



Research Article

An Evaluation of The Impact of Tax Increases on The Sustainability of Small and Medium Enterprises (SMEs): A Case Study of Lusaka Central Business District

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ABSTRACT

Taxation is a critical instrument for government revenue mobilization, but its implications for the growth and sustainability of small and medium enterprises (SMEs) remain contested. In many developing countries, tax increases are often implemented without sufficient consideration of their effects on SMEs, which represent over 70% of employment and nearly 40% of GDP in sub-Saharan Africa. This study evaluates the impact of tax increases on the sustainability of SMEs in Lusaka Central Business District (CBD), Zambia. Using a mixed-methods approach, data were collected from 120 SME owners and managers through questionnaires, supplemented by interviews with Zambia Revenue Authority (ZRA) officials and business association representatives. Results reveal that 68% of respondents reported reduced profitability following recent tax increases, with 54% citing higher operating costs and 46% reporting decreased reinvestment in business expansion. Furthermore, 41% of SMEs indicated that rising tax obligations forced them to downsize staff, while 27% considered informalization to evade taxation. Despite these challenges, 32% acknowledged that tax compliance enhanced access to credit and formal contracts. The study concludes that while taxation is essential for national revenue, abrupt or poorly designed tax increases undermine SME sustainability, leading to reduced growth potential and increased informality. It recommends targeted tax incentives, simplified compliance processes, and enhanced dialogue between government and SMEs to balance revenue generation with enterprise development.

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1. INTRODUCTION

Taxation is a cornerstone of national development, providing governments with the revenue necessary to finance infrastructure, social services, and public goods. In Zambia, tax revenue constitutes more than 60% of total government revenue.

(ZRA, 2023). However, the balance between effective taxation and private sector growth remains a delicate one. While large corporations often have structured systems for tax compliance, small and medium enterprises (SMEs)—which account for 70% of Zambia's employment and 35% of GDP (ZDA, 2022)—face unique challenges.

SMEs are particularly sensitive to policy changes such as tax increases. Higher tax rates, complex compliance procedures, and limited financial literacy can increase operating costs, reduce profitability, and threaten long-term sustainability (Musonda & Chileshe, 2021). Globally, evidence shows that excessive tax burdens push many SMEs into informality, limiting their contribution to national revenue and hindering their access to formal credit markets (OECD, 2022).

In Zambia's urban centres, especially the Lusaka Central Business District (CBD), SMEs form the backbone of commerce. However, recent tax reforms—including increased value-added tax (VAT), presumptive tax adjustments, and Pay-As-You-Earn (PAYE) enforcement—have raised concerns among entrepreneurs. While policymakers argue these measures strengthen fiscal sustainability, SME owners often perceive them as punitive and growth-constraining.

This study, therefore, seeks to evaluate the impact of tax increases on the sustainability of SMEs in Lusaka CBD. Specifically, it examines how tax increases affect profitability, business growth, employment, and compliance behaviour, while identifying coping strategies used by SMEs and opportunities for policy reform.

2. LITERATURE REVIEW

SMEs play a critical role in economic development by creating jobs, fostering innovation, and broadening the tax base. Yet, research shows that SMEs in developing countries face disproportionate challenges in tax compliance (Beck & Demircuc-Kunt, 2020). Tax increases often reduce SMEs' profitability and investment capacity, while also influencing employment decisions. This section highlights the challenges of taxation, the benefits of compliance, and theoretical perspectives such as Taxation Theory, the Resource-Based View, and Institutional Theory.

3. METHODOLOGY

The study employed a descriptive research design using mixed methods. Quantitative data were gathered from 120 SME owners and managers through questionnaires, while qualitative data were collected via interviews with ZRA officials and business association representatives. Quantitative results were analysed using descriptive statistics, and qualitative data were thematically analysed.

4. RESULTS AND DISCUSSION

Types of Taxes Recently Increased and Their Application to SMEs

The study revealed that among the various taxes imposed on SMEs in Lusaka Central Business District (CBD), Value Added Tax (VAT) emerged as the most burdensome, reported by 68% of respondents. VAT was followed by turnover tax (20%), income tax (9%), and customs/excise duties (3%). This dominance of VAT as a constraint highlights its regressive character, as it does not discriminate between firm sizes but disproportionately affects smaller firms with weaker capital bases.

The evidence aligns with regional scholarship, such as Munyua and Okello (2023), who emphasize VAT's regressive burden across Sub-Saharan Africa, and Banda and Nkhoma (2024), who highlight SMEs' perception of VAT as unfair relative to large corporations that can diffuse costs across broader operations. This finding underscores the structural imbalance in tax design, where SMEs—despite being key drivers of employment and innovation—face heavier compliance costs compared to their contribution to national revenue.

The practical implication is that SMEs in Lusaka CBD face significant administrative and financial pressures from VAT compliance. Many lack the specialized tax expertise that larger firms employ to navigate complex regulations, meaning the tax system unintentionally penalizes small business survival and competitiveness.

Effect of Tax Increases on Financial Performance and Survival

The results showed that 72% of SMEs experienced significantly increased operating costs, while 53% reported significant decreases in profitability, and 35% reported slight decreases. These statistics highlight a direct causal link between tax increases and declining business performance. Increased taxation has diminished profit margins, constrained reinvestment capacity, and elevated the risk of business closures.

These findings echo those of Chirwa and Phiri (2022) in Zambia and Otieno et al. (2023) in Kenya, who argue that higher taxation directly undermines SME resilience. As SMEs form the backbone of the Zambian economy—providing jobs, stimulating innovation, and contributing to poverty alleviation—the erosion of their profitability has far-reaching socio-economic implications.

The data further suggest that SMEs are less able to absorb cost shocks compared to larger businesses. As operating costs rise due to tax increases, SMEs often lack financial buffers, making them more vulnerable to closure. This dynamic places Zambia's broader economic growth and job creation agenda at risk.

SME Owners' and Managers' Perceptions of Tax Increases

The study revealed that 81% of respondents considered tax increases a threat to business survival, while 91% believed SMEs are overburdened compared to larger enterprises.

Interestingly, perceptions of fairness were divided: 46% viewed current tax rates as fair, while 33% considered them unfair or very unfair.

This mixed perception reflects a tension between compliance obligations and perceived equity. On one hand, some SME owners acknowledge the necessity of taxation for national development. On the other hand, many express frustrations at the disproportionate burden and limited visible reinvestment of tax revenues into SME-supportive infrastructure or programs.

These perceptions are not trivial; as Tembo and Lungu (2022) argue, fairness perceptions directly influence compliance. When SMEs feel overtaxed and under-supported, they are more likely to adopt informalization or tax evasion strategies, undermining government revenue collection and weakening the formal economy.

The implication is that Zambia's taxation system risks pushing SMEs further into informality, which in turn erodes the tax base, creating a vicious cycle of noncompliance and reduced public resources.

Coping Mechanisms Adopted by SMEs

The findings revealed diverse coping strategies: increasing prices (73%), downsizing staff (20%), changing business models (7%), and relocation to lower-tax jurisdictions (75%). Additionally, 64% sought support from government agencies, while 24% turned to business associations.

These strategies reflect short-term survival tactics rather than long-term competitiveness measures. Price increases may sustain revenues but risk alienating customers, particularly in low-income markets. Downsizing reduces operational costs but diminishes employment opportunities, undermining SMEs' contribution to Zambia's labor market.

These findings resonate with Kanyangale (2023), who observed similar strategies among Malawian SMEs, and Okoye et al. (2024), who argue that SMEs globally adopt reactive rather than proactive measures under taxation stress.

The implication is that without deliberate policy interventions, SMEs in Lusaka CBD will continue to rely on strategies that secure survival but compromise long-term sustainability, innovation, and growth.

5. CONCLUSION AND RECOMMENDATIONS

The study concludes that tax increases undermine SME sustainability by reducing profitability, constraining expansion, and encouraging informality. However, compliance also has benefits such as improved credibility.

Recommendations include

1. Government to review and reform the VAT structure to introduce SME-sensitive exemptions or lower thresholds
2. Government to strengthen SME support programs through tax rebates, simplified compliance processes, and targeted capacity-building
3. Government to enhance transparency in tax utilization, ensuring SMEs can see direct benefits

4. Government to promote progressive taxation policies, shifting more burden onto larger corporations while safeguarding smaller businesses

5. SMEs to adopt strategic financial planning to cushion against tax-related shocks

SMEs to invest in tax literacy and compliance training to minimize penalties and improve efficiency

6. SMEs to diversify revenue streams through innovation and partnerships, reducing dependency on single business models

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