

Tax Policy and the Growth of SMEs: Implications for the Nigerian Economy

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Abstract

Small and Medium Enterprises play a very important role in development of the Nigerian economy. Making up about 97% of the entire economy, they serve as a source of employment generation, innovation, competition, economic dynamism which ultimately lead to poverty alleviation and national growth. Tax policy is one of the factors that constitute the SMEs' economic environment. This research work tries to establish if any relationship exists between the growth of SMEs and the tax policy environment in which they operate in Nigeria. Questionnaires were distributed to SMEs in Zaria, North Central, Nigeria and non probability judgmental sampling method was employed. The hypothesis was tested using Spearman's Rank Correlation. It was found out that from most SMEs surveyed, they were faced with the problem of high tax rates, multiple taxation, complex tax regulations and lack of proper enlightenment or education about tax related issues. Although there was a general perception that tax is an important source of fund for development of the economy and provision of social services, the study revealed a significant negative relationship between taxes and the business' ability to sustain itself and to expand. In order to obtain a vibrant and flourishing SME sector, the tax policy needs to be appropriate such that it will neither be an encumbrance to the SMEs nor discourage voluntary compliance. A suggested solution is by increasing tax incentives through reducing tax rates and increasing tax authorities' support services towards small and medium enterprises.

Key words: SMEs, Tax Policy, Nigerian Economy

1.0 Introduction

Small and medium enterprises (SMEs) form the core of majority of the world's economies. A study carried out by the Federal Office of Statistics shows that in Nigeria, small and medium enterprises make up 97% of the economy (Ariyo, 2005). Although smaller in size, they are the most important enterprises in the economy due to the fact that when all the individual effects are aggregated, they surpass that of the larger companies. The social and economic advantages of small and medium enterprises cannot be overstated. Panitchpakdi (2006) sees SMEs as a source of employment, competition, economic dynamism, and innovation which stimulate the entrepreneurial spirit and the diffusion of skills. Because they enjoy a wider geographical presence than big companies, SMEs also contribute to better income distribution. Over the years, small and medium enterprises have been an avenue for job creation and the empowerment of Nigeria's citizens providing about 50% of all jobs in Nigeria and also for local capital formation. Being highly innovative, they lead to the utilization of our natural resources which in turn translates to increasing the country's wealth through higher productivity. Small and medium scale enterprises have undoubtedly improved the standard of living of so many people especially those in the rural areas.

However, the mortality rate of these small firms is very high. According to the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) Nigeria, 80% of SMES die before their 5th anniversary. Among the factors responsible for these untimely close-ups are tax-related issues, ranging from multiple taxations to enormous tax burdens etc. In many government policies, small and medium enterprises are usually viewed and treated in the same light as large corporations. However, their size and nature makes them unique. Therefore, in dealing with small and medium enterprises, these unique qualities need to be considered. In levying of taxes for these enterprises in particular, issues that need to be considered are how these tax policies can be designed to bolster the growth of SMEs and the most effective ways to administer them. The importance of SMEs as a mechanism of economic growth and development is often ignored. They are perceived as minute establishments that have minimal effect on the state of the economy. However, if conducive environment is created for these SMEs to grow through proper regulation, the SME sector has the highest propensity to transform our economy. In the same light, taxes are important for the government as they are the major source of funds for government expenditure. Income obtained from taxation of individuals and businesses are used to run governments as well as provide infrastructure such as good roads, water supply, and electricity which are essential for the smooth running of these businesses that are mainly manufacturing companies and as such rely on these commodities to survive.

However, Holban (2007) posited that taxation can contribute to development and to welfare through three sources; It must be able to generate sufficient funds for financing public services and social transfers at a high level of quality, it should offer incentive for more employment and for an efficient and lasting use of natural resources, finally it should be able to reallocate income. But in the case of SMEs, tax must be done in such a way that puts their income and need for survival into consideration. It is expedient that enough profit is allowed them for the purpose of expanding their businesses. The tax policy must be one that will not encourage SMEs to remain in the informal sector or to evade or avoid tax payments. Moreso, many small firms in Africa, including Nigeria, choose to remain in the informal sector because the perceived benefits outweigh the perceived costs. Firms rarely see their tax contributions at work and the compliance costs are high, thus discouraging compliance. The government is also discouraged from collecting taxes from small firms, because the cost of monitoring and collecting tax from small businesses by revenue authorities, whose resources are usually scarce, sometime outweighs the revenues generated by small businesses (Stern and Barbour 2005).

The focus of this research therefore is to determine the importance of taxes to the Nigerian economy, to establish the relationship between tax policy and the growth of SMEs in Nigeria and to evaluate the factors that encourage non-compliance with tax obligation by SMEs. The paper is divided as follows: following this section is section 2 which looks at the different literatures on tax and SMEs growth, section 3 discusses the methodology, section 4 looks at the analysis of hypotheses and lastly section 5 concludes the paper.

Statement of Hypothesis

H₀: There is no significant relationship between tax and the SME's ability to expand

2.0 Literature Review

Introduction

Over the years, Nigeria has depended on oil for its major income and foreign exchange. Oil accounts for about 80 percent of federal government revenues, and 95 percent of foreign exchange earnings. The National Centre for Economic Management and Administration (NCEMA) reports that Nigeria, with a population of about 120 million, is Africa's most populous country and the continent's third largest economy yet it still remains one of the poorest oil producing countries. With a continuously declining per capita income, comparatively unfavorable social indicators, dynamic world economy and the fact that countries are looking into alternative sources of energy it is time to begin to look into alternative sources of income for sustenance in the long run when the demand for oil will dwindle to nothing. Even with the present rates of petroleum products, Nigeria's GDP is below ideal with the SMEs contributing therefore it would not hurt to diversify the economy even before the demand for petroleum products finally diminishes. This means it is time to begin to give more attention to the other sectors of the economy.

This translates into looking at non-oil based sectors in Nigeria such as agriculture, manufacturing, commerce and tourism. These industries are primarily made up of SMEs as such it goes without saying that SMEs are important to the Nigerian economy. With over 120 million people, productive farmlands, rich variety of minerals deposits, Nigeria should be a haven for Small and Medium Industries. The human and natural resources base is a significant feature that gives the country a special status in Africa. For governments, however, large companies are a more attractive, more clear-cut and less complex set than SMEs. In designing public policies, particularly tax policies, governments have usually targeted their strategies to large companies (Holban, 2007), there is therefore a need to devise methods to encourage the growth and development of these enterprises to ensure that they reach their full potential. Subsequently, a favorable business and regulatory environment needs to be created for them to thrive. For the purpose of this study, the focus will be on supporting SMEs growth through tax policy. Most large companies have their roots in small and medium enterprises; they started out as SMEs before expanding. This means the future large corporations are the SMEs present today that should be nurtured to ensure their growth. Furthermore, they are generally perceived to be the seedbed for indigenous entrepreneurship and generate all the many small investments, which would otherwise not have taken place (Aryeetey & Ahene, 2004). Therefore, Nigeria needs to further the development of its private sector. It can be done by creating an environment favorable to the growth of SMEs, strengthening the factors that lead to business success, and addressing the problems threatening the existence and advancement of small and medium enterprises (Chu, Kara & Benzing, 2008)

With the dismantling of trade and other barriers, the world has been transformed into a global village. Consequently, SMEs in developing countries are struggling to survive under intense competitive environments both domestic and international. In developing countries like Nigeria, there is an urgent need to provide the required enabling environment for the development of SMEs, so that they could adequately play the role expected of them in economic transformation. Such role includes mobilization of domestic savings for investment, appreciable contribution to gross domestic product, increased harnessing of local raw materials, employment generation, and significant contribution of poverty reduction efforts through sustainable livelihoods and enhancement in personnel income, technological development and export diversification (Smatrakalev, 2006). It is for this reason that an ideal tax policy needs to be adopted in order to ensure economic growth and proper utilization of resources. However this is not the case because taxes which are levied for regulating the investment behavior of the households and not for suffocating any entrepreneur initiative seem to be a major constraint to the development of the SMEs they are out to cater for.

2.1 Definition of SMEs

The Monetary Policy Circular No. 22 of 1988 of the Central Bank of Nigeria defined small-scale enterprises as enterprises whose annual turnover was not more than ₦500, 000. In the 1990 budget, the Federal Government of Nigeria defined small-scale enterprises for purposes of commercial bank loans as those with an annual turnover not exceeding ₦500,000, and for Merchant Bank Loans, those enterprises with capital investments not exceeding 2 million naira (excluding cost of land) or a maximum of ₦ 5 million. The National Economic Reconstruction Fund (NERFUND) put the ceiling for small-scale industries at ₦10 million. Section 37b(2) of the Companies and Allied Matters Decree of 1990 defines a small company as one with an annual turnover of not more than ₦ 2 million and net asset value of not more than 1 million naira. (Ekpenyong & Nyong, 1992). The Small and Medium Enterprise Equity Investment Scheme (SMEEIS) sees the SME as “any enterprise with a maximum asset base of ₦500 million (excluding land and working capital), and with no lower or upper limit of staff”. However, for tax purposes, Section 40(6) of the Companies Income Tax Act Cap C21 LFN 2004 alludes to companies with a turnover of N1 million and below operating in the manufacturing, agricultural production, solid mineral mining, and export trade sectors as SMEs; While subsection 8 states that as from 1988 all companies engaged in trade or business with a turnover of N500,000.00 and below qualify as small and medium enterprises. (Iwuji, n.d)

2.2 Problems Faced SMEs

There are a lot of problems that bedevil SMEs and stunt their growth. Although there are some problems peculiar to a particular country, the challenges faced by SMEs in different countries and geopolitical divisions are basically the same. For instance, a survey of Turkish SMEs by Organization for Economic Co-operation and Development (OECD) in 2004 showed that they were suffering the consequences of policy inconsistency, poor access to finance, insufficient know-how and low level of technology, and so many others. The same problems were also registered by other authors concerning other regions like the Philippines, Malaysia and other European states and of course in Sub-Saharan Africa-Nigeria inclusive as shown by different authors on the issue. Uzor (2004) believes that the constraints faced by SMEs in developing countries are not only accentuated with ineffective policy design, but also by market failures in the region. Their lack information technology and knowledge of automation is gradually being reduced given that they serve as contractors for larger firms particularly the foreign manufacturing firms.

A major difficulty faced by SMEs is that of lack of access to short and long term capital. A publication of the Weekly Trust of Saturday, January 22, 2011 recognizes the fact that collateral-based financing has become increasingly difficult for SMEs, whether as existing businesses, in their expansion states or as startups hence more SMEs are resorting to viability lending in which case they obtain loans based on the viability of the business and health of cash flow. Banks are usually reluctant to lend to SMEs and this is because of problems such as the SMEs' inability to meet the bank's lending requirements, promoters' low education, management and entrepreneurial skills and poor and unreliable financial records which makes financial review difficult. (Aderemi, 2003). There is also the problem of unsound accounting system and lack of full financial disclosure (Jan, n.d.). Aretay & Ahene, (2004) buttressed this assertion by listing lack of access to land, utility installation and services, and import procedures as constraints to SME growth. Summarily, these problems make SMEs a “high-risk” venture. The above named reasons are in and of themselves problems that impede SME growth because not only do they become obstacles in accessing financing, they are capable of hindering growth on their own.

Moreso, in Nigeria, the problems faced by SMEs as posited by Oboh (2002); Okpara (2000); Wale-Awe (2000) and Chu, Kara & Benzing, (2008) include astronomically high operating

costs; lack of transparency and corruption; and the lack of interest and lasting support for the SMEs sector by government authorities, dilapidated state of Infrastructural facilities, unreliable employees and Weak economy, unsafe location, undependable electricity supply are common phenomenon.

2.3 Economic Advantages of Small and Medium Enterprises in Nigeria

SMEs have been an important tool of economic development for Nigeria. The future of any growing economy such as Nigeria's depends on the entrepreneurial energy of vibrant SMEs because a lot of large businesses start out as SMEs. Many authors believe that they are the starting point of development in the economy towards industrialization. Udechukwu (2003) for example sees the SME sector as a very important sector that will enhance the contributions of the private sector and provide the critical building blocks for industrialization and sustainable economic growth. SMEs broaden the base of participation in society, decentralize economic power and give people a stake in the society's future (Williams, 2006). SMEs have also been recognized as a channel for improving the efficiency of domestic markets and making productive use of scarce resources, and thus facilitating long-term economic growth in poor countries (Aryeetey & Ahene, 2004). Given that a large proportion of Nigeria's population relies either directly or indirectly on small and medium enterprises for survival, their importance cannot be overemphasized.

A major contribution made by SMEs is in the area of employment (Yaobin, 2007) Small and medium-sized enterprises are a key source of new jobs, innovation, economic dynamism and greater social inclusion in the European Union. Other important they play an important role in secondary labour markets (that is, they offer a high amount of employment in casual, part-time, low training, low-skilled jobs); they are an invaluable source of 'entrepreneurship', employment growth. Findings from a study carried out by Chu, Kara & Benzing (2008) suggest that Nigerians consider entrepreneurship an avenue leading to job security and improving their livelihood. They also regard business ownership as a means of controlling their destiny and deriving self-satisfaction. Being more labour intensive, SME expansion is more likely to boost employment than large enterprises where expansion means higher degree of automation and machining. Hence, SME subsidization will lead to poverty alleviation (Beck, Demirguc-Kunt & Levine, 2005)

2.4 Theory of Taxation

According to Eftekhari, (2009) taxation has always been an issue for the government and taxpayers alike from the early years of civilization. The issue of taxation has generated a lot of controversy and severe political conflicts over time. According to its importance, several economic theories have been proposed to run an effective system. Taxes are generally classified under three different theories as given: ability to pay principle, benefit approach and equal distribution principle. However, in this paper we shall be considering ability to pay principle.

2.4.1 Ability-to-Pay Principle

As the name suggests, it says that the taxation should be levied according to an individual's ability to pay. It says that public expenditure should come from "him that hath" instead of "him that hath not". The principle originated from the sixteenth century, the ability-to-pay principle was scientifically extended by the Swiss philosopher Jean Jacques Rousseau (1712-1778), the French political economist Jean-Baptiste Say (1767-1832) and the English economist John Stuart Mill (1806-1873). This is indeed the basis of 'progressive tax,' as the tax rate increases by the increase of the taxable amount. This principle is indeed the most equitable tax system, and has been widely used in industrialized economics. The usual and most supported justification of ability to pay is on grounds of sacrifice. The payment of taxes is viewed as a deprivation to the

taxpayer because he surrendered money to the government which he would have used for his own personal use. However, there is no solid approach for the measurement of the equity of sacrifice in this theory, as it can be measured in absolute, proportional or marginal terms. Thus, equal sacrifice can be measured as (i) each taxpayer surrenders the same absolute degree of utility that s/he obtains from her/his income, or (ii) each sacrifices the same proportion of utility s/he obtains from her/his income, or (iii) each gives up the same utility for the last unit of income; respectively.

2.5 Tax Policy and the Growth of SMEs

According to Tomlin (2008), economists argue that the resources smaller companies direct towards tax compliance are resources that could otherwise be used for reinvestment, facilitating future growth. Hence, there is a belief that taxes and a complex tax system put disproportionate pressure on smaller businesses. Small taxpayers under the regular system of taxation are discriminated against, since the compliance requirements, cost of compliance and tax rate are the same for both small and large enterprises. Reducing the compliance costs and tax rate increases the small enterprises profit margin. It also increases the Government's tax revenue, since the simplified provisions for a micro enterprise historically reduce the size of the shadow economy and the number of non-complying registered taxpayers (Vasak, 2008). Furthermore, SMEs usually have to operate in an overbearing regulatory environment with the plethora of regulatory agencies, multiple taxes, cumbersome importation procedure and high port charges that constantly exert serious burden on their operations. Many SMEs have to deal with myriad of agencies at great cost. As stated earlier they are heterogeneous and these differences in size and structure may in turn carry differing obligations for record-keeping that affect the costs to the enterprises of complying with (and to the revenue authorities of administering) alternative possible tax obligations. Public corporations, for example, commonly have stronger accounting requirements than do sole proprietorships, and enterprises with employees may be subject to the full panoply of requirements associated with withholding labor income taxes and social contributions (International Tax Dialogue 2007).

An overly complex regulatory system and tax regime or one opaque in its administration and enforcement makes tax compliance unduly burdensome and often have a distortionary effect on the development of SMEs as they are tempted to morph into forms that offer a lower tax burden or no tax burden at all (Masato, 2009) and this results in a tax system that imposes high expenses on the society. A poorly executed tax system also leads to low efficiency, high collection charges, waste of time for taxpayers and the staff, and the low amounts of received taxes and the deviation of optimum allocation of resources (Farzbod, 2000). Existing empirical evidence clearly indicates that small and medium sized businesses are affected disproportionately by these costs: when scaled by sales or assets, the compliance costs of SMEs are higher than for large businesses (Weichenrieder, 2007). Among the factors militating against SME tax compliance with are: high tax rates, Low efficiency, high collection charges, waste of time for taxpayers and the staff, and the low amounts of received taxes and the deviation of optimum allocation of resources (Farzbod, 2000). Others according to Yaobin, (2007) are double taxation, no professional tax consultancy, weak tax planning, high taxation cost.

2.6 Policy Measures that will Encourage SMEs Growth

Although there is certain policy measures geared towards SME growth in Nigeria, the support needs to be increased, standardized and systematic. Iwuji (n.d) believes that it is the role of the government to provide and enabling environment and social services that support businesses and persons. This means enhancing the investment climate in Nigeria for increased economic growth

and subsequent tax contribution from all citizens which is necessary because a good number of SMEs operate in the informal economy due to the fact that they deem the tax environment within which they operate unfavourable. These SMEs constitute untapped revenue potential and an uneven playing field in many countries (International Tax Dialogue, 2007) as such they need to be captured by the tax net. The legislation is a necessary regulator for protection of the business environment and security of the economic agents, for establishment of the necessary social security regulations but at the same time it hampers the business with additional expenditures and administrative obstacles, which place in different positions the SME. The big companies have more choices possibilities. They can either share part of the staff or hire people to deal only with studying the legal requirements and complying with the new regulations, or contract some personal service firm (like E&Y, Deloitte and Touché, Price Waterhouse etc) to deal with their tax compliance, planning etc. For SME this is a great expense out of their abilities (Smatrakalev, 2006). Shahroodi, (2010) believes that for a tax system to be efficient, the tax policy needs to be designed such that the tax rates are appropriate and rational, the exemptions are lower in amount, the tax collection organization are more efficient, the tax burden of the indigent people should be lighter and the fight against corruption and tax evasion should be much more intense. Tax policies can be designed in such a way that they do not only directly affect SMEs but also indirectly push for their growth for example the practice in China where tax policy has been designed to encourage SME financing by granting exemptions from business tax for financial corporations that provide guarantee for loans to SMEs and granting tax deductions to market entities and venture capitalists that invest in high-tech SMEs the tune of 70% of the investment value.

Another way is by designing tax policies that encourage human capital training. (Yaobin, 2007) declared that special tax regimes for SMEs may be appropriate policy instruments for minimizing the cost of collection. It is important to note that the awareness of the dangers of inadequate attention to the taxation of SMEs has grown. It can lead, for example, to distortions of competition as a result of uneven tax enforcement, with incentives created to limit growth and to avoid tax through artificial splitting of enterprises. Not least, voluntary compliance by larger enterprises themselves, and by wage earners, may be undermined by the (correct) perception that their smaller counterparts, or better-off neighbors, are getting away with poorer compliance. (International Tax Dialogue, 2007) Hence government intervention will help maintain balance while helping countries exploit the social benefits from greater competition and entrepreneurship. Furthermore, policy incentives such as tax rebate for SMEs that put effort on local sourcing of raw materials, serious in adding value to commodities for exports and other business ethics, should be employed by government. Similarly, government could increase funding for the development of the sub-sector through direct budgetary allocations and enhance private sector investment opportunities that will focus on specific areas of capacity enhancement. Tax law should be simplified continuously, mainly for three reasons, namely to lower both compliance costs and administrative costs, to reduce uncertainty faced by taxpayers; and to improve the levels of voluntary compliance (Kasipillai, 2005). And also tax law should be simplified continuously, mainly for three reasons, namely to lower both compliance costs and administrative costs, to reduce uncertainty faced by taxpayers; and to improve the levels of voluntary compliance (Kasipillai, 2005). Pro-business (and Pro-SME) Tax regimes and enforcement should be simple, consistent and predictable.

3.0 Section Three: Research Method

The research is an explanatory or a causal study. This is because it is a research that it is aimed at establishing causal relationship between two variables i.e. the relationship between tax policy and the growth of SMEs. Since it involves collecting the views, perspectives or opinions of

respondents regarding a particular issue or research interest, it employed the survey method using questionnaires, personal interviews with respondents and perusal of past records and publications. This choice was made due to the fact that the survey method is effective when it comes to getting opinions, attitudes and descriptions as well as for getting cause and effect relationships (Ghuari and Gronhaug 2005). The research was on the sample of 150 SMEs with different ownership and legal structures and at different levels of development by so doing obtaining a fair representation of the population.

A total number of 150 questionnaires were distributed, of this number, 107 were returned and 43 were not. This gives a retrieval rate of 71.33% which is reliable enough to base a research on. The location of study for this research is Zaria, Kaduna State. Krejcie & Morgan (1970) in Amadii (2005) agrees with the sample as they proposed the population proportion of 0.05 as adequate to provide the maximum sample size required for generalization. The expert opinion was sought for in order to validate the content and the structure of the questionnaire during the pilot study. For testing the hypothesis, a statistical non parametric Spearman's Rank Correlation is used. Spearman's rank correlation measures the strength of association between two variables i.e the extent to which, as one variable increases, the other variable tends to increase, without requiring that increase to be represented by a linear relationship. Moreover the Spearman Correlation is a non-paracontinuous-level test, which does not assume that the variables approximate multivariate normal distribution. Spearman's test does not depend on the assumption of an underlying bivariate normal distribution. And this is done through the use of SPSS statistical package.

4.0 Section Four: Empirical Results and Implication of Findings

Restatement of Hypothesis

H₀: There is no significant relationship between tax and the SME's ability to expand

4.1 Discussion of Results

From the Spearman's rank correlation in table 1 (see appendix), it was discovered that Spearman's rank correlation coefficient (Rho) obtained was -0.152 at a two-tailed level of significance of 0.015. This means that there is a weak negative correlation between the amount of taxes paid and the number of projects carried out of business profits. Hence, the null hypothesis (H₀) should be rejected and the alternative hypothesis (H₁) accepted.

The negative albeit weak correlation between taxes paid and projects carried out of business profits indicates that the lower the amount of taxes paid by the SME, the greater the growth related business project the profits are used for. The weak correlation suggests that there are some other factors apart from tax that also affect SMEs' ability to expand. According to the International Tax Dialogue (ITD, 2007) a reduced tax rate will free more internal finance for SMEs. This supports the assertion of Horsepower (2001) which states that reduced tax rates improve internal financing which in turn enhance internal accumulation. Furthermore, Tadjibaeva & Komilova (2009) have found that tax rate is one of the factors that affect the prosperity of entrepreneurs.

5.0 CONCLUSION AND RECOMMENDATION

From the foregoing, it can be concluded that SMEs play an important role in the growth and development of the Nigerian economy. It can also be concluded that a friendly tax policy is

instrumental to the survival and growth of these small and medium enterprises. However, taxes for SMEs have been more harmful than beneficial as they increase running costs and slow down growth. Most of the SMEs surveyed are faced with the problem of high tax rates, multiple taxation, complex tax regulations and lack of proper enlightenment or education about tax related issues. Therefore, if SMEs are to flourish, an appropriate tax policy which will not be an encumbrance to SMEs and which will also encourage voluntary compliance needs to be on ground.

5.1 Recommendation

1. Small and Medium Enterprises should be levied lower amounts of taxes so that they will have enough funds for other activities that will lead to business growth. Furthermore it will help SMEs get better equipped to survive in a competitive market.
2. The government should consider increasing tax incentives and exemptions as this will not only attract investors who are potential tax payers, it will encourage voluntary compliance and ultimately leads to expansion of existing business interests of the SMEs in Nigeria.

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APPENDIX

Table 1 Spearman's Rank Correlation

			Estimated Percentage Taxes	Project Carried out of Business Profit
Spearman's rho	Estimated Percentage Taxes	Correlation Coefficient	1.000	-.152(*)
		Sig. (2-tailed)	.	.015
		N	91	91
Projects Carried out of Business Profit	Projects Carried out of Business Profit	Correlation Coefficient	-.152(*)	1.000
		Sig. (2-tailed)	.015	.
		N	91	157

* Correlation is significant at the 0.05 level (2-tailed).

Source: Researcher's Survey, 2011

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