THE EFFECT OF TAXES AND LEVIES ON THE PROFITABILITY OF SUGAR FACTORIES IN KENYA

BY

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DECLARATION

I certify that this research is my original work and has not been presented for a degree in any other university.

Signed: ____________ Date 4/11/2008

George William Otieno

I confirm that the work reported in this research project was carried out by the candidate under my supervision as University Supervisor.

Signature: ____________ Date 04-11-08

R. Maganjo

DEDICATION

Dedicated to my father Michael Otieno Orwa and mother Mary Adero Otieno.

ACKNOWEDGEMENTS

I wish to acknowledge the following persons by name; my supervisor Mr. R. Maganjo who supported me during the research proposal and project work, my wife Sarah and children Emma, Edwin and Velma who gave warmth and encouragements even when all did not seem well.

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Thanks be to the Almighty God for He cared for me and through His will, manage to go this far.

ABSTRACT

The objective of the study is to examine the effects of taxes and levies on the financial performance of sugar factories in Kenya. The study has been occasioned by repeated calls to the government by the millers, growers associations and national leaders (especially from the sugar growing zones) for the rationalization of the taxation regime relevant to the industry. The performance of the sub-sector continues on a downward trend despite efforts by the government and the various stakeholders to revamp it, a fact that threatens its very existence. The initiatives that have so far been taken, sad to say, have seen very little success with the sub-sector sinking deeper into the seemingly unending problems. Earlier researches have recommended further investigations into the problems bedeviling the sub-sector.

The researcher collected data from all the institutions with stakes in the sugar sub-sector. The data were collected from both primary and secondary sources. The primary data were be collected from the management in the sugar factories through designed questionnaires. The secondary data were be collected from the millers, other formal institutional publications, journals and reports.

The results of the research will be used to give more insights into the perceived income and pricing distortions caused by the tax regime in the industry. It will enable the millers and other stakeholders to push the agenda for the scrapping or reduction of taxes and levies in the sub-sector. This will in effect allow the millers to pass down the benefits to the consumers in terms of price reductions. The financial bottomlines of the factories are likely to improve since the levies and taxes contribute to the high cost of producing sugar. The sub-sector is likely to be attractive to prospective investors since its viability as an investment will be clearer from the tax reduction strategy. The researcher expects to show by analysis how the impact of taxes and levies affects the profitability of the milling factories.

The final report will be made available to all key stakeholders in the sugar sub-sector for evaluation and implementation. The results of the study will also be used for any further research in the sugar sub-sector.

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Definition of Terms

ACP	African, Caribbean and Pacific Countries
EAC	East African Community
EU	European Community
COMESA	Common Market for Eastern and Southern Africa
KSB	Kenya Sugar Board
SADC	South African Development Community
SOC	Sony Outgrowers Company
NOCO	Nzoia Outgrowers Company
MOCO	Mumias Outgrowers Company
SDL	Sugar Development Levy
VAT	Value Added Tax
PTA	Preferential Trade Area
US	United States
LDC	Least Developed Countries
KSCCT	Kenya Society for Sugarcane Technologists
KRA	Kenya Revenue Authority
SUCAM	Sugar Campaign for Change
RI	First Ratoon
RII	Second Ratoon
KESGA	Kenya Sugarcane Growers Association
KESMA	Kenya Sugar Manufacturers Association

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Sugarcane was introduced in Kenya in 1902 by the Asians who had come to build the Uganda railway. The first sugar factory was established at Miwani near Kisumu City, Nyanza Province in 1922 and later at Ramisi at the Coast in 1927. Since then, the government has been widely involved in the expansion of sugar production through investments in sugar factories. In Kenya, sugar is produced from sugarcane crop. The crop's lifecycle is 5 years made up of plant crop maturing at 18 months, first and second ratoons (RI and RII) both maturing at 16 months. The international perspective is however different in that some countries like the ACP and EU countries produce sugar from sugar beets.

For most millers, successful sugar production is all about return on-investment. Most countries the world over find the sugar industry very vital in their economic wellbeing. The local sugar factories have been hit by declining profit margins for the past five years. For this reason, cost reduction, which includes tax reforms, is a major consideration of the millers in pursuit of efficiency and profitability.

Sugar is a universal foodstuff and its consumption rises by the day. It is, therefore, fortunate that sugarcane is a crop that has natural sustainability. This natural sustainability has been augmented by a broad scope of technological advances which promotes additional sustainability. Agronomic productivity has been improved and will continue to be maintained by evolving technology with enlightened management. Planning and better land use, the opportunity to transform technology into profitability for sustainable sugar production all translate into high returns which is the prime objective of the millers. Every country is either a producer and exporter, or importer of sugar, which underscores the critical importance of this commodity. The global sugar consumption and production should virtually be equal as witnessed in 2001 when the world sugar economy struck a balance. Before this year, significant statistical surpluses were experienced for five (5) years. There are however indications that a net worldwide shortage will be experienced due to the paradigm shift which is likely to see sugar replaced as the main product in favour of other products like co-generation, production of ethanol as fuel substitute and biogas (*Sugar & commodity Journal, June 2006)*. Globally, the sugar sub-sector has a trail of problems that date back to over a century. The problems are not unique to any particular country but they occur in different geographical locations.

1.1.1 The Local Sugar Sub-Sector

The Kenya Sugar Industry consists of seven factories namely Chemelil, Sonysugar, Miwani and Muhoroni all in Nyanza Province; Mumias, West Kenya and Nzoia in Western Province. The government has a majority shareholding in all the factories except Mumias and West Kenya, which are privately owned. Plans are at advanced stages by the government to put up another sugar factory along River Tana and revive the collapsed Ramisi Sugar factory at the Coast. All the factories, except West Kenya have own farms referred to as nucleus estate and expansive blocks of farms belonging to outgrower farmers.

The outgrowers farms provide about 87% of the sugarcane processed by the factories. The nucleus estates are fully financed and managed by the individual sugar factories, and act to stabilize cane supply to the factory. In most of the factories, farmers have formed outgrower companies which provide certain services to the members. They include Sony Outgrowers Company (SOC), Muimias Outgrowers Company (MOCO), and Nzoia Outgrowers Company (NOCO). Their primary role is to facilitate the growing of sugarcane through provision of loans for cane development.

The services provided by the outgrowers companies range from provision of credit for sugarcane production through loans and capital levy for land preparation, seedcane and fertilizer supplies, etc, to provision of agricultural extension services to the members. The millers have organized themselves under the Kenya Sugar Manufacturers Association (KESMA) and handle harvesting and transportation of cane to the factories although this has proved to be a burden on their cash flows. All services rendered are charged on the farmer's account, and deducted from the final cane proceeds plus interest.

1.1.2 Management of the Sugar Sub-Sector in Kenya

Management of the local sugar factories has for a long time been in the hands of management agents from foreign countries. This was happening under the false guise that there was no local expertise to manage the sugar factories. These technical agents had their mission, vision and objectives stemming from their mother country's development plans. Most likely, these were different from the local sugar factories they were managing. The negative growth of the sub-sector has been associated with its being entrusted to foreigners under very loose terms. Even as concerted efforts are being made to revert the management of all the sugar factories to the locals, political patronage seems to be taking centre stage, another problem that might augur well for the development of the sub-sector. The highest office in the sugar factories, that of the Chief Executive, is political and appointment to the position is done without testing the technical competence and ability to effectively manage the factories. This has been one of the reasons advanced for the poor performance of the sub-sector.

1.1.3 International and Regional Sugar Markets

The trend towards globalization is unstoppable and the sugar trade has not been left behind in this race. With the advent of e-commerce, countries around the world and in specific regions are increasingly forming trading blocs in order to trade competitively. These trading blocs are formed through agreements between the member states of sugar producers. There are four regimes under which sugar is traded in the world namely the Preferential and Quota e.g. EU-SPS, International Sugar Agreements, Free trade Arrangements e.g. EAC, COMESA, SADC and Residual Free Market in Sugar. The main objective of these regional-trading blocs is to push for free trade areas with no barriers and zero or reduced tariffs within member states. Kenya is a member of EAC, COMESA and EU-ACP Cotonou Partnership Agreement. Being a member and signatory to international and regional trade arrangements has got far-reaching effects for the local sugar sub-sector (Dr. Otieno Odek *at al., The challenges and Way Forward for the Sugar Sub –sector in Kenya).*

1.2 Statement of the Problem

In recent years, the performance of the sugar sub-sector in general and that of the sugar factories in particular has been a source of concern to the national economy. Kenya has not realized its dream of achieving self-sufficiency in sugar production despite the huge stakes in the sub-sector and the efforts to do so. The average annual national demand for sugar in Kenya is put at about 630,000 tonnes of sugar while the local subsector can only produce 400,000 tonnes (*Dr. Otieno Odek, P. Kegode and S. Ochola-2003).* Strangely, Kenya was a net exporter of sugar in the 1980s (*Business Africa, 1999*). Presently, some sugar factories are in receivership while some are faced with imminent collapse due to huge debt burden and the inability to sustain their operations since they are not able to break-even.

A good proportion of this burden is attributed to taxes and levies. The sugar industry is heavily taxed with the result that the gains accruing to the farmers and millers are heavily eroded through punitive taxation. High taxation levels are in the form of Value Added Tax (VAT) -16%, CESS -3% and the Sugar Development Levy (SDL)-7%. These taxes are charged on gross sugar sales irrespective of any costs incurred in the processes. What this means is that the taxes and levies are like operation costs deducted from gross sales. Most millers are, therefore, in tax arrears. The ultimate goal should be to significantly reduce or scrap some of the taxes so that the factories can return to profitability and attract further investments. The government will then get its taxes from the improved profits in form of corporation tax. The deficit or shortfall in sugar production can be narrowed by increased activity resulting from the tax incentives. The country can then be nearing its dream of becoming self-reliant in sugar. This is possible given the factories capacities so long as the appropriate move to undertake tax reforms in the industry is taken.

There have been calls from the farming community, the millers, the farmers associations like KESGA and lobby groups that the government should extend the tax incentives introduced in the coffee industry to the sugar sub-sector. The government is yet to give a last word on these demands. Their level of indebtedness continues to rise mainly with the factories resorting to short-term sources of finance to continue with operations. In addition to the heavy tax burden, this is normally very expensive and has got a negative impact on their income. Kenya being a subscriber to the regional Free Trade Area (FTA), there is also the threat of sugar from the regional and world markets given the global trade liberalization. Of great concern is how the tax money is used to help in further development of cane. The infrastructure in the sugarcane growing zones remains in pathetic condition without government and local authority subsidies. The SDL has not been used effectively for the purpose the fund was created and farmers only crave for advances on harvested cane from the millers for cane development.

The millers and farmers associations are of the view that taxation in the industry is too heavy with the government not taking any action. Although a few factories have returned to profitability, the tax burden should be critically looked into to ensure their continued existence.

1.3 General Objective of the Study

The purpose of the study was to analyse the impact of the present taxation on the profitability of sugar factories in Kenya.

1.4 Specific Objectives of the Study

i) To establish the influence of Value Added Tax on the profitability of the sugar factories in Kenya.

ii) To establish the influence of Sugar Development Levy on the profitability of the sugar factories in Kenya.

iii) To establish the influence of Local Authority Cess on the profitability of the sugar factories in Kenya.

1.5 Research Questions

i) Is the government's laxity to reduce taxes and levies the cause of poor performance of the sugar factories in Kenya?

ii) Is the cost of sugar production in Kenya very high due to the prohibitive taxes and levies?

iii) Can tax reforms spur increased production and increase the income or profitability of the sugar factories?

iv) Is the high rate of taxes and levies the reason for the huge tax arrears owed by the factories?

v) Do the high tax rates in the industry contribute to the high cost of locally produced sugar thus encouraging importation of sugar at cheaper prices?

vi) Does the payment of VAT, SDL and Cess in addition to corporation tax on any profits made by the sugar factories amount to double taxation?

1.6 Statement of Hypotheses

The sugar factories are heavily taxed and this could be one of the factors why most of them do not break-even and are therefore loss making. This being the case, the millers have resorted to short- term sources of finance to continue with operations. The cost of farm inputs continues to rise contributing to the overall rise in production costs per ton. The industry is still threatened by importation of cheaper sugar even after taxing the imports at more than 100 percent. The government's warning to the factories to either perform or close without any financial support is another blow to the sub-sector. The factories can operate profitably with tax reforms and reorganisation.

The null hypothesis: There is no significant effect of the taxes on profitability.

The alternative hypothesis: There is a relationship between the taxes and profitability.

$$T = \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3$$

Where T= Profitability

x_1, x_2, x_3 = VAT, SDL and Cess respectively

$\beta_1, \beta_2, \beta_3$= Coefficients of x_1, x_2, x_3 respectively.

1.7 Assumptions of the Study

The study assumes that:

i) The tax rates will remain constant for the study period.

ii) The sugar factories will pursue the profit maximization objective.

1.8 Significance of the Study

The study focuses on the tax structure in the Kenyan Sugar Sub-sector and the prospects of improving the profits of the factories (millers) by necessary tax reforms. It also looks at the possibility of the sub-sector regaining its international and regional position in production and export levels that started declining in the early 1990s. Currently, the country is a net importer of sugar from other world producers to meet the 200,000 tons deficit in annual demand. The local sugar factories are able to increase production to meet the shortfall by attracting more investment with an improvement in their profits.

The government also provides regional economic balance through the sub- sector. A large proportion of the population in Western Kenya depends on the industry as their economic backbone. The role played by the sub-sector in resource generation and allocation dictates that necessary steps should be taken to sustain the industry. The study aims to make the industry more attractive to prospective and existing investors. The decline of the sugar sub-sector is not affordable with the kind of strategic plans of achieving the millennium development goals or industrialization by the year 2021. About 52% of Kenyans live below the poverty line and the collapse of the sugar sub-sector implies reduced income to the 25% of the population that depends on the sub-sector. The study will also be important to the following groups in sub-sector.

i) The Management

This is the group that mills cane and processes it into sugar and its by-products. They are the hardest hit with the problems in the sub-sector. When they operate the factories efficiently and generate profits, the benefits will accrue to other stakeholders. The sugar factories and outgrowers institutions are expected to thrive and increase employment opportunities. They are expected to be profit-making and be able to invest in new technologies and produce more cheaply. Sugar factories are the hub of the sub-sector since resources in the factories flow from the sub-sector into the economy. The study will identify some of the problems that have made it difficult for the sugar factories to generate resources. More insight on how the tax money is used will be given and this can be used to push for the reforms.

ii) Stakeholders

The Government

This is the major shareholder in most sugar factories in the sub-sector. As an investor, it requires good returns on her investment in the sub-sector. The continued existence and growth of the industry assures the government of the possibility of creating employment opportunities which is one of its major responsibilities. The government's interest is also amplified by the simple reason that the sugar sub-sector is a source of revenue generation through taxes. The sugar sub-sector is important to the government since it is a key player in its economic development programmes.

The Sugar Farmers

They are the ones that grow the cane that is processed into sugar. The sugar growers have organised themselves into outgrowers institutions. These institutions face so many problems that they are unable to deliver on their development role and as the voice of the farmers in the sub-sector. This study intends to give insight into some of the problems. The results of the study should provide information that will help the outgrowers institutions become viable concerns. The farmers will benefit from transformed outgrower institutions. Such benefits will be reflected in increased crop yields and better provision of services.

The Public

The decline of the sugar sub-sector can impact negatively on the national economy. This decline can directly affect the general public because income to the government is reduced which may imply increased taxes, borrowing or compromise on some of its development programmes.

It is hoped that the factories will operate more efficiently with the likelihood of lowering the price of the commodity for the benefit of the public. There will, therefore, be an added advantage of corporate social responsibility to the communities. The study will also be used for further research in the sugar sub-sector and possibly in other agriculture sub -sectors. The research is expected to shed light on different perceptions many people have on the sub-sector. It is hoped that the sub-sector will grow and increase economic development with the findings of this research.

1.9 Scope of the Study

The study seeks to analyze the effects of taxes and levies on the profitability of sugar factories in Kenya. The scope will cover the factories in the sub- sector and will be conducted in the sugar growing zones in Western Kenya. The study will concentrate on analysis of key effects of taxation as one of the major problems in the sugar sub - sector in Kenya. The problems are many and are interrelated while some are insignificant to warrant a study.

1.10 Limitations of the Study

The researcher anticipates to encounter the following limitations during the study.

Cost

The costs, right from the preparation stage, proposal writing to data collection and report writing are expected to be high. The researcher cannot fully meet these costs because the study is self-sponsored. The geographical disparity of data collection regions is a major factor contributing to prohibitive costs.

Time

The study is required to be complete in about 3 months period. This period may prove inadequate for the study given that events not anticipated can occur due to uncertainty. Difficulty in obtaining financial statements, power interruptions, weather changes etc are some of the factors that may lead to non-completion within the time limits.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction to Literature Review

Studies conducted on the sub-sector have highlighted pertinent issues which give insight into the problems in the industry. A number of studies and publications on challenges and trade liberalization in the industry have left open options for further investigations on the sub-sector. The end to problems in the sub-sector is a distant dream, a fact suggesting that the players in the industry have not fully appreciated the cause of the problems (*P.B.Ojera-MBA-ESAMI, 2001).* Indications are that concerns are on the solutions rather than on the root cause of the problems. The international sugar journals and the sugar news magazines show that the troubled sugar factories can profitably use some of its by-products to increase their level of income *(The Kenya Society of sugarcane Technologists-KSSCT-Proceedings of the 10th Biennial Congress).* There is also modernization of production methods being adopted worldwide which the factories need to embrace. A consensus appears to have been reached by the local and regional sugar factories to expand their crushing capacities as reported in Kenya, Uganda and Tanzania (*The Sugar News, Issue No. 004-May/June 2005*).

2.2. Previous Studies Done in the Area

2.2.1 Trade Liberalization Effects

The sugar market was not left out in the liberalization of financial and commodity markets in Kenya. However, before the liberalization, the selling price of sugar was controlled by the government at three levels namely: ex-factory, wholesale and retail. These were the good old days when pricing was being fixed after factory production costs were put into consideration. This is no longer feasible with the liberalized markets. The sugar factories are subjected to competition beyond the Kenyan borders and are to consider such factors as quality, conducive trading environment, production costs, alternative production methods, alternative uses for the by-products etc. (P.B.Ojera-MBA-ESAMI, 2001). Publications and research reveal that free trade has a significant effect on the local sugar industry. With liberalization, the scenario in sugar price determination has changed, heralding the era of import parity pricing. Kenya being a price-taker in the world sugar market has to use the import parity price as a guide for local production costs (Njeru, 1996:31).

Research based on a number of parameters, e.g. analysis of sugar held in stores by the millers, analysis of farmers problems, import prices, local sugar retail prices, production levels, challenges and way forward for the sub-sector (Odek Dr. Otieno, P. Kegode and S. Ochola-2003) etc. recommends that further work is necessary on why the local sugar factories costs are higher than those in other countries. The research also reveals that even with protectionism, the industry still looks unstable with complaints of slump prices.

2.2.2 Financial Performance of the Sub-sector

The performance of the local sugar factories has for a long time been on a downward trend. This has earned them a lot of negative publicity in the local media. Further analysis of the reports of the local sugar industries shows that even for the few that have recently posted some profits, the debt ratios are still high meaning that they are highly geared. A quick comparison of the factory debts against other parameters is that the sugar factories which form the hub of the sugar industry are highly indebted and may not recover without a major reorganization and modernization of the production processes to reduce costs. The factories are faced with various problems ranging from poor management to high taxation and investment costs, which have adversely affected their profitability and general economic performance (see Table 1 below). With the economic slump witnessed in the sub-sector, most factories are unable to meet their financial obligations like loan repayments, some of which are denominated in foreign currencies. The sugar factories and grower institutions are best described as technically insolvent and, therefore, cannot attract new investors. This situation forces them to satisfy their working capital needs through short-term financing like overdrafts which are very costly in terms of both principal and interest payments.

Most of the factories operate below their rated capacities of through, put due to operational difficulties like use of old mill technology and cane shortage. On the other hand some factories are unable to cope with the glut of cane due to poor planning leading to lost milling opportunities. The debts written off and the provisions for debts in their books manifest lack of aggressiveness in managing the finances of the factories.

The upfront taxes, escalating overhead costs and reduced production in the sub-sector impact negatively on profitability (P.G.Kaumbutho, L.M.Awiti, E.G.Karuri, Analysis of Sugarcane and Sugar Production Costs). Theoretically, taxes should be charged on profits after all expenses have been deducted (Lewis and Pendrill- Advanced Financial Accounting, 5th Edition). The above scenario is, therefore, largely seen as giving rise to double taxation and reducing profitability of the factories.

2.2.3 Sugar Markets

The raw sugar producing countries are expanding production of white sugar to meet their own domestic demands and for export to countries without refined sugar production. The raw sugar export market, on the other hand, is increasing in volume, primarily because of increases in fructose syrup utilization in the U.S. and Europe and white beet sugar production in Europe. Decline in refinery production, and the quota purchase system in the U.S. have increased the quality specifications in the raw product *(The Kenya Society of sugarcane Technologists-KSSCT-Proceedings of the 10th Biennial Congress).* The proposed sugar reforms of the EU sugar regime tabled by the European Union in 2005 recommended the slashing of sugar prices by 39% over a four year period. This threatens to devastate the economies of ACP/LDC countries supplying sugar to Europe under the EU-ACP sugar protocol *(9th ACP Conference report-2005).* Competition and over production in the world market adds impetus to this situation.

Sugar producers must, therefore, consider higher product quality to sell on a liberalized or competitive market. There are many advantages to the producer, in addition to the competitive advantage. Higher product quality is concurrent with better yields, lower sugar losses, and offers price and other incentives to the producer.

But export markets are not the only consideration – the production of white sugar by raw sugar producers, for instance, is of increasing importance due to the constant upsurge in usage in the industrial and pharmaceutical sectors.

Kenya is still a net importer of sugar (mainly refined sugar) but other types of sugar are now found on the liberalized market (transit sugar) which are cheaper than the locally produced mill- white sugar. The situation calls for concerted effort by the sugar industry to look into ways of increasing through-put, reducing production costs through improved efficiencies so that the locally manufactured sugar can enjoy economies of scale and compete favourably with imported sugar from the local and regional markets.

2.2.4 New Technologies in Sugar Production

Investment in sugar industry has been steeped and long-overdue rationalization and modernization is now under way, focusing on beet agriculture, factory automation, efficient use of energy and water and improvement of sugar quality to compete with the best in the world (*International Sugar Journal-October 1999*). In Kenya, Mumias sugar factory has taken the lead in embracing new technology with the installation of a diffuser and factory automation processes. (*The Sugar News Issue No. 7-2005*). In Mauritius, a number of sugar factories which were manufacturing sugar for export to the EU market closed down when the agreement came to an end because of failure to invest in modern technology that would reduce their costs of production. Many sugar factories all over the world that have not responded to modern methods of production have been facing similar problems and they find it difficult to survive where prices are left to the market forces of supply and demand.

2.2.5 Farmers' Attitudes Towards Cane Growing

Most farmers feel that cane growing no longer satisfies their desired economic needs. Farmers' lobby groups are encouraging the government to close sugar companies arguing that they are heavily indebted and that they are living in debt. These groups have even attempted boycotts over unpaid cane proceeds and more recently the transfer of SDL from the consumer to the farmer *(The Sugar and CommodityJournal, June 2006).* An investigation of the effects of economic liberation on the sugar sub-sector in Kenya cited the source of farmers' dissatisfaction as lack of money occasioned by delayed farmers payments and the high rate of taxes. The study carried out in 2001 revealed that only 57 percent of the farmers across the cane growing zones deem sugar cane growing as satisfactory, with most describing sugarcane as a good venture. This group with the opinion that the sugar sub-sector in Kenya has a solid future however cites delayed payments, rising cost of input charges relating to fertilizers, loan interest and harvesting and transport charges as not healthy (P.B.Ojera-MBA-ESAMI, 2001). The delayed harvesting of cane, some of which is above the harvesting age as spelt in the Sugar Act 2001 is likely to aggravate the above scenario.

2.2.6 Pricing of Sugarcane

The pricing of sugarcane is one of the most crucial determinants of profitability. It is one of the most important variables in the growth and sustainability of the sub-sector.

This is for the simple reason that the revenue collections and profitability rely on the selling price of the product. In the liberalized Kenyan sugar market, specific standards are normally stated in purchase contracts for imported sugars. Therefore, remains between willing seller and willing buyer to peg the price on quality parameters (*The Kenya Society of Sugarcane Technologists-KSSCT-Proceedings of the 10th Biennial Congress).* Though the government has subscribed to the liberalization treaties, it has not reflected this by her efforts to control the price of sugarcane, which accounts for more than 65 percent of the factories inputs (A thesis by O.Waringa, Egerton University 2003). Sugar prices have been fluctuating widely making the revenues of the factories and other stakeholders unpredictable. The pricing aspect of the commodity has had far-reaching influences on the industry.

2.2.7 By-products of Sugar Manufacturing Process

There are a number of by-products in the sugar process. They include molasses, baggasse, co-generation, industrial alcohol, particle board, bio-compost and filter scums. Technological developments world over have made it possible for these by-products to be used as raw material in the production of other products. The slump of sugar price in the world market coupled with instability of same prices has affected factories that breaking even and achieving profitability without diversification into the manufacture of other useful products from the by-products is difficult. In Kenya, the factories have not fully taken the advantage of this except Mumias Sugar Company which has ventured into co-generation and is currently supplying 2.2 MW to the national grid.

2.3 Critical Review of Major Issues

Studies in the sub, sector have cited high taxation in the sub sector as one of the causes of high cost of production. Most of these taxes are consumer taxes levied on the millers at the point of sale of sugar as the product. The SDL is a levy that runs the regulator, KSB and a good part of it is on-lent to farmers through the outgrower institutions or to the millers at an interest rate of 3%. VAT which is supposed to be a neutral tax between factor costs is taking a large amount of income generated by the millers which they are unable to claim fully due to lower corresponding VAT input tax on purchased items. The argument that taxes in the sub, sector have contributed to high production costs looks tenable on grounds research. In view of the important role the sub-sector plays in the economy, various stakeholders have voiced concern on the need to reduce taxes in the sub-sector since the taxes stifle growth of the sub-sector (*Cabinet Memorandum on Revitalization of the Sugar Industry-2006*). The government, on the other hand, views taxation in the sub sector as a way of earning revenues to finance some of its development plans. Despite being a contributor, the sub- sector has not been adequately funded and that has been cited as one of the reasons why its performance has not been impressive (*Stakeholders meeting on Sugar Sub- sector Strategic Plan Review-July 2006).* As the stand-off between the government and stakeholders on high taxes and levies persists, there is every benefit in trying to have a critical review of the taxation regime, tax components and regulation to fully understand the underlying effects and suggest useful reforms.

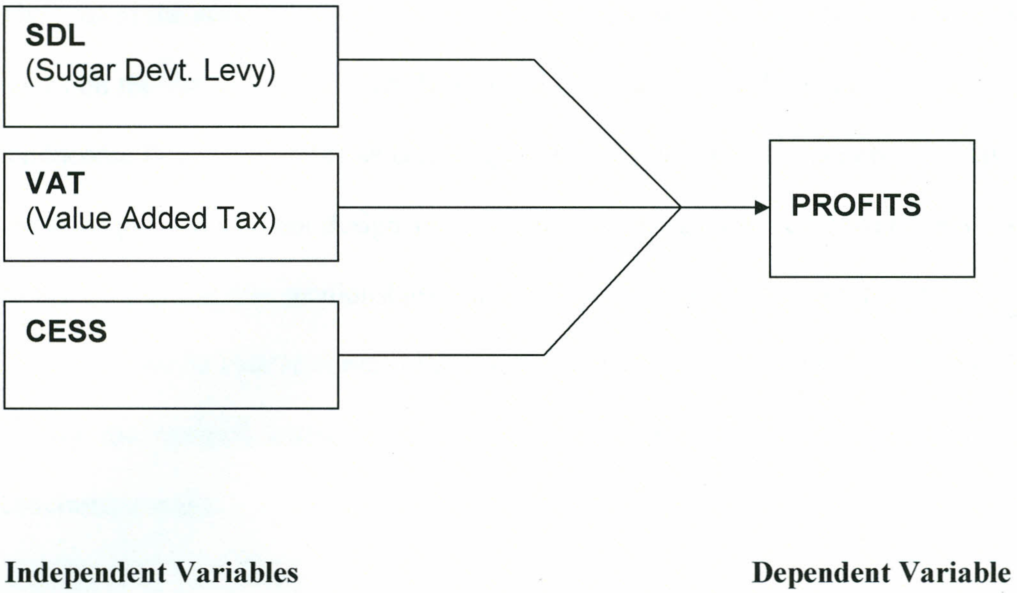
2.4 Summary and Gaps to be Filled by the Study

The study is meant to give a clear relationship between high taxation in the sub-sector and the profitability of the sugar factories. The management of the sugar factories have been in the forefront in condemning the government for high taxation in the sub-sector. They are also on record as stating that this has been the cause of high production costs and, therefore, low profitability. However, these pronouncements have had no research backing to prove their validity. The study hopes to fill this gap.

2.5 Conceptual Framework on Effects of Taxation on Profitability

In recent times, there have been concerns that one of the major contributors to problems facing the sub-sector is punitive taxation. Although this may be tenable on grounds of revenue provision to the government, the millers and other stakeholders find it difficult to address the problem collectively given that the effects do not impact on them in the same way. The sub-sector has, therefore, been thrown into disarray with most of the factories expected to continue recording huge losses. The government takes the taxes upfront with the effect that the incomes of the factories are considerably eroded. Apart from the fact that it fails to listen to repeated calls by the farmers associations, it is also likely that levy remittances from the millers to it are dwindling, compounding their debt burden. This will negatively affect those who rely on the millers as a source of revenue. Sugar prices are also bound to increase while the cane prices are likely to remain as they are. Late payment of cane proceeds to farmers may lead to farmers resentment with a possibility of most of them quitting the business altogether. But if the tax burden is reduced, the effects will be felt by all the stakeholders in terms of better sugar prices, corporate tax payments, prompt levy remittances, etc.

Figure 2.1: Effects of Taxation on Profitability.



Source: Researcher

CHAPTER THREE

METHODOLOGY

3.1 Research Design

The goal of the research was to carry out an in-depth study of the effects of taxes and levies on the income of the sugar factories in Kenya. This will entail the analysis of the income statements of the selected sugar factories and how the tax effects relate to the trading results. This design is quantitative and was selected because it is best suited to describe the relationships between the variables. The significant problem variables were be used to conduct the study which should test the hypotheses and also answer the research questions. The results of the study form the basis of the conclusions made.

3.2 Target Population

The study targets the seven sugar factories as the main stakeholders in the sugar sub-sector. They manufacture and sell sugar, apart from paying all the government taxes and levies. They are expected to provide information on most problems on the local sugar sub-sector.

3.3 Sampling Design

Due to the wide spreads existing within the sugar growing zones and the factories, simple random sampling was used. The factories were categorised according to the various growing zones where a random selection was done to select the sample. Only Secondary data were required from the factories. Other information was obtained from government departments and Kenya Sugar Board. The information obtained was summarized using tables and the analysis was done by quantitative approaches.

3.4 Data Collection Procedures

The data collection procedure used entailed physically visiting the selected sugar factories and collecting 10 (ten) financial statements from each of them. Additionally, questionnaire checklists with relevant research questions will be sent to each of the selected millers. These methods are suitable here because of the quantitative nature of the data required and the need to obtain the relevant issues pertaining to taxes from the management of the factories. After the questionnaire sheets and financial statements had been obtained and the necessary tax and profit figures extracted, analysis was done for conclusion of the study.

3.5 Data Analysis

After the data were collected, they were summarized and analyzed using tables and other quantitative techniques. Regression analysis was used to show the magnitude of the correlation between the given variables.

3.6 Expected Output

The analysis is expected to yield useful information that will be used to make recommendations on the tax effects in the industry. The study is also expected to give a clear indication on whether the competitiveness of the Kenyan sugar is likely to be maintained in the face of competition and whether sustainability of the industry is possible under a reformed tax regime.

3.7 Delimitations

The study was delimited to the following constraints:

Cost

The researcher had to request for a loan from his employer to defray some expenses.

Time

The researcher had to request for leave from the employer to enable completion of the project in time. The researcher also worked late to overcome some project durations that could go overboard.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

This chapter presents an analysis of the data collected during the study. The information collected is presented in order of the sources. The first part relates to data collected from secondary sources which included all the sugar factories in Western Kenya i.e. Mumias Sugar Company, Chemelil Sugar Company, West Kenya Sugar company, Nzoia Sugar Company, Muhoroni Sugar Company and South Nyanza Sugar Company. The second part analyses the primary data collected from the same companies and Kenya sugar board. The interpretation is as follows: -

4.1 Financial Performance of the Sugar Factories

The researcher sought to find out how the sugar factories have been performing over a four year period from 2003. This information was gathered from secondary sources which included the financial statements of individual factories and Kenya Sugar Board. It came out from the study that the sugar factories are posting disproportionate profits as compared to their turnover. Except for Mumias and Nzoia Sugar Companies, none of the other factories has gone beyond Kshs 335,000 profit mark despite all of them posting average impressive turnovers of about Kshs 2.3 billion. This shows that apart from operation costs, there are other factors that affect profitability of the factories.

Table 1 – Profits of individual factories compared to turnover

a) Mumias Sugar Company Kshs. millions

	2003/04	2004/05	2005/06	2006/07
Turnover	12,134,937	12,511,512	11,657,658	12,864,962
Net Profits	791,451	1,289,930	1,526,615	1,393,611
Profit as % of turnover	7	10	13	11

b) Nzoia Sugar Company

	2003/04	2004/05	2005/06	2006/07
Turnover	3,013,751	3,258,557	3,127,580	2,961,657
Net Profits	427,781	505,121	625,755	235,918
Profit as % of turnover	14	16	20	8

c) Sony Sugar Company

	2003/04	2004/05	2005/06	2006/07
Turnover	2,920,719	3,697,528	3,176,778	3,556,159
Net Profits	48,062	284,217	-230,137	103,817
Profit as % of turnover	2	8	(7)	3

d) Chemelil Sugar Company

	2003/04	2004/05	2005/06	2006/07
Turnover	1,925,940	2,600,733	2,880,895	2,996,694
Net Profits	-32,140	33,792	-108,877	85,961
Profit as % of turnover	(2)	1	(4)	3

e) Muhoroni Sugar Company

	2003/04	2004/05	2005/06	2006/07
Turnover	1,445,130	1,336,925	1,448,819	2,536,976
Net Profits	-19,742	-35,563	-12,503	332,672
Profit as % of turnover	(1)	(3)	(1)	13

f) West Kenya Sugar Company

	2003/04	2004/05	2005/06	2006/07
Turnover	1,106,836	1,590,083	2,017,845	1,718,981
Net Profits	86,252	152,029	147,146	191,264
Profit as % of turnover	8	10	7	11

The average profits as a percentage of turnovers were 4.7%, 7%, 4.5% and 7.8% in the years 2003/04, 2004/05, 2005/06 and 2006/07 respectively. The scenario would definitely change if the taxes were reduced since the taxes combined take more than

20% of the gross turnover. This supports the view taken by all the millers that taxes levied on sugar as a product are burdening them to an extent that they at times struggle to break even. Nearly all of the millers were in some kind of tax arrears relating to VAT, Cess and SDL. This confirms that the taxes have not been easy to pay by the millers in addition to other obligations and having to meet operational expenses.

4.2 Taxes and profits of various sugar factories

The taxes paid by the millers are mainly three, that is to say VAT, Cess and SDL. The study has revealed that there is indeed a relationship between the taxes and the profits made by the various sugar factories.

Table 2- Mumias Sugar - Relationship between profits, VAT, SDL and Cess

YEAR	NET PROFIT	VAT	SDL	CESS
2003/04	791,451	1,427,921	676,930	79,323
2004/05	1,289,930	1,268,415	663,789	37,258
2005/06	1,526,615	1,843,318	758,953	32,675
2006/07	1,393,611	1,248,746	702,633	43,730
r		**0.31**	**0.64**	**(0.96)**

The table above shows that both VAT and SDL have a positive correlation with net profits while the correlation between net profits and Cess payments is negative. The correlation between the net profit figures for the four years from 2003/04 to 2006/07 and VAT is positive at 0.31. This means that 31% of the variations in the independent variable Y (profits) can be explained by VAT payments while the rest are due to other factors. The same can be said of SDL, which explains 64% of the variations in profits. However, the correlation between profits and Cess payments in the Mumias case is negative 0.96. What this means is that there is a strong inverse relationship between profits and Cess payments. Graphically, this can be illustrated as follows:-

Graph 1- Mumias Sugar – Relationship between profits, VAT, SDL and Cess

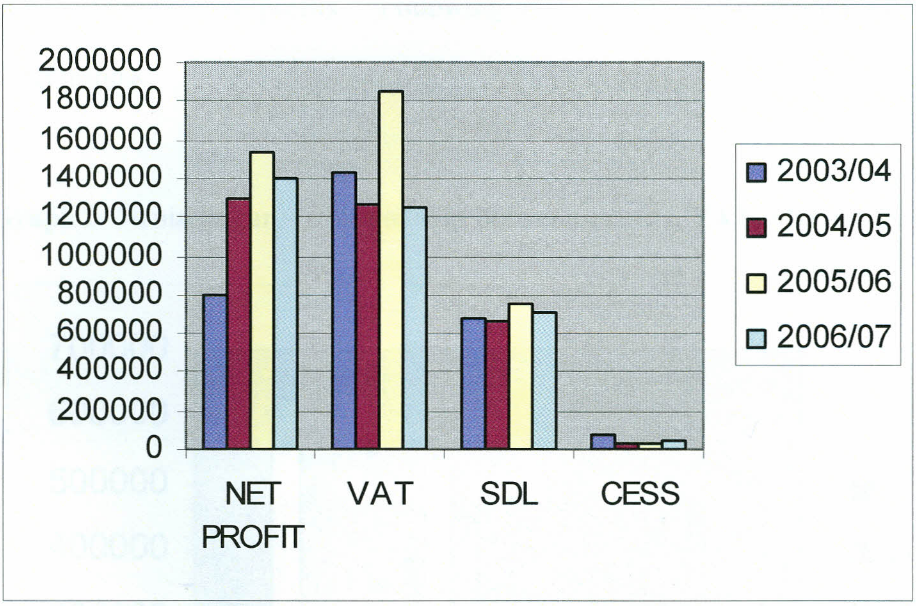


Table 3- Nzoia Sugar - Relationship between profits, VAT, SDL and Cess

YEAR	NET PROFIT	VAT	SDL	CESS
2003/04	427,781	378,301	157,388	2,086
2004/05	505,121	385,510	173,166	1,610
2005/06	625,755	539,632	178,608	4,790
2006/07	265,918	448,310	164,251	8,188
r		**0.43**	**0.72**	**(0.53)**

The Nzoia case is similar to the one of Mumias where VAT and SDL are positively correlated to profits while Cess is negatively correlated. In this case, 43% and 72% variations in profit can be explained by VAT and SDL respectively. The relationship between profits and Cess is such that 53% of the variations can be explained by movements in the opposite direction, that is to say ,whenever there is more Cess payments, profit increases and vice versa. There is very strong correlation between SDL payments and profits. Following is a graphical illustration of the above relationships:

Graph 2- Nzoia Sugar – Relationship between profits, VAT, SDL and Cess

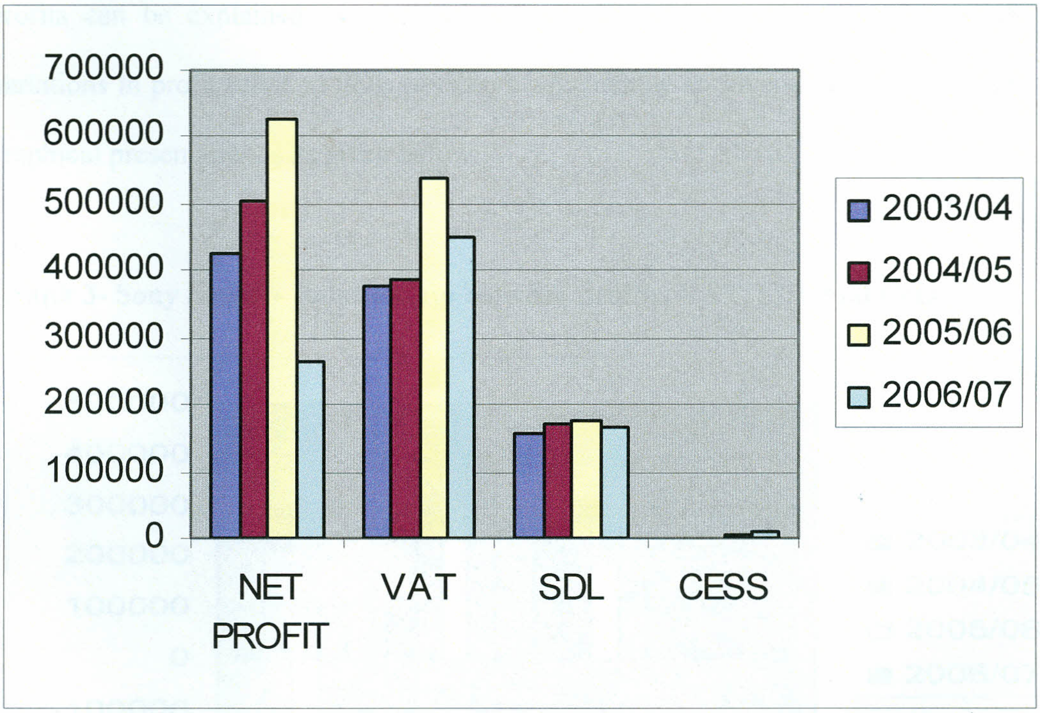
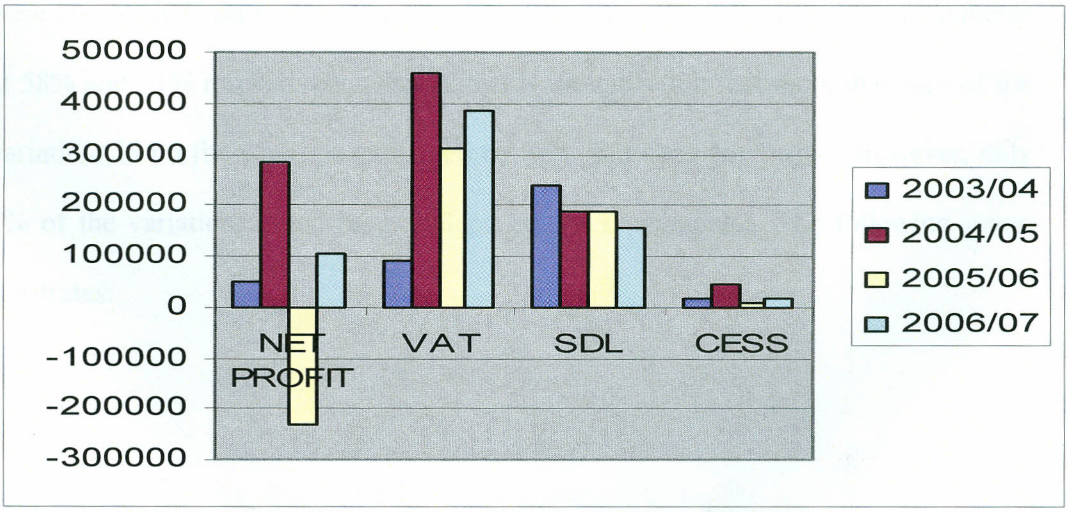


Table 4- Sony Sugar - Relationship between profits, VAT, SDL and Cess

YEAR	NET PROFIT	VAT	SDL	CESS
2003/04	48,062	90,413	239,716	18,137
2004/05	284,217	460,386	185,366	43,253
2005/06	-230,137	312,491	185,376	7,920
2006/07	103,817	385,145	157,415	17,557
r		**0.38**	**(0.07)**	**0.90**

Analysis in the table above presents a different scenario from the first two cases of Mumias and Nzoia factories. In the case of Sony Sugar, the correlation between profits and VAT and Cess are positive. Thirty-eight percent and 90% of variations in profits can be explained by VAT and Cess respectively. However, 7% of the variations in profit relate to SDL payments which show an inverse relationship. The graphical presentation is as given below:

Graph 3- Sony Sugar – Relationship between profits, VAT, SDL and Cess



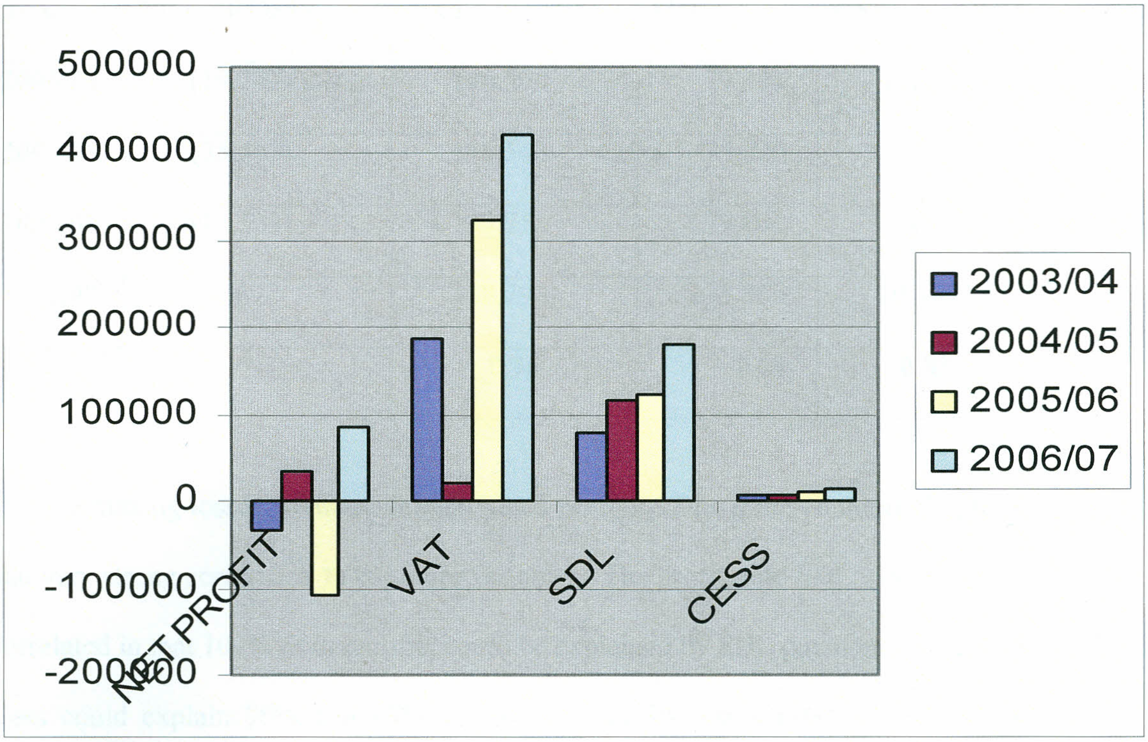
From the graph, it can be noticed that tax and levies payments continued even as the miller made a huge loss of Kshs. 230,137,000. Tax and levies alone amounted to Kshs. 505 million 2005/06 when the loss was made. This in conformity with the feeling of the millers that lowering the rates for taxes and levies could turn some of them to profitability.

Table 5- Chemelil Sugar - Relationship between profits, VAT, SDL and Cess

Year	NET PROFIT	VAT	SDL	CESS
2003/04	(32,140)	188,371	79,663	7,317
2004/05	33,792	20,004	115,078	7,827
2005/06	(108,877)	324,960	122,011	9,199
2006/07	85,961	422,544	179,238	12,662
r		**0.01**	**0.58**	**0.51**

Despite Chemelil making a loss both in the year 2003/04 and 2005/06, the relationships between its profits (losses) and other variables (i.e. VAT, SDL and Cess) were all positive. Strong positive correlation was noted with SDL and Cess payments at 58% and 51% respectively. Again, this is an indication that more than half of the variations in profits could be explained by SDL and Cess payments. However, only 1% of the variations could be explained by VAT payments. The following graph illustrates:

Graph 4- Chemelil Sugar – Relationship between profits, VAT, SDL and Cess



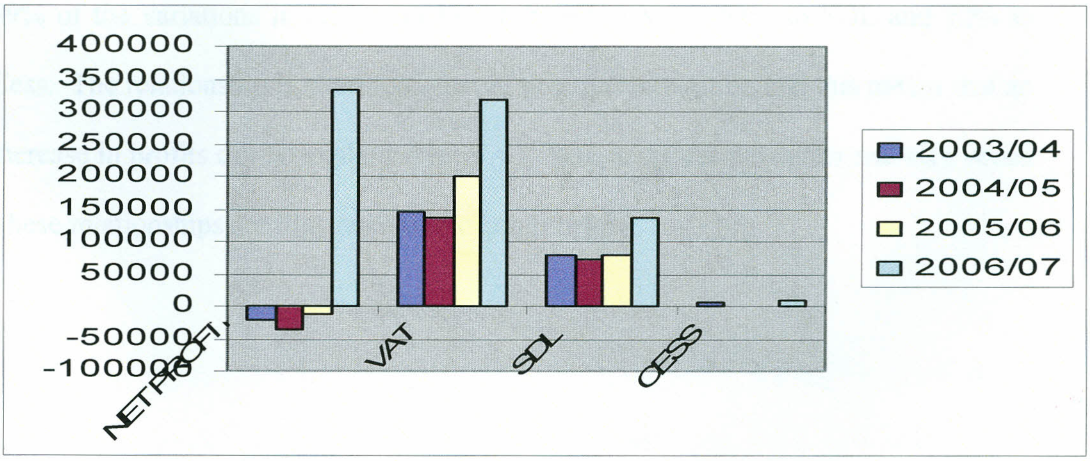
The miller made a loss in the years 2003/04 and 2005/06 of about Kshs 32m and 109m respectively while the tax and levies payments in the respective years were Kshs 374m and Kshs 456m. It can be argued that if the tax and levy rates were reduced by half, the miller could comfortably be in a profit position in the two respective years when it made losses.

Table 6- Muhoroni Sugar - Relationship between profits, VAT, SDL and Cess

Year	NET PROFIT	VAT	SDL	CESS
2003/04	(19,742)	146,506	79,383	6,133
2004/05	(35,563)	136,548	74,220	-
2005/06	(12,503)	199,758	79,801	414
2006/07	332,672	318,793	135,866	10,387
r		**0.96**	**1.00**	**0.83**

Despite making losses for three straight years from 2003 to 2006, Muhoroni's profits had very strong correlation to the other variables. The profits and SDL were perfectly correlated in that 100% of the profits could be explained by SDL payments. VAT and Cess could explain 96% and 83% variation in profits respectively. These strong relationships exist despite the loss position mentioned above which would suggest that as profit goes up, so are payments of taxes and levies and vice versa. The graphical illustration is as follows:

Graph 5- Muhoroni Sugar – Relationship between profits, VAT, SDL and Cess



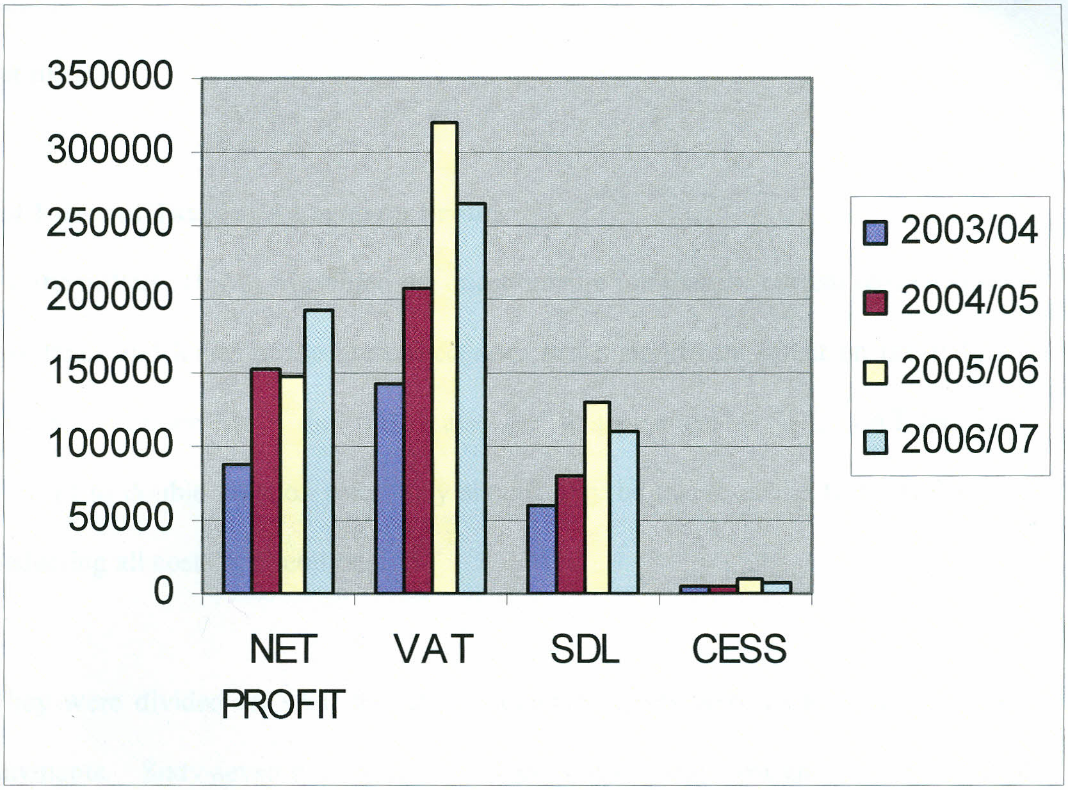
As mentioned above, the miller made total losses of about Kshs 67m in three straight years while tax and levy payments were about Kshs 725m as follows for the three years: VAT- Kshs. 485m, SDL- Kshs. 233m and Cess Kshs. 6.5m. Again, the argument would be how the scenario would look like without or with a reduction of the taxes.

Table 7- West Kenya Sugar - Relationship between profits, VAT, SDL and Cess

Year	NET PROFIT	VAT	SDL	CESS
2003/04	86,252	141,863	60,029	4,278
2004/05	152,029	208,138	79,743	6,142
2005/06	147,146	321,219	128,809	9,158
2006/07	191,264	265,079	109,011	7,912
r		**0.69**	**0.67**	**0.72**

The table above for West Kenya Sugar suggests that there is strong positive correlation between the profits and VAT, SDL and Cess. The analysis shows that 69% of the variations in profit can be attributed to VAT, 67% to SDL and 72% to Cess. The relationship is, therefore, that of positive correlation and this means that an increase in profits can be explained by VAT, SDL and Cess payments and vice versa. These relationships are illustrated in the graph below:

Graph 6- West Kenya Sugar – Relationship between profits, VAT, SDL and Cess



The finding above is illustrated clearly in the graph in that tax and levy payments were more or less moving together with the profits.

4.3 Taxes and Levies Rates, Payments and Arrears

All the 6 (six) companies visited were subject to taxes and levies. Of these, 4 (67%) felt that the rates were high while the remaining 2 (33%) termed the rates as moderate. This was due to the recent reduction of the SDL rate from 7% to 4% in last year's budget. None of the millers felt that the rates are low.

The study revealed that 87% of the millers were not current on their tax and levies payments. The arrears were mainly in respect of SDL and VAT. The arrears were perennial from one year to another for the whole period of the study. This implies that despite posting impressive turnovers, the upfront tax charges present a big challenge for the millers.

4.4 Effect of Taxes and Levies on Profits

All the millers (100%) who filled the questionnaire felt that the current requirement to pay taxes and levies at the prescribed rates has a significant effect on profitability. One hundred percent of the millers also feel that payment of SDL, VAT and Cess amount to double taxation since they should only be taxed on the final profits after deducting all costs of operations.

They were divided on what the actual negative effects were as a result of the tax payments. Sixty-seven percent of the millers felt that the most undesirable effect of the taxes is an increase in production costs while the rest (33%) were of the opinion that the effect is manifested in delayed farmers' payments. None of the millers felt that the effect was either reduced farmers' income or reduced operational capacity.

As to what should be done to counter the negative effects of taxation in the sugar industry, 4 millers representing about 67% felt that tax rates should be reduced to enable them to make more profits. The specific taxes and levies they would like to be reduced are VAT, SDL and Cess. The remaining 33% want a reduction on both VAT and SDL and the scrapping of Cess. This is because the millers already pay land rent and rates to the respective Local Authorities within which they operate.

4.5 Taxation and the liberalized sugar market

The taxation level in the sugar industry is deemed by millers to be one of the factors making it difficult for the local sugar to compete with sugar from COMESA trading bloc. The COMESA safeguard which was supposed to expire on February 28th 2008 was renewed with stricter terms which increase the volumes imported from the trading bloc on a yearly basis The safeguard will now expire officially in the year 2012 when 100% imports will be allowed in the country tax free.

The study found that 50% of the millers believe that the level of taxation in the industry is responsible for the inability of local sugar to compete in the liberalized sugar market. Thirty-three percent said that taxation is only partly to blame for this scenario citing other factors like high costs of production and tax evasion by importers. However, one miller felt that taxation alone was not responsible for failure by the local sugar to compete in the COMESA market. Factors including operational inefficiencies leading to higher production costs per unit, failure by the millers to embrace modern technology and declining yields were also cited as major impediments to competition in a liberalized market.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

This study addressed the effects of taxes and levies on the profitability of sugar factories in Kenya. It was an exploratory study to establish the tax effects as a component of the larger problems faced by the sugar sub-sector in Kenya. The study found that taxation component may cripple the operations of the sugar sub-sector. (Tables 2-7). The study concluded that to improve profitability and sustenance of the sub-sector, the government should introduce tax incentives and reforms. This will enable the government to increase the productivity in the sub-sector to facilitate satisfaction of domestic demand and export the surplus.

5.2 Conclusion

It is clear from the study there is a relationship between the taxes and levies charged on sugar millers in Kenya and their reported profits. Over the years, sugar millers have not been posting meaningful profits, a fact that has worried the government as a major stakeholder in many sugar factories in the country. It is true that as many factories posted losses in some years, the tax payments were well in excess of Kshs. 200 million. On the other hand, the profits posted in particular years by the millers were far below the total amount of VAT, SDL and Cess paid in that year. The analyses on the relationships between tax payments and profits in the report suggest that most changes in profits can be explained by the various tax components to a to a larger extent. The negative or reciprocal relationships can be attributed to arrears paid in particular years and other errors.

Most of the finance managers and chief executives in the sugar factories say that the tax burden is heavy and should be reviewed. Additionally, they are in tax arrears that they are struggling to pay in addition to other obligations to creditors and other operation costs. The government, on the other hand, has been adamant on taxes and maintains that all the sugar factories have to give a return on investment to the shareholders, or else they face closure.

The level of taxation has, however, not been the sole contributing factor to the dismal performance by the sugar factories. This is evident since Mumias, West Kenya and Nzoia and to some extent, Sonysugar have posted profits in addition to paying SDL, VAT and Cess at the prescribed rates. Kenya Sugar Board says that the rate of SDL of 4% is not enough to generate the required funds to finance sugarcane growing and other infrastructural projects in the Kenya sugar factories and join the government in calling for efficiencies in the industry. The regulator maintains that funds released for specific projects for a long time have not been put to good use by the millers and growers institutions through whom they channel the funds.

Most millers say that if the government can review the tax regime as applicable to the industry, this may give them a cost advantage leading to profitability. This, they suggest, can take the form of reducing some of the taxes and even scrapping some altogether.

It is, therefore, clear from the above that taxation in the form of VAT, SDL and Local Authority Cess has a direct influence on the level of profits. However, other costs like inputs for cane development, production inefficiencies and product pricing are also very important in profit determination.

5.3 Recommendations

1. The government should reduce tax rates in the sugar industry since sugar is classified as a basic food. This will enable the millers to increase their profit levels and pay more returns to the shareholders.

2. There should be tax reforms in the sugar sector just as the recent one done in the coffee and tea sectors. This will encourage farmers and millers to increase their efforts to produce cane and process sugar respectively to bridge the current domestic demand deficit.

3. The millers should invest in modern technology to increase extraction and operational efficiencies which is likely to translate to more impressive bottomlines.

4. The government should consider divesting from factories where it is the major shareholder as a move towards privatization and efficiency.

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Appendix

Questionnaire checklist

1. Which taxes /levies do you pay as a miller?

Cess [ ]

VAT [ ]

SDL [ ]

Corp. Tax [ ]

All [ ]

2. D o you believe payment of the above taxes have a significant effect on profitability?

Yes [ ]

No [ ]

Not sure [ ]

3. Do you have any tax/ levy arrears?

Yes [ ]

No [ ]

4. On which taxes are you in arrears?

VAT [ ]

SDL [ ]

Cess [ ]

All [ ]

5. What do you feel about the tax rates?

High [ ]

Low [ ]

Moderate [ ]

6. What do you think are the negative effects of sugar taxes and levies?

High production cost [ ]

Reduced farmers' income [ ]

Delayed payments [ ]

Reduced operational capability [ ]

7. What should be done to reduce the negative tax effects of VAT, SDL and Cess?

Reduce taxes / Levies rates [ ]

Scrap taxes and Levies [ ]

Specify and give reasons...

....

....

8. Do you feel payment of SDL, VAT and CESS in addition to corporation tax on profits amounts to double taxation?

Yes [ ]

No [ ]

9. Is the level of taxation in the sugar industry responsible for inability of Kenyan sugar to compete in the liberalized market?

Yes [ ]

No [ ]

Partly [ ]

Give reasons..

....

....