Effect of Tax Incentives on Foreign Direct Investment in the Petroleum Industry in Nigeria

Arzizeh T. Tapang, Benjamin E. Onodi & Akachukwu H. Amaraihu
Department of Accounting, College of Management Sciences,
Michael Okpara University of Agriculture, Umudike
P.M.B. 7267 Umuahia, Abia State, Nigeria,
arzizeh@gmail.com, benonodi@yahoo.com, hillaryakachi@gmail.com

Abstract
This study focused on the effect of tax incentives on foreign direct investment in the petroleum industry in Nigeria. In the petroleum industry the issue of tax incentive has not really received a positive attention because the people think that the sector is rich enough to pay all taxes. Though there is little level of tax incentives in the oil sector, but this cannot be compared to what we have in the private sector. The ability to sustain itself and to expand petroleum industries are faced with the problem of high tax rates, multiple taxation, complex tax regulations and lack of proper enlightenment or education about tax related issues. These have led to an increase in record of dearth of petroleum industries in Nigeria. An ex-post-facto research design was adopted. Secondary data were collected and analyzed using regression analysis with the aid of STATA 13. The findings revealed that tax incentives proxy by investment tax allowance, non-productive rent, capital allowance has a significant effect on foreign direct investment. Based on the findings it is concluded that firms' enjoying tax incentives will generate more employment opportunities than firms in highly taxed regions. Conducive investment climate is a strong requirement for the flow of sustainable physical investment in an economy. Tax incentives positively influences the living standards and per capital income, and expand variety of goods available to consumers. The study recommends that tax policies should be amended to eliminate double taxation. Also it is recommended that tax incentives should be effectively implemented and efforts should be made by relevant tax authority to ensure that firms benefit from these incentives. Finally, investment climate in the country should be made conducive through effective policy formulation, implementation and the provision of adequate functional physical infrastructure.

Keywords: *Capital Allowance, Foreign Direct Investment, Investment Tax Allowance, Non-Productive Rent, Tax incentives*

1.0 Introduction

1.1 Background to the Study

As part of the effort to provide an environment that is conducive for the growth and development of industries, inflow of foreign direct investment, shield existing investment from unfair competition and stimulate the expansion of domestic production capacity, the federal government has developed package of incentives for various sectors is encouraging tax incentives in the petroleum industry for overall development in Nigeria.

Tax studies have become increasingly sophisticated especially during the past decade and have yielded conflicting results as regards the tax matter. Some studies focus on the cost and benefit of tax incentives while a few look at whether public funds could have been better spent or if tax incentives were economically justified. Tax studies offer little guidance to policy makers who are concerned about tax rates and the effectiveness of employing tax incentives as an economic and developmental tool (Aroh & Nwadioalor, 2009).

Tax incentive itself, is the use of government spending and tax policies to influence the level of national income. This measure encourages the springing up and gradual growth of new enterprises by the reduction of profit tax, which in turn encourages production, influences the production level and curbs unemployment. So, the government should provide such tax incentives in order to boost development which will bring about an increase in employment opportunities and also cause an improvement in the economy (Okafor, 2009).

Amadiegwu (2008), a tax expert wrote that the objective of tax incentive is that by borrowing rather than taxing, the government has a better chance of expanding investment spending which is essential in enlarging production possibilities and attaining a sustainable improvement in the standard of living of the people.

Dotun and Sanni (2009), stated that tax incentives can be targeted on the low income earners, local and developing industries, farmers, which will increase their savings and is necessary for higher investment. Tax incentives create employment opportunities for the people, helps to fight economic depression and inflation thereby increasing the equitable distribution of income and wealth. Petroleum represents a very important mineral in Nigeria economy. The economic well-being of the citizenry is now completely dependent on petroleum. This means that petroleum touches every facet of human life in Nigeria. Petroleum resources have become more important than any other means of generating income to the government in Nigeria.

1.2 Statement of the Problem

The Nigeria Government has over the years adopted one form of incentives or the other for companies operating in the country. This is aimed at encouraging business growth and development in the private sector organization. In the petroleum industry the issue of tax incentive has not really received a positive attention because the people think that the sector is rich enough to pay all taxes.

Though there is little level of tax incentives in the oil sector, but this cannot be compared to what we have in the private sector. The problems faced are in the area of negative relationship between taxes and the petroleum industry. The ability to sustain itself and to expand petroleum industries are faced with the problem of high tax rates, multiple taxation, complex tax regulations and lack of proper enlightenment or education about tax related issues. Not minding other challenges that other industries are facing in developing countries like Nigeria; inadequate capital, poor technical and managerial skills, environmental effects and government regulations are the most affecting the operation of the industries in Nigeria. These have led to an increase in record of dearth of petroleum industries in Nigeria.

1.3 Objectives of the Study

The broad objective of the study is to examine the effect of tax incentives on foreign direct investment in the petroleum industry in Nigeria.

The specific objectives of the study include:

1) To examine the effect of investment tax allowance on foreign direct investment.
2) To examine the effect of non-productive rent on foreign direct investment.
3) To ascertain the effect of capital allowance on foreign direct investment.

1.4 Research Hypotheses

For the purpose of the study, the following null research hypotheses were tested:

1) Investment tax allowance has no significant effect on foreign direct investment.
2) Non-productive rent has no significant effect on foreign direct investment.
3) Capital allowance has no significant effect on foreign direct investment.

2.0 Review of Related Literature
2.1 Conceptual Framework
2.1.1 Concept of tax incentives
Wilson (2010) had a general definition of tax incentives which is an eye opener to this research work. He defined tax incentives as a deliberate reduction in the liability granted by government in order to encourage particular economic unit (e.g. corporate bodies) to act in some desirable way (e.g. invest more, consume more, import less, Pollute less etc). The reduction in liability is all about a reduction in tax rate, reduction in tax base, outright tax exemption, tax deferment, and so on (Oko, 2014; Effiok, Tapang & Eton, 2013).
Also in the view of Ihe (2012), tax incentive is an economic arrangement and strategy where the government asked some companies or individuals to pay less or no tax for certain economic reasons that will encourage development. Tax incentive is needed in the oil and gas sector because; the sector is currently the main stay of the country's economy (Anyanwu, 2015).
According to Akintola (2014), the oil and gas sector is currently the main stay of the nations. It contributes about 90.4% of the country's export trade and 80% of its gross revenue receipt. The applicable incentive frame work in the Nigerian oil and gas sector depends on the segment of the industry in which companies choose to play.

In the view of Akintola (2014), where the company is engaged in exploration and production operations, the fiscal incentives become a relevant consideration.
Preferential tax Regime:

- **a)** Where the company is within its first five years of production operation and has not fully amortized its pre-production capital expenditure, the applicable petroleum profit tax (PPT) rate is 66.75% of the chargeable profit.
- **b)** Where the company has exceeded five years in production operation the applicable PPT rate is 85% of the chargeable profit.
- **c)** Where the company operates under a production sharing contract, the applicable PPT rate is 50% of the chargeable profit. The PSCs signed in 1993 enjoy investment tax credit while those executed from 1998 and above are only entitled to investment tax allowance.

2.1.2 Reduced Petroleum Profit Tax for Marginal Field Operators
Marginal field operators are to enjoy a 55% petroleum profit tax (PPT) rate on chargeable profit. The law enabling the application of the rate is however yet to be promulgated. The uncertainty at the applicable tax regime to the marginal field operator has some where necessitated the grant of pioneer status to some of the successful indigenous concession holders that participated in the first licensing round and who are producing. This could presumably be to provide some fiscal relief in the first 5 years of production.

2.1.3 Reduced royalty rate
Depending on the type of contract arrangement and water level of the acreage, the royalty rate for crude oil production ranges from 0% to 20%. However, companies willing to produce crude oil and gas from fields with a water depth of more than 1,000 meters are exempted from paying any royalty since the rate at that is zero. There is also a reduced rate for marginal field operations. There are also incentives such as for utilization of associated and non – associated gas; cost of drilling the first two appraisal wells, which exploration and production companies are allow to expense at once rather than gradual amortization, dividend distributed from petroleum profit are tax free.

2.1.4 Gas Utilization Incentive

Companies engaged in gas utilization activities can enjoy the following incentives:

- **a)** Income tax incentives: tax holiday of up to 5 years or as an alternative, additional investment allowance of 35%. This is in addition to other available incentives for utilization of gas such as accelerated capital allowances and investment allowances.
- **b)** Exemption from vat on pant, machinery and equipment purchased for utilization of gas in the down-stream petroleum operations.
- **c)** Exemption from custom duties on machinery and equipment or spare parts imported in the exploration, processing or power generation through utilization of Nigeria gas.

The pioneer status is more of less the omnibus and fall back incentive regime which the federal government invokes whenever it seeks to improve the scale of development, exploration or productivity of a particular sector (Akintola, 2014).

2.1.5 Need for tax incentives

According to Uboh (2014), the contribution of this sub sector to the gross domestic products of Nigeria cannot be over emphasized. This is perhaps a major reason for the clamour for incentives for the sub sector. Some of the oil industries contribute to the economy of Nigeria includes: Provision of employment, Power generation (electricity), Domestic cooking, Running vehicles and plants, Construction of roads and Synthetic rubber.

Uche (2010) affirmed that petroleum industry is the leading industries in Nigeria economy, accounting for about 90% of the nation’s total earning and about 75% of total government revenue. This was not the case before 1958 when Nigeria joined the league of oil producing nations.

In the view of Uche (2010), the oil producing companies had the burden of paying petroleum profit tax at 85% and high royalty.

The companies complained that the tax and royalties being paid eroded their merging of the profit. Consequently, the companies were not motivated to invest in the sub-sector again. Thus, this led to reduction in investment and resulted into decline in the oil reserve.

Government in recognition or the complaint came up with a package of incentives different from those in the existing petroleum profit tax Act to motivate the oil companies between 1986 and 1990.the package of the incentives was referred to as: Memorandum of Understanding (MOU). This was the genesis of the incentives that was to motivate investment in the sub se4ctor in Nigeria, with the recognition of the inadequacy of the incentives in the petroleum profit tax. Government continues on regular basis to announce additional incentives in the annual budget speech and in special government releases (Uche, 2010).

2.1.6 Investment opportunities in the oil and gas sector

According to Galleria media limited (2006) foreign and domestic investors are being encouraged through improved fiscal incentives in Nigeria oil and gas sector. In the upstream and downstream sector, the following are some of the areas where there are pressing needs for investors (Udoka, Tapang & Anyingang (2012).

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2.1.7 Incentives and Allowances Accruable to the IOCs

The Nigerian National Petroleum Corporation (NNPC) and the Ministry of Petroleum Resources are aware of the heavy financial burden with which the IOC is saddled by way of high cost of investment, tax regime and the volatile nature of the Niger Delta. In order to cushion the effect of these, certain tax allowance and incentives are made. These incentives are in the nature of: Allowable deductions; Capital allowance; Petroleum Investment Tax Allowance/Tax and Credit Allowance.

2.1.8 Investment Tax Allowance/Tax Credit

This is available where a crude oil producing company executes a production sharing contract with the NNPC. It is claimed as a tax offset. Again, under section 22 of the PPTA 2004 and subject to the provisions of the second Schedule to the PPTA, where a company has incurred any qualifying capital expenditure wholly, exclusively and necessarily for the purpose of petroleum operations, carried out by it, there shall be due to that company for the accounting period in which that asset was first used or for the purpose of such operation an allowance of 5% for on-shore operations and 10% for operations in territorial waters and continental shelf areas up to and including 100 metres of water depth.

2.2 Theoretical Framework

The economists have put forward many theories or principles of taxation at different times to guide the state as to how justice or equity in taxation can be achieved. The main theories or principles that anchored this study are:

2.2.1 Benefit theory:

According to this theory, the state should levy taxes on individuals according to the benefit conferred on them. The more benefits a person derives from the activities of the state, the more he should pay to the government. This principle has been subjected to severe criticism on the following grounds:

Firstly, if the state maintains a certain connection between the benefits conferred and the benefits derived. It will be against the basic principle of the tax. A tax, as we know, is compulsory contribution made to the public authority’s to meet the expenses of the government and the provisions of general benefit. There is no direct quid pro quo in the case of a tax.

Secondly, most of the expenditure incurred by the slate is for the general benefit of its citizens, it is not possible to estimate the benefit enjoyed by a particular individual every year.

Thirdly, if we apply this principle in practice, then the poor will have to pay the heaviest taxes, because they benefit more from the services of the state. If we get more from the poor by way of taxes, it is against the principle of justice?

2.2.2 Ability to pay theory

The most popular and commonly accepted principle of equity or justice in taxation is that citizens of a country should pay taxes to the government in accordance with their ability to pay. It appears very reasonable and just that taxes should be levied on the basis of the taxable capacity of an individual. For instance, if the taxable capacity of a person A is greater than the person B, the former should be asked to pay more taxes than the latter. It seems that if the taxes are levied on this principle as stated above, then justice can be achieved. But our difficulties do not end here. The fact is that when we put this theory in practice, our difficulties actually begin. The trouble arises with the definition of ability to pay. The economists are not unanimous as to what should be the exact measure of a person's ability or faculty to pay. The main viewpoints advanced in this connection are as follows:

(a) Ownership of Property: Some economists are of the opinion that ownership of the property is a very good basis of measuring one's ability to pay. This idea is out rightly rejected on the ground that if a person’s earns a large income but does not spend on buying any property, he will then escape taxation. On the other hand, another person earning income buys property, he will be subjected to taxation. Is this not absurd and

Un-justifiable that a person, earning large income is exempted from taxes and another person with small income is taxed?

(b) Tax on the Basis of Expenditure: It is also asserted by some economists that the ability or faculty to pay tax should be judged by the expenditure which a person incurs. The greater the expenditure, the higher should be the tax and vice versa. The viewpoint is unsound and unfair in every respect. A person having a large family to support has to spend more than a person having a small family. If we make expenditure as the test of one's ability to pay, the former person who is already burdened with many dependents will have to' pay more taxes than the latter who has a small family. So this is unjustifiable.

(c) Income as the Basics: Most of the economists are of the opinion that income should be the basis of measuring a man's ability to pay.

It appears very just and fair that if the income of a person is greater than that of another, the former should be asked to pay more towards the support of the government than the latter. That is why in the modern tax system of the countries of the world, income has been accepted as the best test for measuring the ability to pay of a person.

2.3 Empirical review

Wahab and Diji (2017) carried out a research on the Comparative Analysis of Nigeria Petroleum Fiscal Systems Using Royalty and Tax Optimization Models to Drive Investments. In their research, it was reviewed that The adoption of any petroleum arrangement - concessionary or contractual - is a financial issue that is centered on how costs are recovered and profits divided, which is at the heart of taxation and economic rent theories. Hence countries are expected to make the tax system attractive for the IOCs in order to encourage inward investment. The effectiveness of any petroleum arrangement depends largely on the attractiveness of its underlying tax regime which, in turn, depends on the effectiveness of its design and implementation. The uncertainty created by the non-passage of the proposed Petroleum Industry Bill (PIB) over the years has continued to impede investments in the oil and gas sector in Nigeria. Oil producers Trade Section (OPTS) which is the industry representative body for the oil and gas producing companies in Nigeria have expressed concern over the federal government’s intention to change the laws governing the oil and gas industry including the fiscal terms. The aim of the study is to critically examine whether the Nigerian petroleum tax system is appropriately designed and effectively implemented to achieve the benefits the country desires from its petroleum taxation arrangements. The study reviews the current and post PIB upstream fiscal regimes and undertook a comparative examination of Nigeria’s fiscal regime against selected world fiscal arrangements. The study also determined how Nigeria’s fiscal regime holds up against five key features of importance to government and prospective investors, which are the degree of stability, flexibility, neutrality and how the regime distributes the burden of risk between the resource owner and the oil companies. The study concluded from preliminary studies that the Nigerian tax and royalty fiscal terms have a significant effect on the following profitability index: Actual Value Profit, Discounted Cash flow rate, present value profit and maximum cash impairment; this invariable affects the competitiveness of Nigeria for foreign direct investment.

Ordu (2016) carried out a research on the impact of Tax incentives on economic development in Nigeria that is seen in terms of industrial growth in the nation with evidence from years 2004 to 2014. The population of this study includes 51 respondents drawn from taxpayers, management and members of staff of some selected manufacturing companies in the South-South geo-political zone of Nigeria and Federal Inland Revenue Services. Using probability method, a sample size of 45 respondents were used whilst Thirty (30) companies were studied. The classes of personnel included in the research were administrative managers, accounts managers, internal auditors, and marketing and production staff. Survey method including the use of questionnaire and interview was adopted, whilst correlation method of analysis was adopted. Twenty eight (28) correctly responded copies of questionnaire out of 30 administered were obtained for the analysis, Spearman's Rank Correlation Coefficient (rho) statistical tool was used in testing the hypothesis using Statistical Package for Social Sciences software (SPSS). The findings reveal that sufficient tax incentives enhances industrial growth and economy whilst in conclusion, it was recommended among others that, government should waive certain taxes on corporate bodies to help them develop and mature especially at their early stage. Government should not focus on the revenue that may be lost at this point because in the long-run the benefit surpasses what is lost at the initial time.

George and Bariyima (2015) carried out a research on Tax Incentives and Foreign Direct Investment in Nigeria Given the significance of Foreign Direct Investment (FDI) to economic growth and the use of tax incentives as a strategy among government of various countries to attract FDI, this study examines the influence of tax incentives in the decision of an investor to locate FDI in Nigeria. Data were drawn from annual statistical bulletin of the Central Bank of Nigeria and the World Bank World Development Indicators Database. The work employs a model of multiple regressions using static Error Correction Modelling (ECM) to determine the time series properties of tax incentives captured by annual tax revenue as a percentage of Gross Domestic Product (GDP) and FDI. The result showed that FDI response to tax incentives is negatively significant, that is, increase in tax incentives does not bring about a corresponding increase in FDI. Based on the findings, the paper recommends, amongst others, that dependence on tax incentives should be reduced and more attention be put on other incentives strategies such as stable economic reforms and stable political climate

Gumo (2013) carried out a research on the effect of tax incentives on foreign direct investments in Kenya. In his research, it was discovered that FDI creates employment and acts as a vehicle of technology transfer, provides superior skills and management techniques, facilitates local firm's access to international markets and increases product diversity. Most countries strive to attract FDI because of its acknowledged advantages as a tool of economic development. The study sought to establish the effect of tax incentives on Foreign Direct Investments in Kenya. The study was descriptive and adopted a descriptive research design which was used to give the researcher a comprehensive picture of the variable relationship since the method is the only means of accurately measuring and giving statistical inferences.

The data was collected from secondary data (tax incentives and Foreign Direct Investment) sources collected from Kenya Revenue Authority (KRA), Treasury and Kenya National Bureau of Statistics (KNBS). Descriptive statistics, correlation and multiple linear regression models were used in data analysis. The study established that Kenya has various tax incentives including capital investment allowances offered to resident companies such as Industrial Building Allowance (IBA) granted on capital expenditure incurred on the construction of an industrial building, investment deduction granted to encourage development in manufacturing industries, farm works deduction granted at the rate of 50% per annum for two years, Shipping Investment Deduction granted at the rate of 40% on capital expenditure, and mining allowance which is granted to a person who incurs capital expenditure on searching for, discovery, testing and winning access to minerals; expenses incurred in obtaining acquisition rights over deposits; expenses related to purchase of machinery and buildings together with the development, general administration and management prior to commencement of production. This is granted at the rate of 40% in the first year and 10% from the second to the seventh year. It was established that on investment incentives, investment deduction ($p = .047$) and mining operation deduction ($p = .038$) have positive effect on FDI, while industrial allowance ($p = .054$) has a negative effect. On trade related incentives, export processing zones ($p = .008$) and tax remissions export office ($p = .009$) had positive effect on FDI while manufacture under bond ($p = .004$), as an incentive, had negative effect on FDI. The study concludes that tax incentive would have a positive resultant effect on FDI and recommends that Government need to evaluate its tax incentives policy, and weigh against the benefits that accrue with the intention of spurring investment including introducing evidence based tax incentives that would minimize tax evasion.

Fernando (2009), conducted a study on the impact of tax incentive on the performance of oil sector using primary data, data were estimated using regression analysis. The findings reviewed that the there is a relationship between tax incentive and the performance of oil sector. It was recommended that oil producing sectors should ensure that they take advantage of their tax incentives so as to increase their performance.
Coleman (2008) conducted a research on the impact of tax incentives on industrial development. The study was carried out using primary data and was also analyzed using regression analysis. The findings revealed that there is a significant relationship between tax incentives and industrial development corporate governance and corporate performance. It is recommended that tax incentives should be granted to industries especially new industries for their development.

Yakassi (2001) conducted a study on the impact of tax incentives on the investment of upstream petroleum sector. It was tested using primary and was analysed using regression analysis. It was observed that there is a positive relationship between tax incentives and investment of upstream petroleum sector.

3.0 Methodology

The study adopted an ex-post facto research design. The above research method is ideal for this research work because this research work deals with time series data from 2008-2017. Secondary source of data was collected the financial statement of the sampled petroleum companies and CBN statistical bulletin.
Based on theories and models adopted by Samimi and Abdolahi (2011), Okoye and Gbegi (2013), Izedonmi and Okunbor (2014), and Unegbu and Irefin (2010), this study then modified their model specification as stated below:
FDI= f (ITA, NPR, CA)
From the above functional relationship, the econometric model is specified as thus:

$$FDI = \beta_0 + \beta_1 ITA + \beta_2 NPR + \beta_3 CA + Ui$$

Where:

FDI = Foreign Direct Investment
ITA = Investment Tax Allowance
NPR = Non-Productivity Rent
CA = Capital Allowance
β_0 = Constant to be estimated
β_1 - β_3 = Coefficients to be estimated
Ui = Error term

4.0 Findings

Based on the analysis and the empirical results the study revealed that the estimated coefficient of the regression parameter have a positive sign and thus conform to our a-priori expectation. The implication of this sign is that the dependent variable foreign direct investment is positively affected by tax incentives proxy by (investment tax allowance, nonproductive rent, capital allowance). The study also revealed that there is a very high relationship between by tax incentives proxy by (investment tax allowance, nonproductive rent, and capital allowance) and foreign direct investment. Finally, the result revealed that tax incentives proxy by investment tax allowance, nonproductive rent and capital allowance has a significant effect on foreign direct investment. These findings are in line with the those of Wahab and Diji (2017); Ordu (2016); George and Bariyima (2015), George and Bariyima (2015); Gumo (2013); Fernando (2009),; Coleman (2008) and Yakassi (2001)

5.0 Conclusion/Recommendations

5.1 Conclusion

Based on the above findings it is concluded that firms' enjoying tax incentives will generate more employment opportunities than firms in highly taxed regions. Conducive investment climate is a strong requirement for the flow of sustainable physical investment in an economy. Tax incentives positively influences the living standards and per capital income, and expand variety of goods available to consumers.

5.2 Recommendations

Based on the foregone findings and conclusion, the researcher wishes to make the following policy recommendations:-

1) Tax policies should be designed to eliminate double taxation.

2) Tax incentives should be effectively implemented and efforts should be made by relevant tax authorities to ensure that firms to benefit from these incentives are adequately granted these incentives.

3) Investment climate in the country and state should be made conducive through effective policy formulation, implementation and the provision of equate functional physical infrastructure.

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