
| RESEARCH ARTICLE

Fiscal Policy Reforms and SME Performance in Tanzania: An Empirical Analysis of Tax Policy and VAT Implications

Caroline Z. Mbelle

Department of Finance and Management Studies, Institute of Rural and Development Planning, Dodoma, Tanzania

Corresponding Author: Caroline Z. Mbelle, **E-mail:** eliahmgina@gmail.com

| ABSTRACT

Small and Medium Enterprises (SMEs) are critical drivers of Tanzania's economic development, yet their performance remains constrained by unfavorable fiscal policies, particularly tax-related burdens and Value Added Tax (VAT) administration. This secondary data study examines the impact of fiscal policy reforms on SME performance in Tanzania from 2019-2026, synthesizing evidence from government reports, Tanzania Revenue Authority (TRA) data, and peer-reviewed empirical literature. The research evaluates how income tax policies, VAT reforms, and digital tax system implementations affect SME profitability, cash flow, operational efficiency, and growth trajectories. Key findings reveal that while digital tax reforms (e-filing, Electronic Fiscal Devices) have improved compliance tracking, they simultaneously increased administrative burdens, particularly for micro and small enterprises. VAT registration thresholds at TZS 100 million continue to exclude significant SME sectors from formal registration, with an estimated 4,575 eligible taxpayers remaining outside the tax system by 2022, representing lost government revenue of TZS 23,350 billion. Tax rates (corporate income tax at 30%, VAT at 18%, business license fees) constitute substantial operational cost increases, with survey data from Iringa Municipality showing 70% of respondents reporting that high tax rates increase operational costs and 65% citing VAT-related profit margin compression. The study recommends targeted fiscal policy reforms including reduced VAT rates for essential goods, simplified tax registration procedures, differentiated tax regimes for enterprise size categories, and enhanced taxpayer education programs to improve compliance voluntarily. Evidence-based fiscal decentralization transferring tax administration to regional authorities, coupled with performance-based incentive structures for compliant SMEs, could generate estimated 15-25% compliance rate improvements while supporting long-term SME sustainability.

| KEYWORDS

Fiscal policy reforms, tax policy, VAT, SME performance, Tanzania, tax compliance, informal sector, financial inclusion, economic development.

| ARTICLE INFORMATION

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1. Introduction

Tanzania's SMEs constitute a critical economic pillar, accounting for approximately 95% of all registered businesses and generating millions of people's employment (*Sibiya et al., 2023*). Despite their macroeconomic significance, SME performance has been persistently constrained by multiple factors, with fiscal policy, particularly taxation and VAT administration, emerging as a primary impediment to sustainable growth and formalization. Since 2014, the Tanzanian government has implemented several fiscal policy reforms since 2014, including VAT system, the introduction of digital tax administration through electronic fiscal devices, and the modification of turnover tax

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regimes. However, empirical evidence indicates that these reforms have yielded mixed outcomes, with particular challenges for micro and small enterprises operating at lower turnover levels (Erick, Mdoe, & Mfinanga, 2024).

The rationale for this research is compelling: Tanzania's SME sector generates substantial economic value but contributes minimally to formal tax revenue, with estimates indicating significant revenue leakage due to informal-sector participation and tax non-compliance (Munguasifiwe et al., 2025). The 2014 VAT Act introduced structural reforms intended to broaden the tax base and enhance revenue efficiency; however, SME participation remains suboptimal. A 2023 study revealed that 4,575 taxpayers with turnovers exceeding TZS 100 million remained unregistered, representing lost government revenue of approximately TZS 23,350 billion annually (Nguvava & Athanas, 2023). Fiscal policy reforms intended to improve revenue administration have inadvertently increased SME compliance costs, disproportionately affecting SMEs with limited administrative capacity (Mhango & Phares, 2025).

This study synthesizes secondary data from 2019 to 2026 to empirically analyze how fiscal policy reforms, specifically tax rate structures, VAT implementation mechanisms, and DTA systems, affect SME performance metrics, including profitability, cash flow stability, operational efficiency, and investment capacity. This study addresses critical gaps in Tanzania-specific empirical evidence on fiscal policy impacts by integrating findings from regional comparative studies (Kenya, Rwanda, and Nigeria) and broader African contexts to develop contextually appropriate policy recommendations for enhancing SME-fiscal policy alignment.

2. Literature Review

2.1 Fiscal Policy Frameworks and Development of Small and Medium Enterprises: Global Evidence

Fiscal policy encompassing government expenditure, taxation, and borrowing represents a fundamental mechanism through which governments influence economic activity, capital allocation, and firm performance (Arjang et al., 2025). Fiscal policy for SMEs operates through multiple channels: direct taxation reduces disposable capital for reinvestment, indirect taxation (VAT) affects input costs and consumer demand, and government expenditure shapes macroeconomic conditions affect business profitability. Research across developing economies reveals significant heterogeneity in fiscal policy impacts on SME performance, with effectiveness strongly dependent on implementation quality, institutional capacity, and contextual adaptation (Setiadi et al., 2025).

Vietnam-based panel data analysis examining 88,692 enterprises (2011-2020) demonstrates that reducing the overall tax burden enhances SME performance, although the effects vary significantly across sectors and regions (Cuong & Trang, 2025). Manufacturing SMEs show weaker tax burden sensitivity than the construction and trade sectors, suggesting that sector-specific characteristics must be considered in fiscal policy design. Tax incentives benefit SMEs in disadvantaged regions more substantially than those in major urban centers, implying the potential role of fiscal policy in promoting regional economic development (Cuong & Trang, 2025).

The World Bank's Tax Administration and Firm Performance study establishes that tax compliance costs fall disproportionately on small and young businesses, with administrative burden creating a regressive tax system structure disadvantaging SMEs (DablaNorris et al., 2017). This finding indicates that fiscal policy design that separates tax compliance cost burden from firm size yields efficiency and equity gains. A cross-country comparative analysis identifies that institutional quality, governance stability, and regulatory predictability are significant for SME tax burden impacts as formal tax rates, indicating that comprehensive fiscal reform requires simultaneous institutional strengthening (Kebede, 2025).

2.2 VAT systems, compliance, and economic performance of SME

Value-added tax (VAT) is the dominant indirect tax instrument in most developing economies; however, its impact on SME-specific VAT remains poorly researched and understood in policy contexts (Zubairu et al., 2025). The theoretical appeal of VAT, which offers efficient consumption-based taxation with input tax credits that reduce cascading effects, confronts practical implementation challenges, particularly for SMEs that lack sophisticated accounting systems and face registration threshold barriers (Erick, Mdoe, & Kanire, 2024).

A Nigeria-focused study assessing VAT exemption effectiveness revealed that while VAT exemptions positively influence SME growth indicators (revenue performance and cash flow improvement), their effectiveness is constrained by low taxpayer awareness, limited tax authority support, and procedural complexity (Zubairu et al., 2025). This study demonstrates that policy design alone is insufficient without the implementation of complementary awareness campaigns and administrative simplification. Notably, VAT exemptions positively impact cash flow, a critical constraint for SME operations, suggesting that well-designed VAT reforms can address the financial liquidity challenges of small businesses (Zubairu et al., 2025).

Rwanda's VAT reform assessment reveals that digital VAT systems improve compliance among registered SMEs; however, implementation barriers persist, particularly regarding digital literacy and technology accessibility (Hakizimana & Ntegamaherezo, 2025). The research identifies that post-reform support mechanisms (training, guidance on new regulations, and resource provision) significantly enhance SME adaptation to VAT changes, implying that sustained investment in capacity-building is required for fiscal reforms. VAT rate reforms, registration reforms, and digital system adoption all demonstrated statistically significant impacts on SME performance (mean scores 3.67-3.89 on 5-point scales), suggesting that comprehensive VAT reform packages generate multiplicative performance effects (Hakizimana & Ntegamaherezo, 2025).

Zanzibar-based research examining VAT compliance determinants reveals complex, non-linear relationships: while simplified tax systems and computerized payments improve compliance, higher education levels paradoxically reduce the likelihood of VAT compliance, potentially reflecting educated owners' perception that sophisticated tax avoidance strategies exist (Erick, Mdoe, & Kanire, 2024). This counterintuitive finding suggests that tax knowledge deficiencies may not fully explain non-compliance; rather, the motivated non-compliance of sophisticated actors represents a distinct phenomenon requiring administrative deterrence mechanisms (Erick, Mdoe, & Kanire, 2024).

Kenya's VAT compliance research demonstrates that e-filing systems improve tax filing accuracy and timeliness, accounting for 27% of VAT compliance variance (Muya et al., 2025). However, complementary factors, including taxpayer education, ICT infrastructure quality, and system usability, are essential for technology-driven reform effectiveness, suggesting that DTA represents necessary but insufficient reform components (Muya et al., 2025).

2.3 Tanzania's Fiscal Policy Context and Challenges to Small and Medium Enterprises

Tanzania's fiscal policy environment has undergone substantial evolution since the mid-1990s, with structural reforms addressing tax administration, base-broadening, and modernization (Mwinyimvua, 2024). The 2014 VAT Act represented a comprehensive restructuring effort, incorporating base-broadening measures and addressing legal drafting issues. However, performance assessment reveals concerning outcomes: VAT contribution to GDP (3.6%) remains substantially below government targets (6%) and regional peer averages (4.4% EAC), indicating incomplete reform effectiveness (Nguvava & Athanas, 2023).

VAT efficiency metrics reveal systemic challenges: C-efficiency ratios (actual VAT revenue relative to theoretical maximum) averaged 20.7%, substantially below the EAC regional standard of 25% (Nguvava & Athanas, 2023). This performance gap shows substantial revenue leakage through non-compliance, underreporting, or exemption misuse. The existence of 4,575 potentially eligible VAT taxpayers remaining unregistered by January 2022 represents a critical administrative failure, indicating insufficient compliance monitoring and enforcement mechanisms (Nguvava & Athanas, 2023).

The Tanzania Revenue Authority's technological initiatives, including electronic fiscal devices, e-filing systems, and digital service tax implementation, represent modernization efforts intended to improve revenue administration and reduce compliance costs. However, empirical research reveals mixed implementation outcomes: while EFD adoption correlates with improved excise duty collection (approximately TZS 435.72 billion annual increase post-implementation), broader VAT compliance improvements remain modest (Gomba, 2025). EFD-induced initial compliance cost increases create short-term burdens on SMEs, potentially explaining resistance to technology adoption and continued participation in the informal economy (Mhango & Phares, 2025).

Research on Tanzanian SME tax compliance reveals that the perceived severity of tax penalties generates positive effects on registration and income declaration behaviors; however, penalty effects are insignificant for payment timeliness (*Munguasifiwe et al., 2025*). This finding indicates that administrative mechanisms emphasizing registration penalties succeed in formal sector integration, while payment enforcement requires complementary mechanisms that address SME liquidity constraints. Importantly, the research recommends multi-dimensional compliance approaches incorporating taxpayer education, customer service quality, and administrative efficiency alongside penalty-based deterrence (*Munguasifiwe et al., 2025*).

Iringa Municipality-based research on micro and small enterprise tax perception identifies that 70% of respondents attribute operational cost increases to high tax rates, while 65% cite VAT-related profit margin compression (*Mariki et al., 2025*). This qualitative evidence indicates that SME tax burden perception translates into operational constraints limiting growth investment, supporting quantitative findings on tax impacts on firm performance (*Mariki et al., 2025*).

2.4 Impacts of Tax Policy on the Financial Performance and Growth of SME

The relationship between tax policy and SME growth operates through multiple mechanisms: direct effects via reduced retained earnings available for reinvestment, indirect effects via consumer demand reduction (particularly VAT), and behavioral effects via tax evasion incentives when formal tax burdens exceed perceived government service benefits (*Oluremi & Maku, 2024*). Nigeria-specific research examining the effects of multiple tax instruments on SME growth reveals heterogeneous impacts: while Company Income Tax and VAT demonstrate statistically significant (though negative) associations with SME growth, Custom and Excise Duty effects prove insignificant (*Vctor et al., 2020*). This heterogeneity argues that tax instrument design characteristics, not merely tax rates, substantially influence the impact of SME growth (*Vctor et al., 2020*).

Cross-country analysis demonstrates that tax rate reductions enhance SME performance more substantially in disadvantaged regions than in major urban centers (*Cuong & Trang, 2025*), suggesting that fiscal decentralization targeting regional SME support could yield efficiency gains. A Kenya-focused analysis revealed a strong negative correlation between tax rates and SME growth ($r = -0.645, p < 0.001$), with increases in tax rates directly reducing profitability, customer base expansion, and operational scalability (*Madara & Ghabon, 2025*). This quantified relationship shows that even modest tax rate reductions could generate meaningful improvements in the performance of SME.

2.5 Digital Tax Reforms and Technology Adoption

Digital tax administration reforms, including e-filing, electronic fiscal devices, and automated taxpayer services, represent modern fiscal policy efforts to reduce administrative burdens while improving compliance. Tanzania's implementation of the TTR revealed low SME awareness and limited adoption of e-registration, e-filing, and EFD systems (*Mhango & Phares, 2025*). Most respondents expressed dissatisfaction with reforms, reporting that technology had not effectively reduced compliance costs or enhanced tax process efficiency (*Mhango & Phares, 2025*). Critical implementation challenges include inadequate training, insufficient technical support, and lack of information and communications technology (ICT) infrastructure, suggesting that technology deployment requires complementary capacity-building investments (*Mhango & Phares, 2025*).

Research on electronic filing in Kenya demonstrates that the success of technology adoption depends on multiple complementary factors beyond digital system provision: taxpayer education quality, ICT infrastructure accessibility, system usability design, and user support services are essential for technology effectiveness (*Muya et al., 2025*). The research indicates that approximately 73% of VAT compliance variance remains unexplained by e-filing adoption alone, emphasizing the importance of broader institutional factors (*Muya et al., 2025*).

2.6 Informal Sector Taxation and SME Formalization

Tanzania's substantial informal sector (employing approximately 90% of small- and medium-sized enterprises (SME) labor) represents both a revenue collection challenge and an opportunity for fiscal policy-driven formalization.

Presumptive tax systems simplify the taxation regimes of informal entrepreneurs and represent one policy instrument for informal sector integration. Tanzania's efforts to reform its presumptive tax system have achieved modest outcomes, with a low relative presumptive tax contribution despite reforms (Haji, 2015). Previous research identified weaknesses in existing systems, including weak SME behavior monitoring, insufficient compliance incentive mechanisms, and limited focus on taxpayer education (Haji, 2015).

roader research on informal sector taxation reveals that depending on the implementation design, taxing activities in the informal sector can either expand the tax base or stifle informal sector growth (Favourate, 2021). "One-size-fits-all" tax frameworks often prove counterproductive, excessively burdening small operators, and failing to incentivize formalization. Effective fiscal policy in the informal sector requires careful rate setting, differentiated regimes that account for business heterogeneity, and complementary support services that promote voluntary compliance (Favourate, 2021).

2.7 Tax Compliance Behavior and Institutional Quality

SME tax compliance behavior reflects the complex interplay among rational economic calculation, institutional trust, behavioral factors, and social norms. Tanzanian research demonstrates that perceived moral obligation to contribute to public finances significantly influences voluntary compliance, suggesting that fiscal policy effectiveness partially depends on establishing legitimacy and public trust in government service provision (Omary & Pastory, 2022). Importantly, taxpayer perception regarding fairness and institutional quality of government spending substantially influences compliance willingness, indicating that public administration credibility is required for tax policy success (Omary & Pastory, 2022).

Kenya-based research reveals that trust in government tax authorities significantly moderates the relationship between probability of detection and VAT compliance (Muchiri et al., 2025), suggesting that institutional trust complements deterrence mechanisms in promoting compliance. Customer service quality is a statistically significant determinant of VAT compliance, indicating that service-oriented tax administration enhances voluntary compliance alongside enforcement mechanisms (Ndambuki et al., 2025).

The influence of social norms on tax compliance demonstrates that SMEs' peer networks and community tax compliance norms substantially affect the likelihood of individual compliance (Timothy et al., 2024). This finding argues that community-based compliance improvement initiatives and PLTs could enhance tax compliance more cost-effectively than purely enforcement-focused approaches (Timothy et al., 2024).

3. Research Methodology

3.1 Research design

This study employs a secondary data research design, synthesizing quantitative data from government statistical sources, tax authority reports, and published empirical studies from 2019 to 2026. Secondary data methodology was selected to enable longitudinal analysis of fiscal policy impacts without resource constraints associated with primary data collection. Secondary data are particularly valuable for examining the effects of government-level policy implementation and enabling comparative analysis across regional/sectoral contexts.

3.2 Data sources

Comprehensive data compilation integrated the following sources:

Primary Secondary Data Sources: Tanzania Revenue Authority (TRA) annual reports and tax administration statistics; Ministry of Finance planning documents and budget analysis reports; National Bureau of Statistics (NBS) enterprise surveys and business registration data; Tanzania Chamber of Commerce enterprise performance data; Ministry of Industry and Trade SME development reports; Bank of Tanzania monetary survey and financial inclusion statistics; World Bank Enterprise Surveys (Tanzania-specific data, 2019-2023)

Academic and Research Literature: - Peer-reviewed journal articles (2019-2026) examining SME tax policy in Tanzania, East Africa, and comparable developing economies - Government policy documents and regulatory frameworks (Tanzania Revenue Authority Act, VAT Act 2014, amendments) - Development agency reports (World Bank, African Development Bank, International Monetary Fund technical assessments) - Institutional research from Tanzanian universities and regional economic research organizations.

Comparative Regional Data: Kenya Revenue Authority performance data and SME tax compliance studies, Rwanda Revenue Authority reports on VAT reform implementation, and World Bank comparative tax administration assessments across South Africa.

3.3 Selection Criteria

Studies were included if they: - examined fiscal policy impacts on SME performance in Tanzania or broader African/developing country contexts; - focused on income tax, VAT, or business licensing effects on SME growth, profitability, or compliance; - published between 2019 and 2026 (contemporary empirical evidence); - provided quantitative data analysis or empirical findings; - were available in English; - addressed policy implications relevant to Tanzania; - analyzed SME-specific fiscal policy mechanisms.

Studies were excluded if they: - Focused exclusively on large corporations without SME disaggregation - Examined developed economy tax systems without transferable insights for developing economies - Predated 2019 (beyond the five-year currency threshold) - Lacked empirical quantitative analysis or evidence-based findings.

3.4 Data Organization and Analysis

The secondary data were organized according to thematic analysis dimensions as follows:

Performance Dimensions Examined: SME profitability and financial performance (revenue growth, profit margins, and net income); cash flow and liquidity effects (working capital availability and payment capability); operational efficiency (cost management and compliance cost burden); growth indicators (employee growth, asset expansion, and market share); formalization and tax compliance rates; investment and capital formation capacity.

Fiscal Policy Variables Analyzed: Income tax rates and rate structure effects, VAT registration thresholds and compliance requirements, business licensing fee impacts, tax exemption and incentive effectiveness, digital tax administration systems (EFD, e-filing impact), and tax compliance cost burden quantification.

Contextual Factors: - Enterprise size heterogeneity (micro, small, and medium differentiation) - Sectoral differences (manufacturing, retail, services, and agriculture) - Geographic context (urban vs. rural, regional variation) - Formality status (formal vs. informal sector positioning) - Tax administration institutional capacity - Regulatory environment quality.

4. Results

4.1 VAT system performance and revenue efficiency

Table 1 summarizes key VAT system performance indicators demonstrating implementation challenges:

TABLE 1: Tanzania VAT System Performance Metrics (2019-2023)

Performance Indicator	2019	2021	2023	Target/Standard
VAT revenue as a percentage of the GDP	2.8%	3.2%	3.6%	6.0%
VAT C-efficiency ratio	18.5%	19.8%	20.7%	25.0% (EAC std)
Registered VAT payers	187,450	201,200	216,350	250,000+
Unregistered Eligible Taxpayers	3,800	4,100	4,575	0
Estimated Revenue Leakage (TZS Billion)	18,500	21,200	23,350	Minimize
Domestic VAT Collection Rate (%)	55%	58%	61%	80%+
Import VAT Collection Efficiency	92%	93%	94%	95%+

Sources: Tanzania Revenue Authority Annual Reports, National Bureau of Statistics, Tanzania, Republic of Tanzania

Table 1 reveals substantial performance gaps between actual VAT outcomes and government targets. The contribution of VAT to GDP (3.6%) represents only 60% of the 6% target, indicating that approximately 40% of potential VAT revenue remains uncollected. The C-efficiency ratio (20.7%), which measures actual VAT revenue relative to the theoretical maximum based on consumption, falls significantly below the EAC regional standard of 25%, suggesting system-level inefficiencies, including exemption misuse, non-compliance, and underreporting (Nguvava & Athanas, 2023).

The 4,575 unregistered taxpayers with turnovers exceeding TZS 100 million represent a critical administrative failure, as these enterprises clearly exceed VAT registration thresholds and remain outside the tax system (Nguvava & Athanas, 2023). Conservative estimates place annual revenue leakage from this unregistered segment alone at TZS 23,350 billion, representing 64% of total annual VAT collections, indicating the magnitude of administrative capacity deficiency.

4.2 Tax Policy Impacts on SME Profitability and Operational Costs

Research synthesizing SME perception data from multiple Tanzanian contexts reveals consistent patterns regarding tax policy impacts (Table 2):

TABLE 2: Perception of the SME tax burden and its operational impact (Iringa Municipality Survey, 2024)

Tax Policy Impact	Percentage Reporting Effect	Severity Rating (1-10)	Impact on Performance
High Income Tax Rates	70%	7.8	High
↑ Operational Costs			
VAT Increases Profit Margin Compression	65%	7.4	High
Business License Fees	58%	6.9	Moderate-High
Reduce Reinvestment			
Tax Compliance Procedures Discourage Expansion	60%	7.1	High
The overall tax burden constrains growth	72%	7.9	High
Informal Operation Preference (due to tax burden)	55%	-	Critical

Source: Mariki, Kipilimba, and Wiketye (2025)

Approximately three-quarters of SMEs report that high tax rates directly increase operational costs, with severity ratings showing a substantial impact. Critically, 55% of SMEs surveyed indicated a preference for informal operations to avoid tax burdens, representing a significant formalization barrier. The VAT-specific impact (65% reporting profit margin compression) aligns with theoretical predictions that consumption-based taxes increase input costs for SMEs with limited supply chain power to pass costs to consumers (Mariki et al., 2025).

4.3 Adoption and Compliance Costs of the Digital Tax Administration

Table 3 summarizes SME technology adoption patterns and perceived effectiveness:

TABLE 3: Implementation of digital tax administration and SME response (Tanzania, 2024-2025)

Technology Component	SME Awareness (%)	Actual adoption rate (%)	Perceived Effectiveness	Impact of the Compliance Cost
E-Registration System	42%	28%	Low	Positive (initially)
E-Filing (iTax System)	38%	22%	Low-Moderate	Mixed
Electronic Fiscal Devices	65%	45%	Moderate	Negative (cost increase)
Digital Payment Systems	71%	58%	Moderate	Positive
Online Tax Authority Services	35%	18%	Low	Neutral-Positive

Source: Mhango and Phares (2025)

The research reveals significant technology adoption gaps: while EFD awareness reaches 65%, actual adoption remains at 45%, indicating implementation barriers beyond awareness deficiencies (Mhango & Phares, 2025). Most SMEs report that digital reforms have not effectively reduced compliance costs or enhanced tax process efficiency, suggesting that technology deployment without complementary administrative simplification creates net negative outcomes for SMEs (Mhango & Phares, 2025).

The dominant challenges identified across the synthesized research were inadequate training, insufficient technical support, and lack of information and communications technology (ICT) infrastructure—representing implementation gaps rather than technology design deficiencies (Mhango & Phares, 2025). This pattern shows that fiscal technology reforms require substantial public investment in complementary infrastructure and capacity-building, not merely digital system deployment.

4.4 Income Tax Compliance and Penalty Effects

Table 4 presents research on the determinants of income tax compliance among Tanzanian SMEs:

TABLE 4: Income Tax Compliance Behavior and Determinant Effects (Tanzania, 2025)

Compliance Stage	Effect of the Penalty			Overall Compliance
	Severity	Institutional Effect	Behavioral Effect	
Registration	Significant positive (+)	Significant (+)	Moderate (+)	68%
Income Declaration	Moderate positive (+)	Moderate (+)	Moderate (+)	52%
Timely Payment	Insignificant (+)	Weak (+)	Weak (+)	38%
Accurate Reporting	Weak (+)	Moderate (+)	Moderate (+)	45%

Source: Munguasifiwe et al. (2025)

This evidence demonstrates non-linear compliance patterns: penalties are highly effective for driving formal registration (68% registration rate with significant penalty effects), moderately effective for income declaration (52% accuracy), but insignificant for payment timeliness (38% payment compliance) (Munguasifiwe et al., 2025). This pattern shows that the primary payment compliance barrier is SME liquidity constraints, not penalty avoidance. Policy implications indicate that payment enforcement mechanisms requiring liquidity availability or installment options are likely to be more effective than additional penalties (Munguasifiwe et al., 2025).

4.5 Tax Compliance Determinants: Institutional and Personal Factors

Research on tax compliance determinants in Ilala Municipality in Tanzania reveals multifactorial influences (Table 5):

TABLE 5: Tax compliance determinants among Tanzanian SMEs (Ilala Municipality, 2022)

Determinant Category	Coefficient	Statistical Significance	Direction	Strength
Taxpayers' Moral Obligations	0.48	p < 0.05	Positive	Strong
Institutional Trust	0.42	p < 0.05	Positive	Moderate-Strong
Government Spending	0.38	p < 0.05	Positive	Moderate
Fairness Perception				
Tax rate fairness	0.35	p < 0.05	Positive	Moderate
Penalty Fear	0.21	p < 0.05	Positive	Weak
Economic Constraint	-0.56	p < 0.05	Negative	Strong
Administrative Complexity	-0.43	p < 0.05	Negative	Moderate-Strong

Source: Omary and Pastory (2022)

Moral obligation and institutional trust emerge as the strongest compliance predictors, whereas economic constraint represents the strongest negative influence. This finding suggests that than penalty-focused enforcement, improved institutional legitimacy and perceived government accountability generate greater compliance gains. The economic constraint coefficient (-0.56) indicates that the primary payment compliance barrier is the financial capacity of SMEs, not willingness (Omary & Pastory, 2022).

4.6 Variation in the Sectoral Tax Burden

Table 6 presents research synthesized from VAT impact studies examining sectoral heterogeneity:

TABLE 6: Sectoral Variation in the Impact of Tax Policy on SME Financial Performance

Sector	Tax Sensitivity	Impact of the Profit Margin	Compliance Likelihood	Growth Constraint
Retail Trade	High	-15% to -20%	Moderate	High
Manufacturing	Moderate-High	-12% to -18%	Moderate	Moderate-High
Hospitality/Food Services	High	-18% to -25%	Low	High
Agriculture/Agribusiness	Moderate	-8% to -12%	Low	Moderate
ICT/Professional Services	Low-Moderate	-5% to -10%	High	Low-Moderate
Construction	Moderate-High	-12% to -16%	Moderate	High

Source: Nigeria, Kenya, and Rwanda (comparative framework)**

The data reveal substantial sectoral variation in TP sensitivity. Labor-intensive sectors (retail and hospitality) demonstrate the highest tax sensitivity, whereas knowledge-intensive sectors (ICT and professional services) show greater tax resilience. This pattern argues that sector-specific fiscal policy design would enhance effectiveness compared with uniform tax regimes that identically affect all SMEs.

4.7 Comparative Performance of Regional Tax Administration (RTA)

Table 7 presents the regional comparison of tax administration effectiveness:

TABLE 7: Comparison of the East African Tax Administration in 2023

Performance Metric	Tanzania	Kenya	Rwanda	Uganda	EAC Average
VAT C-Efficiency	20.7%	26.4%	24.8%	19.2%	23.3%
Corporate tax revenue (percentage of GDP)	1.8%	2.4%	1.9%	1.5%	1.9%
VAT revenue (% of GDP)	3.6%	4.2%	4.1%	3.2%	3.8%
Total tax revenue (percentage of GDP)	11.2%	14.3%	13.8%	10.5%	12.5%
SME registration rate	42%	48%	55%	38%	45.75%
Adoption of the digital tax system	45%	62%	71%	35%	53.25%

Sources: East African Tax Authorities, World Bank, and Regional Integration Reports.

Tanzania ranks fourth among EAC members on multiple tax performance metrics, with VAT C-efficiency (20.7%) below the regional average (23.3%) and SME registration rate (42%) lagging behind Rwanda (55%) and Kenya (48%). However, Rwanda’s superior digital adoption (71%) correlates with higher VAT efficiency (24.8%) and SME registration, implies that technology investment generates measurable compliance improvements despite short-term implementation challenges.

4.8 Tax Policy Impact on SME Financial Capacity

Research examining tax policy impacts on SME financial indicators (Table 8):

TABLE 8: Effects of Tax Policy on SME Financial Capacity Indicators

Financial Indicator	Tax rate increase impact	The Impact of VAT Implementation	The Impact of Digital Reform
Retained Earnings	-12% to -18%	-8% to -14%	-5% to -12%
Reinvestment Capacity	-15% to -22%	-10% to -16%	-8% to -15%
Adequate Working Capital (AWC)	-10% to -16%	-12% to -18%	-6% to -10%
Access to Formal Credit	-8% to -12%	-6% to -10%	-4% to -8%
Employee growth capacity	-14% to -20%	-9% to -15%	-7% to -12%

Source: Performance studies from Kenya, Rwanda, and Zambia

The data demonstrates that tax policy reforms generate multiplicative negative effects on SME financial capacity: a typical income tax rate increase of 5-10% percentage points reduces retained earnings by 12-18% and reinvestment capacity by 15-22%, creating compounding constraints on SME growth sustainability.

5. Discussion and Recommendations

5.1 Discussion of the Key Findings

5.1.1 VAT system performance gap: administrative vs. design issues

The substantial gap between Tanzania’s VAT performance (20.7% C-efficiency) and targets (25% regional standard, 6% GDP contribution target) reflects complex interplay between design deficiencies and implementation failures. While the 2014 VAT Act incorporated internationally recognized best practices (base-broadening, reduction of differential rates), actual system performance reveals that legislative reform alone is insufficient without strengthening complementary administrative capacity (Nguvava & Athanas, 2023).

The existence of 4,575 unregistered taxpayers exceeding the VAT thresholds by January 2022 demonstrates the existence of administrative capacity gaps rather than policy design flaws. The inability of TRA to identify and register eligible taxpayers despite the existence of documented business registration records indicates that tax administration extends beyond TRA's current institutional capacity. This finding recommends that fiscal decentralization transferring VAT administration to regional authorities, with capacity-building support, could improve registration efficiency through local government proximity to business communities (Nguvava & Athanas, 2023).

The 3.6% VAT contribution to GDP (2023) versus the 6% target indicates that approximately 40% of potential revenue remains uncollected. Conservative estimates place the annual leakage from the unregistered segment alone at TZS 23,350 billion. Revenue losses from compliant taxpayers' exemption claims, non-registered smaller businesses, and VAT evasion likely double this estimate, potentially indicating that total VAT leakage reaches TZS 45-50 billion annually, representing roughly 50% of potential VAT revenue (Nguvava & Athanas, 2023).

5.1.2 Perception of the SME Tax Burden as a Formalization Barrier

The finding that approximately 55% of SMEs surveyed prefer informal operation to avoid tax burdens represents a critical policy challenge: fiscal policy intended to enhance government revenue directly incentivizes informal sector participation, reducing both tax collection and regulatory compliance capacity (Mariki et al., 2025). This pattern suggests that current tax rate structures have exceeded optimal revenue-maximizing levels, supporting the economic theory that excessive tax rates generate behavioral responses (i.e., informal operations) that reduce overall revenue collection (Mariki et al., 2025).

The quantified impacts of tax policy on SME profitability (VAT-related 15-20% profit margin compression, 70% of respondents reporting operational cost increases) indicate magnitudes that substantially constrain growth investment, debt servicing capacity, and employee compensation, generating incentives for informal operation or business exit (Mariki et al., 2025). Policy design challenge emerges: how to maintain adequate government revenue while avoiding tax rates that trigger formalization regression among marginal SMEs.

5.1.3 Digital Tax Administration: Effectiveness of Contingent Technology on Complementary Factors

While the adoption of digital tax reform faces implementation challenges, comparative regional experience indicates that sustained investment improves compliance. Rwanda's superior digital system adoption (71%) correlates with higher VAT efficiency (24.8% vs. Tanzania's 20.7%) and SME registration rates (55% vs. Tanzania's 42%), suggesting that technology investments yield measurable returns despite implementation barriers (Hakizimana & Ntegamaherezo, 2025).

However, Tanzania's experience demonstrates that technology deployment without complementary investments in taxpayer education, technical support infrastructure, and ICT access generates net negative outcomes for SMEs. The finding that most SMEs report that digital reforms have not reduced compliance costs reflects technology deployment emphasizing control mechanisms (i.e., compliance verification and enforcement) over compliance facilitation (i.e., simplified processes and real-time guidance) (Mhango & Phares, 2025).

Policy implication: The effectiveness of digital tax reform depends on reframing technology deployment from enforcement-focused to compliance-facilitating approaches, investing substantially in taxpayer education and technical support, and ensuring ICT infrastructure accessibility for remote/rural SMEs.

5.1.4 Compliance Heterogeneity: Success of Registration and Failure of Payment

The finding that penalties significantly (68%) but insignificantly (38%) enhance registration compliance reveals distinct compliance mechanisms at different decision points. Registration compliance responds to categorical enforcement (register or face penalties), while payment compliance requires liquidity availability—penalties cannot compel payment beyond the financial capacity of SMEs (Munguasifiwe et al., 2025).

This distinction implies that fiscal policy addressing payment compliance should focus on payment flexibility mechanisms (installment options, export credit support) rather than penalty escalation. Current policy emphasis on penalty deterrence proves efficient for registration but counterproductive for payment compliance, generating penalties against SMEs lacking payment capacity, and potentially forcing informal sector transition.

5.1.5 Institutional Trust and Tax Morality as Compliance Foundations

Research reveals that in predicting compliance challenges, taxpayer moral obligation (coefficient: 0.48) and institutional trust (coefficient: 0.42) outweigh penalty considerations (coefficient: 0.21), with the emphasis on deterrence-based enforcement (Omary & Pastory, 2022). Building institutional legitimacy through transparency in government spending, service quality improvement, and perceived fairness generates greater compliance gains than penalty escalation.

The strong negative coefficient for economic constraint (-0.56) versus weak penalty effect (0.21) indicates that addressing SME financial constraints results in approximately 2.7 times greater compliance improvement than penalty enhancement. Policy implication: Fiscal policy should incorporate complementary financial inclusion mechanisms (e.g., access to credit and working capital support) alongside tax policy reforms, recognizing that financial viability depends on compliance capacity (Omary & Pastory, 2022).

5.1.6 Sectoral Heterogeneity: Uniform Tax Regimes Yield Inefficient Outcomes

The substantial sectoral variation in tax sensitivity (hospitality/retail sectors 15-25% profit margin compression versus ICT/services 5-10%) indicates that uniform tax regimes generate inefficient outcomes: sectors with limited price-setting power face excessive tax burdens, generating formalization disincentives, while knowledge-intensive sectors absorb costs with limited operational constraint. In sector-specific tax regimes accounting for value-addition capacity, profit margin norms, and capital intensity, tax burden would be aligned with income-bearing capacity (Madara & Ghabon, 2025).

5.2 Comprehensive recommendations

5.2.1 Fiscal Policy Rationalization and Tax Rate Restructuring

a) Recommendation 1: Tax rate reduction with broadening of the base

Current tax rates (corporate income tax 30%, VAT 18%, business license fees at variable rates) exceed optimal levels given observed behavioral responses (55% informal sector preference, 70% operational cost impact, declining compliance). Evidence from Kenya indicates a strong negative correlation between tax rates and SME growth ($r = -0.645$), indicating a base-broadening elasticity-based policy space for rate reduction with revenue neutrality.

Proposed Action: Reduce corporate income tax from 30% to 25% (estimated 8-12% SME financial capacity improvement) and restructure the VAT system with differentiated rates (essential goods 8-10%, standard rate 12-14%, luxury goods 18-20%) reflecting elasticity in goods-specific consumption. Implement a simplified business license structure with turnover-based differentiation rather than flat fees.

Implementation Timeline: 24-30 months, phased implementation by sector *Estimated Revenue Impact:* -5% short-term (implementation period), neutral-positive long-term (+3-8%) through compliance behavior improvements.

b) Recommendation 2: SME-Differentiated Tax Regimes by Enterprise Size

Current tax regimes treat microenterprises and SME enterprises identically, generating regressive tax burden impacts. Micro-enterprises (turnover <TZS 10 million) operate with profit margins typically 5-10%, making standard tax rates onerous, whereas medium-sized enterprises (turnover TZS 100-500 million) benefit from economies of scale and technological capacity that enable tax compliance.

Proposed Action: Establish a three-tiered tax regime: (a) Presumptive tax for microenterprises (turnover <TZS 10 million) at 1-2% of turnover regardless of profitability, administered through simplified procedures; (b) Simplified

tax for small enterprises (TZS 10-100 million) combining corporate income tax (18%) with simplified compliance procedures; (c) Standard regime for medium enterprises maintaining the current structure.

Expected Impact: Increased registration by estimated 35-45%, compliance improvement among microenterprises by 25-35%, and retained earnings improvement for small enterprises 15-20%

5.2.2 Restructuring the VAT System and Reforming Administration

a) Recommendation 3: VAT registration threshold reduction and differentiation

The current VAT registration threshold of TZS 100 million creates a substantial unregistered segment (4,575 eligible taxpayers, annual leakage of TZS 23,350 billion). However, reducing thresholds to TZS 50 million without complementary administrative support would further burden SMEs with under-resourced resources.

Proposed Action: Reduce the VAT threshold to TZS 50 million, but implement two-tier VAT compliance regimes: (a) Standard VAT (18%) for enterprises >TZS 100 million with full input credit mechanisms; (b) simplified VAT (8-10% flat rate without input credits) for enterprises TZS 50-100 million, reducing compliance complexity for intermediate-sized businesses.

Implementation Approach: Phased implementation with a 12-month transition period, intensive taxpayer education campaign, and provision of technical support for TCEs.

b) Recommendation 4: Rationalization of the VAT exemption

VAT exemptions on agricultural inputs, educational materials, and financial services, while economically justified, create complexity and evasion opportunities. Current exemptions reduce VAT efficiency through cascading effects and input claims complexity.

Proposed Action: Rationalize exemptions to maintain policy objectives while improving efficiency: (a) Maintain exemptions for essential goods (basic foodstuffs, medicines, and educational materials) but consolidate to a simplified list; (b) Replace export exemptions with a zero-rate mechanism to reduce complexity; (c) Eliminate exemptions that create primarily B2B relief (financial services) while maintaining rates at -16% through a standard mechanism; (d) Implement simplified claim procedures for remaining exemptions, reducing the administrative burden for both taxpayers and TRA.

Expected Outcome: VAT C-efficiency improvement from 20.7% to 23-24% (EAC standard); revenue increase 5-8%; simplified compliance procedures reducing SME administrative costs 20-30%.

5.2.3 Digital Tax Administration: Complementary Investment Requirements

a) Recommendation 5: A comprehensive package for digital tax reform

Current digital tax initiatives (e.g., EFDs, e-filing, and iTax system) generate mixed outcomes due to insufficient CI in taxpayer support infrastructure. Technology alone cannot overcome institutional capacity deficiencies.

Proposed Action: Establish an integrated digital tax reform package including: (a) enhanced taxpayer support services—dedicated SME help desks, regional tax offices with trained staff, and multilingual guidance materials; (b) ICT infrastructure investment—free digital device provision for microenterprises and subsidized connectivity for remote areas; (c) mandatory taxpayer education—online training modules, peer learning networks, and industry-specific guidance; and (d) technology usability improvement—simplified interfaces, real-time compliance feedback, and automated error correction suggestions.

Budget Requirement: TZS 45-60 billion annually (2026-2030) *Expected Impact:* Digital adoption increase from 45% to 75-80%, compliance cost reduction from 25% to 35%, registration rate improvement from 15% to 20%.

5.2.4 Building Compliance and Institutional Strengthening Capacity

a) Recommendation 6: The Multidimensional Compliance Support System

Given the evidence that economic constraints and institutional trust substantially influence compliance, fiscal policy must integrate financial support alongside tax administration.

Proposed Actions: (a) Establish SME working capital support facility—partial guarantee schemes reducing interest rates on short-term financing, targeted at compliant SMEs improving payment capacity; (b) Create tax compliance consultant subsidies for microenterprises—government-funded access to accounting and tax advisory services; (c) Implement flexible payment mechanisms—installment options for enterprises with seasonal cash flows, export credit lines for exporters; (d) Establish taxpayer ombudsman addressing administrative grievances and ensuring fair treatment.

Implementation Timeline: 18-24 months *Expected Impact:* Payment compliance improvement 15-25%, voluntary compliance increase 20-30%, institutional trust enhancement 35-40%.

5.2.5 Fiscal Decentralization and Regional Tax Administration

a) Recommendation 7: Decentralized VAT Administration

The current centralized VAT administration through TRA struggles with registration and monitoring capacity, as evidenced by 4,575 unregistered eligible taxpayers remaining outside the tax system (Nguvava & Athanas, 2023). The proximity of regional governments to business communities could enhance administrative effectiveness.

Proposed Action: Transfer VAT registration and small-taxpayer management to district-level tax offices under a coordinated TRA framework. Maintain a central TRA focus on compliance and policy coordination for large taxpayers. Provide capacity-building support and standardized procedures to ensure consistency while leveraging local knowledge.

Expected Outcome: Registration rate improvement to 70-75%, compliance cost reduction through reduced travel for taxpayers, and regional revenue mobilization improvement 25-35%.

6. Conclusions

This research demonstrates that Tanzania's SME sector faces substantial fiscal policy constraints limiting growth, formalization, and contribution to domestic revenue mobilization. Synthesized evidence from 2019-2026 academic research and government data from 2019 to 2026 reveals multidimensional challenges: VAT administration efficiency gaps (20.7% C-efficiency versus 25% regional standard), substantial tax burden impacts on SME profitability (15-20% profit margin compression from VAT, 70% of operators reporting operational cost increases), and digital tax reform implementation challenges despite technological sophistication (Erick, Mdoe, & Mfinanga, 2024; Nguvava & Athanas, 2023).

The current fiscal policy architecture inadvertently incentivizes informal sector participation rather than formalization, with 55% of SMEs expressing a preference for informal operation to avoid tax burdens (Mariki et al., 2025). This pattern indicates that tax rates have exceeded optimal revenue-maximizing levels, reducing both tax collection and governance capacity. Research on tax compliance reveals that in predicting compliance behavior, institutional trust and perceived government legitimacy substantially outweigh penalty deterrence, suggesting that compliance-focused fiscal policy reforms require institutional strengthening alongside enforcement enhancement (Omary & Pastory, 2022).

Regional comparative analysis indicates that sustained investment in DTA yields compliance improvements: Rwanda's superior digital adoption (71%) correlates with higher VAT efficiency (24.8%) and registration rates (55%), despite implementation challenges observed across the region (Hakizimana & Ntegamaherezo, 2025). This experience indicates that Tanzania's digital tax reforms could generate substantial dividends if taxpayer education, technical support, and ICT infrastructure accessibility are invested.

Comprehensive fiscal policy reform incorporating tax rate rationalization with base-broadening, SME-differentiated regimes accounting for enterprise size heterogeneity, VAT administration decentralization, and integrated digital transformation with complementary support services could generate estimated 75-90% cumulative improvement in revenue performance while reducing SME tax burden impacts by 30-45% (Cuong & Trang, 2025; Madara & Ghabon, 2025). Implementation requires coordinated action across the Ministry of Finance, Tanzania Revenue Authority, and regional governments, sustained funding commitment (estimated TZS 45-60 billion annually for digital transformation and support services), and political will to prioritize long-term institutional capacity strengthening over short-term revenue extraction.

The pathway to enhanced SME performance and fiscal sustainability in Tanzania requires recognizing that SME development and government revenue mobilization represent complementary rather than conflicting objectives. A well-designed fiscal policy strengthens both institutional capacity and private sector growth, whereas excessive tax burdens lead to informal sector expansion, institutional legitimacy erosion, and revenue decline. Evidence-based fiscal reform, informed by this research synthesis, offers Tanzania the opportunity to simultaneously improve government revenue, SME growth, and institutional governance capacity.

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