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# Effects of Capital Allowances on the Performance of Small and Medium Scale Enterprises; Case Study of Construction Companies in Lusaka.

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## Abstract

The main objective of this study was to examine the effects of capital allowances on the performance of most consistent small and medium scale construction companies in Lusaka. Descriptive survey design was employed in the study and the population of interest in this study was made up of One Hundred and thirty-five (135) consistent Small and Medium construction businesses. The sample of 60 respondents was purposively drawn to successfully complete the study. The data that was collected from respondents through questionnaires was analyzed using SPSS. The findings of the study showed that taxes charged to SMEs in the Construction sector are not fair thus it was concluded that construction companies perform poorly without Capital Allowances. The study also revealed that the most common capital allowances in the construction companies include capital allowances on furniture and fittings, computers; capital allowances on motor vehicles; capital allowances on plant, machinery and equipment; and capital allowances on buildings and in the same vain it was noted that SMEs in the construction sector have full Tax Information. In addition to this, regression analysis was used in order to examine how the performance of construction SMEs is affected by capital allowances and it was noted that there is a positive relationship between capital allowances and performance of construction SMEs. All in all, the findings of the study have shown how well tax incentives influence the growth of SMEs in the areas of firm growth. Nonetheless, the study will act as a guide to government in their quest to provide good fiscal policies which would enhance the growth of SMEs in Zambia. This study is important because its findings will help government in addressing impediments to the growth of SMEs through the formulation of right fiscal policies towards SMEs development in Zambia. Government will also be able to identify the importance of small and medium enterprises sector in the achievement of economic development and national growth in Zambia.

**Key Words;** Capital Allowances, Performance, Growth and Profit after Tax.

## Introduction

SMEs play a vital role in the economic development of a country. Studies have indicated that SMEs contribute more than 50% of the gross domestic product (GDP) in many developing countries. More still, SMEs are the largest employers where by more than 90% of the working force is employed by SMEs.

In a bid to stimulate growth of SMEs, a number of countries have used tax incentives, for both investors and listing firms, to promote activity on SME boards. Tax incentives for investors are the more common approach, particularly in advanced markets Mintz (2011). For instance, Poland adopted the policy of encouraging investment in shares of SMEs through removing the so called “back-end” taxes, which are the taxes applied to profits made when selling a security.

In South Korea and India, investors benefit from reduced capital gains taxes on SME equity investments. This is done via the cutting of short-term capital gains tax in half, from 30 to 15%, for shares listed of SMEs. The UK and Spain adopted a tax incentive policy where the retail investors may deduct a set percentage of the value they invest in shares of SME equity. This happens via offering tax offsets only for acquiring shares in new SME equity offerings. In France, the investors can get a tax credit of 18% of the value invested in innovation mutual funds French acronym. The latter invest at least 60% of their portfolios in SME equity. Though these policies have been adopted the possible outcome may not significantly affect entrepreneurs as their interest rather lies with the capital influx from equity offerings in SMEs Baurer (2005).

The Zambian government has progressively improved on provisions for the private sector, supporting investments in major sectors and also helping start-ups to get established and protecting them from foreign competition. This is mainly because the Zambian government has acknowledged that Small and Medium Enterprises, SMEs are a significant driver in the economy and in creation of wealth and a key aspect in encouraging private sector development and partnership. The growth of SMEs is consequently a vital component in the growth strategy of most economies and hold predominant significance for the Zambian economy.

According to the UNCTAD (2000) Present day tax policies and their respective uses date back to the great economic depression in Great Britain in 1926. There was a great decline in economic activities and reduced earnings, shortage of financial resources in the private sectors and reduced per capital income which led to a reduction in the standard of living of the people of Britain. These effects were felt worldwide, and not just in Britain. Consequently, governments devised ways to restore, recover and organize capital to deliver economic and social expenditures in order to improve the living standard of people Pandy (2005). Various policies were created to achieve this, among which were tax incentives.

Taxation, according to Hall (2017) is the demand made by the government of a country for an obligatory payment by the citizens of the country in order to raise revenue, satisfy communal needs of the citizens and control economic and social policies. The taxes collected is used to provide security, social services and make conditions for the economic wellbeing of the society. According to Olokoyo (2010) taxes are used by governments to raise funds in order to meet Government's expenditure needs and to reallocate wealth and organization of the economy. To help the activities of Small Medium Enterprises(SMEs), government introduced Capital allowances as a form of fiscal tax policy for the private sector.

It is a general rule that in computing income or profits of a business or trade, no deduction can be made either for capital expenditure incurred or, for depreciation of assets acquired by such capital expenditure, instead capital allowances can be deducted.

The Income Tax Act CAP 323 of Zambia defines Capital allowances as deductions a business can claim for wear and tear over qualifying fixed assets bought and used in a trade or business Zambia Revenue Authority( 2021)

Under Section 33 of the Income Tax Act, Capital Allowances are to be deducted in ascertaining the gains or profits of a business and the emoluments of any employment or office for each charge year. They are claimed for wear and tear of qualifying fixed assets which includes; Buildings, implements, plant and machinery. Fixtures and fittings, motor vehicles and many other capital assets used in the production of income.

**Objectives and Organisation of the Paper**

The objective of this study was to examine the effects of capital allowances on the performance of small and medium scale businesses in Zambia using 60 consistent construction companies in Lusaka. To achieve this objective, the paper seeks to answer three questions;

1. What are the Capital allowances available to construction SMEs in Lusaka, Zambia?

2. What is the relationship between Capital allowances and the growth of construction SMEs in Lusaka, Zambia?

3. How do Capital allowances influence the performance of the after-tax profits of construction SMEs in Lusaka, Zambia?

The first part of this paper gave an overview of Capital Allowances and how they affect the performance of Small and Medium Scale Enterprises in the Construction sector in Lusaka, Zambia. The second section reviews studies that have looked at Capital Allowances and how they affected the After Tax profits of different companies. The third section of this paper presents the methods of the study. The fourth segment of the paper presents the analysis of the results and their table statistics. The fifth section discusses the findings of the study in light of the reviewed literature, while last two sections gives the conclusions and the recommendations of the research.

## Literature Review

The literature review focuses on the findings on the relationship between Capital allowance and growth of SMEs. The section was being based on a documentary review of literature related to the study variables aimed at enlightening the readers about the current gaps and how to close the gap.

Capital Allowances

UNCTAD (2000) defines capital allowance as expenditures taken from profits before taxes, to lessen the effects of taxation, therefore encouraging savings and investment. These capital allowances come in form of expenses on investments and assets and other activities of the firm/organization.



Capital allowances are supported by numerous Government regulations. They are established to improve the growth and development of firms along with empowering individuals and corporate taxpayers economically. Most SMEs do not know of the existence of these capital allowances and are not aware of the impact they have on the financial growth of their companies. This project thus paid attention to Capital allowances and their effect on the financial performance of small-scale industries with emphasis on selected consistent construction companies in Lusaka, Zambia.

## Growth of SMEs

Countries that have tax incentives for SMEs claim that preferential tax treatment creates a large number of jobs and enhances the level of entrepreneurship that is associated with flexibility, speed, risk taking and innovation Chan et al (2002) and Burger and Udell (1998) emphasize the fact that SMEs are key drivers of economic success, because they are job creators, sales generators and the source of tax revenue. These authors base their assertion on the facts that a large percentage of SMEs contribute to the various countries' gross domestic product, they employ a large percentage of the workforce and the high ratios of small businesses to large businesses in the countries concerned.

According to Burger and Udell (1998) SMEs represent fertile ground for the development of large, profitable, taxpaying employers and SMEs experience high growth rates in comparison to large enterprises. However, tax policies that are aimed at promoting the economic growth of small businesses should be evaluated judiciously, because the inherent characteristics of small businesses can make a specific differentiated tax policy undesirable. Studies undertaken in this regard have produced the following findings: the majority of SMEs have limited growth potential small businesses vary in terms of productivity, job growth, wages, innovation and export performance within the same industry subgroups. Small business also does not all follow the same growth pattern. Certain small businesses will remain small for most of their existence and it is for this reason that it is not obvious why a tax system should influence the growth process. Such intervention, to the extent that it does not act in a lump-sum way, influences marginal decisions and could lead to excessive risk taking and over investment Heshmati (2001).

**Profit After Tax**

Profit after-tax is the earnings of a business after all income taxes have been deducted. This amount is the final, residual amount of profit generated by an organization. The profit after-tax figure is considered the best measure of the ability of an entity to generate a return, since it incorporates both operating income and income from other sources, such as interest income.

The profit after-tax margin is closely watched by investors to see if the income-generating ability of a firm is changing over time. If so, this could be considered a valuation indicator that may result in a change in the stock price.

If a company is publicly held, it also reports profit after-tax on a per share basis. This information appears on the face of the income statement.

**Firm Performance**

SMEs are one of the business entities that make a significant contribution to economic conditions in Zambia. This is the reason why information about the condition and presence of SMEs is important data for the government as an economic indicator.

There are several concepts that are used in measuring firm performance, i.e., operational performance and financial performance. Operational performance is usually measured as a set of several dimensions that reflect the internal operations of an organization in terms of the elements of the product, process quality, efficiency, and productivity Minna (2014). In some studies, operational performance was measured through the productivity, effectiveness, and efficiency of internal operations, while financial performance is measured through measures that include profitability, return on investment, and share price. Increasing innovation, especially in financial performance, has an impact on the company's competitiveness. The competitiveness of a company can be supported by effective performance measurement. As a consequence, the company must know the factors that affect its performance and manage it effectively.

**Neo-classical economic theory on tax incentives**

Neo-classical economic theory on tax incentives claim that providing tax incentives to a group of investors instead of another violates one of the principal doctrines of a good tax system, that of horizontal equity. Such kind of distortions misleads the prices that potential investors face, leading to an inefficient allocation of resources Boadway and Shah (1995). The neoclassicals frequently explain special tax incentives reduce market failures that surround the decision to invest in some sectors and not others, thus government intervenes in the sectors and locations left out. The outcome of these market failures are that some sectors and locations will receive more investments than others. The most cited market failure is positive externalities not adopted in the projects rate of return. For example, in research and development, investment produces a higher social rate of return than a private rate of return Kaplan (2001).

Barbour (2005) argues that there are other claimed benefits of tax incentives, such as symbolic signaling effects and compensation for inadequacies in the investment regime. The establishment of providing investment tax incentives is most often in the form of either capital allowances, tax relief or cash grants. Modern understanding has shown that such kind of incentives plays only a negligible role in investment decisions. Investment decisions for firms are based on factors including certainty about future government policies, future demand projections of the future, prevailing interest rates and moves by competitors. Therefore, incentives are seen as good but not deal breaking. Thus, incentives have remained a popular policy for both developed and developing countries.

**Methods**

The study used descriptive survey design Kinnear and Gray (2002) describes the survey design as a method that involves collecting information from members of a target population by considering the current status of that population with respect to one or more variables. The researcher used a descriptive survey design because it is concerned with describing the characteristics of a particular group and can't influence the independent variables with the view to determine their effect on dependent variables thus their relationship is determined retrospectively. Descriptive approach was useful in the investigation of the causal relationship and strength between Capital allowances offered and the financial performance of Construction Companies in Lusaka. A sample of 60 respondents was selected as determined by the Taro Yamane formula. Data for the research was collected during the months of March and April 2021. This was despite the global Covid-19 pandemic as Zambia and Lusaka specifically was not under lockdown save for the precautions to put on masks and social distancing.

## Results

The results and discussion focused on Capital Allowances and their Effects on the Performance of Small and Medium Scale Enterprises in the Construction Sector in Lusaka District. The results addressed the issues pertaining to the performance of SMEs based on the responses from the sample of respondents from the selected cases based on the analysis of data collected using the research questionnaires



### Interaction with Capital Allowances

*Table 1: Interaction with Capital Allowances*

| **Understanding of Capital Allowances Available** | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Strongly Disagree | | Disagree | | Not Sure | | Agree | | Strongly Agree | |
| | F | % | F | % | F | % | F | % | F | % |
| **Understanding of CA Available** | 7 | 11.7 | 6 | 10 | 6 | 10 | 28 | 46.7 | 13 | 21.7 |
| **SMEs awareness on claiming CA** | 0 | 0 | 0 | 0 | 0 | 0 | 39 | 65 | 21 | 35 |
| **Attended CA Seminars or Workshops** | 7 | 11.7 | 7 | 11.7 | 8 | 13.3 | 29 | 48.3 | 9 | 15 |
| **Filing of Tax Returns** | 6 | 10 | 10 | 16.6 | 0 | 0 | 30 | 50 | 14 | 23.3 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Awareness of Tax Laws on Taxation of SMEs** | 6 | 10 | 8 | 13.3 | 4 | 6.7 | 30 | 50 | 12 | 20 |

*Source: Field Data, 2021*

In table 8, When asked whether the respondents understood what Capital Allowances were available; 7, 11.7% Strongly Disagreed; 6, 10% Disagreed; 6, 10% Were not sure; 28, 46.7% Agreed; and 13, 21.7% Strongly Agreed. Showing that the majority of respondents Agreed to understanding the available Capital Allowances.

Additionally, in Table 8, When asked whether SMEs were aware of claiming Capital Allowances; 29, 65% Agreed; and 21, 35% Strongly Agreed. Showing that All the respondents thought 'SMEs are aware of claiming Capital Allowances.'

Furthermore, in Table 8, When asked whether the respondents attended Seminars or Workshops on Capital Allowances; 14, 23.4% Disagreed; 8, 13.3% were not sure; and 38, 63.3% Agreed. Showing that the majority of respondents attended Capital Allowance Seminars or Workshops.

Also, in Table 8, When asked if they helped file Tax Returns for the company; 16, 26.6% Disagreed; and 44, 73.3% Agreed. Implying that, the majority of respondents knew how to file Tax Returns.

Lastly, in Table 8, When asked about whether the respondents were aware of the Laws on Taxation of SMEs; 6, 10% Strongly Disagreed; 8, 13.3 Disagreed; 4, 6.7% were not sure; 30, 50% Agreed and 12, 20% Strongly Agreed. Meaning, the majority of respondents agreed to knowing the laws on the taxation of SMEs.

## Types of Capital Allowances

*Table 2: Types of Capital Allowances*

| **Capital Allowances** | | | | |
|---|---|---|---|---|
| | Yes | | No | |
| | F | % | F | % |
| **CA on Furniture & Fittings, Computers** | 42 | 70 | 18 | 30 |
| **CA on Motor Vehicles** | 53 | 88.3 | 7 | 11.7 |
| **CA on Plant, Machinery & Equipment** | 52 | 86.7 | 7 | 11.7 |
| **CA on Buildings** | 48 | 80 | 12 | 20 |

*Source: Field Data, 2021*

In Table 9 above, when asked if the respondents knew about Capital Allowances on Furniture, Fittings and Computers; 42, 70% Agreed, while 18, 30% Disagreed.

In addition, In Table 9 above, when asked if the respondents knew about Capital Allowances on Motor Vehicles; 53, 88.3% Agreed, while 7, 11.7% Disagreed.

Furthermore, In Table 9 above, when asked if the respondents knew about Capital Allowances on Plant, Machinery and Equipment; 52, 86.7% Agreed, while 7, 11.7% Disagreed.

Lastly, In Table 9 above, when asked if the respondents knew about Capital Allowances on Plant, Machinery and Equipment; 48, 80% Agreed, while 12, 20% Disagreed.

The results in Table 9 imply that the majority of respondents were aware of the four types of Capital Allowances available in Zambia.

**Performance of SMEs After Capital Allowances**

***After Tax Profits***

*Table 3: After Tax Profits*

| **The Firms After Tax Profits** | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Strongly Disagree | | Disagree | | Not Sure | | Agree | | Strongly Agree | |
| | F | % | F | % | F | % | F | % | F | % |
| **Improvements in after tax profits** | 10 | 16.7 | 12 | 20 | 11 | 18.3 | 18 | 30 | 9 | 15 |
| **Fair Tax Rates Charged to SMEs** | 1 | 1.7 | 3 | 5 | 8 | 13.3 | 32 | 53.3 | 15 | 25 |
| **SMEs have full Tax Information** | 2 | 3.3 | 8 | 13.3 | 5 | 8.3 | 30 | 50 | 14 | 23.3 |

*Source: Field Data, 2021*

In Table 11 above, when asked whether there were improvements in After Tax Profits at their firms after getting Capital Allowances; 10, 16.7% Strongly Disagreed; 12, 20% Disagreed; 11, 18.3% were not sure; 18, 30% Agreed; and 9, 15% Strongly Agreed. Implying that the majority said 'there were improvements in After Tax Profits after Capital Allowances.'

Additionally, when the respondents were asked if the Taxes changed to SMEs were fair; 1, 1.7% Strongly Disagreed; 3, 5% Disagreed; 8, 13.3% were not sure; 32, 53.3% Agreed; and 15, 25% Agreed. Implying that the majority of respondents felt that the taxes changed to SMEs in Construction are not fair.

Lastly, when the respondents were asked if SMEs have full Tax Information; 2, 3.3% Strongly Disagreed; 8, 13.3% Disagreed; 5, 8.3% were not sure; 30, 50% Agreed; 14, 23.3% Strongly Agreed. Implying that the majority of respondents felt that SMEs in Construction have full Tax Information.

***Growth of SMEs***

*Table 4: Growth of SMEs*

| The Growth of the Firm | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Strongly Disagree | | Disagree | | Not Sure | | Agree | | Strongly Agree | |
| | F | % | F | % | F | % | F | % | F | % |
| **CA contributes to the growth of SMEs** | 11 | 18.3 | 9 | 15 | 6 | 10 | 21 | 35 | 13 | 21.7 |
| **CA increase job prospects** | 5 | 8.3 | 9 | 15 | 6 | 10 | 28 | 46.7 | 12 | 20 |
| **CA attract Investors** | 7 | 11.7 | 9 | 15 | 3 | 5 | 27 | 45 | 13 | 21.7 |
| **CA encourage SMEs to continue operating** | 6 | 10 | 7 | 11.7 | 3 | 5 | 29 | 48.3 | 15 | 25 |

*Source: Field Data, 2021*

Table 12 above tabulates responses relating to the growth of SMEs;

When asked if Capital Allowances contributed to the growth of SMEs in construction; 11, 18.3% Strongly Disagreed; 9, 15% Disagreed; 6, 10% were not sure; 21, 35% Agreed; and 13, 21.7 Strongly Agreed. Implying that the majority of respondents felt that Capital Allowances contributed to the growth of Capital Allowances.

When asked if Capital Allowances increased Job Prospects; 5, 8.3% Strongly Disagreed; 9, 15% Disagreed, 6, 10% were not sure; 46.7 Agreed; and 12, 20% Strongly Agreed. Implying that the majority of respondents felt that Capital Allowances increased Job Prospects in Construction Companies.

When asked if Capital Allowances in Construction attract investors; 7, 11.7% Strongly Disagreed; 9, 15% Disagreed; 3, 5% were not sure; 27, 45% Agreed; and 13, 21.7% Strongly Agreed. Implying that the majority of respondents felt that Capital Allowances attract investors to SMEs in Construction.

Lastly, when the respondents were asked if Capital Allowances encourage SMEs in construction to continue operating; 6, 10% Strongly Disagreed, 7, 11.7% Disagreed; 3, 5% were not sure; 29, 48.3% Agreed; and 15, 25% Strongly Agreed. Implying that the majority of respondents felt that Capital Allowances encouraged SMEs in construction to continue operating.

## 5. Discussion

Although the fundamental purpose of taxation is to raise revenue, the tax system inherently and invariably affects economic incentives. This study found that Capital Allowances are a convenient, practical, and flexible instrument for influencing incentives in a direction that contributes to other policy objectives such as investment promotion, job creation, development of disadvantaged regions, or upgrading of the labor force.

Aside from financial incentives, the study found that, the government of the Republic of Zambia have pursued Tax Break programs to maintain economic and political stability, improve the infrastructure and upgrade the labor force. These investment promotion programs that include Capital Allowances have been famously successful; seen in how the Capital Allowances have fostered growth in the construction sector.

Furthermore, the findings of this research are aligned with the study by Otumba (1995) on the relationship between tax incentives and Financial performance of SME's in Ghana, Accra, where the sales were said to be increasing year to year. Based on these results from the sampled SMEs financial statements, the financial performance of the SMEs was good. Since, profitability is said to be a measure of the amount by which a company's revenues exceeds its relevant expenses, the results of their study revealed that the availability of tax incentives led to an increase in the sales during the study period. The findings indicate that tax incentives have a positive effect on the growth of sales of SMEs.

## 6. Conclusion

From the analysis conducted, the following conclusions were made: There is a significant effect of tax incentives on the growth of SMEs. This is manifested by the positive association that was found the explanatory and the dependent variables through empirical analysis. This study therefore concluded that tax incentives are important predictors of the growth of SMEs in terms of sales revenue. The SMEs that claimed for capital allowances had their performance rated to be performing better than those that never applied for capital allowances.

There are legitimate reasons to favor the use of investment tax incentives, but also strong reasons to believe that the fiscal and economic costs may be very high relative to the benefits. In some prominent cases, incentive programs have met with outstanding success. In many other countries, however, they failed to stimulate much investment. And in a few interesting cases, they have been eliminated without harming investment flows.

## 7. Recommendations and Limitations

### Recommendations

Emanating from the findings, conclusions and contributions of the study, the below recommendations were made:

- Government should address the dire need for start-up funds for SMEs by providing incentives for SMEs funding.
- The SMEs industry players should enlighten themselves appropriately on the form of business they want to embark upon before venturing into it to make them better equipped by going for entrepreneurial training programs.
- The government should employ Capital Allowances as a major tax incentive for newly established small and medium enterprises because it stimulates their investing power.

- Government should promote the growth of small and medium enterprises by creating the necessary enabling frameworks and relax the burden of regulating measures and ensure that their efforts are geared towards granting tax incentives to small and medium enterprises.
- Government should create adequate awareness through the tax authorities to explain the role of taxation on development and help small and medium enterprises to understand tax laws in Zambia.

**Limitations of the Study**

Most respondents within the Construction SMEs in Lusaka town had busy schedules and were not readily available at the time the researcher wanted to engage them in the study. However, the researcher made a schedule and had appointments with all selected respondents, who reserved time for him and provided the required data for the study. Feedback for collection of secondary data with Zambia Revenue Authority, Zambia Development Agency and PACRA came late but the researcher managed to catch up with time Limitations of the study.

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