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INFLUENCE OF TAX INCENTIVES ON CAPITAL STRUCTURE DECISIONS OF LISTED FIRMS IN THE NAIROBI SECURITIES EXCHANGE, KENYA

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Abstract

Interest in capital structure decisions research has grown since as the corporate tax increases, tax incentives also grow. This study premised on that, tax incentives do affect capital structure decisions and as such listed firms at NSE, Kenya. The study sought to ascertain the influence of local tax incentives on capital structure decisions of firms that have listed with the NSE. Descriptive research design and correlational research designs were used. Data was collected from a sample of 80 employees using structured questionnaires. The data was coded and analyzed using SPSS version 21 for windows for descriptive statistics and correlation analysis to test the relationship between the variables. The study found a weak but significant relationship between local tax incentives on capital structure decisions of firms listed with the NSE. Thus local tax incentives were not motivating enough to the investors to considerably influence their financing decisions in the listed firms. It is recommended that the local tax should be reviewed by the government in consultation with the stake holders to spur investment. There is need to do more research on effects of deferred taxes on the financial decisions of listed firms.

Keywords: Tax incentives, Capital structure, Listed firms, NSE-Kenya, Local tax

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INTRODUCTION

Interest payments to lenders are more often than not fully tax deductible from taxable income. However, dividend payments to shareholders are not (Graham, 2003). Auerbach (2002) posits that, typically, tax systems encourage the use of debt rather than equity financing. In the same light, it is observed that, as the corporate tax increases, tax incentives also grow. Explicably, therefore, high corporate tax rates are usually associated with greater corporate indebtedness. Auerbach (2002) and Graham (2003) laments that, it is quite difficult to estimate the link between tax incentives and capital structure due to measurement problems. Mihir et al., (2003), therefore, notes that many studies have failed to establish any effect or unexpected relationships between tax incentives and the use of debt.

It is averred that indeed tax incentives do affect choice of capital structure (Hartmann-Wendels et al., 2012). The authors when assessing evidence on tax incentives and capital structure in Germany established a link between the two themes. The foregoing is ascertained by their study findings that, there exists a statistically and economically significant positive correlation between the marginal tax benefits of debt and the debt ratio. The scholars further observed that, tax incentives encourage German firms to employ more debt in their capital structures, ceteris paribus.

In the same study Mihir et al., (2003) considered the choice of capital structure and internal capital markets from a multinational perspective. They noted that, according to cross-country studies of capital structure, multinational firms face diverse tax incentives and legal regimes around the world. The foregoing situation makes it possible to establish the effect of the aforementioned factors on financing choices. It is further asserted that, from the analysis of multinational firms, there can be appropriate estimates of the sensitivity of capital structure choice to tax incentives. Noe (2000) postulated that, the capacity to negotiate with creditors in times of fiscal distress is attractive to the distressed organization, yet it reduces its incentive to avoid bankruptcy. The foregoing occasions an agency problem which is reflected in higher borrowing rates. Panier et al., (2013) study on capital structure and taxes indicate that, capital structure significantly responds to changing tax incentives.

There are more than 50 firms listed at the Nairobi Securities Exchange (NSE) Kenya. The firms are drawn from different sectors which include among others, telecommunication, agriculture, manufacturing, and construction. Andzie (2012) when studying determinants of capital structure decision of listed firms in both Ghana and Nairobi bourses, sought to investigate how firm specific factors like firm size, asset structure, profitability, and corporate tax influence capital structure decision. The study established that tax has a negative effect on

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capital structure decision of listed firms, though in the context of NSE, the influence was rather insignificant.

Statement of the Problem

It is alleged that, in spite of the prominence of tax incentives, establishing the effect of taxes on financing decisions has hitherto been difficult (Graham & Kim, 2009). This is blamed on the argument that, relying on changing tax rates typically faces challenges. For example, it is rather difficult to find tax reforms that generate large variation in tax incentives and controlling of time trends.

Based on the foregoing, it is observed that many empirical studies have fallen short of establishing the significant effects of tax incentives on capital structure. An earlier study by Graham (1999) failed to find evidence that changing tax rates affects financing decisions of a firm. Failure to understand the link between tax incentives and capital structure may disenable the firms listed with the NSE from making appropriate financing decisions.

The implications of the foregoing are far-reaching and can indeed reverberate across the country given that firms listed with the NSE are the largest in Kenya both in terms of their turnover and human resources. In other words, millions of Kenyans and the national economy depend on these firms either directly or indirectly. Financing decisions underscore the success or failure of these firms and, therefore, it is very fundamental to find the influencers of capital structure decisions. This study was necessitated by the premise that, tax incentives do affect capital structure decisions of firms listed with the NSE. The scarcity of empirical studies on tax incentives and capital structure decisions in context of NSE-listed firms has necessitated the proposed study which objects at shedding more light on the afore-highlighted subject.

Objective of the Study

The study aimed at ascertaining the influence of local tax incentives on capital structure decisions of firms listed with the NSE

Research Question

What is the influence of local tax incentives on capital structure decisions of firms listed with the NSE?

Conceptual Framework

The study conceptualized a framework consisting of an independent and dependent variable. The framework indicated that tax incentives made up the independent variable while capital

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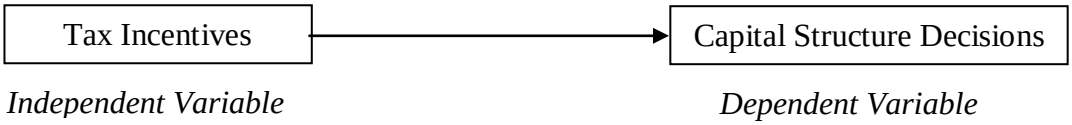
structure decisions made up the dependent variable. Tax incentives were conceptualized to influence the capital structure decisions. The framework for the study was as represented in figure 1 below.

Figure 1: conceptual framework



THEORETICAL REVIEW

Modern Theory of Optimal Taxation

The breakthrough of the modern theory of optimal taxation in the early 1970s opened up a new fertile area of research, but it also created a larger communication gap between theorists and practitioners of public finance. To many applied economists working for governments and international organizations, the new theories of optimal taxation seemed highly technical and abstract, and hence of little policy relevance. Even today it is a widespread view that optimal tax theory has produced very few robust results that can serve as a basis for concrete useful policy advice (Torrance, 2005). The theory of optimal taxation does in fact provide many important lessons for policy makers and that recent theoretical progress in this area may help to bridge the gap between academic research and practical policy advice. The theory of optimal taxation is normative, essentially assuming that policy is made by a benevolent dictator who respects individual preferences as well as some 'social' preference for equality.

One can choose to dismiss this body of theory by pointing out that actual policy makers typically represent specific interest groups and that actual policies tend to reflect some compromise between conflicting interests rather than the maximization of a Bergson-Samuelson social welfare function. Indeed, this is why models of Public Choice and Political Economy help us to understand what is going on in the real world. But one could likewise dismiss models of competitive markets by pointing out that the Walrasian auctioneer does not exist and that many economic agents have market power. Yet few if any economists would deny that the theory of perfect competition and the First Theorem of Welfare Economics provide a useful benchmark for evaluation of resource allocation in actual market economies. In a similar way, assuming that one accepts its philosophical foundations in utilitarianism and methodological individualism, optimal tax theory provides a benchmark against which to evaluate actual public policies (Fitzgerald, 2003).

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Local Tax Incentives and Capital Structure Decisions of Listed Firms

According to Mitton, (2007), a local tax is a tax assessed and levied by a local authority such as a county or municipality. A local tax is usually collected in the form of property taxes, and is used to fund a wide range of civic services from garbage collection to sewer maintenance. The amount of local taxes may vary widely from one jurisdiction to the next. Michael and Clifford (1996) also define a local tax as a tax levied and collected by a state/province and or municipality. Local taxes are collected in order to fund local government service but they often are also used to pay coupons and principals on municipal bonds. Local taxes sometimes come in the form of income or sales taxes, but the largest example of a local tax is property tax. Unlike federal or state taxes, the benefits arising from local taxes are generally apparent at the community level. Municipalities have to face a constant balancing act with regards to levying local taxes, since rising taxes may lead to "taxpayer revolt," while low taxation levels may lead to a cutback of essential services. Different types of institutional investors face different tax regimes, different regulatory constraints (such as solvency ratios for insurance companies and minimum funding requirements for pension funds) and different horizons. VanHorne (1997) observes that different financial instruments have different levels of risk and in order for them to compete for funds these instruments must provide different yields. Securities have different characteristics in default risk, marketability, taxability and embedded options, which account for the different levels of risk and hence different expected return for the investors (Mutsotso, 2007).

The composition of taxes could also change as a result of increased difficulty in taxing mobile tax bases. The overall tax burden from income taxes on mobile tax bases like capital and skilled labor will likely decline across governments, while taxes on immobile tax bases will likely increase (Ngugi, 2008). In the face of tax competition, national governments may attempt to harmonize (or at least coordinate) their tax systems in an attempt to reduce the negative externalities that one government’s decisions impose on other governments. Such harmonization implies that there should be some convergence in tax rates across governments, and in the definitions of tax bases (Claessens, Keen and Pazarbasioglu, 2010).

Taxation and government expenditure as well as monetary policies of the government provide the present and future investors with information of the investment environment. When the economy is growing, corporate earnings and in turn returns and capital gains increase Bhalla (1997). Elton et al (1995) say government fiscal policy for example taxes
tend to be expansive when it encourages spending, when the government reduces tax and or increases the size of the budget. The magnitude in the time-series variation in the tax treatment of equity relative to debt is significantly larger, and arguably cleaner from the tax perspective,

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than previously analyzed tax reforms. An important empirical challenge is finding settings where the relative tax advantage of debt changes substantially while other tax margins are left unaffected. Unfortunately, most significant tax reforms also affect the corporate tax base, introducing biases in the estimated coefficients (Kawano and Slemrod, 2012). Alternatively, relatively minor tax reforms may not trigger large financing responses, even when these effects are important in practice.

Corporate Tax Incentives and Capital Structure Decisions of Listed Firms

Corporate tax can be viewed as either a tax on corporate capital (as the opportunity cost of capital supplied by shareholders is included in the tax base) or as a tax on profits (as the tax base is determined by subtracting costs of production from gross corporate incomes thus leaving only "profits") (Rosen, 1995). The Kenya Revenue Authority (2010) defines corporation tax is a form of Income Tax that is levied on corporate bodies such As Limited Companies, Trusts and Co-operatives. Corporate income tax (CIT) systems generally favour debt financing over equity financing of investments. While the large majority of current CIT systems allow a deduction of interest paid on debt from the CIT base, there is no such deduction for equity. In theory, this distortion could be removed at shareholder level by taxing interest income at the CIT rate and exempting dividend income. However, in practice this is rarely done and it is even less likely with the increasing internationalisation of capital markets makes this even more unlikely since shareholders and creditors are not necessarily taxed in the national tax system where the company is located.

According to Odera (2014), if firms opt for more debt to cover increase in corporate taxes, then the credit market will be constrained as demand for debt financing will go up. However, if the costs of debt are so high, then firms will factor in increased taxes and thus face reduction in after tax profits especially if revenue is not growing at an equal rate. A negative effect of tax on company performance may also lead to a reduction in overall company tax revenue generation. Despite this, the corporate tax rate has been maintained at its current level for over a decade. This means that firms that are not able to use debt to shield their earnings from taxes have to cover the tax rate thus facing high business costs. The tax debate in Kenya today is based on the premise that firms consider corporate tax rate to be high which in turn makes them incur high business costs, rendering them uncompetitive. This is despite the number of tax incentives and rebates that have been put in place to among other things encourage firm establishment, growth and listing. The overall goal of the incentives is to improve firm performance. If firms view tax rates to be very high, then an increase in the tax rate will most likely lead to firms adjusting their capital structure to cover the increased tax rates.

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However, this response depends on the market conditions, especially the costs of financing debt.

According to KRA capital deductions are incentives given to investors on the capital expenditure incurred on industrial buildings and purchase of for the production of income. However, the tax incentives are not necessarily extended to capital investors, that is, they do not cover for debt financing, hence, giving the investors little incentive to invest in bonds. In its charter, resident Companies are taxable at a rate of 30% while non-resident companies are taxable at the rate of 37.5% on their taxable profits. This has elicited arguments by various industry players that the current corporate tax rate is high and has resulted into firms being uncompetitive. Despite these arguments, the corporate tax rate has not changed from 30 per cent of profits for some time; hence it is important to establish the financing decisions of firms given the corporate tax rate.

Implications of Tax Incentives' Variation and Capital Structure Decisions

Tax reform is the process of changing the way taxes are collected or managed by the government. It may involve the adoption of a Value Added Tax (VAT), the expansion of the VAT, the elimination of stamp and other minor duties, the simplification and broadening of personal or corporate income or asset taxes, or the revision of the tax code to enact comprehensive administration and criminal penalties for evasion (Mahon, 1997). Institutional aspects of tax reform involve the Semi-autonomous Revenue Authority Model, where traditional line departments are separated from the Ministry of Finance and granted the legal status of semi-autonomous authorities. Tax reform involves broad issues of economic policy as well as specific problems of tax structure design and administration (Musgrave, 1987). At the theoretical level, tax reforms are initiated either following an economic crisis or as a response to international pressure (Mahon, 1997).

Tax advocacy groups, such as the Institute for Fiscal Studies (IFS, 2011) have long stressed the benefits of "allowance for corporate equity" (ACE) systems as means to achieve tax neutrality in financing decisions. More recently, Mirrlees et al., (2012) describe a broad set of proposals for fundamental tax reform, which include an ACE provision to align the tax treatment of debt and equity. Before Belgium, Austria, Brazil, Croatia, and Italy introduced tax reforms that included features of an ACE. Analyzing the impact of these reforms has, however, been difficult due to several challenges. All countries, except Brazil, abandoned their ACE a short period after it was enacted. The benefit of the ACE was very restricted (Italy), limited to new equity (Austria), or conditioned on payouts to shareholders (Brazil). Additionally, the evaluation of these reforms

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suffered from the lack of large datasets, frequent and concurrent changes in other taxes (e.g., Italy), and the absence of credible control groups to establish the effect of taxes on leverage.

Studies on the popular Belgian National Interest Deduction (NID) tax reforms enacted in 1982, points to mixed results. Van Campenhout and Van Caneghem (2013) surveyed the impact of this tax reform on a sample of 614 small firms; their findings indicated that the NID did not have significant effects on financing decisions. Conversely, Kestens, et al., (2012) using a non-random sample of 13,130 firms and cross-sectional tests, show that the NID significantly affected the leverage ratios of small firms. In concurrent and independent work, Princen (2012) uses a subset of Belgian firms, and argues empirically that the NID led Belgian firms to reduce their leverage ratios, relative to firms in France.

In contrast, Auclert and Struyven (2012) argue empirically that the NID had an insignificant effect on capital structure due to a secular reduction in leverage experienced by Belgian firms since 2001. Therefore, based on these findings it is evident that the exact effect of tax incentives on capital structure decisions remains elusive and is yet to be established as is the main thrust of the current study. Moreover, it should also be noted that it is quite difficult to accurately determine the impact of tax reforms on a firms financing decisions, *ceteris paribas*.

Even though the tax system has continuously changed, in pursuit of the objectives of the Tax Modernization Programme that came into force in 1986, the challenges that confront the tax authorities today are not much different from the pre-reform challenges. With Kenyan firms reporting that about 68.2% of profit is taken away in taxes, tax competitiveness is low and the country remains among the most tax unfriendly countries in the world. The tax code is still complex and cumbersome, characterized by uneven and unfair taxes, a narrow tax base with very high tax rates and rates dispersions with respect to trade, and low compliance (KIPPRA, 2004b).

METHODOLOGY

The research methodology presents the structural outline upon which data collection and analysis was based. It covers the research design, study location, targeted population, the sample selection procedures, data collection instruments, pre-testing for validity and reliability, how data was collected and analyzed.

Research Design

The study adopted both descriptive survey and correlational research designs in evaluating the effect of tax incentives on capital structure decisions of listed firms in NSE. Descriptive design was employed in order to describe the views of the respondents regarding the variables of the

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study. Descriptive survey study is quantitative in nature and is conducted at a specific point in time (Kothari's, 2008). On the other hand, correlational design was used to facilitate deducing of pertinent inferences through correlational analysis. A quantitative approach was applied.

Target Population

A population is a group of individuals, objects or items from which samples are drawn for measurement and the element have certain homogenous characteristics (Kombo & Tromp, 2006). Mugenda and Mugenda, 2003 describes population as, the entire group of individuals or items under consideration in any field of inquiry and have common attribute. The target population for this study was personnel attached to the finance department in all listed firms operating in NSE in Kenya.

Sample size and Sampling procedure

According to Orodho and Kombo,(2002) Sampling is a process of selecting a number of individuals or objects or items from a target population in a way that ensures the selected group contains elements that are representative enough of the entire population. Webster, (1985) contends that a sample is a finite part of population whose characteristic is studied to gain information about the whole population.

Sample size Determination

To determine the sample size, the following formula by Yamane (1967) was used to calculate the sample size

$n = N/ (1+N (e^2))$

Where ***n*** is sample size, ***N*** is Target population, ***e=*** acceptable error **=** +or – (0.05)

Given that *N* =118

n=118/ (1+118 x 0.0025)

n=91

Sampling Procedure

Stratified random sampling was used to get the sample. Stratified random sampling ensures that the heterogeneous elements in subgroups in the strata are reproduced in the sample in the same way, thus all subgroups are included. (Mugenda & Mugenda, 2003) Proportion method was employed to get the sample for each stratum while simple random sampling was used to pick the actual respondents from each stratum.

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Research Instruments

Both primary and secondary data was collected. Primary data is data which is collected afresh and for first time. It's that information that a researcher obtains from the field (Mugenda and Mugenda, 2003). Structured questionnaires were used to collect Primary data. Structured questionnaires are easy to analyze since they are on their immediate useable form, (Kothari, 2004). Data collection schedule was used to collect secondary data.

Data Collection Procedure

Primary data was collected using self-administered questionnaires using a drop and pick technique while secondary data was obtained through analysis of published documents pertinent to capital structure and tax incentives in context of Nairobi bourse available at the NSE handbook for 5 years from 2010 to 2014.

Data Processing and Analysis

Data was coded and classified before being organized as per the objects of study. The collected data was processed and analyzed using both descriptive and correlational analysis with the aid of the SPSS software for windows version 21. Pearson correlation coefficient was used to test the relationships. The associations were tested at $\alpha = 0.05$ significance level.

ANALYSIS AND FINDINGS

Response Rate

The researcher distributed 91 questionnaires of which 80 of them were filled and returned. This represented a response rate of 88% and was characterized as being very good.

Local Tax Incentives on Capital Structure Decisions of Listed Firms

The objective of the study was to ascertain the influence of local tax incentives on capital structure decisions of firms listed with the NSE. This objective was realized by asking the respondent several questions pertaining to the status of the local tax regime and their influence on their financing decisions.

Local tax incentives were defined in terms of the rates, relief for businesses and the fiscal policies. The status of effects of this variable was rated on a 5 point Likert scale ranging from; 1 = strongly agree to 5 = strongly disagree. The results on this are summarized in the Table 1.

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Table 1: Local Tax Incentives on Capital Structure Decisions of Listed Firms

Statement	SA Freq(%)	A Freq(%)	N Freq(%)	D Freq(%)	SD Freq(%)
Do you think that the local taxes levied by the county governments are good for investment?	11(13.8)	18(22.5)	21(26.3)	23(28.8)	7(8.6)
Have these taxes encouraged local investors to invest in your firm?	30(37.5)	5(6.3)	10(12.5)	31(38.8)	4(5.0)
And what about foreign investors seeking to invest in your firm, do they find the local taxes friendly?	0	7(8.8)	22(27.5)	42(52.5)	9(11.3)
Have the local taxes encouraged long time investors in your firm?	9(11.3)	43(53.8)	17(21.3)	10(12.5)	1(1.3)
Have the local taxes encouraged you to issue bonds?	12(15.0)	52(65.0)	16(20.0)	0	0

The results in Table 1 indicate that the local taxes levied by the county governments were perceived as not good for investment by majority (28.8%) of the respondents. As such these taxes were seen as not encouraging local investors to invest in the firms (38.8%). However, this could also be attributed to the investors' views of the firms' capital structure. There was also a feeling that the local taxes were an obstacle to foreign investors seeking to invest in the firms (52.2%) since they were not finding the local taxes friendly. Nevertheless, it emerged that the local taxes had encouraged long time investors in firms (53.8%) who probably sought to take advantage of the tax advantage the local taxes gave to the bond holders. This was made evident by the findings that local taxes encouraged the firms to issue bonds (65%).

This study also sought to establish whether there was a significant relationship between local tax incentives on capital structure decisions of firms listed with the NSE. The findings are given in Table 2.

Table 2: Correlation Summary 1

		Local Taxes Incentives	Capital Structure Decisions
Local Tax Incentives	Pearson Correlation	1	.139
	Sig. (2-tailed)		.033
	N	80	80

*Correlation significant at α=0.05**

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The correlation analysis in Table 2 suggests that there was a significant relationship between local tax incentives on capital structure decisions of firms listed with the NSE ($r = 0.139$, $\alpha = 0.05$). The Karl Pearson's product moment coefficient of correlation $r = 0.139$ is low and suggests that a weak relationship existed between the two variables. This indicates that the local tax incentives were not motivating enough to the investors to considerably influence their financing decisions in the listed firms. It also led to the firms opting to issue bonds in response to the market behavior though it was an expensive form of capital. These findings reflect the views of Bhalla (1997) who argued that taxation and government expenditure as well as monetary policies of the government provide the present and future investors with information of the investment environment. Elton *et al.* (1995) also pointed out that government fiscal policy for example on taxes tend to be expensive when they encourage spending, when the government reduces tax and or increases the size of the budget. Hence, the local taxes levied without due consideration of future investments in the private sector tended to discourage investors who in the end only sought to invest in bonds rather than equity.

CONCLUSION AND RECOMMENDATIONS

Based on the results of the study, it can be concluded that; local tax incentives on capital structure decisions of listed firms were perceived as unfavorable for investment although they still significantly influenced capital structure decisions of firms listed with the NSE. Thus, though the local tax incentives were not motivating enough to the investors they had influenced their financing decisions in the listed firms.

The researcher recommended that local taxes should be adjusted to favor investment as it emerged that a more favorable local tax regime could spur investment in the listed firms. This would consequently lead to favorable capital structure decisions. The researcher further recommended that further studies should be done on the effects of deferred taxes on the financial decisions of listed firms. The researcher observed that there is also need to asses the capitalization challenges facing small firms.

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