

# International Journal of Finance and Accounting (IJFA)

## EFFECT OF CORPORATE INCOME TAX INCENTIVE ON THE PERFORMANCE OF EPZ FIRMS IN KENYA

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### ABSTRACT

The contemporary world is characterized with intergovernmental competition for the sole purpose of attracting multinational companies and this has made fiscal incentives to become a global phenomenon. Poor African countries rely on tax holidays and import duty exemptions, while industrial western European countries allow investment allowances or accelerated depreciation. It is for this reason that this study intended to investigate the influence of effect of corporate income tax incentive on the performance of EPZ firms in Kenya. The research design was correlation research design. Correlation research design was best suited since panel data was used. Census survey was adopted because the population of interest was small. A 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. The results of study revealed that at 5% significance level, corporate income tax incentives had a positive and significant relationship with performance of EPZ firms measured using ROA. The results further revealed that at 5% significance level corporate income tax incentives were found to have positive and significant effect on number of jobs by EPZ firms and length of stay. The study concluded that increase in corporate income incentive led to an increase in the ROA, number of jobs and length of stay of the EPZ firms in Kenya. The study recommended that stakeholders in tax policy should reconsider the economic value of corporate tax incentive.

**Keywords:** *Corporate tax incentives, performance, EPZ firms, ROA, number of jobs created and length of stay.*

### Background of the Study

The contemporary world is characterized with intergovernmental competition for the sole purpose of attracting multinational companies and this has made fiscal incentives to become a global phenomenon. Poor African countries rely on tax holidays and import duty exemptions, while industrial western European countries allow investment allowances or accelerated depreciation (Morisset, 2003). This trend seems to have grown considerably since the early 1990s as evidenced by the number of high profile foreign investments, such as Toyota in Northern France or Mercedes-Benz A. G in the U.S state of Alabama. These have generated considerable debate about whether

governments have offered unreasonably large incentives to entice those firms to invest in their area. The debate about the effectiveness of tax incentives is hardly new and has accumulated a long history (Harris, 1993).

Export Processing Zones (EPZs) were amongst the first initiatives pioneered in developing countries with the aim of promoting export growth and diversification. The first generation EPZs initiated mainly by what were to become the newly industrialized countries (NICs) of East Asia, took the form of providing investors with remissions on import duties for inputs and raw materials, with enhanced or improved infrastructure (usually within a geographically restricted physical area) and with speeded-up customs clearance procedures. These schemes generated some substantial initial impacts, leading to their adoption by a large majority of developing countries today (Din, 1994; Holland, & Vann, 1998).

The Kenyan government pursued an export led growth strategy (Mangieri, 2006). This was a major shift from its previously favored import-substitution policies. In order to stimulate exports, the government implemented export promotion incentives such as the EPZ and manufacturing-under-bond (MUB) schemes. The introduction of these forms of exports compensation, especially with the advent of liberalization and globalization, was intended to move the Kenyan economy towards a more open regime, with increased market access for her products and services in the global market (Mangieri, 2006).

In Kenya, the EPZs, established in 1990, employ around 30,000 people working in 112 enterprises in 42 zones countrywide. Of these, 40 are privately owned and operated and two are publicly owned. Investments in the zones are valued at KShs 21.7 billion (US\$241 million), and the majority of the investors are foreign companies from China, Britain, the US, Netherlands, Qatar, Taiwan and India. A quarter of the firms are joint ventures between Kenyans and foreign companies, and 14% of the enterprises are fully owned by Kenyans. Numerous tax incentives are provided in Kenya's EPZs under the Income Tax Act, the most significant of which are: 10 year corporate income tax holiday, followed by a 25% rate compared to the standard 30% for the next 10 years and 10 year exemption from all withholding taxes, exemption from import duties on machinery, raw materials, and inputs (Network-Africa, T. J. & Action Aid International, 2012).

Work done by Tanzi and Zee in 2001 on tax policies for developing countries indicated that while granting tax incentives to promote investment was common in countries around the world, evidence suggested that its effectiveness in attracting incremental investments above and beyond the level that would have been reached had no incentives been granted, was often questionable. The study indicated that tax incentives could be abused by existing enterprises disguised as new ones through nominal re-organization, and therefore their revenue costs could be high. Moreover, foreign investors, which are the primary target of most tax incentives, base their decision to enter a country on a whole host of other factors (such as natural resources, political stability, transparent regulatory system, infrastructure, and skilled workforce), of which tax incentives are frequently far from being the most important one (Tanzi & Zee, 2001). The study further posited that tax incentives could also be of questionable value to a foreign investor because the true beneficiary of the incentives may in the end not be the investor, but rather the treasury of his home country, especially when any income spared from taxation in the host country is taxed by the investor's home country. Cheng (2008) pointed out that Uganda for instance, had received the largest FDI flows in the region, which have been increasing even though it offers fewer tax incentives than

other East African countries. However in Kenya, which provides a large range of tax incentives, FDI is at a low level and is erratic.

### **Statement of the Problem**

All the evidence suggests that the disadvantages of tax incentives vastly outweigh the advantages and that such incentives are not needed to attract EPZs. Proponents of tax incentives often argue that lower tax burdens give investors a higher net rate of return and therefore free up additional income for re-investment. The host country thus attracts increased EPZ, raises its income and also benefits from the transfer of technology. A further argument, particularly in relation to the less developed countries, is that it is imperative to provide incentives to investors given the otherwise poor investment climate: the volatility in politics, dilapidated infrastructure, the high cost of doing business, the macroeconomic instability, corruption and an inefficient judiciary. Revenue losses are rationalized by arguing that the capital and jobs created will improve the welfare of citizens and expand the economy (Network-Africa & Action Aid International, 2012).

However, the list of the disadvantages of tax incentives is long, as outlined in a recent IMF report. It argues that they: result in a loss of current and future tax revenue create differences in effective tax rates and thus distortions between activities that are subsidized and those that are not could require large administrative resources could result in rent-seeking and other undesirable activities could, in the case of income tax holidays, be a particularly ineffective way of promoting investment. Companies that are not profitable in the early years of operation, or companies from countries that apply a foreign tax credit to reduce the home country's tax on the foreign source income, would not benefit from income tax holidays. In contrast, such holidays would be of less importance to companies that are profitable from the start of their operation could attract mainly footloose firms can be outside the budget and non-transparent (Schwab & Sala-i-Martin, 2011). Tax incentives tend to reduce government revenues by 1—2% of GDP, according to the Organization for Economic Co-operation and Development (OECD). The IMF notes that investment incentives, if they are to be of benefit, should be well targeted and focused narrowly on the activities they seek to promote but that “the corporate income tax holiday usually does not meet the criterion of a well-targeted incentive”. On the other hand tax incentives also have a variety of benefits to a country and these include helping infant companies to quickly establish themselves which leads to creation of employment. Incentives also attract investors hence contributing to economic development. Tax holidays strongly favour transitory rather than sustainable investments and create glaring opportunities for aggressive tax avoidance. A joint report by the IMF, OECD, United Nation (UN) and World Bank comes to the same conclusion, noting that, where governance is poor, corporate income tax exemptions “may do little to attract investment”. When they do, “this may well be at the expense of domestic investment” (Schwab & Sala-i-Martin, 2011)

The application of different rules and procedures complicates tax administration and increases costs. Where the administration of tax incentives is abused, as is often the case, there are also social costs caused by corruption and rent-seeking. Tax incentives are also prone to abuse when the incentive is exhausted and the promoters of the business fraudulently wind it down and simultaneously establish another entity to be accorded the same tax incentives. Tax incentives also tend to favour elite private investors who have adequate capital of their own. In addition, once incentives have been selectively granted, sectors that consider themselves excluded will agitate for



inclusion, widening the incentives still further. Once incentives are provided, they are politically difficult to remove. In some cases, incentives are a further waste of resources in that many companies would invest anyway, without the incentive. Generally, investment incentives are recommended when the business is in the nature of a public good, such as with projects for encouraging green technologies, primary health care and disease prevention, upgrading skills of workers, and research and development (Morisset, 2003). Such tax incentives would only be important if the EPZ firms remained sustainable in terms of performance which includes creation of jobs if the tax incentives are lifted. This study therefore aims to find out if Corporate tax incentives provided to EPZ firms is worthwhile by considering the value such firms add to the economy. The study will address the gap between cost incurred by the government in form of tax incentives and the value the firms receiving tax incentives add to the economy.

### **Purpose of the Study**

The purpose of the study was to investigate the effects of corporate income tax incentives on the performance of EPZ firms in Kenya.

### **Research Hypotheses**

**H<sub>0</sub>:** Corporate income tax incentive has no significant relationship with the performance of EPZ firms in Kenya.

**H<sub>1</sub>:** Corporate income tax incentive has a significant relationship with the performance of EPZ firms in Kenya

### **Justification of the Study**

This study will be of great value to the Government, researchers and corporate tax payers. It formed the basis of reviewing the tax policies and carrying out an evaluation on their effectiveness. A review of the current tax policies can aid in carrying out a cost benefit analysis and guiding the policy makers on appropriate incentives. This can help in formulating fiscal policies aimed at reducing external borrowing and also enhance investments and employment creation. This research may provide the government with empirical evidence on performance of current tax incentives and hence makes informed decision in improving the status quo

The research will provide the corporate tax payers with an insight on available tax incentives and how to utilize them in order to increase their savings for future investments. Rise in level of investments in the country is likely to result to rise in level of revenue for the government through taxation. The researchers will have a basis for further research by adopting different research methodology or extending the period of analysis. The report forms a reference for future studies.

Other various stakeholders may use the information as they take their decisions relative to a firm's performance and position based on the accounting information supplied by it in its annual financial reports and accounts. The study may be of value to Scholars as they may be able to use the research gaps identified in this study to progress further academic discourse on accounting information, performance and investment decision making.

## Literature Review

### Theoretical Review: Taxes in the Theory of Investment Behavior

A simple theory of investment postulates that the desired stock of capital for any firm is proportional to the target level of output. Hence, the desired change in the capital stock each year that is, net investment is proportional to the expected change in output. It follows that the ratio of net investment to GDP depends on the expected rate of GDP growth. This is called the “accelerator” model because it shows that investment rises when output growth accelerates and falls when output growth decelerates (even if the growth rate is still positive) (Jorgenson, 1963).

In other words, an economy on a rapid growth path attracts a high rate of investment, while a stagnant or shrinking economy offers no inducement for net investment aimed at the domestic market. Of course, capital investment is itself a determinant of growth. Hence, we have an interactive system that can create either a virtuous circle of high growth and high investment, or a vicious circle of low growth and low investment. A more realistic version of the model, called the “flexible accelerator,” recognizes that the desired capital stock depends not only on output, but also on the user cost of capital (UCC). In this model investment takes place as long as the value of the added output from an investment exceeds the UCC in other words, when the benefits exceed the cost. From this basic condition one can readily incorporate tax considerations into the analysis. In particular, tax elements heavily influence the UCC, which is the cost per year of deploying capital in an investment project.

A higher user cost of capital reduces the set of viable investment projects. It also provides an incentive for companies to pursue more labor-intensive projects. Conversely, a lower UCC expands the set of viable investment projects, and favors capital-intensive projects. Note that the net impact of tax breaks on job creation is ambiguous, since the changes in investment and labor intensity work in opposite directions. The result may be a very sluggish investment response. The antidote is to reduce uncertainty by establishing a track record of dependable policy management and political stability (Hall & Jorgenson, 1967). Therefore this theory supports both the objective of the study since corporate income tax incentive lower user cost of capital (UCC).

### Empirical Review

The objective of the study by Olaleye, Riro, and Memba (2016) was to examine the effect of company income tax incentives on foreign direct investment in listed Nigerian manufacturing companies. The study adopted descriptive research design and the target population of the study was the 74 Listed Manufacturing Companies with approximately more than 56,000 employees. This study used primary data obtained from administration of the questionnaires. The findings showed strong positive linear relationships between reduced company income tax incentives and foreign direct investment.

Yatskovskaya (2012) conducted a study on corporate income tax credits: examining the relationship between tax credits and employment. The study used aggregate data spanning ten years, from 1999 to 2008, and representing 18 industrial sectors with 180 observations. The data were analyzed using two panel data regression models: fixed effects and between effects. The findings showed that there was no statistically significant relationship between tax credits and employment, indicating that tax credits did not incentivize firms to hire. Total tax deductions

always increased the take-home profit -whether in the form of dividends or in the form of capital gains for owners of the company, and employment was the result of the expansion of businesses in general.

Njeru and Ndimitu (2015) assessed the effect of tax incentives on investment among Export Processing Firms (EPZs) in Kenya. The study adopted a descriptive design. The findings from the study revealed that investments in EPZ firms increased with increase in sales, profit as well as tax incentives. However, the influence of tax incentives on investments in EPZ was insignificant. EPZs have benefited positively through corporate income tax incentives; tax holidays or reduced tax rates, investment allowances; exemption from import tariffs; exemption from sales, wage income or property taxes and subsidized financing.

Zee, Stotsky, and Ley (2002) in their study on tax incentives for business investment: a primer for policy makers in developing countries noted that tax incentives in the form of reductions in the corporate income tax rate could range anywhere from complete exemption (CIT holidays) to a rate that was below the regular CIT rate for qualified investment projects. Of all the different forms of tax incentives, CIT holidays were the most popular among developing countries, but were now rarely found in developed countries. The most frequently cited advantages of CIT holidays were that; they relieved the tax authorities of the burden of administering them; they allowed qualified investors the added benefit of being able to side-steps often complex tax laws, tedious tax regulations, and corrupt tax administrations; and they were neutral in their impact on the relative factor (capital and labour) intensities of qualified projects.

Thus the study hypothesized that;

$H_0$ : Corporate income tax incentive has no significant relationship with the performance of EPZ firms in Kenya.

### **Research Methodology**

The research design was correlation research design. Correlation research design was best suited since panel data was used. Correlation design was suitable for this study because it enabled the researcher to establish the relationship between tax incentives available and performance of EPZ firms in Kenya. Such designs seek to explain how one variable affects another. The use of the correlation research design was considered appropriate to use any time there is need to clarify a perceived problem.

The study population was 86 finance managers drawn from all EPZ firms. The sampling frame of this survey was the finance managers in the firms. The study adopted a census survey design. Census survey was adopted because the population of interest is small and thus 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; profitability, share on profits expatriated, number and value of jobs created and the length of stay of the firms. This secondary data was collected from operating EPZ firms in Kenya. After data was collected through questionnaires, it was prepared in readiness for analysis by editing, handling blank responses, coding, categorizing and keying into statistical package for social sciences (SPSS) computer software for analysis. SPSS was used to produce frequencies, descriptive while STATA software in inferential analysis. The particular descriptive statistics were

frequencies, mean scores and standard deviation. The particular inferential statistics were regression and correlation analysis.

The analysis of variance (ANOVA) was checked to reveal the overall model significance. In particular, the calculated f statistic was compared with the tabulated f statistic. A critical p value of 0.05 was used to determine whether the overall model was significant or not. The individual regression coefficients were checked to see whether the independent variable corporate income tax incentives significantly affected the performance of EPZ firms. A critical p value of 0.05 was also used to determine whether the variables were significant or not.

A regression models used to link the independent variables to the dependent variable as follows;

$$Y = \beta_0 + \beta_1 X + \mu$$

Where;

Y = Performance

X<sub>1</sub> = Corporate Income Tax Incentives

μ = Error Term

The specific models were as follows;

$$ROA = \beta_0 + \beta_1 \text{ Corporate Income Tax Incentives} + \mu$$

$$\text{Number of Jobs} = \beta_0 + \beta_1 \text{ Corporate Income Tax Incentives} + \mu$$

$$\text{Length of stay} = \beta_0 + \beta_1 \text{ Corporate Income Tax Incentives} + \mu$$

In the model,  $\beta_0$  = the constant term while the coefficient  $\beta_i = 1$  were used to measure the sensitivity of the dependent variable (Y) to unit change in the predictor variables X.  $\mu$  is the error term which captures the unexplained variations in the model (Olusola et. al, 2013).

## Research Findings and Discussion

### Description of Corporate Income Tax

The study conducted an assessment of corporate income tax incentive that the EPZ firms benefited from 2003 to 2014. The findings indicate an increasing trend of corporate income tax incentive waived for EPZ firms in Kenya. In 2003 a total of about Kshs 45,547,871 in terms of corporate income tax was waived. In 2004 the figures fall to about Kshs 40 million which decreased further to Kshs 36 million the following year. The highest corporate income tax waived within the study period was Kshs 73,982,932 which occurred in the year 2014.

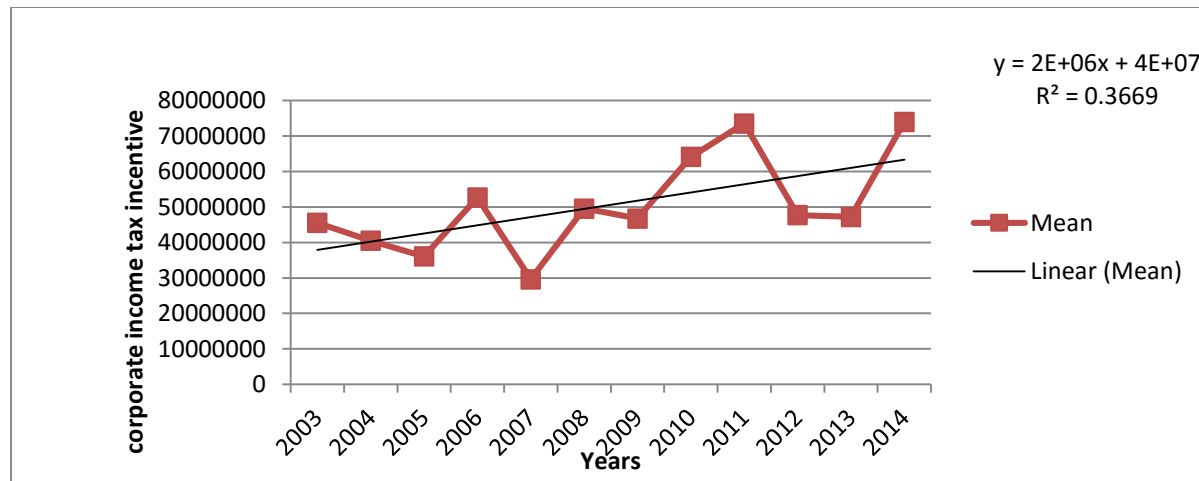


**Table 1: Descriptive of Corporate Income Tax Incentive for EPZ firms**

Year	N	Mean	Std. Deviation
2003	27	45,547,871	60,823,670
2004	42	40,489,627	66,929,535
2005	45	36,086,590	75,262,294
2006	23	52,670,750	97,887,577
2007	44	29,609,336	48,066,636
2008	43	49,556,609	90,567,045
2009	40	46,786,138	88,042,342
2010	37	64,127,925	125,809,761
2011	45	73,548,136	128,357,226
2012	43	47,733,489	67,390,140
2013	51	47,204,195	77,683,517
2014	45	73,982,932	135,242,487
Total	485	50,603,003	92,805,538

**Trend for the Mean of Corporate Income Tax Waived For EPZ**

The trend analysis in the figure below indicates that corporate income tax incentive for the EPZ firms has been fluctuating from 2003 to 2014 with the lowest and the highest waiver occurring in 2007 and 2014 respectively. Figure 4.22 below illustrates the trend analysis of corporate income tax incentive for the study period.



**Figure 1: Trend for the Mean of Corporate Income Tax Waived for EPZ**

**Effects of Corporate Income Incentive on ROA**

The results presented in table 2 present the fitness of model used of the regression model in explaining the study phenomena. Corporate income incentives explained 31.3% of variation in ROA.

Table 2: Model Fitness

Indicator	Coefficient
R	0.56
R Square	<b>0.313</b>
Adjusted R Square	0.055
Std. Error of the Estimate	3.5556

The study conducted a linear regression to ascertain the influence of corporate income tax incentive on the EPZ firm's performance. The performance of firms was measured by ROA.

**Table 3: Effects of corporate Income Incentive on ROA**

Parameter Estimate	B	Std. Error	Beta	t	Sig.
(Constant)	23,489,034.1	6,234,207		3.981	0.002
Corporate Income Incentive	2.345	0.2331	0.289	23.899	0.000

The following null hypothesis was tested:

**H<sub>0</sub>:** There is no significant relationship between corporate income tax incentive and performance of EPZ firms in Kenya.

$$\text{ROA (EZP Performance)} = 23,489,034.1 + 2.345 (\text{Corporate Income tax Incentive})$$

From the findings, the study rejected the null hypothesis that corporate income tax 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 corporate income tax incentive has a positive relationship with the performance of EPZ firms in Kenya.

### Effects of Corporate Income Incentive on Number of jobs

The results presented in table 4 present the fitness of model used of the regression model in explaining the study phenomena. Corporate income incentives explained 21.2% of variation in Number of jobs.

Table 4: Model Fitness

Indicator	Coefficient
R	0.46
R Square	<b>0.212</b>
Adjusted R Square	0.0435
Std. Error of the Estimate	4.8953

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

**Table 5: Effects of Corporate Income Incentive on Number of jobs**

	B	Std. Error	Beta	T	Sig.
(Constant)	-5.88	0.587		-10.01	0.000
Log corporate income incentive	0.656	0.036	0.64	18.296	0.000

The following null hypothesis was tested:

**H<sub>0</sub>:** There is no significant relationship between corporate income tax incentive and performance of EPZ firms in Kenya.

$$Y = -5.88 + 0.656 X$$

Y=Ln (Total Number of workers (EZP Performance))

X=Ln (Corporate Income tax Incentive)

From the findings, the study rejected the null hypothesis that corporate income tax 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 corporate income tax incentive has a positive relationship with the performance of EPZ firms as measured using the total number of workers created in Kenya.

### Effects of Corporate Income 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. Corporate income incentives explained 24% of variation in Length of Stay

**Table 6: Model Fitness**

Indicator	Coefficient
R	0.49
R Square	<b>0.240</b>
Adjusted R Square	0.055
Std. Error of the Estimate	3.55566

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

**Table 7: Effects of Corporate Income Incentive on Length of Stay**

Parameter	B	Std. Error	Beta	t	Sig.
(Constant)	-3.972	0.498		-7.969	0.000
Log corporate income incentive	0.339	0.03	0.515	11.356	0.000

The following null hypothesis was tested:

**H<sub>0</sub>:** There is no significant relationship between corporate income tax incentive and performance of EPZ firms in Kenya.

$$Y = -3.972 + 0.339 X$$

Y=Ln (Length of stay)

X=Ln (Corporate Income tax Incentive)

From the findings, the study rejected the null hypothesis that corporate income tax incentive has a 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 corporate income tax incentive has a positive relationship with the performance of EPZ firms as measured using the years in operation.

### Correlation Analysis for Corporate Income Tax Incentives and Performance

The Table 8 below presents the results of the correlation analysis. The results presented shows that corporate income tax incentive and performance of EPZ firms are positively and significant related ( $r=0.239$ ,  $p=0.000$ ).

**Table 8: Correlation Analysis Results**

		Performance	Corporate Income Tax incentives
Performance	Pearson Correlation	1.000	
	Sig. (2-tailed)		
Corporate Income Tax incentives	Pearson Correlation	0.239**	1.000
	Sig. (2-tailed)	0.000	

### Conclusion, Recommendation and Areas for further research

#### Conclusion

Based on the study findings, the study concluded that corporate income tax 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. Even though the corporate income tax incentive had increased in many

developing countries and benefits associated to it were not clear, this study found that these incentives benefited EPZ firms.

### **Recommendation**

This study recommends that stakeholders in tax policy should reconsider the economic value of corporate tax incentive and conduct a cost benefit analysis of such incentives so that they can benefit these firms more.

### **Areas for further research**

The study recommended that future studies should aim to broaden the causes of low performance of EPZ firms in Kenya not identified in this study. The study also suggested that a study on the remedies to the low performance of EPZ firms be conducted. This would assist in improving EPZ firms in Kenya and to encourage more investors.

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