

Effect of Value Added Tax Incentives on Financial Performance of Export Processing Zone Agro-Processing Firms in Nairobi County Kenya

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Abstract

Many governments employ trade laws and initiatives to increase export trade on a global scale. As a result, numerous trade incentives were introduced. Thus, one of the often-employed strategies to improve the financial performance of EPZ companies worldwide is reportedly the use of tax incentives. The objective of the study was to evaluate the effect of Value Added Tax incentives on the financial performance of EPZ agro-processing firms in Nairobi County Kenya. The study was guided by the Cluster Approach Theory. An explanatory research design was used in this study. This study's target is 203 respondents and a sample size of 134 EPZ agro-processing enterprises in Nairobi, with an 85% response rate. To achieve the goals of the study, standardized questionnaires with closed-ended questions were used for primary data collecting. The data was analyzed using descriptive, inferential statistics, and multiple linear regression analysis. The study found there is a positive and statistically significant effect of VAT incentives on financial performance, $\beta = 0.204(p=0.049 < 0.05)$. The study recommends that the policymakers and the KRA should explore improving and increasing current incentives like VAT exemptions. Future studies may be conducted on non-EPZ firms using other factors such as export promotion incentives.

Keywords: *EPZ agro-processing firms, Value Added Tax incentives, financial performance*

1.0 INTRODUCTION

All governments in the world use tax incentives to improve and grow their economic activity and investment firms. They take advantage of a significant portion of the economy that is either invisible or nonexistent to divert some unique economic activity toward that sector (Kaplan, 2019). To fulfill its tax-incentive duties and obligations, the government provides public goods and services such as maintaining law and order and ensuring security. In addition to obtaining funds, taxes are imposed by the government to guarantee equitable income distribution, economic stability, social welfare advancement, and efficient resource distribution.

Tax incentives, as defined by the Revenue Authority (KRA), are provisions that provide a company, an individual, or a business organization with a beneficial condition that deviates from the norm. The tax incentive programs used by different countries may have distinct structures. Being free from paying taxes for a specific amount of time upon startup is a frequent tax benefit in Kenya. As a result, EPZ companies that export goods benefit from lower tax

rates, a 0% capital income tax rate, tax credits, tax holidays, and an investment allowance tied to expenses. (EPZA Kenya, 2018). Firms, enjoy incentives by creating jobs, hence increasing output that helps to improve the organization's financial performance, investment allowances tax incentives as well as import duty exemptions are independent variables for this study.

Financial performance is determined by market value, growth, and profitability, according to Mitchell, Obeidat, and Bray (2013). They went on to say that growth is an unmistakable sign of a company's ability to expand; as a result, growth is correlated with the firm's overall profits and revenues, and profitability demonstrates the company's capacity for revenue generation. Financial performance is determined by market value, growth, and profitability (Mitchell, Obeidat, & Bray, 2013). They went on to say that growth is an unmistakable sign of a company's ability to expand; as a result, growth is correlated with the firm's overall profits and revenues, and profitability demonstrates the company's capacity for revenue generation

The Kenyan Export Processing Zone Authority Act, Chapter 517 (EPZA, 2022), states that the EPZs offer various investment benefits. These include a 10-year corporate tax holiday and a 25% tax afterward for all firms operating within the EPZ, as well as a 10-year withholding tax holiday, VAT, and customs duty deduction. Athi River being the most developed and largest estate, gives an additional offer such as modern logistics infrastructure, full stamp duty exemption, and, custom duty exemption for the raw materials and construction, which is a 10-year withholding tax exemption on dividends and as well as the remittances that are paid to non-residents. For 20 years, they get a 100% investment deduction.

1.1 Problem Statement

In different studies, scholars argued that tax incentives enhance a high rate of return on equity and assets as well as the profits realized that are reinvested in the business (Uwaume & Ordu, 2014). Therefore, the growth of the economy globally and stiff competition create the need for a competitive tax system which is a strategy used to establish industries among them being EPZ to enjoy trading privileges.

The annual reports (EPZA, 2020) state that exports fell by 5.3% to Kshs 68,572 million from Kshs 72,390 million in 2018, which contributed to the bad financial performance. The total sales margin reduced by 0.1% to Kshs 77,189 million in 2019 from Kshs 77,270 million in 2018. This poor financial performance was attributed to a large extent to not having enough material supply for agro-processing EPZ firms, and other factors touching on the impact of the EPZ program namely, internal shocks and high production costs despite applicable tax incentives. Additionally, the poor financial performance of EPZ was linked to several issues, including global competitiveness, anxiety over general elections, delays in ordering garment firms, and meteorological issues like the drought that disrupted the supply of raw materials to agro-processing industries (EPZA, 2020).

According to the EPZA financial report from 2016, the number of people hired by EPZ enterprises in Kenya has been declining. They also stated that between 2012 and 2015, there was a decline in the number of jobs. This resulted in the poor financial performance of EPZ firms at a very critical time of expanding and growing international trade and stiff beneficial competition. Hence, the need to assess government taxation policies encouraging EPZ economic activities through reducing tax payments and, so the reported poor financial performance of EPZ is a concern on of tax incentives available. It is due to the foregoing that this study sought to investigate the effect of Value Added Tax incentives on the financial performance of EPZ agro-processing firms in Nairobi County Kenya.

2.0 LITERATURE REVIEW

2.1 Theoretical Review

Michael Porter developed the Cluster Approach Theory in 1990. Based on the idea of competitive advantage, this theory serves as a starting point for change for numerous governments and enterprises worldwide. Porter states in this theory that investing is a viable thing and would be the best way to show growth in the financial performance of EPZ (Collins, Bosworth & Soto-Class, 2006).

According to Michael Porter (1990), enterprises in special economic zones (EPZs) are those that operate in the same geographic area and benefit from the same infrastructure development, technology transfer, and technical support as well as access to a diverse pool of skilled labor. Using the clusters method, EPZs limit the government's power to enforce its will on the enterprises and assess the event in terms of potential tax competitiveness. Due to the inadequate government relationship with the companies, an assessment ought to be done. For example, the company's difference in interregional versatility may bring problems to the government to keep them in check. Kuria, (2018) noted in his study that the government cannot tax a company without observing its trends hence this may be a sign of different qualities clustered differently according to the firm's business choice.

For a while now, tax incentives have been used by policymakers at all levels of government to target certain geographic areas. It is crucial to note that the tax advantages vary greatly throughout authorities and have not been the same. To guarantee that tax treatment is efficient, certain tax incentives are designed to encourage capital investment, while others support the creation of jobs. Numerous studies have been conducted regarding tax incentives, which vary by region, to guarantee their ability to generate employment opportunities. This study benefits from an understanding of the cluster approach theory because it addresses investment allowance, tax holidays, and VAT. Additional research that employed the cluster method theory are Hanson (2009), Kuchiki & Tsuji (2008), Kuchiki (2014), and Murage (2012).

In a comparative study of export processing zones in the wake of the sustainable development goals, Adu-Gyamfi, Richard and Asongu, Simplicie and Mmusi, Tinaye and Wamalwa, Herbert and Mangori, and Madei (2020) used a cluster approach. Based on their findings, they concluded that they have re-interviewed common sectors among the EPZs, and among them, they noted that agro-processing is practiced in all countries. They added that although EPZs in Zimbabwe house the tourism industry, they also allow fisheries and meat production in Kenya. Africa's EPZs are dynamic organizations that adapt to shifting trends in the competitive industries that make up the world economy. From the earlier assembly and processing operations, the zones have expanded to encompass science zones, financial zones, technical zones, and even tourism resorts (ILO, 2015). In 2022, Botswana observed that EPZ companies within the business innovation center function within specific industries, hence employing a cluster method. The theory supports the VAT incentives on financial performance.

2.2 Empirical Review

Financial Performance

Financial performance is the position in which an organization achieves its financial goals. According to the EPZ annual financial performance report (EPZ, 2020), the EPZ program is growing well and showing an increasing trend in many indicators. Growth in direct local employment by 5.8 % from 57,099 individuals records in 2019 to 60,390 persons in 2020. Capital investment in the form of machinery and equipment and other funds invested by the

137 operational enterprises grew from Kshs.76,356 million in 2018 from Kshs. 77,691 million in 2019 by 1.8%. The cumulative value of investment for zone and enterprises including developer and operator was recorded at Kshs 107,877 million in 2019 from Kshs 105,066 million in year 2018. in the year 2019, expenditure on local goods and services increased by 3.3% to Kshs 31,858 million compared to Kshs 30,845 million in 2018.

VAT Incentives and Financial Performance

VAT is defined as a tax on the amount by which the value of an article is enhanced at each stage of its production and distribution, as stated in the Value-Added Act, Laws of Kenya (Ernst & Young, 2014). In this study, the scholar looked at how the VAT incentives for export processing zones being Zero rated, exempted and standard rate hence the study focused on the zero-rated goods for export

Chuanwang et al. (2020) used the Difference-In-Difference (DID) technique to study VAT incentives in different kinds of new energy companies in China to look into the empirical impact of these incentives on firms that are listed as new energy. According to Chuanwang et al. (2020), the new energy industry's VAT refunds resulted in a 5% decline in the company's return on equity (ROE). This may be attributed to the tax incentives that caused overcapacity, a twisted industrial chain, and a lack of innovation.

The study demonstrated that incentive programs had a favorable impact on VAT by examining the effects of VAT incentives. Chuanwang et al. provided a fresh viewpoint on the efficacy of tax incentives for China's new energy sector using firm-level data. Zheng (2020) conducted research on Chinese engineering companies that are listed on stock exchanges to examine the connection between corporate investment and the reduction of VAT. The research was conducted between 2009 and 2019. The enterprise growth capability, asset-liability ratio, and return on assets are all related to the VAT coefficient, which was 0.021. They concluded that privately held businesses benefit much more from VAT reductions than do government-owned businesses.

2.3 Conceptual Framework

A conceptual framework can be defined as a set of broad ideas and principles taken from relevant fields of inquiry and used to structure a subsequent presentation A conceptual Framework provides a relationship between the dependent variable and independent variables (Kothari, 2004). The conceptual model represented in Figure 1 describes the relationship between the variables of the study accordingly.

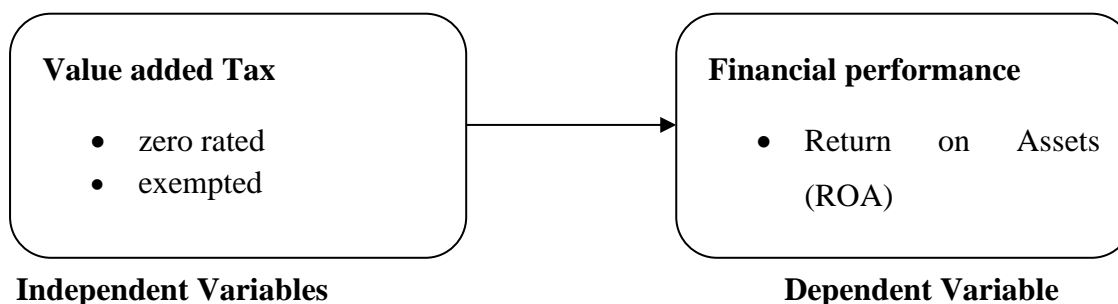


Figure 1: Conceptual Framework

Source: (Researcher, 2024)

3.0 METHODOLOGY

This study adopted the explanatory research design. An explanatory study was carried out to construct concepts that clarify and forecast normal and collective actions (McNabb, 2017). This design was suitable for this study because a study is more extensive in terms of scope than the descriptive research technique. Hence, this design helped in giving a detailed insight as to why some events occurred, or do occur, deducing the causes and effects among many constructs, and clarifying the variances in more than a cluster of answers. The design therefore helped find answers to research questions (McNabb 2017). the target population was the 203 respondents of 7 EPZ agro-processing firms in the Nairobi zone out of the total population of 50 EPZ agro-processing firms in Kenya, Export Processing Zone Authority (EPZA, 2023) namely; Avo Health (EPZ) Ltd, Exotic EPZ Ltd, Fairoils EPZ Ltd, Indu Farm EPZ Ltd, Mara Farm EPZ Ltd, Real Beverages EPZ Ltd and Vermont Flowers EPZ Ltd and a sample of 134 respondents. Primary data was collected using structured questionnaires. Data was analyzed using descriptive and inferential statistics.

4.0 RESULTS AND DISCUSSION

4.1 Descriptive Statistics

4.1.1 VAT Incentives

Table 1 indicates the third variable to evaluate the effect of VAT incentives on the financial performance of EPZ agro-processing firms in Nairobi County Kenya. The results show a high ranking with respect to VAT incentives indicators (Mean scores above 4.0 were recorded for most VAT incentives statement descriptions). The statement "The VAT incentive motivates our company to start and maintain operations in Kenya" had the highest mean score of 4.09, implying that the VAT incentive motivates EPZ agro-processing firms in Nairobi County Kenya to a very large extent. The statement "The VAT incentive increases our company's overall revenues" had the lowest mean score of 3.97, implying that respondents almost disagreed with this statement.

Table 1: Descriptive statistics of VAT incentives

Items	N	Mean	Std. Deviation	Skewness	Kurtosis
Exemption from paying VAT on export services has led to our firm	114	3.99	.825	-.080	-1.296
The VAT incentive motivates our company to start and maintain operations in Kenya.	114	4.09	.847	-.258	-1.336
The VAT incentive increases our company's overall revenues.	114	3.97	.846	-.039	-1.400
Our company expanded quickly as a result of the export services exemption from paying VAT.	114	4.02	.852	-.121	-1.406
VAT incentive affects the share of profits by our firm	114	4.07	.838	-.226	-1.310

Source: Research data 2024

4.1.2 Financial Performance

Table 2 indicates the dependent variable financial performance of EPZ agro-processing firms in Nairobi County Kenya. The results show financial performance indicators (Mean scores above 4.0 was recorded for most financial performance statement descriptions). The statement “The last five years have seen an increase in the company's market share” had the highest mean score of 4.06, implying that there was some increase in the company's market share to a very large extent. The statement “Our business has increased asset usage and generated strong profits” had the lowest mean score of 3.92, implying that respondents almost disagreed with this statement.

Table 2: Financial Performance

Items	N	Mean	Std. Deviation	Skewness	Kurtosis
We experienced an increase in ROI	114	4.01	.857	-.704	.460
Our organization achieves its goals within the set timelines	114	4.02	.862	-.709	.424
Our business has increased asset usage and generated strong profits.	114	3.92	.874	-.493	-.005
The last five years have seen an increase in the company's market share.	114	4.06	.844	-.746	.579
Most workers are driven to achieve company objectives.	114	4.03	.877	-.692	.264

Source: Research data (2024)

4.2 Correlation Analysis

A correlation coefficient enables the researcher to quantify the strength of the linear relationship between two ranked or numerical variables. Pearson correlation analysis was done to determine the relationship between study variables. A correlation coefficient value (r) in the range of 0.1 to 0.29 is considered weak, 0.3 to 0.49 is considered moderate while 0.5 to 1.0 is considered strong extracts from O'Brien, 2007. Table 5 indicates that VAT incentives are positively correlated with financial performance (r= 0.598).

Table 3: Summary of Correlations Statistics of Independent and Dependent Variable

	Financial Performance	VAT Incentives
Financial Performance	1	0.598**
VAT Incentives	0.598**	1

Correlation is significant at the 0.05 level (2-tailed).

Source: Research data (2024)

4.3 Regression Analysis

The results in Table 4 indicated that VAT incentives had a positive correlation with financial performance up to 59.8% or (R= 0.598). The results reveal that VAT incentives caused a variation of 35.7% ($R^2=0.357$ and adjusted $R^2=0.348$) in financial performance. This implies that the remaining 64.3 % of the change was caused by other factors not included in the model.

Table 4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.598 ^a	.357	.348	.49579

a. Predictors: (Constant), VAT incentive

Source: Research data (2024)

Further ANOVA tests were conducted to determine whether the model works in explaining the relationship among variables as postulated in the conceptual model. The findings from Table 7 show an F statistics value of 36.633 with a significance level of 0.000 which was less than the conventional probability of 0.05 significance level. Hence establishing the model is statistically significant. The implication is that the independent variable (VAT incentives) contributes significantly to changes in the dependent variable (financial performance). This shows that the model works and thus accounts for significantly more variance in the dependent variable than would be expected by chance.

Table 5: Analysis of Variance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	31.761	1	31.761	36.633	.000 ^b
	Residual	97.120	112	.867		
	Total	128.881	113			

a. Dependent Variable: Financial performance

b. Predictors: (Constant), VAT Incentives

Source: Research data (2024)

The hypothesis stated that VAT Incentives have no significant effect on the financial performance of EPZ agro-processing firms in Nairobi County Kenya. VAT Incentives have a positive relationship effect on the financial performance of EPZ agro-processing firms in Nairobi County Kenya. The results in Table 8 revealed that the p-value was less than 0.05, $\rho=0.000$ which implies that the relationship was statistically significant and therefore hypothesis was rejected.

Table 6: Regression Coefficients

Model		Standardized Coefficients		Unstandardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.208	.680		3.247	.002
	VAT incentives	.204	.100	.265	2.040	.049

a. Dependent Variable: Financial performance

Source: Research data (2024)

4.4 Discussion of the Findings

The objective was to evaluate the effect of VAT incentives on the financial performance of EPZ agro-processing firms in Nairobi County Kenya. The study found that there is a positive and significant relationship between VAT incentives and financial performance $r= 0.598$, $p=0.000<0.05$. To further investigate the effect of VAT incentives on the financial performance of EPZ agro-processing firms in Nairobi County Kenya the regression model shows a positive and statistically significant effect $\beta=0.204$ and p value $0.049<0.05$. The finding was in agreement with a study done by Chuanwang et al. (2020) used the Difference-In-Difference

(DID) technique to study VAT incentives in different kinds of new energy companies in China to look into the empirical impact of these incentives on firms that are listed as new energy.

5.0 CONCLUSION

The study established that VAT incentives have a positive effect on the financial performance of EPZ agro-processing firms in Nairobi County Kenya. The study findings revealed that the VAT incentive motivates the company to start and maintain operations in Kenya. VAT incentive affects the share of profits by our firm and the company expanded quickly as a result of the export services exemption from paying VAT

6.0 RECOMMENDATIONS

Given the substantial and positive correlation shown between VAT incentives and the financial performance of EPZ agro-processing firms, it is recommended that the policymakers and the KRA should explore improving and increasing current incentives like VAT exemptions. This might include extending tax incentives, raising the proportion of investment allowances, and improving VAT incentives to better meet the requirements of small businesses. Future studies may be conducted on non-EPZ firms using other factors such as export promotion incentives.

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