 1 -23.
- [6]. Bloom, N.R., Griffith and Van Reenen, .I. (2002). Do R & D tax credits work? Evidence from a panel of countries, 1979-1997. Journal of Public Economics. 85, 1-31.
- [7]. Bradford, D.F. (1981). The incidence and allocation effects of a tax on corporate distributions. Journal of Public Economics. 150,
- [8]. Ougi, C. & Zodrow, S. (1991). Nigeria taxation special combined edition Bedfordshire: Graham barn: 3 -10.
- [9]. Dagogo, D. W. (2014a) Degree of operating leverage, contribution margin and the risk-return profite of emerging companies: evidence from Nigeria. International journal of economics and finance, CCSE, <http://www.ccsenet.org/journal/index.php/ijef/>.
- [10]. Dagogo, D. W. (2014b). Determinants of cash flow volatility among Nigerian SMEs. West African journal of business and management sciences. 3 (3). Faculty of business administration, Imo state university, Owerri, Nigeria
- [11]. Keen, M. (2002). Preferential regimes can make tax competition less harmful. National Tax Journal, 54(2), 757-62.
- [12]. Ohaka, J. & Agundu, P. U. C. (2012). Tax incentives for industry synergy in Nigeria: A pragmatic propriety system advocacy. African Research Review, 6 (3) 26
- [13]. Ohaka, J. & Idoniboye, E A (2010). Inventory control sustainability and contemporary challenges of industrial management. International journal of management science. 2 (2)
- [14]. Phillips, A.O. (2004). Nigeria experience with income tax exemption. A Preliminary Assessment, N.J.E.S.S, 10 1 March, p. 46.
- [15]. Stotsky, J.G. and Ley, E. (2002). Tax incentives for business investment: A primer for policy makers in developing countries. World Development. 30(9), 1497-1516.
- [16]. Toaze, D. (2001). Tax sparing: Good intentions, unlimited results. Canadian Tax Journal, 49(4), 879-924.