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EFFECT OF PAY-AS-YOU-EARN AND COMPANY INCOME TAX ON PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN SOUTHWEST NIGERIA

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ABSTRACT

Small and Medium Enterprises have always been considered an important force for economic development and industrialization in smaller economies.These small enterprises have increasingly been recognized as enterprises that contribute considerably to the creation of jobs, economic growth and eradication of poverty in any developing or developed economy. The study is to examined the effect of multiple taxations on performance of SMEs in southwest Nigeria. Secondary data sources were used, Data on SME variables was specifically extracted from published Central Bank of Nigeria Bulletin 2023. The study found that Pay-As-You-Earn and Company Income Tax have a positive and insignificant effect on Small and Medium Enterprises (SMEs) in Nigeria, while Value Added Tax (VAT) has a negative and insignificant effect on SME performance. Multiple taxation was found to increase performance. The study concluded that multiple taxation significantly impacts the performance of Nigerian SMEs. Effective tax management leads to higher performance, as SMEs with higher investment capital rely on their own capital for asset growth, reducing reliance on expensive external funding, resulting in higher profitability. However, size does not support significant economies of scale. The study recommend that SMEs should promote value-added tax, implement robust accounting systems, stay updated with VAT rules, research VAT reliefs, ensure accurate invoices, set aside funds for PAYE obligations, and invest in payroll software.

KEYWORD: *Pay-As-You-Earn, Small and Medium Enterprises,Value Added Tax.*

INTRODUCTION

Globally, taxes have greatly affected the way economies perform regardless of the political and social difference among countries worldwide, “taxes are defined as a compulsory, unrequited payments to a general government(Oyedokun et al., 2021).” These taxes are unreciprocated whereby the welfares received from the government as a result of paying taxes is not usually commensurate to payments taxpayers pay(Roxan, 2020). Economists believe that smaller companies usually have small resources so they usually direct these limited resources towards tax compliance which would have been used for reinvestment and facilitating future growth. Therefore, such a tax system puts a lot of pressure on the small taxpayers whereby both small and large companies face the same tax rates as well as compliance costs, asserts that the finances used by small and medium enterprises in the form of tax submissions are finances that may possibly be used for reinvestment and fostering imminent growth(Small & Brown, 2020). Thus, taxes exert unequal pressure on small and medium enterprises (SMEs) which means that trivial taxpayers meet similar tax requirements as the large firms. SMEs are important for the growth of societies. These enterprises have enhanced economic growth and development through; “offering job opportunities which can help lower the unemployment rate, addressing the demographic challenges posed by growing populations, contributing to the generation of domestic income among others”(OGONDA, 2022). Countries with more SME employment tend to experience higher growth since these enterprises use “more labor-intensive production processes” compared to the large counterparts and thus employ more people(Mjindi, 2021).

Taxation in Nigeria has been also influenced by World Bank policies with the aim of nurturing economic growth and development(Hamilton, 2021). The Nigeria government has transformed a number of tax policies to foster

the growth of small and medium enterprises through harmonization of tax rates and formulating new tax incentives among others to avoid double taxation and tax evasion. However, with all these tax reforms Nigeria still does not have well known clear national taxation policy for the small and medium enterprises. The recent taxation policy only focuses on the legal requirements surrounding the administration of the tax regime instead of yielding strategies to foster the performance of SMEs in Nigeria(Ugwu-oju et al., 2020).

Over the years, various scholars have developed a number of performance measurement methods like the balanced scorecard, ineffectiveness method, goal-oriented method, stakeholder method, time frame method among others(Suttipun & Arwae, 2020). These small enterprises have increasingly been recognized as enterprises that contribute considerably to the creation of jobs, economic growth and eradication of poverty in any economy and also creating of sustainable jobs and opportunities for smaller entrepreneurs are the key strategies to take people out of poverty. Small and medium enterprises are mostly private enterprises, and they face difficulties when dealing with the government in general and the tax administration in particular mostly in the developing countries.

While multiple taxation is the levying of tax by two or more jurisdictions on the same declared income (in the case of income taxes), assets (in the case of capital gains taxes), or financial transactions (in the case of stamp duties). Multiple taxation is a situation in which the same earnings are taxed more than once. Despite the contribution that taxation can make towards the Gross Domestic Product (GDP) of a country in general, much attention is also needed to the side effects of tax on the growth of SMEs. This is because SMEs play a crucial role in driving economic growth in both developing and developed countries. As highlighted previously, as a group, they do not only generate more new jobs than large firms or macro-enterprises but also introduce innovative ideas, products, and business methods. Multiple tax practices in Nigeria came as a result of the absence of a national policy document that defines who has the right to collect tax and what amount to collect by each tier. This situation raises a serious concern about the issue of aligning the tax system to the specific requirements of a particular country's growth need, as it has to balance both short-term and long-term impact of the policy(Mohamed et al., 2020). Small and medium scale enterprises (SMEs) in Nigeria contribute significantly to job creation and economic growth, but their mortality rate is high due to tax-related issues. 80% of SMEs die before their 5th anniversary, and they are often treated as large corporations in government policies. Tax structures should be designed to address specific environmental conditions, as inadequate tax structures can create greater burdens on tax-paying organizations and affect the final consumer. The Regional Program on Enterprise Development survey on Investment Climate in Nigeria highlighted taxation as a key impediment to SMEs' performance, with high tax rates influencing their performance. Despite the Nigerian government's efforts to promote SMEs, taxation remains a major obstacle, affecting their ability to mobilize financial and non-financial resources. Addressing these issues could potentially impact Nigeria's economic growth and development, as SMEs contribute to 90% of the private sector production. This study aims at analyzing the effects of multiple taxation on the profit-oriented performance of small and medium scale enterprises in south-west Nigeria. Furthermore, it analyzed the effect of the independent variables i.e., Tax compliance, multiple tax rates, tax incentives, on the dependent variable i.e., performance of SMEs to be proxied by financial methods and non-financial methods. The aim of the study is to examine the effect of multiple taxations on performance of SMEs in southwest Nigeria. Specific objectives of this research work are to:

a. Determine the influence of Pay-As-You-Earn Tax on the performance of SMEs in southwest, Nigeria.
b. Determine the influence of multiple taxation on performance of SMEs in southwest, Nigeria.

LITERATURE REVIEW

Taxation

In Nigeria, sluggish economic growth and national decline can be attributed to the prevalence of multiple taxes, along with tax evasion and avoidance, which are characteristic of the Nigerian tax system. These issues have become significant concerns for stakeholders. Researchers have pointed out that, as a federal state, Nigeria's fiscal operations adhere to federal principles, which has profound implications for tax system management. Additionally, one scholar noted that a primary issue within the Nigerian tax system is the lack of a national policy document that clearly delineates the authority to collect taxes and the amounts collectible by each level of government. As a result, the current tax system is perceived as imbalanced, unnecessarily complicated, distortionary, and largely inequitable(Navarathne, 2023).

The debate surrounding the merits and drawbacks of a multiple tax system in Nigeria has been intensely contested among academics, tax professionals, and policymakers. This ongoing discord among various levels of government has adversely affected taxpayers' attitudes and their compliance with civic duties, resulting in a rising incidence of tax evasion and avoidance. For example, the Chartered Institute of Taxation in Nigeria has observed that, similar to other developing nations, the administration of income tax in Nigeria is marked by a low compliance

rate. Despite the country's abundant human and natural resources, as well as its economic potential, Nigeria continues to experience one of the lowest levels of tax compliance in Africa(He et al., 2021).

While significant research has been conducted on taxation and taxpayer compliance in developed countries, there has been comparatively little focus on these issues in developing nations. Policymakers and revenue authorities in countries like Nigeria encounter distinct challenges, including limited administrative resources and expertise, ineffective tax administration, widespread evasion, corruption, coercion, low taxpayer literacy, and a general disdain for government. Furthermore, despite numerous tax reforms aimed at enhancing taxpayer compliance and increasing revenue, these efforts have largely proven ineffective. Empirical evidence indicates that the contribution of income taxes to total revenue has consistently remained low and is on the decline. Although various factors contribute to this decreasing compliance, the perception of taxpayers regarding multiple tax charges is particularly significant among these influences.

The system of taxation used in any country determines the performance of businesses whereby countries with auspicious and progressive tax rates have propagated successful businesses. The scholar further asserts that successful businesses have influenced the growth of economies by ensuring equitable distribution of income and investments in the country. In essence, businesses and taxation are interdependent for survival in that when the performance of businesses is affected, also the growth of the economy is equally affected(OGONDA, 2022).

Multiple Taxation

Multiple taxation means imposing more than one tax treatment on the same income. One of the most common cases of this phenomenon is double taxation and triple taxation, which results in multiple taxations of the same income(Oyedokun et al., 2021). Double taxation therefore occurs when the income is taxed twice while triple taxation refers to when the income is taxed thrice. An apt example of double taxation can be seen where the profit of a company is being subjected to the Companies Income Tax Act at the corporate level and withholding tax and PAYE as income tax for the investor all at the same time(Roxan, 2020). The issue of multiple taxation has driven a lot of debate in the global platform, with experts and scholars developing different approaches toward handling the intricacies tagged to the issue by important stakeholders. Different governments, in the course of history, have rolled out very distinct methods suited to their respective tax jurisdictions. However, experts still manage to disagree(Ugwu-oju et al., 2020).

The phenomenon of multiple tax practices is not exclusive to developing nations; rather, it represents a matter of global importance that impacts economies worldwide, regardless of their specific national contexts. In the United States, the issue of taxing workers' income and wages multiple times has garnered scrutiny from scholars such as Professor Richard from the University of Illinois. Additionally, this practice has faced significant criticism from various researchers(Dewi et al., 2021). For example, consider a worker earning $50,000 annually; this individual's income is initially subjected to a 7.65% tax for social security and Medicare. Subsequently, the same income is liable to Federal and State taxes, akin to the Pay As You Earn (PAYE) system in Nigeria, and a third layer of taxation may arise in the form of social security income tax after several years[1]. In Germany, the full imputation system allows for corporation taxes imposed on German corporations to be regarded as a prepayment of tax by investors, contingent upon the distribution of income by the corporation[4]. Furthermore, dividends received by corporate investors from both domestic and foreign corporate investments are entirely exempt from taxation (participation exempt). Without this participation exemption, the elimination of the imputation system would lead to the occurrence of double or multiple taxation on dividends within the corporation(Lawrence & MaryJane, 2023).

Pay as You Earn (PAYE):

The concept of Pay-as-You-Earn, often abbreviated as PAYE, is a tax collection system used by many governments around the world. It is a method of collecting income tax at the source, ensuring that tax revenues are collected regularly and in a systematic manner(Hafezalkotob et al., 2023). PAYE is primarily associated with the taxation of individuals' income, particularly their wages and salaries. Under the PAYE system, employers are responsible for deducting a portion of their employees' earnings and remitting it directly to the government on their behalf(Gakii et al., 2022). This deduction includes income tax as well as various social security contributions, such as retirement and healthcare contributions. This approach provides several benefits for both the government and taxpayers(Eddleston & Mulki, 2021).

For the government, PAYE offers a steady and reliable stream of revenue. By collecting taxes directly from employers, it minimizes the chances of tax evasion and helps ensure compliance. It also spreads the tax burden evenly throughout the year, avoiding the need for lump-sum payments(Deb et al., 2023). This consistent revenue stream is crucial for funding public services and government operations.From the perspective of individual taxpayers, PAYE simplifies the tax process. They don't have to calculate and set aside a lump sum to pay their

taxes, as they do in some other tax systems(De Mooij et al., 2020). Instead, their tax obligations are met incrementally with each paycheck(Coldwell et al., 2022). This approach can help prevent financial strain that might otherwise result from a large, year-end tax bill.

Small and Medium Enterprises

In Nigeria, small and medium-sized enterprises (SMEs) have limited scale and lack extensive organizational frameworks and management practices. They often operate as sole proprietorships or partnerships, making them easier to oversee compared to larger firms with a greater number of employees and lower educational qualifications. The SME sector in Nigeria is diverse, encompassing retail businesses, highly compensated professionals, and significantly scaled manufacturing organizations(Olateju & Ibikunle, 2023). Production processes within SMEs are labor-intensive, and they often act as suppliers to larger manufacturing firms, relying on locally sourced raw materials. SMEs require lower initial capital investments than larger corporations and have more subjective managerial decisions.

Taxation is defined as a mandatory financial transfer from individuals, organizations, and corporations to the government, serving three primary purposes: regulating economic activities, generating revenue for governmental functions, and managing income and employment levels. The revenue generated from taxation is influenced by various factors, primarily the tax base and the tax rate. The tax policy in Nigeria has primarily been used to maximize government revenue, neglecting its potential for optimal resource allocation and income redistribution. The Nigerian tax authorities have focused on adjusting tax rates and bases to ensure sufficient revenue generation, leading to the implementation of various taxes and levies, known as "multiple tax." Taxation remains a contentious issue that has sparked numerous political disputes throughout history. Various economic models have been proposed to facilitate an effective taxation system. Taxes can be broadly classified into direct and indirect categories. The issue of multiple taxation arises when the same income or profit is subjected to taxation by different authorities, either within Nigeria or abroad. Specific arrangements are established to prevent the occurrence of multiple taxation or provide suitable relief as necessary.

THEORETICAL REVIEW

Theory of Business Growth

Various authors have postulated theories on business growth. A scholar stipulated that the rate of growth of a firm is independent of its initial size(Heathcote & Tsujiyama, 2021). By implication it would mean that large firms are preferable in context of private sector development given that they create more employment than small firms. Conversely, a researcher states in his learning model that younger firms learn over time, which helps them improve their performance as they accumulate market knowledge(Owens & Pemberton, 2021). According to this model, young firms grow faster than old ones. Moreover, give that younger firms are usually smaller than older ones (businesses) for the reasons discuss earlier; Jovanovic deduces that small firms grow faster than large ones. This is a convergence process where small firms will eventually become as large as any other longer firm in some sector as time goes by.

As a new small firm start and develops, it moves through some growth stages, such with its own distractive characteristics. He also identified the stages of growth as; existence, survival, success, take off and resource maturity(Paco & Quezon, 2022). In each stage of development as different set of factors is critical to the firm's survival and success the Churchill Lewis model gives an insight into the dynamics of SMEs growth including the distinguishing characteristics, problems and requirement of growing SMEs and explains business growth process amongst SMEs, the precise moment in time in which a startup venture becomes a new business has not yet been theoretically determined. However, the ideal of business survival could be equated with a firm that has fully completed the transaction to stage - two organization in the five stage of small business growth.

Summary of the Literature Review

Similarly, the literature review revealed that the choice of the tax rate should depend on the tax preference accorded to small businesses to promote the growth of SMEs which can be done by lowering tax rates, offering tax holidays as well as relieves to the small businesses. However, the literature on tax rates of small and medium enterprises was not only scant but also failed to offer pragmatic proof on the influence of tax rates on the growth of SMEs. This research strived to cover the raised literature gaps by examining "the effect of the taxation on the performance of Small and Medium Enterprises in south west" to cover the information gap.

METHODOLOGY

This study used the ***ex post facto*** research design to determine the Effect of Multiple Taxations and Performance of Small and Medium Scale Enterprises in Southwest Nigeria. In this research, secondary data sources were used.

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Data on SME variables was specifically extracted from published Central Bank of Nigeria Bulletin, while other pertinent data was sourced from the World Development Indicators of the World Bank database, the National Bureau of Statistics (NBS), the Nigeria Stock Exchange (NSE), and the Statistical Bulletin of the Central Bank of Nigeria (CBN).

Model Specification

$\mathbf{Yi}it = \alpha + \beta_1 X_1 it + \beta_2 X_2 it + £$ ……. (iv)

$\mathbf{PSME}_{it} = \beta o + \beta 1 VATi_{,t} + \beta_2 PAYE_{i,t} + £$ ----------(iv)

Where:

$PSME_{it}$ = Performance of SME's

VAT_{it} = Value Added Tax

$PAYE_{it}$ = Pay as you Earn

β_{it}, α_{it} are parameters of economic relationship estimated

INTERPRETATION AND DISCUSSION OF RESULT

The results (Appendix) showed that a significant value of 0.5462 (t= -0.611458) confirmed the null hypothesis, indicating that Value Added Tax has no statistically significant effect on SME performance. However, a coefficient of -0.022478 (t= -0.022) indicated that a change in Value Added Tax would reduce SME performance by -0.022. The R2 value of 0.092973 indicated that 9.2% of changes in SME were caused by variations in Value Added Tax. The Durbin Watson statistics of 1.755793, which is within the range of 1.5 and 2.0, indicate that the model is not spurious and can be relied upon for predictions. The fixed effect model showed a significant value of 0.0054 (t= -1.097030), rejecting the null hypothesis and confirming that Corporate Income Tax has a statistically significant effect on SME performance in Nigeria. The coefficient of -0.002954 indicates that a change in Corporate Income Tax would reduce SME performance by 0.002954.

The result which is shown in the appendix shows regression analysis between the explanatory variable (Pay As You Earn) and Performance of SME using the random effect model. The table shows a significant value of Pay As You Earn to be 0.0034 (t= 11.27749) meaning that the null hypothesis is rejected and we can confirm that Pay As You Earn has a statistically significant effect on Performance of SME in Nigeria. The result further shows that Pay As You Earn having a coefficient β_2 = 0.067768 explains that Pay As You Earn has a positive effect on Performance of SME. This indicate that a #1 change in Pay As You Earn will improve Performance of SME by 0.067768. The findings of this study revealed that Pay As You Earn has a positive effect on Performance of SME in Nigeria. This implies that Pay As You Earn affect Performance of SME in Nigeria. The result of R^2 revealed 0.516447 indicating that 51.6% change in Performance of SME is caused by variations in Pay As You Earn, the balance of 48.4% is caused by other factors not covered in the model. The Durbin Watson statistics of 1.674968 which is higher than the R^2 value of 0.516447 show that the result of this regression is not spurious hence it can be relied upon to make predictions. Lastly the Durbin Watson statistics of 1.674968 which is within the range of 1.5 and 2.0 showed that the model is free from serial correlation.

DISCUSSION OF FINDINGS

The study found that Pay-As-You-Earn and Company Income Tax have a positive and insignificant effect on Small and Medium Enterprises (SMEs) in Nigeria, while Value Added Tax (VAT) has a negative and insignificant effect on SME performance. Multiple taxation was found to increase performance. The P-value of pay as you earn was 0.0034, confirming that pay as you earn has a statistically significant effect on SME performance. The coefficient 2 = 0.067768 explains that a change in pay as you earn will improve SME performance by 0.067768. The study also found that pay as you earn when regressed alone has a positive effect on SME performance using PSME. This results align with theoretical expectations and some authors' findings, as SME's with sufficient capital are perceived as more secure, which can lead to increased performance. The study also found that Value Added Tax (VAT) had no statistically significant effect on SME performance in Nigeria, but had a negative effect on SME performance with a coefficient of -0.022478. This finding aligns with previous studies in Nigeria showing a negative but significant effect on SME performance(Nandal & Diksha, 2021).

CONCLUSION AND RECOMMENDATION

The study examine the effect of multiple taxations on performance of SMEs in southwest, Nigeria. However, the results showed that multiple taxation are the key factors affecting the performance of SMEs Nigeria. It confirmed that SMEs with good management of its tax payments achieve higher performance. The results is also an indication that an increase in Tax has an explanatory power over the upward movement of performance. A possible explanation for this is that SMEs with higher investment capital, depend on their own capital to fund asset growth.

This reduces dependency on expensive external funding capital, and therefore leads to higher profitability. By reconciling between results of the effect of size SMEs it could be concluded that this effect does not supports the significant economies of scale of SMEs. The study therefore recommend that;

i. SMEs should promote value-added tax to maintain cash flow and reduce operational costs. They should implement robust accounting systems, stay updated with VAT rules and regulations, research and apply for VAT reliefs or exemptions, and ensure accurate invoices with correct VAT rates and details. This helps reclaim VAT and avoid compliance issues. It is also crucial for SMEs to research and apply for VAT reliefs for specific goods or services, ensuring accurate VAT invoices.
ii. Also, SMEs are recommended to ensure they set aside sufficient funds for PAYE obligations to avoid penalties and interest from late payments. They are also encouraged to invest in reliable payroll software can streamline these processes, reducing errors and saving time, they are also encouraged to be transparent about tax deductions.

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