

**TAX INCENTIVES AND FINANCIAL PERFORMANCE OF SMALL AND  
MEDIUM ENTERPRISES IN THE EXPORT PROCESSING ZONES IN  
NAIROBI CITY COUNTY, KENYA**

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## DECLARATION

This project is my original work and has not been presented to any other university for the award of any degree.

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This research project has been submitted for examination with my approval as the university Supervisor.

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## **DEDICATION**

This project is dedicated to my parents Miriam and Gibson Miriti for their continued support, their countless sacrifice and encouragement for me to pursue this degree. My husband Alex and children Njoroge, Mutuma and Wairimu for their support during my time of study.

## **ACKNOWLEDGEMENT**

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May God bless all of you abundantly.

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## ABBREVIATIONS AND ACRONYMS

<b>ANOVA</b>	Analysis of Variance
<b>BDBC</b>	Business Development Bank of Canada
<b>CBD</b>	Central Business District
<b>EPZ</b>	Export Processing Zones
<b>EPZA</b>	Export Processing Zones Authority
<b>FDI</b>	Foreign Direct Investment
<b>GDP</b>	Gross Domestic Product
<b>KPIs</b>	Key performance Indicators
<b>KRA</b>	Kenya Revenue Authority
<b>LDCs</b>	Less Developed Countries
<b>NSE</b>	Nairobi Stock Exchange
<b>ROA</b>	Return on Assets
<b>SMEs</b>	Small and Medium Enterprises
<b>SPSS</b>	Statistical Package for Social Sciences
<b>TREO</b>	Tax Remissions and Exemption Office
<b>VAT</b>	Value Added Tax
<b>VIF</b>	Variance Inflation Factor

## DEFINITION OF TERMS

<b>Capital Gain Exemption</b>	A tax relief granted on profits earned from the sale of capital assets, often to encourage investment or under special conditions defined by tax laws.
<b>Export Processing Zones</b>	Designated areas where businesses enjoy tax and duty exemptions on imported inputs used for manufacturing goods primarily for export purposes.
<b>Financial Performance</b>	A measure of how well a company utilizes its assets and resources to generate income and achieve profitability over a given period.
<b>Investment Allowance</b>	A form of tax relief offered by the government to investors on qualifying capital expenditures to encourage investment in specific sectors.
<b>Small and Medium Enterprises</b>	Businesses that operate within defined limits of employee count, annual turnover, and asset base, often receive targeted support and incentives.
<b>Tax Incentives</b>	Government measures such as tax reductions, exemptions, or credits designed to stimulate investment and growth in specific economic sectors.
<b>Turnover Tax Reduction</b>	A deliberate lowering of the tax rate on gross business revenue, often aimed at supporting small enterprises and boosting economic participation.

**Reducing Capital Gains**

A policy or action aimed at lowering the tax rate imposed on profits from asset sales to encourage investment and reinvestment.

**Turnover Tax**

A simplified tax imposed on the gross income of small businesses, typically replacing multiple complex taxes to ease compliance and enhance revenue collection.

## **ABSTRACT**

SMEs around the world have been characterised to have an influential impact on a country's economic status. However, various issues such as taxes have hindered the start and growth of some. The study examined how tax incentives are influencing the performance of SMEs in Export Processing Zones in Nairobi City County, Kenya. The study specifically sought to find out how investment allowance, capital gain reduction, and turnover tax reduction affected the SMEs performance. In attaining the research objectives, the study embraced normative theory, market efficient and traditional tax theories. The study adopted exploratory research design in which the study's target population was 90 SMEs found within EPZs in Nairobi Processing Zone as of August 2022 and a sample size of 30. Secondary data was used to collect their financial report. The collected data was analysed using SPSS software to find out the relationship between investment allowance, capital gain reduction, and turnover tax reduction how they affect the performance of EPZ SMEs. The findings indicated that all three tax incentives investment allowance, capital gains reduction, and turnover tax reduction had a positive and statistically significant effect on the financial performance of SMEs. These incentives contributed to improved returns, reinvestment capabilities, and overall business growth. The study concluded that tax incentives are crucial instruments for enhancing the financial performance of SMEs in special economic zones. It was recommended that government bodies continue to strengthen and expand tax incentive programs tailored to SME needs to promote long-term viability, innovation, and competitiveness within Kenya's EPZs.

## **CHAPTER ONE**

### **INTRODUCTION**

#### **1.1 Background of the Problem**

Small and Medium Enterprises (SMEs) have long been recognized as key drivers of economic growth, innovation, employment, and poverty reduction globally (Babatunde et al., 2017). Tax incentive programs including investment allowances and capital gains reductions and turnover tax reliefs serve as government tools to boost SME performance during recent years. Such policies demonstrate inconsistent results between different countries and industries because they must contend with industry-specific challenges and structural dynamics (Krauss et al., 2014). Most governments especially the developing ones and particularly Kenya rely on taxes as their main source of revenue to run their development agenda. At the same breadth, SMEs have been in the forefront as the major contributors to Kenya's economic growth and development. In the market economy Small and Medium Enterprises (SMEs) defines tempos of economic growth, structure and quality of gross domestic product (GDP). In all developed countries the share of SME is about 60-70% of GDP. Tax methods that include tax incentives acquire an important role among the tools of state regulation of economic processes, including those in the development of SME.

The development of contemporary national SME witnesses the insufficiency of using tax incentives thus they mostly do not benefit from the incentives (Gritsunova & Lotareva, 2015). Support and stimulation of SMEs is a top priority of taxation policy for many developed countries as well as developing countries, and countries in transition. SMEs are an integral element of any macroeconomic system. Economy and society cannot properly function and develop without such system. The development of business is possible only under conditions of providing effective competition,

creation of favourable climate and rational support from the state, and efficient operation of market mechanisms. The peculiarity of business entities functioning is the necessity to form a favourable specific environment for their successful development.

The rationale behind granting of tax incentives is to exploit investments opportunities, where tax system is seen as an obstacle. They are also used to improve social welfare of the community for example, granting incentives related to health, education or savings for future use. On the other hand, they can also be used to discourage certain activities like overproduction of agricultural produce resulting to instability in prices (Perkew, 2018). Furthermore, several countries have created actual tax incentives in the taxation of the listed companies. Vietnam applied in 2004- 2006 a 50% reduction on the normal Corporate Income Tax (CIT) rate (at that time 28%). The effective tax rate of a listed company was thus 14%. This scheme was introduced when the Stock Exchange was setup but not continued. In case a listed company also had a reduced tax rate or tax holiday because of its investment project, the 50% reduction would only apply after the other tax holiday. Thailand on the other hand applies lower CIT rates for companies that are listed on Thailand's SET (25%) or the MAI (20%) (DFDL, 2011). The normal Thai CIT rate is 30%, but lower rates exist for profits below a certain threshold. The reduced rate for the listed companies applies only for a period of 3 years, not beyond. In addition, Thailand provides an investment tax credit up to 25% of the total qualifying cost of new projects of listed companies (machinery, vehicles, equipment and software).

On the other hand, China's fast-paced industrial and technological development heavily relies on SMEs as central contributors to the nation's growth. Growth within the SME sector has been primarily fueled through broad implementation of Value-Added Tax

(VAT) reductions together with income tax reliefs. Ding (2024) researched how VAT combined with income tax incentives increased SMEs' sales revenue and total asset growth at high-tech and information technology service sector businesses. Research results indicated sector-specific policy approaches deliver better results than generalized tax incentives which prove ineffective across diverse industrial sectors.

Moreover, Germany's globally known SME sector or "Mittelstand" benefits from organized tax and budgetary systems. A study by Schubert and Martikainen (2021) showed that budgetary control mechanisms brought enhanced financial planning together with substantial performance improvements to SMEs throughout Munich Berlin and Stuttgart. The research demonstrated that SMEs saw better results when budgeting and strategic planning methods were combined because this process led to more efficient resource allocation and better cost management alongside precise performance tracking. The combination of proper financial management approaches with effective tax policy demonstrated substantial power to enhance SME success.

In Zimbabwe, SMEs have played an increasingly central role in job creation and economic resilience amid macroeconomic challenges. Tengerapena et al. (2024) discovered that complex tax systems combined with high tax rates and insufficient tax knowledge created major obstacles to SME performance. Research by Tengerapena et al. (2024) found taxation created a damaging negative impact on business financial success for SMEs located in Lowveld/Chiredzi District. The researchers suggested improving SME financial performance by simplifying tax administration systems alongside targeted investment allowances for business stimulation.

In addition, The Rwandan government used tax incentives for SMEs to build sustainable economic development through active promotion of these measures. A

study by Twesige and Gasheja (2019) in Nyarugenge District showed that tax incentives produced a positive link between VAT refunds combined with wear and tear allowances and carry-forward loss provisions and SME development. The research analysis showed 88.8% of SME growth was caused by incentive measures suggesting tax policies with precision can drive financial success. Companies and agencies use tax incentives to create economic development opportunities and attract new investment into their economies (Chukwumerije, 2022). The positive features of these incentives significantly affect financial results observed in SMEs which directly impact business viability throughout the economy.

In Kenya, newly listed companies have been given an incentive to be taxed at a lower rate of 27% as compared to the standard rate of 30% for a period of three years following the date of listing. This was also dependent on such companies offering at least 20% of the share capital to the public (CMA, 2012). Companies that were to apply and get listed got a tax amnesty on their past omitted income, provided they made a full disclosure of their assets and liabilities and undertake to pay all their future due taxes (CMA, 2012). Foreign investors in Kenya have been enabled to acquire shares freely in the stock market subject to a minimum reserved ratio of 25% for domestic investors in each listed company (CMA, 2018). Effective 1 January 2003, newly listed companies were given incentives to pay a lower corporation tax of 25% (i.e., 5 percentage points lower than the standard corporation tax of 30%) for a period of 5 years following their listing. The new legislation applies to companies that float at least 30% of their issued share capital to the public (CMA, 2020).

On the other hand, SMEs across Kenya alongside numerous other nations benefit from two standard tax break provisions called Investment allowance which allows them to

deduct twenty-five percent of their capital asset acquisition expenses from their tax bills. This incentive permits SMEs to deduct a quarter of their capital expenditures from taxable income which helps them improve their production facilities and adopt new technologies. Governing bodies use investment promotion as a strategic strategy to advance economic expansion alongside employment opportunities and business competitiveness. Various research shows that tax incentives help develop SMEs yet multiple developing economies continue to question their effectiveness for enhancing financial outcomes (Andreoni et al. (2012, Anim et al., (2021), Babatunde et al. (2017). SMEs participating in the Export Processing Zones in Nairobi City County have not achieved expected financial improvements through the tax relief programs they receive. The use of investment allowances and capital gains tax reductions along with turnover tax reliefs faces concerns about their implementation structures and accessibility features.

The business expense deduction enabled through investment allowance provides SMEs with an opportunity to reduce their taxable income while they reinvest in their operations. Kandie (2019) demonstrates that investment allowances enhance the financial standing of SMEs when they successfully claim and deploy these assets to create productive business assets. The full effect of this incentive remains limited because SMEs operating within EPZs demonstrate poor technical capabilities and insufficient awareness about how to use it properly. As a result, their performance indicators including profitability and return on assets and liquidity metrics show minimal improvement.

The tax benefits of capital gains serve as a performance enhancement tool that minimizes taxation costs when businesses dispose of their assets. Mayende (2013) demonstrated that reduced capital gains tax creates more financial flexibility for SMEs which leads to better asset management capabilities in constantly changing markets. EPZs in Kenya often prioritize large asset investments through their export-driven manufacturing activities yet researchers have not adequately studied how reducing capital gains taxation would free resources for business growth and working capital. Turnover tax serves as an easy tax structure for businesses with small annual revenue to minimize their tax reporting requirements and decrease administrative complexities. The Rwandan government's reduction of turnover tax rates according to Twesige and Gasheja (2019) led to better financial performance metrics including increased net income alongside reinvestment among formalized SMEs. According to Nwidobie (2020) tax reduction benefits are short-term cash flow improvements which depend on predictable and consistent tax policy environments for sustained long-term advantages. Turnover tax reliefs available to Kenyan EPZ SMEs become less effective for financial sustainability because of an unpredictable regulatory environment.

According to Ohaka and Agundu (2012) successful tax incentives require both well-designed tax education programs and easy-to-comply with regulations. The financial performance impact of tax benefits remained unrealized because SMEs did not understand the benefits and kept poor tax records. The Kenyan business environment reveals many SMEs encounter obstacles from both technical capacity deficits and insufficient financial knowledge.

From the reviews, it can be argued that incentive measures like investment allowances, capital gain reduction, and turnover tax reductions tends to be very helpful in boosting the financial health of SMEs existing in the county's EPZs in Nairobi City County, Kenya. To examine these and other factors that typically underpin various incentives on specific measures of SME performance it is necessary to dissect out and review multiple facets of the situation about investment behaviour, tax planning strategies and the overall business environment. Through the analysis of the influence of tax benefits on SMEs, these policymakers, researchers, and experts can establish policies and strategies which help in the growth of SMEs, and therefore the national economy prospers as well.

### **1.1.3 Tax Incentives in Kenya**

Tax incentives may take several forms. The form of tax incentives in developed countries varies from credits for those investing in assets, depreciation at high rates as well as exciting treatments for R & D expenditures while in developed countries, tax incentives can vary from quickened devaluation, venture duty credits as well as provision of positive expense for those companies that use innovative work. Locally, for the Kenyan case, In Kenya, tax incentives include capital allowance which is defined as expenditures deducted from profits before taxation to reduce the effect of taxation and thus encourage savings and investment (Kuria, 2016). These capital allowances can come in form of expenses on assets, investments and other noncurrent assets/activities of the organization. Another tax incentive is capital gains tax, where exemption/reductions are often proposed as a policy that will increase saving and investment, provide a short-term economic stimulus, and boost long-term economic growth. Finally, we have tax holidays, where a firm is given a reduced (usually zero) tax rate for a specified period, at the end of which the firm begins to pay taxes at the

usual rate. This study will investigate the tax incentives of capital allowance, capital gains tax and tax holidays since these are all offered by the government to SMEs operating in the export processing zone in Nairobi City County.

Tembur (2016) argues that other tax incentives vary from allowances and subsidies on investments and tax credits, special zones, accelerated depreciation, reduced tax rates as well exemptions on tax as well as special zones, reductions in tax rates and indirect tax incentives. Resident companies enjoy a corporate tax rate 30% while non-resident companies receive higher rate of 37.5%. EPZs are taxed at 25% for the 10 years succeeding the tax holiday. The Institute of Economic Affairs (2012) reports that tax incentives are always advancing and are widespread. It argues that tax incentive is an arrangement that concedes any individual or action great conditions that move away from the ordinary arrangements of the excise enactments.

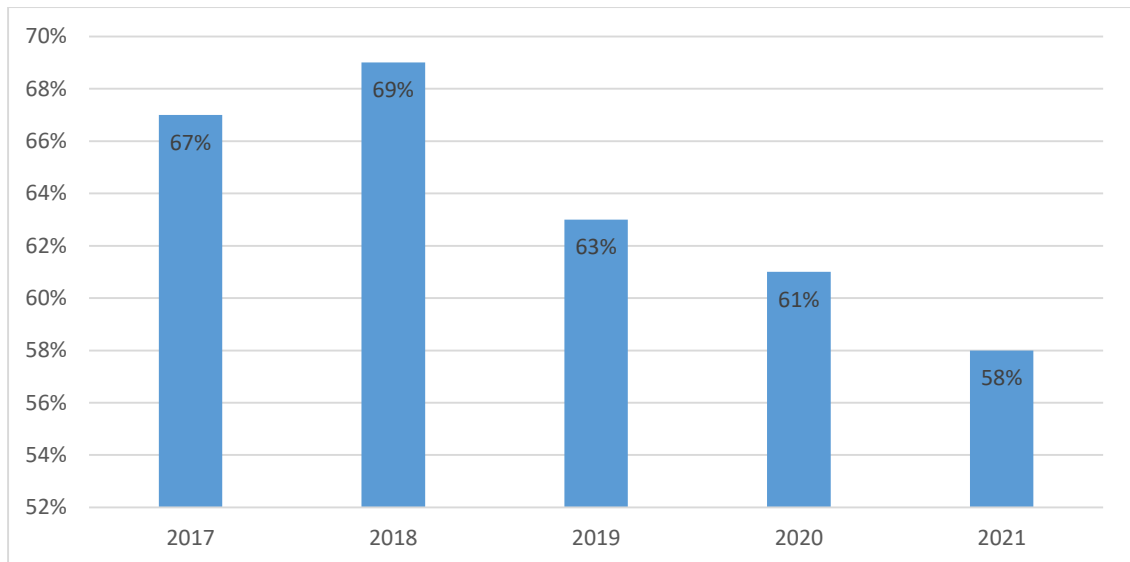
In Kenya, companies including those operating at EPZ benefit from major tax incentives especially capital allowances such as Investment building deductions (IBD), Investment deduction (ID) and Wear & Tear allowances by claiming deductions from their corporate tax liability. Incentives lower the cost of the firm especially where the government offer subsidies and other forms of incentives to firms such as low interest rates, grants, lowering the cost of labour, and improving transportation networks to make transportation cost low, with reduced costs, the net profit posted by firms will be high and hence leads to high financial performance. Ohaka & Agundu (2012) argue that firms that are eligible for tax incentives normally have higher returns. Tax incentives also make investments more attractive and in turn enhance profitability of a firm. Tax incentive generate employment and encourage the self-employed to incorporate into limited companies, this leads to improved financial performance of firms because

limited companies perform better given the fact, they can assess external sources of capital as compared to some traders (Uliarta & Setyowati, 2019). Incentives lower the cost of the firm especially where the government offer subsidies and other forms of incentives to firms such as low interest rates, grants, lowering the cost of labor, and improving transportation networks to make transportation cost low, with reduced costs, the net profit posted by firms will be high and hence leads to high financial performance (Kuria, 2016).

Kuria (2016) examined the effects of tax incentives on the performance of export processing zone (EPZ) firms in Kenya and observed that African countries rely on tax holidays and import duty exemptions, while industrial western European countries allow investment allowances or accelerated depreciation. The performance of EPZ firms was measured by profitability, gross margins and the number of jobs EPZ firms created. The study adopted a descriptive and explanatory research design. The study assessed the performance of EPZ firms against the tax incentives they benefited for the last ten years. The results of multivariate regression model revealed that total sales, exports and ROA indicated an increasing trend from 2003 to 2014. The result further indicated a decreasing trend in the number of employees recruited by EPZ firms. The study however was not focused on SMEs at the EPZ.

## **1.2 Statement of the Problem**

According to the CMA Report 2020, the SMEs including those in the EPZs have indicated a decline in their profits as in the chart below.



**Figure 1.1: Proportion of Profitable SMEs in 2017, 2018, 2019, 2020, and 2021.**

*Source: CMA Report 2020.*

Figure 1.1 displays the percentages of businesses that generated profits in 2017, 2018, 2019, 2020, and 2021. 67.0% of the businesses that replied to the interview questions stated that they made profits in 2017. In 2018, the percentage of profitable businesses rose to 69.0 percent, but in 2019, 2020 and 2021, it fell to 63%, 61% and 58% respectively. Accordingly, SMEs need help and government support if they are to remain sustainable and profitable. One such measure that the Kenya government has taken, is offering tax incentives to SMEs.

Despite the critical role Small and Medium Enterprises (SMEs) played in Kenya’s economic development, their financial performance remained vulnerable due to limited access to capital, high operational costs, and burdensome tax regimes. In response, the Kenyan government had introduced various tax incentives aimed at enhancing SME performance, particularly in designated zones such as the Export Processing Zones

(EPZs). However, the actual impact of such incentives including investment allowances, reduced capital gains tax, and turnover tax reductions on the financial performance of SMEs in EPZs had remained under-researched and unclear. Previous studies (Andersen et al., 2017; Anim et al., 2021) had shown mixed outcomes, indicating that while tax incentives attracted investment and reduced compliance costs, their effectiveness depended on firm size, sectoral dynamics, and administrative efficiency. Furthermore, evidence from tax compliance literature (Andreoni et al., 2012) suggested that unclear policy implementation could undermine intended benefits. In Nairobi City County, where many SMEs operated within EPZs, there was insufficient empirical data examining how these tax incentives specifically influenced their financial outcomes. This knowledge gap hindered policymakers from designing well-targeted fiscal policies. Therefore, this study sought to evaluate the actual effect of key tax incentives on SME financial performance in Nairobi's EPZs to inform evidence-based policymaking.

### **1.3 Objective of the Study**

#### **1.3.1 General Objective**

The study sought to examine the impact of tax incentives on SME's financial performance: A Case study of Nairobi County, Kenya's SME's in EPZ.

#### **1.3.2 Specific Objectives**

Specific Objectives:

- i. To examine the relationship between investment allowance and the financial performance of Small and Medium Enterprises (SMEs) in the Export Processing Zone (EPZ) of Nairobi City County, Kenya.
- ii. To assess how reductions in capital gains tax relate to the financial performance of SMEs in the EPZ of Nairobi City County, Kenya.

- iii. To determine the extent to which turnover tax reductions are associated with the financial performance of SMEs in the EPZ of Nairobi City County, Kenya.

### **Research Hypothesis**

$H_{01}$ : There is no significant effect of investment allowance on the financial performance of SMEs in the EPZ.

$H_{02}$ : There is no significant effect of capital gain reduction on the financial performance of SMEs in the EPZ.

$H_{03}$ : There is no significant effect of turnover tax reduction on the financial performance of SMEs in the EPZ.

### **1.4 Significance of the Study**

The primary beneficiaries of this study are Small and Medium Enterprises (SMEs) operating within the Export Processing Zone (EPZ) in Nairobi City County. These businesses will gain valuable insights into how various tax incentives investment allowances, reduced capital gains, and lower turnover tax affect their financial performance, enabling them to make informed financial and strategic decisions. Policymakers and government agencies, such as the Kenya Revenue Authority (KRA), will also benefit by understanding the effectiveness of existing tax incentives and identifying areas for policy improvement to support SME growth. Additionally, financial advisors and consultants can use the findings to guide SMEs on optimizing tax benefits. Academic researchers and students in finance and taxation will benefit from the study's contribution to existing literature and future research direction. Lastly, investors may use this insight to assess the financial viability of SMEs in the EPZ, enhancing confidence in funding or partnering with these enterprises.

### **1.5 Scope of the Study**

The scope of this study is focused on evaluating the impact of tax incentives on the financial performance of Small and Medium Enterprises (SMEs) operating within the Export Processing Zone (EPZ) of Nairobi City County, Kenya. The study specifically examines three key tax incentives: investment allowance, capital gains reduction, and turnover tax reduction. Data was collected from secondary sources, primarily financial reports of 30 SMEs operating in the EPZ, covering the period from 2018 to 2022. The findings of this study are relevant to SMEs in Kenya's EPZs but may also provide insights for other similar business environments.

### **1.6 Limitations of the Study**

This study faced limitations such as limited access to financial records of SMEs in the EPZ due to confidentiality concerns, which may have affected data accuracy. Time constraints and the reluctance of some respondents to disclose tax-related information also posed challenges. The study was delimited to SMEs operating within Nairobi City County's Export Processing Zone, excluding those in other regions. Additionally, the focus was restricted to three tax variables investment allowance, capital gains tax, and turnover tax thus other tax factors influencing financial performance were not covered.

### **1.7 Organization of the Study**

The research was structured in five chapters with the first chapter seeking to provide the paper's introduction examines the background of the study, the problem of the statement, study objectives, and significance of the study. The second chapter entailed the study literature review; third chapter examine the study's methodology. Chapter four on the other hand, focused on the research results and findings while chapter five was a final part of the study that focused on the study's conclusion, summary and recommendations.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter reviews present studies that have investigated the effect of tax incentives and SMEs performance. This chapter reviewed in three other subsections in subsequent paragraphs, which will make it easier to understand and follow. First, the review of previous theories to test the study problem and the study objective is further discussed in the chapter. Thereafter is the conceptual framework made of the assumed relationship between the independent and dependent variables. The other part is an empirical review section which includes an appraisal of previous studies upon which the study gaps are derived from.

#### **2.2 Theoretical Review**

This section explores key theories relevant to the study of taxation and SME performance. It includes the Benefit Theory of Taxation, Resource-Based View (RBV), and Theory of Tax Neutrality. These theories provide the foundation for understanding the relationship between taxation policies and SME growth within the EPZ.

##### **2.2.1 Benefit Theory of Taxation**

The Benefit Theory of Taxation was proposed by Ernst Lindahl in 1919. The theory assumes that citizens should pay taxes in proportion to the benefits they receive from government services. It operates on the principle of an exchange relationship between the taxpayer and the government, where taxes are considered a payment for services rendered. Lindahl argued that individuals derive varying levels of satisfaction or utility

from public goods and, as such, should contribute to public revenue based on their individual marginal benefit from such goods.

The core content of the Benefit Theory suggests that taxation should be voluntary and equitable, with individuals agreeing to pay taxes in line with the perceived benefit they gain from public expenditure (Kolsrud et al., 2018). This approach emphasizes fairness and efficiency in tax allocation, if each citizen's tax liability reflects their usage of government services. The model also introduces a demand-and-supply framework for public goods, where tax payments are treated analogously to prices in a market for private goods.

A study by Oladipupo and Obazee (2016) applied this theory to analyze public finance systems in developing countries, highlighting how aligning tax contributions to public service usage can enhance taxpayer compliance and revenue collection efficiency. Similarly, Muli (2017) used the theory in a study on Kenyan SMEs, arguing that if small enterprises perceive tangible benefits from government services (such as infrastructure or incentives), they are more willing to comply with tax regulations. In the current study, the Benefit Theory of Taxation supports the independent variables specifically, investment allowance, capital gains reduction, and turnover tax reduction (Kolsrud et al., 2018). These tax incentives can be interpreted as benefits extended by the government to SMEs in return for their tax compliance and economic contributions. The theory is therefore instrumental in justifying why such incentives are expected to positively influence SME performance (Sifile et al., 2018). If SMEs perceive that tax policies are structured to provide clear economic advantages such as easing financial burdens or encouraging investment, they are more likely to respond positively, resulting in improved financial performance.

Furthermore, the Benefit Theory aligns with the government's role in supporting small businesses through tax reforms and fiscal policies that enhance competitiveness and sustainability. By recognizing tax incentives as benefits, SMEs may view them as enabling factors that lower operational costs and promote growth. In essence, the theory explains how the structure of tax policies can influence the behavior and performance of SMEs. It emphasizes that when businesses perceive a justifiable return from paying taxes such as access to reduced tax rates, allowances, or investment opportunities they are more inclined to operate efficiently and grow sustainably. This directly ties into the study's objective of assessing the effect of tax incentives on the financial performance of SMEs operating in the Nairobi EPZ.

### **2.2.2 Resource-Based View (RBV)**

The Resource-Based View (RBV) was proposed by Jay Barney in 1991. This theoretical framework posits that a firm's sustainable competitive advantage stems from its ability to acquire and manage valuable, rare, inimitable, and non-substitutable (VRIN) resources. According to RBV, internal firm-specific resources such as technology, skills, organizational processes, and financial capital are more crucial in determining performance than external environmental factors. The RBV assumes that resources are distributed heterogeneously across firms and that some firms possess capabilities that are not easily replicated (Lubis, 2022). These resources, if properly managed, can become strategic assets that give the firm a long-term competitive edge. The focus of RBV is on the internal capabilities of an organization, emphasizing that leveraging unique resources enables firms to achieve superior performance outcomes.

A relevant application of the RBV is found in the work of Wernerfelt (1984) and later Barney (1991), who formalized the theory's contribution to strategic management. In taxation research, Mwangi and Wekesa (2020) applied the RBV to examine how internal financial management practices among SMEs in Kenya influence their responsiveness to tax incentives, showing that firms with stronger resource structures benefit more from government tax interventions. In the context of this study, the Resource-Based View supports the dependent variable financial performance of SMEs (Bromiley & Rau, 2016). Tax incentives such as investment allowances, capital gains reduction, and turnover tax relief represent external enablers that become valuable internal resources once accessed by SMEs. For example, when an SME utilizes a tax incentive to invest in modern equipment or expand operations, the incentive translates into a firm-specific resource that can drive performance.

RBV is particularly relevant because it provides a theoretical basis for understanding how tax incentives (external interventions) become internal strategic assets when SMEs capitalize on them effectively (Bromiley & Rau, 2016). These resources, once internalized, contribute to revenue growth, asset expansion, and profitability key indicators of financial performance. Moreover, the RBV helps explain why some SMEs benefit more from tax incentives than others. Firms with better strategic planning, financial literacy, or resource utilization capacity can translate the same tax benefit into more significant performance gains. This perspective justifies the study's focus on evaluating the effect of tax incentives on SME performance, recognizing that these incentives serve as critical resources in enhancing the competitiveness and financial health of the firms.

### **2.2.3 Theory of Tax Neutrality**

The Theory of Tax Neutrality was initially proposed by classical economists such as Adam Smith in 1776 and later refined by Frank Ramsey in 1927. The theory asserts that taxes should be designed in a manner that does not distort economic decision-making by individuals or businesses. Its fundamental premise is that taxation should be neutral in nature, meaning it should neither encourage nor discourage specific economic activities. This neutrality ensures that economic agents make decisions based on market conditions and business efficiency rather than tax considerations (Seriah, 2024). The central assumption of the theory is that individuals and businesses are rational actors who respond to incentives. Therefore, when a tax system is non-neutral such as when it offers selective tax incentives it may lead to inefficient allocation of resources. Tax neutrality implies fairness, efficiency, and minimal distortion, making it a benchmark for evaluating the effectiveness of any tax policy (Fleurbaey & Maniquet, 2018). The theory emphasizes two types of neutrality: production neutrality, where tax policy does not affect business production decisions, and consumption neutrality, where consumer choices remain unaffected by taxation.

The theory has been applied in numerous empirical studies, including one by Bird and Zolt (2005), which examined the effects of tax policies in developing countries. Their findings showed that many tax incentives, particularly in emerging economies, often violate the principle of neutrality by offering benefits to specific sectors or firms, leading to inequity and inefficiency. Such policies, while aimed at spurring growth, can inadvertently create market distortions and reduce overall productivity. In the context of this study, the Theory of Tax Neutrality is particularly relevant to the independent variables: investment allowance, capital gain reduction, and turnover tax reduction.

These incentives, if poorly designed, can influence the behavior of small and medium enterprises (SMEs) in a way that undermines fair competition and efficient business practices. The theory provides a framework for assessing whether these tax incentives promote SME financial performance without causing undesirable economic distortions.

## **2.3 Empirical Review**

### **2.3.1 Investment Allowance and SME's Performance.**

Kemuma (2014) examined the impact of investment allowance on Nairobi Stock Exchange earnings. Descriptive methods were used for this investigation. On December 31, 2013, 61 of the major companies listed on the Nairobi Stock Exchange were included in the research population. Given the paucity of non-financial companies trading on the NSE, a census approach was adopted for this study. Using descriptive approach and cross-sectional approach it was found that return on investment had an impact on liquidity, financial leverage and investment decision. However, Kemuma's study focused on listed firms rather than SMEs within the EPZ. It did not explore specific tax incentives like investment allowance. The current study bridges this gap by examining how investment allowance directly affects the financial performance of SMEs in Nairobi City County's EPZ, which are often excluded from capital market-focused research yet play a significant economic role.

Karanja sought to focus into how firms' investment choices affected their bottom lines in the Kenyan city of Limuru (2016). Because it allowed for the most comprehensive gathering of pertinent data, a survey format was selected for this research endeavor. By use of questionnaires the study sought to examine the correlation between investment decisions and financial performance by reviewing respondent data, ranking criteria, and

doing regression analysis. The results demonstrate the need for caution on the part of business owners when determining where to invest the company's funds. While Karanja's study highlighted investment decisions generally, it did not isolate the impact of tax-based incentives such as investment allowance on SME performance. The present study fills this gap by specifically investigating how investment allowance influences financial performance of SMEs in the EPZ, thus providing tax-specific insights relevant to government policy for SME support.

Cohen and Klepper took a cross-sectional look at the mechanisms behind investment decisions and the connections to firm success (2016). These empirical conclusions were based on data collected from three successive surveys conducted in Sweden on the topic of innovation. To account for both selection and simultaneity biases, we employed the industry-standard multi-stage estimate procedure. The hypothesis that increasing R&D spending will lead to higher productivity (as measured by the share of sales attributable to new goods and processes) was corroborated by the data. Their research emphasized R&D and innovation in a developed country context, overlooking developing economies and tax incentives like investment allowance. This study addresses this by focusing on Kenyan SMEs in the EPZ and assessing the tangible financial impact of investment allowance, thereby adding localized evidence to policy discussions on SME support mechanisms.

### **2.3.2 Capital Gain Reduction and Financial Performance of Small Medium Enterprises**

Kuria et al (2017) analyzed how the capital allowance incentive in Kenya's Export Processing Zones (EPZs) affected the output of EPZ enterprises. The research

methodologies used in this investigation were both descriptive and explanatory. This study used a stratified sample design since EPZ companies in Kenya might be classified into one of four categories. One hundred and eighty-six businesses operating in Kenya's Export Processing Zones (EPZ) were surveyed and evaluated (EPZA). The form of inquiry utilized was very similar to that of a census. A census was carried out even though there were already so few residents. The information of all 86 EPZ companies was analyzed. The most common tool for gathering information was questionnaires. Data on firm lifetime, return on investment, and net new jobs created were culled from publicly available sources (and their value). Secondary information was gathered from EPZs in Kenya. The study linked the economic expansion of EPZ companies over the past decade to the tax advantages those companies got. From the analysis, which was done through descriptive approach, it was established that, the capital allowance tax incentive for EPZ businesses was positively correlated with return on investment, new jobs created, and length of stay. Companies' return on investment (ROI), new job creation, and staff retention were all positively affected by a rise in the capital allowance tax incentive. Though Kuria et al. analyzed capital allowance in EPZs, they did not isolate SMEs or differentiate capital allowance types like capital gains reduction. The current study narrows this focus to SMEs specifically, examining how reducing capital gains affects their financial performance in Nairobi's EPZ, thus addressing the need for SME-specific tax analysis.

Nduati (2020) studied the impact of rising stock prices on profitability among Kenya's publicly traded manufacturing firms. According to the study findings, financial benefits from capital allowances for NSE-listed companies, potentially enhancing the sector's overall financial health. Nduati's research dealt with general profitability of manufacturing firms, omitting SME-specific implications and ignoring capital gains

reductions. This study bridges the gap by targeting SMEs in the EPZ and focusing on capital gains reduction, offering targeted insights for taxation policies affecting small businesses in Kenya.

On the other hand, Muli's (2020) study on how real estate were affected by capital gains in Motoko Machakos County. Conducting a survey of 31 registered real estate agencies in Mavoko with a total workforce of 143 staff with the use of questionnaires revealed a weak link, not significant, between capital allowances and performance. Furthermore, the lock effect was identified as a cause of falling productivity. Muli's study, while relevant, concentrated on real estate firms and not SMEs in EPZs. Moreover, it did not connect capital gains to financial performance within export zones. This study addresses this gap by evaluating how capital gains reduction affects SMEs in EPZs, offering tailored insights for enhancing tax policy effectiveness in industrial zones.

### **2.3.3 Turnover Tax Reduction and Financial Performance of Small Medium Enterprises**

Various studies have been conducted to find out the impact of turnover tax reduction on SME's performance, for instance Kenya's (2015) study aimed to examine how turnover tax reduction influenced SME's performance in Nairobi County. Through a descriptive approach the results were displayed in tabular form. The results showed that 88.6% of the variance in ROI for SMEs could be accounted for by the model (ROI). The findings suggest that Turnover Tax hinders the progress of businesses. Nonetheless, the financial success of a corporation is significantly correlated with its size, liquidity, age, and growth. Kenya's study broadly linked turnover tax to ROI but did not focus on SMEs in EPZs, nor did it differentiate among types of tax incentives. This study extends discussion by directly examining how turnover tax reduction

impacts SME financial performance specifically in the EPZ context of Nairobi City County.

Bolboros analysed how turnover taxes in Vintila affected business results (2016). The study used secondary data sources secondary data sources mined from financial data from 2009 through 2013 from the company in question seeking to find out the relationship between firm's profitability and income turnover tax from the findings there was a relative impact of the various factors influencing tax loads was determined using chi-square and correlation analysis. The findings showed that turnover tax is affected by government mandates. Different to the review the current study seeks to examine how SME's performance is affected by tax turnover rather than tax rates. Bolboros (2016) examined turnover tax in a different jurisdiction and industrial setting, failing to address SME-specific dynamics in Kenya's EPZs. The current study fills this contextual and sectoral gap by focusing on Nairobi's EPZ SMEs and exploring how turnover tax reductions affect their financial performance in a localized setting.

For the five years from 2011 to 2015, Kamau (2018) studied the results of publicly traded agricultural enterprises in Kenya to see how changes in tax rates affected their bottom lines. Descriptive statistics were used to learn more about the independent variable. The explanatory research design's independent and dependent variables were then analyzed for their correlation. The study population as of December 31, 2015, included all seven agricultural companies trading on the Nairobi Stock Exchange. As a result, the study was essentially a census survey conducted between 2011 and 2015. In this research, we looked at how the effective tax rate affected profitability. There was no correlation between the effective tax rate and either ROE or ROA. Besides, the firm's ROA or ROE was not influenced by effective tax rate. Kamau (2018) focused on agricultural firms and effective tax rates but overlooked turnover tax and SMEs. Our

study addresses this by shifting focus to EPZ-based SMEs, specifically analyzing how reductions in turnover tax impact financial performance, thereby offering sector-specific, actionable policy recommendations.

In this regard, Cho and Yoon (2023) made an attempt to gauge the influence of revenue incentives established by the government on the profitability and sustainability of SMEs in South Korea. The aim of the study is that we conduct research and to find out whether the tax relief for investment improves the investment efficiency and sustainability of small and medium enterprises. They adopt a compiled research quantitative method by using data from SMEs in Korea to analyse the tax deduction claimed effect on investment efficiency. The author concluded that this financing tool was not efficient enough, if considering the Tobin's Q value referring to taxpayers, big companies including SMEs, would more likely look at tax items than the investment performance. Though this study discovered that SMEs' investment via the budget for employment creation was more effective, it underlines that the retention of human resources is the key for sustainability. Overall, the report reached a conclusion that tax credits for SMEs' efficient investments should also be combined with employment creation. Their study centered on Korean SMEs and did not assess specific tax types like turnover tax or Kenyan EPZs. The current research addresses this gap by focusing on Nairobi's EPZ SMEs and examining turnover tax reduction, offering country-specific policy insights to support SME sustainability.

Twesige et al. (2020) carried out their study by determining the role of tax relief on small and medium enterprises of Nyarugenge district in Rwanda. The scholars assessed tax exemptions during the process of SME development in the frame of Rwanda's economy. The case study approach, which involves qualitative and quantitative

information acquired from the SMEs in the Nyarugenge District region, was the research design for this study. Thanks to the research that was conducted, they discovered that there was a strong link between a positive tax environment and success of SMEs in the area. Companies owning most of the SMEs in Rwanda, saw things such as wear and tear, loss carry-forward and VAT as the paths in the country's growth process. Reportedly, tax incentives is the greatest driver for the SMEs' growth. Thus, it advocates for the construction of the policies that are formulated for SME advancement among the East African Community member states (e. g., Republic of Rwanda). Though Twesige et al. (2020) linked tax incentives to SME growth, the study was conducted in Rwanda with a general tax lens. The current study focuses specifically on turnover tax reduction and targets SMEs within Nairobi's EPZs, thus contextualizing the findings to Kenya's economic and policy environment.

Werekho (2023) assessed tax impact on economic progress and SMEs' compliance factors. The goal was to look at how the compliance tax on SMEs complicated the relationship between taxation and economic growth. The research adopted a quantitative research methodology and data was collected from SMEs in Nigeria using questionnaires which were administered to them. The studies of the researchers pinpointed a link between the tax system and economic development; this link was reinforced by tax compliance, with the latter serving as an anchor for economies to grow. During the research process, the study found that the policy must involve the elements which will enhance tax compliance of SME owners, which, in turn, will result in a better economy. Werekho's (2023) work highlighted tax compliance in Nigeria but did not focus on turnover tax or the financial outcomes of SMEs in EPZs. Our study bridges this by examining how turnover tax reduction affects SME performance in the EPZ context, contributing to taxation and compliance discourse in a Kenyan setting.

Anim et al., in (2021) investigated how tax regulation, tax appeal and the growth of SMEs are related with the size of organization as mediator. Their hypothesis is that tax administration and tax incentives will matter in SME growth through different firm size basis. This research was geared toward using a quantitative research method and data was collected through questionnaires administered to SMEs in Ghana. It was revealed that tax incentives were the key factor affecting SME development particularly the ones having a lower threshold. The study confessed that the tax incentives lead to SME growth, especially the smaller business enterprises (SMEs). Consequently, it formulated policies which were deliberate for small medium enterprises development. While Anim et al., in (2021) addressed tax incentives and SME growth, they did not examine turnover tax in EPZ environments. The present study fills this geographical and policy-specific gap by analyzing how turnover tax reduction influences financial outcomes for SMEs in Nairobi's EPZ, offering Kenya-centric evidence for SME tax reforms.

Ilodigwe (2023) analyzed the effect of multiple taxation of SMEs efficiency of in Nigeria. One of the objectives was to determine how tax systems with multiple layers affect the performance of SMEs in Nigerian specific context. Qualitative research was conducted for the study, involving semi-structured interviews and focus group discussions with SME owners and other stakeholders in Nigeria. Their discoveries emphasized several problems SMEs encountered because of multiple taxation payments which in turn impaired their efficiency. The study found that the government has to adopt some reforms to provide tax relief to SMEs to enhance their efficiency and participate meaningfully in the growth of the overall economy. Ilodigwe studied the effects of multiple taxation in Nigeria, neglecting specific taxes like turnover tax and SMEs in Kenya's EPZ. Our research fills this void by focusing on turnover tax

reduction and its direct impact on SME financial performance within Nairobi's EPZ, aiding in tailored policy development.

Harry and Aisha (2022) examined the impact of taxation on the profitability of SMEs in Uganda. They wanted to know the effect of rates taxation on the profitability of small and medium-size companies in Uganda. The study applied a quantitative research approach, looking at financial data from small and medium enterprises in Uganda to folding the connection taxation and profitability. The results collected pointed to a negative impact of taxation on SME profitability, therefore, this was another factor which highlighted the requirement for the reforms of taxes. The study highlighted that policymakers ought to focus on the tax changes that bring growth and competitiveness of SMEs. This study explored general taxation in Uganda, but not the turnover tax or SME environments within EPZs. The current research addresses this by focusing on the impact of turnover tax reduction on SME performance in Nairobi's EPZ, enabling targeted fiscal strategies for economic growth.

Cheong and others (2020) in their study focused on the existence of linkage between the access to credit, tax structure and the performance of manufacturing SMEs in Malaysia. The objective was to establish the effect that tax structure has on the performances of SMEs with special reference to Malaysia. This research employed a survey research method that quantitatively examined credit records and financial returns of Malaysian manufacturing SMEs as a way of establishing the important causal relationship between credit accessibility, tax policy and business performance. The research findings highlighted that tax structure impacted on SME performance; hence empowering policy makers in formulating and enhancing the relevance of its SME to the growth and competitiveness of the Malaysia. The study provided empirical evidence to

support the proposition that policymakers should resort to such factors as credit access and tax structure for crafting tax policies for supporting SME development and competitiveness. Cheong et al. (2020) examined tax structure and credit access in Malaysia, lacking focus on turnover tax or Kenyan EPZ SMEs. The current study bridges this context and scope gap by investigating how turnover tax reduction influences financial performance of SMEs within Nairobi City County’s EPZ framework.

## 2.4 Summary of Literature Review

This chapter has reviewed the literature pertinent to the subject under study. Literature has been reviewed in line with the study objectives. Global, continental and studies contexts have been explored in this study. The conclusions from the studies, irrespective of geographical context, concurs that application tax incentives affect the financial performance of SMEs. As summarized in Table 1, previous studies show that investment allowance, capital gain tax exemption, and turn over tax engender certain effects on the financial performance of SMEs.

**Table 2.1: Summary of Literature Review**

<b>Author (Year)</b>	<b>Focus of the Study</b>	<b>Key Findings</b>	<b>Identified Gaps</b>	<b>Current Study Focus</b>
Kemuma (2014)	Investment allowance and NSE earnings	ROI affects liquidity, financial leverage, and investment decisions	Focused on NSE-listed firms, not SMEs in EPZ	Investigates how investment allowance influences financial performance of SMEs in Nairobi EPZ

Karanja (2016)	Investment decisions and firm performance in Limuru	Investment decisions correlate with financial performance	Did not address tax incentives or SMEs specifically	Examines investment allowance impact on SME financial performance in Nairobi EPZ
Cohen & Klepper (2016)	R&D investment decisions and firm productivity in Sweden	R&D spending increases productivity	International context with a focus on R&D; not applicable to Kenyan SMEs	Explores investment allowance effects on SME performance in Nairobi EPZ, a local tax context
Kuria et al. (2017)	Capital allowance impact on EPZ firms in Kenya	Positive correlation between tax incentives and ROI, job creation	Did not disaggregate SMEs from general EPZ firms	Focuses specifically on SMEs within Nairobi EPZ and capital gain reduction impact
Nduati (2020)	Stock prices and profitability in manufacturing firms	Capital allowance boosts the financial health of listed firms	Not SME-focused; excluded turnover tax considerations	Explores capital gain reduction effects on SME

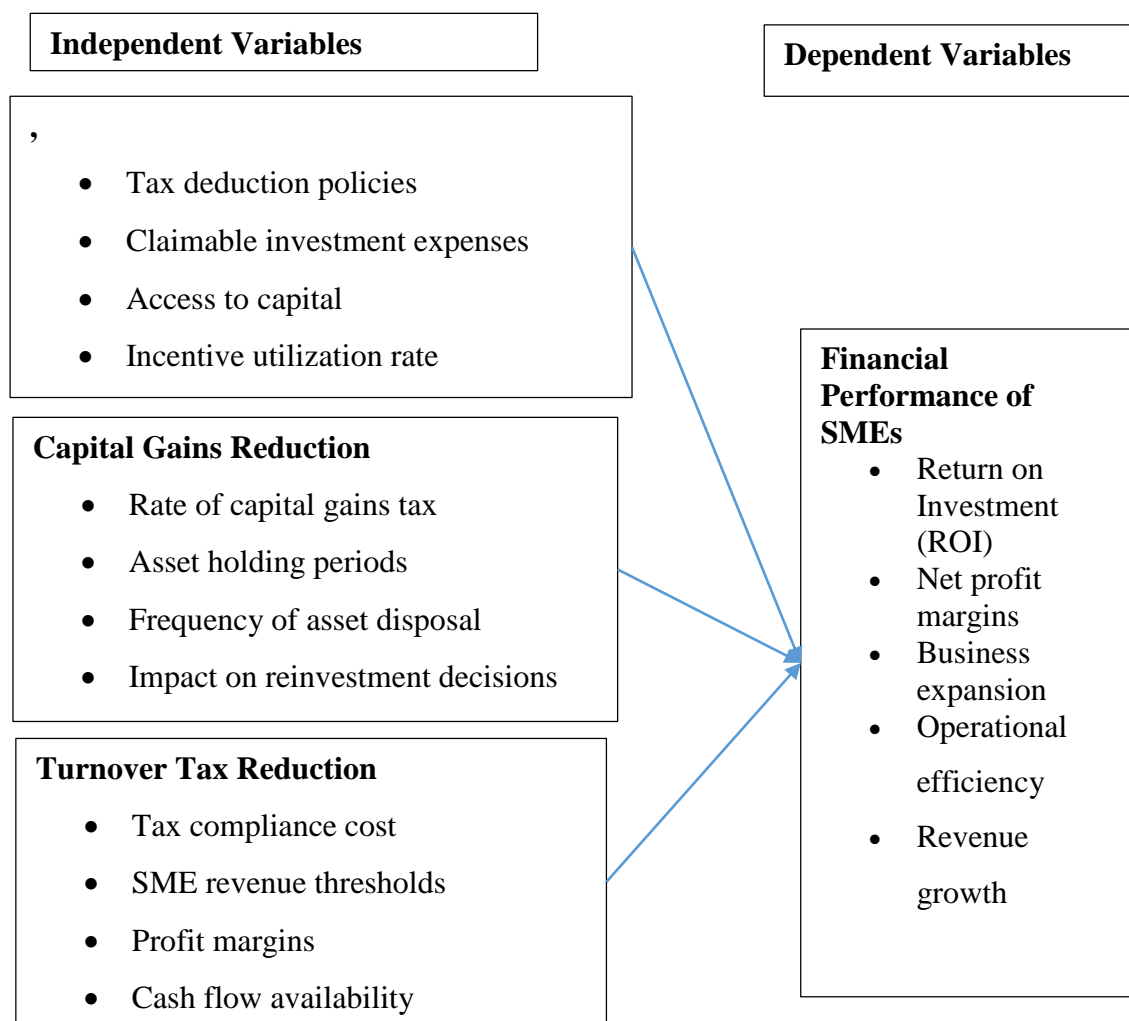
				performance in EPZs
Muli (2020)	Capital gains impact on real estate in Machakos	Weak link between capital gains and performance	Real estate-specific; lacks SME focus	Assesses capital gain reduction influence on SME performance in Nairobi EPZ
Kenya (2015)	Turnover tax and SME performance in Nairobi	Turnover tax hinders business growth; ROI is affected by firm size and age	Did not analyze turnover tax reduction directly	Investigates effect of turnover tax reduction on SME financial performance in Nairobi EPZ
Bolboros (2016)	Turnover tax and business profitability in Vintila	Tax loads influenced by government policy	International setting; not focused on SME sector	Focuses on turnover tax reduction and SME performance in Nairobi EPZ context
Kamau (2018)	Tax rates and profitability in agricultural firms	No significant link between tax rate and profitability	Excluded SMEs and turnover tax considerations	Assesses turnover tax reduction influence on SME performance in EPZ

Cho & Yoon (2023)	Revenue incentives and SME sustainability in Korea	Investment tax relief not efficient; HR retention vital	Global context; focused on large SMEs, not Nairobi EPZ	Examines turnover tax reduction as a policy tool for improving Nairobi EPZ SME sustainability
Twesige et al. (2020)	Tax relief and SME development in Rwanda	Strong link between tax incentives and SME growth	Regional study with different tax frameworks	Evaluates tax incentives, especially turnover tax reduction, in Nairobi EPZ SMEs
Werekho (2023)	Tax compliance and SME performance in Nigeria	Tax compliance improves economic growth	Did not assess investment allowances or turnover tax	Focuses on turnover tax reduction and its effect on SME performance in Nairobi EPZ
Anim et al. (2021)	Tax incentives and SME growth in Ghana	Tax incentives crucial for small business growth	Did not explore specific types like turnover tax or investment allowance	Focuses on specific tax incentives and their impact on Nairobi EPZ SMEs

Ilodigwe (2023)	Multiple taxation and SME efficiency in Nigeria	Multiple taxes reduce SME performance	Focus on multiple taxation rather than reduction of specific tax types	Investigates how turnover tax reduction affects SME efficiency in Nairobi EPZ
Harry & Aisha (2022)	Taxation and SME profitability in Uganda	Taxation negatively affects SME profitability	No examination of turnover tax reduction impact	Studies impact of turnover tax reduction on SME profitability in Nairobi EPZ
Cheong et al. (2020)	Tax structure, credit access, and SME performance in Malaysia	Tax structure impacts SME growth and competitiveness	Not focused on specific taxes like turnover or capital gain	Evaluates tax structure through turnover tax reduction in Nairobi EPZ SMEs

## 2.5 Conceptual Framework

This study adopts a conceptual framework that links tax incentives specifically investment allowance, capital gains reduction, and turnover tax reduction as independent variables influencing the financial performance of SMEs in the Export Processing Zone (EPZ) of Nairobi City County. The framework illustrates how these tax policies impact key financial indicators such as profitability, cash flow, and business growth, ultimately shaping the overall financial performance of the SMEs.



**Figure 2.1: Conceptual Framework**

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

Chapter three of the study specifically sought to answer the study objectives by developing the key approaches that would be used in collecting the relevant data required. The chapters present the methods adopted in collecting, analysing and presenting data.

#### **3.2 Research Design**

This study adopted a descriptive research design to examine the influence of tax incentives on the financial performance of small and medium enterprises (SMEs). According to Mugenda (2008), a descriptive research design involves collecting and analysing data to describe the characteristics of a particular phenomenon as it exists in its natural setting. The method does not involve manipulation of variables, making it appropriate for studies that seek to observe and describe relationships between variables as they naturally occur. The descriptive design was considered suitable for this study because it allows for the collection of quantitative data, which is essential for measuring and analysing the extent to which tax incentives affect financial performance. By using structured questionnaires, the researcher was able to gather standardized information from a representative sample of SMEs, enabling statistical analysis and interpretation of trends and patterns. This approach facilitated the identification of associations between the independent variable (tax incentives) and the dependent variable (financial performance), without establishing causality. The design was particularly advantageous due to its ability to present factual and accurate information, enabling the researcher to generalize findings to the wider population of SMEs within the study area. Furthermore, it supported the study's objectives by providing data that could be used to make

evidence-based recommendations for policymakers, tax authorities, and SME stakeholders. In this study, the approach was used because it offered a logical framework for understanding the current state of SME performance in relation to tax policy (Mugenda, 2008). Therefore, the descriptive design was not only methodologically appropriate but also essential in producing reliable and generalizable insights into the research problem.

### **3.2.1 Research Philosophy**

Research philosophy refers to the belief system or worldview that guides the researcher in choosing methods, interpreting data, and understanding the nature of knowledge (Saunders & Thornhill, 2007). It is a vital component in shaping the research approach and determining how evidence is collected and interpreted. In this study, the positive philosophy was adopted, which assumes that reality is objective, measurable, and independent of the researcher. This aligns with the study's quantitative orientation, focusing on observable and quantifiable data. Positivism is particularly suited for this research, which seeks to evaluate the impact of market penetration, market development, and product development strategies on the performance of commercial banks measured in terms of profitability, market share, and asset growth. This philosophy supports the use of structured tools such as questionnaires and statistical analysis to test hypotheses and examine relationships between variables. By applying a positive lens, the study ensured objectivity and reliability, reducing researcher bias and enabling generalization of findings. Understanding the research philosophy also helped guide the selection of methodology and tools that aligned with the study's goals. As such, adopting a positive paradigm was essential for producing credible, evidence-based conclusions that inform strategy and performance improvement in the banking sector.

### 3.2 Empirical Model

This study adopted a multiple linear regression model to examine the effect of selected tax incentive variables on the performance of Small and Medium Enterprises (SMEs). Regression analysis is a reliable statistical tool used to determine the strength and nature of the relationship between a dependent variable and one or more independent variables. It is particularly appropriate for this study, which aims to quantify how specific tax incentives influence SME performance.

The empirical model used in the study represents:

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \varepsilon$$

Where:

$Y$  = Dependent Variable (SME Performance)

$\beta_0$  = Constant

$X_1$  = Investment Allowance

$X_2$  = Capital Gain Reduction

$X_3$  = Turnover tax reduction

$\varepsilon$  = Error term

#### 3.2.2 Operationalization and measurement of Variables

This section presents the operational definitions of study variables. Tax incentives investment allowance, capital gain reduction, and turnover tax reduction were measured as binary variables. SME financial performance was assessed using revenue and profit data. All tax incentives were hypothesized to have a positive influence on financial performance outcomes.

**Table 3.1: Operationalization and measurement of Variables**

<b>Variable</b>	<b>Type</b>	<b>Operationalization</b>	<b>Measurement</b>	<b>Hypothesized Direction</b>
Investment allowance	Independent	Presence or absence of investment allowance	Binary (1 = Present, 0 = Absent)	Positive
Capital gain reduction	Independent	Presence or absence of capital gain reduction	Binary (1 = Present, 0 = Absent)	Positive
Turnover tax reduction	Independent	Presence or absence of turnover tax reduction	Binary (1 = Present, 0 = Absent)	Positive
Financial performance	Dependent	Financial performance of SMEs in the EPZ	Numeric scale (e.g., revenue, profit)	n/a

### **3.3 Target Population**

According to Kothari (2004), a population refers to a group of individuals, items, or events that possess a common characteristic and from which data can be collected. Borg and Gall (2013) similarly define a population as the total number of elements or cases that meet a particular criterion of interest to the researcher. In this study, the population comprised all Small and Medium-sized Enterprises (SMEs) operating within the Export Processing Zones (EPZs) in Nairobi County.

The target population was drawn from a list of registered SMEs at the Nairobi City County Council's business licensing office, representing different sectors such as service, agro-processing, manufacturing, and hospitality. These SMEs formed the basis from which the sample was drawn. The total target population was 90 SMEs across the four sectors, as outlined in the sampling frame below (Table 3.1). The diversity of

sectors was included to ensure that findings from the study could be generalized to reflect broader SME performance trends in EPZs across Nairobi. A sample size of 30 SMEs was selected using stratified random sampling to ensure proportional representation from each sector. This sampling approach was ideal due to the relatively small population size and the need for inclusive sectoral insights.

**Table 2.2: Distribution of Target Population**

<b>Classification</b>	<b>Target Population</b>	<b>Sample Size</b>
Service	15	5
Agro-Processing	20	7
Manufacturing	35	12
Hospitality	20	6
<b>Total</b>	<b>90</b>	<b>30</b>

**Source: Nairobi City County (2022)**

### 3.4 Sampling Design

This study employed a stratified random sampling technique, a probability-based method, to ensure fair representation and allow for generalization of findings to the broader SME population. The target population of 50 SMEs within Nairobi’s EPZs was categorized into four sectors: service, agro-processing, manufacturing, and hospitality. A sample size of 30 SMEs was selected proportionally from each stratum using simple random sampling within the groups. This approach minimized selection bias and ensured that each SME had an equal chance of being included. The sample size was deemed adequate to reflect sectoral diversity while remaining manageable for data collection and analysis. The study used stratified random sampling using a formula:

$$n = \frac{N}{1 + Ne^2}$$

Where:

$n$  = Sample size

$N$  = Target population

$e$  = maximum acceptable margin of error (5%)

$$n = 100 / [1 + 90 (0.05*0.05)] = 90 / 2.97 \approx 30$$

### **3.5 Data Collection Instruments**

A cross-sectional approach would be adopted. Furthermore, the study intends to use data collection sheets in collecting secondary data. Secondary data would be collected from the chosen firms' financial reports. The study used reports published between 2018-2022. The study sought to use the latest reports to help in getting more updated outcome.

The research focused on small scale and medium scale firms that are doing business in exports processing zone at Nairobi EPZ. The data regarding this population was obtained from the Nairobi County Council's business license office. The Nairobi EPZ structure, a disparate array of sectors, is one which includes service, agro-processing, manufacturing, and hospitality. This selection aimed to ensure a comprehensive representation of SMEs in Nairobi, Kenya, facilitating generalization of the study's outcomes. By accessing data from the Nairobi County Council's business license office, which oversees the registration and licensing of businesses operating within the EPZs, the study can obtain comprehensive information about SMEs across different industries. This provides a tool/source, which helps the researchers to study not only the SMEs operating in the EPZs but also their entire business network.

### **3.6 Data Collection Procedure**

After the development of the data collection instruments, the study proceeded with the systematic process of gathering the necessary data. The data collection was conducted

using secondary data sourced from financial reports of SMEs operating in the Nairobi EPZ. The reports, covering the period from 2018 to 2022, were obtained from the Nairobi County Council’s business license office. This method was chosen because it allowed access to comprehensive and updated information, essential for the study’s objectives. The instruments were administered through document reviews, where the researcher examined the financial reports of selected firms. The secondary data collection approach was justified as it provided reliable, large-scale data without needing direct interaction with the businesses, ensuring minimal disruption.

### **3.7 Data Analysis and Presentation**

The study employed both descriptive and inferential statistical methods using SPSS and STATA software. Descriptive analysis was used to summarize data through measures such as mean, standard deviation, and frequency distribution. For inferential analysis, the study applied a panel regression model to incorporate both cross-sectional (different SMEs) and time-series (data over a 5-year period) dimensions, enhancing the robustness and reliability of the results. The model assessed the effect of various tax incentives on SME performance.

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \mu_i + \varepsilon_{it}$$

Where:

$Y_{it}$  = SME Performance for firm  $i$  at time  $t$

$\beta_0$  = Constant

$X_{1it}$  = Investment Allowance

$X_{2it}$  = Capital Gain Reduction

$X_{3it}$  = Turnover Tax Reduction

$\mu_i$  = Unobserved firm-specific effect

$\varepsilon_{it}$  = Error term

### **3.7.1 Diagnostic Tests**

The results of regression analysis tests are interpreted differently when these assumptions about the data are violated. There should be an equal quantity of information in each data point. The regression slope of a study was drawn to the data points with the most information when some of the data points contain less information than others. Another assumption is that since a multiple linear analysis has many independent variables, there should be little to no correlation between them. If the independent and dependent variables are highly correlated, it may be difficult to ascertain their exact correlations (Casson & Farmer, 2014). The assumptions for the regression model will be tested using linearity, normality, multicollinearity and homoscedasticity.

### **3.7.2 Test for Normality**

Normality assumption in multiple regression analysis requires that error terms have zero mean and constant variance, following a normal distribution. Skewness and kurtosis are analysed to assess data normalcy. Extreme skewness ( $|\text{skew-index}| > 3.0$ ) and kurtosis (kurtosis index  $> 8.0$ ) indicate departure from normality (Kline, 2005). Cunningham (2008) suggests even slight violations with skewness  $> 2.0$  and kurtosis  $> 7.0$ . Zero skewness denotes symmetry; positive/negative values imply smaller/greater values respectively. A kurtosis value close to zero indicates near-normal distribution, while positive kurtosis suggests peakiness (Creswell, 2008). Kurtosis and skewness of  $\pm 2$  suffice for analysis.

### **3.7.3 Testing for Linearity**

This study will employ Pearson's relationship to test for consistent variables to the underlying process (Dancey, 2004). When a positive correlation coefficient is shown,

this means that a relationship between the variables is positive, while the negative sign indicates that they are forming a negative relationship. (Field, 2009).

#### **3.7.4 Testing for Multicollinearity**

Multicollinearity, when variables provide redundant information, is tested using the variance inflation factor (VIF). VIF values less than 3 indicate no multicollinearity, while values above 10 require investigation (Hair et al., 2010; Field, 2009). Tolerance values below 0.1 also signify no multicollinearity. To determine significance, hypotheses will be tested with a significance level of  $P < 0.05$ , using SPSS Version 24 for analysis.

#### **3.8 Ethical Consideration**

This study adhered to strict ethical standards in handling secondary data. Financial reports obtained from the Nairobi County Council's business license office were used solely for academic purposes and treated with confidentiality. No identifiable information of the SMEs was disclosed, ensuring anonymity and privacy. Permission was sought from relevant authorities before accessing the data. The research avoided data manipulation or misrepresentation, maintaining integrity and accuracy throughout the analysis. Additionally, the study complied with institutional research ethics guidelines, emphasizing transparency, objectivity, and respect for data ownership. Ethical approval was obtained where necessary to support the legitimacy of the research process.

## CHAPTER FOUR

### RESULTS AND ANALYSIS

#### 4.1 Introduction

Chapter Four discusses the research findings in respect of the impact of tax related incentives including Investment Allowance, Capital Gain Reduction and Turnover Tax Reduction on the financial performance of SMEs established in EPZ. By performing regression analysis and ANOVA the chapter analyses how these independent variables affect the financial result, namely ROA.

#### 4.2 Results

##### 4.2.1 Descriptive Statistics of Study Variables

Table 5 shows the mean, standard deviation, minimum, and maximum values for financial performance and tax-related variables.

**Table 3.1: Descriptive Statistics of Study Variables**

	N	Minimum	Maximum	Mean	Std. Deviation
Financial Performance (ROA)	30	2.20	7.00	4.4567	.3977
Investment Allowance	30	0	1	.87	.046
Capital Gain Reduction	30	0	1	.87	.046
Turnover tax reduction	30	0	1	.90	.005
Valid N (listwise)	30				

The descriptive statistics given in Table 4.1 gives an initial look into the mean values of all the variables that has been used in this study. Regarding Investment Allowance, a variable, the mean was 0.87. This value is a dichotomy, where 1 is assigned when the firm has an investment allowance and 0 is assigned when a firm does not. A mean of 0.87 suggests that a substantial proportion of the SMEs in the study benefited from an investment allowance. More particularly, this mean shows that, on average, close to

87% of the SMEs benefitted from an investment allowance. The mean value of Capital Gain Reduction was also 0.87. This indicates that for this particular variable, 87% of the SMEs suffer on average some decline in capital gains. On the other the statistical of Turnover Tax Reduction was mean = 0.90. A mean of 0.90 suggest that on average 0.90% of the SMEs were impacted in a positive way by the reduction in turnover taxes.

#### 4.2.2 Correlation Analysis Between Tax Incentives and Financial Performance (ROA)

Table 4.2 presents the correlation results, showing the strength and significance of relationships between financial performance (ROA) and tax incentives.

**Table 4.2: Correlation Analysis Between Tax Incentives and Financial Performance (ROA)**

		Financial Performance (ROA)	Investment Allowance	Capital Gain Reduction	Turnover tax reduction
Financial Performance (ROA)	Pearson Correlation	1	.487	.383	.421
	Sig. (2-tailed)		.002	.000	.002
	N	30	30	30	30
Investment Allowance	Pearson Correlation	.487	1	.354	.331
	Sig. (2-tailed)	.002		.007	.001
	N	30	30	30	30
Capital Gain Reduction	Pearson Correlation	.383	.354	1	.396
	Sig. (2-tailed)	.000	.007		.002
	N	30	30	30	30
Turnover tax Reduction	Pearson Correlation	.421	.331	.396	1
	Sig. (2-tailed)	.002	.001	.002	
	N	30	30	30	30

The correlation analysis provides valuable insights into how tax incentives influence the financial performance (ROA) of SMEs in the Export Processing Zone (EPZ) of Nairobi City County.

Objective i: To understand how investment allowance affects the financial performance of SMEs, the results showed a positive and significant correlation ( $r = 0.487$ ,  $p = 0.002$ ). This suggests that SMEs benefiting from investment allowances tend to experience improved financial performance. The correlation indicates that investment allowances have a moderate but meaningful impact on the financial health of SMEs, as they enable greater investments in assets, which likely contribute to higher returns.

Objective ii: The impact of reducing capital gains taxes on the financial performance of SMEs was also found to be positive ( $r = 0.383$ ,  $p = 0.000$ ). This significant correlation suggests that the reduction of capital gains taxes results in enhanced financial performance for SMEs. By reducing tax burdens on profits from investments, SMEs are likely to reinvest these savings into expanding their operations, leading to improved profitability.

Objective iii: The correlation between turnover tax reduction and financial performance ( $r = 0.421$ ,  $p = 0.002$ ) indicates that SMEs that benefit from a reduction in turnover taxes show a notable improvement in their financial performance. This suggests that reducing turnover taxes allows SMEs to retain more earnings, which can be utilized for reinvestment in business growth, further boosting profitability.

In summary, all three tax incentives investment allowance, capital gains reduction, and turnover tax reduction positively and significantly influence the financial performance of SMEs in the EPZ, underlining the importance of these incentives for enhancing SME performance.

The findings of this study are consistent with previous research that emphasizes the positive impact of tax incentives on the financial performance of SMEs. For instance, Eric and Ahabwe (2022) found that tax incentives such as investment allowances positively influenced the profitability of SMEs in Uganda, supporting the significant correlation observed in this study. Similarly, Feyitimi et al. (2016) highlighted that tax reductions, including capital gains and turnover taxes, contribute significantly to the growth of SMEs in developing economies. They argued that such tax incentives allow SMEs to retain more capital for reinvestment, thereby fostering growth. Additionally, Gamage et al. (2020) affirmed that tax incentives improve the survival and profitability of SMEs, as they reduce the financial burdens on small businesses, enabling better cash flow and higher reinvestment potential. This aligns with the study's finding that reduced turnover taxes and capital gains taxes positively impact SME financial performance in the EPZ of Nairobi City County, Kenya. These studies support the notion that well-structured tax incentives can boost the financial performance and growth prospects of SMEs.

#### **4.2.3 Coefficients of the Regression Model for Financial Performance (ROA)**

Table 4.3 presents the regression coefficients for the model, which examines the impact of tax incentives on the financial performance (ROA) of SMEs in the EPZ of Nairobi City County.

**Table 4.3: Coefficients of the Regression Model for Financial Performance (ROA)**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	4.329	1.150		3.764	.001
Investment Allowance	.596	.694	.366	.860	.002
1 Capital Gain Reduction	.587	.701	.364	.837	.000
Turnover tax reduction	.434	.792	.433	.169	.002

a. Dependent Variable: Financial Performance (ROA)

Objective one sought to understand how investment allowance affects the financial performance of SMEs in the Export Processing Zone (EPZ) of Nairobi City County, Kenya. According to the study, it was found that investment allowance had a significant positive effect on financial performance. Specifically, a unit increase in investment allowance resulted in a 0.596 increase in the financial performance (ROA) of SMEs, with a p-value of 0.002. This indicates that investment allowance positively impacts the financial performance of SMEs in the EPZ, leading to the rejection of  $H_{01}$ , which stated there is no significant effect.

Objective two aimed to explore the impact of reducing capital gains on the financial performance of SMEs in the EPZ of Nairobi City County, Kenya. The study revealed that capital gain reduction had a significant positive effect on financial performance. A unit increase in capital gain led to a 0.587 increase in the financial performance (ROA) of SMEs, with a p-value of 0.000. This result demonstrates that capital gain reduction

positively influences the financial performance of SMEs, thereby rejecting  $H_{02}$ , which posited that there is no significant effect.

Objective three sought to evaluate how reducing turnover tax influences the financial performance of SMEs in the EPZ. The study found that turnover tax reduction also had a significant positive impact on financial performance. A unit increase in turnover tax reduction led to a 0.434 increase in financial performance (ROA), with a p-value of 0.002. This finding suggests that reducing turnover tax enhances the financial performance of SMEs, resulting in the rejection of  $H_{03}$ , which assumed no significant effect.

The positive and statistically significant correlations between financial incentives such as investment allowance, capital gain reduction, and turnover tax reduction and the financial performance of SMEs in the EPZ of Nairobi are consistent with findings in existing literature. According to Cho and Yoon (2023), tax relief policies designed to stimulate SME investments contribute positively to both financial efficiency and long-term sustainability. Similarly, Cheong et al. (2020) emphasize that tax structures significantly influence SMEs' performance by improving cash flow and encouraging reinvestment. These incentives allow firms to redirect resources towards growth activities, which aligns with the observed moderate positive correlations in the present study. Calitz, Wallace, and Burrows (2013) further support that investment-related tax incentives have a stimulatory effect on business productivity and profitability. From a broader fiscal perspective, Brautigam et al. (2012) argue that effective taxation policies not only support state-building but can also foster an enabling business environment for SMEs. Additionally, Canicio and Zachary (2014) establish a causal relationship between tax revenue measures and economic growth, indicating that well-structured tax

incentives can spur performance improvements at both firm and macroeconomic levels. These findings collectively affirm that multiple and complementary tax incentives can positively impact SME financial outcomes, as observed in the Nairobi EPZ context.

#### 4.2.4 ANOVA Results Summary

**Table 4.4: ANOVA Results Summary**

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	2.691	3	.897	.557	.000 <sup>b</sup>
1	Residual	41.882	26	1.611		
	Total	44.574	29			

a. Dependent Variable: Financial Performance (ROA)

b. Predictors: (Constant), Turnover tax reduction, Investment Allowance, Capital Gain Reduction

The analysis of variance (ANOVA) results for the given model provides insights into the overall significance of the regression, which examined the impact of investment allowance, capital gain reduction, and turnover tax reduction on the financial performance of SMEs, measured by Return on Assets (ROA). The regression analysis was done to examine the relation between two continuous variables. The obtained value of the significance equalled to 0.000 indicates that these results could not have happened by mere chance, and this is below the widely used 0.05. Basically, the measure of dependability was quite high, and it justified that the independent variables (investment allowance, capital gain reduction and turnover tax reduction) have contributed positively to the financial performance of the SMEs operating in the EPZ. This high level of statistical significance provided support to the study and evidence

that the three tax related incentives used had a positive impact to SMEs under study's financial performance.

The relationship between tax incentives and SME financial performance has gained empirical support across diverse contexts. Liu and Mao (2019) provide firm-level evidence from China indicating that well-structured tax incentives enhance investment and productivity, ultimately driving financial gains. Similar conclusions are drawn in the African context. Mayende (2013) shows that in Uganda, tax incentives significantly improve firm performance, particularly when aligned with investment needs. In Kenya, Mbugua et al. (2014) and Magiya (2016) both report that tax reliefs, such as turnover tax reductions and capital gains exemptions, ease financial pressure on SMEs and encourage growth. However, the effectiveness of such measures also depends on SME awareness and compliance. Luttmer and Singhal (2014) argue that tax morale—individuals' intrinsic motivation to pay taxes is a crucial determinant of how firms respond to tax policies. If firms perceive tax incentives as fair and accessible, compliance improves, thereby amplifying their financial benefits. Moreover, Malthouse (2016) emphasizes that in competitive urban economies like London, supportive tax regimes can be the differentiating factor for SME sustainability and performance. These findings reinforce the notion that tax policy, when designed and communicated effectively, can play a pivotal role in enhancing SME financial outcomes and broader economic development.

#### 4.2.5 Model Summary Results

**Table 4.5: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.846 <sup>a</sup>	.860	.048	.06920

a. Predictors: (Constant), Turnover tax reduction, Investment Allowance, Capital Gain Reduction

Descriptive statistics which assist in evaluating the adequacy of the regression model and the variation in financial performance which is Return on Assets (ROA) of the SMEs operating in the EPZ context are presented in the model summary table. Of primary importance is obtaining an R value which is greater than zero and, as such, the initial R value of 0.846 clearly shows the positive signs and it is hopeful that through investment allowance, capital gain reduction, and turnover tax reduction, SMEs' performance will be strikingly positive. This high measure of association points to the fact that tax incentives are well connected to enhanced financial performance. On the other hand, the R Square value of 0.860 signifies that 86% of the variance in financial performance is explained by the independent variables in the model. This indicates that out of all the factors that could affect the financial performance the model is representative of most of them, therefore serves its purpose well.

### 4.3 Hypothesis testing

**Table 4.6: Hypothesis Results**

Hypothesis	Sig	Hypothesis Test Results at 0.95 CI	Discussion on Results
<b><i>H<sub>01</sub></i>: There is no significant effect of investment allowance on the financial performance of SMEs in the EPZ.</b>	0.002	Reject Null Hypothesis because (0.002 < 0.05)	There is a significant positive effect of investment allowance on the financial performance of SMEs. This is supported by the Sig. value of 0.002, which is within the 5% significance threshold. These findings align with research that shows investment allowances promote capital investments and improve financial performance.
<b><i>H<sub>02</sub></i>: There is no significant effect of capital gain reduction on the financial performance of SMEs in the EPZ.</b>	0.000	Reject Null Hypothesis because (0.000 < 0.05)	Capital gain reduction significantly enhances the financial performance of SMEs. The Sig. value of 0.000 confirms a strong positive relationship, meaning that reductions in capital gains tax allow businesses to reinvest profits.
<b><i>H<sub>03</sub></i>: There is no significant effect of turnover tax reduction on the financial performance of SMEs in the EPZ.</b>	0.002	Reject Null Hypothesis because (0.002 < 0.05)	The reduction in turnover tax significantly improves financial performance, confirmed by the Sig. value of 0.002. This finding agrees with the hypothesis that turnover tax reduction leads to greater profitability by decreasing the tax burden on revenue, consistent with other findings.

## **4.4 Discussion**

### **4.4.1 Relationship between Tax Incentives and SME performance**

From the research results, it was found to exist a positive correlation with the development of SMEs as it was revealed through the results of the study on the effect of tax incentives. Thus, this finding supports other learning that holds that tax incentive is one of the critical factors for the growth and sustainability of SMEs, especially in the conditions where financial challenges are common factors that hinder business development. Various research engage the perception that tax incentives offer the money relief required by SMEs to sustain and develop their operations for sustained growth. For instance, Anim et al., (2021) noted that tax administration and incentives play a vital role regarding the SMEs' growth especially when other variables such as firm size and industrial type are taken into consideration. Its findings pointed out the fact that the tax break lessens the cost pressure on SMEs to make more resources available to fund growth and operations. This is in concordance to findings in the current study, on how measures to reduce turnover tax impact the growth of an SME.

In addition, the literature supports the study's results with Abd (2015) establishing that tax incentive encouraged the growth of Malaysian SMEs. Abd (2015) stressed the fact that tax relief measures enhance the performance of business organizations by reducing otherwise costly demands, namely tax. In general, financial assistance that comes in form of tax credits helps SMEs to undertake activity that contributes to business growth including new product development, expansion into new markets and human capital acquisition. Some of the tax incentive policies that the government of Malaysia has implemented to foster SMEs growth have been widely acknowledged to have enhanced the ability of SMEs to realise steady growth even in the current volatile economic world through solving their most acute financial challenges. This perception reflects the

present study through which high significance of tax incentives in the SME growth was ascertained.

The findings of the present study also align with the study of Andreoni et al. (2012), who examined compliance with taxes, incentives and economic activities of business ventures. They stated that where tax incentive programs are properly formulated, they enhance compliance while at the same time stimulating growth and development of businesses. The study also highlighted that the SMEs that follow the tax laws of the country are likely to receive the available incentives to improve on their financial performance as well as growth. Hypotheses of interest include tax incentives for credits on R&D or deductions of capital investment has a way of availing resources to SMEs for growth activities. In this regard, tax incentives work as a driving force for innovations and growth of SMEs that in turn helps the companies to increase competitiveness in domestic and global arenas.

In addition, based on the study's findings, it can be explained that the provision of tax incentives helps to lower the financial pressure on SMEs, and thus enables them to improve their Business Efficiency. Reducing taxes paid enable SMEs to invest heavily on strategic sectors including research and development of products, branding, and employee training. Reinvestment, thus, results to higher operations and productivity which are key factors to growth. The extent to which SMEs are able to use tax savings for growth enhancing activities has been well captured in earlier studies. For instance, Anim et al. (2021) pointed out that tax incentives not only benefit business development but also lead to increased stability and sustainability of SMEs that thus receive the necessary financial freedom to respond to certain economic conditions.

Furthermore, tax incentives play a crucial role in addressing one of the primary challenges faced by SMEs: They all face constraints in terms of funding which seems to be the biggest hindrance to success. Most SMEs throughout the world particularly in developing economy face a major problem of getting loans or investment capital mainly because of their size, high risks or inadequate security. This pressure is well managed due to tax incentives that ensure the cost of conducting business is cut down considerably. For instance, the cuts in corporate income tax or specific types of business activity relieve SMEs' financial pressure right away, enhance their cash flow, and decrease dependence on external funds. It also enables the SMEs to fund growth-oriented activities other than incurring more debt, thus increasing their longevity. This plurality of positive effects Commonwealth of Independent States has supported by Abd. (2015), which has noted in turn that Malaysian SMEs have benefited from tax incentives to payroll ha on cash flows and diminished financial constraints.

#### **4.4.2 Influence of Tax Compliance on SMEs Performance**

The research established a positive correlation between Compliance to tax policies and Business performance; it was found that firms that complied with tax laws are bound to make gains on government policies aimed at awarding the firms the competitive edge in business through improved financial position. In line with existing studies, tax compliance has been identified as a key success factor where small and medium enterprises are involved especially in developing countries. Bird et al (2006) state that it is societal institutions and mechanisms of tax compliance that help the businesses to stay afloat within the legal constraints but also facilitate their access to a range of governmental aids. In the case of SMEs, the current correlation between compliance and business performance is rather significant: compliance with the tax legislation not only helps to avoid the legal threats but also opens the perspectives for the participation

in the state-organized stimulation programs that can facilitate the growth of the enterprise.

Compliance with taxation laws help firms to adhere to legal requirements thus creating credibility with the government and the entire business fraternity. Often, the governments use tax compliance to determine the entitlement of one or another tax credit, deduction or exemption. Companies that show compliance regularly are likely to receive such measures that help in reducing their costs, which, thus, enhances business performance. Klemm and Van Parys (2012) report that tax compliance is an essential prerequisite to the optimal use of the tax incentives since compliant firms are in the better place to take advantage of the available programs. For example, if an SME business operates in line with the corporate income tax laws, he or she could be eligible to pay lower tax on the profits earned and reinvested in the business. Such financial benefits enhance the firm's liquidity position and overall financial position, which gives the management a green light to embark on expansion of operations, adoption of new technologies or diversification into new products and/or markets.

Thus, the compliance with the tax legislation can help to establish better relations with the financial institutions and investors as the latter are more willing to deal with the firms that meet the legislation requirements as such firms are less risky. This enhanced credibility can lead to easy access of external funds in form of loans or equity investment needs of the SME's especially when the company seeks to expand. Tax compliance is essential since failure to meet these laws will lead to penalties, and when SMEs show compliance, they are financially disciplined and credit worthy thus enhancing creditors' willingness to fund them. This access to financing enhances the position of the firm to fund growth-related activities that results in better performance

in generalities. As to this point of view, the results of the study confirm that the firms following the requirements of the tax legislation enjoy better financial conditions and improved opportunities for growth. Furthermore, it also reduces legal impacts that arise from failure to observe tax laws including fines for non-compliance, interest charge on unpaid taxes and damaging effects on business reputation. Noncompliance of tax laws exposes firms to penalties, which reduce cash flow and thus the profit; this applies specifically to those without sustainable cash flows. These penalties are much more than mere tricks because they reduce the profits of the firm in the short run as well as cause long term damaging effects in the reputation of the firm hence the problem of accessing customers, partners and investors. Kirchler et al. (2008) to opine that voluntary tax compliance has positive relationship with the business performance of an organization, as organizations in the higher tax compliance zone are found to have better performance than other organizations. Firms maintain a voluntary compliance with tax regulations whereby they do not have to deal with the adverse effects of audits, penalties and legal cases hence leading to efficiency in terms of business aspects that lead to growth.

In addition, the results establish a connection between the level of tax compliance and the opportunity to access government incentives and more so in the developing economy where SME's exploits financial dearth. Government incentives, for example, tax credits for R& D, or the purchase of new tools, or the registration of new employees, mean very credible sources of financial support for the compliant firm. It also employed tax incentives as forms of encouraging investment in areas that are of essential importance to the firm's operations while at the same time alleviating the tax burden the firm incurs. For example, an SME that plays the intended part regarding tax laws and meets the conditions of R&DT tax credit will likely be in a better position to inject

capital into research on new and better products or processes that could enhance its market position. Co support initiatives indicate that by taking advantage of such incentives, the firms which are fully compliant can be able to lift their financial performance and gain strength in the market.

Furthermore, in relation to the study Klemm and Van Parys (2012) who argued that ability to use tax relief programs in SMEs is enhanced by tax compliance to tax regulations. Some of these incentives which are commonly in the forms of tax holidays, deductions, and credits, offer significant financial incentives that clearly have a role of enhancing business performance. This is because, the measures can lead to considerable reductions in operational costs and hence increase resources for investment in productive factors, capital, skills, advertising or new products, and entry into new markets. Compliance also means reducing the general tax rates since SMEs will be able to reinvest the tax credit in promising sectors of the business.

#### **4.4.3 Impact of Tax Incentives on Innovation and Competitiveness**

The study highlighted a significant relationship between tax incentives and innovation among small and medium-sized enterprises (SMEs), revealing how these incentives play a critical role in promoting innovation and improving competitiveness. The results showed that the provision of tax incentives lead firms to show greater potential in terms of innovation whereby competitive advantages in the market was possible. Dechezleprêtre et al. (2016) offer robust evidence for this conclusion stating that tax incentives, especially R&D ones, act as potent catalyst of innovation. From their research, the authors find evidence that firms receiving R&D tax incentives make higher levels of innovative investments and increase their competitive advantage in the domestic as well as the export markets.

From the findings, it is evident that tax incentives are positively related with innovation with special reference to technological change and new products. This is achieved through tax relief whereby by providing such reliefs firms can spread their financial weight on the development of new technologies and products hence improving the firm's competitiveness on the market. Through tax incentives for the SMEs, the financial pressure is eased, and the remaining money can be pumped into Research and Development thus producing new products, services or business models. It comprises a craft of growth and competitiveness that in turn helps businesses to adapt to changes in the market forces, customer needs and technological changes. Therefore, even though tax incentives are mostly seen as pure sources of relief, it must be noted that they are also important strategic tools for supporting development in the long-run – particularly in such sector as innovative one.

Similarly with Kimti (2010) Klemm (2010) established that it is feasible to point out that business tax incentives remain needed for policy makers to encourage the SMEs and particularly those in the developing world regarding innovation and productivity. To this effect, the study claimed there might be difficulties for SMEs in competing with bigger, more authoritative counterparts that sunders do provide better favourable conditions in terms of accessibility to resources. In the kinds of economy like the developing economies, the access to capital and external financing may be scarce, therefore the incentives put in place on taxes prove essential in stimulating SMEs to undertake certain risks to invest in innovations. This way they can elevate their performance and efficiency to the optimal level, necessary for the enhancement of competitiveness of their products both on the national and international level. Klemm (2010) advocated that innovative stimulus for such SMEs is most driven by tax

incentives as the firms in the emerging economies seek to reduce the existing gap between them and the large firms.

Furthermore, Bergner et al. (2017) pointed out was the questions of tax incentives for the SMEs in the European Union and their impact as they noted that such incentives enable the companies to cut down their operational expenses. By reducing the tax burden, firms can redirect financial resources toward expansion and innovation, which in turn boosts their competitive edge. For the SMEs that usually cannot afford the same number of margins and resources as bigger companies, it is crucial that the money saved from taxation incentives could be reinvested in innovation to maintain the competitiveness in the market. This is in line with the current research that established that tax relief measures enhanced SMEs' ability to adopt new technologies and processes, thus improving their overall productivity.

Tax incentives also help sustain a culture of constant innovation among the SMEs through a continuous process of trying out different activities that they Flag 6 incorporate into their operations. The tax deduction schemes reduce the amount of money that firms can spend on R & D activities, and this makes them to undertake risks in a controlled manner as they search for new ideas and unexplored business models. This culture of innovation does not only help to improve the competitiveness of the firms, but also the result strengthens the economic growth of the sector. Analysing firms that adopted R&D tax incentive, Dechezleprêtre et al. (2016) discovered that such competitors are active in on-going innovation where they constantly undertake scouting for chances to enhance their ranges of products competitive forces.

## **CHAPTER FIVE: SUMMARY OF THE FINDINGS, CONCLUSION, AND RECOMMENDATIONS.**

### **5.1 Introduction**

This chapter presents a summary of the key research findings, followed by the conclusions drawn from the analysis. It also outlines recommendations based on the study objectives and results. The chapter aims to highlight how turnover tax incentives affect the performance of SMEs, drawing insights from the data collected and analysed. The section also suggests areas for further research to enhance knowledge and inform policy development.

### **5.2 Summary**

According to the first objective, which sought to understand how investment allowance affects the financial performance of SMEs in the EPZ of Nairobi City County, the findings show a moderate positive correlation ( $r = 0.487$ ,  $p = 0.002$ ) and a significant unstandardized coefficient ( $B = 0.596$ ,  $p = 0.002$ ). This suggests that investment allowances positively influence SME financial outcomes by encouraging reinvestment and productivity, supporting prior findings by Liu and Mao (2019). For the second objective, which explored the impact of reducing capital gains, results indicate a significant relationship ( $r = 0.383$ ,  $p = 0.000$ ;  $B = 0.587$ ,  $p = 0.000$ ). This implies that reducing capital gains tax enables SMEs to reallocate resources more efficiently, improving asset turnover and profitability, as also observed by Mayende (2013). Regarding the third objective, which evaluated the influence of turnover tax reduction, the correlation is moderately strong ( $r = 0.421$ ,  $p = 0.002$ ), and the regression coefficient ( $B = 0.434$ ,  $p = 0.002$ ) confirms its positive impact. Turnover tax reduction enhances liquidity and reduces tax pressure on SMEs, thus improving return on assets.

### **5.3 Conclusion**

In conclusion, the impact of tax incentives on SMEs is multifaceted, with varying effects on performance, growth, and innovation. The analysis also brings out the reality that it is necessary to establish the factors surrounding tax incentives and their effects on SMEs. Tax incentives, designed to stimulate economic activity, have been a focal point in numerous studies and discussions across different regions and sectors. Literature review shows that tax incentives can play a huge role in determining SME performance so long as some characteristics like the design and implementation of these incentives are properly addressed. For example, Abd (2015) has pointed out that tax incentives are one of the most influential factors that can significantly affect the Malaysian SMEs' performance while noting that the extent of its positive influence may depend on certain factors such as the SME's typology and the prevailing national economic conditions. In the same way, Andersen, Kett, & von Uexkull (2017) examined about tax incentives for corporations for FDI in developing countries arguing that an effectively designed tax incentive can lead to improvement in investment in a nation and therefore boost the SMEs.

The terms of tax incentives is also supported in terms of growth where Babatunde et al., (2017) pointed out that tax incentives played certain role in the growth of Africa's economy by encouraging investors and expanding business ventures. This is anchored on other studies like by Cheong et al., (2020) where it was established that the tax incentives do enhance credit and the performance of SMEs in Malaysia. But there are other factors between tax incentive and SMEs firm growth such as firm size and the industry sector highlighted by Anim et al., (2021). Their findings indicate that possibly larger firms reap more from tax incentives, however smaller firms can be confronted

with problems in optimally exploring these opportunities due to limitations in resource and competence.

On the other hand, tax compliance plays a crucial role in the effectiveness of tax incentives. Andreoni, Erard, and Feinstein (2012) emphasize the importance of tax compliance in ensuring that tax incentives achieve their intended outcomes. Thus, based on Torgler (2012) and Kirchler, Hoelzl, and Wahl (2008), tax incentives are equally a function of the level of tax morale as well as the given legal architecture. In the case of tax incentives, evidence suggests that a favourable level of compliance and the nature and perception of taxpayers toward taxes will improve the outcomes of the incentives while negative compliance will dampen the results. Moreover, the impact of tax incentives on innovation and competitiveness is noteworthy. The evidence from Dechezleprêtre et al. (2016) shows that taxes on R&D do increase innovation at the firm level, which is expected to enhance the SMEs' long-run growth and competitiveness. This result is in line with the findings by Liu and Mao (2019) where they establish that tax incentives enhance investments and productivity hence supporting the argument that tax incentives promote innovation.

On the other hand, there are also challenges that are found when implementing tax incentives, they include; undue favouring of the targeted industries resulting to misallocation of resources and possible negative impact on tax revenues. The shortcomings and hazards of business tax incentives are analysed by Klemm (2010) and Klemm and Van Parys (2012) in terms of causes and consequences connected with fiscal effectiveness. To eliminate such risks and fully realise the potential of these policies, it is important to make sure that set tax incentives are properly designed and aligned. Thus, the study holds that despite the apparent benefits of tax incentives in the

improvement of SME performance, growth, and innovation, the impact is influenced by many factors from design, through implementation, to compliance. Hence, these elements should be well considered by the policymakers to facilitate the efficient execution of the goals and objectives of providing tax incentives to SMEs to enhance the intended goals and objectives of the tax law. The further research should follow up on these processes and offer solutions for improving the effectiveness of tax incentives.

#### **5.4 Recommendations**

##### **For SMEs in EPZs:**

SMEs should maximize tax incentives by ensuring compliance and seeking professional tax advice. Reinvesting savings from these incentives into growth and innovation is crucial for enhancing financial performance. Primarily, SMEs should set up internal tax compliance units or assign trained personnel to monitor and manage tax obligations. This ensures timely filing, accurate reporting, and alignment with incentive requirements such as investment allowances. Dedicated compliance enhances eligibility for incentives and reduces the risk of penalties.

##### **For Kenya Revenue Authority (KRA)**

The application process of tax incentive and communication for SMEs need to be made easier by KRA to enable the firms to access and get more of the incentives. The other agencies can also supplement this effort in the fight against evasion to improve on the compliance.

##### **For Policymakers**

Government is encouraged to assess all the incentives being offered in light of taxation and improve them so as to provide support to SMEs present locally as well as to woo

investors. Failure or lack of success of such incentives needs to be evaluated frequently to check on its achievement of the intended goals.

**For the Export Processing Zone Authority (EPZA):**

Furthermore, the EPZA should be obliged to offer other supporting services including financing and capacity levels. SMEs in EPZs are also likely to benefit from enhanced infrastructure in relation to tax advantages for improved performance.

**For Other SMEs outside EPZs:**

SMEs outside EPZs should be demanding similar tax incentives as their counterparts within EPZs and demanding generally inclusive policies. Forming associations can amplify their voice and needs regarding tax policy reforms.

**5.4.1 Suggestions for Future Studies**

Future studies should use a greater number of SMEs and from different industries to increase the generalizability of the study. Cross sectional surveys could have made it possible to get other information that could have explained other effects and implications of provision of tax incentives in the long run. The use of such research methods as interviews could help to gain more insights about SMEs situation with tax incentives. The case evaluation of policy changes or the efficacy of a new programme could help better understand how to construct incentives. Cross-country comparison may draw attention to the practices and policies concerning the use of tax incentives and enhance the programs worldwide. Furthermore, future studies should focus on gathering comprehensive and up-to-date data from a broader range of SMEs to enhance the accuracy and generalizability of the findings.

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## **APPENDICES**

### **APPENDIX I: DATA COLLECTION SHEET**

#### **DATA COLLECTION SHEET**

This data collection sheet is designed to gather key information related to the effects of tax incentives on the financial performance of Small and Medium Enterprises (SMEs). The primary focus of this data collection is to assess the impact of three specific tax incentives: Investment Allowance, Capital Gain Reduction, and Turnover Tax Reduction on the Return on Assets (ROA) over a five-year period (2018-2022).

#### **Purpose of the Data Collection:**

The purpose of this data collection is to analyze how various tax incentives influence the financial performance (measured by ROA) of SMEs across different sectors. This information is vital for understanding the role of tax policies in enhancing the competitiveness and growth of SMEs.

#### **Data Collection Period:**

Data will be collected for the following years: 2018, 2019, 2020, 2021, and 2022.

#### **Target Participants:**

This data collection will focus on 30 SMEs from various sectors such as technology, healthcare, agriculture, and retail. Each SME's financial data will be captured for the specified years to allow for comprehensive analysis.

**Section A: General SME Information**

<b>Variable</b>	<b>Description</b>
SME ID / Name	Name of the SME being assessed
Year	Year of observation

**Section B: Tax Incentives and Financial Performance Data**

<b>Year</b>	<b>Investment Allowance (Ksh in millions)</b>	<b>Capital Gain Reduction (%)</b>	<b>Turnover Tax Reduction (%)</b>	<b>Financial Performance (ROA %)</b>
2018				
2019				
2020				
2021				
2022				

## APPENDIX II: APPROVAL OF RESEARCH PROJECT PROPOSAL



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GRADUATE SCHOOL

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Internal Memo

FROM: Executive Dean, Graduate School

DATE: 16<sup>th</sup> August, 2024

TO: Nelly M. Miriti  
C/o Accounting and Finance Dept.

REF: D53/CTY/PT/29723/2014

**SUBJECT: APPROVAL OF RESEARCH PROJECT PROPOSAL**

This is to inform you that Graduate School Board at its meeting of 14<sup>th</sup> August, 2024 approved your Research Project Proposal for the M.B.A Degree Entitled, "Tax Incentives and Financial Performance of Small and Medium Enterprises in the Export Processing Zones in Nairobi City County, Kenya."

You may now proceed with your Data Collection, Subject to Clearance with Director General, National Commission for Science, Technology and Innovation.

As you embark on your data collection, please note that you will be required to submit to Graduate School completed Supervision Tracking and progress report Forms per semester. The Forms are available at the University's Website under Graduate School webpage downloads.

Also, please ensure that you publish article(s) from your project before submitting it to Graduate School for examination as per the Commission for University Education and Kenyatta University guidelines.

Thank you.

**ANNBELL MWANIKI**  
**FOR: EXECUTIVE DEAN, GRADUATE SCHOOL**

c.c. Chairman, Accounting and Finance.

Supervisors:

1. Dr. Ambrose Jagongo  
C/o Department of Accounting and Finance  
Kenyatta University

AM/ww

*Transforming Higher Education... Enhancing Lives*  
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Page 1 of 1

## APPENDIX III: RESEARCH AUTHORIZATION



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NAIROBI, KENYA  
Tel. 8710901 Ext. 57530

Our Ref: D53/CTY/PT/29723/2014

DATE: 16<sup>th</sup> August, 2024

Director General,  
National Commission for Science, Technology  
and Innovation  
P.O. Box 30623-00100  
**NAIROBI**

Dear Sir/Madam,

**RE: RESEARCH AUTHORIZATION FOR NELLY M. MIRITI - REG. NO. D53/CTY/PT/29723/2014**

I write to introduce **Nelly M. Miriti** who is a Postgraduate Student of this University. The student is registered for M.B.A degree programme in the **Department of Accounting and Finance**.

**Nelly** intends to conduct research for a M.B.A Project Proposal entitled, **"Tax Incentives and Financial Performance of Small and Medium Enterprises in the Export Processing Zones in Nairobi City County, Kenya."**

Any assistance given will be highly appreciated.

Yours faithfully,


A handwritten signature in blue ink, appearing to read 'Eliud Njagi', is written over a blue circular stamp.

**PROF. ELIUD NJAGI**  
**EXECUTIVE DEAN, GRADUATE SCHOOL**

AM/see




**APPENDIX IV: RESEARCH PERMIT**


  
**NATIONAL COMMISSION FOR SCIENCE, TECHNOLOGY & INNOVATION**

**Date of Issue: 02/October/2024**


**RESEARCH LICENSE**




**This is to Certify that Mrs.olly mawako muthi of Kenyatta University, has been licensed to conduct research as per the provision of the Science, Technology and Innovation Act, 2013 (Rev.2014) in Nairobi on the topic: **TAX INCENTIVE AND FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISE IN THE EXPORT PROCESSING ZONE IN NAIROBI CITY COUNTY, KENYA** for the period ending : **02/October/2025**.**

**License No: MAC0617P/144072P**

**Applicant Identification Number: 142548**

**Director General**
  

  
**NATIONAL COMMISSION FOR SCIENCE, TECHNOLOGY & INNOVATION**

**Verification QR Code**
  


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**See overleaf for conditions**