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The Effect of Tax Incentives on Enterprise Performance: A Conceptual Framework

Peng Qiong, Zuriadah Ismail

Faculty of Management and Economics, Universiti Pendidikan Sultan Idris, Malaysia

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ABSTRACT

This study aims to investigate the effect of tax incentives on enterprise performance, focusing on the mediating role of innovation input and the moderating role of innovation output. Drawing on Resource-Based Theory and Institutional Theory, the research constructs a conceptual model to demonstrate how tax incentives enhance market competitiveness and overall performance by promoting innovation activities. The findings reveal that tax incentives not only directly improve financial performance by alleviating tax burdens but also indirectly boost enterprise performance through increased innovation input. Additionally, high levels of innovation output positively moderate the relationship between tax incentives and enterprise performance, amplifying the positive effects of these incentives.

Keywords. Tax incentives, Enterprise Performance, Innovation input, Innovation output,

INTRODUCTION

In the context of globalization and rapid technological advancements, China's economy is undergoing significant transformation and upgrading. The traditional growth model, which heavily relies on factor inputs, is increasingly insufficient to meet the demands of modern development, positioning innovation as the primary driver of economic growth. Since the 18th National Congress, the innovation-driven development strategy and associated policies have consistently emphasized the strategic importance of innovation within the economic framework (Hu et al., 2024; Xi, 2022).

Amid this backdrop, Specialized and Sophisticated SMEs have emerged as key contributors to economic and innovation development. According to the Ministry of Industry and Information Technology (MIIT), Specialized and Sophisticated enterprises are SMEs that demonstrate excellence by focusing on niche markets, achieving high levels of specialization, showcasing unique competitive advantages, and maintaining continuous innovation (MIIT, 2022). For these technology-oriented enterprises, which prioritize innovation and technological progress, sustaining unique advantages and innovative capabilities is crucial for establishing and expanding their market presence (Ma & Liu, 2024).

While tax incentives are vital policy tools for fostering innovation by reducing tax burdens, enabling increased R&D investment, and subsequently enhancing innovation capacity and market performance, much of the existing research has focused on their direct impact on enterprise performance or the link between tax incentives and innovation outcomes. However, there is a relative scarcity of studies examining how tax incentives influence overall enterprise performance through the mechanisms of innovation input and output. A comprehensive understanding of the pathways through which tax incentives affect enterprise performance can reveal the actual effectiveness of these policies and their potential to support sustainable enterprise growth. Therefore, this study aims to systematically explore how tax incentives, by influencing innovation

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input and output, enhance the overall performance of Specialized and Sophisticated SMEs, providing both theoretical and empirical support for policy optimization.

LITERATURE REVIEW

Tax Incentives and Enterprise Performance

Tax incentives have been extensively studied for their effect on enterprise performance, with numerous studies affirming their positive effects. Tian et al. (2020) demonstrated that tax incentive policies significantly enhance corporate R&D investment, thereby promoting both innovation and financial performance. Similarly, Agrawal et al. (2020) found that such policies provide crucial financial support to SMEs, helping them overcome funding constraints and achieve technological advancements. However, some studies highlight potential negative or limited outcomes of tax incentives. Song et al. (2020) observed that, in certain cases, tax incentives may lead to a "crowding-out effect" on R&D expenditure, where firms decrease their independent R&D investments and rely more on government support to reduce costs. The relationship between tax incentives and performance is influenced by various factors. Razi et al. (2024) highlighted that although tax incentives are intended to enhance enterprise performance, their effects can differ under conditions of board diversity, indicating that managerial and structural elements may mitigate their impact. Furthermore, research by Xiong et al. (2023) and Lin & Lin (2023) demonstrated that factors such as political connections, the firm's location, and ownership structure can moderate the effectiveness of tax incentives on innovation performance.

Innovation Input and Enterprise Performance

Innovation input is widely recognized as a crucial driver of enterprise performance, encompassing the allocation of financial, human, and other resources (Cohen & Levinthal, 1990). Feng et al. (2022) highlighted the substantial positive impact of innovation input on the performance of high-tech firms in China, consistent with findings by Kiiru et al. (2023), who observed similar outcomes in Kenyan SMEs, demonstrating that innovation input enhances enterprise performance across various contexts.

However, innovation input does not always yield immediate benefits and may have negative repercussions if governance structures are insufficient. Zhao, Fu, and Liu (2021) found that under such conditions, innovation input could lead to delays or even detrimental effects on enterprise performance. This finding underscores the importance of effective management frameworks to translate innovation input into performance improvements. Factors such as external financing methods, industry characteristics, and firm size significantly affect the relationship between innovation input and performance. Feng et al. (2022) emphasized that equity financing positively moderates the relationship between innovation input and enterprise performance, while debt financing can have the opposite effect, increasing financial pressure and limiting innovation potential. Jin and Choi (2019) noted that the influence of product innovation and R&D investment varies among firms of different sizes within the IT and business services sectors. Additionally, Zhao et al. (2021) identified that ownership concentration negatively moderates the relationship between innovation input and performance, potentially constraining innovation capabilities.

Innovation Output and Enterprise Performance

Innovation output encompasses the tangible results of a firm's innovation efforts, such as new products, technologies, and patents, directly representing the firm's innovation capabilities (Freeman & Soete, 1997). Abernathy and Clark (1985) emphasized that innovation output acts as a bridge between innovation input and enterprise performance, serving as a vital indicator of a firm's competitive standing. Tidd and Bessant (2020) also noted that if innovation input does not culminate in successful innovation output, its potential to enhance performance may be constrained.

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The "innovation profitability" framework proposed by Hai et al. (2022) posits a potential U-shaped relationship between innovation output and financial performance, shaped by the complexity of innovation processes and varying levels of market acceptance. Research has demonstrated that individual financial constraints and fundamental market limitations can moderate this relationship, affecting the efficiency with which innovation output translates into performance improvements (Henderson & Clark, 1990). Baláž et al. (2023) highlighted that the significance of innovation strategies for enterprise performance changes across different phases of the innovation cycle, emphasizing the importance of a long-term approach when evaluating the impacts of innovation activities. Kanellopoulos and Tsekouras (2023) observed that innovation efficiency serves as a moderating factor in the relationship between innovation output and enterprise performance. Although innovation efficiency may not directly impact performance, it can influence the relationship between knowledge management and performance outcomes.

Theoretical Review

Institutional Theory

Institutional theory originated in the early 20th century, with Selznick (1957) emphasizing that organizational behavior is influenced not only by functional tasks but also by external environments and cultural norms. Meyer and Rowan (1977) posited that organizations often adopt practices not necessarily aimed at enhancing efficiency but rather to achieve legitimacy. DiMaggio and Powell (1983) further developed this concept by introducing “institutional isomorphism,” which explains why organizations under external pressures tend to adopt similar strategies and structures. They identified three mechanisms of isomorphism: coercive, mimetic, and normative. By the 1990s, institutional theory expanded from a macro-level focus to include micro-level analyses, examining how external institutions influence internal decision-making and behavior. Zucker (1987) explored how institutional norms shape individual and organizational behavior through socialization processes, while Lawrence and Suddaby (2006) highlighted how organizations internalize institutional elements into their strategic plans. Scott (2008) proposed a three-pillar framework of institutions—regulative, normative, and cultural-cognitive—that collectively shape organizational responses to external pressures.

Resource-Based Theory

The Resource-Based Theory, first proposed by Wernerfelt (1984) and later developed by Barney (1991), emphasizes that firms can achieve a sustained competitive advantage if their resources are valuable, rare, inimitable, and organized. Barney argued that resources possessing these characteristics enable firms to outperform their competitors and maintain long-term advantages. Grant (1991) further stressed that knowledge is a fundamental capability for achieving a competitive advantage, suggesting that firms should focus on effectively integrating and utilizing their internal knowledge and resources. The rarity and inimitability of resources are essential for creating a sustainable competitive edge. Dierickx and Cool (1989) underscored that inimitable resources safeguard a firm’s competitive position by making it difficult for rivals to replicate or acquire them. Peteraf (1993) expanded on this by emphasizing that resource heterogeneity and immobility are also crucial for attaining and maintaining a competitive advantage. The uniqueness and irreplaceability of these resources allow firms to sustain differentiation and remain competitive in the market.

Construction of the Conceptual Framework

The Effect of Tax Incentives on Enterprise Performance

Tax incentives function as a policy tool aimed at reducing firms' tax burdens, thereby freeing up financial resources, alleviating fiscal pressures, and enhancing operational performance. Existing research underscores that tax incentives provide firms with additional economic resources that can be invested in R&D, technological advancements, and other strategic initiatives, contributing directly to improved short-term

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financial outcomes and long-term competitiveness (Twesige & Gasheja, 2019; Walter et al., 2022). For SMEs, this type of support is particularly vital, especially when they face financial constraints and competitive market environments. The financial relief provided by tax incentives enables these enterprises to better navigate market fluctuations and address short-term challenges more effectively (Gupta & Lynch, 2016). Additionally, from a capital structure perspective, tax incentives help reduce the cost of capital, optimize financial structures, and enhance overall firm value (Graham, 2008).

Tax policy represents a critical external institutional factor with significant influence on corporate behavior. Research demonstrates that tax incentives can improve a firm's innovative capacity and market adaptability by reducing tax liabilities and providing financial support. This impact is especially crucial for SMEs, which often face resource limitations, positioning tax incentives as a pivotal factor in promoting innovation and competitive advantage (Twesige & Gasheja, 2019; Walter et al., 2022; Aghion et al., 2009). Empirical evidence consistently supports the positive relationship between tax incentives and enterprise performance. For example, Xiong et al. (2023) reported that high-tech firms in mainland China benefitting from a preferential 15% tax rate exhibited significant improvements in innovation output. Similarly, Huang and Liu (2024) found that fiscal and tax incentives significantly enhanced innovation efficiency, with financial constraints playing a mediating role. Moreover, research by Abdelhakim and Zouaghi (2022) in Tunisia indicated that, under specific conditions, tax incentives can markedly improve firms' financial performance.

The Mediating Role of Innovation Input

Tax incentives not only directly enhance enterprise performance by reducing tax liabilities but also indirectly stimulate increased innovation input. Innovation input, encompassing financial and human resources dedicated to R&D, technology acquisition, and related activities, is considered a key driver of firm competitiveness (Cohen & Levinthal, 1990). By alleviating financial constraints, tax incentive policies enable firms to allocate more resources to innovation activities, fostering a virtuous cycle. Dosi (1988) highlighted that innovation input strengthens firms' technological capabilities and market adaptability, thereby enhancing performance. Empirical evidence indicates that innovation input not only contributes to technological accumulation but also diversifies products and services, enhancing market share and profitability (Freeman & Soete, 1997).

According to the resource-based theory (RBT), innovation is an essential internal resource for achieving sustainable competitive advantage (Suardhika, Yuesti, & Latupeirissa, 2018). By increasing innovation input, firms accumulate unique and difficult-to-replicate resources, such as technical expertise, intellectual capital, and proprietary technology. The effective integration and utilization of these resources can significantly strengthen a firm's market competitiveness (Abu Bakar & Ahmad, 2010). Thus, tax incentives promote enterprise performance by encouraging innovation input, enabling firms to build valuable resources and enhance their market positions.

The Moderating Role of Innovation Output

Innovation output, represented by new product development, technological breakthroughs, and patents, reflects the tangible outcomes of a firm's innovation activities. High levels of innovation output can amplify the impact of tax incentives on enterprise performance, placing firms in a more competitive position. Research demonstrates that innovation output significantly improves a firm's market reputation and brand value, as well as its long-term competitiveness and profitability (Abernathy & Clark, 1985). Furthermore, higher levels of innovation output allow firms to leverage financial resources and support facilitated by tax incentives to achieve superior performance (Tidd & Bessant, 2020).

From the perspective of the resource-based theory, higher innovation output enhances the efficiency with which firms utilize innovative resources, thus amplifying the positive effects of tax incentives on enterprise performance. This perspective aligns with institutional theory, which posits that firms respond to external

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policy incentives by increasing innovation output to bolster legitimacy and market competitiveness (Walter et al., 2022). Innovation output contributes not only to short-term performance improvements but also lays the groundwork for long-term success. As firms accumulate innovation achievements, they can expand their market share, strengthen brand influence, and solidify their leadership within the industry (Laosirihongthong, Prajogo, & Adebanjo, 2014). Therefore, innovation output serves as a crucial moderating factor in the relationship between tax incentives and enterprise performance, enhancing the market competitiveness and long-term development potential fostered by tax incentives.

Conceptual Framework

This study develops a conceptual framework to illustrate the relationships among tax incentives, innovation input, innovation output, and enterprise performance. In this framework, tax incentives serve as the independent variable, directly enhancing enterprise performance by alleviating tax burdens and indirectly influencing performance through the promotion of innovation input and output. Innovation input is considered a mediating variable, demonstrating how tax incentives encourage firms to allocate more resources to R&D and technological innovation, ultimately improving enterprise performance. Innovation output is defined as a moderating variable, clarifying how higher levels of innovation output amplify the positive effect of tax incentives on enterprise performance.

The framework is grounded in both institutional theory and resource-based theory. Institutional theory emphasizes the influence of external environments on a firm's strategies and resource allocation, while resource-based theory posits that internal resources, such as innovation capabilities, are essential for achieving competitive advantage. Tax incentives, as an external resource, facilitate firms' acquisition of new knowledge and technologies, thereby enhancing their innovation capabilities (Costa & Matias, 2020). Prior research has demonstrated a positive relationship between tax policies and firms' R&D investments, suggesting that tax incentives help SMEs overcome financial constraints and promote technology transfer and the realization of innovative outcomes (Abdurazzakov et al., 2020). Innovation, as a core internal resource, leads to the development of new products and market opportunities, enhancing competitiveness (Lestari et al., 2020), and can optimize production processes to improve efficiency and reduce costs (Adisaksana, 2022). Additionally, innovation can create technological barriers that prevent imitation by competitors, thereby reinforcing a firm's market position (Tsoukatos et al., 2017).

In this conceptual framework, tax incentives directly improve enterprise performance by reducing tax burdens and increasing the availability of disposable funds while also indirectly enhancing competitiveness and market position through increased innovation input. Furthermore, higher levels of innovation output act as a moderator in the relationship between tax incentives and enterprise performance, making the positive impact more pronounced in competitive markets. The detailed conceptual framework is presented below.

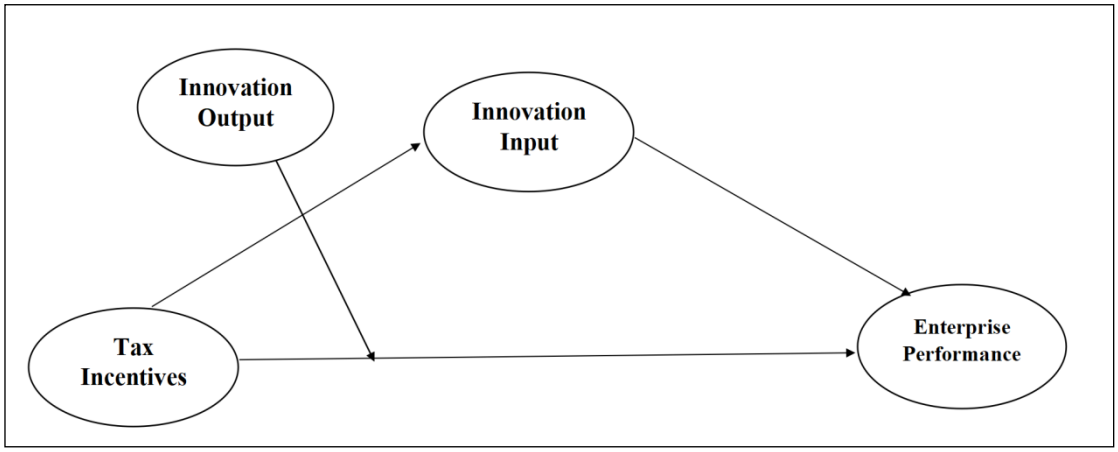

Figure 1 Conceptual Framework

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DISCUSSION AND CONCLUSION

This study integrates resource-based theory and institutional theory to analyze how tax incentives influence enterprise performance through the mechanisms of innovation input and innovation output. It fills a gap in the current literature by investigating the internal pathways through which tax incentives contribute to enterprise performance. While most existing studies focus on the direct effects of tax incentives or the impact of innovation input alone, this research extends the discourse by examining both the mediating role of innovation input and the moderating role of innovation output. This comprehensive perspective contributes theoretical insights into how tax policies can enhance firm innovation and competitiveness.

Practically, these findings provide valuable guidance for policymakers aiming to optimize tax incentive policies to better foster innovation and enhance enterprise performance. By clarifying how tax incentives influence performance through innovation mechanisms, the research serves as a reference for targeted policy development, ensuring that incentives are more effectively designed and implemented. For firms, understanding the importance of boosting both innovation input and output can inform resource allocation and strategic planning, enabling them to leverage tax policies more effectively to secure a competitive edge in the market.

However, the study is limited by its theoretical approach, which lacks empirical validation. Future research should incorporate empirical data to test and refine the proposed framework, enhancing its generalizability and robustness. Expanding the scope to include different types of firms or conducting comparative studies across industries and countries would help verify the model's applicability in varied contexts.

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