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TAX INCENTIVES AND FINANCIAL PERFORMANCE OF MICRO, SMALL AND MEDIUM ENTERPRISES

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Abstract: Tax incentives are seen as a tool used in encouraging companies to survive and perform better which Micro small and medium enterprises (MSMEs) are part. The study therefore investigated the relationship between tax incentives and financial performance of MSMEs in Rivers State, Nigeria. The study adopted the survey research design. The study population comprises indigenous MSMEs providing services for the oil and gas companies in Rivers State. The purposive and the convenient sampling methods were used to select thirty (30) companies. The structured four likert scale questionnaires were adopted as two copies of the questionnaire were sent to each company selected to make it sixty (60) respondents. The data collected were then analysed using the descriptive and the linear regression analysis. The result showed that capital allowance has significant and positive relationship with net profit margin at 0.000 probability value and 0.366 R square. Also, loss relief has significant and positive relationship with net profit margin at 0.000 probability value and 0.425 R square. The study then recommended that MSMEs should focus on effective asset management and reinvestment strategies and also incorporate loss relief as part of their financial planning to enhance NPM during recovery periods. The study concludes that tax incentives have positive and significant relationship with MSMEs in Rivers State Nigeria.

Keywords: Capital allowance, loss relief, NPM, MSMEs

1. INTRODUCTION

1.1. Background to the Study

MSMEs are widely regarded as the backbone of economic development in both advanced and developing countries, including Nigeria. They play a crucial

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role in job creation, poverty reduction, and innovation, accounting for a significant portion of economic activity. In the assertion of National Bureau of Statistics, MSMEs in Nigeria contribute approximately 48% of the national GDP, employ over 80% of the workforce, and account for 96% of businesses in Nigeria (National Bureau of Statistics, 2022). The SMEs are seen to be basic and absolute tools in the process of Nigeria's industrialization (Inim et al., 2020) and are the core foundation of the economy in Nigerian since they stand as employment generation basis, economic vitality, rivalry and novelty; thus adding to growth national and lessening poverty (Deloitte Nigeria, 2018).

Taxation is one of the major issues affecting the financial performance of MSMEs. Given their limited resources, high tax burdens can be detrimental, affecting their liquidity, operational efficiency, and overall financial stability. Recognizing the importance of MSMEs to economic growth, the Nigerian government has introduced various tax incentives designed to reduce the financial pressure on these businesses and promote their growth. These incentives include tax holidays, capital allowances, loss relief, and reduced corporate tax rates for small businesses. The concept of tax incentives refers to the special provisions in tax laws that offer exemptions, deductions, or reductions aimed at encouraging certain economic activities. In the case of MSMEs, these incentives are intended to encourage reinvestment, expansion, and improved financial performance. Though various tax incentives introduced in Nigeria aimed at improving the financial performance of MSMEs in Nigeria, many MSMEs continue to struggle with profitability and sustainability. Many MSMEs still struggle with issues such as poor financial management, inadequate infrastructure, high operational costs, and limited access to finance. These challenges raise critical questions about the effectiveness of the tax incentives provided by the government.

Therefore, this study seeks to investigate the relationship between tax incentives and the financial performance of MSMEs in Rivers State, Nigeria. It aims to determine whether tax incentives like capital allowances and loss relief have a significant impact on the Net Profit Margin of MSMEs.

1.2. Study Aim and Objectives

The aim is to investigate the effect of tax incentives on growth of SMEs in Nigeria. Specifically, the objectives of the study are to:

(i) To investigate the relationship capital allowance has with net profit margin of MSMEs in Rivers State, Nigeria.

(ii) To assess the relationship loss relief has with net profit margin of MSMEs in Rivers State, Nigeria.

1.3. Research Hypotheses

Two hypotheses were formulated:

Ho_1. Capital Allowance has no significant relationship with net profit margin of MSMEs in Rivers State, Nigeria.

Ho_2. Loss relief has no significant relationship with net profit margin of MSMEs in Rivers State, Nigeria.

2. CONCEPTUAL FRAMEWORK

2.1. Tax Incentives

Tax incentives are benefits that are financial in nature presented by governments to give encouragement to businesses or individuals to engage in certain economic activities that are perceived to be beneficial to the national economy. Tax incentives till date are evolving globally and still remain popular and relevant in all economies. Ugwu, et al. (2020) defined tax incentives as deductions that are excluded or exempted from liability from tax offered to entice and also encourage investors in certain sectors preferred in an economy for a given period. Tax incentives are given by tax authorities with the aim or goal of achieving greater investments that will result eventually in higher and guaranteed future production for a positive effect on the country's economy. For MSMEs in Nigeria, these incentives are aimed at reducing the tax burden, thereby allowing them to reinvest profits, expand operations, and improve overall financial performance.

In Nigeria, tax incentives are critical for stimulating economic growth, especially in sectors where MSMEs play a dominant role, such as agriculture, manufacturing, and services. These incentives not only reduce the cost of doing business but also promote compliance with tax regulations, as firms are more likely to engage with the tax system if they see a direct financial benefit (Ariyo, 2018). Tax incentives are considered effective if they can positively influence business growth and investment, but there are debates regarding their overall impact on MSMEs' performance. In many cases, the effectiveness of tax incentives depends on the ability of MSMEs to navigate the complexities of tax administration and to utilize available resources efficiently (Zwick & Mahon, 2017).

Promoting economic growth and investment; attracting; support startups and MSMEs; encouraging compliance; and encouraging investment in key

sectors are some arguments in favour of tax incentives. While arguments against tax incentives are loss of government revenue: inequitable distribution of benefits; complexity and administrative costs; limited impact on long-term investment; risk of misuse and corruption; and distortion of market competition. The arguments for tax incentives emphasize their ability to drive economic growth, attract investment, and support MSMEs, especially in developing economies like Nigeria. However, the arguments against tax incentives highlight potential drawbacks, such as revenue loss, unequal distribution of benefits, and administrative complexities. The effectiveness of tax incentives largely depends on their design, implementation, and the broader economic context in which they operate.

Tax incentives are critical tools used by governments to promote economic growth and encourage investment. Among these, loss relief and capital allowance stand out as mechanisms designed to reduce businesses' tax liabilities.

2.2. Capital Allowances

Capital allowance is a tax relief that lets businesses deduct capital expenditures from taxable income. This measure encourages investment in physical assets, such as machinery and equipment (Federal Inland Revenue Service, 2023). Capital allowance is a key component of the tax system, designed to provide relief to businesses by allowing them to deduct the cost of qualifying capital expenditure from their taxable income over a period of time. They are a form of tax relief granted to businesses on qualifying capital expenditures. It operates as an alternative to accounting depreciation, with the government setting predefined rates at which businesses can deduct these costs over time. Unlike accounting depreciation, capital allowance is prescribed by law, with fixed percentages based on the type of asset and its expected useful life. In the context of MSMEs in Nigeria, capital allowances serve as an essential tax incentive to encourage investments in business assets and infrastructure, fostering growth and improving long-term financial sustainability. They are designed to incentivize MSMEs to invest in non-current assets, that is, items of property, plant and machinery (PPE). In Nigeria, capital allowances are designed to encourage businesses to invest in productive assets, thus improving long-term financial performance. Capital allowance incentivizes modernization and expansion by reducing the effective cost of capital investments. It also supports environmentally sustainable practices by offering enhanced allowances for green technologies (HM Revenue & Customs, 2023).

The United Kingdom offers Annual Investment Allowance and Writing Down Allowance as key tax incentives, with special rates for certain asset classes like energy-saving equipment (HM Revenue & Customs, 2023). In United States, Section 179 of the Internal Revenue Code allows businesses to expense qualifying property up to a limit in the year of acquisition (Internal Revenue Service, 2023). And in Nigeria, the Companies Income Tax Act (CITA) provides deductions for capital allowances, with rates varying based on asset type.

While capital allowances are beneficial to the business, predetermined rates may not align with actual asset depreciation. Additionally, some jurisdictions limit allowances to specific asset categories, excluding unconventional investments (OECD, 2021).

2.3. Loss Relief

Loss relief is another tax incentive designed to support businesses during times of financial difficulty. Loss relief is a fundamental element of tax policy that allows businesses to offset losses incurred in one financial year against profits made in another. Loss relief refers to a provision in tax laws allowing businesses to claim deductions for losses incurred in a particular period, either by applying them to future profits (carry-forward loss relief) or reclaiming taxes paid in prior years (carry-back loss relief). Businesses can carry forward losses to offset profits in subsequent years, reducing tax burdens over time (OECD, 2021).By using these provisions, businesses can reduce their tax liabilities, creating a buffer during unprofitable times and aiding long-term financial stability. For MSMEs, loss relief is particularly beneficial as it allows them to offset current financial losses against past or future profits, reducing their tax liability during lean periods. Loss relief allows businesses to offset taxable profits against previous, current, or future losses, thereby reducing overall tax liability. This measure is particularly valuable for businesses experiencing financial difficulty or fluctuating income (HM Revenue & Customs, 2023). Loss relief incentivizes entrepreneurship by mitigating the financial risks associated with starting or maintaining a business. It provides a financial cushion for businesses during volatile economic periods, ensuring long-term sustainability (OECD, 2021). Nevertheless, loss relief often faces restrictions to prevent abuse.

Losses in United Kingdom can be carried forward indefinitely to offset future profits, subject to restrictions (HM Revenue & Customs, 2023). In the United States, The Tax Cuts and Jobs Act of 2017 limited carry forwards to 80% of taxable income but eliminated time limits on their use (Internal Revenue

Service, 2023). While in India, Section 72 of the Income Tax Act allows businesses to carry forward and set off losses for up to eight assessment years (Income Tax Department, 2023).

Comparative analysis of capital allowance and loss relief are provided below in terms of purpose, timing, scope and economic impact.

Purpose: Capital allowance encourages capital investments by reducing taxable income while loss relief mitigates the financial impact of losses on taxable income.

Timing: Capital allowance applies to capital expenditure on assets over time while loss relief applies to profits from past, present, or future years**.**

Scope: Capital allowance focus is on asset-related expenses while the focus of loss relief targets operational losses.

Economic Impact: Capital allowance stimulates growth and modernization through investment while loss relief promotes business continuity during downturns

2.4. Financial Performance

Financial success, Mamidu and Akinola (2019) determines or gauges the capacity of a company in producing new resources through activities that are ongoing. Edori and Edori Opined that a company must make profit in order to continue in business and grow overtime ((2022). Meaning that, making profit is part of good financial performance. The performance of a company is frequently measured using financial information that is generated in a specific reflected in financial statements **(**Purnamasari, 2015). Investors repeatedly used financial information in their assessment of share's price and to make decisions on investment. This is because reported financial information by firm are used for the assessment of companies' economic success. Major and Edori (2020) believe that it is pointer to how the soundness of firms' finances relates with profitability. They further opined that financial performance explains the way cost is controlled and the how of revenue generation. Ohaka, et al (2020) state that business entities that have higher financial performance are capable of attracting more investors than lower financial performant companies. Financial performance shows predominantly the financial health of a business enterprise (Major & Edori, 2020). Igweagbara and Edori (2023) that financial performance is known for the measurement of a "firm's total financial health" covering specified time duration.

2.5. Net Profit Margin

Net profit is the available profit to the firm after all expenses and charges have been deducted from the gross profit and any other income added. Edori and Edori (2022) defined net profit as the revenue portion remaining after all expenses are subtracted from the gross profit made by a firm. The net profit can be employed as tool for measuring firm's profitability and operational efficiency (George, 2019). It is one of the major tools employed while comparing two or more firms' performance. The net profit, according to Edori and Egileoniso (2024) can be used as tool in measuring the profitability, operational efficiency and financial performance of a company.

The NPM is a ratio that shows earnings that are left for shareholders (equity and preference) as a net sales percentage. NPM elaborate the ability companies to earn particular profit as a result of selling a unit of her product after all expense (direct and indirect expenses) are deducted (Farooq, 2019). That is, NPM shows the revenue proportion that is turned into net profit. It remains one of the two determining elements of ROA and it reflects ROE holders for the time concerned. Edori and Egileoniso (2024) asserts that portion of the revenue translated into net profit is displayed by NPM. A firm's profit margin equals the net profit or the net income after taxes and extraordinary items excluded divided by the firm's total revenue.

$$NPM = \frac{Net\ profit\ after\ tax}{Total\ revenue}$$

3. THEORETICAL REVIEW

3.1. Optimal Taxation Theory

Frank P. Ramsey developed the theory in 1927. The "optimal taxation theory" is a branch in economics and it considers the way in which taxes should be structured that will result in a lowest (least) deadweight costs, and/or brings out the best results on social welfare. Deadweight cost relates demand and supply elasticity for goods and the theory deals with how deadweight costs will be minimized. Inim et al (2020) elucidated that charging highest rates of tax on goods with "most inelastic supply and demand" will produce the least total deadweight costs. When taxes are restructured, through tax policies, and it reduces costs and burden on SMEs, it will lead to higher profit hence making more funds available for growth. A good tax administration and effective tax

incentives for SMEs will reduce the tax burden on them and will invariable result to increased profitability.

4. METHODOLOGY

The map of a research work by a researcher or a full outline that shows how a research will be performed is called the research design. The study proposed the non-probability sampling technique. Therefore, the sample of the study was restricted thirty (30) MSMEs in Rivers state with focus on the Managers and Accountants; resulting to sixty (60) respondents. The Likert 4-scale questionnaire was used. The descriptive and the linear regression methods were used in analyzing data collected from the field by means of structured questionnaire

5. DATA PRESENTATION

Table 1: Questionnaire Distributed and Returned

Numbers	*Questionnaire*	*Percentage (%)*
No. Distributed	60	100%
No. Retrieved	60	100%
No. Not Retrieved	0	0%
Useful Response	60	100%

It is shown in table 4.1 that 60 copies of questionnaires were distributed to the respondents representing 100%. All sixty copies of questionnaires were returned and were all useful.

Table 2: Number and Percentage of Respondents on Capital Allowance

Capital Allowance					
S/N	*Question*	*Strongly Agreed*	*Agreed*	*Disagreed*	*Strongly Disagreed*
1	Capital allowance has made it easier for my business to acquire necessary machinery and equipment.	8 13.33%	14 23.33%	18 30%	20 33.34%
2	The availability of capital allowance has improved my company's financial stability.	16 26.67%	36 60%	61 0%	2 3.33%
3	I regularly take advantage of capital allowance when calculating my business's taxable income.	26 43.33%	34 56.67%	0 0%	0 0%

contd. table 2

S/N	*Question*	*Strongly Agreed*	*Agreed*	*Disagreed*	*Strongly Disagreed*
4	The rates for capital allowances are sufficient to encourage investment in long-term assets.	6 10%	18 30%	26 43.33%	10 16.67%
5	The Nigerian capital allowance policy is supportive of MSME growth and development	14 23.33%	32 53.34%	12 20%	2 3.33%

Table 3: Number and Percentage of Respondents on Loss Relief

Loss Relief					
S/N	*Question*	*Strongly Agreed*	*Agreed*	*Disagreed*	*Strongly Disagreed*
6	My business has benefited from the ability to carry forward losses to future profitable periods.	12 20%	18 30%	16 26.67%	14 23.33%
7	The process of claiming loss relief is straight forward for my business.	20 33.33%	36 60%	4 6.67%	0 0%
8	Loss relief has helped reduce my business's tax liabilities during years of loss.	22 36.67%	38 66.33%	0 0%	0 0%
9	I am satisfied with the loss relief provisions available to my business.	14 23.33%	26 43.33%	16 26.67%	4 6.67%
10	The ability to offset losses against future profits has helped my business maintain financial stability.	18 30%	38 63.34%	2 3.33%	2 3.33%

Table 4: Number and Percentage of Respondents on Net Profit Margin

Net Profit Margin (NPM)					
S/N	*Question*	*Strongly Agreed*	*Agreed*	*Disagreed*	*Strongly Disagreed*
11	Tax incentives have significantly improved my business's net profit margin.	12 20%	34 56.67%	8 13.33%	6 10%
12	Loss relief provisions have positively impacted my business's net profit margin.	12 3.34%	36 60%	8 13.33%	2 3.33%
13	My company's net profit margin is a direct result of the tax incentives and allowances we receive.	6 10%	28 46.67%	22 36.67%	4 6.66%
14	The Nigerian tax system has a significant effect on the net profit margin of my business.	8 13.33%	40 66.67%	10 16.67%	2 3.33%
15	Net profit margin is a useful metric for evaluating the impact of tax incentives on business performance.	34 56.67%	26 43.33	0 0%	0 0%

6. ANALYSIS

6.1. Descriptive Analysis

Table 5: Result of Data Analysis on Dimensions and Measures of the Study Variables Descriptive Statistics

	N	*Minimum*	*Maximum*	*Mean*	*Std. Deviation*
CA	60	1.00	4.00	2.8000	.92686
LR	60	1.00	4.00	3.0200	.83922
NPM	60	1.00	4.00	2.9867	.78567
Valid N (listwise)	60				

The table presents descriptive statistics for three variables: capital allowance, loss relief, and net profit margin, measured across 60 observations. Each variable has 60 observations, which implies that the data is consistent across all variables with no missing values in this subset. Each variable has a minimum value of 1.00 and a maximum value of 4.00, suggesting that all variables were measured on a 4-point scale, ranging from 1 to 4. Capital allowance average score is 2.80, indicating that responses lean slightly above the midpoint (which would be 2.5). The mean for loss relief is 3.02, suggesting that responses are generally above the midpoint and closer to the upper limit of the scale. Net profit margin mean is 2.99, showing that responses are also slightly above the midpoint. The standard deviation for capital allowance is 0.93, indicating moderate variability around the mean. Loss relief has a standard deviation of 0.84, showing slightly less variability compared to capital allowance. NPM's standard deviation of 0.79 shows consistency.

6.2. Test of Hypothesis

Ho_1. Capital Allowance has no significant relationship with net profit margin of MSMEs in River State, Nigeria.

Table 6: Regression Result on the Relationship between Capital Allowance and Net Profit Margin

Model Summary

Model	*R*	*R Square*	*Adjusted R Square*	*Std. Error of the Estimate*
1	.605[a]	.366	.361	.62792

a. Predictors: (Constant), CA

ANOVA[a]

Model		*Sum of Squares*	*Df*	*Mean Square*	*F*	*Sig.*
1	Regression	33.620	1	33.620	85.270	.000[b]
	Residual	58.353	59	.394		
	Total	91.973	60			

a. Dependent Variable: NPM

b. Predictors: (Constant), CA

Coefficients[a]

Model		*Unstandardized Coefficients*		*Standardized Coefficients*		
		B	*Std. Error*	*Beta*	*T*	*Sig.*
1	(Constant)	1.552	.164		9.482	.000
	CA	.513	.056	.605	9.234	.000

a. Dependent Variable: NPM

The model summary shows the correlation between the observed and predicted values of NPM. An R of 0.605 indicates a moderately strong positive relationship, suggesting that increases in capital allowance are associated with increases in NPM. The R Square indicates that 36.6% of the variance in NPM can be explained by capital allowance. This reflects a moderate level of explanatory power, meaning that capital allowance accounts for over a third of the variability in NPM.

The regression value of 33.620 in the ANOVA (Analysis of Variance) represents the variation in NPM that is explained by capital allowance. The residual value of 58.353 is the variation that remains unexplained by the model. The F value of 85.270 tests whether the overall regression model is statistically significant. A high F-value indicates that the model provides a good fit to the data. The Significant value of 0.000 and its association with the F-statistic is less than .05, indicating that the model is statistically significant. Therefore, capital allowance is a significant predictor of NPM.

In the coefficients table, the constant value of 1.552 is the intercept, meaning that when capital allowance is zero, the predicted value of NPM is 1.552. The unstandardized coefficient shows that for every one-unit increase in capital allowance, NPM is expected to increase by 0.513 units, assuming other factors

remain constant. The Beta value of 0.605 is the standardized coefficient for capital allowance, equivalent to the correlation in this simple regression model, indicates the strength of capital allowance's effect on NPM. The t has a value of 9.234 and Sig. value of 0.000). The t-value tests the significance of capital allowance in predicting NPM. A high t-value and a p-value of 0.000 signify that capital allowance is a statistically significant predictor of NPM.

Ho_2 Loss relief has no significant relationship with net profit margin of MSMEs in Rivers State, Nigeria.

Table 7: Regression Result on the Relationship between Loss Relief and Net Profit Margin

Model Summary

Model	*R*	*R Square*	*Adjusted R Square*	*Std. Error of the Estimate*
1	.652[a]	.425	.421	.59782

a. Predictors: (Constant), LR

ANOVA[a]

Model		*Sum of Squares*	*Df*	*Mean Square*	*F*	*Sig.*
1	Regression	39.081	1	39.081	109.352	.000[b]
	Residual	52.893	148	.357		
	Total	91.973	149			

a. Dependent Variable: NPM

b. Predictors: (Constant), LR

Coefficients[a]

Model		*Unstandardized Coefficients*		*Standardized Coefficients*		
		B	*Std. Error*	*Beta*	*t*	*Sig.*
1	(Constant)	1.144	.183		6.254	.000
	LR	.610	.058	.652	10.457	.000

a. Dependent Variable: NPM

Model Summary: The R value of 0.652 represents the correlation between loss relief and net profit margin (NPM). An R value of 0.652 indicates a moderately strong positive relationship, suggesting that as loss relief increases,

NPM also tends to increase. The R Square of 0.425 shows that about 42.5% of the variance in NPM is explained by loss relief. This means that loss relief has a moderate-to-strong explanatory power regarding the variability in NPM.

ANOVA (Analysis of Variance). The regression value of 39.081 reflects the amount of variance in NPM explained by the model. The residual value of 52.893 represents the variance in NPM not explained by loss relief. The F-statistic 109.352 shows whether the overall model is significant. A high F-value suggests a good model fit. The p-value is less than .05, indicating the model is statistically significant, so loss relief is a significant predictor of NPM.

Coefficients. The constant value of 1.144 shows the y-intercept, indicating that when loss relief is zero, the predicted NPM is 1.144. This unstandardized coefficient shows that for every one-unit increase in LR, NPM is expected to increase by 0.610 units. The standardized coefficient (Beta) measures the strength of the relationship between loss relief and NPM, with 0.652 indicating a moderately strong positive relationship. The t value is 10.457 and significance value is 0.000. The t-value tests the significance of loss relief as a predictor of NPM. A high t-value and a p-value of 0.000 indicate that loss relief significantly predicts NPM.

7. CONCLUSIONS

The facts generated from the study indicated that there is a significant relationship between tax incentives and financial performance of MSMEs in Rivers state, Nigeria. The four hypotheses tested showed significant relationship. The study therefore concludes that there is a significant relationship between tax incentives and financial performance of MSMEs in Rivers state, Nigeria.

8. RECOMMENDATIONS

The study made the following recommendations based on the findings of the study:

(i) Since capital allowance impacts NPM, MSMEs should focus on effective asset management and reinvestment strategies. By strategically investing in assets that qualify for capital allowances, MSMEs can lower their taxable income and improve net profit margins. This approach can be complemented with cost-management practices to ensure that tax savings translate into improved profitability.

(ii) MSMEs should incorporate loss relief as part of their financial planning to enhance NPM during recovery periods. Effectively using loss relief helps MSMEs offset prior losses against current profits, thereby improving net profit margins in profitable years. Business owners should work with financial advisors to optimize loss relief strategies, ensuring that temporary losses have a minimal long-term impact on profitability.

By adopting these targeted recommendations, MSMEs can strategically leverage tax benefits like capital allowance and loss relief to improve their financial performance.

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