AN ASSESSMENT OF TAX RELIEFS AND ECONOMIC DEVELOPMENT IN NIGERIA

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Abstract

The mission of any government is the maximization of the social welfare of its citizens. In achieving this, government provides certain amenities to the citizens such as good roads, sound health, education, law and order. The provision of these are found to be cash consuming which the government may not be able to meet on its own without imposing compulsory levy on the citizens. Therefore, in as much as the imposition of tax is inevitable, some measures are put in place by the government to reduce the burden of tax on taxpayers. This is aimed at providing the tax payers with a sufficient disposable income which its resultant effect is the improvement of standard of living of the citizenry. For the purpose of the study, four private universities in Nigeria were purposively selected out of 34 licensed private universities in Nigeria. Questionnaires were administered to thirty lecturers in each of those four selected private universities which gave a total of 120 respondents. Statistical Package for Social Sciences (SPSS) was used to analyze the data collected and Pearson Product Moment Correlation was used to test the hypotheses formulated. The result of the analysis showed that, though, there are tax reliefs provisions for the reduction of tax liability, the reliefs system in Nigeria is not efficient and adequate to improve the standard of living.

Key-words: Taxation, Reliefs, Disposable Income, welfare, Development

Introduction

Tax is imposed on the income of individuals and companies by the government in order to raise fund for the achievement of government objectives of welfare maximization (Ola 2004). With regards to the tax imposed on the income of individuals, certain tax rates are applied on the individualsô assessable income and the higher the rate the higher the tax paid by the individual, thereby resulting in reduction in the disposable income available for personal use of individuals. This would thereby affect the economy of the nation because, the higher the amount available for the personal use the more improved the standard of living which in turn improves the economy of the nation (Fasoto 2001). Excessive tax regime discourages investment and leads to tax evasion (Ola 2000). The ability of the individual to play important role in the development of the nationøs economy would largely depend on the ability of each individual to participate in the economic activities in the nation. This also depends on the living standard of such an individual and it is a function of the income available for the use of the various individuals (Ayua 1986). Ishola (2005) argued that despite the importance and usefulness of taxation as an instrument of generating revenue for the government to perform government businesses, it has a way of affecting the development of the economy in a negative manner by way of reducing the income that is available to the tax payer on whom tax is imposed. Ogundele (1999) averred that tax affects the economy in many ways like reduction in the resources available to the economy by distorting economic incentives, so less labour is provided, less capital in the form of new savings is available and less investment in education and new plant and equipment. In addition, the distortion as a result of tax imposition affects the resources employed in the economy and also nationøs output. However, it is very important to note that no matter how effective the tax system in a particular country is, individual also contributes to the development of the nationøs economy by way of paying taxes to the government and also participates in other economic activities of the nation (Ishola 2005).

Statement of Problem

No one pays tax with a smile in his mouth (Philips 1991). The introduction of taxation is aimed at certain goals such as management of a countryøs economy, improvement in general standard of living and most importantly to raise revenue for the government to be able to meet up with expenditures in the provision of public goods and other basic amenities for the citizens (Ayua 1986). It is very important to know that no matter how effective the tax system in a particular country is, individual also contributes to the development of the nationøs economy by way of paying taxes to the government and participating in other economic activities of the nation (Soyode and Kajola 2006). However, the ability to participate effectively in the economic activity depends on the level of living standard of the citizens which also depends on the disposable income available to the tax payers (Ayua 1986). As advantageous as the payment of taxes to the government is, as a result of its contribution to the economy, it affects tax payers who are the citizens of the country in a negative way because it reduces the tax payersô income which deprives them of basic necessities of life (Murphy and Higgins 2004). In order to ameliorate this resultant negative effect on the tax payers, government has put in place a palliative measure in form of various tax reliefs like personal allowance, children allowances, dependent relatives and many others (Aguolu 2004). Therefore, this study seeks to examine the nature of tax reliefs available to tax payers in order to see if they are sufficient enough to enhance the standard of living of Nigerian tax payers.

Research Questions

i) What are the tax reliefs available to tax payers?
ii) What relationship exists between disposable income and the standard of living?

iii) Are the tax reliefs available adequate to guarantee enough disposable income?
iv) Are the rates of the reliefs frequently reviewed in line with the current economic needs?

Research Objectives

The general objective of this study is to investigate the relationship that exists between the tax reliefs and the economic development in Nigeria. This broad objective is broken down into the following specific objectives:

i) To assess the adequacy of tax reliefs available to the tax payers in Nigeria.
ii) To assess the relationship that exists between the disposable income and the standard of living of individual tax payers.
iii) To assess the relationship between tax reliefs and tax payersô income in Nigeria

Research Hypotheses

The following hypotheses shall be empirically examined:

Hypothesis 1: Tax relief available is not adequate to improve the standard of living of Nigerian tax payers

Hypothesis 2: There is no significant relationship between the disposable incomes and the standard of living of the tax payers.

Literature Review: Tax and Tax Relief

Ogundele (1999) defined tax as the process or machinery by which community or group of people are made to contribute funds in some agreed quantum for the purpose of the administration and development of the society**.** Soyode and Kajola (2006) defined taxation as a system of raising money for the use of the government by means of contributions from individual, person and corporate bodies. Idowu and Fashina (2007), defined taxation as a system of imposing a compulsory levy by the government on all income, goods and services, and properties of individual, partnership, trustees, executors and companies. Adesola (2004), described tax as a compulsory contribution imposed by the government. He concluded that, the tax payers may receive nothing in return for the tax paid. Ijewere (1991) added that, tax is like any other compulsory contribution that is levied in cash or kind on a natural or artificial entity on the basis of a legislature by the public authority. Such authorities may be federal, regional or local; by definition so far, it is not a private entity or organization. Adesola (2000) said tax is a compulsory levy which a government imposes on its citizens to enable the government to obtain the required revenue to finance its activities. The tax law regulating taxation of individuals is Income Tax Management Act of 1961 which was replaced by Personal Income Tax Decree 104 of 1993. The decree provides for the taxation of employees, sole traders, partnership and the likes (Fasoto 2001). Fasoto went on to say that, the Federal Government of Nigeria is responsible for revenue collection and revenue allocation for the development programmes at the three levels of government in Nigeria. However, the tax authority responsible for the assessment and collection of personal income tax of an individual (which is the main focus of this study) is the tax authority of the territory in which the office of the employer is located, that is the State Internal Revenue Service. In the case of the members of Armed Forces, residents of the Federal Capital Territory and External Affairs Officers, the relevant tax authority is the Federal Board of Inland Revenue (Ola 2004). Dalton (1996) described tax reliefs as a form of allowance granted to tax payers in order to reduce the amount to be paid as tax. Different people always have different ideals about tax reliefs (Philips 1991). If you want to negotiate a lower settlement with the Internal Revenue Service (IRS) it may be wrongly taken as tax reliefs. On the other hand, the Internal Revenue Service uses the term to mean specialized tax deductions for people who experience business loss due to disaster. Others use the term more generally to refer to any legal method a tax payer takes to reduce the amount of taxes due for payment. The Roman and Roman study conducted in year 2007, presents strong evidence that higher taxes tend to diminish economic activity. Gregory (2007) added that, the magnitude of the effects of taxes on the economy, in contrast to Roman and Roman opinions, was interested in identifying the feedback effect of tax changes. For example, if Congress reduces the tax on income without any consequent change in the level of economic activity or tax payerōs behaviour, then the tax policy change would obviously reduce tax receipts. This is sometimes referred to as the óStatic Revenue Effectö. However, such a tax reduction would increase the level of investment and therefore, the level of income and output. The gains from tax base and increase in government revenue are the feedback effect, sometime called the óDynamic Effectö. To measure the feed back effect, Gregory (2007) stated a Standard Neoclassical Growth Model of the economy, or the Ramsey Model. A Neoclassical Growth Model suggests a general nature of the relationship among capital, labour and output. To make the model operational, the Neoclassical Model employed conventional parameter values for key variables, such as the responsiveness of labour supply to changes in after tax wage rate.

Concept of Tax Relief and Economic Development

Personal Relief is the allowance granted to every individual tax payer who has a source of income during the year of assessment (Soyode and Kajola 2006). Every tax payer is entitled to an allowance which is a fixed amount plus a percentage of earned income. The current rate of personal allowance is ^5,000 plus 20% of Earned Income with effect from 1998. The implication of this is that any tax payer that receives earned income shall be allowed to deduct ^5,000 +20% of Earned Income from his total income before whatever is left is subjected to tax and helps to reduce the burden of tax. Children allowance is another important relief enjoyed by a tax payer that has children. According to Idowu and Fashina (2007), children allowance is granted to a tax payer who, during the preceding year of assessment, maintains a biological offspring or an adopted child (with a proviso that, no relief has been claimed on such an adopted child by any tax payer during the year of assessment). The following conditions must be met before children allowance can be enjoyed: (i) it is subject to a maximum number of four children (ii) those children must not exceed the age of sixteen and in a situation where any exceeds sixteen, such must be a full time student or be apprentice in a trade and (iii) the child must not be a married person. With effect from 1998 to date the allowance has been ^2500 per child (Ola 2004). This allowance is granted to tax payer who has children as a way of defraying the cost incurred for the well being of the children. However, this allowance cannot achieve its purpose effectively as the amount of ^2500 granted on each child per annum is not substantial when compared with actual amount spent on maintaining a child in a year (Idowu and Fashina 2007). Concerning the Dependent Relative allowance, Soyode and Kajola (2006) averred that, a tax payer can claim an amount of ^2000 on every dependant maintained during the year preceding the year of assessment. Dependant relative in this context can be an aged parent; tax payer spouseōs aged uncle and other close relative that is incapacitated by age or infirmed by disease. The allowance can be claimed on two dependants whose annual incomes are not more than ^6000 in a year. Another important relief is life assurance. According to Ayua (1986), the allowance is granted to a tax payer who, during the preceding year of assessment, paid premium on an assessment on his life or on the life of his spouse. It must be noted that life assurance relief is not granted on a child because it is believed that nobody has an insurable interest on a child. Life assurance relief is very beneficial to the tax payer, because any amount paid as premium shall not be taxed thereby, reducing the tax liability of the tax payer (Ola 2004). Disabled person allowance is available for an employee who is incapacitated during the course of his lawful employment or through the use of special equipment and the services of an attendant in the course of a paid employment. With effect from 1989, if a disabled person has a source of earned income and employs the use of an equipment or assistant in the course of deriving his income. Such a person will be entitled to additional relief. With effect from 1998 tax year, the relief shall be granted at the higher rate of ^3,000 or 15% of earned income. This allowance is granted in order to reduce the proportion of income of a disabled employee which is spent on the use of supporting machine, or employment of assistant. With effect from 1987 year of assessment, the cost of equity participation by an individual in a company floated exclusively for the research and development shall be allowed for deduction from total income provided the amount of deduction does not exceed 25% of the total income for that year of assessment. Any amount that can not be deducted as a result of the above restriction shall be carried forward to subsequent years until the total cost of equity is fully relieved (Soyode and Kajola 2006). In addition, this donation to any recognized research centre by an individual is an allowable deduction from the total income provided the amount of deduction does not exceed 10% of taxable income.

According to Soyode and Kajola (2006), some of the other allowable statutory deductions are as follows:

a) Transport allowance which is subject to a maximum of ^20,000 per annum and any amount in excess of this shall be subject to tax.
b) Rent subsidy allowance which is subject to maximum of ^150,000 per annum and excess is liable to tax.
c) Meal subsidy allowance is the maximum of ^5,000 per annum
d) Entertainment allowance is the maximum of ^6,000 per annum
e) Leave allowance is granted at 10% of annual basic salary
f) Utility allowance is subject to the maximum of ^10,000 per annum

According to Investopedia Dictionary, standard of living is defined as the level of wealth, comfort, material goods and necessities available to a certain socio economic class in a certain geographical area. It must be noted that the standard of living of citizens in a country has direct relationship with the economic development of that country. Economic development is the increase in the standard of living of a nationȏs population with sustained growth from a simple, low- income economy to a modern, high-income economy. Its scope includes the process and policies by which a nation improves the economic, political and social well-being of its people (Peter, 2005). Conclusively, it can be deduced that with the available tax relief, it is obvious that there is an adequate provision of the law aimed at reducing the tax burden, and this should also be capable of improving the standard of living. The problem limiting the effectiveness lies in the irregularity in the review of the tax relief act. Most of these provisions have been in existence for so many years and are still in use to date. For instance, the ^2,500 per child granted as children allowance is not a reasonable amount when compared with the current economic state of Nigeria.

Methodology

The population for this study consisted of 34 licensed private universities by the National University Commission as at November 2010. Out of which 4 Universities (Bowen University, Ajayi Crowder University, Covenant University and Redeemerôs University) were purposively selected as samples for the study. The samples however, consisted of 120 lecturers (30 lecturers from each University) chosen from those selected 4 Universities, having considered all the reliefs granted to them by the government. The selection of the samples was independent of sex and the status of the lecturers chosen.

Instrument

The instrument consisted of a 15 ïterm survey questionnaire with a -4 Likert scale response options. Thus, Strongly Agree (SA), Agree (A), Disagree (D), and Strongly Disagree (SD). The content and face validity of the research instrument were done through the assistant of experts in psychometrics. The working experience, job and marriage status coupled with educational attainment of the respondents were considered when the questionnaires were being administered on the respondents.

Data Analysis

The scoring scale for the items is positive statements with the response options SA, A, D, and SD were given as 4,3,2, and 1point respectively and the reverse was used for a negative item. Simple percentage was used for interpretation of data for clarity and simplicity of comprehension. The items in the questionnaire were administered on the respondents to observe the extent to which the stated objectives have been achieved through the responses of the respondents;

Table 1: Data Presentation and Analysis

S/N	VARIABLES	SA %	A %	D %	SD %
1	I enjoy tax relief on my income	90 75%	15 12.5%	7 5.8%	8 6.7%
2	Tax relief has improved my standard of living	85 70.8%	10 8.3%	15 12.5%	10 8.3%
3	There are better ways asides from tax relief to improve my standard of living	95 79.1%	5 4.17%	12 10%	8 6.7%
4	Performance of lecturers can be affected by the standard of living	110 91.7%	10 8.3%	_	_
5	Standard of living depends on the available disposable income of an individual	86 71.7%	12 10%	10 8.3%	12 10%
6	The available tax reliefs are enough to cushion the effect of tax burden	4 3.33%	6 5%	23 19.2%	87 71.7%
7	All tax payers should be taxed at the same rate irrespective of income level	15 12.5%	10 8.3%	65 54%	30 25%

8	High tax regime encourages tax evasion	65 54%	35 29.2%	12 10%	8 6.7%
9	To reduce tax burden, tax planning should be encouraged by the government	70 58.3%	35 29.2%	10 8.3%	5 4.2%
10	Public goods provided by government is commensurate with the amount paid as tax	5 4.2%	10 8.3%	55 45.8%	50 41.7%
11	The method of tax collection (PAYE system) in Nigeria is not efficient	56 46.7%	40 33.3%	16 8%	8 6.7%
12	The amount imposed on tax payers is too high	98 81.7%	10 8.3%	8 6.7%	4 3.3%
13	Tax allowances are not often reviewed to reflect the current economic situation of the tax payers	86 71.7	18 15%	10 8.3%	6 5%
14	Improved standard of living of citizens brings about economic development to the nation	90 75%	12 10%	_	8 6.7%
15	A proper and constant review of reliefs and allowances will improve standard of living	80 66.7%	28 23.3%	8 6.7%	4 3.3%

Source: Field Work; 2010.

Table 2: Calculation of Correlation (test of Hypothesis 1)

Options	Point (X)	Response (Y)	XY	X^2	Y^2
SA	4	4	16	16	16
A	3	6	18	9	36
D	2	23	26	4	529
SD	1	87	87	1	7,569
×	10	120	147	30	8,150

Source; From Field Work, 2010.

$$r = \frac{n\times\ XY - \times X \times Y}{ã\ [(n\times X^2\ ï\ (\times X)^2][n \times Y2\ ï\ (\times Y)^2]}$$

$$= \frac{4\,(147)\ ï\ (10\times120)}{ã\ [(4\times30)\ ï\ (10)^2][(4\times8{,}150)\text{-}\ (120)^2}$$

$$= \frac{588\ ï\ 1200}{ã(120\ \text{-}100)\ (32{,}600\ \text{-}14{,}400)}$$

$$= \frac{-\ 612}{603} = -\ 1.02$$

Decision

Since r cal of -1.02 is less than 0.5 level of significance, which suggests that there is a perfect negative correlation relationship between the variables. The null hypothesis that says ótax reliefs available are not adequate to improve the standard of living of the Nigerian tax payersô is therefore accepted and the alternative hypothesis is rejected.

Table 3: Calculation of Correlation (test of hypothesis 2)

Options	Point (X)	Response (Y)	XY	X^2	Y^2
SA	4	86	344	16	7396
A	3	12	36	9	144
D	2	10	20	4	100
SD	1	12	12	1	144
×	10	120	412	30	7784

Source; From Field Work, 2010.

r = n× XY - × X × Y
ã [(n× X^2 ï (× X)^2][n × Y^2 ï (× Y)^2]

4 (412) ï (10 ×120)
ã [(4×30) ï (10)^2][(4×7784)- (120)^2

1,648 ï 1,200
ã (120 -100) (31,136 -14,400)

448 = 0.77
579

Decision

Since r cal of 0.77 is greater than 0.5 level of significance, it suggests that there is a strong and direct relationship between the variables. The null hypothesis is therefore rejected and the alternative hypothesis that says ñThere is a significance relationship between the standard of living and the available disposable income of individual tax payersô is accepted.

Findings

From the result of the study, the following findings were made:

- The tax imposed on tax payers by the government with the aim of developing the economy has a lot of negative inherent effects of heavy tax burden on the tax payers.
- The effort of government at reducing the burden of tax (through tax reliefs) has made little or no contribution to solving the problem of heavy tax.
- It was discovered that with or without tax reliefs, the rate at which personal income tax is imposed on the income of lecturers that represent the tax payers in the country is too high. Therefore, it reduces the disposable income of tax payers.
- It was also observed that despite the huge revenue being collected through tax imposition, the services provided are not found commensurate with the revenue. This suggests one of the major contributors to tax evasion and avoidance in Nigeria.
- Also the tax laws and the amounts granted as reliefs have been overdue for upward review to reflect the current economic conditions because, the available tax reliefs are found not to be adequate to cushion the effect of tax burden.
- It was also observed that the Nigerian tax administration was not efficient. The method of tax collection (PAYE) is not efficient in Nigeria.

Conclusion

Having recognized the immense contribution of tax and tax reliefs to the development of the Nigerian economy, the government should pay more attention to the provision of infrastructural development so that tax payers may continue to see the reasons why they should voluntarily pay taxes to the government. Also, the tax administration system should be more efficient and effective by regularly looking into all the areas where tax assessment, collection and proper remittance can be improved. Finally, the tax reliefs and allowances rates must be reviewed constantly and frequently in line with the current economic situations in the country.

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THE IMPACT OF RECAPITALIZATION POLICY ON THE PROFITABILITY OF NIGERIAN BANKS

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Abstract

The last recapitalization policy in the Nigerian Banking industry, among other things raised the minimum capital base of the commercial banks from ₦2billion to ₦25billion. This policy generated mixed reactions both from the banking and non-banking public on its appropriateness to Nigerian banks. This study evaluates the impact of the policy on the profitability of the banks. Three banks were randomly selected for the study. Meanwhile, two sets of data were used for the analysis; the first was obtained through the administration of questionnaire, the second set of data, which included the capital base and profit before tax, extracted from the annual reports of each of the selected banks, for the various years were analyzed using correlation co-efficient and regression analysis. The findings indicate a positive correlation between capital base and profit before tax. Periodic voluntary recapitalization is recommended.

Key Words: Recapitalization, Profitability and Banks

Introduction

Capital is difficult to define (Berger *et al.*, 2005: 54). When it is viewed narrowly, bank capital can be seen as the amount contributed by the owners of a bank which gives them the right to enjoy all the future earnings of the bank. However, apart from the amount contributed directly by owners, profits which are due to them are often retained in the form of reserves. Including these reserves in the computation of bank capital makes it to be more widely defined as óshareholders fundsô or ónet worthô (Anyanwaokoro, 1996: 140). Bank capital performs numerous functions: it is a source of loanable funds, it helps forestall liquidity crises and it aids in preventing episodes of financial distress. As a source of loanable funds, capital is an input that can substitute for deposits and other types of borrowed funds. It is a cushion for loan losses and, hence, protects the bank from the threat of insolvency and other forms of financial distress that leads to regulatory intervention (Hughes and Mester, 1997:2). The higher the level of capital, the lower the risk of insolvency and the greater the degree of protection from financial distress. A bankôs capital is therefore seen as a measure of its financial strength and signals the bankôs safety to less informed depositors and other outsiders.

From its amount and structure are derived important qualitative parameters by which the prudence of the bankôs conduct may be ascertained (Bobáková, 2003: 25). Due to the importance of bank capital, it is widely regulated. Bank capital regulations usually border on the minimum share capital, maintenance of adequate reserves and capital adequacy ratios. The Impact of Capital base on Bank Profitability in Nigeria is the aim of this study; we are primarily focused on the regulation of the minimum share capital of banks in Nigeria.

Since 1952, the minimum share capital requirement for banks operating in Nigeria has been increased by bank regulators nine times, namely in 1958, 1962, 1969, 1988, 1991, 1997, 2000, 2001 and 2004. Anyanwaokoro (1996: 137) observed that all banking legislations in Nigeria have included the stipulation of minimum capital requirements for banks. The most recent regulation occurred in 2004 when banks were compelled to raise their capital to N25 billion (pronounced as *twenty five billion naira*) with full compliance before 31 December 2005.

However, a principal difference between the most recent regulation and previous ones was the capital base definition. In the recent regulation, the capital base of banks was defined as ópaid up share capital and reserves unimpaired by lossesô (Okagbue and Aliko, 2005: 1). Moreover, there has been no empirical evidence on the relationship that exists between capital base and profitability. Based on these, the study is guided by the following questions: Is there any significant relationship between share capital and profitability of banks? Is the new minimum share capital requirement of banks justified? Is the new share capital an aid to minimizing banking distress?

Statement of the Problem

The good health of the banking industry is of immense importance to any economy. The last increase in the minimum capital bases for banks in Nigeria has generated mixed reaction both from the banking and non-banking public on its appropriateness to Nigerian banks. Given the present economic reality, what is the appropriateness of this policy to Nigerian banks in particular and to the Nigerian economy at large? There is also the need for empirical evidence on the relationship that exists between capital base and profitability in the banking industry.

Objective of the Study

The objective of this paper is to examine on the basis of empirical evidence, the true relationship between capital base and bank profitability in Nigeria using correlation co-efficient and regression analysis. We will empirically determine whether share capital amount and status had significant relationships with the profitability of banks. If a significant relationship existed, then the new share capital regulation was justified because it had a significant effect on bank profitability and, by implication, bank stability. On the other hand, if no significant relationship existed, then the new share capital regulation was inappropriate in enhancing bank profitability and stability, as well as in minimizing distress in the Nigerian banking industry at the time.

Brief History of Recapitalization Policies in Nigeria

Before 1952, there was no legal minimum capital requirement for banks operating in the Nigerian colony (Uche, 1998: 30). The absence of any licensing requirement, minimum paid-up capital requirement, and, in fact, any meaningful regulation for banks made it possible for all and sundry to set up banks during this period (Uche, 1997: 226). As a result, the pre-1952 period has been termed a *free banking era* (Brownbridge, 2006: 3; Anyanwaokoro, 2001: 92; and Nwankwo, 1980: 47). A number of the banks set up during this era failed within a few years of opening. Some of the indigenous banks merely opened their offices, collected money from depositors, and disappeared. Worried by the spate of establishment of banks and sensing that further failures were imminent, the Colonial

Government, in 1948, commissioned a commission of enquiry headed by Mr. G. D. Paton, a consultant for the Bank of England, to óenquire generally into the business of banking in Nigeria and to make recommendations to the Government on the form and extent of control which should be introducedô. Paton submitted his report in October 1948. His report culminated in the 1952 Banking Ordinance (Nwosu and Nwosu, 1998: 6). The ordinance stipulated *inter alia* that all banks should have a nominal share capital of at least £25,000 (equivalent of N 50,000) of which not less than £12,500 (equivalent of N 25,000) should be paid up (Anyanwaokoro, 2001: 96). Sections 5(2) and 6(2) of the said Ordinance however gave the existing banks three years within which to comply with the provisions of the ordinance or discontinue banking business and cease to use the word bank or any of its derivatives in the name under which it is carrying on business (Uche and Ehikwe, 2001: 135).

Since 1952, the minimum amount of share capital stipulated by Nigeriaôs bank regulators has continued to rise. The 1958 Banking Ordinance, which repealed the 1952 Ordinance, raised the share capital requirement for foreign banks from £100,000 to £200,000. The requirement for the indigenous banks remained unchanged (Ogowewo and Uche, 2006: 167). There were series of upward review of minimum share capital between 1958 and 2000. In 2001 AD, the minimum capital was raised to N2 billion for new banks while existing banks were expected to meet this level by December 2004 (CBN, 2006: 1).

Before the December 2004 deadline for the N 2 billion minimum paid up share capitalization had been reached, in July of the same year (i.e. 2004), the CBN changed the rules of the game. At the 273rd meeting of the Nigerian Bankersô Committee held at the CBN headquarters in Abuja on *Black Tuesday* (Orogun, 2004: 15), 6th of July 2004, the then newly appointed Governor of the CBN, Professor Charles Soludo, made pronouncements on Nigerian banking sector reforms. A principal feature of the reforms was the requirement that the minimum capitalization for banks be raised to N 25 billion (approx US$195 million) from the prevailing minimum of N 2 billion (approx $16 million) with full compliance before 31 December, 2005. This was an increase of 1150 per cent (Ogowewo and Uche, 2006: 161). A principal difference between this increase of minimum capital requirements and previous ones was the capital base definition. For the purpose of the reforms, the capital base of banks was defined as ópaid up capital (ordinary shares and non-redeemable preference shares) and reserves unimpaired by lossesô, i.e. total shareholdersô funds (Okagbue and Aliko, 2005: 1).

From the foregoing review, it is clear that, rather than establish a minimum share capital ratio based on asset size and bank risk-taking that is to be uniformly applied on all banks in the Nigerian banking industry, Nigerian bank regulatorsô regulations of bank share capital have, until now, always set a minimum quantum which does not depend on the regulated banksô respective asset sizes, off balance-sheet activities or risk exposures.

Reasons for Bank Capital Base Regulation

It is widely believed that the more capital a bank has, the more resistant it will be to failure. If a bank is not adequately capitalized, its capital funds can easily become impaired by losses. If this happens, the end results are distress and possibly failure. In Nigeria, inadequate capitalization was partly blamed for the collapse of several indigenous banks during the free banking era (Anyanwaokoro, 1996: 137 and Brownbridge, 2006: 11). The survival of the foreign banks established within the era has been linked to their being well capitalized (Uche, 1998: 30). Bank capital is therefore regulated mainly to curb bank distress and failure. For example, it was to curb the spate of bank failures that the 1952 Banking Ordinance stipulated minimum capital requirements for banks operating in Nigeria. Similarly, share capital regulations in the 1990s were a consequence of a distress crisis in the Nigerian banking industry (Nwosu and Nwosu, 1998: 9). Recently, the CBN clearly stated that one of the major reasons *inter alia* for its adjustments of the minimum paid up capital of banks is to minimize distress risk (CBN, 2006: 1).

The banking industry is special in terms of regulation as experience has shown that failure (bankruptcy) in this industry has external consequences. The concern to safeguard the viability of the depository industry arises from the fact that financial failure has significant external effects that reach beyond the depositors and stockholders of the financial firm (Uche, 2001: 71 and Uche, 2000: 158).

Since banks are entrusted with public funds, the collapse of any bank will have a far reaching effect than the collapse of any other business (Anyanwaokoro, 1996: 47). These negative externalities are systemic risks, bringing about large economic and social costs. When a bank fails, its customersô money is involved. Hence, the bankôs failure may lead to the collapse of its customersô businesses, which equally has a chain of consequences on the customers and the economy in general. For this reason, Olashore (1988: 43) emphasized that the regulation of the operations of banks is necessary.

Furthermore, the failure of a large number of banks or the failure of a small number of banks could set off a chain reaction (spill-over effect) that may undermine the stability of the financial system and lead to its collapse. This has come to be known as the contagion effect. This effect is more pronounced when the failure is widely perceived not to be isolated; and the reason for the failure is either unknown or is not clearly seen to be specific to the failed bank or group of banks. Public information about the condition of individual banks is highly imperfect and so when a number of banks fail, it may be difficult to tell whether the cause is idiosyncratic shocks to individual banks or a more widespread shock that jeopardizes many other banks (Berger *et al.,* 2005: 17). Thus, the news that some banks failed, in the absence of any official action, may create destructive widespread ópanicô runs on other solvent but illiquid banks, by depositors who are unsure whether the shock may affect their banks (Bhattacharya and Thakor, 1993). In such a scenario, therefore, irrespective of the bankôs balance sheet strength, it may still be rendered insolvent by the actions of other banks (Bank of England, 1984).

Hence, it has been argued that the losses of depositary failure and their external effects are usually large. Advancements in information technology have also added to the contagion problem. Through advancements in information technology, there has been a steady rise in the entwinement of banks not just with their customers, but also with other financial institutions. Therefore, no matter how small a bank may be, the impact of its failure may be far-reaching for the entire financial system. In line with this, the 1985 Annual Report of the Federal Reserve Bank of New York commented as follows:

> The interconnections among institutions and markets in the new environment get more and more complex. A shock that starts in one market may spread quickly along this network until it finds a weakness in some seemingly unrelated place. In fact there is a growing tendency to build financial links along regulatory fault lines where the responsibility for supervisory oversight is weak, divided or clouded (Quoted in Uche, 2000: 159).

Interbank markets may be another channel through which the problems of one bank are transmitted rapidly to other banks since interbank transactions are large, variable, and difficult for outsiders to monitor (Guttentag and Herring, 1987). Increased integration of the financial system, which has resulted in a rise in inter-bank dealings, has increased the prospects of contagion should one bank fail.

Banks build up private information on informationally opaque customers through screening, contracting, and monitoring over the course of bank-borrower relationships. When a number of solvent but illiquid banks fail, the value of this information and the relationships themselves may be lost, making it difficult for some borrowers to continue financing investments. In turn, this reduction in credit extended may exacerbate regional or macroeconomic difficulties (Bernanke, 1983). For instance, the cumulative failure of the depositary industry has been identified by some scholars as the reason behind the great depression of the 1930s (Spellman, 1982: 9). Significant bank failures may also threaten the integrity of the payments system, making it difficult for financial resources to flow to where their returns are highest. Moreover, widespread bank failures could undermine the effectiveness of monetary policy. According to the "lending view", monetary policy operates largely through changing the quantity of bank loans, which would be difficult to control in a banking panic (Bernanke and Blinder, 1992). Concern about these social costs from a systemic crisis leads regulators to attempt to achieve a higher degree of safety for banks by manipulating their minimum capital requirements.

In another twist, Berger *et al.* (2005: 16) argue that regulators require capital to protect themselves against the costs of financial distress, agency problems, and the reduction in market discipline caused by the safety net. The conventional wisdom is that the more capital a bank has, the more protection it is able to provide depositors and, implicitly, the regulatory authorities and deposit insurance agencies (Uche, 1998: 30). Regulators, as representatives of the deposit insurance corporation, the Central Bank, and the taxpayers who stand behind them, are also vulnerable to costs of financial distress and expropriations of value. Hence, they increase bank capital requirements in order to protect themselves from the adverse consequences of bank failure(s).

From the foregoing, it is clear that bank capital is regulated mainly to curb bank distress and failure and their numerous adverse consequences. The individual capital structure is necessarily suboptimal from a social point of view because an individual bank does not take account of the negative externalities generated by its own failure. The aim of capital regulation, therefore, is to compel banks to attain an acceptable minimum. Determining this acceptable minimum is oftentimes a task that is shrouded in mystery and therefore widely perceived to be arbitrarily performed. In Nigeria, there have been several increases in the minimum quantum of bank share capital. The most recent increase in 2004 was to help banks become stronger players in the Nigerian, African and Global economy (Ogowewo and Uche, 2006: 162). The main aim of this paper is to examine the impact of the capital base on the profitability of the banks.

The Relationship between Capital Base and Bank Profitability

Profit is the essential prerequisite of a competitive banking institution and the cheapest source of funds. It is not merely a result, but also a necessity for successful banking in a period of growing competition on financial markets. The basic aim of a bank's management is to achieve a profit, as the essential requirement for conducting any business (Bobáková, 2003:

21). Several studies have been conducted to examine the link between capitalization and bank profitability. For example, Berger (1995) examined the relationship between the return on equity and the capital asset ratio for a sample of US banks for the 1983-1992 time period. He showed that the return on equity and capital to asset ratio tend to be positively related.

In another similar study, Abreu and Mendes (2002) investigated the determinants of bank interest margins and profitability for some European countries. They reported that well-capitalized banks face lower bankruptcy and funding costs and this advantage translates into better profitability. Naceur (2003) explains that the higher equity-to-asset ratio, the lower the need for external funding and therefore higher profitability. Bobáková (2003: 22), agreeing that capital influences bank profitability, argues that in the arithmetical sense the yield on own capital grows ceteris paribus as the capital proportion declines, since a given volume of capital supports a higher volume of assets.

Banking business thrives on public confidence. To win and retain such public confidence, a bank must be able to convince the public of its stability and display its readiness to repay customersô deposits and accommodate genuine credit needs of customers (Anyanwaokoro, 1996: 140). Adequate capitalization helps to accomplish this. A bank with adequate capitalization will surely gain more public confidence than a poorly capitalized bank. This is why Janson (2005: 16) emphasizes that a deposit-taking institution needs to hold capital to attract depositors. Insufficient capitalization might cause enlightened depositors to restrain from placing their deposits in the bank; and enlightened investors may also refrain from investing in it. This has adverse effects on the bankös profitability.

Based on the foregoing arguments, it is widely believed that overall bank returns would be enhanced by increased capital requirements. The positive correlation between returns and capital has also been demonstrated by Furlong and Keeley (1989), Keeley and Furlong (1990), Berger (1994) and Kwan and Eisenbeis (2005). Hence, bank regulators increase banksô minimum capital requirements in order to shore up profitability and minimize risk of distress in the banking sector.

However, contrary to the foregoing arguments of a positive correlation between returns and capital, Hughes and Mester (1997: 5) actually discovered that higher levels of capitalization are associated with higher variable costs. It has also been argued that whether more capital decreases the risk of bankruptcy depends on what happens to the asset portfolio when the new capital is introduced.

Furthermore, since capital is costly to raise (as compared say to pure debt), banks would be under pressure to generate higher returns from the additional capital, thereby forcing them to take on greater risks. The only effective mechanism for controlling bankruptcy risk is to restrict asset portfolio choices made by banks (Shah, 1996: 279; Uche, 1998: 30).

Numerous other researchers have also argued that the profitability and stability of the banking sector is not just conditional upon the capitalization of its banks, but also upon macro-economic conditions as well as the soundness of the individual banksô managements. A stable macro-economic environment contributes to the effective growth of savings, sound investment decisions and consequently also to economic growth. Bank profitability, to a large extent, is determined by the situation on the financial market, domestic as well as foreign. An important role in ensuring banksô stability at the macro- and micro-level is played by the central bank, which through monetary policy and the application of suitable monetary instrument parameters can positively influence the banking sectorös stability.

The management of the banking institution itself is also a prerequisite for achieving stability and profitability of a bank. The quality of a bankôs management directly influences the bankôs ability to work efficiently in a competitive environment. An important component of a bankôs management geared to achieve a successful business result is the effective management of its assets and liabilities structure. The composition of a bankôs assets influences the bankôs profitability. Bobáková (2003: 22) finds that this influence is more in transforming economies than in standard economic environments.

Methodology

The data used in this study were obtained from the audited financial statement of the three selected banks covering the period between the year 2002 and 2006. To empirically analyze the relationship between capital base and bank profitability, the data obtained were analyzed. Correlation coefficient and regression analysis were used to analyze the data. The correlation co-efficient is given as
R = (×XY - NẔXẔY) / (ãɆX^2 ï NX^2)(ɆY^2 - NY^2) while the regression equation is given as: Y = a + bX, where: óRô is the correlation co-efficient; óYô is the predicted score of the dependent variable (profit before tax); óaô is the intercept concept; óbô is the regression co-efficient or slope; óNô is the number of years and óXô is the scores of the independent variable (capital base). (Nzelibe 1995:212 - 213)

Data Analysis

To determine whether capital base has some effect on profitability of banks, the correlation co-efficient órô was calculated. The closer the value of órô is to 1.00, the stronger the relationship. Since the value of órô as shown in table 1 below equal 0.8294, 0.98 and 0.968 respectively for the three banks, it shows that capital base strongly affect profitability. In other words, there is a significant relationship between capital base and profitability. This justified the new minimum share capital requirement in the banking industry in Nigeria.

Table 1: Data used in the Analysis and the Results

	Bank A		Bank B		Bank C	
Year	X (Capital Base)	Y (Profit Before Tax) ^ômillion	X (Capital Base)	Y (Profit Before Tax) ^ômillion	X (Capital Base)	Y (Profit Before Tax) ^ômillion
2006	100,500	15,360	93,801	15,154	52,273	12,378
2005	43,215	12,939	37,790	9,165	31,092	7,265
2004	39,732	11,794	15,674	6,405	10,360	3,445
2003	35,891	12,217	12,652	5,440	7,973	3,287
2002	32,240	8,983	9,306	4,000	5,565	3,121
Regression	Y = 50832 + 0.2079X		Y = 1772 + 0.185X		Y = 665 + 0.244X	
Correlation R	0.8294		0.98		0.968	

Source: Obtained from the audited financial statements of the three banks for the various years

Conclusion

This paper is on the impact of recapitalization policy on the profitability of banks in Nigeria. The objective of this paper is to examine, on the basis of empirical evidence; the true relationship between capital base and bank profitability in Nigeria. This will indicate the appropriateness or otherwise of the recapitalization policy. The findings both from the review of related literature and data analysis revealed that there is a strong positive correlation between capital base and profitability of banks. In other words, increase in capital base of banks will improve profitability considerably. If there is improved profitability, all things being equal, the incidence of distress and liquidation of banks would also be minimized. One can conclude therefore, that the recapitalization policy in Nigerian banks is appropriate and justified.

Recommendation

It is recommended that the management of each of the banks should always ensure that the banks capital bases are adequate. Furthermore, whenever the capital base of any of the banks fall out of place, the bankôs management should embark on voluntary recapitalization.

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