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Effects of Tax Incentives on Financial Performance of Savings and Credit Cooperative Societies in Nairobi County, Kenya

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Abstract

Savings and Credit Cooperative Societies (SACCOs) are regarded globally as key players in economic growth of a majority of countries. Vibrant and dynamic cooperative sectors contribute largely to the economic development of different countries. SACCOs in Kenya actively contribute to 30% of the economy, this is possible because they are well distributed all over. The purpose of this study was to establish the effects of tax incentives on financial performance of SACCOs in Nairobi County. The study focused on corruption and influence theory, agglomeration economies theory and neoclassical theory. The study adopted a descriptive research design. The study population comprised of all the registered SACCOs in Nairobi County. A sample of 41 SACCOs was arrived at using 10- 30% of target population as representative rule and stratified random sampling technique. Secondary data from SASRA was collected and analyzed to establish the association between tax incentives and profitability of SACCOs. This study established that there is a positive relationship between capital allowance, accelerated depreciation and financial performance of SACCOs in Nairobi County. From the study on correlation analysis, the results showed capital allowance and accelerated depreciation positively influenced the profitability of SACCOs. This means when capital allowance and accelerated depreciation increases, so does the profitability of SACCOs. It further indicated a negative relationship between tax and financial performance. On regression analysis, R-Squared was 0.505 which is a variation of 50.5% of financial performance explained by tax incentives and which depicts a positive relationship of financial performance and the independent variables. The analysis of variance showed that tax incentives positively impacted on the performance of SACCOs. The study therefore recommended that the government should provide more and a diversity of tax incentives to the SACCOs, especially capital allowance and accelerated depreciation and tax exemptions, since an increase in each of them increases the profitability of SACCOs. The researcher further advocates for similar studies to be conducted in other Counties apart from Nairobi County and in different sectors such as the real estate sector among others.

Keywords: Tax Incentives, Financial Performance, Savings and Credit Cooperative Societies

Introduction

SACCOs are regarded globally as key players in economic growth of a majority of countries. Vibrant and dynamic cooperative sectors contribute largely to the economic development of different countries. SACCOs in Kenya actively contribute to 30% of the economy, this is possible because they are well distributed all over (Karagu & Okibo, 2014). It is through SACCOs that many Kenyans save their funds for investment in businesses and home ownership further contributing to Kenya's Vision 2030 development

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agenda. In an attempt to stimulate growth and good financial performance of SACCOs, tax incentives are offered to motivate them to increase their investments (Mintz & Chen, 2011). In countries like Russia for example, tax incentives are a useful tool for increasing the profitability and improving the financial performance of businesses (Markov, 2016). Among the EU policy makers, tax incentives are a commonly used threshold to slightly reduce the tax liability of firms.

The study focused on corruption and influence, agglomeration economies and neoclassical theories. According to corruption and influence theory, countries with weak tax laws and firms involved in bribing government leaders enjoy illegal high levels of tax incentives. Agglomeration of economies theory which was developed by Garcia- Mila and McGuire explains that, firms which are located in the cities have got many skilled workers than their counterparts in rural areas and thus they receive high tax incentives. Neo-classical theory which was developed by Solow in 1956 indicates that there should be no inequality in the distribution of tax incentives, all qualified firms should be provided with tax incentives.

According to James (2013) tax incentive is the process of reducing the tax liability which is available on various investments, through deviations from the unnecessary taxes levied in the system. It is provision for taxes that is made available for SACCOs to decrease the tax liability. Tax incentive is characterized by accelerated depreciation, tax credits and reductions in tax rates/exemptions and capital allowance.

The general health of a company over a given time span is regarded as financial performance (Bhunia, Mukhuti & Roy, 2011). It is an analysis on the appraisal of growth of a firm. Most of the SACCOs rely on financial performance to evaluate the success and proper business governance. However, few existing indicators will be used by SACCOs. Some of the financial performance indicators used are tools that determine the revenue of businesses and allow them to fulfill the given obligations (Arcenildo Valderes Da Silva Nunes, 2012). The trend analysis of various SACCOs in Kenya indicate that they had a good development in capital, loans, deposits and total assets (Buluma, Kung'u, & Mungai, 2017). In this study financial performance was determined using ratios such as firm size, firm growth, liquidity and Capital Assets Management Earnings Liquidity (C.A.M.E.L) among others which were derived from the statements of businesses.

In Kenya, tax incentives are categorized into export or investment promotion incentives. Export promotion incentives comprises of Export Processing Zone (EPZ), the Tax Remissions and Exemptions Office (TREO) and Manufacture under Bond (MUB). The aim of EPZ is to Promote FDI, while TREO and MUB were meant to promote manufacture of goods in the country for export. Investment Promotion Incentives include Investment Deductions (ID) which is for processing machines, Industrial Building Deductions (IBD) which is granted on factory buildings and staff quarters, Mining Allowance which is granted on Mining and Farm Work Deductions (FWD) which is usually granted on capital expenditure incurred in farming (Githaiga, 2013). Despite the significance of stability of SACCOs, very scarce research on SACCOs and tax incentives is available.

Research Problem

SACCOs in Kenya were performing poorly in the past few years leading to some of them collapsing with member's deposits, this was attributed to many difficulties like heavy taxation, stiff competition, poor corporate governance and instability (Chahayo, Bureti, Juma, Maende & Aketch, 2013). This challenges made them to contribute negatively to the economy of the country. SACCOs worldwide are significant channels of economic prosperity, they play a vital role in granting finances to the needy (Karagu & Okibo, 2014). However, reports reveal that attaining proper utilization of tax incentives by many nations to support firms like SACCOs remain an unrealized dream (Feyitimi, Temitope, Akeem, & Samuel, 2016). Some governments are faced with fiscal indiscipline towards firms due to their inability to give tax incentives, charging multiple taxes, introducing new levies and difficulty in effectively implementing tax policies.

Research has been undertaken on tax incentives globally and locally. However, little research has been undertaken on tax incentives and its effects on SACCOs. A research was done on how policy makers from poor countries benefit from using tax incentives (Zee et al, 2002) the variables used were not exhaustive, these variables include the business investment- market failures and investment costs which did not consider all aspects of tax incentives and financial performance, but only pointed out that, the preferred form of tax incentives are those that provide for faster recovery of investment costs. Feyitimi et al, (2016) undertook a study in Nigeria about contribution of tax incentives from the government to growth of SME's, but the research was not done in the local context but in a different location, in West Africa and in a developing country representing a contextual gap. In Uganda, Mayende (2013) analyzed how the performance of

manufacturing industries is affected by tax incentives in regards to value added and gross sales. But he only considered the manufacturing firms.

Onyango (2015) conducted a study in Nairobi County on how performance of five star hotels is affected by tax incentives, that research revealed conflicting findings as IBD and ID negatively affected financial performance whereas W&T had a positive effect on the hotels. Gumo (2013) sought to establish how FDI in Kenya is affected by tax incentives, though he didn't consider capital allowance which is an important part of tax incentives to be analyzed under the study. Murage (2012) investigated how the EPZ firms in Kenya are affected by tax incentives especially in Business Investment, the research however revealed that the impact on the dependent variable is not significant. Lack of consistency and adequate empirical literature in the results of the previous studies necessitates further research to be conducted. While the above researchers made great contributions, this study thus deliberate on establishing if actually the profitability of SACCOs is affected by tax incentives.

Research Objective

To determine the effects of tax incentives on financial performance of savings and credit cooperative societies in Nairobi County.

Literature Review

Theoretical Review

Theories supporting the study include corruption and influence theory, Agglomeration economies theory and Neo classical theory.

Corruption and Influence Theory

This theory was advanced by Van Roy (1970), who proposed that corruption is the unlawful use of authority for the purpose of obtaining money, favors, or status for oneself or for another person, or for the benefit of a particular group or class. Corruption is misuse of public power by breaking down the set rules and regulations for self-interest (Jain, 2011). In this theory, tax incentive in most cases don't represent or indicate tax revenue maximization. Instead, it reflects the ability of the firms to bribe leaders in a given government. Pani and MPani (2009) points out that, corruption can be reduced by offering proper political and economic incentives which are appropriate to the firms.

The theory contributes to the occurrence of tax incentives, some firms get tax reductions and tax exemptions through bribing and coercing government and tax officials. The percentage of tax incentive given to most firms determined by their capability to bribe. Pellegrini and Gerlagh (2004) adds that if public institutions such as political parties, legal system, civic groups and the media become weak and ineffective, they definitely cannot be able to expose the corrupt. Corruption and very high tax incentives leads to negative net revenues of a country, poor allocation of resources, poor financial performance of firms and poor economic growth.

According to this theory, tax incentives are higher in countries which have a weaker rule of law. Furthermore, tax revenue collected is not properly used to serve the purpose of the firms. For instance in USA in the 19th and 20th century, various railroad companies were involved in bribing politicians in return for generous tax incentives (Glaeser, 2001). According to Imam and Jacobs (2007) complex tax laws and systems can contribute to corruption in a country. Moreover, tax officials should be well paid, well trained, well oriented, competent and above all have high integrity when operating or handling tax issues. This will help prevent corruption in distribution of tax incentives to SACCOs.

Agglomeration Economies Theory

This theory is a representation of contribution of literature of Garcia-Milà and McGuire (2001). They indicated that cities prefer to have many firms in a situation where agglomeration economies are present. These cities are mainly concerned in getting high spillovers from the firms and in return offer these firms high tax incentives. Nevertheless, the type and location of a firm determines a lot whether it will have a high spillover or not, cities which have got skilled workers and are located in marketable areas where they receive specialized services tend to get high spillovers (Agarwalla, 2011). Agglomeration economies therefore suggests tax incentives will be most in firms that have a large number of skilled laborers. Glaeser (2001) argues that agglomeration of economies becomes more sensible in cities with many firms which are growing rapidly than in those with just a few number of big firms, because, it becomes easy to rationalize tax incentives for small firms as opposed to big firms. Agglomeration tax incentives are also given to firms which are divers in terms of their operations leading to a liquidity increase.

According to this theory, a firm that is located in a good spot in the city and is able to attract other firms into that city, will definitely be rewarded with high tax incentives. However, the shortcoming of this theory is that firms located away from the city will be rewarded with little or no tax incentives. The location and performance of firms is indirectly affected by agglomeration economies which though do not contribute to their economic growth (Neumark, Junfu & Wall, 2006). Garcia-Milà and McGuire (2001) in this theory prove that, the net tax payments of the public services are likely to become negative due to high tax incentives.

Neo-classical Theory

This theory dwells on labour, technology and capital. It was developed by Solow (1956) who articulates that the population growth rate and the technical progress plays a critical role in a government's long run growth rate. This theory mostly focuses on the human beings in an organization. Though taxation interferes with the incentive to invest in human or business capital. This theory further posits that a good organization is that in which there is a combination of informal and formal sectors. It advocates for low tax rates, tax incentives and limited government spending for firms so that they may flourish and perform well financially. Colmar (2005) indicates that tax incentives offers many benefits like compensation for losses in investments and symbolic signaling effects. Tax cut also causes a rise in labor supply as the workers will be able to increase their work efficiency, effectives and working hours. The government will be able to increase its tax revenue, because due to low tax rates, the firms will submit their taxes effectively and thus tax evasion and tax avoidance will be a thing of the past.

In Neo-classical economic theory, a tax system of horizontal equity to the investors is a 'good tax system' and it prevents prejudice in the provision of tax incentives (Barbour, 2005). Furthermore, the presence of inequality in distribution of tax incentives in particular sectors will discourage investors, and lead to a drop in growth.

Empirical Review

Klemm and Parys (2009) researched on effects of tax incentives in encouraging investments as well as a tool of tax competition. The study was done between 1985 and 2004 in more than 40 Caribbean and Latin American countries. The study found that tax holidays had strategic interactions, however, no evidence was found for competition over tax credits. The research also concluded that FDI is attracted by longer tax

holiday. A study was done on why tax incentives are important to policy makers. It was ascertained that they should only be for correcting firms which experience market failures and that, investments can only be recovered faster through implementing the preferred form of tax incentives (Zee et al, 2002).

In a targeted population represented by a sample of 100 businesses in Osun State Industrial area in Nigeria, Feyitimi et al, (2016) assessed the role that various governmental tax incentives play in contributing to the growth of SMEs. Primary data was retrieved through interviews, observations and questionnaires. The research design used was descriptive. The study revealed a correlation of taxation and SME's growth. In Uganda, a study was done to analyze what effects tax incentives had on the profitability of manufacturing industries. Panel data technique was used in the research. The results were that tax incentives triggers industries to perform well in sales (Mayende, 2013). The study recommended the government to implement policies such as, technical skills in development for proper utilization of available tax incentives for better performance of firms.

A survey on how FDI is affected by tax incentives was done in Kenya where-by Gumo (2013) collected secondary data from KRA, KNBS and the treasury and used a research design that was descriptive. The study found that on investment incentives, both mining operation deduction and investment deduction positively affect FDI, while industrial allowance negatively affect FDI. The study therefore concludes that, FDI is positively affected by tax incentives. Ngure (2018) studied how firms in the manufacturing sector in Kenya are affected by tax incentives. The target population was 725 firms. The sample size was made up of 90 firms. Secondary data obtained was from 2011 to 2016. It was established that excise, custom duty and capital allowance incentives positively affected performance of companies. The study findings recommended the need and expansion of tax incentives. Murage (2012) investigated how EPZ firms are affected by tax incentives especially in Business Investment in Kenya, 104 EPZ firms in Kenya made up the target population, where the researcher selected 65 firms located in Nairobi Metropolitan. It was discovered that an increase in profits, sales and tax incentives is likely due to an increase in investment in EPZ firms.

Research Methodology

The research was conducted through a descriptive research design which is suitable because it uses smaller samples for an in-depth analysis of the larger population that was studied. Furthermore, a descriptive design is better as it describes and explain a phenomenon rather than predict it. It gives a holistic explanation of the way variables relate in the study.

Stata software was used to analyze and interpret the data. Correlation Analyses helped to examine the difference between variables, while multiple regression analysis examined the significance of existing relationship between them. The results were interpreted in tables.

The regression model applied for data analysis was:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where;

Y = Financial Performance (Measured by ROA)

X_1 = Accelerated Depreciation (Annual depreciation on total assets)

X_2 = Tax rates (Tax on total revenue)

X_3 = Capital Allowance (Capital allowance against the total assets)

β_0 = Constant term

β_1 to β_3 = Beta coefficients

ε = Error term

Findings in table 1 below showed the descriptive statistics on ROA, Capital allowance, Tax and Accelerated depreciation incentives of SACCOs.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ROA	41	.3526341	.6474611	.016	3.031
CapitalAll~e	41	.0324878	.0293523	.001	.099
Tax	40	.796975	.8522681	.008	3.714
Accelerate~n	41	.0644146	.1420359	.002	.739

In table 1 above the mean for ROA was 0.3526341, capital allowance had a mean of 0.0324878, tax and accelerated depreciation had a mean of 0.796975 and 0.0644146 respectively. ROA had a standard deviation of 0.6474611, capital allowance had a standard deviation of 0.0293523, tax and accelerated depreciation had a standard deviation of 0.8522681 and 0.1420359 respectively. Basically, capital allowance and accelerated depreciation had smaller standard deviations meaning that, their values in the data set were close to the mean/average. Moreover, a small standard deviation signify a high degree of uniformity of the observations as well as homogeneity of a series. Tax had a large standard deviation indicating that its values in the data set were farther away from the mean revealing a low degree of uniformity. Among the variables, capital allowance had the minimum value of 0.001 denoting that it had the smallest value in the data set. Whereas, Tax had the maximum value of 3.714 indicating that it had the largest value in the data set.

Results and Discussions

From table 2 below, there's a weak positive correlation between capital allowance and ROA as indicated by the coefficient factor of 0.1578. The results also revealed a negatively weak correlation between tax paid and ROA as depicted by a factor of -0.0860. Lastly the results showed a weak positive correlation between accelerated depreciation and ROA as indicated by a factor of 0.2448. This clearly indicates a negative relationship between tax paid and profitability of SACCOs and a positive relationship between capital allowance and accelerated depreciation on financial performance of SACCOs in Nairobi County.

Table 2: Correlation Matrix

	ROA	Capita~e	Tax	Accele~n
ROA	1.0000			
CapitalAll~e	0.1578	1.0000		
Tax	-0.0860	-0.1052	1.0000	
Accelerate~n	0.2448	-0.1124	-0.1477	1.0000

The results in table 3 below show R squared is 0.505 which means 50.5% of variation of financial performance are explained by tax incentives. The correlation coefficient R depicts what relationship exist between the research variables. The results above shows a positive relationship existing among the variables as outlined by a figure of 0.3004.

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Table 3: Regression Analysis

R	=	0.3004
R-squared	=	0.505
Adj R-squared	=	0.201
Root MSE	=	.6482

In table 4 below, the sum of square for regression or variables between groups was 16.0745398; f statistics value was 6.73. The probability significance was 0.0025 which is below the significance level of 0.05 and which shows that tax incentives influence performance.

Table 4: Analysis of Variance

Analysis of Variance					
Source	**SS**	**df**	**MS**	**F**	**Prob > F**
Between groups	16.0745398	31	.518533543	6.73	0.0025
Within groups	.693693667	9	.077077074		
Total	16.7682335	40	.419205838		

According to table 5 below, the established regression model was;

$$Y= 0.1663761 + 4.190404X_1- 0.0214859 X_2 +1.190199X_3$$

With the independent variables at a constant, the model above shows a unit increase in capital allowance and accelerated depreciation would lead to an increase in performance by 4.190404 units and 1.190199 units respectively. Whereas a unit increase in tax would lead to a decrease in performance by 0.0214859 units.

Table 5: Regression Model Coefficients

ROA	Coef.	Std. Err.	t	P>t	[95% Conf.	Interval]
Capital Allowance	4.190404	3.655661	1.15	0.259	3.223621	11.60443
Tax	-.0214859	.1240941	-0.17	0.864	.2731603	.2301886
Accelerated Depreciation	1.190199	.736046	1.62	0.115	.3025713	2.68297
_cons	.1663761	.203633	0.82	0.419	.2466108	.579363

From the study on correlation analysis, the results showed capital allowance and accelerated depreciation positively influenced the profitability of SACCOs. This means when capital allowance and accelerated depreciation increases, so does the profitability of SACCOs. This findings are in agreement with the research findings of Ngure (2018) which found that capital allowance positively influence the financial performance of manufacturing firms in Kenya. However, the research results showed that tax negatively affected the performance of SACCOs. An increase in tax charged on SACCOs would lead to a decline in their profitability, this results are similar to those of Kinyua (2015) who studied the effects of turnover tax on financial performance of SMEs in Nairobi County and found that, performance of SMEs reduced due to high taxes.

On regression analysis, R-Squared was 0.505 which is a variation of 50.5% of financial performance explained by tax incentives and which depicts a positive relationship of financial performance and the independent variables. The analysis of variance showed that tax incentives positively impacted on the performance of SACCOs, in view of the fact that, the sum of square for regression or variables between groups was 16.0745398; f statistics value was 6.73. The probability significance was 0.0025 which is below the significance level of 0.05 and which shows that tax incentives influence performance.

Conclusions and Recommendations

The objective of the research was to establish the effects of tax incentives on financial performance of SACCOs in Nairobi County. The population study was all the 41 licensed SACCOs. Descriptive statistics and data analysis were done on the secondary data collected from SASRA using Stata. From correlation analysis, the findings revealed that capital allowance and accelerated depreciation positively influenced ROA, while tax impacted negatively on ROA. R squared was 0.505 which means 50.5% of variation of

financial performance were explained by tax incentives. From the analysis of variance, the probability significance was 0.0025 which is below the significance level of 95% or 0.05, indicating the impact on performance due to tax incentives.

The established regression equation for the study was;

Y= 0.1663761 + 4.190404X1- 0.0214859 X2 +1.190199X3

With the independent variables at a constant, from the above equation, a unit increase in capital allowance and a unit increase in accelerated depreciation leads to an increase in financial performance by 4.190404 units and 1.190199 units respectively. A unit in tax leads to a decline in performance by 0.0214859 units.

From the analysis, the research concluded that tax had a negative effect on financial performance of SACCOs whereas both capital allowance and accelerated depreciation had a positive significant effect. Therefore, SACCOs should strive to ensure that they get capital allowance and accelerated depreciation incentives from the government to enable them make more profits in subsequent years. The government therefore should offer continuous tax incentives to SACCOs.

Currently, the government does not levy tax on income interest which is the main source of income for SACCOs, but tax is charged on all the other sources of income of SACCOs, therefore, as far as the research findings and conclusions of this study are concerned, the government should provide more tax incentives to the SACCOs especially capital allowance and accelerated depreciation and tax exemptions, since an increase in all of them increases the profitability of the SACCOs. The government should also provide a wide range of tax incentives which will encourage the establishment and continuous growth of SACCOs. SACCOs should on the other hand be able to identify the various tax incentives being offered by the government and work towards achieving them.

The study sought to analyze the effects of tax incentives on financial performance of SACCOs in Nairobi County. The research indicates that high tax rates discourages the establishment and operations of SACCOs in Nairobi County, therefore, affecting the economic growth of the country. Some SACCOs in Nairobi County have closed shop due to operating at loses and paying the government hefty taxes on income interest, licensing and registration. These SACCOs collapse with shareholders or investors savings leading to massive loses, and discouraging many Kenyans from saving their funds for investment in businesses and

home ownership, further deterring the achievement of Kenya's Vision 2030 development agenda. It is at the backdrop of this that the government should offer tax incentives to SACCOs so that they can be operational. The researcher advocates for similar studies to be conducted in other Counties apart from Nairobi County. The researcher also recommends studies to be done on tax incentives and real estate firms in Kenya. The study further recommends that research on tax incentives and performance of non-listed companies in NSE should be carried out.

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