THE EFFECT OF TAX INCENTIVES ON THE INVESTMENTS OF EXPORT PROCESSING ZONE FIRMS IN KENYA

BY

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DECLARATION

This research project is my original work and has not been submitted for a degree in any other university.

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This research project has been submitted for examination with my approval as the university supervisor.

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DEDICATION

I dedicate this research to my son Adley that it may encourage him to achieve higher levels of education. It is also dedicated to my wife Dr. Waturi for encouraging me to achieve higher levels of education and for the precious time I spent away from her while carrying out the research.

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LIST OF ABBREVIATION

AGOA – African Growth and Opportunity Act

CIT – Corporate Income Tax

EPZs – Export Processing Zones

EPZA- Export Processing Zone Authority

FDI – Foreign Direct Investment

GDP – Gross Domestic Product

METR – Marginal Effective Tax Rate

MUB- Manufacturing-Under–Bond

NGO – Non-Governmental Organization

NICs- Newly Industrialised Countries

VAT – Value Added Tax

WTO – World Trade Organization

ABSTRACT

The purpose of the study was to establish the effect of tax incentives in Export Processing Zones firms on business investment in Kenya. Specifically, the study establishes the various types of tax incentives offered to EPZ firms on their business investment in Kenya as well as the effect of tax incentives on investment. This study adopted a descriptive design. The population for the study included all 104 Export Processing Zones firms in Kenya where the researcher selected all firms situated in the Nairobi Metropolitan (that is Nairobi and Kajiado Districts) purposively giving 65 firms. The study used both primary and secondary data. For the primary data, a set of semi-profit/value added questionnaires was used to collect data.

A pilot study was conducted by the researcher and the results were analyzed for validity and reliability of the research instruments. The Pearson's Product Moment Correlation Co – efficient was used where it was found to be 0.87 and indication that the instruments were consistent. Descriptive statistical techniques were utilized in data analysis while inferential analysis was used to reach conclusions that extend beyond the immediate data alone by determining the relationship between tax incentives and investments of export processing zones firms. The output was presented by use of tables, bar graphs and pie charts.

The study in consistence with the statistical data shows that, investments in EPZ firms increase with increase in sales, profit as well as tax incentives. However, given the high significance level, 0.39, the influence of tax incentives on investments in EPZ is

insignificant. Given the findings of this study, the researcher recommends that the Government of Kenya should consider other incentives apart from the tax particularly on those that will enhance more sales, being the most significant factor attracting investment in EPZ granted to attract foreign direct investment, especially those provided to EPZ firms.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

In a world where an increasing number of governments compete hard to attract multinational companies, fiscal incentives have become a global phenomenon. Poor African countries rely on tax holidays and import duty exemptions, while industrial western European countries allow investment allowances or accelerated depreciation. This trend seems to have grown considerably since the early 1990s as evidenced by the number of high profile foreign investments, such as Toyota in Northern France or Mercedes- Benz A. G in the U.S state of Alabama. These have generated considerable debate about whether governments have offered unreasonably large incentives to entice those firms to invest in their area. Still, this debate about the effectiveness of tax incentives is hardly new and has accumulated a long history (Harris, 1993).

Export Processing Zones (EPZs) were amongst the first initiatives pioneered in developing countries with the aim of promoting export growth and diversification. The first generation EPZs initiated mainly by what were to become the Newly industrialised countries (NICs) of East Asia, took the form of providing investors with remissions on import duties for inputs and raw materials, with enhanced or improved infrastructure (usually within a geographically restricted physical area) and with speeded-up customs clearance procedures. These schemes generated some substantial initial impacts, leading to their adoption by a large majority of developing countries today (Din, 1994).

Kenya has spent substantial public funds on creating and promoting EPZs, with comparatively little success until very recently. In part, this would seem to be because at the same time that public investments in EPZs were completed (mid 1990s), the government enacted trade liberalization measures that significantly reduced the competitive benefits of locating in an EPZ (Madani, 1999). The importance of external factors for EPZ 'success' is nowhere more evident than in sub-Saharan Africa this decade. African Growth and opportunity Act (AGOA) has provided (time-limited) preferences to qualifying African garment manufactures that are not available to Asian exporters. This has led to jump in investments (to EPZs) in many qualifying countries such as Lesotho and Kenya, as documented in Rolfe and Woodward (2005). Thus, we see the EPZ investment performance is extremely mixed and appears to be driven by a wide range of factors, both internal and external to the host economy. Although the changing fortunes of different sectors and even national economies are visible in EPZs, crucial determinants can be traced to changes in global trading rules and value chain dynamics rather than the design of EPZs themselves (Zee et al, 2002).

Tax incentives neither make up for serious deficiencies in a country's business investment environment nor generate the desired externalities. But when other factors, such as infrastructure, transport costs, and political and economic stability are more or less equal the taxes in one location may have a significant effect on investor's choice. Even if tax incentives were quite effective in increasing business investment flows, the costs might well outweigh the benefits. Tax incentives are not only likely to have a negative direct effect on fiscal revenues but also frequently create significant

opportunities for illicit behaviour by tax administrators and companies. This issue has become crucial in emerging economies, which face more severe budgetary constrains and corruption that industrial countries do (Adala, 2008).

But more recent evidence has shown that when other factors such as infrastructure, transport costs, and political and economic stability are more less equal, the tax in one location may have a significant effect on investors' choices. This effect is not straight forward, however. It may depend on the tax instrument used by the authorities, the characteristics of the business firms, and the relationships between the tax systems in the home and recipient countries (Morisset and Pirnia, 2000).

The core of most export promotion schemes is to provide the inputs to the production of exports at world prices. This recognizes that exports generally only earn world or border prices for the exporter. Lowering the costs of tradable inputs at least to their world or border price levels is important to gain export price competitiveness for the EPZs.

The establishment of EPZs seems to be synonymous with the country providing a multitude of tax breaks and tax holidays to attract foreign direct investment to their zones. Kenya has experienced improved clothing and textile export performance since the inception of the EPZ program in 1990's, the country has not managed to secure its share of the global clothing and textile trade market (Adala, 2008).

The Kenyan government pursued an export – led growth strategy (Republic of Kenya, 2003). This was a major shift from its previously favoured import-substitution policies. In order to stimulate exports, the government implemented export promotion incentives such as the EPZ and manufacturing-under–bond (MUB) schemes. The introduction of these forms of exports compensation, especially with the advent of liberalization and globalization, was intended to move the Kenyan economy towards a more open regime, with increased market access for her products and services in the global market (Republic of Kenya, 2003).

In recent years, the globalization process has led to the emergence of new issues. Not only have companies tended to become more mobile, but also governments have to deal with this new dimension in the design of their national tax policy. The gradual elimination of barriers to capital movements have stimulated governments to compete for Foreign Direct Investment (FDI) in global markets as well as reinforced the role of tax policy in this process. This recent competitive trend has to be offset by the increasing pressure that governments face to harmonize their tax policies within regional (or international) agreements. A second important issue has been the recognition that tax policies of the home and host countries are interconnected and that this link influences the behaviour of multinational. There has been a great deal of evidence, especially after the changes in the U.S tax laws during the late 1980s that home country tax policy affects both the multinational firm's behaviour and the effectiveness of tax policy in the countries where these firms operate and invest (Hauffer and Wooton, 1999).

1.1.1 Tax Incentives

A tax incentive can be defined either in statutory or in effective terms. In statutory term, it would be a special tax provision granted to qualified investment projects (however determined) that represents a statutorily favourable deviation from a corresponding provision applicable to investment projects in general (i.e. projects that receive no special tax provision). An implication of this definition is that any tax provision that is applicable to all investment projects does not constitute a tax incentive. Hence, for example a tax provision that allows the profits of a foreign-funded investment project to be taxed at half the regular CIT rate is a tax incentive, but a general reduction in the CIT rate by half, even if it is intended for a limited duration is not (Chia and Whalley, 1995).

In effective terms, a tax incentive would be a special tax provision granted to qualified investment a project that has the effect of lowering the effective tax burden measured in some way on those projects, relative to the effective tax burden that would be borne by the investors in the absence of the special tax provision (Chia and Whalley, 1995). There is a growing attention to the costs associated with tax incentives and not only to their possible benefits. Tax incentives are likely not only to have a direct negative impact on fiscal revenues but also, and frequently, create significant possibilities for suspicious behaviours from tax administrations and companies (Harris, 1993).

The focus on improving incentives for selected export firms are among the many measures used. Tariff reductions or exemptions on intermediate inputs as well as other fiscal incentives are almost always employed. Other common features are access to (high

quality) infrastructure and streamlined customs procedures (Mckay, 2004). Tax incentives are a prominent feature of many tax codes in both developed and developing countries. Developed countries tend to use targeted investment incentives, generally embodied in the income tax law. Developing countries tend to use a combination of targeted and more general incentives, which may be embodied in the income tax law, the investment and other laws, or simply government decrees. Although several countries have expanded their use of tax incentives, this experience is not uniform, with some countries cutting back on such incentives, and some reintroducing them, after a period of reduced use (Zee; Stotsky and Ley, 2002).

1.1.2 Business Investments

In a knowledge-based economy, business performance and overall levels of economic growth are increasingly dependent on the development and exploitation of intellectual assets. A number of countries offer tax incentives to encourage and reward business expenditures on intellectual assets. The global business investment driver analysis assumes that the most important prescription for successful global implementation of business investment is a tax waiver on imported production inputs (Shah, 1995). Human resources will increasingly become a key global business investment driver for many firms. Historically organizational design focused on efficiently allocating people to work tasks.

Firms pursuing strategies that entail globally dispersed production functions and rationalized and flexible operations find it necessary to share manufacturing planning systems, process control systems and inventory systems across country boundaries (Sergeant and Mathews, 1999). The opportunity to deal with a supplier is one global entity is an exacting potential driver for world wide integration and coordination. World wide procurement offers opportunities for competitive advantage through economies of scale, enhanced buyer power, increased reliability, and the opportunity to redirect shipments among production facilities.

Successful business investment often employs an international design team. The international composition means that the team lives in a multicultural environment on a day-to-day basis, and reflects the environment that the firm must accommodate (Zee et al, 2002).

1.1.3 The Overview of Export Processing Zones (EPZs)

Export Processing Zones (EPZs) in their traditional form (fenced-in industrial parks where export-oriented investors enjoy free port status) emerged in the period 1950-1975 and first became widely adopted between 1975-1985. Currently there are more than 3,500 EPZs in 130 countries. EPZs have been mainly but not exclusively targeted at attracting Foreign Direct Investment (FDI) in labour-intensive manufacturing or services, and/or are also open to domestic investor participation. Some newer EPZs also depart from the traditional model by embracing wider regions (Gibbon; Jones and Thomsen, 2008).

Export processing zones are prevalent around the world, especially in developing countries, as a means to promote exports and also to attract certain types of labour-intensive industries (Warr, 1989). Tax incentives available in these zones. Indeed, complete exemption from all taxes for economic activities carried out in these zones is not uncommon. While it is sometimes argued that a number of the incentives offered to EPZ investors are incompatible with (World Trade Organization) WHO rules, both most of the measures incorporated in traditional EPZs and those that form part of later generations of export growth and diversification policy are actually permitted under these rules. Furthermore, a total of 65 developing countries members of WTO may legally provide any type of export incentive, including these that are otherwise illegal under WTO rules, until 2015.

1.2 Research Problem

It seems clear that the advantages of EPZs in their traditional form of closed-off zones where investors enjoy different types of preferential treatment over those available in host economies generally (e.g. rebates on duties for imported inputs and raw materials, subsidized access to enhanced infrastructure, fast-track customs treatment, etc) have been steadily eroded. These advantages depended on developing country economies being generally characterized by high levels of trade protectionism, patchy and unreliable infrastructure and customs departments whose basic orientation was toward collecting taxes (Warr, 1999).

While most early studies examine the impact of taxes on the average foreign investors, there were many reasons to believe that this impact differs greatly depending on the characteristics of the multinationals company. International investors often have at their disposal numerous alternative methods of structuring and financing their investments, arranging their transactions between related parties located in different countries, and returning profits to investors. These alternatives have important tax implications, and there is considerable anecdotal evidence that tax considerations strongly influence the choices that firms make (Fiflio and Blonigen, 2000).

Several studies have been conducted on Export Processing Zones in Kenya. Mutung'a (2006) studied the response of trade unions to challenges posed by conditions of work at the EPZs in Kenya. Hapisu (2003) addressed the relationship between strategic planning and competitive advantage in the EPZs in Kenya. Chabari (2000) studied the role of EPZs in Kenya. Therefore this clearly indicates that no study has been conducted on the impact of tax incentives on business investment of EPZs in Kenya.

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 or location-specific advantages. In these EPZs firms, managers have responded more favourably to tax incentives. This finding is not really surprising because export-oriented firms such as garments manufactures are operating in highly competitive markets with very slim margins. Moreover, these EPZs firms are often highly mobile, and more likely to compare taxes across alternative locations. Hence taxes can be an

important part of their cost structure, and the firms can easily move to take advantage of more favourable tax regimes.

According to Chabari (2000), many countries especially in the industrial world allows fast write –offs for investment expenditures, either all investments, or those they especially want to induce through tax allowances or credit. He identifies that investment tax allowances have distinctive advantages. The incentive is correctly targeted at the desired activity since an EPZ company receives the benefit of lower corporate taxes only if it makes capital investments. What is the effect of tax incentives in export processing zones firms on business investments in Kenya?

1.3 Objectives of the Study

The study will:

1) Establish the various types of tax incentives offered to EPZ firms on their business investment in Kenya.
2) Establish the effect of tax on investment in EPZ firms in Kenya.

1.4 Value of the Study

This study will be useful in a number of ways. In particular, the study;

It will assist academicians and scholars interested in issues of tax incentives on business investment, especially in the EPZs in understanding how these tax incentives impact on the business investment of EPZs.

It will assist the EPZs management in the formulation of policies, standards, guidance and procedures for tax incentives on business investment. They may also understand the need for the government providing tax incentives to the EPZs business investment.

It will add onto the foundation that is being laid in research on the tax incentives for business investment of EPZs globally, with special emphasis of the developing countries. It will also act as a resource for government in understanding the need and usefulness for these tax incentives on foreign business investment. It will be a primer for policy making for the government.

It will provide an insight into the challenges of implementing these tax incentives on business investment. It would justify the need for having tax waivers and exemptions of duties for EPZs business investment to the economy.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter discuses essential issues that form the background of the study. It is organized systematically starting from the theoretical literature, main discusses, empirical evidence on tax incentives for business investment especially foreign direct investments, and eventually the summary of the study.

2.2 Theoretical Review

The use of tax incentives is widespread even though the available empirical evidence on the cost-effectiveness of such incentives in stimulating investment is highly inconclusive. An important contribution factor to this development is undoubtedly the heightened need perceived by many countries, especially in a regional context, to compete for investment in a world of broadening trade liberalization and high capital mobility. To these countries, tax incentives are often a visible and flexible handle for attracting investment (Surrey, 1970).

Equally important in fuelling the spread of tax incentives could have been the impressive economic successes of a number of Asian countries that also happened to make heavy use of such incentives, although the extent of the contribution of the incentives to the growth performance of these countries is unclear (Tanzi & Shome, 1992).

2.2.1 A q – Theory Approach

The approach inspired by Tobin's q-theory of investment (Tobin, 1969). In all endogenous growth models, output growth is driven by the ceaseless accumulation of physical, human or knowledge capital. The rate of real investment determines the rate of capital accumulation and this is where the q-theory comes in. Tobin's approach focuses on the ratio of a firm's stock market value to the replacement cost of its capital.

The stock market value of a unit of capital is the present value of its income stream; its replacement cost is the marginal cost of new capital in exogenous growth models, q determines the steady-state capital-labour ratio. In endogenous growth models, it determines the level of real investment. Now because endogenous growth models all make assumptions implying that a constant level of real investment yields constant growth, changes in (or more precisely 1–1) predict growth rate changes (Baldwin and Forslid, 1996).

The effects of tax policy on capital accumulation and valuation based on James Tobin's q theory of investment. Tobin (1969) argued, increases in the return to capital will raise the market value of existing capital signalling the profitability of additional investment. Additional investment will drive down the marginal product of capital, reducing the asset price of capital goods until equilibrium is restored. While models linking the stock market to investment have been estimated, they have not been used to examine the impact of economic policies on investment.

This approach has several advantages when compared to previsions empirical approaches to modelling investment. Almost all previous evaluations of tax policy's impact on investment have relied on single equation models linking investment to its proximate determinants, usually output and the cost of capital. For the most part, individual taxes have been ignored and the process of adjustment has been handled in an ad hoc fashion. Most critically, existing approaches to modelling investment decisions are subject to the "Lucas criticism". The estimated parameters are not likely to be invariant to the choice of policy rules. The equations thus do not provide a basis for estimating the true effects of changes in policy rules (Summer, 1981).

Several authors including Von Furstenberg (1977), Ciccolo (1977) and Engle and Foley (1975) have estimated variants on equations with exception of Ciccolo (1977), no account was taken of tax effects. Ciccolo's tax adjustments differ from those used here because he takes no account of individual taxes, and implicitly makes different assumptions about the tax treatment of adjustment costs. These studies have all related components of business fixed investment to q, which may not be appropriate for non-corporate investment.

2.2.2 The Common –Agency Approach

This approach involves limiting the government's power to tax in interesting ways and then investigating the resulting implications for tax competition. One such aspect is incompleteness in a government's information about the firms that it is attempting to tax. For example, firms may differ in the degree to which they are interregionally mobile, but

such differences may be difficult for the government to observe. In this case, the government cannot tax a firm in a way that directly depends on its unobserved aspects of firm behaviour that may serve as signals of these characteristics, such as the firm's business investment decisions (Wilson, 1999).

The common – agency approach seems especially useful for analyzing the taxation of multinational, such as EPZs. Many countries attempt to tax the income of foreign subsidiaries, suggesting a common agency problem in which the home and host countries are the principals. Bond and Gresik (1996) present an interesting model in which the home and host countries independently confront the multinational with subsidies and trade taxes. Relative to setting these policy instruments cooperatively, tax competition is shown to lower the countries aggregate welfare and leave the multinational worse off. In other words, the inefficiencies associated with tax competition turn out to be detrimental to all parties.

2.3 Types of Tax Incentives

Tax incentives usually take the form of direct or indirect taxes. Indirect tax incentives are usually either partial or full exemptions from import tariffs excises, and/or sales tax on (in the case of VAT, the zero-rating of) inputs purchased by qualified enterprises. Direct tax incentives are usually categorized into two categories; those that tax corporate profits at a lower nominal rate than the regular Corporate Income Tax (CIT) rate; and those that provide more attractive terms for recovering investment costs than under the regular CIT provisions (Easson, 2001).

2.3.1 Indirect Tax Incentives

Granting indirect tax incentives to export-oriented industries is a prevalent practice worldwide. Conceptually, relieving inputs used in the direct production of exports from the burden of indirect taxes is clearly justifiable on the principle of destination-based taxation, and should, in general, be supported. The question that remains is largely one of execution rather than policy; what would be the preferred mechanism to grant such incentives to minimize the leakage risks; since exercises are seldom imposed on inputs, the issue mainly concerns tariff and Value Added Tax (VAT) exemptions. (Zee et al, 2002).

Tariff exemptions are in two common mechanism, which effect tariff exemptions on imported inputs used in the production of exports; the first one is duty drawback schemes. Here tariffs are first payable upon importation of all inputs, but are then refunded on that portion of imported inputs embedded in goods that are actually exported; refunds are typically provided on the basis of some input-output relationships of the exported goods in question; and the second one is suspensive regimes, where the payment of tariff on imported inputs is suspended upon importation by qualified exporters (the typical qualifying criterion is a threshold level of exports to total sales); those inputs used in the production of goods sold domestically would become taxable at a later stage (Chia & Whalley, 1995).

VAT exemptions is a form of export-oriented incentive, granting indirect tax incentive. Since exports are zero-rated under a destination-based VAT and, therefore do not bear

any VAT burden, the zero-rating of inputs used in the direct production of exports is strictly unnecessary (Mclure, 1999). But, major exporters are perpetually in an excess VAT credit position when their inputs are taxed and will therefore bear a possibly significant cash-flow burden even if such credits are refunded in a timely fashion (Mchure, 1999).

2.3.2 Direct Tax Incentives

Direct tax incentives under the Corporate Income Tax (CIT) can be broadly classified into two categories; those that tax corporate profits at a lower nominal rate than the regular CIT rate; and those that provide more attractive terms for recovering investment costs than under the regular CIT provisions. While the intended goal of any incentive in both categories is the same; to reduce and effective CIT burden on business investment. for analytical purposes it is important to distinguish the two, as they could entail very different policy and administrative implications (Easson, 2001).

Incentives in the form of reductions in the CIT rate could range anywhere from complete exemption (CIT holidays) to a rate that is below the regular CIT rate for qualified investment projects. Of all the different forms of tax incentives, CIT holidays are the most popular among developing countries, but are now rarely found in developed countries. The most frequently cited advantages of CIT holidays are that; they relieve the tax authorities of the burden of administering them; they allow qualified investors the added benefit of being able to side-steps often complex tax laws, onerous tax regulations,

and corrupt tax administrations; and they are neutral in their impact on the relative factor (capital and labour) intensities of qualified projects (Zee et al, 2002).

CIT holidays provide strong incentives for tax avoidance, as taxed enterprises could enter into economic relationships with exempt ones to shift their profits to the latter through transfer pricing; the duration of CIT holidays, even if formally time-bound, is prone to abuse and extension by investors through creative investment (e.g. the closing down and re-starting the same project under a different name but with the same ultimate ownership) (Chirinko, 1993).

Investment allowances are incentives that typically stipulate that certain percentages of the initial costs of plant and equipment investments can be written off immediately as expenses in the current period, in addition to the normal allowable depreciation on the full costs of such investments. Compared with CIT holidays, these incentives have a number of advantages. They are, for example, a much better targeting instrument than CIT holidays for promoting particular types of investments, as noted earlier, and their revenue costs are much more transparent and easier to control (a property shared with CIT rate reductions). Investment allowance is a type of tax incentive that is most amenable to both effective targeting and transparent administration (Chia and Whalley, 1995).

Investment tax credits is another form of direct tax incentive. In contrast to investment allowances, investment tax credit provides stipulated percentages of investment costs that

could be deducted from CIT liabilities. If the CIT rate is uniform, investment and investment tax credits are clearly equivalent forms of tax incentives in all substantive aspects, and hence share the same advantages and shortcomings as the former are directly expressible in terms of the latter irrespective of the scale of the investment (Easson, 2001).

2.4 Effects of Tax Incentives

Tax incentives for business investment employ a formula that relates the cost of using an asset for a given period of time (say, a year) to its purchase price, tax variables, and a discount rate. There is also the crucial issue of how to define tax policy changes and to measure the after – tax rate of return. Which taxes should be included in the regressions (corporate profit tax, trade taxes, domestic indirect taxes, etc) should these taxes be integrated in one aggregate or several indicators. Understanding the exact impact of tax policy on investment decisions has led to the development of the popular concept of effective tax rate (Estache and Gasper, 1995).

Tax incentives neither make up for serious deficiencies in a country's investment environment nor generate the desired externalities. But when other factors, such as infrastructure, transport cost, and political and economic stability are more or less equal, the taxes in one location may have a significant effect on investor's choices. This effect varies, however, depending on the tax instrument used, the characteristics of the multinational company, and the relationship between the tax systems of the home and recipient countries (Morisset and Pirnia, 2000).

2.4.1 Negative Effects of Tax Incentives

Tax incentives have been used by countries to achieve a variety of different objectives, not all of which are equally compelling on conceptual grounds. Stimulating investment in general, and in most developing countries attracting Foreign Direct Investment (FDI) in particular, is usually the primary motivation for granting tax incentives. Other commonly cited objectives include reducing unemployment, promoting specific economic sectors or types of activities as a matter of either economic or social policy, and addressing regional development needs. Quite often countries pursue multiple objectives with overlapping tax incentives (Zee et al., 2002).

There are several potentially serious adverse consequences from the widespread use of tax incentives. First and foremost, they erode the tax base, either because many investments (especially highly profitable ones) would have taken place even without them, or because they are given to investments not eligible to receive them through abuse of provisions in relevant laws and regulations by either officials or investors, or both (Chia and Whalley, 1995).

Tax incentives distort resource allocation, as some activities, as some activities are encouraged over others not because they are necessarily more economically productive, but because they have been given a tax advantage. Granting of tax incentives creates opportunity for corruption and socially unproductive rent – seeking activities (Chirinko, 1993). In view of the potentially harmful effects from the spread of tax incentives, many economists have argued that to attract investment, countries should instead implement

appropriate financial policies to ensure macroeconomic stability, and should pursue tax and other structural reforms to enhance competitiveness and better enable the market to efficiently allocate resources (Zee et al., 2002).

The realistic approach that recognizes that, regardless of their limitations, tax incentives are unlikely to be abandoned by most especially developing countries as policy instruments for furthering a variety of national objectives, notably for attracting /competing for FDI and /or stimulating the general level of investment. For this reason, it focuses not on the complete elimination of tax incentives, but on ways to minimize their harmful effects (Eassaon, 2001).

2.4.2 Positive Effects of Tax Incentives

A crucial consideration that bears on the decision to grant tax incentives should be their cost effectiveness. This implies that the mere identification of the existence of positive externalities associated with certain types of investment projects is not sufficient in and of itself for justifying the use of incentives in all instances. Rather, their use should be predicated on the belief that the benefits to the economy that can be expected from an increase (if any) in the incentive-favoured activities would actually outweigh the total costs of the tax incentives granted (Fiflio and Blonigen, 2000).

Cost-effectiveness is a positive effect of tax incentive on business investment globally. Granting tax incentives entails four types of costs; distortions between investments granted incentives and those without incentives; forgone revenue (on the assumption that

the government operates under a revenue constraint, so that the cost revenue would have to be compensated from alternative distortive taxes); administrative resources required to administer them; and the social costs of corruption and/or rent-seeking activities connected with abuse of tax incentive provisions. While these costs could be substantial, the benefits to the economy that could be attributed solely to tax incentives are less clear and not easily quantifiable. Hence, the cost-effectiveness of tax incentives is often questionable (Zee et al, 2002).

The distortion costs of tax incentives could arise even if such incentives are used to correct for externalities, since the amount of incentives granted may not conform exactly to the extent of the externalities involved, due to the inherent difficulties in measuring the latter. By extension, such costs would also arise wherever tax incentives are erroneously granted to investment projects with no positive externalities, as could happen (for example) through abuse and leakage on the system (Hall and VanReenan, 2000).

The revenue costs of tax incentives have two different dimensions. First, investment projects could have been if there has been no tax incentives. For these projects, which typically comprise those of the highest profitability and, therefore, having the greatest economic merits, the availability of tax incentives would simply represent a free gift from the government to either the investors or, if they are of foreign origin, the treasury of their home countries. The latter outcome would come about if any income that is spared from investors' home countries as it would be the case when these countries have tax systems that are based on the residence principle (Chirinko, 1993).

2.4.3 Other Related Benefits of the Incentives

Conceptual validity of the various objectives of tax incentives, offers convenience to group all the factors that could have a bearing on an (domestic or foreign) investor's decision to undertake an investment project in any country under four categories; tax-related considerations; non tax-related economic considerations; non economic considerations; and social policy considerations (Zee et al, 2002). Tax-related considerations refer to features in the tax system as a whole that have an impact on the effective tax burdens on investment projects.

Foreign exchange earnings is an important benefit of FDI. Improvement of the hard currency earnings of the host economy is frequently cited as a major objective behind an EPZ which is a foreign direct investment. This can occur principally from increased (net) exports but may also come from the initial FDI injection where this goes to domestic actors (e.g., construction, purchase of equipment). In turn this is expected to boost the balance of payments position of the host economy, thereby relaxing possible macroeconomic constraints.

Employment creation is a major motivation behind many EPZ the reduction of unemployment is a major motivation behind many EPZs, especially where urban unemployment or informal sector activity is high. While most jobs created in traditional EPZ involve low-wage assembly tasks, it has been noted that the recent trend EPZs in some countries to seek to attract capital-intensive production processes means that these

may either require fewer workers or more skilled workers, or both (Carr and Chen, 2004; Sargent and Mathews, 1999).

Export diversification is a global benefit of foreign direct investment in especially EPZs. Expanding not only the volume but also the variety of exports is often considered important from the point of view of risk mitigation, particularly as regards reducing dependency on primary commodities which can be subject to significant price volatility. The larger share of products that firms export, the less inputs they are likely to buy locally since firms that sell on the local market "mark a greater effort to integrate themselves into the host nation". This is commonly referred to as export orientation (Rolfe and Woodward, 2005).

Technology and skills transfers are frequently cited potential benefits of foreign investment both under EPZ and more generally are the transfer of technology to domestic firms and upgrading the skills (human capital) of local workers. In turn these may generate positive (productivity) spillovers for the domestic economy, such as creating a workforce trained in modern manufacturing that can be employed by domestic firms (Mckay, 2004).

2.5 Empirical Evidence

The research examining the effect of tax policy on investment is large and diverse. The basic framework relies on the neoclassical model of the value-maximizing firm to yield a derived demand for capital and hence investment. The additional investment generated by

tax incentives can be compared to the revenue forgone from these incentives as a measure of the cost effectiveness of this investment (Zee et al., 2002).

Chirinko (1993) and Hossett and Hubbard (1997) provide comprehensive reviews of research on determinants of investment, focusing mainly on investment in plant and equipment. From this general formulation, two main approaches were used in the early research. Jorgenson (1963) and others developed the notion of the "user cost of capital" which can be viewed as the dollar "rental price" of one unit of capital for a single period, and is determined by the price of investment goods, taxes, and adjustment costs.

In a volume by Shah (1995), the effect of tax incentives is examined using several different methodologies for a range of developing countries. Although the study holds a favourable view of certain tax preferences, especially those encouraging new investment in machinery and equipment and Research and development, Shah (1995) concludes that, in general tax incentives significantly erode the tax revenue base without substantive efforts on investment.

Estache and Gasper (1995), for example, find that the extensive use of incentives in Brazil resulted in significant revenue losses compared to the investment generated, and resulted in a significantly distorted tax system. Boadway, Chua, and Flatters (1995) find that the tax holidays granted to pioneer firms in Malaysia were of little value for infant industries or the targeted sector, this conclusion in part was attributed to the lack of appropriate carry-forward provisions regarding losses. Mintz and Tsiopoulos (1995) find

that in central Europe, tax allowances and credits would probably be more cost effective than tax holidays in attracting foreign investment, without undue revenue losses.

Hapisu (2003) points that the global strategy of international corporations investing in the EPZs may be to seek the cheapest reliable international supplier instead of a comparable domestic source. This is because they may want to "preserve the international mobility of their processing operations" and forging a long term economic relationship with country suppliers would defy this strategy.

Tariff and other indirect taxes are rather important tax sources for governments in many developing countries, such as Kenya, where the actual direct tax (income tax) collection is well below the potential/legal tax ceiling. Foregoing such an important source of income may not be a trivial policy choice. More specifically, if domestic firms do not benefit from functional drawback policies, the tariff free inputs for the firms in the EPZs acts as import subsidies competing against domestic input production and discouraging creation of backward linkages. If countries do not allow domestic sales of EPZ products, the potential for forward linkages vanishes as well (Chabari, 2000).

2.6 Summary

Tax incentives can be granted in a variety of different forms, not all of which are equally cost-effective in achieving their intended objectives. One determinant of the merit of a tax incentive is its effectiveness in stimulating investment. In theory this effectiveness can be measured by its impact on the METR of investment. Conceptually the effective

tax burden on an investment project is simply the difference between its real pre-tax rate of return (p) and the reap post –tax rate of return (s) to the investor of that project (Hall and VanReenen, 2000).

The impact and the nature of incentive schemes may also differ if they apply to new or existing companies. For example Rolfe et al (1993) shows, using a survey of managers of US firms, that start up companies will prefer incentives that reduce their initial expenses (equipment and material exemption), while expanding firms will prefer tax incentives that target profit. He also reports that apparel industries will prefer incentives related to depreciable assets because they utilize more fixed assets than service industries.

Many governments rely on tax incentive schemes in their effort to lure foreign investors. This selective approach, in contrast to a generalized tax reduction, is attractive to many countries because it may minimize the initial effect on fiscal revenues and, in principle should help to target specific industries or activities that would bring the greater benefits to the country. It can also be argued that incentives may have a signalling effect on the government's commitments to stimulate EPZs, as they are generally easier to implement than a general reform of the tax system (Bond and Samuelson, 1986).

Incentives will generally neither make up for serious deficiencies in the investment environment, nor generate the desired externalities. Thus, advisors often counsel long-run strategies of improving human and physical infrastructure, and where necessary streamlining government policies and procedures, thereby increasing the chances of

attracting investment on a genuine long-term basis. Indeed, the importance of fundamental factors like economic conditions and political climate is underlined by the fact the most serious investors are often unaware of the full range of incentives on offer when they invest, and that they often do not consider alternative locations. When other factors such as political and economic stability, infrastructure and transport between potential locations, taxes may exert a significant impact on investment (Morisset and Pirnia, 2000).

The effect of tax variables on investment flows is well studied. This briefly is reviewed in this research, but further suggestions on a study, on how tax incentives influence investment should be undertaken. But unless they are well targeted, they are rarely cost-effective.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This section deals with the methodology used in carrying out the research. It highlights the research design, target population, sample size and sampling techniques, research instruments, reliability and validity of instruments, data collection and data analysis procedures.

3.2 Research Design

According to Gay (1981) descriptive research design is a process of collecting data in order to test hypotheses or to answer questions concerning the current status of the subjects of the study. The study adopted a descriptive design this is because the study aims at giving accurate description on the situation of the tax incentives and the probable effect on export processing zone. In order to maintain these occurrences, descriptive survey is preferred because it makes enough provision for the protection against bias and maximizes reliability of the evidence collected (Kothari, 2004). Descriptive research studies are designed to obtain pertinent and precise information concerning the current status of a phenomenon and whenever possible, to draw a valid general conclusion from the facts discovered (Kombo and Tromp, 2006).

3.3 Population

Population is the entire group of individuals, events or objects having common characteristics (Mugenda and Mugenda, 1999). Cooper and Schindler, (2006) call it a population of interest from which the individual participants or object from which the measurement is taken. The target population for this research comprised of all the Export Processing Zones Firms in Kenya which according to EPZ Authority (2012), there are 104 in number categorized as active, dormant, closed or setting up as presented in Appendix II.

3.4 Sample Size and Sampling Techniques

The researcher selected all EPZ firms situated in the Nairobi Metropolitan (that is Nairobi, Athiriver and Kajiado Districts) purposively giving 65 firms. This ensured that all clusters of the population were represented in the study including the active zones, setting up zones as well as dormant zones. This technique is appropriate for this study since according to Best and Khan (1998), ideal sample should be enough to serve as adequate representation of the population with much convenience which the researcher wishes to generalize the findings. At the same time, the sample size was adequate since it represents 62.5 percent, far much above the 20 percent, which is recommended by Norman and Fraenkel (2001) as the minimum adequate sample size for any study.

3.5 Data Collection Instruments and Procedures

The study used both primary and secondary data. For the primary data, a set of semi-profit/value addedd questionnaires was used to collect data. According to Mugenda and

Mugenda, (1999) questionnaires are suitable to obtain important information about the population. (Orodho, 2004) said this method reaches large number of subjects who are able to read and write independently. Profit/value added questions were used in order to get specific information by providing a list of possible alternatives from which the respondents select the answer that best describe their opinion while unprofit/value addedd questionnaires was used in order to allow respondents to express their feeling and opinion. The study collected information from the Finance Managers or such other manager charged with the task or informed on tax operations within the organization. Secondary data, on the other hand entailed review of documentaries such as organization journals and statements of account to derive the required information. The researcher considered the financial statements of the selected firms for the period from 2007 to 2011 to perform a trend analysis.

The researcher visited the selected export processing zones firms, brief the administration on the purpose and objectives of the study. The finance managers were briefed on the purpose and objectives of the study and need to give candid responses and suggestions on how to improve the zones based on tax incentives. The researcher then administered the research instruments to the respondents, who were assured of confidentiality and security. The questionnaire was collected immediately the research participants complete them. This ensured high return rate of the questionnaires.

3.5.1 Data Validity and Reliability

Validity is the degree to which a test measures' what is supposed to measure (Gay, 1992). To ascertain whether the items in the questionnaire were suitable for their task, pre- test questionnaire was analyzed and the weaknesses noted. This analysis helped to determine the quality of the research instruments. The researcher modified and redesigned the instruments accordingly so as to ensure it is well defined to achieve the intended results during the main study. Both content and construct validity were established. Content validity is the degree to which the sample of the test items represents the content that the instrument is designed to measure. Construct validity is the extent to which a particular test can be shown to measure a hypothetical construct that is a theoretical construction about the nature of human behavior (Mulusa, 1990).

A pilot study was conducted by the researcher and the results were analyzed for validity and reliability of the research instruments. During the pre test, respondents were requested to leave answered items they find ambiguous. Completed questionnaire were later analyzed and improved depending on the need to do so. The research instruments were piloted in two EPZs which were not be involved in the main study.

The research instruments are said to be reliable if they consistently yield similar results when re tested with similar subjects (Mugenda and Mugenda, 1999). The researcher used test retest technique of evaluating reliability of the questionnaire. The same instruments were administered to finance managers of selected EPZ firms to test whether similar responses would emerge. The two scores of each respondent were analyzed to check for

consistency of responses. The scores from the first test were correlated with scores from the second test. The Pearson's Product Moment Correlation Co–efficient was used where it was found to be 0.87 and indication that the instruments were consistent.

3.6 Data Analysis

Data from the field was edited and coded according to themes which emanated from the research objectives and questions. Descriptive statistical techniques were utilized in data analysis. The coded data was analyzed using the statistical package for social sciences (SPSS). Descriptive statistics such as mean and percentages were utilized to analyze demographic information and the like type of responses. Responses obtained from questionnaires were organized, tabulated and analyzed through the use of simple frequencies and percentages. This is a less complex means of data analysis and enabled large group readers to understand the results of the study. Inferential analysis was used to reach conclusions that extend beyond the immediate data alone by determining the relationship between tax incentives and performance of the EPZ firms. The output was presented by use of tables, bar graphs and pie charts.

3.6.1 Analytical Model

To analyze the relationship between performance of EPZ firms and tax incentives, the following model was used:

$$I = \alpha+\beta_1X_1+\beta_2X_{2+}\ \beta_3X_3+\beta_4X_4+\epsilon$$

Where:-

'I' dependent variable and it represents investments of EPZ firms.

'α' was the autonomous component, which was level of performance of EPZ firms that was not affected by the factors in question. It also gives the intercept of the curve.

'β_1' This was the coefficient of proportionality which tells the amount by which performance of EPZ firms changes due to a unit change in tax incentives.

'X_1' this was one of explanatory variable, tax incentives.

'β_2' It was a coefficient of proportionality which was showing by how much our dependent variable change with one unit change in profit/value added.

'X_2' this presents second independent variable profit/value added.

'β_3' This was the coefficient of proportionality which tells the amount by which performance of EPZ firms changes due to a unit change in sales.

'X_3' this was one of explanatory variables, sales.

'β_4' This was the coefficient of proportionality which tells the amount by which performance of EPZ firms changes due to a unit change in total expenditure.

'X_4' this was one of our explanatory variable, total expenditure.

'ϵ' was a random error term and takes care of other factors that influence performance of EPZ which are not defined in the model.

Table 3.2 indicates the unit of measure for the variable relations in this study.

Table 3.1: Measure of Variables

	Variable	Unit of measure
1.	Investment of EPZ firms	Level of investments through capital employment
2.	Tax incentives	Determined by the total amount of Tax waivered for the zone in particular fiscal period
3.	Profit/Value Added	Amount of net profit after interest and tax earned in an year
4.	Sales (Exports)	Annual sales
5.	Total expenditure	Total amount of expenditure incurred in a particular year

Source: Author (2012)

The test of significant of the model was done by the use of t-test. Independent variables were the tax incentives, profit/value added, sales (exports) and total expenditure while the dependent variable was the level of investments in EPZ.

CHAPTER FOUR

DATA ANAYSIS, FINDINGS AND DISCUSSION

4.1 Introduction

This chapter presents the data findings, analysis and interpretation. The purpose of the study was to establish the impact of tax incentives in Export Processing Zones (EPZs) on business investment in Kenya. Specifically, the study establishes the various types of tax incentives offered to EPZs on their business investment in Kenya as well as the impact of tax incentives on investment. Data was analyzed using both descriptive and inferential statistics aided by a statistical tool for social scientists.

4.2 Demographic Information

This section presents the location of the respondent's zone, state of the zone, duration since the zone was set up in Kenya, department of the respondent as well as designation of the respondent.

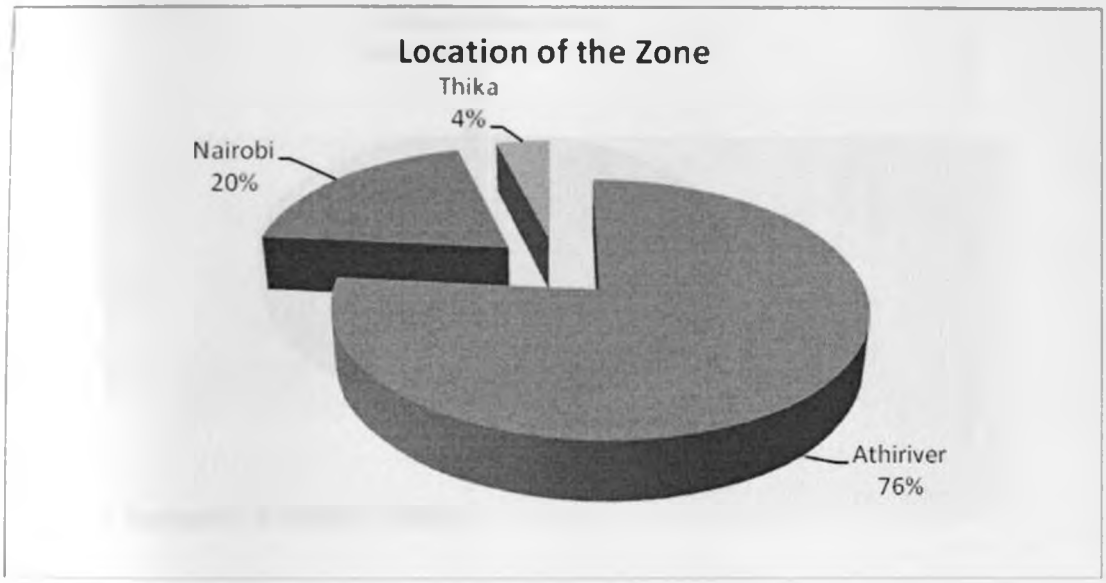
4.2.1 Location of the Zone

Table 4.1: Location of the Zone

	Frequency	**Percent**
Athiriver	39	76.5
Nairobi	10	19.6
Thika	2	3.9
Total	**51**	**100.0**

Source: Research Findings (2012)

Figure 4.1: Location of the Zone



Source: Research Findings (2012)

Findings indicated that, majority (76%0 of the respondents had their zones located in Athiriver, 20% said their respective zones are in Nairobi while the remaining 4% indicated that their zones are located in Thika.

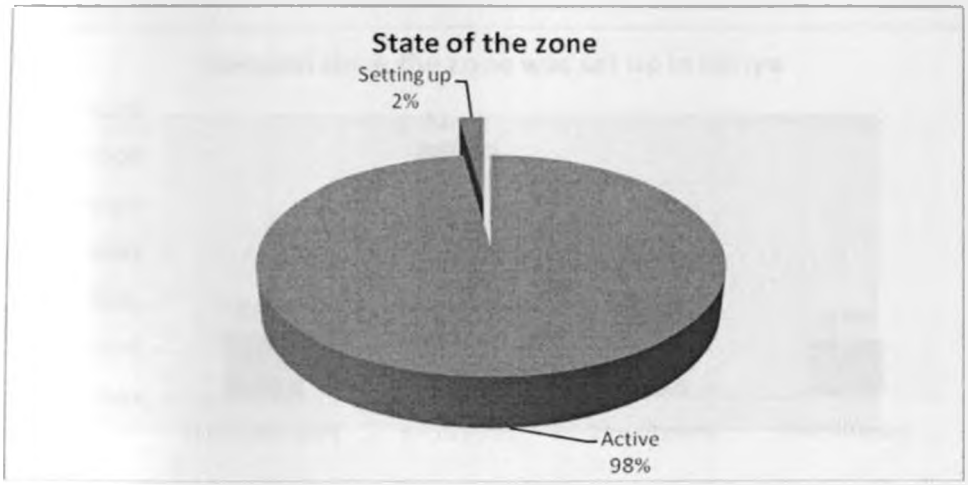
4.2.2 State of the Firms

Table 4.2: State of the Firms

	Frequency	Percent
Active	50	98.0
Setting up	1	2.0
Total	**51**	**100.0**

Source: Research Findings (2012)

Figure 4.2: State of the Zone



Source: Research Findings (2012)

Regarding the state of the zone, findings disclosed that, 98% of the zones understand were active while only 2% were dormant. This indicates that undisputable majority of EPZs in Kenya are active.

4.2.3 Duration since the Firm was Set Up in Kenya

Table 4.3: Duration since the Firm was Set up in Kenya

	Frequency	Percent
Less than 5 years	7	13.7
5 – 10 years	27	52.9
11 – 20 years	11	21.6
Over 20 years	6	11.8

Source: Research Findings (2012)

Figure 4.3: Duration since the Firm was Set up in Kenya

Source: Research Findings (2012)

The study also sought to establish the duration since the firm was set up in Kenya. From the findings, 52.9% of respondents indicated that their firms were established 5 – 10 years ago, 21.6% 11–20 years ago, 13.7% less than 5 years ago while the remaining 11.8% of EPZs were found to have been established over 20 years ago. This implies that most EPZs were established at least 5 years ago.

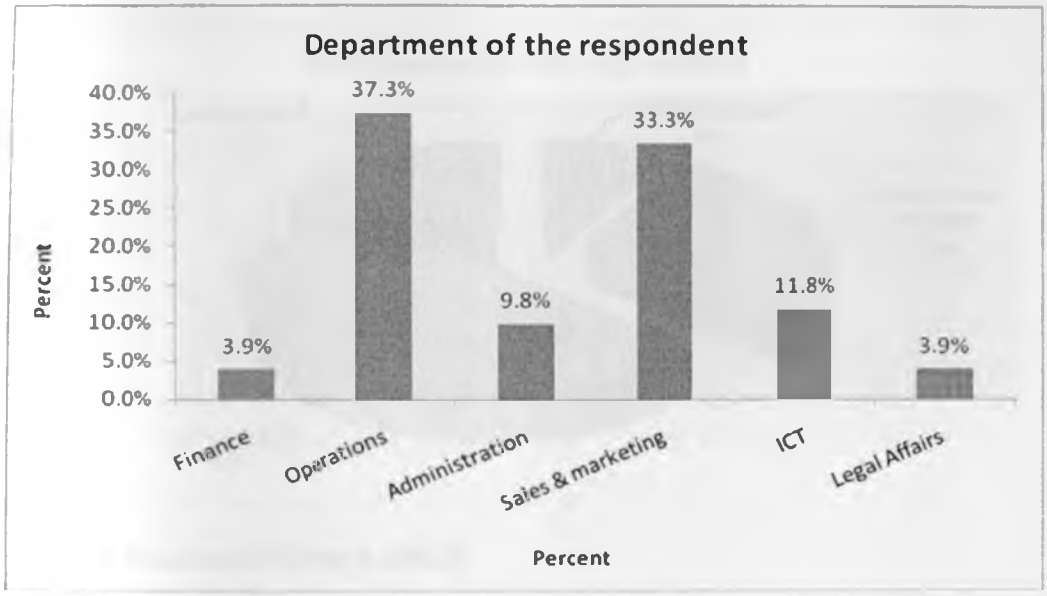
4.2.4 Department of the Respondent

Table 4.4: Department of the Respondent

	Frequency	Percent
Finance	2	3.9
Operations	19	37.3
Administration	5	9.8
Sales & marketing	17	33.3
ICT	6	11.8
Legal Affairs	2	3.9

Source: Research Findings (2012)

Figure 4.4: Department of the Respondent



Source: Research Findings (2012)

Concerning the departments from which the respondents were drawn, it was found that 3.9% were from, finance 37.3% from operations, 9.8% from administration, 33.3%from Sales & marketing and 11.8% from ICT. Other respondents (3.9%) were from the legal affairs. This implies that majority of the employees in EPZ are either in Operations Department or Sales and Marketing.

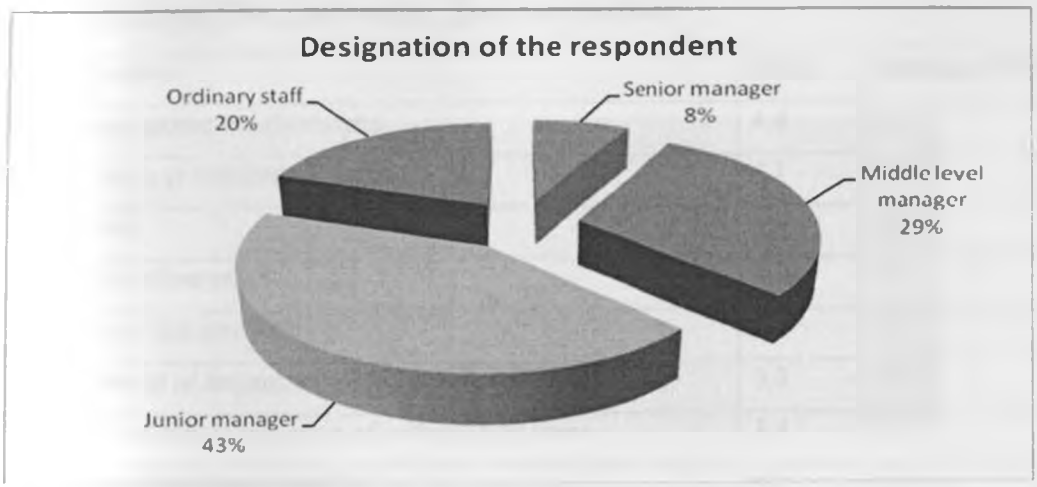
4.2.5 Designation of the Respondent

Table 4.5: Designation of the Respondent

	Frequency	Percent
Senior manager	4	7.8
Middle level manager	15	29.4
Junior manager	22	43.1
Ordinary staff	10	19.6
Total	**51**	**100.0**

Source: Research Findings (2012)

Figure 4.5: Designation of the Respondent



Source: Research Findings (2012)

Regarding the designation of the respondent, 43.1% were in the junior management, 29.4% in the middle level management, 19.6% being the ordinary staff while 7.8% were senior managers. This implies that majority of respondents were in the management of their respective firms.

4.3 Types of Tax Incentives Offered to EPZ Firms

This section is presented in a 5-point Likert scale where 1 represents the least extent while 5 represent the greatest extent. Mean and standard deviation were then used to interpret the results were the higher the mean the larger the extent and vice versa. As per the standard deviation, a higher value indicated a larger deviation from the mean and vice versa. The most prevalent factor would therefore be considered as the one with higher mean (close to 5) and a lower standard deviation (close to 0).

Table 4.6: Level to which Respondent's Business Investments have Benefited on The Following Tax Incentives

Tax incentive	Mean	Standard Deviation
Corporate income tax incentives	4.4	0.7
Tax holidays or reduced tax rates	4.1	0.8
Tax credits	3.4	1.2
Investment allowances	4.0	1.5
Accelerated depreciation	2.8	1.5
Reinvestment or expansion allowances	3.3	0.8
Exemption from or reduction of withholding taxes	3.4	1.3
Exemption from import tariffs	4.0	1.5
Exemption from export duties	3.1	1.8
Exemption from sales, wage income or property taxes	3.9	1.4
Reduction of social security contributions	2.7	1.1
Subsidized financing	3.6	1.1
Grants or loan guarantees	4.7	0.5
Provision of infraprofit/value added, training	2.0	1.1
Preferential access to government contracts	2.4	1.5
Protection from import competition	2.3	1.2
Subsidized delivery of goods and services	2.8	1.4

Source: Research Findings (2012)

Most respondents expressed that their business investments have benefited on the grants or loan guarantees (4.7), corporate income tax incentives (4.4), tax holidays or reduced tax rates (4.1), investment allowances (4.0), exemption from import tariffs (4.0), exemption from sales, wage income or property taxes (3.9) and subsidized financing (3.6). On the other hand, only a few respondents had the feeling that, their businesses have benefited from provision of infraprofit/value added, training (2.0), protection from import competition (2.3), preferential access to government contracts (2.4), reduction of

social security contributions (2.7), subsidized delivery of goods and services (2.8) and accelerated depreciation (2.8).

4.4 Effect of Tax Incentives on Investment

Table 4.7: Positive Effect of Various Attractive Incentives Extended To the Export Processing Zones

Positive impact	Mean	Standard Deviation
Tax breaks	3.9	1.0
Procedural incentives	3.6	1.3
Better infraprofit/value added	2.1	1.3
Travel connections and quality of life	3.5	1.5
Low cost location	2.6	1.3
High quality manpower	3.6	1.1
Increased foreign exchange earnings for the state	4.7	0.5
Increased gross exports that are used to boast business investments in the country	3.7	1.1
Job creation / income creation for the nationals	3.3	0.9
Average wage in EPZ higher than average wage outside the firm	2.3	1.2
Good source of labor training and learning by doing. Assists countries in developing an industrial labor force	3.6	1.2
Management and supervisory training	3.1	1.7

Source: Research Findings (2012)

Positive impact of tax incentives on performance of EPZs as indicated by the respondents include increased foreign exchange earnings for the state (4.7), tax breaks (3.9), increased gross exports that are used to boast business investments in the country (3.7), high quality manpower (3.6), good source of labor training and learning by doing including assisting

countries in developing an industrial labor force (3.6) and procedural incentives (3.6) as well as travel connections and quality of life (3.5). Better infraprofit/value added and average wage in EPZ being higher than average wage outside the firm were however stated as the least positive impacts derived from tax incentives to EPZ.

Table 4.8: Negative Effect of various attractive incentives extended to the export processing zones

Negative impact	Mean	Standard Deviation
The administration is legally complicated and conflictive	4.3	1.1
The government revenue loss through taxation is not worth it	2.3	1.2
They represent unfair international competition and accelerate the race to the bottom	2.8	1.4
The workers are denied their basic rights	2.0	1.1
There are unhealthy competitions in the manufacturing sector caused by the tax incentives to the EPZ	3.7	1.0
Free firm companies do not pay the social costs of production and may be creating a health and environment "time-bomb" in developing countries	3.0	1.1

Source: Research Findings (2012)

Regarding the extent to which respondents agree with some allegations regarding the negative impact of the tax incentives to the free firms, the administration is legally complicated and conflictive was found to be the most prevalent factor with mean of 4.3 while the observation that, there are unhealthy competitions in the manufacturing sector caused by the tax incentives to the EPZ had mean of (3.7). Respondents also moderately argued that, free firm companies do not pay the social costs of production and may be

creating a health and environment "time-bomb" in developing countries with mean of 3.0. Tax incentives, however, are not connected with the argument that, the workers are denied their basic rights as supported by mean of only 2.0.

Chia and Whalley (1995) contends that, there are several potentially serious adverse consequences from the widespread use of tax incentives. First and foremost, they erode the tax base, either because many investments (especially highly profitable ones) would have taken place even without them, or because they are given to investments not eligible to receive them through abuse of provisions in relevant laws and regulations by either officials or investors, or both. In addition, tax incentives distort resource allocation, as some activities, as some activities are encouraged over others not because they are necessarily more economically productive, but because they have been given a tax advantage. Granting of tax incentives creates opportunity for corruption and socially unproductive rent – seeking activities (Chirinko, 1993).

Table 4.9: Respondent's opinion on the extent to which some factors affect the investment of firms in EPZs in Kenya

	Mean	Standard Deviation
Tax incentives awarded by the government	3.6	1.4
Annual sales realized	3.8	0.4
Amount of profit made in a particular fiscal period	4.4	0.9
Cost of production (expenditure)	4.2	1.1

Source: Research Findings (2012)

Regarding the respondent's opinion on the extent to which some factors affect the performance of firms through business investments for firms in export processing zones in Kenya, factors mentioned were the amount of profit made in a particular fiscal period (4.4), cost of production (4.2), annual sales realized (3.8) as well as tax incentives awarded by the government (3.6). The findings are consistent with the argument by Shah (1995) that, the effect of tax incentives is examined using several different methodologies for a range of developing countries. Although the study holds a favourable view of certain tax preferences, especially those encouraging new investment in machinery and equipment and Research and development, Shah (1995) concludes that, in general tax incentives significantly erode the tax revenue base without substantive efforts on investment.

4.5 Inferential Findings

4.5.1 Coefficients

Table 4.10 Coefficients

	Un-standardized coefficients		Standardized coefficients			95% confidence interval for B	
Model	B	Std. Error	Beta	t	Sig	Lower Bound	Upper Bound
(Constant)	0.64	0.01		1.55	0.85	(0.11)	1.56
Profit/value added	0.53	0.33	0.53	0.58	0.44	(0.14)	0.14
Tax incentives	0.85	0.05	0.10	0.86	0.39	(0.16)	0.11
Total expenditure	0.33	0.25	0.33	0.54	0.95	(0.07)	0.21
Sales	0.56	0.10	0.64	5.48	0.00	0.22	0.23

Source: Research Findings (2012)

Table 4.10 illustrates the analytical coefficients for the variable relations. The researcher considered five variables to be significantly influencing performance of EPZ which included the organization profit/value added, tax incentives, total expenditure and sales. The study revealed that the most prevalent factor among the five mentioned was sales with beta value of 0.64 while tax incentives, profit/value added and total expenditure had beta value of 0.10, 0.85, 0.53 and 0.33 respectively. At 95% confidence level, all explanatory variables apart from sales were not significant since had an alpha of more than 0.05 (that is, 0.44 for profit/value added, 0.39 for tax incentives and 0.95 for total expenditure. Sales were considered significant for this study because the significant level was stated at 0.05 which was less than 0.05. Based on objectives of this study, even if tax incentives contribute to direct investments in EPZ, the influence is insignificant.

4.5.2 Analytical Model

From the model, the constant value of 0.64 implies that the level of investment of EPZ will have an index of 0.64 when coefficients for all variable factors are zero. This is an indication that the five independent variables under investigation were positively related to the dependent variable (investment of EPZ firms).

$$\mathbf{I = \alpha + 0.53X_1 + 0.10X_{2+} \beta_3 0.33 + 0.64X_4 + \epsilon}$$

4.6 Interpretation of the Findings

The study in consistence with the statistical data shows that, investments in EPZ firms increase with increase in sales, profit as well as tax incentives. The Export Processing Zones (EPZ) programme recorded a downward trend in the performance of key indicators

in 2009, as a result of adverse effects of global economic recession, especially in the US Market which is a prime destination of EPZ exports. The situation was further aggravated by unfavourable business environment characterized by high costs of production and stiff competition from Asian countries. The EPZ programme is undergoing transformation to Special Economic Zones (SEZ) with a wider scope of activities envisaged to meet the objectives of the Vision 2030.

According to Ministry of Planning (2011), the number of enterprises operating under the EPZ rose to 83 in 2009 from 74 in 2008. Local ownership of investment within the EPZ increased from 14.3 per cent in 2008 to 19.3 per cent in 2009. Joint ventures went up by 24.1 per cent compared to 24.7 per cent in 2008 while foreign investments constituted 56.6 per cent in 2009 compared to 60 per cent reported in 2008. The authority has started implementing an incubator project in order to attract and nurture local business.

As argued by Fiflio and Blonigen, (2000), a crucial consideration that bears on the decision to grant tax incentives should be their cost effectiveness. This implies that the mere identification of the existence of positive externalities associated with certain types of investment projects is not sufficient in and of itself for justifying the use of incentives in all instances. Rather, their use should be predicated on the belief that the benefits to the economy that can be expected from an increase in the incentive-favored activities would actually outweigh the total costs of the tax incentives granted. At the same time, foreign exchange earnings are an important benefit of FDI. Improvement of the hard currency earnings of the host economy is frequently cited as a major objective behind an EPZ

which is a foreign direct investment. This can occur principally from increased (net) exports but may also come from the initial FDI injection where this goes to domestic actors (e.g., construction. purchase of equipment). This in turn is expected to boost the balance of payments position of the host economy, thereby relaxing possible macroeconomic constraints.

CHAPTER FIVE

SUMMARY CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of the study, conclusions and recommendations. The study also presents the suggestion for further studies.

5.2 Summary

Most respondents expressed that their business investments have benefited on the grants or loan guarantees (4.7), corporate income tax incentives (4.4), tax holidays or reduced tax rates (4.1), investment allowances (4.0), exemption from import tariffs (4.0), exemption from sales, wage income or property taxes (3.9) and subsidized financing (3.6). Positive impact of tax incentives on performance of EPZs as indicated by the respondents include increased foreign exchange earnings for the state (4.7), tax breaks (3.9), increased gross exports that are used to boast business investments in the country (3.7), high quality manpower (3.6), good source of labor training and learning by doing including assisting countries in developing an industrial labor force (3.6) and procedural incentives (3.6) as well as travel connections and quality of life (3.5).

Regarding the extent to which respondents agree with some allegations regarding the negative impact of the tax incentives to the free firms, the administration is legally complicated and conflictive was found to be the most prevalent factor with mean of 4.3 while the observation that, there are unhealthy competitions in the manufacturing sector

used by the tax incentives to the EPZ had mean of (3.7). Regarding the respondent's opinion on the extent to which some factors affect the performance of firms through business investments for firms in export processing zones in Kenya, factors mentioned were the amount of profit made in a particular fiscal period (4.4), cost of production (4.2), annual sales realized (3.8) as well as tax incentives awarded by the government (3.6).

5.3 Conclusions

The study reveals that, the level to which EPZs have benefited on the following tax incentives include grants or loan guarantees; corporate income tax incentives; tax holidays or reduced tax rates, investment allowances; exemption from import tariffs; exemption from sales, wage income or property taxes and subsidized financing. The Firms however do not largely benefit from subsidized delivery of goods and services; accelerated depreciation; reduction of social security contributions; preferential access to government contracts; protection from import competition as well as provision of infraprofit/value added, training. Notable was the fact that, tax incentives, even though they related directly to investments, they have very little influence as given by a high significance level of 0.39.

Positive impact of various attractive incentives extended to the export processing zones include increased foreign exchange earnings for the state, tax breaks, increased gross exports that are used to boast business investments in the country, high quality manpower, good source of labor training and learning by doing and assisting countries in

developing an industrial labor force as well as procedural incentives. Negative impacts, on the other hand include the administration is legally complicated and conflictive; unhealthy competitions in the manufacturing sector caused by the tax incentives to the EPZ and free firm companies not paying the social costs of production and may be creating a health and environment "time-bomb" in developing countries. It is also worth noting that, performance of EPZs is highly influenced by the amount of profit made in a particular fiscal period, cost of production (expenditure), annual sales realized and tax incentives awarded by the government.

5.4 Recommendations for Policy

Given the findings of this study, the researcher recommends that:

The Government of Kenya should consider increasing the tax incentives granted to attract foreign direct investment, especially those provided to EPZs. This would entail undertaking a review, to be made public, of all tax incentives with a view to reducing, or removing many of them, especially those that involve the exercise of discretionary powers by the relevant authorities. Those incentives that remain must be simple to administer and shown by the government to be economically beneficial.

Stakeholders in the EPZ should provide on an annual basis, during the budget process, a publicly available tax expenditure analysis, showing annual figures on the cost to the government of tax incentives and showing who the beneficiaries of such tax expenditure are. To conduct annual, comparable and publicly available, tax expenditure analyses, The Government of Kenya should increase the capacity for it to

alyze tax incentives and negotiate for mutual and better benefits with the EPZ vestors. Given the fact that Lack of information and knowledge is an issue for ccessful EPZs, there should be a widespread dissemination of knowledge among overnment officials and businesses, for the various commitments and mechanisms in the ountry intended to promote fiscal benefits. This would ensure increase in the overnment revenues.

5.5 Limitations of the Study

The researcher encountered limitation of time. Time constraint was experienced due to the nature of data that was to be collected as it needed authorization from various level of authorities. At the same time, the different components and variables that were many in number plus the number of years the data was to be collected. The researcher mitigated this problem by planning on manpower where a large team was involved in data collection.

The other limitation was on that some respondents feared disclosing the financial information for their respective enterprises as they feared breach of confidentiality. The researcher however assured them that the information given would be treated with high confidentiality.

Researcher also faced financial limitations as the time given for data collected demanded for more research assistants to be employed, a fact that made the budget to go higher than budgeted for. This problem was however dealt with by making arrangements to pay for the research services in installments.

5.6 Suggestions for Further Studies

The researcher suggests the following for further studies given the scope and limitation of the study:

A study on the effects of tax incentives on export processing zones should be carried out at an expanded scope to cover all zones in Kenya. This would enable linking the demographic factors with the grand effects of tax incentives.

Another study should be carried indicating the retrospective effects of tax incentives and assessing the magnitude of the effects. This would offer a comparative study on the net effects of tax incentives to the overall growth of economy in Kenya.

The study should be carried out on the effects of other identified factors not within the scope of this study.

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APPENDICES

APPENDIX I: QUESTIONNAIRE

PART I: DEMOGRAPHIC INFORMATION

1. Name of the Zone (optional) _____

2. Location of the Zone

   a) Athi River [ ]

   b) Nairobi [ ]

   c) Thika [ ]

   d) Any other (specify) _____

3. Nature of the product exported _____

4. State of the zone

a) Active [ ]

b) Dormant [ ]

c) Closed [ ]

d) Setting up [ ]

i. If closed, when was it closed _____

ii. What was the reason behind closing _____

5. Duration since the zone was set up in Kenya

   a) Less than 5 years [ ]

   b) 5 – 10 years [ ]

   c) 11 – 20 years [ ]

   d) Over 20 years [ ]

6. Department of the respondent

   a) Finance [ ]

   b) Operations [ ]

   c) Administration [ ]

   d) Sales & marketing [ ]

   e) ICT [ ]

   f) Legal Affairs [ ]

   Any other (specify) _____

PART II: POSITIVE EFFECT OF TAX INCENTIVES

7. In general, to what extent would you have benefited from the various attractive incentives extended to the export processing zones?

Positive impact	Not at all	Less extent	Moderate extent	Large extent	Very large extent
a) Tax breaks					
b) Procedural incentives					
c) Better infrastructure					
d) Travel connections and quality of life					
e) Low cost location					
f) High quality manpower					
g) Increased foreign exchange earnings for the state					
h) Increased gross exports that are used to boast business investments in the country					
i) Job creation / income creation for the nationals					
j) Average wage in EPZ higher than average wage outside the zone					
k) Good source of labor training and learning by doing. Assists countries in developing an industrial labor force					
l) Management and supervisory training					
m) Any other					

8. To what extent in your opinion do the following factors affect the performance of firms through business investments for firms in export processing zones in Kenya:

Tax incentive	**1**	**2**	**3**	**4**	**5**
a) Tax incentives awarded by the government	[ ]	[ ]	[ ]	[ ]	[ ]
b) Annual sales realized	[ ]	[ ]	[ ]	[ ]	[ ]
c) Amount of profit made in a particular fiscal period	[ ]	[ ]	[ ]	[ ]	[ ]
d) Cost of production (expenditure)	[ ]	[ ]	[ ]	[ ]	[ ]

9. What do you think should be done to improve on the impact of the various attractive incentives extended to the export processing zones

1. _____
2. _____
3. _____
4. _____
5. _____

PART III: NEGATIVE EFFECT OF TAX INCENTIVES

10. There has been perception that tax incentives extended to the EPZ are beneficial on one side while they are a hefty cost to the host country's business investments. To what extent you agree with the following allegations regarding the negative impact of the tax incentives to the free zones?

    Use the scale 1 for strongly disagree with 5 as strongly agree

Negative impact	1	2	3	4	5
a) The administration is legally complicated and conflictive	[ ]	[ ]	[ ]	[ ]	[ ]
b) The government revenue loss through taxation is not worth it	[ ]	[ ]	[ ]	[ ]	[ ]
c) They represent unfair international competition and accelerate the race to the bottom	[ ]	[ ]	[ ]	[ ]	[ ]
d) The workers are denied their basic rights	[ ]	[ ]	[ ]	[ ]	[ ]
e) There are unhealthy competitions in the manufacturing sector caused by the tax incentives to the EPZ	[ ]	[ ]	[ ]	[ ]	[ ]
f) Free zone companies do not pay the social costs of production and may be creating a health and environment "time-bomb" in developing countries	[ ]	[ ]	[ ]	[ ]	[ ]
g) Any other (specify)	[ ]	[ ]	[ ]	[ ]	[ ]

11. In your opinion, what best should be done to alleviate the negative impact caused by tax incentives towards the free zones on business investments

    1. _____

    2. _____

    3. _____

    4. _____

    5. _____

PART IV: TYPES OF TAX INCENTIVES

12. From a scale of 1 to 5 where 1 represents least extent while 5 represents the greatest extent, indicate the level to which your business investments have benefited on the following tax incentives

Tax incentive	1	2	3	4	5
e) Corporate income tax incentives	[ ]	[ ]	[ ]	[ ]	[ ]
f) Tax holidays or reduced tax rates	[ ]	[ ]	[ ]	[ ]	[ ]
g) Tax credits	[ ]	[ ]	[ ]	[ ]	[ ]
h) Investment allowances	[ ]	[ ]	[ ]	[ ]	[ ]
i) Accelerated depreciation	[ ]	[ ]	[ ]	[ ]	[ ]
j) Reinvestment or expansion allowances	[ ]	[ ]	[ ]	[ ]	[ ]
k) Exemption from or reduction of withholding taxes	[ ]	[ ]	[ ]	[ ]	[ ]
l) Exemption from import tariffs	[ ]	[ ]	[ ]	[ ]	[ ]
m) Exemption from export duties	[ ]	[ ]	[ ]	[ ]	[ ]
n) Exemption from sales, wage income or property taxes	[ ]	[ ]	[ ]	[ ]	[ ]
o) Reduction of social security contributions	[ ]	[ ]	[ ]	[ ]	[ ]
p) Subsidised financing	[ ]	[ ]	[ ]	[ ]	[ ]
q) Grants or loan guarantees	[ ]	[ ]	[ ]	[ ]	[ ]
r) Provision of infrastructure, training	[ ]	[ ]	[ ]	[ ]	[ ]
s) Preferential access to government contracts	[ ]	[ ]	[ ]	[ ]	[ ]
t) Protection from import competition	[ ]	[ ]	[ ]	[ ]	[ ]
u) Subsidised delivery of goods and services	[ ]	[ ]	[ ]	[ ]	[ ]
v) Any other (specify)	[ ]	[ ]	[ ]	[ ]	[ ]

13. Kindly elaborate your answer above by explaining the level of benefit

_____

_____

_____

_____

_____

14. What steps in your opinion should government take to enhance the different types of incentives on EPZ to promote business investments?

1. _____
2. _____
3. _____
4. _____
5. _____

PART V: CHALLENGES ENCOUNTERED ON THE IMPLEMENTATION OF THE TAX INCENTIVES

15. What challenges do you encounter when implementation of the tax incentives?

1. _____
2. _____
3. _____
4. _____
5. _____
6. _____

7. _____

8. _____

16. What are the suggestions for improvement?

1. _____

2. _____

3. _____

4. _____

5. _____

APPENDIX II: CATEGORIES OF EPZ FIRMS IN KENYA

Location	Active	Setting up	Dormant	Closed	Total
Athiriver	39	9	0	0	48
Nairobi	12	0	0	2	14
Mombasa	28	5		0	33
Ruaraka	2		1	0	3
Kajiando	1	0	0	0	1
Thika	3				3
Murang'a	1				1
Eldoret	1	1			2
Total	**87**	**14**	**1**	**2**	**104**

APPENDIX III: LIST OF EPZ FIRMS

1. AAA Growers EPZ Ltd
2. Africa Apparel EPZ Ltd.
3. Africa Finest Produce Epz Ltd
4. Algerasi Group EPZ K. Ltd
5. All Fruit EPZ Ltd
6. Alltex EPZ Ltd
7. Alpha Logistics EPZ Ltd
8. Asante Gifts & Souvenirs EPZ Ltd
9. Ashton Apparel EPZ Ltd
10. Avenue Fresh Produce EPZ Ltd
11. Balaji EPZ Ltd
12. Base Bite Agencies EPZ Ltd.
13. Biocorn Products EPZ Ltd.
14. Blue Sky Films EPZ Ltd.
15. Botanical Extracts EPZ Ltd.
16. Capital Industrial Park EPZ Ltd
17. Celebrity Fashions K. EPZ Ltd
18. De La Rue Currency and Security Print EPZ Ltd.
19. Earth Oil Kenya Proprietary EPZ Ltd
20. Envirofit Kenya (EPZ) Ltd
21. Erdemann (EPZ) Ltd.
22. ET Elasto Tech (EPZ) Ltd
23. Forest Gate EPZ (K) Ltd
24. Future Garments EPZ Ltd.
25. Garsen Holding EPZ Ltd.
26. Ginger Ink Films EPZ Ltd.
27. Global Apparels (K) EPZ Ltd
28. Gokal Beverages (EPZ) Ltd.
29. Gold Crown Foods EPZ Ltd.
30. Golden Light EPZ Ltd.
31. Halai Brothers (EPZ) Ltd
32. Hantex Garments EPZ Ltd
33. Hardy Technology Park EPZ Ltd
34. Hui Commercial EPZ K. Ltd
35. Ideal Solution EPZ Ltd
36. Imperial Teas (EPZ) Ltd
37. Indu Fresh EPZ Ltd.
38. Insta Products EPZ Ltd.
39. Ivee Aqua EPZ Ltd.
40. Ivee Infusions Epz Ltd
41. Jungle Cashshews EPZ Ltd
42. Jungle MAC EPZ Ltd
43. Kapric Apparels EPZ Ltd.
44. Kencall EPZ Ltd.
45. Kensis EPZ Ltd
46. Kenya Fluorspar EPZ Ltd.
47. Kenya Knit Garments EPZ Ltd.
48. Kenya Marine Contractors EPZ Ltd.
49. Kenya Metal Refineries EPZ Ltd.
50. Kenya Trading EPZ Ltd.
51. Kipevu Inland Container EPZ Ltd.
52. Leatherlife EPZ Ltd.
53. Lifesciences Consultants EPZ Ltd.
54. Lycan (EPZ) Enterprises Ltd
55. Manda Bay SEZ EPZ Ltd
56. Matrix Global Trade EPZ K. Ltd.
57. Mega Garments EPZ Ltd
58. Metal Refinery EPZ Ltd.
59. Middle East Texco EPZ Ltd.
60. Mitsumi Distribution (EPZ) Ltd
61. Mombasa Apparels EPZ Ltd
62. Mugama Containers EPZ Ltd
63. Mukafa EPZ Ltd

64. New Wide Garments (K) EPZ Ltd
65. Newland EPZ Ltd.,
66. Nodor Kenya EPZ Ltd.
67. NRS International EPZ Ltd
68. Nutro Manufacturing EPZ Ltd.
69. Oilfields Logistics Services Africa EPZ Ltd (OLSA)
70. Ojijo International EPZ (K) Ltd
71. Olivado EPZ Ltd.
72. Olivado Kenya EPZ Ltd.
73. Orion EPz Ltd.
74. PJ Dave EPZ Ltd.
75. Pontact Productions EPZ Ltd.
76. Premium Machinery Distributor EPZ Ltd.
77. Protex Kenya EPZ Ltd.
78. Pure Fry EPZ Ltd
79. Real Beverages EPZ Ltd.
80. Red Dot Distribution EPZ Ltd
81. Redington EPZ Ltd
82. Reltex Tarpaulins Africa EPZ Ltd.
83. Revital Healthcare EPZ Ltd.
84. Ricardo EPZ International Co. Ltd.
85. Royal Garments EPZ Ltd
86. Rupa Cotton Mills EPZ Ltd.
87. Sajan Printers EPZ Ltd.
88. Sajan Trading EPZ Ltd.
89. Sameer Africa Epz Ltd
90. Sameer Industrial Park EPZ Ltd
91. Sandton Park EPZ Ltd.
92. Savannah Cement (EPZ) Ltd.,
93. Saw Africa EPZ Ltd.
94. Senior Best Garments K. EPZ Ltd.
95. Shin Ace Garments K. EPZ Ltd.
96. Sino Link EPZ Ltd.
97. Soko EPZ Ltd
98. Solitaire Gems EPZ Ltd.
99. Soyana Industrial Park (EPZ) Ltd
100. Spartan Relief EPZ Ltd.
101. SV Polymars EPZ (K) Ltd
102. Sweet R US EPZ Ltd.
103. Tailormade Jeanswear (EPZ) Ltd
104. Taurus EPZ Ltd.

source:

March 14, 2012

EPZ