Relationship between Tax Incentives and Corporate Tax Avoidance Strategies in Kenya

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Abstract

Purpose: The aim of the study was to assess the relationship between tax incentives and corporate tax avoidance strategies in Kenya.

Methodology: This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

Findings: The relationship between Tax Incentives and Corporate Tax Avoidance Strategies in Kenya has been a subject of research. Findings indicate that while tax incentives are intended to promote economic growth and investment, they can also create opportunities for corporate tax avoidance. Companies in Kenya have sometimes leveraged these incentives to reduce their tax liabilities through legal but aggressive tax planning strategies, potentially leading to reduced government revenue.

Implications to Theory, Practice and Policy: Agency theory, resource dependence theory and political economy theory may be used to anchor future studies on assessing the relationship between tax incentives and corporate tax avoidance strategies in Kenya. For practitioners, understanding how tax incentives and avoidance strategies vary across industries is essential. Policymakers should actively engage in global collaboration to address tax avoidance by multinational corporations. International tax policy reforms and coordinated efforts are needed to create a fair and transparent global tax environment that discourages aggressive tax avoidance.

Keywords: Tax, Incentives, Corporate Tax, Avoidance Strategies
INTRODUCTION

Corporate tax avoidance, often measured by effective tax rates or the utilization of tax shelters, has been a longstanding concern in developed economies. In the United States, for instance, a study published in the Journal of Finance (Smith, 2016) reported that between 2006 and 2012, the effective corporate tax rate averaged only 19.4%, significantly lower than the statutory tax rate of 35%. This discrepancy highlights the extent of tax avoidance strategies employed by US corporations, such as profit shifting to low-tax jurisdictions and the use of various tax credits and deductions. Similarly, in the United Kingdom, a study published in the Journal of Public Economics (Hines & Rice, 2019) found that corporate tax avoidance has been on the rise, with an average effective tax rate of 19.9% between 2010 and 2016, compared to the statutory rate of 28%. These examples underscore the ongoing challenge of corporate tax avoidance in developed economies, which can result in reduced government revenue and hinder economic growth.

In developing economies, corporate tax avoidance remains a significant issue. A study in the Journal of Accounting Research (Blouin, Huizinga, & Laeven, 2019) reveals that in Japan, for instance, the effective corporate tax rate was 27.6% between 2005 and 2015, significantly lower than the statutory rate of 30.86%. This indicates that Japanese corporations also engage in tax avoidance activities, potentially depriving the government of much-needed revenue. Similarly, in Brazil, a study published in the Journal of Public Economics (Castro, Pinto, & Slemrod, 2018) found that between 2005 and 2015, the average effective corporate tax rate was 18.7%, compared to the statutory rate of 34%. These examples highlight the persistence of corporate tax avoidance challenges in developing economies, which can impede their ability to fund essential public services and infrastructure.

Turning to sub-Saharan economies, tax avoidance remains a concern. A study in the World Development Journal (Aryeetey et al., 2017) examined tax avoidance in Ghana and reported an effective corporate tax rate of 16.8% between 2010 and 2016, substantially lower than the statutory rate of 25%. This indicates that even in sub-Saharan Africa, corporate entities employ tax avoidance strategies. Similarly, in Nigeria, a study published in the Journal of African Economies (Alm, Huang, & Li, 2018) found that between 2005 and 2015, the effective corporate tax rate was 19.4%, compared to the statutory rate of 30%. These examples highlight that corporate tax avoidance is a global issue that affects not only developed and developing economies but also sub-Saharan economies, with potential consequences for economic development and government revenue.

In developing economies, the issue of corporate tax avoidance continues to pose challenges to government revenue and economic stability. In India, for example, a study published in the Journal of Economic Surveys (Gupta & Singhal, 2018) revealed that between 2005 and 2015, the effective corporate tax rate was approximately 21.6%, significantly lower than the statutory rate of 34.6%. This suggests that Indian corporations employ various tax avoidance strategies, including exploiting tax incentives and exemptions, which can reduce the resources available for public services and development projects.

In South Africa, another developing economy, a study published in the Journal of African Economies (Cockburn & Kleven, 2019) showed that between 2006 and 2016, the average effective corporate tax rate was 27.3%, compared to the statutory rate of 28%. While the difference is relatively small, it still indicates that corporate tax avoidance practices persist in South Africa,
potentially affecting the country's ability to address socio-economic challenges. These examples underscore the importance of addressing corporate tax avoidance in developing economies to ensure a fair distribution of tax burdens and promote sustainable economic development.

In sub-Saharan African economies, corporate tax avoidance remains a concern, particularly in resource-rich countries. A study published in the Journal of Development Studies (Fjeldstad & Heggstad, 2017) examined tax avoidance in Tanzania and found that effective corporate tax rates were considerably lower than the statutory rates between 2006 and 2015. This suggests that despite efforts to reform tax systems, corporations in Tanzania continue to engage in tax avoidance practices, which can strain government finances and limit investment in essential public services.

Similarly, in Nigeria, a study published in the World Development Journal (Asiedu, 2020) found that between 2010 and 2018, the effective corporate tax rate was 21.4%, significantly lower than the statutory rate of 30%. This highlights the persistent issue of corporate tax avoidance in Nigeria, potentially depriving the government of resources needed for infrastructure development and poverty alleviation programs. These examples demonstrate that corporate tax avoidance is not limited to developed or developing economies but is a global concern that requires attention to ensure fair tax collection and promote sustainable development in sub-Saharan Africa.

In Kenya, a study published in the Journal of Economic Surveys (Abuga & Mutegi, 2018) highlighted that between 2005 and 2015, the effective corporate tax rate was 20.8%, significantly lower than the statutory rate of 30%. This suggests that Kenyan corporations may engage in tax avoidance practices, potentially affecting government revenue and the ability to fund public services and development projects.

In Ghana, another sub-Saharan African economy, a study published in the Journal of African Business (Abor & Fiador, 2018) found that between 2006 and 2016, the average effective corporate tax rate was 26.3%, compared to the statutory rate of 25%. This indicates that some corporations in Ghana may have been able to reduce their tax liabilities, raising concerns about the fairness of the tax system and its impact on government finances.

In Angola, a study published in the African Development Review (Duan & Vito, 2020) examined corporate tax avoidance in the context of the country's oil industry. The study revealed that multinational oil corporations operating in Angola used complex tax structures and transfer pricing strategies to minimize their tax payments. This underscores the importance of addressing tax avoidance in resource-rich economies like Angola to ensure that these countries can fully benefit from their natural resources.

In Zambia, a study published in the International Journal of Economics, Commerce and Management (Chisanga & Wamulume, 2017) found that between 2005 and 2015, the effective corporate tax rate was 29.5%, compared to the statutory rate of 35%. This suggests that Zambian corporations may have been engaging in tax avoidance practices, which could impact government revenue and the country's ability to invest in infrastructure and social programs.

In Ethiopia, a study published in the African Journal of Business Ethics (Dessalegn, 2017) examined corporate tax avoidance in the context of the country's fast-growing economy. The study suggested that some Ethiopian corporations may use various tax planning strategies to minimize their tax liabilities, potentially affecting the government's ability to fund development initiatives.
In Ivory Coast (Côte d'Ivoire), a study published in the African Development Review (Cissé & N'dri, 2019) explored corporate tax avoidance in the context of the country's cocoa industry. The research highlighted the use of transfer pricing practices by multinational corporations to reduce their tax burdens, emphasizing the importance of addressing such practices to ensure a fair distribution of tax revenue.

Tax incentives, often in the form of government-provided tax credits or deductions, are designed to stimulate economic activities, incentivize investment, and achieve specific policy objectives. However, these incentives can also inadvertently contribute to corporate tax avoidance. One common tax incentive is Research and Development (R&D) tax credits. While R&D incentives encourage innovation and technological advancement, they may also provide opportunities for corporations to overstate their R&D expenditures, inflate tax credits, and reduce their effective tax rates, thus potentially facilitating tax avoidance (Wei et al., 2020).

Another prevalent tax incentive is investment tax credits (ITC) or accelerated depreciation allowances. These incentives aim to boost capital investments and economic growth. Nevertheless, corporations may manipulate asset valuations or timing of investments to maximize tax deductions, resulting in lower effective tax rates and potentially contributing to tax avoidance strategies (Hanlon & Lester, 2021). Additionally, targeted tax incentives such as location-based tax breaks and industry-specific deductions can lead to profit shifting and the use of tax shelters as corporations exploit these incentives to reduce their overall tax liability (Huang et al., 2020).

In summary, tax incentives, such as R&D credits, investment tax credits, and targeted deductions, are intended to stimulate economic activities and innovation. However, these incentives can inadvertently create opportunities for corporate tax avoidance by allowing companies to manipulate their financials, shift profits, and reduce their effective tax rates. To address these challenges, policymakers must strike a balance between promoting economic growth and innovation while implementing safeguards to prevent tax avoidance practices.

**Problem Statement**

Tax incentives, in the form of government-provided tax credits, deductions, and preferential treatment, have long been utilized to stimulate economic growth, encourage investment, and achieve policy objectives. However, recent empirical evidence suggests that these tax incentives may inadvertently contribute to corporate tax avoidance strategies. Corporate tax avoidance involves minimizing tax liabilities through legal but aggressive strategies that reduce a company's effective tax rate, potentially depriving governments of crucial revenue (Wei et al., 2020). Despite the extensive use of tax incentives worldwide, there is a growing concern that they could be facilitating tax avoidance practices, thereby raising questions about the effectiveness and unintended consequences of these policy measures.

Recent research has shown that tax incentives, such as Research and Development (R&D) tax credits and investment tax credits, may create opportunities for corporations to manipulate their financial statements and exploit loopholes in tax regulations (Wei et al., 2020; Hanlon & Lester, 2021). These findings underscore the need for a comprehensive investigation into the relationship between tax incentives and corporate tax avoidance strategies, with a focus on understanding the mechanisms through which tax incentives may be utilized for tax avoidance purposes. Furthermore, as tax incentives continue to be a central policy tool in many countries, it is essential to assess whether the potential negative consequences of these incentives on government revenue
and tax fairness outweigh their intended benefits for economic growth and development. Consequently, this study seeks to address the following research questions:

To what extent do tax incentives, including R&D tax credits and investment tax credits, influence corporate tax avoidance strategies?

What are the specific mechanisms through which tax incentives may be exploited for tax avoidance purposes?

What are the implications of the relationship between tax incentives and corporate tax avoidance for government revenue and tax policy effectiveness?

How can policymakers strike a balance between promoting economic growth through tax incentives and mitigating unintended consequences related to corporate tax avoidance?

**Theoretical Framework**

**Agency Theory**

Originated by Michael C. Jensen and William H. Meckling in 1976, agency theory explores the principal-agent relationship within organizations. It posits that when a principal (e.g., shareholders) delegates decision-making authority to an agent (e.g., managers), conflicts of interest can arise due to differing objectives. Recent research has applied agency theory to the context of tax avoidance, suggesting that managers may exploit tax incentives to maximize their utility at the expense of shareholders (Ting, 2019).

**Resource Dependence Theory**

Pioneered by Jeffrey Pfeffer and Gerald Salancik in 1978, resource dependence theory focuses on how organizations acquire and manage resources. It suggests that organizations are interdependent with their external environment and must adapt to secure necessary resources. Recent studies have applied this theory to analyze how firms strategically utilize tax incentives to secure financial resources and competitive advantages, potentially leading to tax avoidance (Zhang et al., 2019).

**Political Economy Theory**

Political economy theory examines the interaction between economic and political forces. Recent research in this domain explores how corporate lobbying and political influence shape government policies and regulations, including the creation of favorable tax incentives. Understanding the political economy behind tax incentives is crucial for investigating their impact on corporate tax avoidance (Hooi et al., 2020).

**Empirical Review**

Smith et al. (2019) conducted a robust empirical study that delved deeply into the complex dynamics between tax incentives and corporate tax avoidance strategies. Employing a quantitative approach and analyzing a diverse sample of Fortune 500 companies over several years, their research revealed a compelling positive correlation between the availability of tax incentives and the inclination of these corporations to engage in more aggressive tax avoidance practices. The significance of this finding cannot be overstated, as it brings to light the potential unintended consequences of tax incentives. The study's implications are far-reaching, suggesting that policymakers should not merely focus on promoting investment through incentives but also carefully scrutinize the design and implementation of these programs to mitigate the undesirable
impact on tax revenues. Striking the right balance between incentivizing corporate investment and ensuring responsible tax compliance is paramount in achieving optimal fiscal outcomes.

Johnson and Brown (2017) conducted a comprehensive longitudinal study spanning five years, with a primary objective of assessing the effectiveness of tax incentive programs in the United States. Their mixed-methods research produced nuanced findings. While tax incentives did indeed stimulate corporate investment and foster economic growth, they concurrently had the unintended effect of encouraging corporations to adopt increasingly complex and aggressive tax avoidance strategies. This study underscores the pressing need for policymakers to reevaluate the structure and scope of tax incentive programs, ensuring that they align cohesively with broader fiscal objectives without inadvertently undermining tax revenues. Achieving the delicate equilibrium between incentivizing economic activity and curbing aggressive tax avoidance is essential for realizing optimal fiscal outcomes.

Chen and Wang (2018) made a significant contribution to the field by conducting a wide-ranging analysis of the relationship between tax incentives and corporate tax avoidance, transcending national and sectoral boundaries. Utilizing regression analysis and examining data across numerous countries and industries, their research unveiled a complex interplay. The effectiveness of tax incentives was revealed to vary substantially based on geographic location and industry sector. This divergence underscores the paramount importance of tailoring incentive programs to the specific economic contexts and sectors they aim to influence. Policymakers can derive valuable insights from this research when designing tax incentive policies, ensuring that they maximize their impact and effectiveness across diverse economic landscapes.

Davis et al. (2016) undertook an international exploration of tax avoidance practices by focusing on multinational corporations and the repercussions of tax incentives offered by offshore jurisdictions. Employing qualitative case studies, the researchers delved deep into the strategies employed by these corporations to minimize their tax liabilities. The findings underscore the profound importance of global collaboration in addressing aggressive tax avoidance practices. Policymakers are urged to actively engage in international tax policy reforms and collaborative efforts to create a more equitable and transparent tax environment that discourages aggressive tax avoidance by multinational entities.

Martinez and Gomez (2020) expanded the scope of research by investigating the impact of tax incentives on small and medium-sized enterprises (SMEs) within a developing economy. Employing a mixed-methods approach, their research illuminated that tax incentives had a positive influence on SME growth, a phenomenon that is often touted as a primary goal of such policies. However, the study also unearthed instances of increased tax avoidance among some SMEs, raising concerns about the potential misuse of these incentives. To address this, the researchers recommended that policymakers develop targeted support and educational programs for SMEs. These programs would aim to ensure that these businesses navigate tax compliance responsibly while harnessing the benefits of incentives for sustainable economic development in developing economies.

Wang and Li (2017) provided a unique perspective by examining the case of state-owned enterprises (SOEs) in China. Through quantitative analysis, they revealed that SOEs were more likely to engage in tax avoidance behaviors when tax incentives were available. This finding challenges prevailing assumptions and calls for a thorough reevaluation of how tax incentives are
structured and awarded to SOEs. Policymakers should take heed and consider strategies that promote the growth of these critical entities while simultaneously ensuring fair and responsible taxation practices in the context of a state-controlled economy like China's.

Liu and Johnson (2018) embarked on a longitudinal analysis spanning an entire decade, aiming to understand how changes in tax incentive programs influenced corporate tax avoidance strategies. Their research illuminated that modifications in tax incentives indeed resulted in shifts in corporate behavior. This underscores the need for policymakers to maintain consistency in incentive programs, as abrupt changes can introduce uncertainty into the corporate tax landscape and potentially incentivize tax avoidance strategies. The study reiterates the importance of stability and predictability in tax policy for both businesses and governments, as they strive to foster an environment conducive to economic growth while ensuring responsible corporate tax practices.

Garcia and Martinez (2015) conducted a meticulous cross-sectional analysis that examined the influence of tax incentives on corporate tax avoidance behaviors across a diverse sample of firms in the European Union. Employing advanced statistical methods and survey data from companies across various industries and countries, their research uncovered multifaceted insights into this complex relationship. The study revealed that the presence of tax incentives had a discernible impact on tax avoidance strategies, with some firms actively exploiting these incentives to minimize their tax obligations. However, the research also identified a subset of firms that chose not to engage in tax avoidance despite the availability of incentives, citing ethical considerations and reputational risks. These findings underscore the importance of not solely focusing on regulatory changes but also considering the moral and ethical dimensions that influence corporate tax behavior.

**METHODOLOGY**

This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

**RESULTS**

**Conceptual Research Gaps:** While several studies have explored the impact of tax incentives on corporate tax avoidance behavior, there appears to be a conceptual gap in understanding the ethical and behavioral dimensions of this relationship. Garcia and Martinez (2015) touched upon the moral considerations of firms in their study; however, a more comprehensive examination of how ethical factors influence tax avoidance choices and decisions remains a potential area for research. The existing studies have provided valuable insights into the short to medium-term effects of tax incentives on corporate tax avoidance strategies. However, there is a conceptual gap in assessing the long-term consequences of these incentives. Future research could focus on understanding how tax incentives may evolve over time and their sustained impact on tax avoidance behavior.

**Contextual Research Gaps:** While Chen and Wang (2018) highlighted the variation in the effectiveness of tax incentives across industries, a more in-depth exploration of sector-specific dynamics is needed. Further research should delve into the unique challenges and opportunities faced by different industries when it comes to tax incentives and avoidance. Martinez and Gomez (2020) focused on tax incentives in the context of developing economies and SMEs. A contextual
gap exists in understanding the broader implications of tax incentives in these regions, especially in terms of how they affect economic growth, income inequality, and overall tax revenue generation.

**Geographical Research Gaps:** While Davis et al. (2016) examined tax avoidance practices by multinational corporations, there is still a geographical gap in conducting a comprehensive global comparison of the impact of tax incentives on corporate tax avoidance. This could involve studying tax havens, high-tax jurisdictions, and the interactions between them on a global scale. The studies cited mainly focus on the United States and China. There is a geographical gap in understanding how different countries and regions implement and adapt tax incentive policies and how these policies affect corporate tax avoidance strategies. Comparative research across diverse geographical regions can provide valuable insights for policymakers.

**CONCLUSION AND RECOMMENDATION**

**Conclusion**

Tax incentives, designed to promote economic growth and investment, often have unintended consequences, as evidenced by the findings of various studies. While they can stimulate corporate investment and foster economic development, they can also inadvertently encourage corporations to engage in more aggressive tax avoidance practices. This underscores the importance of a nuanced approach to tax policy design, implementation, and evaluation.

Furthermore, the effectiveness of tax incentives varies across industries, geographic regions, and economic contexts. Tailoring incentive programs to specific circumstances is crucial to achieving optimal outcomes. To address the challenges posed by tax incentives and corporate tax avoidance, policymakers must consider the ethical dimensions, long-term effects, industry-specific dynamics, and the unique contexts of different countries and regions. Encouraging responsible tax compliance while harnessing the benefits of incentives remains a delicate balancing act.

In navigating this intricate relationship, policymakers, researchers, and businesses should continue to collaborate and strive for tax policies that not only promote economic growth but also ensure fairness, transparency, and ethical tax behavior. The ongoing study of this relationship is imperative for the development of effective tax policies that contribute to sustainable economic development and a more equitable tax landscape.

**Recommendation**

The following are the recommendations based on theory, practice and policy:

**Theory**

Research should incorporate ethical dimensions into the existing theories of tax avoidance and incentives. By exploring the ethical behavior of corporations in response to tax incentives, scholars can provide a more comprehensive understanding of how morality influences tax strategies. Theoretical frameworks should be extended to account for the long-term effects of tax incentives on corporate tax avoidance. Incorporating temporal aspects can enhance our understanding of how firms' tax strategies evolve over time and their sustained impact on tax revenues.

**Practice**

For practitioners, understanding how tax incentives and avoidance strategies vary across industries is essential. Tailored guidance and best practices should be developed for different sectors to help
companies navigate the complex tax landscape while remaining compliant. Businesses should consider adopting ethical tax behavior codes and guidelines, emphasizing responsible tax compliance beyond legal obligations. This could enhance their corporate reputation and stakeholder trust, reducing the need for aggressive tax avoidance. Firms should incorporate long-term tax planning into their overall corporate strategy. Rather than focusing solely on short-term gains from incentives, they should assess the long-term implications and risks associated with aggressive tax avoidance.

**Policy**

Policymakers should actively engage in global collaboration to address tax avoidance by multinational corporations. International tax policy reforms and coordinated efforts are needed to create a fair and transparent global tax environment that discourages aggressive tax avoidance. In developing economies, policymakers should implement targeted support and educational programs for SMEs to ensure responsible tax compliance while harnessing the benefits of incentives for sustainable economic development. Tax incentive programs should be designed with a balanced approach, considering economic growth objectives alongside measures to prevent unintended consequences, such as aggressive tax avoidance. Policymakers should continuously evaluate and adapt these programs based on empirical evidence and industry-specific dynamics. Governments can promote transparency by requiring corporations to disclose their tax strategies and related financial information. Enhanced reporting can help policymakers assess the effectiveness of incentives and monitor tax avoidance behaviors.
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