Effect of Capital Allowance Incentives on the Performance of EPZ firms in Kenya

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Background of the study

- The contemporary world is characterized with intergovernmental competition for the sole purpose of attracting multinational companies
- Making fiscal incentives to become a global phenomenon
- African countries rely on tax holidays and import duty exemptions, while industrial western European countries allow investment allowances or accelerated depreciation
- Export Processing Zones (EPZs) were amongst the first initiatives pioneered in developing countries with the aim of promoting export growth and diversification

Background of the study

- These schemes generated some substantial initial impacts, leading to their adoption by a large majority of developing countries today (Din, 2008)
- The debate about the effectiveness of tax incentives is hardly new and has accumulated a long history (Harris, 1993)

Background of the study

- In Kenya, the EPZs, established in 1990, employ around 30,000 people working in 112 enterprises in 42 zones countrywide
- Numerous tax incentives are provided in Kenya's EPZs,
  - 10 year corporate income tax holiday, followed by a 25% rate compared to the standard 30% for the next 10 years and
  - 10 year exemption from all withholding taxes,
  - exemption from import duties on machinery, raw materials, and inputs
  - Exemption from VAT and excise duty

Background of the study

- One of the findings of the literature is that the impact of tax rates on investment decisions is generally higher on export oriented companies such as EPZs, than those seeking the domestic market
- According to Chabari (2000), many countries especially in the industrial world allows fast write –offs for investment expenditures
- The literature on the forces driving EPZ has also identified both policy and non-policy factors as drivers of EPZs (Fedderke and Romm, 2006)

Background of the study

- Thomas (2007) found that the U.S. federal government allowed for accelerated depreciation, which is considered as an incentive offered to attract investment into the United States
- In Canada, Thomas (2007) found that the incentives game was being played at the provincial level and that they were much more highly centralized than in the United States
- Research work in the Caribbean countries by Bain in 1995, (as cited in Van Parys & James, 2010) estimate revenue loss from tax concessions to have been between 23.5 percent in Anguilla to 53.9 percent in Grenada
- A later study by Goyal and Chai (2008) calculated revenue losses of between 9½ and 16 percent of GDP

Background of the study

- Tanzi and Zee in 2001 on tax policies for developing countries indicated that while granting tax incentives to promote investment was common in countries around the world, evidence suggested that its effectiveness in attracting incremental investments above and beyond the level that would have been reached had no incentives been granted, was often questionable

Background of the study

- A 2010 study by the University of Nairobi found that the main reasons for firms investing in Kenya are access to the local and regional market, political and economic stability, and favourable bilateral trade agreements
- Fiscal concessions offered by EPZs were mentioned by only 1% of the businesses sampled
- Explaining partly why the IMF, and other international organisations such as the African Development Bank (AfDB), has been pressing governments in East Africa to radically reduce their tax exemptions

Statement of the Problem

- Evidence suggests that the disadvantages of tax incentives vastly outweigh the advantages and that such incentives are not needed to attract EPZs
- This study aims to find out if capital allowance incentives provided to EPZ firms is worthwhile by considering the value such firms add to the economy
- The study will address the gap between cost incurred by the government inform of capital allowance incentives and the value the firms receiving tax incentives add to the economy

Hypothesis

- *H0: Capital allowance tax incentives have a negative significant relationship with the performance of EPZ firms in Kenya*

- *H1: Capital allowance tax incentives have a positive significant relationship with the performance of EPZ firms in Kenya*

Justification of the study

- Study is of value to the Government, researchers and corporate tax payers. It forms the basis of reviewing the tax policies and carrying out an evaluation on their effectiveness
- A review of the current tax policies can aid in carrying out a cost benefit analysis and scrapping off the incentives that have little benefits
- Can help in formulating fiscal policies aimed at reducing external borrowing and also enhance investments and employment creation
- This research will provide the government with empirical evidence on performance of current tax incentives and hence makes informed decision in improving the status quo

Scope of the study

- This study focused on finance managers in all the 106 EPZ firms in Kenya
- The data used in the study covered the last 10 years that is from 2014 to 2005

Theoretical and Conceptual framework

- **Optimal Tax Theory** - EPZs may have attracted more firms because of the distortion caused by tax incentives available.
- **Normative Theory** - In the case of this study the theory suggests that influx of EPZ firms is anchored on tax incentives provided, other than the need to add value to the economy
- Taxes in the Theory of Investment Behaviour
- Economic Growth Theory

Operation conceptual framework

Independent Variables		**Dependent Variables**		**Tests**
Capital allowances (CA)	Capital allowances / Total assets	Performance	• Profitability • Number of Jobs created	Correlation & regression analysis Accept if p< 0.05 or otherwise reject

Empirical Review

Capital allowances and Performance of EPZs

- The literature review shows that capital flows play an increasingly dominant role in the global economy of which the most critical transmission mechanism is through international trade i.e. FDI, portfolio flows and loans remittances
- Karamata (2013) stated that exchange and capital controls could affect trade through multiple channels, including domestic price of imports, transactions costs, the volatility of exchange rates, inter-temporal trade and portfolio diversification

H0: Capital allowance has no significant effect on the performance of EPZ firms in Kenya

Research Methodology

Research philosophy

- Positivistic philosophical approach
- Researcher set up the hypotheses on the basis of the existing relevant theories

Research design

- The research design was descriptive and explanatory.
- Descriptive design was because it will focus on complex analysis to bring out the correlation of variables.
- Explanatory relationship seeks to establish how one variable affects changes in another.

Population

- All finance managers from the 106 EPZ firms in Kenya from which the target and accessible sample was be drawn.

Proposed Research Methodology

Sampling Frame

- Provides a means for choosing the particular members of the target population that are to be interviewed in the survey (Bailey, 2008)
- The sampling frame of this survey was be finance managers in the firms

Data Collection Method

- Primary data was obtained using questionnaires
- Secondary data from the registered firms was be collected on; profitability, number and value of jobs created and the length of stay of the firms

Proposed Research Methodology

Data Collection Instruments

- Both primary and secondary data was collected to avoid mono-method bias

Research Procedures

- Questionnaires was designed based on the research objectives

Proposed Research Methodology

Proposed data analysis and presentation techniques

- Descriptive statistics such as, mean and frequencies was used to perform data analysis
- The data was analyzed using procedures within Statistical Package for Social Sciences (SPSS)
- The analysis of variance (ANOVA) was checked to reveal the overall model significance. In particular, the calculated f statistic was compared with the tabulated f statistic
- A critical p value of 0.05 was used to determine whether the overall model will be significant or not

Research Findings

- Study concluded that capital allowances incentives had a positive effect on the performance of EPZ firms in Kenya as measured by gross margins and number of jobs created

Recommendations

- Study recommended that stakeholders in tax policy should reconsider the economic value of capital allowances incentives
- Conduct a cost benefit analysis of such incentives so that they can benefit these firms more and help expand the foreign direct investments into the country

Areas for further research

- Study recommended that future studies should aim to broaden the causes of low performance of EPZ firms in Kenya not identified in this study.
- Study also suggested that a study on the remedies to the low performance of EPZ firms be conducted. This would assist in improving EPZ firms in Kenya and to encourage more investors.