

International Journal of **Finance**

(IJF)

EFFECT OF CUSTOM DUTY INCENTIVES ON THE
PERFORMANCE OF EPZ FIRMS IN KENYA

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EFFECT OF CUSTOM DUTY INCENTIVES ON THE PERFORMANCE OF EPZ FIRMS IN KENYA

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Abstract

Purpose: the purpose of this study was to determine the effect of custom duty Incentive on the performance of EPZ firms in Kenya.

Methodology: This research used correlation research design. Sample size of all the 86 registered EPZs firms was used in this study. Primary data was obtained using questionnaires. Secondary data from the registered firms was collected on; ROA, number and value of jobs and the length of stay of the firms. The study used both descriptive and inferential statistics to conduct data analysis.

Results: The results of study revealed that at 5% significance level, custom duty incentives had a significant relationship with performance of EPZ firms measured using ROA. The results further revealed that at 5% significance level, custom duty incentives were found to have a significant relationship with performance of EPZ firms measured using the total number of workers in Kenya. The results also revealed that at 5% significance level, custom duty incentives were found to have positive and significant relationship with performance of EPZ firms measured using the number of years in operation

Unique contribution to theory, practice and policy: Based on the study findings, the study recommended that the government should offer increased excise duty incentives in order to cut down on imports and in that way promoting the growth of demand for domestic products in the country. The government could pursue this strategy in order to curb smuggling and also to promote the growth of the tourism industry. The study further recommends that policy makers should adopt strategic incentive plans or targeted incentive scheme that targets specific industry or a strategic tax incentive that add value or contribute positively to the economy and are in line with the country's vision 2030.

Keywords: *Custom duty incentives, performance, EPZ firms, ROA, number of workers and years of operation*

1.0 INTRODUCTION

1.1 Background of the Study

To attract multinational companies, the world in the recent years is characterized by extreme competition between governments and because of this, tax incentives are a global issue. Countries in the Europe give investment allowances while those poor developing ones give tax holidays as well as duty exemptions (Morisset, 2003). In the recent past, there has been an increase in the trend, as evidenced by expansion of companies such as Toyota to Northern France as well as Mercedes-Benz to the Alabama state in the USA. There are therefore questions on whether governments have overstepped in these offers of incentives. This has in the long run raised debate after debate on the suitability of tax incentives (Harris, 1993).

Majority of governments in the world use trade programs or policies to enhance modern exchange of goods and services across borders, to do so they set up industrial estates by fencing such an area to facilitate the manufacture of goods meant for export by specialized firms; that fenced region set aside by governments is referred to Export Processing Zone (EPZ) (World Bank, 1992). Other such instruments incorporate import tax drawback game plans, brief admissions and export subsidies. Aggarwal (2005) argues that an incentive strategy such as trade advancement plays a critical role in financial development but of late, strategies such as free preparing zones (EPZs) as well as organized commerce zones (FTZs) have gained grounds.

Export processing Zones (EPZs) were amongst the primary initiatives pioneered in developing countries so as to promote the growth of exports as well as diversification. The primary generation EPZs initiated principally by new industrial countries of East Asia, took the shape of providing investors with remissions on import duties for inputs and raw materials, with increased or improved infrastructure and with speeded-up customs clearance procedures. These schemes generated some substantial initial impacts, resulting in their adoption by an oversized majority of developing countries today (Din, 1994; Holland & Vann, 1998).

Governments all over the world use tax incentives to enhance economic activities and investments by firms, they use these form of incentives to channel some special economic activities towards some important sectors of the economy where they are either not felt or not existing at all (Kaplan, 2001).

In the USA, Thomas (2007) argues that 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 isn't the norm. In the year 2004, accelerated depreciation for machinery and instrumentality was in the tune of US dollars 44.7 billion. Jensen and Malesky (2010) remarked that despite broad skepticism concerning the advantages of globalization, USA offered tax incentives to draw in investment. They indicate that the scale of those incentives was usually thought to be too large to be welfare enhancing although it drew skepticisms among various economists. However despite the mounting proof to the contrary, there has been an increase in the size, frequency and magnitude of the tax incentives offered by the US federal government which implies that the country considers foreign investment as well as extent of development more important.

Thomas (2007) argues that for the case of Canada, tax incentives are more centralized than in the USA. For the case of USA, only the federal government is involved in setting up the tax

incentives but in Canada, it's not only the federal government, but also the provincial governments who are involved. In Caribbean countries, Van Parys & James (2010) argue that tax incentives have led to losses for instance a loss of 23.5% was recorded in Anguilla and a loss of 53.9% was recorded in Grenada. Furthermore, similar sentiments are echoed by Goyal and Chai (2008) who revealed that if not well planned, tax incentives can also lead to losses. The scholars argued that, tax incentives led to a loss of between 9% - 16%. This therefore reveals that, tax incentives are a double edged sword with both benefits and severe repercussions.

The Institute of Economic Affairs (2012) reports that tax incentives are always advancing and are widespread. It argues that tax incentive is an arrangement that concedes any individual or action great conditions that move away from the ordinary arrangements of the excise enactments.

The form of tax incentives in developed countries varies from credits for those investing in assets, depreciation at high rates as well as exciting treatments for R & D expenditures while in developed countries, tax incentives can vary from quickened devaluation, venture duty credits as well as provision of positive expense for those companies that use innovative work. Locally, for the Kenyan case, Tembur (2016) argues that tax incentives vary from tax holidays, allowances and subsidies on investments, special zones, accelerated depreciation, reduced tax rates as well exemptions on tax. Resident companies enjoy a corporate tax rate 30% while non-resident companies receive higher rate of 37.5%. EPZs are taxed at 25% for the 10 years succeeding the tax holiday.

1.2 Statement of the Problem

The scholars who propose tax incentives argue that it leads to higher rates of return on both equity and assets and that frees up some revenue to be reinvested in the business (Uwaume & Ordu, 2014). With increased globalized economies characterized by stiff competition, there is thus a need for competitive tax systems, a strategy aimed at establishment of industries including EPZ so as to establish trading advantage.

According to the Singa (2007), there is an increase in the number of countries using EPZs in sub-Saharan Africa. Despite this growth in EPZs activity, EPZs still experience poor financial performance. There has been a decreasing trend in the number of employees recruited by EPZ firms in Kenya. Also the number of jobs decreased significantly between 2007 and 2009 (EPZ financial report, 2015). This extension of poor financial performance of EPZs has now happened in the face of expanding global trade and stiff beneficial competition. The economic competition has seen developed countries dominate the domestic firms, a situation that calls for government intervention to encourage financial performance of EPZs.

Uwaume and Ordu (2014) carried out a study to establish the impact of tax incentives on economic development in Nigeria. The study found that sufficient tax incentive enhances industrial growth and economy. Tembur (2016) conducted a study on the Effect of Tax Incentives on Financial Performance of Export Processing Zone Firms in Kenya. The study used IBD, W&T and ID as independent variables (and size and asset utilization as independent variables) and thus an indication of conceptual gap. The current study used custom duty incentives as THE independent variable. Chukwumerije and Akinyomi (2011) studied the impact of the tax incentives on the overall performance of registered small scale industries in Rivers State, Nigeria. They concluded that there was significant positive relationship between tax incentives

and profitability, staff strength and the growth and development of small scale industries. Gumo (2013) conducted a study on the effect of tax incentives on foreign direct investments (FDI) in Kenya but did not focus on financial performance. His study established that investments deductions and mining operation deductions incentives policy have a positive effect on FDI while industrial allowance has a negative influence. Therefore, this study sought to bridge the research gap by investigating on the effects of custom duty incentives on the performance of EPZ firms in Kenya.

1.3 Purpose of the Study

The purpose of the study was to investigate the effects of custom duty incentives on the performance of EPZ firms in Kenya.

1.4 Research Hypotheses

H₁: Custom duty incentives have a significant relationship with the performance of EPZ firms in Kenya.

H₀: Custom duty incentives have no significant relationship with the performance of EPZ firms in Kenya.

2.0 LITERATURE REVIEW

2.1 Cluster Approach Theory

Advanced by Michael Porter in the year 1990, the cluster approach is based on the idea of competitive advantage and has been used as improvement criteria used by different national governments and local authorities and neighborhood powers all around the world. He built up this theory with the contention that the associations in the aggressive precious stone (diamonds) are more serious and in this manner more viable when firms work in nearness (Tembur, 2016). It argues that EPZ are mechanical bunches that are amassed in certain geographic locale; these businesses share normal factors such as infrastructure, pool of skilled human capital, training and technology transfer, information and technical support.

This approach includes constraining the government's ability to impose in intriguing ways and after that examining the subsequent ramifications for tax competition. One such angle is deficiency in a government's data about the organizations that it is endeavoring to assess. For instance, firms may contrast in interregional versatility, yet such contrasts might be troublesome for the government to watch. For this situation, the legislature can't tax a firm in a way that straightforwardly relies on upon its unobservable parts of firm conduct that may serve as signs of these qualities, for example, the company's business venture choices (Murage, 2012).

In the last few decades, a flurry of incentives that have targeted certain geographical regions have been implemented by policy makers in all levels of the government. These incentives that have been offered are not uniform across different jurisdictions. There are those that are specifically tied to offering tax credits hiring and training employees while others have been limited to creation of jobs. The majority of them however offer incentives that are related to capital investment. These three tax incentives seem to operate in different settings that are inherent in the various jurisdictions but in effect they do have something in common which is the creation of differential tax treatments that are found in these tax jurisdictions, which are

homogenous and are based on a certain point in the tax jurisdiction. The focus of past studies on the analysis of geographically targeted-tax examining the programs that have been established at state level and particularly the effect these programs have had on employment.

Cluster Approach Theory is relevant to this study since it informs the independent variable which is custom duty incentives. Some of the studies that have used Cluster Approach Theory include Kuchiki (2005), Kuchiki, & Tsuji (2008), Hanson (2009) and Murage (2012).

2.2 Empirical Review

Onyango (2015) sought to establish the effect of custom duty tax incentives on financial performance of Five-Star hotels in Nairobi County. The study adopted the use of quantitative descriptive design. For the purpose of the research, the population constituted all the seven Five-Star hotels in Nairobi County. A census was conducted for all the seven Five-Star hotels using a questionnaire. The response rate attained was 100%. The data collected was provided by management accountants of the Five -Star Hotels. Data collected was analyzed using multiple regression models to establish the association between tax incentives and financial performance of the Five-Star Hotels in Nairobi County. The study revealed that there is 89.5% variation in financial performance of Five-Star Hotels due to changes in ID, IBD & W&T. The regression output found a statistically significant strong positive relationship between W&T and financial performance of Five-Star Hotels in Nairobi County. It also established a negative association between ID, IBD and financial performance of Five-Star Hotels in Nairobi County. The study recommended that the government should encourage tax incentives in the form of W&T which is beneficial to the financial performance of the Five-Star Hotel in Nairobi County. It also recommended that the government should review the policies that guide the provision of ID & IBD.

The study by Onyango (2015) helped built literature on the theme under study and focused on the same context as the current study however the study revealed some conceptual knowledge gaps as well as the methodological knowledge gaps which this study aimed to fill. The study focused on custom duty incentive only while the current study focused on among other incentives, the corporate income tax income incentive, capital allowance tax incentive and excise tax incentive. The study also focused on the hotel industry which is a different context due to sectorial differences. The current study on the other hand focused on the manufacturing firms which operated in the export processing zones in Kenya. The study by Onyango (2015) primary data collected quantitatively through structured questionnaires while the current study used both primary and secondary data for analysis to achieve the research hypothesis.

In Nigeria, Ohaka and Dagogo (2015) sort to establish the effect of custom duty tax incentives on performance of firms operating in the manufacturing sector. By use of descriptive research design, qualitative and quantitative primary data and descriptive statistics, the research hypotheses were achieved. The target population was sixty firms listed at the Nigerian Stock Exchange at the time of the study. The data collected was not normally distributed and hence the study focused on the use of t-tests for analysis. The results of the study established that custom duty incentives led to a positive improvement in the performance of the manufacturing firms listed at the Nigerian Stock Exchange in the study period. It therefore recommended that

Nigerian government should provide more incentive for manufacturing firms in Nigeria if their vision of becoming one of the top twenty nations by the year 2020 is to be realized.

The study by Ohaka and Dagogo (2015) built a good literature on the role of tax incentives on performance by specifically focusing on custom duty tax incentive. By focusing on listed manufacturing firms in Nigeria, the study played a role of opening knowledge gaps for other studies to expand the topic. Since the study was carried out in Nigeria which has a different macro environment of operations, the current study focused on Kenya so as to have findings that can be compared due to contextual differences. The study conducted by Ohaka and Dagogo (2015) focused listed firms while the current study opted to focus on firms operating under the export processing zones. This was a contextual knowledge gap that necessitated the study to compare the effect of tax incentive between small affirms and large firms. The study by Ohaka and Dagogo (2015) also focused on only value custom duty incentive. The current study built more on this by including other tax incentives for instance corporate income tax incentive, capital allowance tax incentives and excise tax incentive. This played a role in building to the existing knowledge on different forms of tax incentives and their role on performance. At the same time, it helped fill a conceptual knowledge gap in the study. The method of analysis used in the study by Ohaka and Dagogo (2015) was a t-test. The current study adopted multivariate regressions to achieve the study objectives instead of adopting a t-test method so as to bring more insight in the findings.

In Kenya, Musyoka (2012) focused on establishing the effect of custom duty tax incentive on firm performance. The main focus of the study was incentives related to investment, incentives related to trade, exemptions on the imports duty and test its effect on the FDI influx into the country. The study collected data spanning 10 years which was time series in nature. The study used basic analysis such as descriptive statistics like mean, standard deviations, maximum and minimum values. The results established that the tax incentives did not have a significant improvement in the FDI.

The study by Musyoka (2012) focused on a similar theme as the current study in that knowledge gaps were presented based on the methods of data analysis, context of the study and the concept based on the choice of the study variables. The study focused on the effect of tax incentives on foreign direct investment. The tax incentives established were incentives related to investment, incentives related to trade and exemptions on the imports duty while the dependent variable was foreign direct investment. The current study focused on the role of tax incentives on performance in terms of profits, number of jobs created and length of stay. The study by Musyoka (2012) used secondary data only while the current study relied on quantitative data collected through closed ended questions as well as secondary data. There was also a difference in the methods of data analysis employed as the current study used more than descriptive analysis only.

In their study, Atawodi and Ojeka (2012) examined the effects of custom duty tax incentives on the overall performance of manufacturing firms in Nigeria. The study aimed at identifying the effect that tax incentive would have on the performance of manufacturing firms. A total of 100 structured questionnaires were distributed to the staff of the selected manufacturing firms. The hypothesis was tested using the regression analysis. The results of the empirical review showed that tax incentive would affect the funds available for investment in the manufacturing industries. The finding also showed that companies that were privileged to enjoy tax incentives from the

government were willing to pay their taxes as they fall due and that tax incentives would significantly increase the number of manufacturing industries in Nigeria. The study therefore recommended that there should be more awareness among manufacturing firms in Nigeria on the tax incentive available to them. They should be encouraged to take advantage of tax incentives in order to increase the number of manufacturing industries in Nigeria.

The study by Atawodi and Ojeka (2012) built a good literature on the role of tax incentives on performance by specifically focusing on custom duty tax incentive. By focusing on listed manufacturing firms in Nigeria, the study played a role of opening knowledge gaps for other studies to expand the topic. Since the study was carried out in Nigeria which has a different macro environment of operations, the current study focused on Kenya so as to have findings that can be compared due to contextual differences. The study conducted by Atawodi and Ojeka (2012) also focused on listed firms while the current study opted to focus on firms operating under the export processing zones. This was a contextual knowledge gap that necessitated the study to compare the effect of tax incentive between small affirms and large firms. The study by Ohaka and Dagogo (2015) also focused on only value custom duty incentive. The current study built more on this by including other tax incentives for instance corporate income tax incentive, capital allowance tax incentives and excise tax incentive. This played a role in building to the existing knowledge on different forms of tax incentives and their role on performance. At the same time, it helped fill a conceptual knowledge gap in the study.

Philips (2010) observed that custom duty incentives will not only generate employment but will motivate the self-employed to incorporate into limited liability companies. This will lead to improved profitability of the firm. Okelle (1995) noted that an economy can be healthy through generous tax incentives to corporate tax payers, to projects, the profitability of which may not likely materialize until about three to five years.

Using panel data, Gamble (1998) examined whether custom duty tax incentives improved the financial performance of firms. The fixed effects panel regression was established and the results revealed that custom duty tax incentive did play a significant effect on improving performance of the investigated firms.

Amirahmadi and Wu (1995) conducted a study of export processing zones in Asia and in his findings he argues that custom duties incentives have encouraged import dependency of the zones. EPZ firms if producing for export can import machines parts and equipment duty free. These firms tend to rely on imported production inputs usually of higher quality and more price-competitive than those made domestically. Therefore EPZ firms don't provide market for domestically produced items and these also question their effectiveness in contributing to economic growth.

3.0 RESEARCH METHODOLOGY

This research used correlation research design. Sample size of all the 86 registered EPZs firms was used in this study. Primary data was obtained using questionnaires. Secondary data from the registered firms was collected on; ROA, number and value of jobs and the length of stay of the firms. The study used both descriptive and inferential statistics to conduct data analysis.

4.0 DATA ANALYSIS AND PRESENTATION

4.1 Description of Custom Duty Incentive

The results in the Table 1 show the mean for year 2003 to 2014 for custom duty waived for EPZ firms in Kenya. The result indicated that custom duty incentive for EPZ firms has been increasing across time. The years 2006 and 2009 experienced a slight decrease in custom duty incentive. A cumulative total of 770 firms benefited from custom duty incentive between 2003 and 2014. In the year 2012 a record 74 EPZ firms benefited from custom duty incentive.

Table 1: Custom Duty Incentives Statement from Primary Data

| Year | N | Mean(Millions) | Std. Deviation |
|-------|-----|----------------|----------------|
| 2003 | 57 | 43,510,551 | 45,953,823 |
| 2004 | 61 | 62,065,226 | 72,413,408 |
| 2005 | 62 | 61,001,886 | 82,319,084 |
| 2006 | 36 | 53,629,966 | 63,906,898 |
| 2007 | 63 | 83,636,443 | 157,511,760 |
| 2008 | 66 | 80,164,248 | 117,095,486 |
| 2009 | 72 | 58,373,094 | 88,675,801 |
| 2010 | 65 | 81,932,076 | 132,674,907 |
| 2011 | 70 | 100,082,118 | 148,798,620 |
| 2012 | 74 | 112,116,015 | 177,276,955 |
| 2013 | 71 | 124,217,706 | 231,798,682 |
| 2014 | 73 | 130,243,305 | 237,080,179 |
| Total | 770 | 85,320,535 | 150,062,882 |

4.2 Custom Duty Incentives Trend

The trend analysis of custom duty incentive indicates an increasing trend. This implies that custom duty incentive for EPZ firms has been on the rise across the study period.

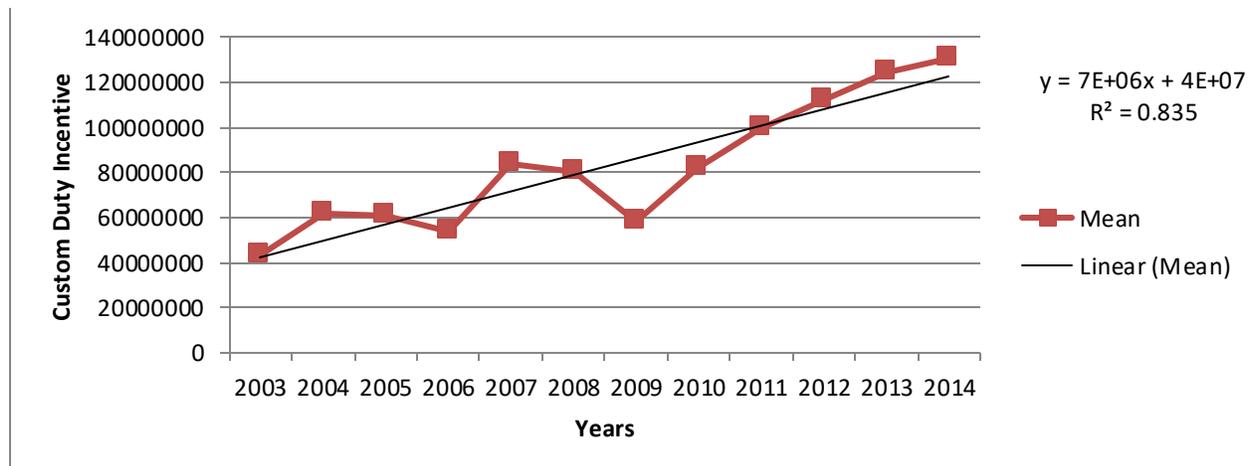


Figure 1: Trend Analysis of Custom Duty Incentive

4.3 Effects of Custom Duty Incentive on ROA

The results presented in table 2 present the fitness of model used of the regression model in explaining the study phenomena. Custom duty incentives explained 50.1% of variation in ROA.

Table 2: Model Fitness

| Indicator | Coefficient |
|----------------------------|--------------|
| R | 0.710 |
| R Square | 0.501 |
| Adjusted R Square | 0.0345 |
| Std. Error of the Estimate | 3.7865 |

This study sought to determine the effect of custom duty incentive on the performance of EPZ firms in Kenya. A linear regression model was adopted to ascertain the relationship between custom duty incentive and performance of EPZ firms which was measured by ROA. The findings are shown in Table 3.

Table 3: Effects of Custom Duty Incentive on ROA

| Parameter Estimate | B | Std. Error | Beta | t | Sig. |
|-----------------------|--------------|--------------|-------|--------|-------|
| (Constant) | 32,894,983.1 | 10,623,731.4 | | 2.812 | 0.000 |
| Custom Duty Incentive | 2.521 | 0.195 | 0.461 | 11.971 | 0.000 |

The following null hypothesis was tested:

H₀: There is no significant relationship between Custom duty Incentive and performance of EPZ firms in Kenya.

$$\text{ROA (EPZ Performance)} = 32,894,983.1 + 2.521(\text{Custom Duty Incentive})$$

From the findings, the study rejected the null hypothesis that Custom duty Incentive has no significant relationship with performance of EPZ firms in Kenya. This is because the probability value (p-value = 0.000) was less than the conventionally value of 0.05. Therefore, the study concludes that custom duty incentive has a positive relationship with the performance of EPZ firms in Kenya.

4.4 Effects of Custom Duty Incentive on the Number of jobs

The results presented in table 4 present the fitness of model used of the regression model in explaining the study phenomena. Custom duty incentives explained 22.5% of variation in Number of jobs.

Table 4: Model Fitness

| Indicator | Coefficient |
|----------------------------|--------------|
| R | 0.150 |
| R Square | 0.225 |
| Adjusted R Square | 0.3235 |
| Std. Error of the Estimate | 4.8764 |

The study conducted a linear regression to ascertain the influence of Custom duty on the EPZ firm's performance. The performance of firms was measured by the total number of workers.

Table 5: Effects of Custom Duty Incentive on the Number of jobs

| Parameter | B | Std. Error | Beta | T | Sig. |
|-----------------|--------|------------|-------|--------|-------|
| (Constant) | -4.138 | 0.47 | | -8.812 | 0.000 |
| Log custom duty | 0.525 | 0.028 | 0.564 | 18.928 | 0.000 |

The following null hypothesis was tested:

H₀: There is no significant relationship between Custom duty Incentive and performance of EPZ firms in Kenya.

$$Y = -4.138 + 0.525X$$

Y=Ln (Number of jobs (EPZ Performance))

X=Ln (Custom duty Incentive)

From the findings, the study rejected the null hypothesis that custom duty incentive has no significant relationship with performance of EPZ firms in Kenya. This is because the probability value (p-value= 0.000) was less than the conventionally value of 0.05. Therefore, the study concluded that custom duty incentive has a positive relationship with the performance of EPZ firms as measured using the total number of workers in Kenya.

4.5: Effects of Custom Duty Incentive on the Length of Stay

The results presented in table 6 present the fitness of model used of the regression model in explaining the study phenomena. Custom duty incentives explained 14.4% of variation in Length of Stay.

Table 6: Model Fitness

| Indicator | Coefficient |
|----------------------------|--------------|
| R | 0.120 |
| R Square | 0.144 |
| Adjusted R Square | 0.3344 |
| Std. Error of the Estimate | 4.5623 |

The study conducted a linear regression to ascertain the influence of Custom duty on the EPZ firm's performance. The performance of firms was measured by the number of years in operation.

Table 7: Effects of Custom Duty Incentive on the Length of Stay

| Parameter | B | Std. Error | Beta | t | Sig. |
|-----------------|--------|------------|------|--------|-------|
| (Constant) | -3.454 | 0.381 | | -9.055 | 0.000 |
| Log custom duty | 0.295 | 0.022 | 0.49 | 13.378 | 0.000 |

Results revealed that custom duty incentive was positively and significantly related with length of stay ($r=0.295$, $p=0.000$). The negative constant value of -3.454 shows that without custom duty incentive, holding other factors constant, the length of stay of firms would be decreasing over time.

The following null hypothesis was tested:

H₀: There is no significant relationship between Custom duty Incentive and performance of EPZ firms in Kenya.

$$Y = -3.454 + 0.295X$$

Y=Ln (Length of Stay (EPZ Performance))

X=Ln (Custom duty Incentive)

From the findings, the study rejected the null hypothesis that custom duty incentive has no significant relationship with performance of EPZ firms in Kenya. This is because the probability value (p -value = 0.000) was less than the conventionally value of 0.05. Therefore, the study concluded that custom duty incentive has a positive relationship with the performance of EPZ firms as measured using the number of years of operation.

5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

Based on the study findings, the study concluded that custom duty incentives had a positive effect on the performance of EPZ firms in Kenya as measured by the ROA, number of jobs and length of stay.

5.2 Recommendations

Based on the study findings, the study recommended that the government should offer increased excise duty incentives in order to cut down on imports and in that way promoting the growth of demand for domestic products in the country. The government could pursue this strategy in order to curb smuggling and also to promote the growth of the tourism industry. The study further recommends that policy makers should adopt strategic incentive plans or targeted incentive scheme that targets specific industry or a strategic tax incentive that add value or contribute positively to the economy and are in line with the country's vision 2030.

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