

CORPORATE TAXATION AND FINANCIAL PERFORMANCE OF DEPOSIT MONEY BANKS IN NIGERIA: A DYNAMIC FIXED EFFECTS APPROACH

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Abstract

Motivated by the conflicting results reported by previous studies, this study investigated the impact of corporate taxation on bank financial performance in Nigeria using the dynamic fixed effects framework. Corporate taxation is proxied by corporate income tax, while bank financial performance is measured by earnings per share. The study is based on balanced panel data consisting of 10 quoted deposit money banks in the Nigerian stock exchange from 2010 to 2019. The banks are ACCESS, FIDELITY, GTB, FCMB, FIRST BANK, UBA, UNION BANK, STANBIC IBTC, ZENITH and STERLING BANK. Our dynamic fixed effects model is formally validated by the Hausman test, which shows that unobserved bank-specific factors (such as management quality and leadership style) have a significant correlation with corporate tax practices. Consistent with the stakeholder theory, our results show that corporate taxation is value-enhancing as it leads to higher profitability. However, bank profitability is also found to be persistent and depends on its own one period lagged value. These results are robust as incorporating bank size do not significantly affect the relationship between corporate taxation and bank profitability. Hence, we conclude that corporate taxation is a significant determinant of bank financial performance in Nigeria.

Key words: Corporate taxation, bank profitability, dynamic fixed effects model.

Introduction

Corporate taxation and its impact on firm performance has continued to attract scholarly attention, despite being a well-researched topic in corporate finance literature. The main issue of concern is whether corporate taxation is value-enhancing or destroys value. This issue is particularly important because of the important role of corporate taxation in government revenue and fiscal policy as well as the implication corporate tax payment on both corporate governance and firm stakeholder management.

Generally, taxation is a legal means of raising money for the purpose of government by means of contributions from individuals and corporate bodies (Soyode & Kajola, 2006). Corporate taxes are periodic

contributions made by corporations to the government of the country or nation in which they operate or have a significant presence. Corporations and public corporations pay corporate taxes on their net profits. Unincorporated organizations such as commercial, factory, and provident societies, clubs, and trade associations, are also subject to the company tax (Raza, Ali & Abassi, 2011). Corporate taxes, according to Aransiola (2013), are taxes charged on companies based on the amount of profit earned.

The incidence of corporate tax on companies is that it affects the fund available for expansion and dividends re-investment, thereby impacting negative on the products and services produced by such company and also serves as a disincentive to

the investing public (Ezugwu & Akubo 2014). Hence, corporate tax reduces the fund available for re-investment and growth of a business. It also affects dividend payment or distribution thereby discouraging the investors or investing public (Ezugwu & Akubo, 2014). Therefore, there is need to keep the tax as modest and moderate as possible, especially in the face of economic recession occasioned by the covid-19 pandemic.

The corporate profit tax is a central component of government fiscal policy. It has an effect on a country's macro and microeconomics. As a result, tax reforms aimed at lowering the tax rate could boost the value of businesses (Neghina & Goegeta, 2012). The importance of corporate profitability and a low corporate tax rate cannot be overstated. Furthermore, Akinleye (2019) contends that when company income tax is deductible on an investment return in the absence of a tax incentive, it appears to affect the trend and essence of investment transactions or decisions made by investors to a greater degree. This is because taxation decreases an investment's profitability to the extent that the tax rate in effect (Vržina & Dimitrijević, 2019). A company or business must be able to earn a rate of return that is at least as high as the cost of capital in order to be worthwhile. The importance of taxation as a core determinant of investment decisions and its profitability is primarily determined by government policies (Vržina & Dimitrijević, 2019).

Finally, as companies make profit when paying low taxes, they would have more funds to reinvest and grow (Djankov et al., 2008). If tax rates are high and there are insufficient tax benefits to reduce the tax burden on companies, the opposite happens. However, Corporate income tax and profitability are proxied with many

indicators as observed in the literature (Vržina & Dimitrijević, 2019). In this study, we employ corporate income tax expenses as a proxy for corporate taxation while profitability is proxied with earnings per share.

Several studies (for example, Beigi, et al. (2013), Gallemore, et al. (2017), Olamide, et al. (2019), and Omodero and Ogbonnaya (2018)) have considered the empirical relationship between corporate taxation and firm profitability both in developing and developed countries. Unfortunately, these studies fail to reach consensus as they reported conflicting results. While some studies find that corporate tax is value-enhancing in line with the stakeholder theory, others find that corporate taxation has a deleterious effect on profitability.

This study contributes to the literature by investigating the impact of corporate taxation on firm profitability within the dynamic fixed effects framework, focusing on quoted deposit money banks in Nigeria. The main contribution of the study is the use of dynamic fixed effects model, which allows bank profitability to depend on its own one period lagged value, heterogeneity parameter and corporate taxation. To our knowledge, this empirical strategy, which helps to determine the extent of persistence in bank profitability, is novel in the Nigerian literature.

The remainder of this study is structured as follows. The next section discusses both the theoretical and empirical literature. Section 3 discusses the data, variables, and modeling strategy. Section 4 contains data analysis and discussion of findings. Section 5 contains summary and conclusion.

Literature Review

Theoretical Foundation

Our theoretical review is based on agency theory and stakeholder theory. These theories are discussed below.

Agency Theory

Jensen and Meckling (1976) proposed the agency theory of corporate governance that is focused on conflicts of interest between the company's owners (shareholders management, government and major debt financiers. Conflicts of interest between firm owners and firm management are because the owners and managers of the corporate enterprises are separated from those that run the business on day-to-day basis (Bauer et al., 2018). However, these parties, including shareholders and managers, are subject to taxation.

The benefit that shareholders and managers derive from their contractual arrangement is limited by corporate tax (Bauer et al., 2018). For example, if the profit of the management falls below their expectation, a contractual arrangement will be avoided due to the existence of taxation. Furthermore, corporate taxes limit the information content of managerial performance measures as well as their reward impact.

Profit after tax motivates management to participate in tax avoidance practices, but it is often noisier than profit before tax because it is affected by tax laws, such as adjustments in tax rates. Taxation has an effect on transfer rates, which are used for internal alignment and regulation, and are a deciding factor in the distribution of taxable profits especially in multinational companies (Bauer et al., 2018).

The role of corporate taxation in agency problems between company owners

and managers has gotten a lot of attention recently. (e.g., Bauer et al., 2018; Shackelford & Shevlin, 2001; Hanlon & Heitzman, 2010). According to this agency theory assumption, dividend taxation, for example, increases the cost of capital and, as a result, has a negative impact on corporate investment, dividend payouts, and overall corporate profitability (Chetty & Saez, 2007). Furthermore, Wells et al. (2001) argue that dealing with the investment impediments themselves (lack of expertise, regulatory and enforcement costs) is more difficult and time-consuming than putting in place a grant or tax scheme to mitigate the effects of such impediments. While providing a subsidy to offset an existing distortion is the second-best option, this is what often occurs in practice.

Zee et al. (2002) however, contend that there are also agency problems between government agencies in charge of attracting investment and those in charge of the general business environment. While investment promotion agencies may help organize government efforts to encourage investment, they often lobby for tax cuts without realizing the costs to the economy.

Stakeholder theory

Stakeholder theory offers managers a new outlook on decision-making. Stakeholders, according to Freeman (1984), are "all individuals that may influence or be influenced by the achievement of an organization's intent" (p.49). For banks, the major stakeholders are managers, depositors, regulators, employees, government, and shareholders. The stakeholder theory implies that a firm performance depends on its relationship with the stakeholders, hence corporate tax planning and management is value-enhancing and can significantly improve the

overall profitability of a firm (Minnick, & Noga, 2010).

Tax compliance is a sensible and normal way for businesses to promote and enhance positive stakeholder relationships, which is consistent with the underlying belief of the stakeholder approach. As a result, managers' views of tax as an expense to be reduced should change as they realize their responsibilities in meeting the needs of all stakeholders (Godos-Dez et al., 2011).

In general, stakeholder theory implies that companies must have social obligations in addition to corporate responsibilities, taking into account the needs of all parties impacted by the firm's strategy actions or policies. A company's ability to balance the diverse needs of its stakeholders or stakeholders is critical to its success (Hidayati, & Fidiana, 2017).

Empirical Review

Beigi, et al. (2013) used the panel data framework to investigate the extent to which firm profitability depends on firm-specific factors including corporate taxation. Their study focuses on listed companies in Tehran stock market from 2004 to 2010. Among their main findings is that corporate taxation has a negative and significant impact on profitability measures.

Gallemore, et al. (2017), using a sample of single-state commercial banks and exploit cross-sectional sample covering 31 (29) percent of total U.S. commercial bank loans (deposits) consisting of 351,767 bank-quarter observations from 11,860 unique banks spanning from 1996-2013, examine the association between corporate taxation and bank outcomes, including lending growth, leverage, liquid asset holdings, and risk-taking. More specifically, they find no evidence that changes in income tax rates have an effect on bank activity. The study,

however, find compelling evidence that the tax rate has significant effects on specific types of banks and during times of economic downturn and credit risk uncertainty, highlighting potentially significant policy implications for regulators and policymakers. Finally, the findings show how corporate income taxation influences bank outcomes such as lending and leverage, which affects the capital available to non-bank corporations and individuals.

Khan, et al. (2017) investigate the effect of capital gains taxation (CGT) on dividend policy among firms listed on the Karachi Stock Exchange (now known as the Pakistan Stock Exchange or PSX), using both static and dynamic panel data models (generalized methods of moments) to examine dividend payment behavior for a sample of 284 non-financial firms from 26 sectors listed at the PSX from the years 2006–2014. The dividends to total assets ratio was used as a dependent variable, and a taxation dummy was used as an explanatory variable, along with other control variables such as liquidity, leverage, profitability, last year's dividend, and firm scale. Profitability, leverage, and last year's dividend are the most important determinants of dividend payments in the Pakistani industry, according to the regression results.

Abiahu and Amahalu (2017), in a study on the effect of taxation on the dividend policy, conducted OLS estimation and Pearson coefficient of correlation using time-series data over the period 2006 – 2015 for quoted deposit money banks in Nigeria. The yielding evidence suggest that there is a negative significant relationship between tax and dividend policy. More specifically, that tax has statistically significant effect on dividend policy of banks in Nigeria.

Omodero and Ogbonnaya (2018), in a panel study of 12 banks for a period spanning for 2006 to 2016 using company income tax as the independent variable and profit after tax to examine the effect of corporate tax on the profitability of deposit money bank in Nigeria, found that company income tax has a positive and significant impact on profitability for three banks namely: Access Bank, Diamond Bank and GTB. While there is evidence of negative and insignificant impact of company income tax on profitability for the remaining 9 banks.

Using the pooled OLS method, Olamide, et al. (2019) investigated the link between corporate tax planning and financial performance of systematically important banks (SIBs) in Nigeria. The explanatory variables are actual corporate income tax owed by the selected banks relative to pre-tax profits, investment in non-current assets, thin capitalization, which is the ratio of the total debts of each bank to its total assets and the lease option that measures the lease arrangement for the banks, while firm size serves as the control variable. According to the findings, the effective tax rate has a negative and substantial impact on financial results. Furthermore, thin capitalization has a positive significant effect on SIBs' financial performance in Nigeria, while capital intensity and the lease alternative have had no impact on SIBs' financial performance in Nigeria. The study concluded that corporate tax planning affects financial performance depending on the adopted tax planning strategies.

In another empirical study, Ajayi, et al. (2019), using cross-section 8 deposit money banks for 2017, produced evidence that point towards the existence of a strong positive relationship between companies' income tax (CIT) and Corporate Profitability

proxied by Return on Asset of Deposit Money Banks (DMB's) in Nigeria. In the study, OLS technique was utilized to obtain estimation for the relationship between the variables of interest.

In an attempt to investigate the relationship between corporate tax and profitability, Adejumo (2020), using the generalized method of moment for 9 banks from 2012 to 2018, found that corporate tax planning, measured by effective tax rate, plays an instrumental role in affecting profitability (Return on Assets) of Nigerian listed deposit money banks. Further, evidence shows that effective tax rate has a significant negative effect on profitability (ROA). Additionally, the study found a significant positive effect of capital adequacy ratio as a control variable on profitability. However, both age and size of the banks have no significant effect on banks' profitability.

Further estimates provided by James, Akanbi and Olaronke (2020) using panel/time-series data for randomly selected 10 active banks quoted in the Nigerian Stock Exchange over the period 2010-2016 to empirically determine the effect of banks' corporate tax on the values of shareholder's wealth in Nigeria. Using Generalized Method Moment GMM the study concludes that, the tax has an interactive effect on growth and value of banks (shareholders' wealth maximization).

Methodology

Data and Variables

Our panel dataset is balanced, consisting of 100 firm-year observations obtained from ten (10) deposit money banks (DMBs) that are listed the Nigerian stock exchange over the period from 2010 to 2019. The banks, which are purposively selected based on data availability, are

ACCESS, FIDELITY, GTB, FCMB, FIRST BANK, UBA, UNION BANK, STANBIC IBTC, ZENITH and STERLING BANK. All data are sourced from financial accounts and annual reports of the individual banks and are empirically analyzed in EViews 11.

The variables are described below:

Bank Financial Performance (EPS):

This is measured by earnings per share, which is defined as the ratio of profit after tax to total number of ordinary shares outstanding.

Corporate Taxation (CTAX):

This is the main explanatory variable and is proxied by corporate income tax.

Firm Size (SIZE):

This is used as the control variable and is measured by the natural logarithm of total assets.

Figures 1 – 3 show the graphical display of the study variables based on their means and standard deviations.

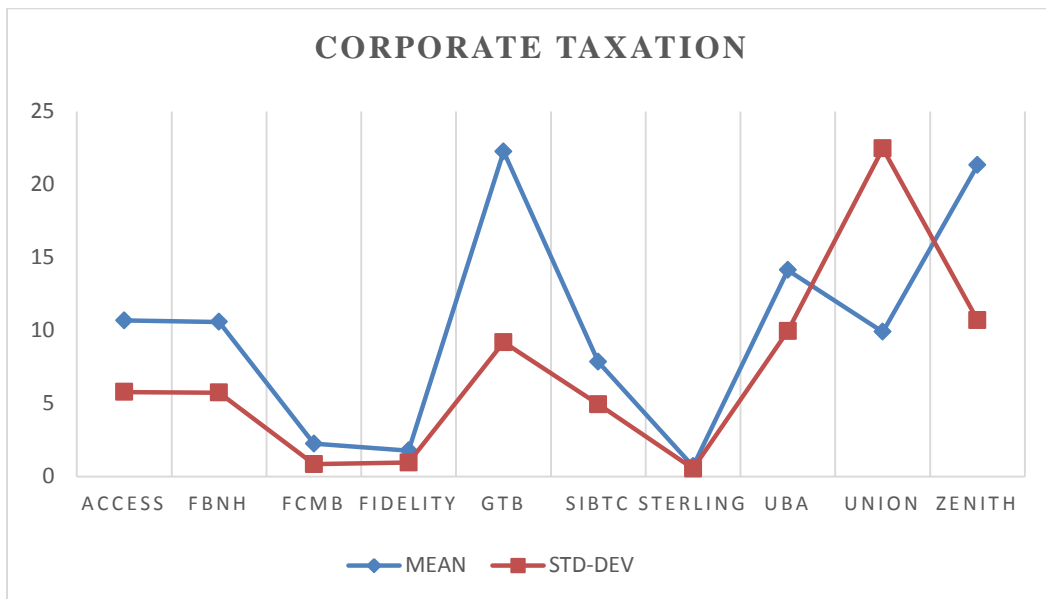


Figure 1: Corporate Taxation for the Individual Banks

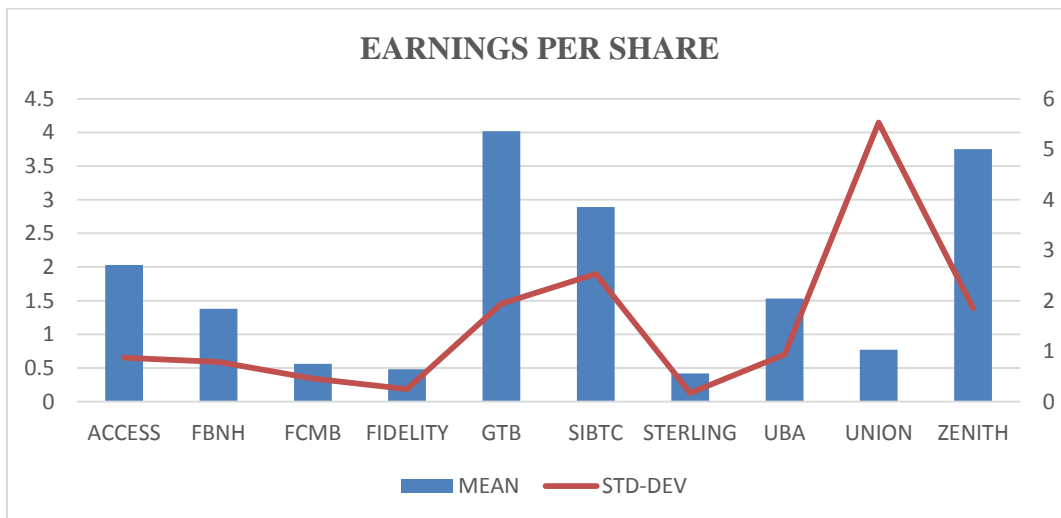


Figure 2: Earnings Per Share for the Individual Banks

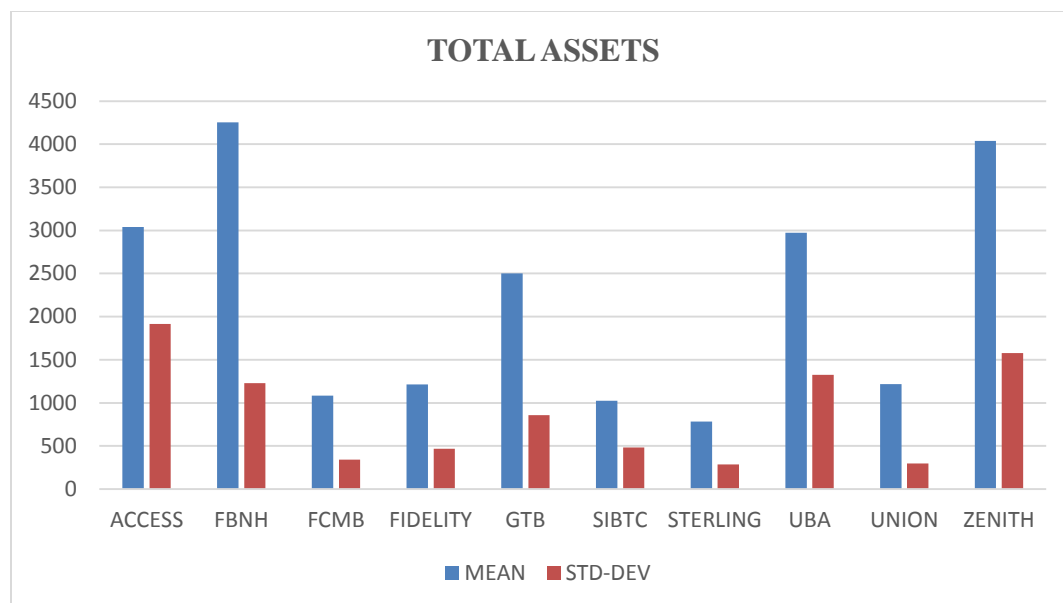


Figure 3: Total Assets for the Individual Banks

Data Analysis

Econometric Models and Method

To investigate the effect of corporate tax on bank financial performance, we specify the following empirical model.

$$EPS_{it} = \beta_0 + k_i + \beta_1 EPS_{it-1} + \beta_2 CTAX_{it} + \varepsilon_{it} \quad (1)$$

For $i = 1, 2, \dots, 10$ and $t = 1, 2, \dots, 10$. Our empirical model allows bank profitability to depend on its own one period lagged value as well as corporate income tax. Hence, our model is dynamic, with β_1 capturing the persistence in bank profitability. Further, the parameters, k_i are incorporated to capture the effect of unobserved bank-specific factors (such as management quality and leadership style), hence our dynamic panel

model is also heterogenous. Finally, we assume that k_i correlates with CTAX, hence our model is a dynamic fixed effects specification. However, we employ the Hausman specification test to test the validity of this assumption.

To ensure that our empirical analysis is robust, we respecify our empirical model with firm size incorporated as an additional explanatory variable as follows:

$$EPS_{it} = \gamma_0 + k_i + \gamma_1 EPS_{it-1} + \gamma_2 CTAX_{it} + \gamma_3 SIZE_{it} + \varepsilon_{it} \quad (2)$$

We argue that larger banks are more profitable than smaller banks, hence, we expect γ_3 to be positive and significantly different from zero.

Descriptive Statistics

Table 4.1: Pooled Descriptive Statistics for CTAX, EPS and TOTAL ASSETS

| STATISTICS | CTAX (₦ Billion) | EPS | TOTAL ASSETS (₦ Billion) |
|------------|---------------------|--------|-----------------------------|
| Mean | 10.15 | 1.78 | 2212.66 |
| Maximum | 70.01 | 8.30 | 7147.00 |
| Minimum | 0.07 | -12.66 | 260.69 |
| Std Dev | 11.55 | 2.43 | 1600.54 |
| Skewness | 1.94 | -1.25 | 1.15 |

| | | | |
|-----------------------|-------|--------|--------|
| Kurtosis | 8.88 | 14.69 | 3.47 |
| Jarque Bera (p-value) | 00000 | 0.0000 | 0.0000 |

Empirical Analysis

Table 2 presents the dynamic fixed effects results for models 1 and 2. We can see that the results for the two models are largely comparable, with the Hausman statistic (p-value < 0.01) clearly rejecting the null hypothesis that the heterogeneity parameter is uncorrelated with corporate taxation in the bank profitability model. This confirms our modeling assumption, hence bank-specific factors such as management quality and leadership style play an important role in the relationship between corporate taxation and bank profitability.

In terms of goodness of fit, the results show that the two models are highly explained and significant. As shown by the Adj. R-squared, and for both models, almost 80% of the total variations in earnings per share are accounted for, while the remaining 20% are due to other factors not included in the model. The probability of the F-ratio (p-value = 0.0000) is almost zero for both models, hence our empirical results are highly significant.

Table 2: Dynamic Fixed Effects Results; () contains p-values

| Variables | Model 1 | Model 2 |
|-----------------------|-----------------------|-----------------------|
| Intercept | -0.0804 (0.5131) | -3.1037** (0.0245) |
| EPS(-1) | 0.4828*** (0.0000) | 0.3812*** (0.0005) |
| CTAX | 0.1878** (0.0158) | 0.2013*** (0.0084) |
| LTA | – | 0.3988** (0.0277) |
| R-Sq | 0.8098 | 0.8224 |
| Adj R-Sq | 0.7807 | 0.7924 |
| F-statistic (p-value) | 0.0000*** | 0.0000*** |
| Hausman | 11.787*** (0.0028) | 17.869*** (0.0005) |

Source: Output from EViews 11

****indicates significance at 5% level.**

*****indicates significance at 1% level.**

For the individual coefficients, as expected, the EPS(-1) beta is positive, sizable and has a very low probability for both models, hence it is significant both statistically and in economic sense. For model 1 (without firm size), this beta is 0.4828, showing that, holding other factors constant, a 1% increase in earnings per share

in the current period would, on average, cause about 0.48% increase in earnings per share one year after. This implies that bank profitability is persistent and can be predicted based on its past behaviour. For model 2, this coefficient is 0.3812, hence, its value does not change significantly with the incorporation of firm size in the model.

Therefore, omitting this important dynamic parameter in the bank profitability model would lead to serious misspecification bias.

The results also show that corporate income tax has a positive and significant effect on bank profitability. For model 1, the coefficient of 0.1878 shows that when corporate income tax increases by 1%, bank profitability, measured by earnings per share, would concurrently increase by about 0.19%, holding other factors constant. As indicated by the p-value, this resultant increase is also significant at 5% level. For model 2, this coefficient is estimated at 0.2013, with a p-value of 0.0084, hence it is highly significant, implying that the result for the impact of corporate taxation is consistent and robust. This leads to the rejection of the null hypothesis, which states that bank profitability is not a significant function of corporate income tax. This implies that higher corporate income tax leads to higher bank profitability. Hence, consistent with the stakeholder theory, corporate income tax, which also proxies corporate government responsibility, has a significant explanatory power for bank profitability. The results agree with the several previous studies including Ajayi, et al. (2019) and Omodero and Ogbonnaya (2018). On the contrary, our results disagree with Beigi, et al. (2013).

Further, consistent with our apriori expectation, our results show that firm size has a positive and significant impact on bank profitability. The coefficient linking firm size to profitability has an estimated value of 0.3988 (p-value = 0.0277), which is sizable and significant at 5% level. Hence, while profitability responds significantly to changes in firm size, larger banks are more profitable than smaller banks. This result disagrees with Adejumo (2020).

Summary and Conclusion

This study, which is motivated by the conflicting results reported by previous studies, investigated the impact of corporate taxation on bank financial performance in Nigeria using the dynamic fixed effects framework. Corporate taxation is measured by corporate income tax, while bank financial performance or profitability is measured by earnings per share. The dataset comprises 10 quoted deposit money banks in the Nigerian stock exchange covering from 2010 to 2019. The banks are ACCESS, FIDELITY, GTB, FCMB, FIRST BANK, UBA, UNION BANK, STANBIC IBTC, ZENITH and STERLING BANK.

Consistent with the stakeholder theory, our results show that corporate taxation is value-enhancing as it leads to higher profitability. However, bank profitability is also found to be persistent and depends on its own one period lagged value. These results are also robust as incorporating bank size do not significantly affect the relationship between corporate taxation and bank profitability. Hence, we conclude that corporate taxation is a significant determinant of bank profitability in Nigeria.

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