The Effect of Tax Incentive on the Growth of Small and Medium Enterprises in Nepal

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Abstract

This study analyzes the effect of tax incentive for the growth of small and medium enterprises in Nepal. The dependent variable is growth of small and medium enterprises. Similarly, the selected independent variables are tax incentive, tax holiday, tax credit, investment allowance and loss carried forward. The primary source of data is used to assess the opinions of the respondents regarding the tax incentive, tax holiday, tax credit, investment allowance and loss carried forward for growth of small and medium enterprises. The study is based on primary data of 125 respondents. To achieve the purpose of the study, structured questionnaire is prepared. The correlation coefficients and regression models are estimated to test the different factors affecting growth of small and medium enterprises in Nepal.

The result shows that tax holiday has positive impact on growth of small and medium enterprises. It means that increase in tax holiday leads to growth of small and medium enterprises. Similarly, tax incentives has positive impact on growth of small and medium enterprises. It means that increase in tax incentive leads to growth of small and medium enterprises. Likewise, tax credit has a positive impact on growth of small and medium enterprises. It shows that increase in tax credit leads to growth of small and medium enterprises. Furthermore, investment allowance has positive impact on growth of small and medium enterprises. It indicates that increase in investment allowance leads to growth of small and medium enterprises. Moreover, loss carried forward has a positive impact on growth of small and medium enterprises. It indicates that increase in loss carried forward leads to increase in growth of small and medium enterprises.

Keywords: tax incentive, tax holiday, tax credit, investment allowance, loss carried forward, growth of small and medium enterprises

1. Introduction

The growth of SMEs refers to their ability to expand operations, increase revenue, enhance employment, and improve overall productiv ity. SMEs account for a significant proportion of total businesses, playing a crucial role in the nation's gross domestic product (GDP). As in the case with most developing and even developed nations small and medium-sized enterprises (SMEs) in Nepal, despite encompassing a significant sphere of the national economy, face significant challenges (Yoshino and Taghizadeh-Hesary, 2016). The importance of Small and Medium Scale Enterprises (SMEs) 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' Gross Domestic Product (Feyitimi *et al.*, 2016). Tax Incentives had been perceived to influence the growth of small and medium enterprises (SMEs) (Olayemi and Folajimi, 2021). According to Hall and Van Reenen (2000), investment allowances play a significant role in stimulating productivity and fostering innovation in SMEs. A tax holiday is a governmental incentive that temporarily reduces or eliminates taxes for consumers or businesses (Guzman, 2023).

Devereux and Griffith (1998) analyzed that the taxes and the location of production. The study stated that the loss carried forward policies encourage risk-taking and long-term investments, critical factors for SME growth and sustainability. Similarly, Ayyagari *et al.* *(*2007) studied that the small and medium enterprises across the globe. The study argued

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that the policies supporting entrepreneurship, such as tax incentives, can catalyze SME growth by fostering a conducive business environment. Likewise, Beck and Demirguc-Kunt (2006) examined that the small and medium-size enterprises: Access to finance as a growth constraint. The study demonstrated that the growth of SMEs is influenced by various factors, including government policies, financial incentives, and access to resources. Further, Adebisi and Gbegi (2013) assessed that the effect of multiple taxation on the performance of small and medium scale business enterprises. The study revealed that multiple taxation has negative effect on SMEs' survival and the relationship between SMEs' size and its ability to pay taxes is significant. Moreover, Atawodi and Ojeka (2012) examined that the factors that affect tax compliance among small and medium enterprises (SMEs) in North Central Nigeria. The study showed that SMEs lower percentage of taxes to allow enough funds for business development and better chances of survival in a competitive market. In addition, Teraoui *et al.* (2011) investigated that the impacts of tax incentives on corporate financial performance: the case of the mechanical and electrical industries sector in Tunisia. The study found that the strong involvement of the Tunisian government for assistance of Tunisian export's firms to improve their competitiveness through the development of a free trade zone with the European Union.

Feyitimi *et al.* (2016) examined that the tax incentives and the growth of small and medium scale enterprises in developing economy. The study revealed that there is a friendly tax policy for all startup 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. Similarly, Hossain and Rahman (2016) analyzed that the small and medium enterprises development in Rangpur division: Problems and prospects. The study revealed that the process of industrialization, the government has identified the Small and Medium Enterprise (SME) sector as the priority sector and also as an engine of industry. Likewise, Piza *et al.* (2016) assessed that the impact of business support services for small and medium enterprises on firm performance in low-and middle-income countries. The study indicated that business support to SMEs improves firms' performance and confidence interval helps create has a positive effect on labour productivity on exports and on firms' investment. Further, Ezeagba (2019) studied that the tax holiday and industrial growth in Sub–Saharan Africa: A study of selected SMEs in Nigeria. The study found that there is a positive effect of tax holiday on industrial growth, suggesting that increasing tax holidays to productive and priority sectors of African economy will increase the continent's gross domestic products. Moreover, Twesige and Gasheja (2019) investigated that the effect of tax incentives on the growth of small and medium-sized enterprises (SMEs) in Rwanda. The study indicated that there is a strong positive and significant relationship between tax incentives and the growth of small and medium enterprises in Rwanda. Additionally, Anim *et al.* (2020) analyzed that the tax administration, tax incentive and smes' growth: The moderating effect of firm's size. The study revealed that tax administration accounts for a statistically significant positive weak variance in SMEs' growth, whilst tax incentives account for a statistically significant positive moderate variance in SMEs' growth.

Gardi *et al.* (2021) investigated that the effects of financial accounting reports on managerial decision making in small and medium-sized enterprises. The study identified that understandability, relevance, and quality of the financial reports mediates a positive correlation between financial accounting reports and managerial decisions. Similarly, Kassa (2021) examined that the factors influencing taxpayers to engage in tax evasion: Evidence from Woldia city administration micro, small, and large enterprise taxpayers. The study indicated that tax fairness, tax knowledge, and moral obligation significantly influence taxpayers to engage in tax evasion, and the remaining moral obligation and subjective norms were not statistically significant to influence taxpayers to engage in tax evasion. Likewise, Obafemi *et al.* (2021) investigated that the impact of tax incentives on the growth of small and medium scale enterprises in Kwara state. The study revealed that all newly established enterprises should benefit from a tax policy that is advantageous to them, ideally in the form of a tax holiday or the implementation of a growth limit that is stable enough to support tax payments. Further, Olayemi and Folajimi (2021) examined tax incentives and the growth in sales revenue of small and medium enterprises (SMEs) in Ondo and Ekiti States, Nigeria. The study concluded that tax incentives proxies, of investment allowance, tax holiday, tax credit and tax deferment were significant determinants of the growth in sales revenue of SMEs. Moreover, Vu and Le (2021) analyzed that the effect of tax planning on firm value: A case study in Vietnam. The study found that firm value is negatively impacted by tax planning, according to regression analysis using GLS.

Deyganto (2022) assessed that the effect of tax incentives practices on the sustainability of micro, small and medium enterprises in Ethiopia during the outbreak of corona virus pandemic. The study revealed that tax holiday, tax allowance, reduction in the tax rate, accelerated depreciation, loss carry forward, and tax exemption have a positive and statistically significant effect on the sustainability of the MSMEs. Similarly, Sukri *et al.* (2023) studied that an analysis of eco-innovation capabilities among small and medium enterprises in Malaysia. The study revealed that eco-innovation capabilities encourage SMEs to engage in waste management, recycling or reusing resources, research and development, sustainable goods that utilize customer requests, and the use of environment management machines. Likewise, Digil *et al.* (2024) examined that the impact of tax holidays in the development of small and medium scale enterprises (SMEs) in Adamawa state. The study found that both sales tax holidays and business investment tax holidays have significant impact in the development of small and medium scale enterprises in Adamawa state.

In the context of Nepal, Ghimire (2011) examined that the micro and small enterprises in Nepal: Prospects and challenges. The study revealed that governmental and non-governmental sector some initiatives have been carried out through multifold activities like community development program, micro finance program and cooperative programs. Similarly, Dangol *et al.* (2020) investigated that the impact of COVID-19 on Nepalese small and medium enterprises. The study found that SMEs are unsatisfied with the government's response to COVID-19 and the role of government is inevitable in safeguarding SMEs. Likewise, Rai *et al.* (2020) assessed that the evidence from micro and small enterprises in Nepal. The study demonstrated that common practices of MSEs are moving for opportunities, the culture of using plan, governing resources, innovation leading, organizational culture, employee motivation, capacity building, and communications and ICT use. Further, Karki *et al.* (2023) investigated that the structural stability of the relationship between indirect taxes and government expenditure in Nepal. The study showed that customs charges did not affect government spending in Nepal, while value-added and excise taxes had a statistically significant positive impact. Moreover, Bhatta (2023) studied that the impact of capital expenditure on economic growth: A Study of Nepal. The study stated that the importance of government expenditure on Nepal's economic growth, filling a gap in existing literature and offering valuable insights for policymakers.

The above discussion shows that empirical evidences vary greatly across the studies on the effect of tax incentive on the growth of small and medium enterprises. Though there are above mentioned empirical evidences in the context of other countries and in Nepal, no such findings using more recent data exist in the context of Nepal. Therefore, in order to support one view or the other, this study has been conducted.

The major objective of the study is to determine the effect of tax incentive on the growth of small and medium enterprises in Nepal. More specifically, it examines the relationship of tax incentive, tax holiday, tax credit, investment allowance and loss carried forward with growth of small and medium enterprises in Nepal.

The remainder of this study is organized as follows. Section two describes the sample, data and methodology. Section three presents the empirical results and the final sections draws the conclusion.

2. Methodological aspects

The study is based on primary sources of data which were gathered from 7 different province of Nepal. For primary data a structured questionnaire was used. This study contains a sample of 7 province of Nepal whose respective data are collected from a total of 125 respondents. The respondents' views were collected on tax incentive, tax holiday, tax credit, investment allowance, loss carried forward and growth of small and medium enterprises. This study is based on descriptive as well as causal comparative research designs.

The model

The model used in this study assumes that growth of small and medium enterprises depends upon effects of tax incentive. The dependent variable selected for the study is growth of small and medium enterprises. Similarly, the independent variables are tax incentives, tax credit, tax holiday, investment allowances and loss carried forward. Therefore, the model to be estimated in this study is stated as follows:

$$GSMEs = \beta_0 + \beta_1 TI + \beta_2 TC + \beta_3 TH + \beta_4 IA + \beta_5 LCF + e$$

Where,

TI = Tax Incentives

TC= Tax Credit

TH= Tax Holiday

IA= Investment Allowances

LCF= Loss Carried Forward

GSMEs= Growth of small and medium Enterprises

Tax holiday was measured using a 5-point Likert scale where respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include "Tax holidays during the initial years of operation are crucial for the survival of new SMEs", "Tax holidays encourage the establishment of more SMEs in Nepal" and so on. The reliability of the items was measured by computing the Cronbach's alpha ($\alpha = 0.835$).

Tax incentives was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree.

There are 5 items and sample items include "Tax incentives provided by the government significantly enhance the growth prospects of SMEs in Nepal", "Access to tax incentives motivates SMEs to expand their business operations" and so on. The reliability of the items was measured by computing the Cronbach's alpha (α = 0.723).

Tax credit was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include "Tax credits for research and development have a positive impact on innovation within SMEs", "The availability of tax credits encourages SMEs to invest in new technologies and training" and so on. The reliability of the items was measured by computing the Cronbach's alpha (α = 0.799).

Investment allowance was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include "SMEs in Nepal are aware of and utilize investment allowances effectively", "The criteria for claiming investment allowances are clear and easily accessible to SMEs" and so on. The reliability of the items was measured by computing the Cronbach's alpha (α = 0.732).

Loss carried forward was measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly Agree. There are 5 items and sample items include "The ability to carry forward losses is vital for the financial stability of SMEs in Nepal", "The current rules for carrying forward losses are favorable for the long-term growth of SMEs" and so on. The reliability of the items was measured by computing the Cronbach's alpha (α = 0.775).

Growth of small and medium enterprises were measured using a 5-point Likert scale where the respondents were asked to indicate the responses using 1 for strongly disagree and 5 for strongly agree. There are 5 items and sample items include "The availability of tax incentives influences my decision to invest in new projects and business ventures", "The current tax incentives in Nepal are sufficient to support the expansion and sustainability of SMEs" and so on. The reliability of the items was measured by computing the Cronbach's alpha (α = 0.842).

The following section describes the independent variables used in this study along with hypothesis formulation.

Tax incentive

Tax incentives are government provisions or policies that reduce the tax burden on individuals or businesses to encourage certain behaviors, investments, or activities that are seen as beneficial to the economy or society. A tax incentive is an aspect of a government's taxation policy designed to incentivize or encourage a particular economic activity by reducing tax payments. Tax incentives are strategy used to enhance growth by all countries, additional focus is made by many transitions and developing countries (Obafemi *et al.,* 2021). Tax expenditures refer to revenue losses that a government incurs by providing tax exemptions, deductions or allowances, tax credits, preferential tax rates or deferral of tax payments legally to any party in the economy (Gravelle, 2013). Similarly, Siyanbola *et al.* (2017) discovered that tax incentives are significant strategic drive for business and industrial growth in Sub-Saharan States including Ghana. Some countries experiencing bad administration, in general, have resorted to partially privatizing their tax administration

(Kiser and Karceski, 2017). Based on it, this study develops following hypothesis:

H_1: There is a positive relationship between tax incentive and growth of small and medium enterprises.

Tax holiday

A tax holiday is a governmental incentive that temporarily reduces or eliminates taxes for consumers or businesses. The objective of a tax holiday is to encourage economic activity and foster growth. Tax holidays may also be offered to businesses as an investment incentive (Nathan and McGranahan, 2010). A tax holiday is a temporary tax break. In the United States, tax holidays often suspend state and local sales taxes paid by consumers (Janssen, 2012). Twesige and Gasheja (2019), found tax holiday has a significant and positive relationship with the growth of SMEs (b=0.664, sig=0.056) indicating that 66.4% of the variation in the growth of SMEs is explained by tax holiday. Based on it, this study develops following hypothesis:

H_2: There is a positive relationship between tax holiday and growth of small and medium enterprises.

Tax credit

A tax credit is a direct reduction in the amount of tax a person or business owes to the government. Unlike a tax deduction, which lowers the amount of income subject to tax, a tax credit directly reduces the final tax liability, making it a more beneficial option for reducing tax payments. A tax credit is an amount of money that taxpayers can subtract, dollar for dollar, from the income taxes they owe. Zee *et al*. (2002) investment tax credit is directed toward new manufacturing plant and equipment purchased for first time use in manufacturing or processing. Investment tax credits are earned when qualified buildings or equipment are purchased for use in the firm (Ohaka, and Agundu, 2012). Castellacci and Lie (2015) demonstrated that RandD tax credits significantly enhance SMEs' innovation outputs and competitiveness, thus driving growth. Based on it, this study develops following hypothesis:

H_3: There is a positive relationship between tax credit and growth of small and medium enterprises.

Loss carried forward

Loss carried forward is a tax provision that allows businesses or individuals to use a net operating loss (NOL) or other types of losses in one tax year to offset taxable income in future years. A loss carry forward represent an accounting technique that applies the current year's net operating loss (NOL) to future years' net income to reduce tax liability. When the business makes a loss, the loss can be carried forward to offset the future profits of the business (Twesige and Gasheja, 2019). Princen (2012) found that tax systems with loss carryforward features lead to higher firm survival rates and investment levels, especially for SMEs operating in uncertain markets. Deyganto (2022) revealed that tax holiday, tax allowance, reduction in the tax rate, accelerated depreciation, loss carry forward, and tax exemption have a positive and statistically significant effect on the sustainability of the MSMEs. Based on it, this study develops following hypothesis:

H_4: There is a positive relationship between loss carried forward and growth of small and medium enterprises.

Investment allowance

An investment allowance is a type of tax break that is extended to companies as a means of motivating those companies to invest capital in various ventures. Investment allowances are deductions from taxable income based on some percentages of new investment; it is used by the Nigerian government to encourage investment in some preferred sectors of the economy (Olayemi and Folajimi, 2021). Investment's allowance/Accelerated depreciation is the deduction of some fraction of an investment from taxable profits (in addition to depreciation) (Twesige and Gasheja, 2019). Investment allowance, for instance, allows SACCOs to deduct a portion of the cost of acquiring assets from their taxable income, thereby reducing their tax liability and freeing up funds for investment and operational purposes (Oeta *et al.,* 2019). Based on it, this study develops following hypothesis:

H_5: There is a positive relationship between investment allowance and growth of small and medium enterprises.

3. Results and discussion

Correlation analysis

On analysis of data, correlation analysis has been undertaken first and for this purpose, Kendall's Tau correlation coefficients along with means and standard deviations have been computed, and the results are presented in Table 1.

Table 1

Kendall's Tau correlation coefficients matrix

This table presents Kendall's Tau coefficients between dependent and independent variables. The correlation coefficients are based on 125 observations. The dependent variable is growth of small and medium enterprises (GSMEs). The independent variables are TH (Tax holiday), TI (Tax incentive), TC (Tax credit), IA (Investment allowance), and LCF (Loss carried forward).

Variables	Mean	SD	GSMEs	TH	TI	TC	IA	LCF
GSMEs	3.520	0.900	1					
TH	3.222	0.856	0.516**	1				
TI	3.322	0.810	0.436**	0.324**	1			
TC	3.298	0.811	0.457**	0.337**	0.615**	1		
IA	3.355	0.835	0.553**	0.418**	0.550**	0.572**	1	
LCF	3.673	0.948	0.561**	0.408**	0.458**	0.492**	0.540**	1

Table 1 shows the Kendall's Tau correlation coefficients of dependent and independent variables. The study shows that tax holiday is positively correlated to growth of small and medium enterprises. It means that increase in tax holiday leads to increase in the growth rate of small and medium enterprises. Similarly, there is a positive relationship between tax incentives and growth of small and medium enterprises. It means that increase in tax incentive leads to growth of small and medium enterprises. Likewise, tax credit has a positive relationship with growth of small and medium enterprises. It shows that increase in tax credit leads to growth of small and medium enterprises. Furthermore, there is a positive relationship between investment allowance and growth of small and medium enterprises. It indicates that increase in investment allowance leads to growth of small and medium enterprises. Moreover, loss carried forward has a positive relationship with growth of small and medium enterprises. It indicates that increase in loss carried forward leads to increase in growth of small and medium enterprises.

Regression analysis

Having analyzed the Kendall's Tau correlation coefficients matrix, the regression analysis has been carried out and the results are presented in Table 2. More specifically, it presents the regression results of tax holiday, tax incentive, tax credit, investment allowance, loss carried forward on growth of small and medium enterprises in Nepal.

Table 2

Estimated regression results of tax holiday, tax incentive, tax credit, investment allowance and loss carried forward on growth of small and medium enterprises in Nepal

The results are based on 125 observations using linear regression model. The model is GSMEs = $\beta_0 + \beta_1 TH + \beta_2 TI + \beta_3 TC + \beta_4 IA + \beta_5 LCF + e$, where the dependent variable is growth of small and medium enterprises (GSMEs). The independent variables are TH (Tax holiday), TI (Tax incentive), TC (Tax credit), IA (Investment allowance), and LCF (Loss carried forward).

Model	Intercept	Regression coefficient of					Adj.	SEE	F-value
		TH	TI	TC	IA	LCF	R_bar^2		
1	0.744 (3.511)**	0.832 (14.269)**					0.621	0.584	203.610
2	1.553 (5.802)**		0.658 (8.193)**				0.348	0.766	67.119
3	1.075 (4.008)**			0.782 (9.963)**			0.442	0.708	99.260
4	0.877 (3.559)**				0.848 (11.678)**		0.522	0.656	136.375
5	0.785 (3.401)**					0.861 (12.882)**	0.571	0.621	165.938
6	0.372 (1.662)	0.697 (10.605)**	0.263 (3.806)**				0.658	0.554	120.213
7	0.265 (1.169)	0.635 (8.904)**	0.139 (1.540)	0.218 (2.079)*			0.667	0.547	83.766
8	0.14 (0.631)	0.54 (7.161)**	0.074 (0.822)	0.123 (1.167)	0.299 (3.142)**		0.69	0.528	69.898
9	0.013 (0.061)	0.452 (6.200)**	0.037 (0.658)	0.034 (0.335)	0.196 (2.132)*	0.362 (4.378)**	0.73	0.492	68.215

Notes:

i. Figures in parenthesis are t-values.
ii. The asterisk signs (**) and (*) indicate that the results are significant at one percent and five percent level respectively.
iii. Growth of small and medium enterprises is the dependent variable.

Table 2 shows that the beta coefficients for tax holiday are positive with growth of small and medium enterprises. It indicates that tax holiday has a positive impact on growth of small and medium enterprises. This finding is similar to the findings of Twesige and Gasheja (2019). Similarly, the beta coefficients for tax incentive are positive with growth of small and medium enterprises. It indicates that tax incentive has a positive impact on growth of small and medium enterprises. This finding is similar to the findings of Siyanbola *et al.* (2017). Likewise, the beta coefficients for tax credit are positive with growth of small and medium enterprises. It indicates that tax credit has a positive impact on growth of small and medium enterprises. This finding is not similar to the finding of Catellacci and Lie (2015). Further, the beta coefficients for investment allowance are positive with growth of small and medium enterprises. It indicates that investment allowance has a positive impact on growth of small and medium enterprises. This finding is consistent with the findings of (Olayemi and Folajimi, 2021). Moreover, the beta coefficients for loss carried forward are positive with growth of small and medium enterprises. It indicates that loss carried forward has a positive impact growth of small and medium enterprises. This finding is similar to the finding of Princen (2012).

4. Summary and conclusion

Small and medium enterprises (SMEs) refer to businesses that maintain revenues, assets, or number of employees below a certain threshold. These thresholds can vary depending on the country or region. SMEs play a crucial role in the economy by creating jobs, fostering innovation, and contributing to economic growth. The effect of tax incentives on the growth of Small and Medium Enterprises (SMEs) in Nepal can be significant in terms of fostering business development, improving competitiveness, and encouraging investment. However, the actual impact depends on the design, implementation, and accessibility of the tax incentives. The government should focus on creating a supportive and streamlined environment that enables SMEs to fully benefit from the available incentives. With the right approach, tax incentives can significantly contribute to the development of a vibrant SME sector in Nepal, which is crucial for the overall economic growth and development of the country.

This study provides insightful information regarding the effect of tax incentive on growth of small and medium enterprises in Nepal. The study analyzes various significant variables that could impact growth of small and medium enterprises in Nepal. These variables include how tax incentive, tax holiday, tax credit, investment allowance and loss carried forward effect the growth of small and medium enterprises.

This study attempts to examine the effect of tax incentive for the growth of small and medium enterprises in Nepal. The study is based on primary data with 125 respondents.

The major conclusion of the study is that tax incentive, tax holiday, tax credit, investment allowance and loss carried forward have a positive impact on growth of small and medium enterprises. The study also concludes that tax holiday is the most significant factor followed by loss carried forward and investment allowance that explain the factors affecting growth of small and medium enterprises in Nepal.

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