THE INFLUENCE OF CAPITAL STRUCTURE ON CORPORATE EFFECTIVE TAX RATES OF LISTED FIRMS IN TANZANIA

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ABSTRACT: *This study examines the relationship between capital structure and corporate effective tax rates using data from 25 randomly selected listed firms on the Dar es Salaam Stock Exchange over a ten-year span (2013–2022). We employed a random fixed effect panel regression model while controlling for firm-specific variables such as size, profitability, age, and growth. The study reveals a significant and negative relationship between capital structure and effective tax rates, implying that firms utilising higher debt financing tend to experience lower effective tax rates. Additionally, firm size and profitability exhibit a significant relationship with capital structure. These findings hold significant implications for Tanzanian businesses, suggesting that they may enhance tax efficiency through strategic capital structure decisions. For policymakers, the results provide empirical insights on potential tax policy reforms, potentially fostering a more favourable business environment in Tanzania. This research contributes empirical evidence on the financial and tax dynamics of listed firms in Tanzania.*

KEYWORDS: Capital structure, effective tax rates, listed firms, Tanzania.

INTRODUCTION

The capital structure of a firm, defined as the mix of debt and equity used to finance its operations, is a critical decision for businesses operating in any economy (Nenu et al., 2018). It shapes a firm's financial risk, cost of capital, and ultimately, its financial performance (Le & Phan, 2017). One critical dimension of a firm's financial performance is its effective tax rate, which represents the actual tax paid as a percentage of pre-tax income. Understanding the relationship between capital structure and effective tax rates is of paramount importance for firms to optimise their capital structure choices that minimise tax burdens and maximise profitability, as well as make well-informed decisions about tax planning (Singh & Bagga, 2019).

Additionally, Ezirim et al. (2017) argue that firms strive to ensure their financial sustainability. Understanding the implications of capital structure decisions on effective tax rates is essential, as the financial structure of a company is not a static entity but evolves over time and is influenced by various internal and external factors. These factors include the economic environment (Moraes et al., 2021), the regulatory framework (Alipour et al., 2015), market conditions (Lazăr & Istrate, 2018), and the company's own financial and operational characteristics.

Over the past few decades, Tanzania has experienced economic growth, market expansion, and financial market development (Fjeldstad et al., 2019; Hundsbæk Pedersen & Bofin, 2019), all of which have an influence on the financial decisions of listed companies. The tax environment has also evolved, with changes in tax laws and regulations affecting the tax liabilities of businesses. These dynamics create a unique and evolving backdrop against which the influence of capital structure on effective tax rates can be examined.

Tanzania, a diverse and rapidly growing East African economy, has been attracting increasing attention from investors and corporations, both domestic and international (Epaphra & Mwakalasya, 2017; Lotto & Mmari, 2018). As firms aim to maximise their profitability and ensure their financial sustainability, understanding the implications of capital structure decisions on effective tax rates is essential. Ifeoma and Meshack (2018) argued that the financial structure of a company is not a static entity, as it evolves over time and is influenced by various internal and external factors. These factors include the economic environment (Lotto & Mmari, 2018), regulatory framework (Rashid et al., 2018), market conditions (Bui et al., 2023; Hundsbæk Pedersen & Bofin, 2019), and the company's own financial and operational characteristics. Understanding how changes in capital structure affect effective tax rates can help firms make informed financial decisions and navigate the complex tax landscape in Tanzania.

While there is a substantial body of literature on the relationship between capital structure and taxation in developed economies, e.g., Aronmwan and Okaiwele (2020), Ibrahim et al. (2018), and Ifeoma and Meshack (2018), research specific to Tanzanian listed firms remains limited. This study addresses this gap in the literature by examining the influence of firms' capital structure on corporate effective tax rates in the Tanzanian context.

The outcomes of this study have implications not only for Tanzanian listed firms but also for policymakers, investors, and other stakeholders interested in the Tanzanian business environment. By gaining a deeper understanding of the dynamics between capital structure

and corporate taxation, firms can make informed financial decisions to enhance their tax efficiency and overall financial performance. Additionally, this study contributes to discussions about tax policy reforms, as it provides empirical evidence on how specific capital structure choices impact the government's tax revenue collection and, by extension, the broader Tanzanian economy.

In the subsequent sections of this study, the literature review is presented in Section 2, followed by methodology in Section 3. Section 4 presents a discussion of the results, and Section 5 presents the conclusions of this study.

LITERATURE REVIEW AND HYPOTHESIS FORMULATION

The relationship between capital structure and corporate effective tax rates has been a subject of substantial interest in the realm of finance and taxation. The study by Modigliani and Miller (1958) laid the foundation for discussions on capital structure, emphasising that, under certain assumptions, capital structure is irrelevant to a firm's value. However, the subsequent evolution of corporate taxation has led researchers to examine the influence of capital structure on effective tax rates. This is particularly relevant in emerging economies like Tanzania, where tax policies and regulations are continuously evolving (Fjeldstad et al., 2019).

Various studies, e.g., Cao and Whyte (2023), have explored the impact of capital structure on tax planning, finding that firms may leverage debt to reduce their tax liabilities. In contrast, Bui et al. (2023) suggested that tax-shield benefits are balanced with potential financial distress costs, necessitating an optimal capital structure. Additionally, Ifeoma and Meshack (2018) explored the effect of taxation on the dynamic capital structure decisions of quoted industrial firms in Nigeria and found that firms may use debt financing to create interest tax deductions, thereby reducing their tax liabilities. The incentive for such tax planning arises from the tax shield effect, where the interest expenses on debt are deductible from taxable income. This results in lower taxes paid by the firm and, consequently, a lower effective tax rate.

Furthermore, DeAngelo and Masulis (1980) introduced the concept of a trade-off between the benefits of tax shields and the costs of financial distress and bankruptcy. This trade-off theory posits that firms need to find an optimal level of leverage (debt) in their capital structure, balancing the advantages of interest tax deductions with the risks of financial distress that come with higher levels of debt. The optimal capital structure decision aims to minimise the weighted average cost of capital, taking both debt and equity into account.

Moreover, Dakhli (2022) argued that corporate tax avoidance strategies can be influenced by a firm's financial leverage, leading to variations in effective tax rates. Firm characteristics like size (Rahman & Yilun, 2021) and profitability (Rahman & Yilun, 2021) have also been identified as critical factors in tax management, as larger firms with higher profits tend to have more resources and incentives to engage in effective tax planning. Studies have also highlighted the role of firm characteristics in shaping tax planning and effective tax rates. For example, Flagmeier et al. (2023) found that firm size is a significant factor in tax management, with larger firms having more resources and incentives to engage in effective tax planning. Larger companies tend to possess dedicated tax departments or external

advisors, enabling them to implement complex tax strategies that can effectively reduce their tax liabilities.

Profitability, another key firm characteristic, has been shown to influence effective tax rates. Rahman and Yilun (2021) demonstrated that highly profitable firms tend to have more substantial incentives and capabilities for tax planning. Profitable firms can leverage their financial resources to engage in sophisticated tax management strategies, which, in turn, result in lower effective tax rates. In addition to firm characteristics, the age of a firm can also play a role in its tax management strategies (Munisi, 2017; Rahman & Yilun, 2021). While the literature is less conclusive on the direction of this relationship, it is recognised that the age of a firm can impact its financial behaviour and management practices. The dynamic nature of business environments means that the tax planning strategies of older, more established firms may differ from those of newer companies.

Furthermore, the growth rate of a firm has been found to be an essential factor in influencing tax planning and effective tax rates. Mayor et al. (2022) argued that corporate tax avoidance strategies can be influenced by a firm's growth rate. Rapidly growing firms may engage in specific tax planning strategies to take advantage of their growth and expansion, which can have implications for their effective tax rates.

Moreover, the relationship between capital structure and corporate effective tax rates of listed firms can be understood through the lenses of both the pecking order theory and the trade-off theory. According to the pecking order theory, firms prefer internal financing (retained earnings) over external financing, which includes debt, due to information asymmetry and adverse selection issues (Myers, 1984). In the context of tax management, this theory suggests that firms may prioritise using internally generated funds to meet their financing needs. In this case, their capital structure decisions could be influenced by their internal cash flows, potentially impacting their effective tax rates. On the other hand, the trade-off theory posits that firms aim to balance the tax benefits of interest deductions from debt with the costs of financial distress and bankruptcy. This theory implies that firms may utilise debt financing to create interest tax shields, leading to lower effective tax rates. These theories, when applied to listed firms, provide insights into how their capital structure choices are intricately linked to their effective tax rates as they navigate the trade-offs and preferences for internal versus external financing (Dinis Mendes et al., 2023). Therefore, in line with these theories and previous research, we hypothesise that:

Hypothesis: *Capital structure negatively influences the corporate effective tax rates of listed firms in Tanzania.*

METHODOLOGY

This section presents the research methodology applied to this study as follows:

Research Design and Data

The study applied a retrospective longitudinal research design where quantitative data were collected from the annual reports of 25 listed firms on the Dar es Salaam Stock Exchange (DSE) for a period of ten years from 2013 to 2022. The study used the purposive sampling technique to select the 25 firms out of 28 listed firms based on the following criteria: first, firms must have been listed in DSE before 2013; second, they must have been in operation for a period of ten or more years from 2013; and third, they must disclose all information on the variables in this study.

Variables and Measurements

The Effective Corporate Tax Rate (ECTR) was the dependent variable. The ECTR is subject to various definitions and measurement choices (Oliveira et al., 2022). The numerator of the ECTR, which represents the tax expenses, can be defined differently in the literature, including either current year tax alone or a combination of current year tax and current year provision for deferred tax (Janský, 2023). This study follows the definition provided by International Accounting Standard (IAS) 12.5, using the numerator as the sum of current-year tax and current-year deferred tax obtained from the income statement. The inclusion of deferred tax is believed to provide a more accurate result (Oliveira et al., 2022). Regarding the denominator, various measurements have been used, such as operating cash flow, profit before interest and tax, or profit before interest and tax. This study opts for profit before tax as the denominator to represent the proportion of profit paid as tax, aligning with the definition of effective tax rate in IAS 12.86. Consequently, the ECTR in this study was measured by:

$$ECTR = \frac{\text{Tax expenses (current year tax + current year deferred tax)}}{\text{Profit before tax}}$$

The capital structure (CST) of the firm was an independent variable measured by the total debt-to-total assets ratio. The total debt comprises both short-term and long-term debt with interest. The same measure was applied by previous similar studies, such as Khémiri and Noubbigh (2018), Munisi (2017), and Oliveira et al. (2022). Also, we controlled for firm-specific variables such as firm size (Fsize), profitability (Pt), firm age (Fage), and growth rate (Growth) to improve the accuracy of the analysis by preventing confounding factors (Black Hair et al., 2010). The firm size was measured by the natural log of total assets (Alipour et al., 2015; Hailegebreal & Wang, 2018). We employed the financial ratio Return on Assets (ROA) to measure profitability. This measure has also been applied by Rahman and Yilun (2021) and Oliveira et al. (2022). Organisation age was measured by the natural log of the number of years since the firm has been established, and firms' growth was measured by a percentage change of the total assets expressed as: the total assets at the end of the observed financial year minus the total assets at the previous year of the observed period, divided by the total assets at the previous year of the observed period (Abiodun, 2013).

Empirical Model

Given the nature of our data which is panel data, we employed a panel regression model, specifically the Random Effect (RE) to examine the influence of capital structure on corporate effective tax rates of listed firms in Tanzania. Therefore, the empirical model was specified as follows;

$$ETR_{it} = \alpha_0 + \beta_1 CST_{it} + \beta_2 lnFsize_{it} + \beta_3 lnFage_{it} + \beta_4 Pt_{it} + \beta_5 growth_{it} + \varepsilon_i$$

where; β stands for coefficients value; ETC = effective corporate tax rate, CSR = capital structure, Fsize = firms' size, Fage = firms age, Pt = profitability, growth = firms' growth, ε is the error term, α represents the intercept, and i and t denote the cross-sectional units and period, respectively.

RESULTS AND DISCUSSIONS

This section provides a descriptive analysis of all variables in this study, the diagnostic tests and inferential findings from the random effect model.

Descriptive Analysis

Table 1 presents the descriptive analysis of all variables employed in the study. The results reveal the variation in effective corporate tax rates, with a mean of 0.38 and a range from 0.30 to 0.73. Similarly, capital structure shows considerable diversity among the sampled firms, with a mean of 0.70 and a range from 0.01 to 0.78. Firm size indicates a wide distribution, with a mean of 1,700,000 (in millions), ranging from 1,460 to 11,600,000. Firm age spans from 14 to 89 years, averaging 38 years, indicating the diversity in business maturity. Profitability values range from 1 to 16, with a mean of 3.54. Lastly, on average, the growth rate was 1.24 with a standard deviation of 1.890, ranging from 0.04 to 8.63.

Table 1: Descriptive Analysis

Variable	Observations	Mean	Std. Dev	Min	Max
Effective corporate tax rate	250	0.38	0.65	0.30	0.73
Capital structure	250	0.70	0.83	0.01	0.78
Firm size	250	1,700,000	2,990,000	1,460	11,600,000
Firm age	250	38	27	14	89
Profitability	250	3.54	2.980	1	16
Growth rate	250	1.24	1.890	0.04	8.63

Source: *Author (2023)*

Diagnostic Tests

To evaluate the reliability of the assumptions and ensure that the assumptions of the regression analysis are met, the following tests were performed: normality was tested using skewness and kurtosis; from Table 2, both variables were normally distributed, as the values

for skewness were less than +/-2 and the kurtosis was less than +/-3 (Black Hair et al., 2010). The variance inflation factor (VIF) tested the presence of multicollinearity; the values of VIF were less than 10, indicating that the assumption was not violated. Further, the Breusch-Pagan/Cook-Weisberg test for heteroskedasticity was performed with the null hypothesis that there is constant variance. The p-value was 0.73; we failed to reject the null hypothesis, meaning the assumption was not violated. Another assumption of panel data was the absence of serial correlation (Black Hair et al., 2010). We performed Durbin's alternative test with the null hypothesis that there is no serial correlation. We failed to reject the null hypothesis due to the p-value of 0.32, which indicates that there was no serial correlation in our data. Lastly, the Hausman test was performed to select between the Fixed Effect and Random Effect models. The Hausman p-value of 0.89 suggested that the Random Effect model was the appropriate estimation technique to apply in this study.

Table 2: Normality and Multicollinearity Test

Variable	VIF	1/VIF	Skewness	Kurtosis
Effective corporate tax rate			0.45	2.58
Capital structure	1.50	0.66	0.40	1.87
Firm size	1.14	0.87	1.00	3.23
Firm age	1.35	0.74	-0.36	2.64
Profitability	1.10	0.90	0.43	2.96
Growth rate	1.25	0.80	0.35	2.65
Mean VIF	1.27			

Source: *Author (2023)*

Empirical Analysis

Table 4 presents the findings on the influence of capital structure on the corporate effective tax rates of listed firms in Tanzania. We found that capital structure is negatively and significantly related to effective tax rates. This implies that firms with higher levels of debt in their capital structure tend to have lower effective tax rates. This result aligns with the predictions of the trade-off theory. The trade-off theory posits that firms seek an optimal balance between the tax benefits of debt and the costs associated with financial distress. In this context, it suggests that firms may strategically use debt to reduce their tax liabilities, which is supported by the negative coefficient for capital structure. Similar results were reported by Cao and Whyte (2023) and Ifeoma and Meshack (2018).

Furthermore, the findings reveal that firm size has a negative and significant relationship with effective tax rates, indicating that larger firms tend to have lower effective tax rates, which may be attributed to their ability to engage in more sophisticated tax planning and management, in line with the pecking order theory. The pecking order theory implies that firms prefer internal financing over external debt, and larger firms typically have more substantial internal cash flows to fund investments and potentially employ tax-minimising strategies, which can lead to lower tax rates. Lastly, profitability was positively and significantly related to effective tax rates. This implies that firms with higher profitability tend to have higher effective tax rates. The positive relationship between profitability and tax rates aligns with the trade-off theory, which suggests that firms with more profits may use debt to optimise their tax benefits.

Table 4: Random Effect Model: ECTR Dependent Variable

Variable	[1]	[1]	[1]
Capital structure	-0.174	-0.171	-0.140
	(0.033)**	(0.028)**	(0.024)**
Firm size	-1.334	-1.322	-1.723
	(0.092)*	(0.090)*	(0.030)**
Firm age	-0.044		
	(0.902)		
Profitability	0.059	0.059	0.037
	(0.014) **	(0.019)*	(0.019)*
Growth rate	0.005	0.005	
	(0.581)	(0.578)	
Constant	0.342	0.326	0.351
	(0.020)**	(0.000)***	(0.000)***
Observations	250	250	250
R-squared	0.63	0.63	0.64
Breusch-Pagan/Cook-Weisberg	0.730	0.730	0.730
Durbin-Wu-Hausman	0.320	0.320	0.320
Hausman Test	0.890	0.890	0.890

Source: Author (2023). Robust standard errors are reported in parentheses. *$p<0.10$, **$p<0.05$ and ***$p<0.01$.

CONCLUSIONS

This study examined the influence of capital structure on corporate effective tax rates among listed firms in Tanzania. It was revealed that capital structure has a statistically significant negative relationship with effective tax rates, indicating that firms with a greater reliance on debt financing tend to experience lower effective tax rates. Additionally, among the controlled variables, both firm size and profitability emerged as significant factors influencing effective tax rates. This suggests that larger firms and those with higher profitability levels tend to secure a tax advantage, underscoring the importance of these dimensions in tax planning and corporate financial strategies. The pecking order theory and trade-off theory help to explain the reasoning behind these strategies. Also, these findings not only contribute to our understanding of the relationship between capital structure and tax rates but also hold practical implications for businesses and policymakers seeking to optimise their financial decisions and tax liabilities. Future studies could focus on examining the influence of capital structure on the effective tax rate by comparing listed and unlisted firms in Tanzania to gain more comprehensive insights into the dynamics of relationships in a broader economic context.

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