The Effect of Tax Rates on Financial Performance of Small and Medium-Sized Enterprises in Busia County, Kenya

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Abstract- Small and Medium-Sized Enterprises (SMEs) play a crucial role in Kenya's economic development, yet they face significant challenges from taxation policies. This study examined the effect of tax rates on the financial performance of SMEs in Busia County, Kenya. Using a descriptive and correlational research design, the study collected primary data from 87 SME owners through structured questionnaires from a target population of 1,556 active SMEs. Data analysis employed descriptive statistics and simple linear regression. The findings revealed a strong positive correlation ($R = 0.901$) between tax rates and financial performance, with tax rates explaining 81.2% of the variance in SME financial performance ($R^2 = 0.812$). The regression coefficient ($\beta = 0.864$, $p < 0.001$) indicated that well-structured and predictable tax rates significantly enhance SME financial outcomes. The study concludes that transparent and stable tax rate policies create an enabling environment for SME growth. Policymakers should implement progressive tax rates that account for business size and revenue capacity to foster SME development.

Indexed Terms- Tax Rates, Financial Performance, Small and Medium Enterprises, Kenya

I. INTRODUCTION

Small and Medium-Sized Enterprises (SMEs) constitute the backbone of Kenya's economy, contributing approximately 33% of GDP and employing over 80% of the workforce (Kenya National Bureau of Statistics, 2020). Despite their significant contribution, SMEs face numerous challenges, with taxation being critical in affecting their financial performance.

The taxation environment in Kenya operates at both national and county levels, creating a complex regulatory framework. SMEs are subject to various taxes including VAT, PAYE, and corporate income tax at national level, while county governments impose additional levies such as business permits and various fees (Wawire, 2017). This multi-layered taxation system often creates significant burden for SMEs operating with limited financial resources.

Busia County, located in western Kenya along the Uganda border, presents a unique context for examining tax rates and SME performance. The county serves as an important trade hub, hosting numerous SMEs engaged in cross-border trade, agriculture, manufacturing, and services. However, these enterprises face challenges related to taxation policies, including high tax rates and complex compliance requirements (Nyamita, 2018).

Traditional economic theory suggests that higher tax rates reduce business profitability by increasing operational costs and reducing disposable income for reinvestment (Devereux & Griffith, 2003). However, recent studies show the relationship is more nuanced, with factors such as tax predictability and transparency playing crucial roles (Bird & Zolt, 2015).

This study examines the effect of tax rates on financial performance of SMEs in Busia County, addressing the gap in county-specific taxation impact analysis. The findings provide empirical evidence for policymakers in designing effective taxation policies that balance revenue generation with business development objectives.

II. LITERATURE REVIEW

2.1 Theoretical Foundation

This study is anchored on the Resource-Based View (RBV) theory by Barney (1991), which emphasizes the significance of unique resources and capabilities in achieving competitive advantage. In taxation context, the theory provides a framework for analyzing how tax policies influence resource availability and utilization by SMEs. High or unpredictable tax rates constrain access to financial resources, limit investment in human capital, and reduce funds for business expansion (Barney, 2001).

2.2 Empirical Literature

Several studies have examined tax rates and business performance with mixed findings. Djankov et al. (2010) found that higher tax rates generally reduce business investment and growth, though moderated by tax administration efficiency and public service availability.

In Kenya, Muriithi (2017) examined corporate tax rate impacts on SMEs in Nairobi County, finding negative correlation between tax rates and financial performance. Higher tax obligations reduced funds for investment and operational activities, constraining business growth. Wawire (2017) found that high tax rates combined with complex regulatory requirements significantly affected business profitability.

Nyamita (2018) studied Western Kenya, including Busia County, finding that high tax rates led to reduced profits and limited reinvestment capacity. The study suggested progressive tax rates accounting for business size would better support SME growth.

Recent studies by Kipyego and Kiiru (2022) found elevated tax obligations negatively affect SME financial outcomes, emphasizing the importance of tax predictability and transparency. International studies like Amoako and Gyabaah (2020) in Ghana found excessive tax rates negatively impacted profitability, with many businesses unable to meet obligations due to poor cash flow.

2.3 Research Gap

Most existing studies focus on national-level analysis with limited county-specific taxation impacts. There's insufficient empirical evidence on how tax rate policies affect SME financial performance in border counties like Busia. This study addresses these gaps by providing county-specific evidence on the tax rate-performance relationship.

III. RESEARCH METHODOLOGY

3.1 Research Design and Study Area

This study employed descriptive and correlational research designs to examine the relationship between tax rates and SME financial performance. The study was conducted in Busia County, specifically Busia Town, selected due to its strategic location as a border county with Uganda, making it an important hub for cross-border trade.

3.2 Target Population and Sampling

The target population comprised 1,556 active and licensed SMEs in Busia Town. Using Mugenda and Mugenda's (2003) formula with 21% coefficient of variation and 2% standard error, a sample size of 103 SMEs was determined. With 84.47% response rate, the final sample consisted of 87 SMEs. Stratified random sampling ensured representation across different business sectors.

3.3 Data Collection and Analysis

Primary data was collected through structured questionnaires administered to SME owners and managers. Tax rate variables were measured using 5-point Likert scale, covering tax burden perceptions, profitability impact, and growth effects. Financial performance included revenue growth, profitability, cash flow, and competitive performance indicators.

Data analysis employed descriptive statistics and simple linear regression using SPSS. The regression model was: $Y = \beta_0 + \beta_1 X_1 + \varepsilon$, where Y represents financial performance, X_1 represents tax rates. Diagnostic tests including normality and multicollinearity were conducted with significance level of 0.05.

IV. RESULTS AND DISCUSSION

4.1 Descriptive Statistics

Demographics revealed 62.1% male and 37.9% female respondents. Education levels showed 42.5% with bachelor's degrees, 29.9% diplomas, 16.1% postgraduate, and 11.5% certificates. Age distribution showed 34.5% aged 31-40 years, 24.1% aged 21-30 years. Business experience showed 58.6% operating for 6-10 years, indicating established SMEs with sufficient experience.

Tax rate perception analysis revealed "My business would perform better financially if tax rate were reduced" had highest mean of 4.14 (SD = 1.102). "High tax rates have reduced my business's profitability" had mean of 4.08 (SD = 0.883). "Tax rates in Busia County are higher compared to other counties" recorded mean of 4.00 (SD = 0.791), indicating SMEs feel disadvantaged by relatively higher county tax rates.

4.2 Regression Analysis Results

Simple linear regression analysis showed strong positive correlation ($R = 0.901$) between tax rates and financial performance, with R-squared of 0.812, indicating 81.2% of variance in SME financial performance explained by tax rate factors. ANOVA results confirmed statistical significance ($F = 366.094$, $p < 0.001$).

The regression equation: $Y = 3.153 + 0.864X_1$, where Y represents financial performance and X_1 represents tax rates. The positive coefficient ($\beta = 0.864$, $t = 19.134$, $p < 0.001$) indicates that for every unit increase in tax rate favorability or predictability, financial performance increases by 0.864 units.

4.3 Discussion of Findings

The positive relationship between tax rates and financial performance, while initially counterintuitive, reflects that SMEs operating in structured and predictable tax environments perform better than those facing uncertain taxation. This aligns with Njuguna and Waweru (2024), who found predictable tax regimes lead to improved financial management.

The positive relationship may indicate that tax-compliant SMEs operating within formal economy have better access to business opportunities, government contracts, and financial services. This supports Mwangi and Otieno (2024) findings that companies with well-managed tax compliance achieve higher profit margins.

The finding suggests SMEs perceive tax payment as part of social contract providing access to public goods, business legitimacy, and market opportunities, aligning with RBV theory emphasizing how institutional factors influence resource availability and business performance.

However, descriptive statistics show SMEs still perceive current tax rates as burdensome. The positive correlation may reflect that SMEs with better financial management and formal structures are more likely to comply with taxes and achieve better performance.

CONCLUSION

This study examined tax rate effects on SME financial performance in Busia County, revealing strong positive relationship with tax rates explaining 81.2% of financial outcome variance. The positive relationship suggests well-structured, transparent, and predictable tax policies create enabling environments for SME growth.

While SMEs express concerns about high tax rates, those operating within formal tax systems achieve better financial performance, possibly due to increased access to opportunities, financial services, and market legitimacy. The study contributes county-specific evidence highlighting the nuanced taxation-performance relationship.

From theoretical perspective, findings support RBV theory's proposition that institutional factors significantly influence business performance through resource availability impact. The positive relationship suggests formal tax compliance enhances SMEs' access to resources and opportunities outweighing direct taxation costs.

RECOMMENDATIONS

1. Based on findings, policymakers should create transparent and predictable tax rate policies enabling SMEs to plan finances effectively. Tax rate changes should be communicated well in advance with clear implementation guidelines.
2. Government should implement progressive tax rate structures accounting for SME size and revenue capacity. Smaller enterprises should benefit from lower rates or graduated structures increasing with business growth.
3. Tax authorities should invest in improving administration systems making compliance easier through user-friendly digital platforms, clear guidance, and training programs enhancing SMEs' tax literacy.
4. Government should strengthen linkage between tax payment and business opportunity access, helping SMEs perceive tax compliance as business legitimacy investment rather than cost burden.
5. County governments should coordinate with national authorities to eliminate overlapping obligations and ensure reasonable combined tax burden. Tax policy harmonization across counties would address competitiveness concerns.
6. Future research should explore mechanisms through which tax policies influence SME performance, including tax compliance role in enhancing business opportunity access. Comparative studies across counties would provide insights into how local contexts influence taxation-performance relationships.

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