Effects of Value Added Tax (VAT) Knowledge on SMEs Performance and Factors Affecting SMEs Performance in Morogoro Tanzania

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ABSTRACT

Small and Medium-sized Enterprises (SMEs) play a crucial role in driving economic growth and development in Tanzania. However, the performance of SMEs is hindered by various factors, including the challenges posed by value-added tax (VAT). This study investigates the effects of VAT knowledge and other factors on the performance of SMEs in Morogoro, Tanzania. The research objective is to provide a comprehensive understanding of the key determinants influencing SME success and growth in the region. The study assesses the level of VAT knowledge among SME owners, examines the relationship between VAT knowledge and SME performance, and analyses the impact of factors such as business location, initial capital investment, years of experience, and type of business on overall SME performance. The supply and demand theory are employed as the theoretical framework to understand how changes in costs, induced by VAT, affect the supply decisions of SMEs and consumer responses to price changes. Despite government efforts to address challenges faced by SMEs through regulatory simplification, tax reforms, and digitalization, the performance of SMEs continues to be hindered by VAT-related administrative costs, pricing, and forecasting customer needs. This study aims to fill the research gap by providing valuable insights and recommendations for policymakers and business stakeholders to foster a supportive environment that promotes the sustainable growth and development of the SME sector in Tanzania.

Keywords: Economic Growth, Business Costs, Small and Medium-sized Enterprises (SMEs), Value-Added Tax (VAT)

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I. INTRODUCTION

Small and Medium-sized Enterprises (SMEs) play a pivotal role in driving global economic growth, serving as catalysts for development at local, national, and international levels (Singh et al., 2019). The significance of SMEs manifests through their contributions to job creation, fostering innovation, diversifying industries, enhancing adaptability, intensifying competition, and boosting exports, all of which collectively contribute to the Gross Domestic Product (GDP) of their respective countries (Herculina et al., 2022; Kanire et al., 2024). According to the World Bank Statistics Report (2023), SMEs constitute nearly 90% of the world's businesses and provide 50% of global employment opportunities (Dimoso & Andrew, 2021; The World Bank [WB], 2023; Kitole, 2023; Kitole & Esabo, 2022). Furthermore, the WB's (2023) business report indicates the presence of approximately 44 million SMEs in Africa. In Tanzania, reports released by the National Bureau of Statistics (NBS) and the Economic and Social Research Foundation (ESRF) in 2021 reveal the existence of more than three million SMEs employing over five million individuals (Kitole & Esabo, 2024; ESRF, 2016).

Despite the significant contributions of SMEs to Tanzania's economy, value-added tax (VAT) poses a challenge that, if not properly regulated, can discourage the emergence of new SMEs and lead to the decline of many existing ones (Kitole & Utouh, 2023; Debala, 2023). The NBS (2020) integrated labor survey, conducted in 2015, revealed that out of 154,618 surveyed SMEs, only 82,238 (53.19%) remained in business for no more than five years (Fumbwe et al., 2021). This finding indicates that over half of the enterprises experience a decline and ceasing operations. One reason cited for this phenomenon is that VAT increases the prices of commodities, consequently reducing the market share of SMEs' products.

In response to these challenges, the government of Tanzania has made notable efforts to address the situations that hinder the performance of SMEs. These efforts include simplifying regulatory procedures, implementing tax reforms, and promoting digitalization to enhance the efficiency of VAT payments (United Republic of Tanzania (URT), 2023. However, despite these initiatives, the performance of SMEs continues to be impeded by increased business operation costs, such as compliance expenses and day-to-day cash flow obstacles arising from the requirement to pay VAT prior to receiving customer payments (Sidek, 2022). The administrative costs associated with VAT regulations, particularly those related to pricing and forecasting customer needs, cause distress for most SMEs (Mohammed and Abdulraqeeb, 2022; Kanire et al., 2024). This study examines the effects of VAT knowledge and other factors on SME performance in Morogoro, Tanzania. By understanding the impact of VAT and identifying the key determinants of SME performance, this study provides valuable insights for policymakers and business stakeholders to support the growth and development of the SME sector.

1.1 Problem Statement

Despite the efforts made by the government to address the challenges faced by SMEs in Tanzania, such as simplifying regulatory procedures, tax reforms, and promoting digitalization, the performance of SMEs continues to be hindered by factors related to value-added tax (VAT). The administrative costs associated with VAT compliance, pricing, and forecasting customer needs pose significant obstacles for SMEs. There is a lack of a comprehensive understanding of how VAT knowledge and other factors impact the performance of SMEs in Tanzania, particularly in the context of Morogoro. This study aims to fill this gap by investigating the effects of VAT knowledge and identifying key determinants of SME performance.

1.2 Research Objective

The primary objective of this study was to investigate the impact of value-added tax (VAT) knowledge and various other factors on the performance of Small and Medium-sized Enterprises (SMEs) in Morogoro, Tanzania. This study aims to provide a holistic understanding of the key determinants that influence the success and growth of SMEs in the region. To achieve this, the study assessed the level of VAT knowledge among SME owners in Morogoro and examined the relationship between VAT knowledge and SME performance. Additionally, the study identified and analyzed the effects of crucial factors such as business location, initial capital investment, years of experience, and type of business on the overall performance of SMEs. Through a thorough investigation and analysis of these aspects, the study pursued to provide valuable insights and recommendations for policymakers and business stakeholders to foster a supportive environment that promotes the sustainable growth and development of the SME sector in Tanzania.

II. LITERATURE REVIEW

2.1 Theoretical literature review

The supply and demand theory are traced back to several economics' pioneers. However, it gained prominence in the late 18th century with the works of Adam Smith, who developed this theory in his seminal work 'The Wealth of Nations,' published in 1776."Supply and demand theory posits that in a competitive market, the price and quantity of goods are determined by the intersection of the supply and demand forces, which are stated as the law of demand. It states that as the price of a good decreases, the quantity demanded increases, and vice versa at ceteris paribus. Conversely, the law of supply asserts that as the price of a good increases, the quantity supplied increases, and as the price decreases, the quantity supplied decreases, ceteris paribus (Msacky & Mmassy, 2022). The supply and demand theory is highly relevant in this study in studying the effect of Value Added Tax (VAT) on Small and Medium-sized Enterprises (SMEs) performance. The theory helps to understand how changes in costs, induced by VAT, affect the supply decisions of SMEs and how consumers respond to changes in prices. Using this theory, the dependent variable is the quantity of demanded and supplied goods and services which measures the performance of SMEs while the independent variable is the cost of goods and services which is affected by the imposition of VAT which accelerates the production costs.

The demand and supply theory in this theory is strengthened due to its predictive power as the theory provides the robust framework on examining how the prices of the goods and services change due to imposition of VAT and how this is going to affect the supply and demand decisions of the SMEs and customers respectively. However, despite the strengths, this theory is also attacked due to the application of ceteris paribus condition which paves the way of neglecting other variables which might affect the quantity demanded and supplied. Also, demand and supply theory assume that the SMEs have to operate under perfect competitive markets which is characterized by the presence of many

buyers and sellers, no government intervention, no alternation of prices since both buyers and sellers are taken as price takers as they take the price as given as determined by the market forces of demand and supply and symmetric information among the buyers and sellers.

Generally, despite the weaknesses of this theory, the theory is a powerful tool in explaining how the prices of the goods and services change due to imposition of VAT and how this is going to affect the supply and demand decisions of the SMEs and customers respectively.

2.2 Empirical Literature Review

According to Singh (2019) who examined the Impact of Value Added Tax on Business Enterprises in Mettu Townin Ethiopia, a study which has the main objective of examining the impact of value addition tax on business enterprises in Ethiopia particularly in Mettu Town of Oromia region. In this study both primary and secondary data were used in which primary data were collected from the 350 business owners who were obtained by judgmental sampling technique and secondary data were obtained from State Bureau Authority. Data analysis was done using descriptive analysis because qualitative research design was employed and therefore most of the data collected were qualitative in nature. This study came to find a contradictory results on impact of VAT on business entrepreneurship in Ethiopia since the findings show that VAT is not a sole factor that impact the performance of SMEs in Ethiopia. Some other factors such as nature of business, location where business is positioned, business experience and number of employees also impact the performance of SMEs in Ethiopia in which when the business with food related goods, located in urban areas with large number of people, more business experience and large number of trained employees is likely to perform better.

Similarly, another study written by Debala (2023) called dynamic effects of VAT collection on SMEs performance and its determinants in Benishangul-Gumuz region Ethiopia which used mixed explanatory cross sectional survey research design with both primary and secondary data in which 281 sample size was used out of which 261 were tax paying SMEs and 21 tax officers who are directors and supervisors. The employed proportional and purposive sampling method. The study adopted binary logistic regression analysis to find the VAT negatively affect the performance of SMEs as it was used in Ethiopia while the factors which determine the payments of VAT are tax payers, knowledge on tax, tax law enforcement and tax staff knowledge on better ways to collect tax.

Furthermore, Chindengwike (2022) conducted a study titled 'The Influence of VAT on SMEs Performance in Developing Countries,' which employed secondary data with a time series design in Tanzania from 1998 to 2020."The data were taken from Tanzania Revenue Authority (TRA) and Bank of Tanzania (BOT) as well as World Bank (WB). In this study cointegrations method was used and came to find that VAT has negative correlations with the growth of business sector in Tanzania.

In contrast, Kuria (2018) conducted a study titled 'The Effect of VAT Incentives on the Performance of SMEs in Kenya.' The main objective was to determine the effect of VAT incentives on the performance of SMEs in Kenya. The study employed a correlation research design with a sample size of 86 registered SMEs." In this study questionnaire was used as a tool of primary data collection, while secondary data such as Returns on Investments (ROA), number and value of jobs and the number of years that an SMEs stays in the business. Then, finally, using both descriptive and inferential statistics, this study revealed that VAT at 5% significance level had a positive and positive correlation with SMEs performance and number of jobs and value which was measured using ROA.

Furthermore, in Kenya, as outlined by Kamar (2015), SMEs provide job opportunities, foster innovation, competition, and economic growth."This study which was done in Kenya with the main objective of examining the effects of government taxation policy on performance of SME in Kenya and particularly Uasin Gishu County. In order to achieve the purpose of this study, the specific research objective was addressed: to find out the effects of government taxation policy on sales revenue of SME. In this study both primary and secondary data were used making the total sample of 180 individuals who were selected using stratified sampling technique. Using explanatory research design and application of questionnaire, interview and document analysis for data collection, this study found that government VAT taxation policy has significant effect on the performance of SMEs. The researcher added that, higher VAT rates significantly lead to poor performance of SMEs due to lack of customers who avoid higher prices. Concurrent to this study, Ma (2018) on his study called Effective Tax Planning of Value - Added Tax under the Background of Small and Medium Enterprises Business Tax Change to Value-added Tax which was conducted in Shandong using paper review analysis, the study came to find that Small and Medium Enterprises are very important component of the local economy as they create employment opportunities which has a pivotal role for local, national and global economy, however, the setting of VAT and Pay As You Earn (PAYE) is retarding the performance of SMEs since higher tax rates reduce their profit margins and therefore the ROA gets reduced.

The study called The Impacts of Value-Added Tax Audit on Tax Revenue Performance: The Mediating Role of Electronics Tax System, Evidence from the Amhara Region, Ethiopia which was done by Mu (2022) using primary data sources from 377 VAT registered taxpayers in Amhara Region which applied Ability to Pay taxation theory, structural equation model, path diagram, and multiple regression with SPSS software for data analysis to identify the relationship between VAT rates and audit and tax revenue performance. This study revealed that inefficient tax rates and audits associated with poor tax education to taxpayers significantly reduce the performance of SMEs in Amhara region.

III. METHODOLOGY

This study employed cross sectional research design, since the data was collected from 240 SMEs who were purposively chosen from 600 SMEs in Morogoro urban to form a sample at one point in time. Therefore, the study used primary data from SMEs. SMEs have been chosen in this study using purposive sampling technique since the researcher ought to get necessary information from the sample which has information about the effects of VAT on the performance of SMEs and therefore the tax paying SMEs became the best sample in this study. Further, descriptive, and linear regression model analysis were employed to examine the effects of VAT on the sales of SMEs. Moreover, variable used in this study have been explained at Table 1.

Table 1
Variables, Descriptions, Measurements, Category and Expected Relationship

S/N	Variables Description	What does it measure	How to measure it	Type of variable measurement	Expected sign
1	Number of sales	Number of sales measure the number of supplies that SME sells.	This measures the quantity of goods supplied by SMEs.	Descriptive	+
2	Type of goods and services sold	This measures the category that goods and services belong	This was measured by considering if goods and services measured are food related or non-food related goods	Categorical	+
3	VAT education	Measures VAT education that SME seller has	This was measured by considering if SME received any VAT education/training or not	Categorical	+
4	Years of experience	Measures the number of years SME has been operating	This was measured by the number years SME has been operating	Continuous	+
5	Capital	Measures the amount of capital invested in business	This was measured by considering the capital invested by SME in business	Continuous	+
6	Number of workers in SME	Measures the number of workers in SME	This was measured by considering the number of workers in SME	Continuous	+
7	Sex of SME's owner	Measures sex of SME' s owner	This was measured by the sex of SMEs owner	Categorical	+
8	Location	Measures the area where SME is operating	The residing area was the location of a SME, whether the SME is in central district business area or not	Categorical	+

IV. FINDINGS & DISCUSSIONS

4.1 Response Rate

Results in Tabe 2 show that out of the total, 190 (79.17%) were male, while 90 (20.83%) were female. This information indicates that the majority of the SMEs owners were males. Moreover, 200 SMEs equivalent to 83.3% of all SMEs were located in central business areas while 40 SMEs which is equivalent to 16.7% were located in periphery region of the district.

Table 2

Description of SMEs Characteristics

Variables	Frequency	Percent
Male	190	79.17
Female	50	20.83
Total	**240**	**100**
Central Business Area	200	83.33
Periphery Business Area	40	16.77
Total	**240**	**100**
Received	60	25
Not received	180	75
Total	**240**	**100**
Food related business	110	45.83
Non-food related business	130	54.17
Total	**240**	**100**

Additionally, regarding the reception of VAT education or training to SMEs owners, results in Table 2 indicates that among the total sample of 240 SMEs owners, only 60 SMEs (25%) had VAT education/training, while 180(75%) which is majority of SMEs had never received VAT education or training. Results on the type of business that SMEs are doing indicate that out of the total sample population of 240 SMEs, 110 SMEs (45.83%) deals with food related business, while 130 (54.17%) deals with non-food related business.

Table 3

Descriptive Statistics for Continuous Variables

Variable	Observation	Mean	Standard error	Minimum	Maximum
Number of workers	240	6	1.932235	1	16
Years of experience	240	4.5	1.09391	1	20
Capital invested	240	500,000	15,000.37	150,000	10,000,000

Table 3 provides the descriptive results for the number of workers, years of experience and initial capital invested in business. The table includes mean, standard error, minimum, and maximum values for each variable. As shown in Table 3 the mean number of workers in all 240 surveyed SMEs is 6 meaning that on average, the SMEs in the sample have around 6 workers with a standard error of 1.932235 which represents the variability associated with the estimate of the mean. It indicates the average deviation of the individual observations from the mean. In this case, a standard error of 1.932235 suggests that the number of workers for SMEs in the sample vary, on average, by approximately 1.93 workers. The minimum observed number of workers is 1, while the maximum observed number of workers is 16. In addition to that results show that the mean years of experience of SMEs in business in the sample is approximately 4.5 which suggests that, on average, the years of experience in business of SMEs in the sample population is 4.5, with a standard error of 1.09391 suggesting that the actual years of experience mean varies by approximately plus or minus 109391 years from the estimated mean of 4.5. The minimum observed year is 1 year, while the maximum observed years are 20 years.

Furthermore results in Table 3 depicts the mean initial capital invested in business for SMEs in the sample is approximately 500,000TZS which suggests that, on average, the initial capital invested in business by SMEs in the sample population is 500,000 TZS with a standard error of approximately 150,000 TZS suggesting that the mean initial capital invested in business varies by approximately plus or minus 150,000 TZS from the estimated mean of 500,000 TZS. The minimum initial capital invested is 150,000 TZS, while the maximum initial capital invested is 10,000,000 TZS.

Table 4
Multiple Linear Regression Model Results

Quantity sold	Coefficient	Standard errors	t value	P>t	95% confidence interval	
Sex of SME owner	0.3459112	1.328677	0.26	0.795	-2.271905	2.963727
SME location	3.296835	1.802436	1.83	0.069	-0.2544008	6.848071
Number of workers	-0.0055337	0.0112915	-0.49	0.625	-0.0277807	0.0167133
Initial capital invested	0.8415011	0.2086486	4.03	0.000	0.4304129	1.252589
Years of experience	-0.022397	0.0015372	14.57	0.000	0.0193681	0.0254253
VAT education	0.7360704	0.154635	4.76	0.000	0.4314019	1.040739
Type of business	0.7799661	0.6546765	1.19	0.235	-0.509905	2.069837

The multiple regression model in Table 4 aims to analyze the relationship between quantity sold (the dependent variable) and independent variables: sex, SME location, number of workers, initial capital invested, years of experience, VAT education and type of business. The coefficient for sex of SME owner is 0.3459112. It suggests that, holding all other variables constant, when SME owner is a male, quantity sold of the goods is 0.3459112 higher than that of female. The result was not statistically significant at the conventional 1%, 5% and 10% level of significance (p-value = 0.795). The coefficient for location of SME is 3.296835. It suggests that, holding all other variables constant, when SME is located in central business area, quantity sold of the goods is 3.296835 higher than that of periphery located SME. The result was found to be statistically significant at the conventional 10% level of significance (p-value = 0.069).

The coefficient for number of workers in SME is -0.0055337. It suggests that, holding all other variables constant, one more worker in SME is decreases the quantity sold of goods by -0.0055337. This result was however found to be statistically insignificant at the conventional 10% level of significance (p-value = 0.625). The coefficient for initial capital invested in business by SME is 0.8415011. It suggests that, holding all other variables constant, a TZS increase in initial capital invested by SMEs increases the quantity sold of goods by 0.8415011 This result was however found to be statistically insignificant at the conventional 10% level of significance (p-value = 0.000).

The coefficient for years of experience in business of SME is -0.022397. It implies that, while controlling for other variables, a year of experience increase decreases the quantity sold of goods by SME by -0.022397. The effect is statistically significant at 1% significance level (p-value = 0.000). The coefficient for VAT education of SME owner is 0.7360704. It suggests that, holding all other variables constant, when SME owner has tax education, quantity sold of the goods is 0.7360704 higher compared to SME owner who has no tax education. The result was found to be statistically significant at the conventional 1% level of significance (p-value = 0.000). The coefficient for the type of business that SME is doing is 0.7799661. It suggests that, holding all other variables constant, when SME is doing food related business, quantity sold of the goods is 0.7360704 higher compared to SME which is dealing with non-food related business. The result was found to be statistically not significant at the conventional 1% clevel of significance (p-value = 0.235).

4.2 Discussion

This study aimed to examine the effects of VAT knowledge and other factors on the performance of SMEs. The descriptive analysis found that most SMEs are owned by males, have no VAT education, are located in central business areas, and are engaged in non-food-related businesses. These findings are consistent with the study by Kamar (2015), which also found that the majority of SMEs are owned by individuals lacking VAT education and are concentrated in central business districts, primarily in non-food-related businesses. Interestingly, this study's findings contradict Kamar's (2015) results regarding the gender of SME owners, as this study found that most currently operating SMEs are owned by females instead of males.

The empirical results of this study reveal a positive relationship between SME performance and the location of the business, where SMEs located in urban areas tend to have higher sales. This aligns with the findings of Alotaibi (2021), who observed that SMEs in urban areas have larger sales volumes despite the presence of VAT, compared to those in rural areas.

Additionally, the study found that as the initial capital invested in the business increases, the performance of SMEs also improves, which is consistent with the results of Obafemi et al., 2021. They suggest that larger initial capital investments indicate SMEs' better understanding of the business and its implications, which in turn accelerates their performance as they strive to maximize sales and returns.

Interestingly, this study uncovered that while years of experience negatively affect SME performance, VAT education has a positive impact. The findings regarding years of experience align with the existing literature, which highlights the potential drawbacks of prolonged operational experience, such as complacency and resistance to change. Conversely, the positive influence of VAT education underscores the importance of financial literacy for effective business management, as SMEs with a strong grasp of VAT principles can benefit from enhanced financial practices, accurate reporting, and reduced legal risks related to tax compliance.

V. CONCLUSIONS & RECOMMENDATIONS

5.1 Conclusion

In conclusion, the primary objective of this research was to investigate the impact of value-added tax (VAT) knowledge and various other factors on the performance of small and medium enterprises (SMEs). The thorough analysis results this study provided valuable insights into the key characteristics of SMEs.

The majority of SMEs are owned by males, lack sufficient knowledge about VAT, are situated in central business areas, and predominantly operate in non-food-related industries. The empirical findings of the study indicated a negative relationship between SME performance and their location in rural areas. Additionally, the results emphasized the importance of initial capital investment in improving the performance of small and medium-sized enterprises.

5.2 Recommendations

Based on these findings, the study offers several recommendations. Firstly, it is imperative for policymakers and business stakeholders to prioritize the provision of VAT education to SME owners, particularly those with limited knowledge in this domain, as this education can have a positive impact on their performance.

Secondly, efforts must be undertaken to boost the growth of SMEs in urban areas and promote higher levels of initial investment, as these aspects may contribute to an overall enhancement in performance. Recognizing the negative influence of extensive business experience, it is advisable for SMEs to strike a balance between knowledge accumulation and adaptability through continuous learning. This will ensure that they remain agile in evolving markets.

Furthermore, business visionaries and entrepreneurs should consider expanding their ventures beyond non-food-related businesses, as suggested by the findings of this examination. This diversification may offer new opportunities for growth and improved performance.

Despite the valuable information obtained from this examination, it is imperative to acknowledge its restrictions. It is crucial to recognize that the research is based on a specific context, and therefore, generalizing the findings to different regions or industries may not be entirely appropriate. Furthermore, the cross-sectional design of the study limits its ability to establish causal relationships, warranting caution when drawing definitive conclusions about the impact of variables on SME performance. These additional studies would provide a more comprehensive understanding of the factors that influence SME performance and allow for more robust conclusions to be drawn.

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