

Influence of VAT Incentives on Financial Performance of Manufacturing Companies in Kenya

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ABSTRACT

The purpose of the study was to determine the influence of VAT incentives on financial performance of manufacturing firms in Kenya. The study focused on all manufacturing companies registered under Kenya Association of Manufacturers. The null hypothesis of the study was that there is no statistically significance association between VAT incentives and financial performance of manufacturing companies in Kenya. Descriptive survey research design was adopted where a sample of 211 respondents was selected from a target population of 447 manufacturing firms using stratified random sampling technique. The study collected data for a period covering 10 years, which was from 2009 to 2018. The targeted respondents were the accountants and officers in senior management. The response rate on the questionnaires issued was 73.5%. Both descriptive and inferential data analysis was carried out. The data failed in the test of normality and so the study applied ordinal regression analysis for the determination of the model. The findings of the study revealed that VAT incentives had statistically significant influence on financial performance of manufacturing companies in Kenya; hence, null hypothesis was rejected at 0.05 level of significance. The study concluded that influence of VAT incentives leads to improvement in financial performance of manufacturing firms in Kenya. Hence, VAT incentives are key to financial performance of manufacturing companies. The study therefore recommended that the management of manufacturing companies should utilize VAT incentives that are offered by the government, and the government should review the VAT policy so as to widen the gap on VAT incentives.

KEYWORDS: Financial Performance; Manufacturing Companies; VAT Incentives.

1. INTRODUCTION

1.1. BACKGROUND OF THE STUDY

There has been great competition between governments world over in an effort to promote their countries as investment hubs. Governments have embraced means to encourage promotion of industries, and taxation policies have been taken as one of the major means of giving the solution especially in starting up of domestic industries (UNCTAD, 2019). Governments prepare legislatives necessary for the promotion of industries for economic development. Governments do so by introducing incentives so as to encourage both individuals and body corporates (Basu and Srinivasan, 2002). Many countries depend on tax incentive schemes in order to attract foreign investors. Tax incentives have been embraced by many countries simply because they have a lower effect on fiscal revenues in comparison to general tax deduction; they also target some specific organizations that would result to greater value addition to the country (Morisset and Jacques, 2003).

1.1.1 GLOBAL PERSPECTIVE OF VAT INCENTIVES

Globally, tax incentives are used by governments to promote economic activities and encourage investments in various sectors of the economy which include manufacturing firms (Kaplan, 2001). In the USA, the government allowed accelerated depreciation that is taken into account as an associate incentive offered to draw in investments into the USA as compared to other countries where wide obtainable accelerated depreciation is not the norm (Thomas, 2007).

A study by Zwick and Mahon (2014) in the USA on the effect of tax incentives on equipment investment showed that accelerated depreciation leads to an increase in investment by 18.5% on average for the period from 2001 to 2004 and an increase of 31.2% for the period from 2008 to 2010 in the manufacturing sector. It was concluded that tax incentives have a significant influence on firm's performance.

1.1.2. REGIONAL PERSPECTIVE OF VAT INCENTIVES

In a survey conducted in African countries, tax incentives took position 11 out of 12 countries in terms of locational factors which influence investment. The survey further showed that 90% of the investors would still have invested even if tax incentives were not offered (World Bank Group, 2015). A survey conducted between 1985 and 2004 in 40 Latin American, African countries, and Caribbean countries to determine the effect of tax incentives on investment revealed that tax incentives have no effect on investment (IMF, 2015). According to the survey, tax incentives are not the driving force of the investment. Despite the poor influence of tax incentives on setting the investment firms, African countries have continued to grant tax incentives.

1.1.3. LOCAL PERSPECTIVES OF VAT INCENTIVES

In Kenya, tax incentives take the following different forms: investment allowance, tax holidays, tax credits, special zones, accelerated depreciation, VAT tax exemptions, indirect tax incentives, and reduction in tax rates (IEA, 2012). The main categories of tax incentives are investment promotion incentives and export promotion incentives. By imposing high rates of tax, manufacturing companies are discouraged in terms of investment because they have less fund to reinvest and hence there is need to offer tax credits (Uwalomwa *et al.*, 2016).

1.1.4. PERFORMANCE OF MANUFACTURING SECTOR

Manufacturing sector today has become the channel through which less developed countries are able to benefit from globalization and hence narrow the income gap with the developed countries (Amakom, 2012). However, in Kenya, manufacturing companies have experienced performance challenges which is well reflected in their reporting of the end of year profits and their decline to the contributions of the GDP in the country. Data from Kenya National Bureau of Statistics show the contribution of the manufacturing sector to the GDP declined from 11.8% in 2011 to 8.4% in 2017 (KNBS, 2018). Tax incentives are of great value in as far as economic development is concerned, they are a means by which governments lower the cost of capital for new industries with high risk while still sustaining high tax rates for general tax collection (IEA, 2012).

1.2. STATEMENT OF THE PROBLEM

The contribution of the manufacturing sector to GDP for the last 5 years has continued to decrease from the high of 9.4% in 2015 to the lowest of 7.5% in 2019 (KAM, 2021). This is an indicator that instead of Kenya industrializing it is deindustrializing. The continuing decline in the contribution of manufacturing sector to GDP is a threat to the achievement of the policy target of 15% by 2022 as set in the Big Four Agenda (KAM, 2021).

Among the challenges facing manufacturing sector include numerous regulations which the manufacturing industries are supposed to comply with. Numerous regulations are costly and difficult to administer especially where there are different agencies involved. Manufacturing firms are required to obtain multiple licenses and pay various fees which makes the operation of the business costly (KAM, 2021). There have been attempts to improve the sector through policy interventions such as the Kenya Vision 2030 Manufacturing Sector policy. The Kenya Vision 2030 recognizes the manufacturing sector as a one of the main players in the economic pillar in order to achieve the expected GDP growth rate of 10% per annum so as to make the country achieve the status of a middle-level income by 2030 (KAM, 2018). The vision 2030 was intended to reinforce the local content and capacity of locally manufactured goods and to increase the share of manufactured goods in the local market from 7% to 15%. In order to meet these objectives, some key targets were set which include development of SME parks, industrial manufacturing clusters among others (KAM, 2018).

Despite the measures put in by government, the performance of the manufacturing sector is still wanting. The poor financial performance is reflected by the closure of some manufacturing firms such as Pan African Paper Mills Limited which closed due to debts totaling to Sh 9 billion, Eveready East Africa Limited closed due to increased finance costs, Cadbury East Africa Kenya and the downward trend in financial performance of Mumias Sugar Company Ltd (Burre and Omagwa, 2017). This study considered the VAT incentive as one of the policy interventions that the government has offered to the sector but its effect has not been adequately studied.

1.3. OBJECTIVE OF THE STUDY

The objective of this study was to determine the influence of VAT incentives on financial performance of manufacturing companies in Kenya.

2. LITERATURE REVIEW

This section highlights the empirical literature relevant to the study.

2.1. EMPIRICAL REVIEW

2.1.1. EFFECT OF VAT INCENTIVES ON FINANCIAL PERFORMANCE

A study was carried out on effects of VAT incentives on performance of EPZ firms in Kenya (Kuria, 2018). The study was conducted because of the continued reporting of poor financial performance of EPZ firms in Kenya. The study was based on

optimal theory of taxation, normative theory, agency theory of taxation, and cluster approach theory. The study covered the period from 2003 to 2014. The study used regression model and Pearson correlation method in determining the relationship between the variables. All the independent variables were measured by the ratio of the tax incentive to total assets. The performance of EPZ firms was measured by ROA, number of jobs, and length of stay. The study also applied firm size as the moderating variable. The results of the study revealed that VAT incentives have a positive significant relationship with the performance of EPZ firms measured by ROA at 5% level of significance. The study by Kuria (2018) applied linear regression model while the current study applied ordinal regression model, it also applied Pearson correlation method while the current study applied spearman rank correlation method. The methodology of data correction by Kuria (2018) was different from the current study in that the independent variables were measured by ratio scale while the current study applied the Likert scale.

Falkenhall, Manssson, and Tano, (2019) carried out a study on the impact of VAT reforms on financial performance of restaurants in Sweden. The study focused on 222 restaurant firms and applied the synthetic group as the control. The data were collected from the statistics of Sweden business register. The study was carried for the period 2003 to 2014. In this study, industries were grouped according to their similarity in development. The analysis of the study revealed that reduction of VAT had a positive influence on financial performance of restaurants, where financial performance was measured by turnover and profitability. The current study did not group the industries but rather treated all of them just to be manufacturing firms.

3. METHOD(S)

The study applied descriptive research design which is a fact finding enquiry that aims at establishing the facts as they are at the time of the study (Cooper and Schindler, 2011). It was the most appropriate in this study since the subject of the study was to establish the effect of the VAT incentives on financial performance at the time of the study.

The study was conducted in Kenya and targeted the manufacturing companies registered under Kenya Association of Manufacturers (KAM). The registered manufacturing companies were 447 classified as Building mining and construction, Leather and foot wear, Plastic and Rubber, textiles and apparel, timber wood and furniture, chemical and allied, energy electrical and electronics, food and beverages, metal and allied sector, motor vehicle assemblies and accessories, paper and board, and pharmaceutical and medical equipment. The study applied both primary and secondary data. Primary data were collected by use of questionnaires which were distributed to the accountants and cashiers in the organizations who were the respondents. Secondary data were gathered from audited financial reports of the manufacturing companies. Sample technique applied was random stratified sampling.

Sample size was determined by the use of Yamane formula which states as follows:

$$n = \frac{N}{1 + Ne^2}$$

n = sample size

N = population size

e = level of precision

the level of precision is taken as 0.05

$$\text{hence, } n = \frac{447}{1 + 447(0.05)^2} = 211$$

Descriptive and inferential statistics were used for data analysis. The study applied frequencies and percentages in carrying out descriptive analysis. Data presentation was done in form of tables. Measures of central tendency and measures of dispersion were measured by the mean and standard deviation, respectively. VAT incentive was the independent variable and was measured by ordinal scale, financial performance which was the dependent variable measured by ratio scale. The collected data were analyzed and tested for multicollinearity and normality. The data did not reflect multicollinearity, when the data were subjected to the test of normality the data violated the assumption of normality. Due to the violation of the assumption of normality, the study applied nonparametric method of analysis. The financial performance which was measured by ratio scale was transformed to ordinal scale by use of SPSS version 25. Table 1 shows the results of continuous data transformed to ordinal scale.

Table 1. Transformation to ordinal scale.

ROA	Ordinal scale
Below 8.77	1
8.78–16.45	2
16.46–24.14	3
24.15–31.82	4
31.83–39.5	5

The study then applied ordinal regression analysis technique.

The ordinal regression model is expressed as

$$\text{Logit } [P(Y \leq j)] = \beta_0 - (\sum \beta_i X_i) + \varepsilon$$

β_0 is the intercept

β_i is the coefficient of the independent variable X_i

4. RESULTS

The indicators of VAT incentives were zero-rated goods and services, exempt goods and services, preferential VAT rates, and VAT refunds.

4.1. TEST OF HYPOTHESIS

H_0 : There is no statistically significance relationship between VAT incentives and financial performance of manufacturing companies in Kenya.

By use of SPSS ordinal regression procedure, the following results in Table 2 were generated for the model fitting.

Table 2. Model fitting information on VAT incentives.

Model	-2 Log Likelihood	Chi-Square	df	Sig.
Intercept only	69.652			
Final	55.491	14.160	1	0.000
Link function: Logit.				

The results in Table 2 give the results of the model fitting information which indicates a chi-square statistic p-value of 0.000 which is significant since it was less than 0.05. This means that the model gives a statistically significant improvement over the intercept only model. It was concluded that there was a significant relationship between VAT incentives and financial performance of manufacturing companies in Kenya.

4.2. TEST OF THE GOODNESS OF FIT

The study conducted the test for the goodness of fit to determine whether the observed data were consistent with the fitted model. The results were shown in Table 3.

Table 3. Goodness-of-fit on VAT incentives.

	Chi-Square	df	Sig.
Pearson	13.412	15	0.571
Deviance	13.564	15	0.559
Link function: Logit.			

The results in Table 3 show that the p-value of the two statistics was greater than 0.05; for Pearson, the p-value was 0.571 while for Deviance, it was 0.559. It was thus concluded that the model did fit the data well.

4.3. PSEUDO-R SQUARE

The test for the determination of the proportion of variance was conducted; this was performed by the determination of Pseudo-R square. The results were shown in Table 4.

Table 4. Pseudo-R square.

Pseudo R-Square	
Cox and Snell	0.087
Nagelkerke	0.092
McFadden	0.031
Link function: Logit.	

Pseudo-R square by use of Nagelkerke gave a value of 0.092. This meant that 9.2% of the change in financial performance can be explained by VAT incentives, while 90.8% of the change in financial performance can be explained by other factors not in the study.

4.4. PARAMETER ESTIMATES ON VAT INCENTIVES

In order to be able to derive the model for the analysis, the parameter estimates were established as they appear in Table 5.

Table 5. Parameter estimates on VAT incentives.

		Estimate	Std. Error	Wald	df	Sig.	95% Confidence Interval	
							Lower Bound	Upper Bound
Threshold	[ROAORDINAL = 1]	1.645	0.730	5.085	1	0.024	0.215	3.075
	[ROAORDINAL = 2]	2.887	0.754	14.657	1	0.000	1.409	4.365
	[ROAORDINAL = 3]	4.158	0.784	28.131	1	0.000	2.622	5.695
	[ROAORDINAL = 4]	4.826	0.806	35.889	1	0.000	3.247	6.405
Location	VATAVERAGE	0.617	0.174	12.536	1	0.000	0.275	0.958
Link function: Logit.								

The results of the Table 5 show that VAT incentive was a significant predictor of financial performance; this was determined by the fact that p-value was 0.000 which was less than 0.05, and the log odd was 0.617. Hence for every one-unit increase on VAT incentives, there is a predicted increase of 0.617 in the log odds of falling at a higher level on the financial performance measured by ROA. The following models were derived to show the prediction categories of the influence of VAT incentives on financial performance.

For category 1

Logit [P (ROA ≤ 1)] = 1.645 – (0.617X)

For category 2

Logit [P (ROA ≤ 2)] = 2.887 – (0.617X)

For category 3

Logit [P (ROA ≤ 3)] = 4.158 – (0.617X)

For category 4

Logit [P (ROA ≤ 4)] = 4.826 – (0.617X)

4.5. TEST OF ANOVA

Friedsman ANOVA was tested so as to determine the significance of the independent variable on the dependent variable. The results were presented in Table 6.

Table 6. Friedman test.

Test Statistics ^a	
N	155
Chi-square	91.267
Df	1
Asymp. Sig.	0.000
^a Friedman test.	

The result shows a p-value of 0.000 which was significant since it was less than 0.05. This meant that there was a significant difference between the means of the two variables. These was an indicator that the selected model was significant and hence the variables tested fitted the model.

5. DISCUSSION

The study showed that VAT incentives have a positive effect on financial performance of manufacturing companies in Kenya. The study established that zero-rated goods and services as well as exempt goods and services highly influenced the financial performance of manufacturing companies. The study also established that preferential VAT rates and VAT refunds do not highly influence the financial performance of manufacturing companies. The study concurred with the study by Kuria (2018) that VAT incentives highly influence the financial performance of manufacturing companies in Kenya.

The study established that VAT incentives have a significant influence on financial performance of manufacturing companies in Kenya. The null hypothesis that there is no statistically significant relationship between VAT incentives and financial performance of manufacturing companies in Kenya was therefore rejected and conclusion made that there is a statistically significant relationship between VAT incentives and financial performance in Kenya. The results indicate that there is need to

focus more on zero-rated goods and VAT exempt goods as they influence much on financial performance of manufacturing companies in Kenya as well as offering more VAT incentives by reviewing the VAT policies. The study agrees with Olaleye (2016) who concluded that there is a need to lay better strategies for the improvement of VAT incentives.

6. CONCLUSION

The study has shown that VAT incentives have a significant influence on financial performance of manufacturing companies in Kenya. The study therefore concluded that the government should review the VAT policy and widen the bracket on zero-rated goods and services as well as exempt goods and services as they highly influence the financial performance. The study established that preferential VAT rates do not influence financial performance of manufacturing firms and therefore they would rather be replaced by exempt goods.

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