



THE IMPACT OF TAX POLICY ON TAX COMPLIANCE AND THE GROWTH OF SMALL AND MEDIUM ENTERPRISES (A CASE STUDY IN IRAQ)

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Article history:		Abstract:
Received:	24 th September 2025	Unlike most previous research investigated the impact of tax policy on SMEs' growth. However, this study investigates the differential effect of three components of the tax policy on the growth of SMEs in Iraq. Furthermore, the study is enhanced by incorporating tax compliance as a moderator. Panel Data were collected from 257 SME owners who have been registered for the past three years and subjected to registration in value-added tax and have the audited financial reports for two years from 2024 and 2025. In this study, the Hausman test was applied and found that the fixed effect model is appropriate for analysis. The findings demonstrate that increased income tax, value-added tax, and presumptive tax impose a greater burden on SMEs, which in turn negatively affects the growth of the SMEs. SMEs that pay taxes regularly often exhibit low after-tax Profit. In contrast, firms that regard tax compliance as a significant factor can mitigate the adverse effects of taxation. This finding provides implications for governments to improve taxpayer services and streamline timely payments by alleviating the tax burden associated with SMEs. This research contributes to the literature on tax policy and SMEs studies for developing countries. These results provide insights for policymakers to enhance economic growth and corporate development in low-income nations to improve employability rates.
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1. INTRODUCTION

Small and medium-sized companies (SMEs) form the foundation of most economies across the globe. These enterprises play a crucial role in providing employment opportunities, introducing new inventions, and improving the economy for everyone, particularly in nations experiencing economic upheaval or post-war rebuilding (Angelakis & Manioudis, 2025). Despite their small size, they are among the most significant enterprises in the economy because when their individual impacts are pooled, they outperform the larger corporations (Gherghina, Botezatu, Hosszu, & Simionescu, 2020). For the economic advancement of any country, it is imperative to enhance both the employment rate and the well-being rate. The industrial revolution plays a crucial role, as industry serves as the backbone of any country, making its development essential. Any developing nation must implement measures to regulate its employment rate and support its small and medium enterprises. Consequently, the question arises: what factors inhibit the sustainability of these enterprises? Policy



makers are accordingly more concerned with SMEs in unstable and resource-dependent economies like Iraq. These businesses may diversify the economy away from its reliance on oil and other export industries, absorb excess labor, and strengthen local value chains (Adom, 2023). However, SMEs' participation in sustainable development is heavily influenced by the country's policy environment, notably the tax structure, which encourages businesses to formalize, invest, and grow their operations (Waskita & Ashari, 2025). Taxes are mandated in every nation primarily to generate revenue for governmental purposes. Nevertheless, existence as small and medium-sized companies (SMEs) is not always straightforward. These firms primarily strive to generate revenue to finance their operations and often have difficulties in settling costs and fulfilling regulatory compliance obligations.

Thus, tax policy has various implications for SMEs, including financial burden, compliance costs, administrative complexity, and a predicted level of assurance in tax enforcement (Lavic, 2023). According to (Krysovatty, Fedosov, Tymchenko, & Silchenko, 2020), taxation can contribute to development and welfare in three ways: it must be able to generate sufficient funds to finance high-quality public services and social transfers, it must offer incentives for more employment and efficient and long-term use of natural resources, and it must be able to reallocate income. As a result, knowing how alternative tax policies affect profitability and sales is critical for a growth-oriented reform strategy. Excessive taxes and substantial tax burdens are contributing factors to premature firm closures. As a result, it can be stated that the person who bears the additional tax burden on an SME is still in the early stages of their business's life cycle, so when they do not receive profitability, which does not cover their costs, their profitability rate is very low, and they must close their business.

Recent empirical research has shed light on how various forms of taxation, such as corporation and income taxes, value-added tax (VAT), and presumptive tax, impact the performance of small enterprises (Bhalla, Kaur, & Sharma, 2022; Evans & Tran-Nam, 2023; Ojo & Shittu, 2023; Ojuma, 2020). According to studies conducted in both established and developing nations, high tax rates and inadequate VAT systems diminish profit margins, restrict investments, and hinder businesses from entering the formal sector (Azaria & Robinson, 2005; Mascagni, Dom, Santoro, & Mukama, 2023). Simultaneously, simple or presumed systems built for small businesses might minimize compliance costs and stimulate formal involvement, but they can be unjust if applied uniformly to all sorts of small businesses (Moynihan, Giannella, Herd, & Sutherland, 2022). Similarly, another study trend has examined tax compliance behavior, revealing that timely payment is dependent not just on the fear of enforcement, but also on taxpayers' feelings of fairness, administrative simplicity, and comfort. (Author et al. 2018; Author et al. 2022). Importantly, several recent studies have shown that the total impact of tax policy is dependent on a company's compliance behavior: enterprises that pay taxes on time and in full. They may obtain reputational and contractual advantages that help to balance the tax cost, while noncompliant businesses suffer financial pressures and fines that exacerbate the tax effect (Ndlovu & Schutte, 2022).

However, three major deficiencies in this sector restrict the policy's impact. First, most empirical information focuses on the entire tax burden or a single tax type (e.g., income tax or VAT), but SMEs confront many tax responsibilities at the same time, the overall effect of which is yet unknown. Second, the role of tax compliance, particularly timely payment compliance, as measured by the proportion of total tax owed paid on time, has received less attention in panel data analyses than profitability, even though this compliance reflects the company's true relationship with the tax system. Third, evidence for weak and oil-dependent economies, such as Iraq, is limited; specific conditions here (administrative capacity, informal sector size, and industrial structure) can affect the impact of tax policy in different ways, making results from other countries less applicable.

This research aims to fill such gaps. It examines the influence of three distinct tax policies - income tax, VAT, and presumptive tax - on SMEs' profitability, as well as whether timely tax compliance decreases or enhances these connections. Based on owner-reported data from VAT-registered and tax-inspected SMEs in 2024 and 2025, this study investigates the direct and conditional effect of tax policy by examining changes inside the organization. This work has three key academic contributions. This is one of the first empirical studies to examine the differential effect of three distinct tax policies in a tax system using panel data. Theoretically, it combines tax burden and compliance. To emphasize that the true economic effect of the tax is determined not only by its design, but also by the payment behavior of businesses. SMEs have been an important tool of economic development for Iraq. The future of any growing economy, such as Iraq, depends on the entrepreneurial energy of vibrant SMEs because a lot of large businesses start as SMEs. From a policy standpoint, the results of this research give practical implications for tax administrators, allowing governments to create policies that promote the expansion of SMEs rather than raising their tax burden; thus, this work contributes both practically and academically. Improve tax compliance payments so that SMEs may preserve profitability while complying, and academically,



within what has been established as a moderator. Three primary sections make up the outline for this paper. Literature is presented in the next part, which is then followed by model estimates. The last portion is comprised of discussion, which is then followed by policy implications and concluding remarks.

2. LITERATURE REVIEW

2.1. Income Tax Policy and the Growth of SMEs

Income tax, both the official rate and real tax burden, has long been seen as a key element determining corporate profitability and growth (Janský, 2023). The majority of SME are concentrated in the service and commercial sectors. Therefore, profitability is the lifeblood of such enterprises. When there is significant market rivalry and small enterprises have limited authority to increase prices, higher income taxes diminish their earnings and limit their ability to reinvest (Xue, Cai, & Zhang, 2025). According to recent research, the effective tax burden, rather than the tax rate, has the greatest influence since it incorporates exemptions, credits, and enforcement realities (Schwab, Stomberg, & Xia, 2022). Evidence from many nations demonstrates a negative association between a greater effective income tax burden and SME profitability (Lavic, 2023; Roman, Marcu, Rusu, Doacă, & Siriteanu, 2023). When taxes rise, earnings fall, particularly for enterprises with already thin profit margins or cash-strapped operations. In emerging nations, tight tax scrutiny or the reimposition of prior years' taxes creates company uncertainty (Jacob, Wentland, & Wentland, 2022). It discourages investment large proportion of SME costs are devoted to paying tax; they will be forced to shift the tax burden onto the consumer. They will ultimately make their goods and services uncompetitive, which will have a negative impact on their Profit or growth. Recent studies have explained the relationship using an experimental method, such as how political limitations or taxation have changed throughout time (Mascagni, 2018). The findings demonstrate that the tax burden has a major impact on the profitability of small and medium-sized businesses (Judith, Maduabuchi, Igwe, Ehis, & David, 2022). Nonetheless, there are two issues with the existing literature. The majority of studies only look at income taxes; they don't include the effects of other taxes, including value-added tax or other taxes. The relationship between corporate tax compliance and these effects has not been well studied. The goal of the present research is to fill this gap. Consequently, the following hypothesis is put forth:

H1: *The income tax policy has a negative influence on the growth of SMEs in Iraq.*

2.2. VAT and SMEs

Companies pay an input tax known as value-added tax on the products they acquire. It is possible to receive a refund, which is distinct from income tax. In sophisticated countries, this system is impartial for enterprises. Nevertheless, VAT is considered an extra expense in countries that implement the deduction system (Kowal & Przekota, 2021). When informal enterprises are involved in the supply chain, or refunds are delayed. The Value Added Tax (VAT) can discourage the establishment of new small and medium-sized enterprises (SMEs) and exacerbate the decline of existing businesses, despite their substantial contribution to the Iraqi economy (Al-Jubouri, 2022). The growth of the SME sector and the economy is adversely affected by taxes on small and medium-sized enterprises (SMEs), which result in a decrease in profits, capital, employment, and sales. The burden of calculating value-added tax, issuing invoices, and managing refund claims is a significant burden for small and medium-sized enterprises (SMEs) as a result of a dearth of administrative resources, according to research. Research conducted in the past has demonstrated that over 50% of organizations reduce their workforce and cease operations (Thekkoot, 2024). Consequently, it can be asserted that value-added tax elevates the pricing of SMEs' products, which is detrimental for these enterprises in their nascent phase, as they ultimately transfer the financial burden to customers or consumers, resulting in a significantly diminished profit margin and potentially leading to the demise of their businesses. The conclusion must be drawn that the value-added tax adversely affects the expansion of SMEs.

As a consequence, the market share of products produced by small and medium-sized enterprises decreases, failure to recover funds by companies thus, profits are immediately diminished. The performance of small and medium-sized enterprises is still hindered by high operational costs, including compliance fees and daily cash flow challenges that arise from the customer's obligation to pay value-added tax prior to receiving payments (Ojo & Shittu, 2023). Subsequently, the growth of small and medium-sized enterprises is adversely affected by the VAT policy. Conversely, the enhancement of digital VAT submission and reclaim systems resulted in an increase in company margins and an increase in compliance. The majority of VAT research investigates the consequences of administrative reforms, such as modifications to refund policies or electronic invoicing (Hesami, Jenkins, & Jenkins, 2024). The results indicate that the adverse effects of VAT are mitigated when the system is fortified (Keen & Lockwood, 2010). At the same time, the burden on the sales and survival of small and



medium-sized enterprises is exacerbated when the system is weakened. Consequently, VAT can be detrimental to small businesses in the absence of administrative capacity, despite the fact that it broadens the tax base. Thus,

H2: *The VAT policy has a negative influence on the growth of SMEs in Iraq.*

2.3. Presumptive tax policy and SMEs

Small enterprises are intended to be companies incorporated into the tax system through the implementation of a presumptive or turnover-based tax (Aditya, 2020; Duve & Schutte, 2021). It possesses both advantages and disadvantages. A presumptive tax system that is well-designed can alleviate administrative burdens and integrate informal enterprises into the formal system. However, companies with low margins are at a disadvantage if the rates are unjust and fail to account for the disparity in profitability between different sectors (ABDULHAMID, 2023). Research indicates (Bucci, 2020; Leontyev & Ketners, 2023) that the advantages of this system are enhanced when presumptive tax rates are maintained in accordance with the actual distribution of profits, and very small enterprises are exempted. Nevertheless, research is rare on the actual impact of this tax in fragile economies where enforcement is unequal. Hence,

H3: *The presumptive tax policy has a negative influence on the growth of SMEs in Iraq.*

2.4. Tax Compliance as a Moderator

Tax compliance has been hindered by the substantial changes to tax laws, which exhibited complexity to the extent that only tax experts can understand (Musimenta, 2020). This might lead to challenges for taxpayers who do not have access to a tax specialist to enlighten them on the complex nature of tax laws. Tax compliance research, advantages, on more than just penalties and fines, but also on trust, administrative excellence, and taxpayer convenience (Azmi & Daud, 2024). According to a recent study, the percentage of timely tax payment indicates a company's financial health as well as its connection with the system (Adegbite, 2025). The outcomes are mixed: more compliant companies may have lower earnings because they pay more taxes, but they may also gain from bank loans, government contracts, and less audit risk. Furthermore, some research distribution increases compliance, mitigates the negative consequences of taxes by lowering the possibility of penalties, liquidity issues, and reputational harm (Doran, 2009). Taxes affect earnings and sales in various ways. Income taxes and non-refundable VAT diminish business margins, whilst presumptive taxes and supply chain delays might affect sales. Low-margin retail and service industries are particularly vulnerable to these levies, while industrial corporations are largely resilient. Some firms reduce margins to retain sales. Thus,

H4_{a,b, and c}: *The tax compliance moderates the relationship of income tax policy_(a), VAT tax policy_(b), and presumptive tax policy_(c), and access to growth of SMEs in Iraq*

3. METHODOLOGY

3.1. Research Design

This study uses quantitative and explanatory research techniques to investigate how factors of tax policies—income tax policy, value-added tax (VAT) policy, and preemptive tax policy influence the profitability of Iraq's small and medium-sized enterprises. This study also investigates the moderating impact of tax compliance on this relationship. A panel data framework was employed in this research better to understand the cause-and-effect relationship between several economic factors. Data from the same firms were gathered for two fiscal years (2024 and 2025), allowing for simultaneous cross-sectional and time-series analyses. The collected panel dataset enhanced the reliability of the analysis because it considers specific aspects of SMEs.

3.2. Sampling procedure

A purposive sample approach was employed to choose only small and medium-sized enterprises (SMEs) that are registered with the tax system and financially active. The sample frame was gathered from the Iraqi Securities Commission (ISC) and the Chamber of Commerce, which supplied names of verified registered SMEs.

The following criteria were established for inclusion:

1. The firm has been continuously operating for at least three years.
2. Be properly registered with the national tax authority;
3. Have a valid VAT registration number.
4. The tax authority has conducted at least one official inspection or audit of the firm.

Owners and financial managers who Iraq'sese criteria were contacted and encouraged to take part in the research. Participants were guaranteed total anonymity and that the data they supplied would only be used for educational reasons before participation.

3.3. Data Source and Description



Although the information was acquired directly from SME owners via a mixed-format questionnaire, the major data is really secondary, derived from the firms' official financial and tax records. The questionnaire search's both quantitative and open-ended qualitative questions to obtain numerical information such as tax amount, compliance rate, and financial outcomes. The data was collected for two periods - 2024 and 2025 - and included the following variables:

Table 1: Description

Variable Type	Variable	Measurement Description
Independent Variables	Income Tax Policy, Value-Added Tax Policy, Presumptive Tax Policy	Reported tax rates or amounts (in percentage or currency) paid by each SME.
Moderator	Tax Compliance (Payment Compliance)	Ratio of taxes paid on time to total tax liability (%).
Dependent Variables	Profitability (Net Profit, Sales Revenue)	Reported total Profit and annual sales turnover for each year.
Control Variables	Firm Size, Firm Age	Log of Total assets; years since establishment.

3.4. Estimation of Model

To examine the link between variables, the research used panel data regression methods utilizing Stata. The panel data format enables control over elements that are unique (unobserved or concealed) to each business and can only alter or distort cross-sectional results.

Model 1: The basic model.

This model examines how various tax policies, such as income firms' alue-added tax, and presumptive tax policy, impact SMEs' profitability. In addition, variables such as firm size and age control are considered. The findings are more accurate and dependable.

$$\text{Profit}_{it} = \beta_0 + \beta_1 \text{ITP}_{it} + \beta_2 \text{VATP}_{it} + \beta_3 \text{PTP}_{it} + \beta_4 \text{Size}_{it} + \beta_5 \text{Age}_{it} + \mu_i + \epsilon_{it} \quad \text{Equation 01}$$

Where Profit reflects the Profit or sales of the firm in the year t ; ITP is the income tax policy; VATP is the value-added tax policy; and PTP is the presumptive tax policy. Size and age control the influence of the company's size and age, respectively. The error term is denoted by ϵ_{it} , whereas μ_i represents the components that cannot be quantified but stay constant within each organization.

Model 2: Moderation Model

Equation 02 analyzes how tax compliance moderates the proposed relationship of tax policy components on the growth of SMEs. In simple words, it is being observed how tax policies affect the growth of SMEs, making them more compliant with tax policies.

$$\text{Profit}_{it} = \beta_0 + \beta_1 \text{ITP}_{it} + \beta_2 \text{VATP}_{it} + \beta_3 \text{PTP}_{it} + \beta_4 \text{TC}_{it} + \beta_5 (\text{ITP}_{it} \times \text{TC}_{it}) + \beta_6 (\text{VATP}_{it} \times \text{TC}_{it}) + \mu_i + \epsilon_{it} \quad \text{Equation 02}$$

In this equation, TC denotes tax compliance. The interaction factors reflect the moderating effect. Additionally, size and age are included as control variables.

4. Data analysis and Results

4.1. Descriptive Statistics

Table 2 shows that SMEs' profit margins average about 0.322, with some firms recording losses (min -0.26) while others earn good margins (max 0.573). The tax policy variables likewise vary substantially (ITP mean =0.185, sd 0.11; VATP mean =0.346, sd 0.031; PTP mean =-0.254), reflecting wide differences in effective tax burdens. SMEs are fairly new on average (mean age ~9.8 years) and the company's log-size =0.387).

Table 2: Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
Profit	0.322	0.156	-0.26	0.573
ITP	0.185	0.11	-0.391	0.367
VATP	0.346	0.031	0.18	0.431
PTP	-0.254	0.336	-1.285	0.37



SIZE	0.387	0.04	0.276	0.471
AGE	9.77	0.328	3.6	16.5

In the correlations (Table 3), profit margin shows only weak associations with the tax variables: e.g. Profit is slightly positively correlated with ITP ($r=+0.074$) but negatively with VATP ($r=-0.114$) and positively with PTP ($r=+0.196$). Firm size correlates positively with ITP ($r=+0.303$) and with PTP ($r=+0.371$), while age correlates positively with PTP ($r=+0.466$). Profit itself correlates negatively with size ($r=-0.153$) and strongly negatively with age ($r=-0.378$), perhaps reflecting lifecycle effects or omitted heterogeneity. These zero-order correlations suggest that hSMEs' VAT burdens tend to go with lower profits, but once firm fixed effects and controls are accounted for, the regression analysis reveals the more definitive relationships.

Table 3: Correlation

	Profit	ITP	VATP	PTP	SIZE	AGE
Profit	1.000					
ITP	0.074	1.000				
VATP	-0.114	-0.253	1.000			
PTP	0.196	0.142	-0.275	1.000		
SIZE	-0.153	0.303	-0.006	0.371	1.000	
AGE	-0.378	-0.131	-0.179	0.466	0.112	1.000

The Variance Inflation Factor (VIF) is employed to present the results of the multicollinearity test in Table 4. The absence of multicollinearity is indicated by the fact that all variables exhibit VIF values that are significantly lower than the conventional threshold of 10 (Kalnins & Praitis Hill, 2025). The independent variables are not highly correlated, as indicated by the mean VIF of 1.34, and they can be reliably incorporated into the regression model.

Table 4: Multicollinearity

Variable	VIF	1/VIF
ITP	1.57	0.638
VATP	1.36	0.733
PTP	1.29	0.773
SIZE	1.26	0.796
AGE	1.19	0.838
Mean VIF	1.34	

4.2. Results

The fixed-effects regressions (Table 5) reveal that all three tax policy measures have significant negative impacts on SME profit margins. In the preferred fixed-effects model, the coefficient on the income tax policy index (ITP) is -0.185 ($t=-2.53$, $p=0.012$), meaning that, holding firm-specific effects constant, a one-unit increase in the ITP index is associated with roughly a 0.185 drop in profit margin. Likewise, the VAT policy index (VATP) has a coefficient of -0.231 ($t=-3.98$, $p<0.001$), and the presumptive tax index (PTP) is -0.164 ($t=-5.47$, $p<0.001$). In substantive terms, these magnitudes imply that higher tax burdens reduce profitability: for example, a 0.1 increase in VATP would correspond to about a 0.023-point decline in profit margin. By contrast, the controls are positive: larger firms (size) have higher margins (coef= $+0.298$, $p=0.036$) and older firms also have more Profit (coef= $+0.091$ per year, $p=0.015$). All tax coefficients are statistically significant at conventional levels and maintain their sign in both fixed- and random-effects specifications (though Hausman tests favor fixed effects). The consistently negative tax coefficients align with intuition: heavier effective taxation (higher ITP, VATP, or PTP) compresses net Profit. These results echo other evidence that onerous tax obligations raise costs and erode margins.

For example, a recent Ugandan study notes that multiple levies (income, VAT, local taxes) "increase operational costs, reducing profit margins" for small traders.

Table 4: Result of Baseline Model: Fixed effect Vs. Random Effect

Variable	Fixed effect			Random effect		
	Coefficient	t	p	Coefficient	t	p
ITP	-0.185	-2.53	0.012	-0.142	-2	0.045
VATP	-0.231	-3.98	0	-0.205	-3.3	0.001
PTP	-0.164	-5.47	0	-0.149	-4.52	0
SIZE	0.298	2.11	0.036	0.254	2.02	0.043
AGE	0.091	2.46	0.015	0.078	2.23	0.026
_cons	2.304	2.82	0.005	2.628	3.36	0.001

Hausman Test $\chi^2(5) = 57.24^{***}$

4.3. Interactions

When the Tax Compliance (TC) was included as a moderator, the results of the Fixed Effect Model (Table 6) demonstrated that compliance affects profitability both directly and indirectly. According to the findings, the direct effect of tax compliance is negative (coefficient = - 0.915, $p = 0.018$), that is, companies that pay more taxes on time have relatively low profit margins because they actually pay most of their tax liabilities. However, when the interaction terms were considered, the effects of all of them turned out to be positive and statistically significant (ITP \times TC coef = 0.467, $p = 0.001$; VATP \times TC coef = + 0.592, $p = 0.005$; PTP \times TC coef = + 0.075, $p < 0.001$). This means that higher tax compliance reduces the negative impact of tax on profits. In other words, companies that are regular in paying "taxes have a relatively small reduction in their profits from the tax burden. For example, if tax compliance is 100%, the total impact of ITP on profitability would be $-1.845 + 0.467 = -1.378$, while if compliance is zero, the impact would be -1.845 . This trend shows that companies that pay taxes regularly suffer a relatively small drop in profits as a result of any tax policy. One possible reason for this may be that compliant companies avoid penalties, maintain a good reputation, and possibly receive operational or service benefits, which help reduce the tax burden. Research-wise, this result indicates that if governments promote compliance through simplification or incentives, it can reduce the negative impact of taxation on SMEs.

Table 6: Result of the Moderation Model: Fixed effect Vs. Random Effect

Variable	Fixed effect			Random effect		
	Coefficient	t	p	Coefficient	t	p
ITP	-1.845	-3.6	0	1.367	1.6	0.11
VATP	-2.134	-2.93	0.004	2.515	1.39	0.164
PTP	-0.089	-3.42	0.001	0.062	1.26	0.207
SIZE	0.217	2.13	0.034	-1.177	-5.11	0
AGE	0.041	2.28	0.024	-0.253	-9.89	0
TC	-0.915	-2.38	0.018	2.526	0.91	0.363
ITP*TC	0.467	3.29	0.001	-0.56	-1.86	0.062
VATP*TC	0.592	2.81	0.005	-0.905	-1.32	0.186
PTP*TC	0.075	4.41	0	0.048	3.43	0.001
_cons	3.208	3.14	0.002	1.727	0.25	0.806

Hausman Test $\chi^2(5) = 124.66^{***}$

5. DISCUSSION



The findings of this study are consistent with a broad set of previous studies. In both developed and developing economies, it has been observed that a high tax burden weakens the performance of small companies (Almosawi & Wahaib, 2024). For example, a new study on Kenyan small and medium-sized companies (SMEs) found a strong negative correlation between the tax rate and the growth of companies. The rationale of this negative influence is that higher taxes increase costs, decrease profits, and reduce reinvestment. Furthermore, corporate tax rates have been significantly reduced in the last two decades in many developed OECD countries (Asen, 2020). The purpose of these reductions was to recognize that heavy taxes limit business activity. Studies on tax compliance also show that high tax rates deter people from joining the system (Schwab et al., 2022). For example, a study conducted on various sectors in Ghana revealed that higher VAT rates reduce the willingness of SMEs to pay taxes, i.e. the heavy tax burden can shrink the economy.

Nevertheless, simplifying the tax system or reducing the administrative burden generally improves the establishment and growth of companies (Anim, Awotwe, Nyarku, & Kusi, 2020). For example, according to the World Bank's research on 29 OECD countries, the establishment of new companies increases by about 4% if the tax administrative burden is reduced by 10% (de Leon Miranda, 2025). Similarly, an EU study concluded that uniform tax rules for all companies place a disproportionate burden on small companies (Flamant, Godar, & Richard, 2021), as a large proportion of their limited resources is spent on compliance tasks. Therefore, even a small improvement in tax administration for the SME sector can have a big impact on the economy.

These results can be considered in accordance with standard tax and compliance theories. According to the theory of tax incidence, small businesses, which have limited market power, are generally not able to pass on the burden of high taxes entirely to consumers or employees, so the burden falls directly on profits and wages. For example, raising the value-added tax (VAT) in the competitive retail sector usually reduces the profits of companies, instead of increasing prices. Similarly, according to the tax compliance cost theory, each tax system imposes a fixed administrative burden (such as record keeping, form submission, audit, etc.), which is particularly heavy on small companies. According to the OECD, SMEs face large fixed costs for conformity that prevent them from getting into the Bank's system and hinder their growth (OECD, 2024). This international evidence is consistent with our findings in Iraq: heavy tax policies reduce profits and the formal economy, while effective tax compliance and simple systems reduce these negative impacts.

Conversely, the intricate and complicated tax systems may result in a decrease in formal business activities (Jensen, 2022). The standard reports of Iraqi companies serve as evidence that the tax system is less transparent and the costs are high (Al-Refiay, Barrak, Isam Elaibi Al-Tameemi, & Pazhohi, 2025). As most of businesses are afraid to participate in value-added tax refund procedures because it is a complex procedure with an additional cost and a high cost to file VAT, and the Allingham-Sandmo model, which is an economic model, states that companies are then involved in formal activities within such situations that result in an audit (Magasha, Gillo, & Alex, 2025). As risk grows and skills develop, it has a negative impact on company growth. Similarly, past research has shown that taxes in countries with complicated processes and high filing costs have a poor performance rate among SMEs (Roman et al., 2023). They frequently conduct business informally in order to circumvent substantial tax liabilities and operate with low profit margins. The results of our study also demonstrated that the influence of tax compliance weakens the negative relationship between tax components and the growth of SMEs. According to the behavioral tax theory, SMEs that prioritize compliance are more adept at comprehending voluntary tax regulations (Ndlovu & Schutte, 2024). This stabilizes investment and diminishes tax evasion. As a conclusion, it can be said that those SMEs that effectively implement tax compliance within their businesses are able to get rebates and ability to survive in long terms. They also reduce the burden of their liability, which means that their debt ratio is reduced, and ultimately, the business has the capacity to raise capital in the future.

Conversely, organizations that demonstrate inadequate compliance will incur double penalties. Taxes directly diminish profits. However, they can also result in a reduction in revenue flow or sanctions. In other words, the effective tax burden on SMEs is diminished when they pay taxes on time and avoid penalties. The tax burden is relatively less on compliant enterprises, as evidenced by positive interactions. Thus, in accordance with the positive interactions, the tax burden is significantly lower for businesses that comply with the tax regulations.

Nevertheless, the negative base effect of compliance also suggests that increased compliance is correlated with lower profits. That is logical because the payment of additional taxes diminishes the after-tax income. Consequently, our findings demonstrate both aspects of the Laffer Curve: while the revenue base from compliance is broader, the impact of each additional tax is more pronounced when firms tax more accurately. In conclusion, the studies conducted in various countries



demonstrate that the profitability and development of SMEs are not the only factors influenced by high tax burdens and complex tax systems. However, taxes generally result in a revenue deficit, particularly when compliance is challenging.

4.1. Policy Implications

Based on the results of this study, we have numerous policy implications for tax reformers, governments, and emerging economies, particularly for SMEs in Iraq. Policymakers should prioritize simplification of tax procedures, reduce compliance costs rather than focusing on increasing tax rates (Elumilade, Ogundeji, Achumie, Omokhoa, & Omowole, 2022). For instance, simplify procedures for filling out forms, digital reporting, clear communication of tax obligations, and the voluntary reduction of administrative burdens. The second is the moderator effect of tax compliance, which tells us that SMEs that are aware of the tax should be fair, transparent, and predictable to comply with it and reduce the negative impact of taxation. It emphasizes the importance of building trust between taxpayers and the tax authority (Gangl, Hofmann, & Kirchler, 2015). Consistent enforcement of taxpayer education and improvements to the service by creation of digital payment platforms, the continuation of tax education programs, and the expansion of reward schemes, so that revenue collection increases and the firm's growth accelerates. The next result shows that the presumptive and value-added tax policies should also be redesigned. The results show that the value-added tax and presumptive tax system should be built based on realities for small businesses, and the government should adopt the graduated tax rate or turnover-based tax to reduce the burden of micro and small businesses and the faster the value-added tax refund and favor audit delay, the greater the cash flow of SME companies. Finally, the government should launch broader SME support programs such as easy access to credit, financial training programs, incentives for formal registration, and all of these measures will increase voluntary compliance and help to grow tax bases and sustainable businesses (Doh & Kim, 2014). Thus, in summation, there should be a simple, fair, and transparent tax system that will assist the government and SMEs in growing the economy and levelling the tax burden.

4.2. Conclusion

Small and medium-sized businesses have a significant impact on a country's economic growth. In addition to these enterprises, they play an important part in growing the country's GDP and individuals' living standards. To investigate the impact of different components of tax policies on the growth of SMS in Iraq, the panel data was taken from their owners, and then the fixed random effect model was applied to the collected data. As a conclusion, the results reveal that income tax, value-added tax, and presumptive tax have a negative impact on the growth of SMEs, indicating that countries should promote the business of SMEs by applying company-friendly policies. Furthermore, this study also examines the moderating effect in the proposed relationship, which is tax compliance. It weakens the direct relationship because they understand that tax processes are easier. Thus, findings of this paper contribute valuable understandings into the complex relationship between taxes and the growth of Small and Medium-sized Enterprises (SMEs) in Iraq. The last contribution is that this research adds to how the link between taxes and SMEs may be investigated in Iraq in the future.

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