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TAXATION AND SME'S SECTOR GROWTH

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ABSTRACT

The SMEs sector's importance in the economic development of any country in recent years cannot be underrated especially with regard to creation of employment, innovation, uplifting the people's standard of living and financial contribution to the growth of the countries GDP. This sector's growth is hindered by the challenges of lack of financial resources to expand, the entrepreneur managerial skills, unskilled labour, production of poor quality goods, lack of market for their products, infrastructure and above all taxation policy which does not favour their growth potential. The study looked at tax influence on SMEs sector growth in Kenya. The study employed descriptive design. Primary data was collected on valuables contributing to tax influence and their effect of the growth of SMEs. A sample of 268 respondents representing 30% of targeted population of 806 enterprises in the production sectors of Nyeri Industrial area , selected through stratified and random sampling techniques. Data was collected through questionnaires, interviews and observations when necessary and it was analyzed using binary logistic regression empirical model to estimate the contribution of each valuable to the growth effect. The study found that there was a significant correlation between taxation and SMEs sector growth. The study recommends that there be a friendly tax policy for all start up businesses preferably a tax holiday, or an introduction of a growth limit which can be said to be a level stable enough to sustain tax payment.

Keywords: *Employment, Innovation, Tax Influence, Managerial Skill, Growth Potential.*

INTRODUCTION

The SME's sector plays a crucial role in maintaining high employment and income generation and is therefore critical for a country to achieving sustainable growth. To enhance their role, SME's need to focus on a number of key business challenges such as reducing costs, improving employee productivity and building competitive advantage through producing quality products and services and other entrepreneurial interventions (UNCTAD, 2005). To achieve the growth potential of the SME's sector the government has to play a role of providing the necessary infrastructure to the sector and this is only achievable through taxing the same sector i.e reaping the benefits of the said infrastructure.

Official statistics indicate that a high proportion of new firms fail within three years of start-up. For example, in the UK,according to a study done by Cressy and Storey,for the government (2006) found that 30 per cent of new firms appear to cease training by the third year and 50 per cent by the fifth year. Official statistics need to be treated with caution and are likely to overstate the true failure rate; for example, a successful start-up firm may cease to exist when taken over by another firm; some business owners leave and re-enter self-employment, dependent on labour market conditions. However, it is accepted that there are only a small proportion of new firms that grow to employ 50 or more workers. One of the factors that might affect such limited numbers of high-growth firms is the potential loss of control faced by the entrepreneur as the firm grows. New small firms and entrepreneurs that are successful are predominantly located in the developed part of the UK, which suggests that the environment and infrastructure are at least as important as the characteristics of the entrepreneur. It is also likely that the development of inter-firm networks is more advanced in that Part of the country. This scenario is replicated all over the world.

Not surprisingly, official figures show low survival rates for new firm formation. Official figures show that less than 55 per cent of new VAT registrations survive for longer than three years, and less than 40 per cent survive for longer than five year. Cressy and Storey, using an independent database, claimed that less than 30 per cent of new firms survived longer than six years. Gibb(2010), however, has argued that high death rates of small firms is a myth, partly because VAT registration survival rates may not be indicative of true survival rates; a de-registration may not indicate business closures as such, just a decision to leave the VAT register but continue trading. Gibb claims that stability rather than volatility is truer picture of the small firm sector. There are various types of taxes which the governments use in raising required revenue but those taxes have either positive or negative effect of growth in SME's sector. Thus, the need for a study to look at taxation and its effects on SME's sector growth and determines whether it is the root cause of the above scenario (i.e SME’s not achieving their growth potential) and looking at solutions that can solve the problem.

According to Dalton,(1996) tax is a compulsory contribution imposed by a public authority irrespective of the amount of service rendered to the tax payer in return; Professor Seligman (2004)defined it into compulsory contributions from a person to the government to defining the expenses incurred in the common interest of all without reference to special benefits compared. The government offers these functions of ‘administrative, development and social function effectively and adequately.

While growth of any firm or sector is measured by the contribution and number of employment it is providing and increase in sales, income, profit and thus capital which portrays a survival capability in case of any problem facing the sector or firm.

Salemi (2010) argues that there are various types of taxes i.e. income tax, cooperation tax, sales tax, excise tax, custom duty, fees, prices, fines, special assessments, VAT along others. The government levy taxes to accomplish the following purpose i.e. raise revenue, maintain economic stability, solve unemployment problem, offer protection policy, social welfare and help achieve fair distribution of resources by optimally allocating resources and increase the rate of economic formula. But when imposing any tax, the following conditions and challenges must be fulfilled i.e. equality, certainty, convenience, economical productivity, elasticity, flexibility, simplicity and durability otherwise it wont be fulfilling its objectives. Another challenge of taxation is those who try not to pay tax through evading or avoidance.

In order for SME’s sectors to grow, the level of taxation set must be friendly and not stifle the running of the business. Holtz-Eakin (1995) argues as to whether there is an economic case for the preferential tax treatment of SME’s. Some of the factors that could be advance in favor tax concessions for SME’s includes: firstly, presence of externalities provided by small firms that benefit the economy, the rewards for which are not fully captured by small firms, for example if small firms were highly innovative, but the majority of the advantages accrued to large businesses who, because of their market power, were able to buy small firms for less than they are worth. Secondly, there is a need to provide tax breaks for small firms, on the basis of equity and thirdly the tax system should not affect the growth of the SME’s in a negative way.

Holtz-Eakin (1995), discusses whether there is an economic case for the preferential tax treatment of small businesses. It has been argued that several factors would provide valid reasons for favorable tax treatment. These include the presence of externalities provided by small firms that benefit the economy, the rewards for which are not fully captured by small firms, if they were highly innovative, but the majority of the advantages accrued to large businesses who, because of their market power, were able to buy small firms for less than they are worth. In addition there was a need to provide tax breaks for small firms, on the basis of equity. Finally if there was evidence that capital market imperfections were leading to under-investment in small firms, for example lenders were restricting the amount of finance provided to small firms. The last point of concern is, if the level of taxation was constraining the willingness of entrepreneurs to take risks.

Engen & Skinner (1996)) acknowledges that the structure of taxes is as important as tax rates. In contrast Branson and Knox (2001) argue that tax rates were six times more important than tax structure in their study of post war New Zealand. In response to a radical proposal to reform taxation in the US, Calgari (1998) provides a critique of the claims saying that a proposed “flat-tax” would substantially reduce costs of compliance.

The flat-tax is called a Hall Rabushika tax after the names of the proposers (Hall and Rabushika, 1983, 1995). A flat tax is intended to provide a much simpler system with a single tax rate payable on business profits, wages, and retirement and compensation income above a personal allowance. All transactions are recognized on a cash basis only and no personal deductions apart from the individual tax allowance are admissible, thus substantially reducing compliance costs. Personal capital gains and investment income are also exempt. Business income includes sale revenue, gross rents, royalties and sales of property used in the business. Business expenses include remuneration, purchases of goods or services for the enterprise and costs of managing business property, but exclude interest, dividends, depreciation and fringe benefits to staff. It is argued that this simplified method of calculating income will also reduce tax planning activity.

Stiglitz (1985) classifies tax planning opportunities into three broad areas: postponing taxes from current to future periods arbitraging across income streams from higher to lower tax rates by switching income from high to low tax brackets. Calgari .(1998) shows that all three of these opportunities could still exist under a flat tax and offers suggestions of how these loop-holes could be closed, albeit at the expense of simplicity.

(Carroll, et al. (2000). It also concludes that on average, portfolio entrepreneurs appear to offer more attractive growth prospects than other entrepreneur, therefore providing a case for support tailored to the aspirations and needs of novice, serial, and portfolio entrepreneurs and developing entrepreneurs’ skills. However there is one suggestion for tax policy, i.e. that there should be incentives to encourage serial and portfolio entrepreneurs to invest profits and funds from a business sale.

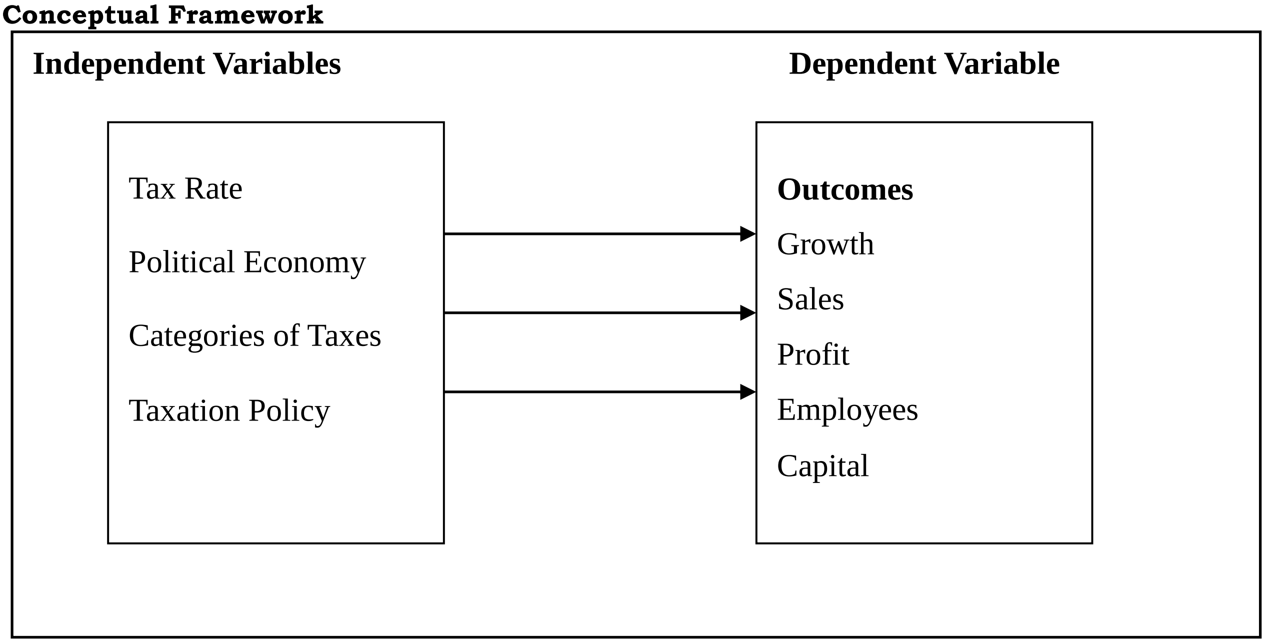
In the UK, Capital Gains Tax (CGT) has two features that help promote this. The first is taper relief on capital gains, which reduces the amount of the gain on business assets that are chargeable for CGT to 50 percent after being held for two years and 25 percent after three (Taylor, 1996). The second is roll-over relief that exempts from CGT any capital gains that are subsequently reinvested in another business, subject to certain restrictions. Keuschnigg (2004) considers the impact of capital gains taxes on Venture capital portfolios. The paper develops a theoretical model around the argument that venture capitalists not only finance but also advise and thereby add value to young entrepreneurial firms. As a result the prospects of venture capital backed firms depend on the joint efforts of entrepreneurs and informed venture capitalists.

The model is developed for a venture capitalist with a portfolio of firms. For this reason, managerial support is spread across the portfolio of companies and can become inefficiently low if the portfolio continues to expand. There are two main assumptions, first that the returns from the venture are known, and second that the entrepreneur will only undertake a risky investment if its value exceeds the safe wage that could be earned.

Gentry and Hubbard (2000) use self-employment data as a measure of entrepreneurship and model the choice between paid employment and entrepreneurship. The model incorporates tax rates to determine the likelihood of entrepreneurial entry. Although certain householders' characteristics are used in the model, it does not incorporate some of the other factors thought to impact on the decision to become self-employed) such as independence (Taylor, 1996), or being your own boss (Hamilton, 2000).

Many scholars have addressed the questions that emerge from this literature especially the in-elasticity of tax location decisions with respect to tax differences across jurisdictions. The issue of incomplete integration between personal and corporate tax systems has also been addressed. The resulting non-neutral tax systems are often inefficient, distorting the allocation of resources. Governments need to review tax bias against entrepreneurs and design tax policies for entrepreneurship to remedy market failures, while avoiding adverse side-effects. Marginal tax rates exert a statistically and quantitatively significant influence on the growth of firms. This leads to the conclusion that raising income tax inhibits the growth of small firms. Policy should be explored with a view to addressing the uncontrolled littering of plastic shopping bags and the consequent environmental impacts in Nairobi as well as the country as whole should be based on the core requirements of sound waste management hierarchy. Ultimate solutions however, will only be attained when the rationales of sustainable consumption and production are met.

Conceptual Framework



METHODOLOGY

The study employed descriptive design and used 30% of the target population 806 SME's in production industry, chosen from each of the stratum (categories of either micro, small and medium) selected by use of simple random sampling, which yielded a sample size of 268 respondents operating in Nyeri district. Patton (2002) recognizes a sample size 30% of the target population as enough for descriptive survey studies. This approach ensured that all the strata within the study area were included in the study and thus taking into consideration the socio-economic dynamics of the area by spreading the sample Nyeri district. The main data collection instruments were questionnaires, observations and interviews.

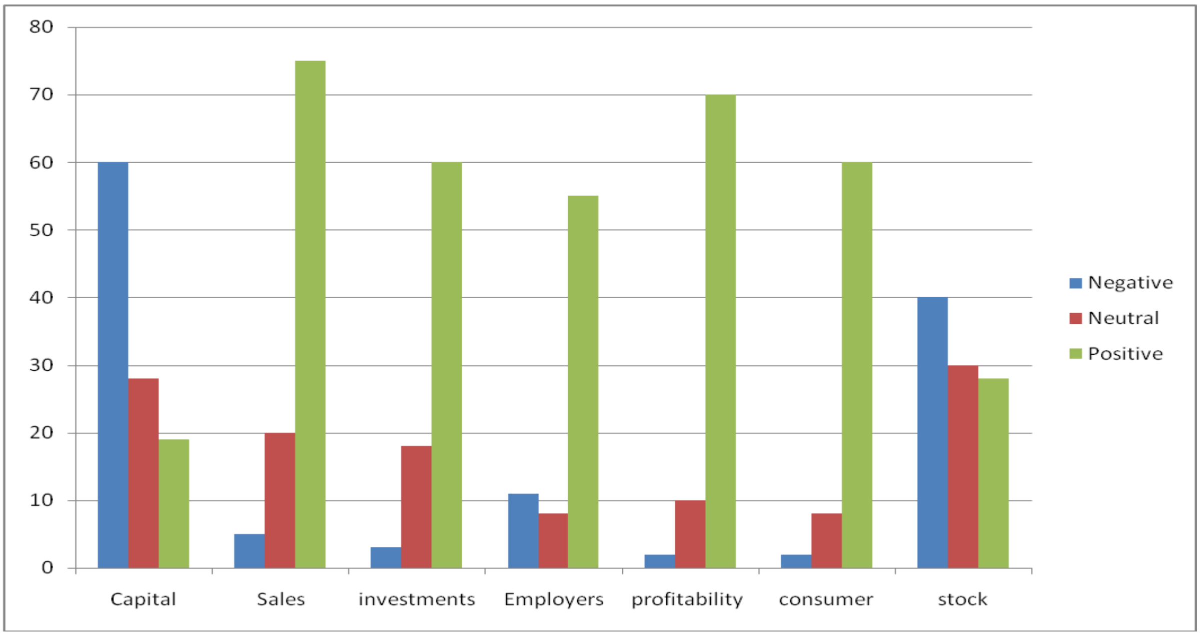
Reliability and validity was ensured through pretesting, done using 20 respondents prior the main data collection. Data collected was analyzed descriptively and presented in form of frequency and percentage tables. Logic model was adopted in the study and the data was analyzed based on the model variables.

FINDINGS

It was expressed with a lot of concern that there was a lot of uncertainty about the future of SME's sectors growth in Kenya.

Respondents complained that the new taxes only made an already heavy tax burden worse. The cost of doing business in the country was said to have moved from an already high to an extremely higher level prohibitive for business growth. The respondent's reviewed the impact of taxes on, sales, stock, capital, investment, profitability, and the consumer were varying. These responses are presented and discussed in the next section. See table 4.0 - 4.6

Table 4.0 : Influence of the Tax on Stock



The business owners cited that to curb this cost, the most immediate action was inevitably to increase the cost of their products as well as reducing the number of workers employed. This had led to loss of jobs in a country desperate to create jobs for its increasing population of jobless citizens.

The first to loose their jobs because of taxation in many SME's were the casual workers followed by seasonal workers. Permanent workers were forced to take unskilled jobs to remain in employment. This tended to kill their motivation and it was reported that quite a number were already seeking employment in alternative sectors of the economy such as government institutions.

The study revealed that respondents perceived the impact of the taxes on sales as negative. They cited increased prices resulting from the tax as prohibitive leading to customers seeking alternative ways of satisfying their needs. This had a negative impact on the overall SME's growth since decreased sales tended to decrease profit and production as well. However this minimized consumption of products as well as earning government income which could be utilized for improving the standard of living management system as well for research and development activities.
The respondents pointed out that as more taxes are imposed on the SME's less and less profits were made. Since the same taxes were not applicable in other countries, some SME's were considering an option of shifting to other countries where such taxes do not exist.

This could have a negative impact on the countries economic growth at a time when such investments were needed to create income and jobs for the countries growing population.

This was because with diminishing sales and profits from the taxes, the businesses quickly adjusted by reducing their work force in bid to cut their expenditures. This made a large number of workers to lose their jobs. However 20 per cent of the respondents perceived the impact of taxes on employment as positive. The respondents argued that taxes could boost employment in the country only if they were reasonable, decided in a participatory manner with the stakeholders and used in a transparent way.

Though the respondents agreed that paying taxes was necessary, they were concerned that much of the tax charged was never used by the central government to provide infrastructural support

The study found that there is a positive correlation between taxation and lack of growth of the SME's sectors necessary for the businesses to increase their production efficiency and thus increase their profits.

CONCLUSION

This is evident from the fact that the sales, profits, capital and employment level in these SME's had drastically reduced. It was clear that the SME's in this sector were operating under a heavy tax burden which was prohibiting their growth and development.

Players in the sector saw taxes as just government way of earning revenue with no much good to the SME's and the society at large. Therefore there is an urgent need to identify policy options that can help in establishing an efficient resource use in the country. However, in order to find solutions to these problems, there is need for an active involvement of all the stakeholders such as the government, manufacturers, NEMA, KAM, and KEBS.

The government should be particularly involved in translating the policies into achievable goals, by taking the required initiatives. There is need for outlined institutional rules, responsibilities, obligations, and approaches to legal instruments, and undertakings of each stakeholder in order to facilitate a balance between industrial development and economic growth. The study concluded that taxation of SME's in the early stages has a negative effect on the SME's sectors growth and the economy at large.

RECOMMENDATIONS

There is need for all stakeholders to work together and develop harmonious tax policy which should benefit both the government and the manufacturing sector. There is also need to have an incubation period which SME's will be granted by the government to help themselves to become self sufficient and independent thus be able to withstand tax burden. This will create a positive attitude towards payment of tax when everybody is involved in its administration.

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