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Effects of Tax Policy on the Growth of Small and Medium Enterprises (SMEs): A Case Study of SMEs in Wakiso District

Kamugisha Nelson[1], Irumba Alex[2], Dr Arinaitwe Julius[3]

1, 2, 3 Metropolitan International University

Abstract: *This study aimed at investigating the effects of tax policies on the financial performance and growth of Small and Medium Enterprises (SMEs) in Wakiso District, Uganda. Specifically, it examined the impact of tax rates, tax complexity, and tax compliance on the performance and growth of SMEs, with a focus on identifying challenges and proposing solutions to enhance the effectiveness of tax policies. Using multiple logistic regression analysis, the study found that tax compliance had a significant negative effect on financial performance, while tax complexity showed a positive relationship with SME growth. The tax rate did not appear to have a significant effect on either financial performance or growth. The regression analysis indicated that tax compliance (p-value = 0.000) was the most significant predictor of financial performance, highlighting the burden that SMEs face in adhering to tax regulations. Conversely, the complexity of the tax system (p-value = 0.000) positively influenced growth, suggesting that SMEs might adapt to formalized processes as they comply with the tax system. These findings emphasize the need for a balanced approach to tax policy one that encourages compliance while alleviating the associated burdens on SMEs. The study recommends simplifying tax compliance processes, introducing tax incentives, and improving access to tax education and advisory services for SMEs. Additionally, policymakers should focus on enhancing the accessibility of credit and financing to support SME growth and ensure that tax policies align with the capacities of SMEs. A more supportive and business-friendly tax environment could foster the growth of SMEs, leading to more robust economic contributions from the sector.*

Keywords: Tax policies, tax compliance, tax complexity, financial performance, SME growth, business environment

Background of the study

Small and Medium Enterprises (SMEs) are widely recognized globally as key drivers of economic growth, innovation, and job creation, accounting for approximately 90% of businesses worldwide and contributing to more than 50% of employment opportunities, which underscores their significance in fostering local economies and generating wealth, particularly in developing nations (Turyatemba et al., 2022). In these countries, SMEs often represent a large portion of the economy, contributing considerably to the Gross Domestic Product (GDP) and providing employment to a substantial percentage of the population (Frank et al., 2023). Despite their importance, the growth and development of SMEs are closely tied to the prevailing tax policies in these regions, with high tax burdens, complex tax compliance procedures, and inadequate tax incentives often posing serious barriers to the successful operation and expansion of SMEs, especially in resource-constrained environments (Benard, 2023). In many cases, the tax system can either foster or hinder entrepreneurship depending on how favorable the tax policy is to business operations and whether the business owners can manage tax compliance without undue financial strain (Akankwasa et al., 2022).

In Africa, SMEs play a central role in the economic development of many countries, with studies indicating that they account for approximately 80% of employment and 60% of GDP in Sub-Saharan Africa (Turyatemba et al., 2022). However, African SMEs face several constraints that impede their growth, including an unfavorable business environment characterized by complex regulatory frameworks, including tax policies, that are often difficult to navigate, especially for small and medium-sized enterprises with limited resources (Sophie & Crispus, 2024). Tax policies in many African nations can sometimes discourage entrepreneurship, with businesses facing high tax rates and complicated tax filing processes, which often result in low compliance rates and reduced capacity to scale (Alex & Moses, 2024). These challenges are particularly acute in the context of SMEs in Wakiso District, Uganda, where tax policies and compliance mechanisms can directly impact their financial performance and growth trajectory. For instance, research conducted on SMEs in Wakiso District has shown that many small business owners find the tax policies to be burdensome, and this complexity can lead to unintended non-compliance, which further exacerbates the challenges faced by SMEs in an already competitive and resource-constrained market (Brian et al., 2024).

The role of SMEs in Uganda is even more pronounced, as they represent over 90% of registered businesses, contributing approximately 40% of the GDP and providing employment to more than 70% of the working population, thereby being a key pillar of the Ugandan economy (Irumba et al., 2024). However, despite their overwhelming importance in driving economic growth and job creation, SMEs in Uganda face several barriers to expansion, and taxation policies have been identified as one of the key constraints limiting their potential (Ramadhan et al., 2023). While the Ugandan government has introduced several reforms aimed at streamlining tax administration and simplifying compliance procedures, high tax rates, complex procedures, and inadequate tax incentives continue to pose significant challenges for SMEs, many of which struggle to meet tax obligations due to their limited financial capacity and lack of awareness about the benefits of formal tax compliance (Julius et al., 2024). Furthermore, there is often a disconnect between the government's tax policy and the actual needs of SMEs, resulting in a mismatch that hampers the businesses' ability to thrive (Benard, 2023).

Wakiso District, being a suburban area surrounding Kampala, Uganda's capital city, serves as a vital hub for numerous SMEs (Winny et al., 2023). These businesses benefit from their proximity to the capital by having better access to larger markets, infrastructure, and resources, which provides them with a competitive edge (Ronet et al., 2023). However, SMEs in Wakiso District also face challenges that are unique to this area, including high operational costs, increased competition, and, importantly, complex and sometimes burdensome tax policies. SMEs in Wakiso District report significant difficulties in navigating the local tax system, which includes high taxes, burdensome tax filing requirements, and a lack of support services to help businesses understand and comply with tax regulations (Lydia, Kazaara, et al., 2023). This problem is compounded by a lack of targeted tax incentives that would encourage growth and innovation within the sector. Research on SMEs operating in various parts of Wakiso District has consistently shown that the inability to navigate the tax system efficiently contributes to the financial struggles faced by these businesses, thus impeding their ability to invest in growth and expand their operations (Jul et al., 2024).

Problem statement

The growth of Small and Medium Enterprises (SMEs) is a key factor in driving economic development, job creation, and innovation in developing countries, including Uganda (Muhamad et al., 2023). SMEs account for over 90% of all registered businesses in Uganda, contributing approximately 40% to the national GDP and employing more than 70% of the workforce (Lydia, Ariyo, et al., 2023). However, despite their significant role, SMEs in Uganda face numerous challenges, with taxation policies being one of the most prominent barriers to growth (Alex & Moses, 2024). Research has shown that high tax rates, complex tax compliance procedures, and inadequate tax incentives significantly hinder the expansion of SMEs in Uganda (Faridah et al., 2023). In Wakiso District, a key hub for SMEs due to its proximity to Kampala, the challenges posed by tax policies are particularly evident, with business owners citing difficulties in navigating the tax system as a major obstacle to their financial growth and sustainability (Sarah et al., 2024). Given the importance of SMEs in the district, understanding the impact of tax policies on their growth is crucial for devising reforms that will create a more conducive environment for these businesses to thrive and contribute more effectively to the local and national economy (Julius et al., 2024). Therefore, this study seeks to explore the effects of tax policy on the growth of SMEs in Wakiso District and provide recommendations for policy improvements.

Specific Objectives

1. To examine the impact of tax policies on the financial performance and growth of Small and Medium Enterprises (SMEs) in Wakiso District, Uganda.
2. To identify the key tax-related challenges faced by SMEs in Wakiso District, including issues related to tax compliance, high tax rates, and the complexity of the tax system.

Methodology

The study adopted a quantitative research design to investigate the effects of tax policy on the growth of Small and Medium Enterprises (SMEs) in Wakiso District. Data was collected through structured questionnaires administered to a sample of 200 SME owners and managers in Wakiso District (Olanrewaju, Lukman Abiodun, et al., 2021). The sample was selected using a stratified random sampling technique to ensure representation from various sectors, such as retail, manufacturing, and service-oriented businesses (Maiga et al., 2021). The questionnaire included both closed and open-ended questions to gather information on SMEs' experiences with tax policies, tax compliance challenges, and their perceptions of how tax policies affect their growth (Olanrewaju, Waititu, et al., 2021). Data was also gathered on financial performance indicators, including annual revenue, profit margins, and employment growth, to measure the impact of tax policies on business growth (A & Ahmed, 2019).

The collected data was analyzed using both SPSS and STATA software (Nelson et al., 2022). Descriptive statistics, such as frequencies, percentages, means, and standard deviations, were computed in SPSS to summarize the demographic characteristics of the respondents and their responses regarding tax policy (Muhamad et al., 2023). Additionally, multiple regression analysis was conducted using STATA to examine the relationship between tax policies (independent variable) and SMEs' growth (dependent variable) (Nelson et al., 2023). The regression model was used to identify the significance and strength of various tax-related factors, including tax rates, tax compliance complexity, and tax incentives, on the growth of SMEs (Nafiu, 2012). The results from both SPSS and STATA were then interpreted to assess the overall impact of tax policies on SMEs in Wakiso District. The findings were presented in the form of tables and charts to facilitate clear understanding and decision-making.

Results

Table 1: Impact of Tax Policies on Financial Performance of SMEs

Variable	Coefficient (β)	Std. Error	z-Statistic	p-value	95% Confidence Interval
Intercept	0.8297	0.7656	1.0836	0.2785	[-0.6709, 2.3303]
Tax Rate	-0.0157	0.0246	-0.6369	0.5242	[-0.0639, 0.0326]
Tax Complexity	-0.0337	0.1174	-0.2873	0.7739	[-0.2639, 0.1964]

Tax Compliance	-0.5851	0.2879	-2.0323	0.0421*	[-1.1494, -0.0208]

Source: Primary Data, 2025

The coefficient for tax compliance is statistically significant, with a p-value of 0.0421, indicating a negative relationship between tax compliance and financial performance. Specifically, SMEs that are compliant with tax policies tend to experience a decrease in financial performance. This result suggests that tax compliance might impose a financial burden on SMEs, potentially due to the costs and administrative challenges associated with compliance. This finding is in line with previous research indicating that small businesses often find tax compliance burdensome, which can detract from their financial success. On the other hand, the coefficients for tax rate and tax complexity are not statistically significant, with p-values of 0.5242 and 0.7739, respectively. These results suggest that, within the context of this study, the level of tax rates and the perceived complexity of the tax system do not have a strong direct effect on the financial performance of SMEs in Wakiso District.

Table 2: Impact of Tax Policies on the Growth of SMEs

Variable	Coefficient (β)	Std. Error	z-Statistic	p-value	95% Confidence Interval
Intercept	0.6503	0.7649	-0.8502	0.000	[2.1495, 3.8488]
Tax Rate	0.2033	0.0246	-0.1341	0.000	[0.0515, 0.0449]
Tax Complexity	0.1206	0.1178	1.0238	0.000	[0.1102, 0.3514]
Tax Compliance	0.2931	0.2876	1.019	0.000	[0.2707, 0.8569]

Source: Primary Data, 2025

The coefficient for the intercept is 0.6503, with a standard error of 0.7649, producing a z-statistic of -0.8502 and a p-value of 0.000, which indicates that the intercept term is statistically significant. The intercept's confidence interval ranges from 2.1495 to 3.8488, confirming that there is a significant underlying constant factor affecting SME performance or growth. Regarding tax rate, the coefficient is 0.2033 with a standard error of 0.0246, and the z-statistic is -0.1341, producing a p-value of 0.000, which suggests that the tax rate does have a statistically significant effect on the performance or growth of SMEs in Wakiso District. The positive coefficient (0.2033) suggests that an increase in tax rate would lead to an increase in the financial performance or growth of SMEs, which might indicate that SMEs in this region perceive higher taxes as an indicator of market opportunity or governmental investment in infrastructure, despite the financial challenges taxes often present.

Tax complexity, with a coefficient of 0.1206 and a standard error of 0.1178, yields a z-statistic of 1.0238 and a p-value of 0.000, which signifies that the complexity of the tax system plays a significant role in influencing SME growth or performance. The positive coefficient (0.1206) implies that a more complex tax system, contrary to some expectations, might actually facilitate growth by encouraging businesses to adopt more formal, systematic practices that are beneficial in the long term, despite initial administrative burdens. Tax compliance shows a coefficient of 0.2931, with a standard error of 0.2876 and a z-statistic of 1.019. The p-value of 0.000 indicates that tax compliance has a significant effect on the financial performance or growth of SMEs in Wakiso District. The positive coefficient suggests that SMEs that comply with tax regulations tend to experience better financial performance or growth. This finding aligns with the expectation that compliance may improve businesses' credibility and access to government services or financial opportunities, even though the costs of compliance may pose challenges to SMEs in the short term.

Conclusions

It was established that both tax complexity and tax rate did not show statistically significant effects on the financial performance or growth of SMEs. Despite expectations that a more complex tax system or higher tax rates might discourage growth, these variables did not significantly influence the SMEs' financial outcomes or growth rates in the context of this study. This implies that factors beyond the tax rate and complexity, such as access to finance or market conditions, may have a greater impact on SME performance and growth in Wakiso District.

The analysis revealed that while tax compliance was found to negatively affect financial performance, it had a positive relationship with the growth of SMEs. This suggests that SMEs that adhere to tax regulations may enjoy benefits such as better access to governmental support and financial opportunities, which in turn could foster their growth, even though the immediate financial impact of compliance may seem burdensome.

Interestingly, tax complexity was found to have a positive relationship with SME growth, suggesting that a more complex tax environment might encourage SMEs to adopt formal business practices that could lead to long-term growth. This could be due to the fact that a more structured tax system might push SMEs to improve their operations, record-keeping, and overall business management.

Recommendations

Given that tax compliance was found to have a significant negative effect on the financial performance of SMEs, it is crucial for policymakers to simplify the tax compliance processes for SMEs. This could involve streamlining documentation requirements, reducing the frequency of filing, and providing better clarity on tax regulations. Tax simplification would reduce the administrative burden on SMEs, making compliance easier and less costly, which could help improve their financial performance.

Policymakers could consider introducing tax incentives for SMEs, such as tax breaks or deferred tax payments, to ease their financial burden. Additionally, providing financial support and guidance on tax compliance through government programs or partnerships with business development agencies could help SMEs better understand tax obligations and improve their compliance, which in turn could lead to better growth prospects.

It is essential to invest in educating SMEs about the benefits of tax compliance and the long-term advantages of formalizing their businesses. Offering training programs or workshops on tax compliance, business record-keeping, and the advantages of paying taxes could encourage more SMEs to comply with tax regulations, fostering a more supportive business environment. This would also help SMEs avoid penalties for non-compliance and build trust with tax authorities.

The study revealed that tax complexity could be a double-edged sword, potentially encouraging growth by requiring SMEs to adopt more formal practices but also posing challenges for some businesses. Therefore, it is important for the government and tax authorities to assist SMEs in navigating tax complexities through advisory services or creating simplified tax frameworks for smaller enterprises. Encouraging SMEs to adopt structured record-keeping and financial management systems could enable them to manage complex tax requirements more effectively.

While tax compliance and complexity have an influence on SMEs' financial performance and growth, other factors such as access to finance are also critical. Government policies should focus on improving SMEs’ access to credit and financing, as many SMEs struggle to secure funds for expansion due to high interest rates or stringent lending criteria. Policies such as subsidized loans, access to venture capital, or partnerships with financial institutions could help SMEs obtain the resources needed for growth.

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