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Factors Influencing Tax Evasion among SMEs in Tanzania: The Role of Tax Rates in Iringa Municipality

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ABSTRACT

This study examines the influence of tax rates on tax evasion among small and medium enterprises (SMEs) in Iringa Municipality. Despite reforms by the Tanzania Revenue Authority (TRA), SMEs continue to exhibit high levels of non-compliance, largely attributed to burdensome tax rates. A descriptive research design was employed, and data were collected from 80 SME owners using structured questionnaires. Quantitative analysis through SPSS (version 20) revealed that high tax rates significantly increase the likelihood of evasion, as they reduce profit margins and create strong incentives for underreporting. Results indicate that 72% of respondents agreed that tax rate changes have a great influence on evasion, while 68% cited thresholds for taxation as key triggers for concealment of income. The findings are consistent with Allingham and Sandmo's (1972) model, which predicts that higher tax burdens increase evasion incentives, but they also highlight the unique challenges of SMEs operating under tight financial constraints. The study recommends a review of SME tax rates, adoption of tiered structures, and alignment of rates with profit levels to encourage compliance.

KEYWORDS*-Compliance, Iringa Municipality, Small and Medium Enterprises, Tax Evasion, Tax Rates*

1. Introduction

Tax evasion remains a persistent challenge for both developed and developing economies, eroding government revenue and weakening public service delivery. Globally, research shows that high tax rates, system complexity, and weak enforcement are major drivers of non-compliance among small and medium enterprises (SMEs) (Allingham, 1972; Slemrod, 2007). In sub-Saharan Africa, where SMEs account for the majority of businesses, tax evasion is exacerbated by limited tax literacy and high participation in the informal sector (Fjeldstad, 2014).

In Tanzania, SMEs constitute more than 90% of registered businesses and are central to revenue generation, yet they are also the most prone to non-compliance (Ndokole, 2023). High tax rates are consistently reported as a leading cause of evasion, especially for firms with narrow profit margins (Clotfelter, 1983). In Iringa Municipality, SMEs operate under the dual burden of elevated tax rates and limited administrative capacity, creating fertile ground for evasion. While previous studies have explored SME tax compliance at the national level, limited empirical evidence exists on how tax rates specifically influence evasion in Iringa.

This paper therefore investigates the influence of tax rates on tax evasion among SMEs in Iringa Municipality, contributing localized insights that can inform both policy reforms and practical strategies for improving compliance.

2. Literature Review

2.1 Theoretical Review

The Allingham and Sandmo model has long provided a foundation for understanding tax evasion behaviour. It views taxpayers as rational actors who weigh the benefits of underreporting against the likelihood of detection and the severity of penalties(Gemmell, 2016). Central to this model is the prediction that higher tax rates increase incentives to evade, since they reduce after-tax income. In the context of SMEs, where margins are often narrow, this becomes particularly relevant. For instance, firms struggling with liquidity pressures may perceive tax compliance as a threat to survival and thus turn to concealment strategies. While the model is useful in showing the economic calculus behind evasion, it has been criticised for its narrow focus on financial incentives, overlooking social and psychological influences such as ethics, tax morale, or trust in institutions (Cummings et al., 2009)cu.

To complement this economic lens, the Theory of Planned Behavior broadens the analysis by emphasising how attitudes, social norms, and perceived behavioural control shape tax compliance decisions(Ajzen, 2020). Taxpayers who view compliance positively, perceive strong social expectations to obey the law, and believe they have the ability to meet obligations are more likely to comply. In Tanzania, where limited tax awareness constrains record-keeping and deadline adherence, this theory underscores the role of education and empowerment in encouraging voluntary compliance (Chindengwike & Kira, 2022). It also highlights that compliance behaviour is not only a matter of costs and penalties but also of perceptions of capacity and social legitimacy.

Equally relevant is Fiscal Exchange Theory, which frames taxation as a social contract. Compliance is more likely when taxpayers believe that their contributions are reciprocated through visible public services(Dupor, 2000). Conversely, when mismanagement, corruption, or inequitable distribution of resources is perceived, evasion rises. This perspective is critical in developing contexts, where trust in state institutions is often fragile. In Tanzania, evidence shows that citizens' willingness to comply improves when local governments demonstrate transparency and responsiveness in service delivery (Fjeldstad, 2014).

Finally, Deterrence Theory reinforces the idea that compliance is shaped by enforcement strength. It suggests that the certainty of audits and the severity of penalties act as deterrents against evasion(Sörenson, 2024). While this framework highlights the importance of institutional capacity, it has been challenged for assuming that enforcement alone can secure compliance. In contexts like Iringa, excessive penalties may alienate small businesses, while consistent but fair enforcement tends to build both deterrence and legitimacy (Abjadi et al., 2023).

2.2 Empirical Literature Review

Empirical studies consistently demonstrate that high tax rates are a significant driver of tax evasion, particularly among SMEs where profit margins are narrow. Clotfelter (1983) shows that as tax rates rise, compliance declines as businesses attempt to preserve liquidity by concealing income. Similar findings emerge from Fagbemi et al (2010) in Nigeria, where SMEs responded to elevated rates by shifting activities into informal markets. In Tanzania, Mkenda et al (2023) found that perceptions of unfair or excessive tax burdens encouraged under-reporting and non-registration. These results align with the Allingham and Sandmo model, underscoring that SMEs, unlike larger firms, often lack the capacity to absorb tax-induced shocks and thus turn to evasion as a survival mechanism. However, not all studies agree on the magnitude of this effect. In some contexts, improved enforcement and incentives have been shown to mitigate rate-induced evasion, suggesting that the impact of tax rates is mediated by institutional strength.

Tax awareness also emerges as a crucial determinant of compliance behaviour. Daniel & Faustin (2019) observed in Rwanda that targeted education campaigns improved SMEs' record-keeping and deadline adherence, which translated into higher voluntary compliance. Likewise, Morris Karithi Njilu (2023) reported in Kenya that ignorance of tax procedures directly contributed to widespread evasion. In Tanzania, Shao & Dida (2020) highlights that limited book-keeping skills, coupled with poor understanding of obligations, perpetuate both intentional and unintentional evasion among SMEs. These findings reinforce the Theory of Planned Behaviour, showing that when taxpayers believe they lack the capacity to comply, non-compliance becomes more likely. Yet, challenges persist in sustaining awareness programmes, as their effectiveness often depends on continuous engagement and accessibility to small firms operating in informal or semi-formal spaces.

The complexity of the tax system further compounds compliance challenges. Cummings et al (2009) argue that ambiguous regulations and frequent changes increase compliance costs, disproportionately affecting smaller enterprises. Evidence from Uganda confirms that complicated filing requirements overwhelm SMEs, discouraging formalisation(Musimenta, 2020). In Tanzania, Shao & Dida (2020) note that procedural burdens, including multiple registrations and inconsistent guidelines, act as strong incentives for evasion. Digital interventions such as electronic fiscal devices and e-filing systems have been introduced to address these challenges, but their uptake has been uneven, often hindered by infrastructure gaps and limited training. This suggests that while system simplification holds promise, without parallel investment in capacity-building, complexity will continue to fuel evasion.

Taken together, these studies highlight that tax evasion among SMEs is shaped by an interplay of economic pressures, informational gaps and systemic inefficiencies. High tax rates create strong financial incentives for concealment; limited awareness constrains the ability of SMEs to comply; and complex systems increase compliance costs beyond manageable levels. Although individual studies often focus on one factor, the Tanzanian case illustrates that these drivers reinforce one another.

3. Methodology

The study employed a quantitative descriptive research design to assess the influence of tax rates on SME tax evasion in Iringa Municipality. The target population comprised registered SMEs, from which a simple random sample of 80 respondents was selected to ensure representativeness. Primary data were collected using structured questionnaires designed to capture perceptions of tax rates, thresholds, and transparency, measured on a five-point Likert scale. Descriptive statistics were used to summarise the data, while multiple regression analysis was conducted to examine the influence of tax rates on tax evasion behaviour. Ethical considerations were observed by obtaining informed consent from participants and ensuring confidentiality of responses.

4. Results

The study examined the influence of tax rates, tax awareness, and tax system complexity on tax evasion among SMEs in Iringa Municipality. Data from 80 respondents were analysed using descriptive and inferential statistics.

4.1 Influence of Tax Rates

Findings indicate that changes in tax rates strongly influence compliance behaviour. As shown in Table 1, 61.3% of respondents agreed that fluctuations or increases in rates encouraged evasion. Transparency was also significant, with 62.5% reporting that clear communication of rates reduced non-compliance as shown in Table 2. In addition, 70.1% of SMEs agreed that current thresholds incentivise under-reporting or non-registration to remain below taxable levels as shown in Table 3. Collectively, these results confirm that unpredictable rates, limited transparency, and rigid thresholds contribute to SME evasion.

Table 1. Influence of tax rate changes on tax evasion (n = 80)

Response	**%**
Strongly agree	15.0
Agree	46.3
Neutral	10.0
Disagree	21.3
Strongly disagree	7.5

Table 2. Influence of tax rate transparency on tax evasion (n = 80)

Response	**%**
Strongly agree	40.0
Agree	22.5
Neutral	26.3
Disagree	7.5
Strongly disagree	3.8

Table 3. Influence of taxation thresholds on tax evasion (n = 80)

Response	**%**
Strongly agree	46.3
Agree	23.8
Neutral	5.0
Disagree	25.0

4.2 Influence of Tax Awareness

Awareness emerged as a crucial factor shaping compliance. Results show that SMEs with limited understanding of tax obligations were more likely to engage in evasion. Over 60% of respondents indicated that awareness programmes improve voluntary compliance a shown in Table 4, consistent with findings from Rwanda and Kenya. These results suggest that enhancing taxpayer education is essential to reducing both intentional and unintentional evasion.

Table 4. Tax awareness and SME compliance (n = 80)

Response	**%**
Strongly agree	28.8
Agree	31.3
Neutral	18.8

Response	**%**
Disagree	13.8
Strongly disagree	7.5

4.3 Influence of Tax System Complexity

Complexity in the tax system was also identified as a driver of evasion. More than half of respondents reported that ambiguous regulations, frequent changes, and cumbersome filing procedures discouraged compliance as shown in Table 5. SMEs noted challenges in adopting electronic fiscal devices and e-filing systems, largely due to limited training and infrastructure gaps. This evidence suggests that while digitalisation has potential to simplify compliance, without adequate capacity-building, complexity will continue to fuel evasion.

Table 5. Perceptions of tax system complexity (n = 80)

Response	**%**
Strongly agree	32.5
Agree	27.5
Neutral	15.0
Disagree	18.8
Strongly disagree	6.3

4.4 Tax Evasion Practices

The study further examined specific practices of evasion among SMEs. As shown in Table 6, the most common methods included under-reporting income (72.5%), overstating deductible expenses (58.8%), and avoiding registration to stay below taxable thresholds (51.3%). These practices were often rationalised as survival strategies in response to high compliance costs and perceived unfairness of the system.

Table 6. Reported tax evasion practices among SMEs (n = 80)

Practice	**% Reporting**
Under-reporting income	72.5
Overstating deductible expenses	58.8
Avoiding business registration	51.3

4.5 Regression Analysis

Regression analysis confirmed that all three variables; tax rates, awareness, and system complexitysignificantly influenced SME tax evasion at the 5% level. As presented in Table 7, tax rates had the strongest effect ($\beta = 0.421$, $p < 0.01$), followed by system complexity ($\beta = 0.376$, $p < 0.05$) and tax awareness ($\beta = 0.293$, $p < 0.05$). The model explained 62.4% of the variance in tax evasion behaviour, demonstrating the importance of structural, informational, and administrative factors in shaping compliance outcomes.

Table 7. Regression results for factors influencing tax evasion

Variable	**β**	**Sig.**
Tax rates	0.421	0.000
Tax awareness	0.293	0.018
Tax system complexity	0.376	0.007
$R^2 = 0.624$; Adj. $R^2 = 0.611$		

5. Discussion

The findings reinforce the Allingham and Sandmo (1972) model, which posits that higher tax burdens increase incentives for evasion. In Iringa, SMEs facing narrow margins and limited capital reported that fluctuations in tax rates and rigid thresholds created strong pressure to conceal income or avoid registration. Regression analysis confirmed that tax rates had the strongest effect on evasion ($\beta = 0.421$, $p < 0.01$). Similar studies in Kenya byMorris Karithi Njilu (2023)and Ghana Peprah et al (2020) confirm that high and unpredictable rates drive SMEs into informal operations as a survival strategy. These results suggest that tax rate policies must account for the financial realities of small enterprises in order to avoid undermining compliance.

Beyond economic calculations, the findings also reflect behavioural and institutional perspectives. The Theory of Planned Behaviour helps explain why low levels of tax awareness exacerbate non-compliance. Many respondents reported poor record-keeping and limited understanding of obligations, consistent with evidence from Rwanda (Daniel & Faustin, 2019) and Kenya (Morris Karithi Njilu, 2023). This implies that even where rates are reasonable, SMEs may still evade if they perceive compliance as complex or beyond their capacity. Fiscal Exchange Theory (Levi, 1988) further clarifies that perceptions of fairness matter: opaque thresholds and inconsistent communication erode trust in tax authorities, reinforcing evasion as a rationalised response.

The role of enforcement is also evident. While Deterrence Theory highlights that audits and penalties should discourage evasion, the results suggest that in Iringa, excessive reliance on penalties risks alienating SMEs. Respondents indicated that complexity in procedures and limited support for electronic systems made compliance difficult. This aligns with findings in Uganda (Musimenta, 2020), where burdensome filing systems encouraged evasion despite penalties. Thus, enforcement alone may be insufficient; instead, a combination of predictable tax rates, continuous taxpayer education, and simplified systems is needed to foster voluntary compliance.

6. Conclusion and Recommendations

This study concludes that tax evasion among SMEs in Iringa Municipality is shaped by structural, informational, and administrative factors. Tax rates were found to have the strongest influence, with high and unpredictable rates reducing willingness to comply and compelling SMEs to under-report income. Perceptions of unfair thresholds and limited transparency further undermined trust in the system. Tax awareness also emerged as a critical determinant, as poor record-keeping and inadequate knowledge of obligations constrained voluntary compliance. In addition, tax system complexity discouraged compliance, particularly where filing procedures were cumbersome and digital tools under-supported.

On this basis, three sets of recommendations are offered. First, policy makers should pursue predictable, tiered, and transparent tax structures that reflect the financial realities of SMEs. Stable thresholds and clearer communication would reduce incentives for concealment. Second, the Tanzania Revenue Authority should scale up continuous taxpayer education programmes, targeting SMEs with practical guidance on record-keeping, deadlines, and the use of digital compliance tools. Finally, simplification of tax procedures and greater investment in infrastructure and training for electronic fiscal devices and e-filing systems are required to lower compliance costs. Together, these reforms would encourage greater voluntary compliance, reduce evasion, and contribute to a more sustainable tax system.

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