Impact of Tax Reforms on the Liquidity of Nigerian Stock Market (1982-2021)

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Abstract

This study examined the impact of tax reforms on the liquidity of Nigerian stock market. Secondary data were used for this study. The relevant data were sourced from Securities and Exchange Commission Statistics and Federal Inland Revenue Service Statistics Report between 1982 and 2021. Vector Auto Regressive (VAR) Model comprising Impulse Response Function (IRF) and Variance Decomposition (VD) was used to analyze the determinants and the liquidity of the stock market. The results of the VAR Model showed that the stock market liquidity (proxied by turnover ratio) significantly responded to changes in the movement of the tax reform indicators and positive both in the short and long run. This study concluded that a positive relationship exists between tax reforms and stock market liquidity. It was recommended that the regulatory body of tax administration must intensify efforts to mitigate the impacts of the global financial crisis on the Nigerian Exchange Group.

Key words: Tax reforms, Stock market Liquidity, Impulse Response Function, Variance Decomposition, Nigerian Exchange Group

Introduction

Reforms are focused on enhancing the performance and efficacy of organizations or industries (Soludo 2004). Financial reforms are primarily aimed at reforming the institutions and markets of the financial sector by various policy initiatives (Anyanwu 2010). As opined by Idowu and Babatunde (2012), reform is the most commonly known measure used to stimulate the growth of the financial market. Financial reforms have therefore been planned to achieve productivity in all financial sectors of the economy (stock market) in such a way that financial deepening is promoted and living standards are increased (Akpunonu *et al.* 2019).

Every economy relies on taxes as a major source of stable income and as a gauge of its health. As a result, the effectiveness of taxation in increasing the government's income base is crucial to the advancement of the nation. Tax revenue is generally reliable compared to other types of income, especially oil money, which allows governments to plan with more assurance than when relying primarily on natural resources.

It is well known that one of Nigeria's economy most urgent policy issues is raising domestic revenue. Reforms therefore, have a great chance of improving the collection of greater taxes. Finding the ideal balance for a nation's economy depends heavily on structural improvements. The tax revenue that can be collected from the petroleum business in Nigeria is particularly undervalued due to transactional opaqueness. Not just the petroleum sector, but the entire Nigerian economy needs reforms to bring in more money and improve governance by fostering transparency and accountability in both the public and private sectors.

A key tactic for enhancing the efficiency of a nation's tax administration is tax reform. It is implicitly acknowledged that many countries' tax administration systems suffer from organizational failure because they do not operate at their peak potential, which distorts the objective of tax laws (Pellechio & Tanzi, 1995). Tax administration must therefore operate successfully and efficiently in order for taxation to have the desired impact on resource allocation, income distribution, and macroeconomic stability and growth.

Most nations' tax reform programs have the goal of improving tax administration by tackling systemic flaws in revenue collecting. This entails streamlining the tax collecting and payment process, encouraging taxpayer cooperation voluntarily, and implementing a logical flow of processes for effectively recognizing and handling noncompliance (Pellechio & Tanzi, 1995). Nigeria is an excellent candidate for tax management improvements due to her overreliance on oil money. The knowledge that Nigeria has one of the lowest tax-to-gdp ratios in the world underpins the need of updating its tax administration (and other fiscal) systems.

Stock market liquidity refers to the ease with which the shares are exchanged on the market. The liquidity is determined by the ratio of the securities traded to the total national production, which is calculated as: the total value of the securities traded/GDP. According to Osinubi (2002), stock market liquidity promotes profitable interactions between the share market and the money market. Therefore, with a liquid stock market, banks accept shares as collateral for lending purposes, thereby growing access to credit for growth. Oke and Mokuolu (2004) highlighted liquidity as an essential aspect of the stock market and pointed to its ability to distribute capital effectively and to allow investors to quickly divest their properties.

According to Idowu and Babatunde (2012), stock market liquidity can be measured using two indicators. The first variable is the value traded which is the ratio of total value traded to GDP and it measures the value of stock transactions relative to the size of the economy. The second variable is the turnover ratio calculated as the ratio of the total value traded divided by stock market capitalization which often measures the value of equity transactions relative to the size of the stock exchange.

Statement of the problem

According to Olomola (1994), Structural Adjustment Programme (SAP) was designed to restructure and diversify the productive base of the economy, achieve fiscal balance, balance of payment equilibrium, intensify growth potential of the private sector and set the economy on the path of steady and balanced growth. A major blank of this programme is the restructuring of the fiscal sector and the liberalization of the control and regulation of financial institutions and markets.

The reform efforts were driven by short-run fiscal stimulus initiatives and quantitative trade restrictions, while underlying economic and financial conditions continued to worsen. Government revenue dropped from 24 percent of GDP between 1980 and 1985 to 12 percent, reflecting the sharp drop in oil prices as well as the reduced buoyancy of non-oil taxes. The negative impact on oil and customs revenue of the overvalued exchange rate, combined with the depressing effect of increasingly complex import controls on the customs tax base, has exacerbated the difficulties (NCEMA 2013).

Furthermore, due to Nigeria's over-reliance on oil money, the federal government has amended the new tax legislation. The goals of Nigeria's tax reforms are to: bridge the gap between national and local needs funding; ensure taxation as a fiscal policy tool to improve the provision of services to all; improve the level of tax revenue derived from non-oil activities in comparison to oil revenue; and make efforts to constantly review tax legislation to reduce/manage tax evasion and to restructure the tax system (Alli, 2009).

Thus, this study is inspired by the fact that, over the last decade, the Nigerian tax system has undergone

immense changes. Hence, the need for a critical examination on the impact of tax reforms on the liquidity of stock market in Nigeria. The justification for the time frame is to cover major era of tax reforms in Nigeria.

Hypothesis

H_1: Tax reforms have an impact on stock market liquidity in Nigeria.

H_0: Tax reforms do not have an impact on stock market liquidity in Nigeria.

This study is therefore divided into five sections with introduction discussed above. Section two dwells on the literature review while section three explains the methodology. Section four analyzes and discusses the findings of the study and section five ends with conclusion and recommendation.

Literature Review

In Nigeria, tax reforms became imperative because of the existence of the tax system, which was dynamic, inelastic, ineffective, inequitable and unjust, according to Anyanwu (1997). Tax reform is the method of reforming the way the government collects or handles taxes. Tax reforms have various objectives: some are aimed at reducing the level of government taxation for all citizens, some are aimed at making the tax system more egalitarian or less progressive. Others aim to simplify the tax system and make it more understandable or more responsible for the system.

Tax reforms in developing countries are a fiscal instrument designed to minimize dependency on foreign sources by increasing satisfactory tax revenues in order to fund government spending with a view to achieving sustainable long-term economic development. Despite the significant tax reforms implemented in Nigeria, there has been criticism of their failure to achieve the income mobilization objective.

The Nigerian tax system has witnessed series of reforms since 1904 to date. The impacts of the various reforms in the country are: establishment of income tax in Nigeria between 1904 and 1926; grant of autonomy to the Nigerian Inland Revenue in 1945; the Raisman Fiscal Commission of 1957; creation of the Inland Revenue Board in 1958; the declaration of the Petroleum Profit Tax Ordinance No. 15 of 1959; the promulgation of Income Tax Management Act 1961; formation of the Lagos State Inland Revenue Department; the promulgation of the Companies Income Tax Act (CITA) 1979; establishment of the Federal Board of Inland Revenue under CITA 1979; launching of the Federal Inland Revenue Service between 1991 and 1992; and tax policy and administration reforms amendment 2001 and 2004 (Jelilov, Abdulrahman and Isik 2016).

Another reform introduced by the Nigerian government was the creation of the Nigerian Tax System Study Group. The group, which was launched on 6 August 2002, sought to study the tax system and make appropriate recommendations for a better tax policy and an overall improvement of the tax administration in the country. This community is composed of corporate, academic, intellectual and government individuals. The outcome of the reform was the approval by the Federal Executive Council of nine (9) new tax reform bills for consideration by the National Assembly, which were subsequently passed as Acts.

The Acts include: Federal Inland Revenue Service Act 2004; Companies Income Tax Act 2004; Petroleum Profit Tax Act 2004; Personal Income Tax Act 2004; Value Added Tax Act 2004; Education Tax Act 2004; Customs, Excise Tariffs, etc. (Consolidation) Act 2004; National Sugar Development Act 2004; and National Automotive Council Act 2004 (Jelilov *et al.* 2016).

According to Jelilov *et al* (2016), it is important to deal with the urgency of such reforms in order to recognize the value of tax policy reforms. First, in order to safeguard against the instability of crude oil

prices and to foster fiscal sustainability and economic viability at lower levels of government, there is an urgent need to diversify a country's revenue portfolio. Second, Nigeria works on a cash budget system, where expenditure plans are often channeled into estimates of revenue. This allows for the ability to assess the optimum tax rate for a given expenditure level.

According to Herbert, Nwarogu and Nwabueze (2018), tax reforms are necessitated under the following three conditions: (a) there is an exigency to modernize tax administration as part of a broad fiscal reform strategy or in response to observed deficiency, inefficiency and ineffectiveness in the tax system; (b) a response to the demands of a growing economy, in which expansion of the tax net is needed to integrate uncaptured tax payers, such as the growing number of informal sector players; and (c) the imperatives of ICT and software applications as well as changes in macroeconomic policies dictate the need for or compel fiscal reforms, for example, to complement macroeconomic, trade and investment policies.

Accuracy in the projection of revenue is therefore of vital importance for the implementation of an effective system for sustainable fiscal policy management. However, this can be accomplished if changes to current tax policies are undertaken in order to achieve any change. Thirdly, petroleum and trade taxes are the subject of the Nigerian tax system, while direct and indirect taxes such as value added tax (VAT) are ignored. This constitutes a systemic issue for the tax system of the country. While direct taxes and VAT have the potential for expansion, their effect is limited due to the country's dominant informal sector. Finally, macroeconomic stability has been threatened by the widening fiscal deficit over the years, and the prospects for economic growth make the concept of tax reform very appealing.

In the backdrop of the tax reforms, Muriithi and Moyi (2003) examined the productivity of Kenya's tax system. The results indicate that, despite the fact that the effects of the reforms were not always consistent, they had a positive effect on both the general tax system and on individual tax burdens. According to the report, direct taxes were affected more by the reforms than indirect taxes were, which suggests that revenue leakage is still a significant issue for indirect taxes. The study further argued that the relative efficiency of direct tax reforms, which not only made the tax code simpler but also cut down on opportunities for evasion and corruption, is what accounts for direct taxes' improved responsiveness.

A research of Cameroon's indirect tax policies and revenue mobilization was carried out by Choifor (2008). In order to determine whether the initial tax revenue situation was improved by the tax reforms or whether they instead helped to engineer the tax system's response to changes in the tax bases in order to raise enough revenue to meet the economy's needs, annual time series data covering the years 1980 to 2003 were used. It was also determined which indirect tax hurdles became more responsive (flexible) or remained rigid after the tax reform as well as which of the indirect tax hurdles were affected (elasticity). According to the study's conclusions, the tax structure in Cameroon was inelastic.

Meshak and Jeff (2014) used time series data spanning thirty (30) years, from 1983 to 2012, to undertake research on the effectiveness of the Nigerian tax system. The study used Mintab statistical software's regression function and utilized the tax elasticity and buoyancy approach. Individual tax sources were all significant at the 5% level of significance according to the study's findings. Petroleum Profit Tax (PPT), Custom Excise Duty (CED), and Total Tax Revenue (TTR) were all negative and below one, according to the buoyancy result.

In Nigeria, the effect of tax reforms on the country's federal revenue generation was studied by Oriakhi and Ahuru in 2014. Annual time series data spanning the years were used in the study (1981-2011). The regression analysis was used in the study as well. The overall amount of tax income collected by the federal government was regressed on a number of tax receipts, including petroleum profit tax, value-added tax, and custom excise duty, which were used as proxies for tax reform. According to the report, the government may increase tax income by streamlining the tax system, decreasing tax fraud and avoidance, and lowering

tax burdens by reducing the PIT from 25% to 17.5% and the CIT from 30% to 20%..

A study on the impact of tax reforms on the elasticity and buoyancy of the Kenyan tax system was undertaken by Omondi et al. in 2014. The effects of tax reforms on tax buoyancy and elasticity estimations, as well as the impact of the tax modernization program and revenue administration reforms, were examined using annual time series data spanning the years 1963 to 2010. Regression analysis was used in the study to regress tax revenue on income. The findings indicated that Kenya's overall tax system had an elasticity of 0.690, which suggests that an increase in national income resulted in a less than commensurate rise in tax collection.

Ebi and Aladejare (2016) looked at how much tax income in Nigeria increased as a result of economic growth between 1980 and 2013. To analyze the short- and long-term buoyancy of government revenue streams, which were divided into total tax revenue (TTR), oil revenue, and non-oil revenue, the study used the auto-regressive distributive lag approach. The short- and long-term results showed that government revenue was only weakly buoyant. According to the findings, it was advised that systemic corruption at the points of revenue collection and remittance be dealt with and that the development of the non-oil industry should not be treated lightly.

In the research of Ebi and Ayodele (2017), the study estimated the elasticity and buoyancy of key tax components in Nigeria between 1981 and 2014, as well as the effects of tax revisions on those components. When analyzing the data, the error correction mechanism (ECM) technique was used. The findings showed that all tax components were inelastic, and post-reform tax elasticities have generally increased.

The findings from the above literatures show that there is a disparity in findings, resulting in research gaps, which this article tries to fill. Thus, the goal of this research is to see if the existing tax reforms have had an impact on the liquidity of listed companies on the Nigerian Exchange Group. This validates the purpose of the study.

Methodology

The type of data used in this research work is the secondary data. The relevant data for the study was obtained from Federal Inland Revenue Services (FIRS) publications and Security and Exchange Commission (SEC) publications between 1982 and 2021.

The formulation of this model is based on the empirical review of Al-Faki (2006), Yusuf (2009) and Ogunmuyiwa (2010) who opined that the best measure for stock market liquidity is turnover ratio, which is represented as the number of shares traded divided by market capitalization. Also, the representation of the independent variables is in line with Herbert *et al* (2018) and Ebi and Ayodele (2017).

The dependent variable is TOR while the independent variables are PPT, CIT, VAT, ED and DM. Thus, the model is expressed as:

$$TOR = ?(PPT, CIT, VAT, EDT, DM) \qquad (1)$$

Transforming equation (1) into econometric linear form yields equation 2 as follows:

$$TOR = B_0 + B_1 PPT + B_2 CIT + B_3 VAT + B_4 EDT + B_5 DM + ? \qquad (2)$$

The logarithmic transformation of equation (2) is designed to bring the variables to the same base, hence the model becomes:

$$Log\ (TOR) = B_0 + B_1\ Log\ (PPT) + B_2\ Log\ (CIT) + B_3\ Log\ (VAT) + B_4\ Log\ (EDT) + B_5\ Log\ (DM) + u$$

$$(3)$$

Where:

TOR = Turnover Ratio

PPT = Petroleum Profit Tax (proxied as oil revenue)

CIT = Company Income Tax

VAT = Value Added Tax (private consumption)

EDT = Excise Duties (import and export of goods and services)

DM = Tax reform dummy. It assumes the period of 0 during non-reforms and 1 during tax reform period

B_0 = Constant (intercept) term

B_1-B_5 = Coefficient parameters of the independent variables

u = Stochastic error term

Apriori Expectation: $B_1, B_2, B_3, B_4, B_5 > 0$

Results and Discussions

A unit root test was conducted to ascertain the stationarity of the data before estimation using Augmented Dickey Fuller (ADF). The results in table 4.1 below revealed the unit root properties (stationarity) of the variables employed in this research work.

The test results showed that Company Income Tax (CIT), Excise Duty Tax (EDT), Petroleum Profit Tax (PPT), Value Added Tax (VAT), and Turnover Ratio (TOR) all have unit root properties but became stationary after first differencing that is I(1).

Table 4.1: Results of Unit Root Test

Variables	ADF T- Statistics		Remarks
	Level	1st Difference	
Company Income Tax (CIT)	-1.3846	-6.5236***	I(1)
Excise Duty Tax (EDT)	-1.0911	-4.8866***	I(1)
Petroleum Profit Tax (PPT)	-2.5377	-5.3862***	I(1)
Turnover Ratio (TOR)	-2.3719	-6.0901***	I(1)
Value Added Tax (VAT)	0.3457	-6.0556***	I(1)

Source: Author's computation, 2022

NB:　　　*** Indicates significance at 1%

　　　　** Indicates significance at 5%

*Indicates significance at 10%

Impulse Response Function Analysis of Tax Reforms on Stock Market Liquidity

Impulse Response Function (IRF) employs Vector Auto-Regressive models (VAR). The aim is to describe the evolution of a model's variable in reaction to a shock in one or more variables. It explains the reaction of an endogenous variable to one of the innovations. The IRF is used to further assess the tendencies of significant Granger-Causality results.

An Impulse Response Function (IRF) was further run to disclose the connection between the variables in the model. The IRF model reveals the response of a particular variable to a shock or an impulse in another variable in the system that involves some other variables as well, because Granger-Causality may not reveal the complete story about the connection between variables in the model. The blue line is the impulse response function, while the red lines are the 95% confidence intervals. The IRF always lies within the 95% confidence intervals.

Response of D (TOR) to D (PPT)

The initial response of turnover ratio (TOR) to petroleum profit tax (PPT) was positive. In the 2nd year, it steeply declined below the zero (0) line and steadily increased up to equilibrium in the 5th year and remained so in the long-run.

Response of D (TOR) to D (CIT)

The response of turnover ratio (TOR) to company income tax (CIT) was steeply positive from the initial stage up till period 6 when it unnoticeably fell below the line zero (0). And remained stable from period 7 over the years.

Response of D (TOR) to D (VAT)

The initial response of turnover ratio (TOR) to value added tax (VAT) was stable. It then swiftly declined in the 3rd year increased swiftly again in the same year to reach equilibrium over the remaining years.

Response of D (TOR) to D (EDT)

The response of turnover ratio (TOR) to excise duty tax (EDT) was positive. It swiftly declined in the 2nd year slightly below line zero (0). And then steadily increased in the 4th year until the fifth year when it steadily declined to reach a state of equilibrium in the long-run.

Response of D (VAT) to D (TOR)

At the initial stage, the response of value added tax (VAT) to turnover ratio (TOR) negative until the 4th year when it became stable over the years.

Response of D (PPT) to D (TOR)

The initial response of petroleum profit tax (PPT) to turnover ratio (TOR) was positive. But swiftly declined to line zero (0) in year one (1). It remained stable until the 3rd year when it slightly lifts above the equilibrium and later maintained a stable position over the years.

Response of D (CIT) to D (TOR)

The response of company income tax (CIT) to turnover ratio (TOR) was positive initially but steadily declined below line zero (0) in period 2 until period 3 when it steadily rose to equilibrium. It gradually increased in period 5 only to decline steadily slightly below equilibrium in period 6 until it maintains a stable state all through equilibrium level.

Response of D (EDT) to D (TOR)

At the initial stage, the response of excise duties tax (EDT) to turnover ratio (TOR) was negative until the 4th period when it became stable over the years.
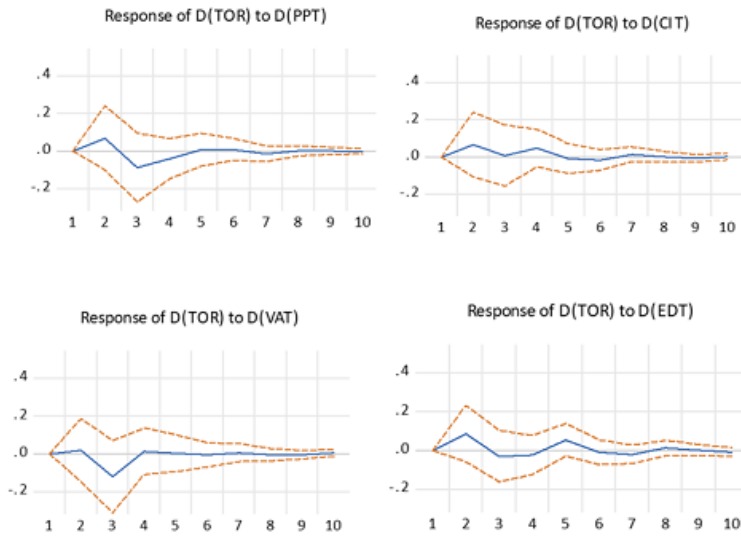

Figure 4.1: Response to Cholesky One S. D. (d. f. adjusted) innovation S. E. (Response of Stock Market Liquidity to Tax Reforms)
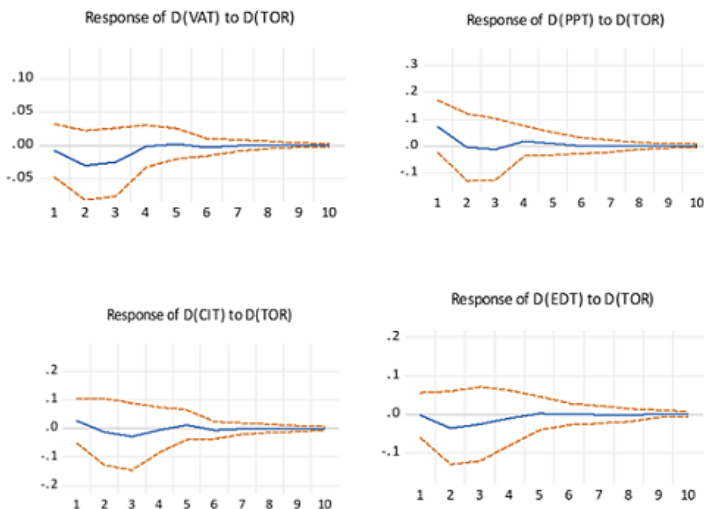
Source: Researcher's findings, 2022

Figure 4.2: Response to Cholesky One S. D. (d. f. adjusted) innovation S. E. (Response of Tax Reforms to Stock Market Liquidity)

Source: Researcher's findings, 2022

Variance Decomposition Analysis of Tax Reforms on Stock Market Liquidity

Variance decomposition displays the percentage of the error made forecasting a variable overtime due to a specific shock. That is, how much of the variability in the dependent variable is explained by its own shocks versus the shocks in the other variables in the system.

Statistically speaking, while impulse response function (IRF) traces the effects of a change to another endogenous variable in the VAR environment, Variance Decomposition Analysis (VDA) separates the variations in an endogenous variable into the component shocks in the model. Thus, the variance decomposition analysis provides information about the relative relevance of each of the random innovations affecting the variables in the VAR model. As in the impulse response function, the variance decomposition applies the Choleski Decomposition for identifiable purposes.

The variance decomposition analysis results for tax reforms, using the selected variables: Turnover Ratio (TOR); petroleum profit tax (PPT); company income tax (CIT); value added tax (VAT); and excise duties tax (EDT) over a 10-year horizon are presented in the table 4.3 below:

Variance Decomposition of TOR

The results of the variance decomposition as shown in the table below shows that turnover ratio (TOR) was 100 percent explained by its shock in the first year, but it reduced to 82% in the long-run. Other complementary results show that PPT have 5%, CIT have 3%, VAT have 6%, and finally EDT have 5% report for the fluctuations in the stock market liquidity in the long-run.

Variance Decomposition of PPT

The VDA for PPT show that it was well explained by its shock (94%), and partly explained by TOR (6%) in the short-run while the other variables no contemporaneous effect on PPT. In the long-run however, the following variables TOR, CIT, VAT and EDT explained 5%, 3%, 2% and 6% respectively of the shocks on PPT.

Variance Decomposition of CIT

The variance decomposition of CIT is 97% in the first period with TOR and PPT having a shock of 1% and 2% respectively. Other variables VAT and EDT have no contemporaneous effect on CIT in the short-run. In the long-run however, TOR, PPT, VAT and EDT explained 1%, 20%, 20% and 3% respectively of the shocks on CIT.

Variance Decomposition of VAT

In the first period, all the variables except EDT have contemporaneous effect on VAT. In the 10th period however, TOR, PPT, CIT and EDT explained 8%, 9%, 10% and 1% respectively changes in FINDEEP.

Variance Decomposition of EDT

The shocks in EDT were largely explained by itself with a percentage of 95% while the remaining variables have negligible effect on EDT in the short-run. But in the long-run, TOR, PPT, CIT and VAT explained 2%, 19%, 15% and 7% changes in EDT respectively.

Source: Authors' computation (2022)

Summary of Findings and Recommendations

The study examined the impact of tax reforms on the liquidity of Nigerian stock market using time series data for the period of 1982 to 2021. The study used Vector Auto Regressive (VAR) Model comprising Impulse Response Function (IRF) and Variance Decomposition (VD) to analyze the determinants and the liquidity of the stock market with the aid of R-Studio. The results from the IRF show that the response of stock market liquidity (TOR) to the variables of tax reforms (PPT, CIT, VAT and EDT) is positive. However, the response of PPT and CIT to TOR is positive in the short run while the response of VAT and EDT to TOR is initially negative until the 4th period when it became stable over the years. The results of the VD show that turnover ratio (TOR) was 100 percent explained by its shock in the first year, but it reduced to 82% in the long-run. Other complementary results show that PPT have 5%, CIT have 3%, VAT have 6%, and finally EDT have 5% report for the fluctuations in the stock market liquidity in the long-run. In conclusion, the result of the analysis revealed that the stock market liquidity (proxied by turnover ratio) significantly responded to changes in the movement of the tax reform indicators. It was recommended that the regulatory body of tax administration must intensify efforts to mitigate the impacts of the global financial crisis on the Nigerian Exchange Group.

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