



NADI INSTITUTE

AFFILIATION:¹ Ministry of Finance, Indonesia² Universitas Siber Asia, Indonesia***CORRESPONDENCE:**

fahmiandhika.r90@kemenkeu.go.id

ARTICLE HISTORY**Received:**

13 February 2026

Reviewed:

25 February 2026

Revised:

1 March 2026

Accepted:

6 March 2026

Article Type: Systematic Review

VAT Threshold Effectiveness: Behavioral Distortions, SME Growth Traps, and Perceived Fairness

Fahmi Andhika Rusthadi^{1*}, Muhammad Irkham Maulana¹, Witdya Vernanda²**Abstract:**

Value Added Tax (VAT) registration thresholds are designed to reduce administrative burdens for small businesses, yet they often create unintended behavioral and economic distortions. This study synthesizes empirical evidence from twenty-seven selected journal articles to evaluate the impact of VAT thresholds on business decision-making, SME growth, and voluntary compliance. The review identifies three critical findings. First, the threshold acts as a "fiscal cliff," triggering widespread strategic distortions such as "bunching" (turnover suppression) and "business splitting" (fragmentation), as firms restructure to exploit horizontal inequities between taxed and exempt entities. Second, the threshold functions as a "growth trap" for Small and Medium Enterprises (SMEs); high, regressive compliance costs deter formalization, incentivizing firms to stagnate voluntarily rather than face the administrative burden of entering the tax net. Third, the study establishes a causal link between perceived horizontal inequity and eroded tax morale, demonstrating that voluntary compliance is heavily dependent on the perceived procedural and distributive fairness of the tax system. The findings suggest that to mitigate these distortions, policymakers should prioritize digital adoption to lower compliance costs, implement smoothing mechanisms at the threshold, and enhance transparency to restore taxpayer trust.

Keywords: VAT Threshold, Business Splitting, Bunching, Compliance Costs, Horizontal Equity, Tax Morale.

Introduction

The implementation of registration thresholds within Value Added Tax (VAT) or Goods and Services Tax (GST) systems represents a crucial fiscal policy instrument designed to balance administrative efficiency with revenue optimization. However, global literature highlights that establishing these limits often triggers serious issues regarding the principle of horizontal equity, where business entities with equivalent economic capabilities are treated differently solely based on whether their turnover falls slightly above or below the threshold. This inequity impacts not only market structure but also fundamentally influences taxpayer compliance behavior.

Empirical studies consistently demonstrate that VAT thresholds create significant behavioral distortions among firms, widely known as the "bunching" phenomenon or business fragmentation. This phenomenon occurs when firms deliberately suppress their reported turnover just below the threshold to avoid VAT registration obligations and the associated compliance costs. In India, for instance, bunching behavior is driven by size-dependent reporting requirements, resulting in revenue shifting and underreporting (Mittal, 2019).

Similarly, tax data analysis in Finland reveals that bunching is primarily driven by VAT reporting compliance costs rather than the tax rate itself, ultimately hindering small business growth (Rauhanen et al., 2016). Meanwhile, in the United Kingdom, while significant bunching distortions are detected, a complex dynamic exists where some firms opt for voluntary registration due to supply chain considerations (Liu et al., 2019).

The economic impact of VAT threshold policies on the growth of Micro, Small, and Medium Enterprises (MSMEs) and compliance costs varies significantly depending on the threshold level applied. Literature compares these dynamics between high-threshold countries like Indonesia and low-threshold countries like Thailand. In Indonesia, a high threshold is considered to reduce the administrative burden for MSMEs, enabling greater resource allocation for innovation (Maharani, 2024; Safrizal & Astuti, 2024). However, this policy also creates sectoral pressures and potential margin reductions due to other tax reforms (Fathoni, 2025). Conversely, in Thailand, a low threshold results in high compliance costs that impede small business growth and encourage informality and misreporting (Muthitacharoen et al., 2021). Comparatively, high thresholds are viewed as more efficient and fair for small entrepreneurs, though they risk reducing the revenue base if not balanced with other policies (Fadillah et al., 2025; Satterthwaite, n.d.).

Beyond technical economic impacts, the issue of horizontal equity regarding VAT thresholds has a strong correlation with psychological aspects of taxation, specifically tax morale and voluntary compliance. Horizontal equity—the principle that individuals with similar incomes should pay similar taxes—is a critical dimension of tax fairness that influences compliance behavior (Farrar & Thorne, 2012). Research indicates that perceptions of distributive fairness have a strong effect on compliance; when taxpayers believe others are paying their fair share, their willingness to comply increases (Marshall et al., 2023; Nathan et al., 2024). Furthermore, perceptions of transparency and accountability in the tax system have been proven to enhance institutional trust (Naslia & Yulianti, 2024). In contrast, perceived unfairness due to thresholds triggering

unfair competition can drive taxpayers toward the informal sector or non-compliance (Kanbur & Keen, 2014).

Based on the exposition above, this study employs a Systematic Literature Review (SLR) method to synthesize global evidence and address the following research questions:

- RQ1: To what extent does global literature demonstrate business decision distortions, such as business splitting, resulting from horizontal inequity at the VAT threshold?
- RQ2: What are the economic impacts of VAT thresholds on the compliance behavior of small and medium taxpayers?
- RQ3: How does the perception of horizontal inequity regarding VAT thresholds influence the voluntary compliance of small entrepreneurs?

Research Method

This study employs a Systematic Literature Review (SLR) approach to comprehensively analyze the impact of VAT/GST thresholds on horizontal equity, business distortions, and tax compliance. The review process follows the Preferred Reporting Items for Systematic Reviews and Meta-Analyses (PRISMA) guidelines to ensure transparency and reproducibility.

2.1. Data Source and Search Strategy The Scopus database was selected as the primary source for literature retrieval due to its extensive coverage of high-impact journals in economics and business. The search was conducted using a specific string of keywords and Boolean operators designed to capture relevant studies on VAT thresholds, tax fairness, and taxpayer behavior.

The following search string was executed in the "Article Title, Abstract, Keywords" field:

```
TITLE-ABS-KEY ( ( "VAT" OR "GST" OR "Value Added Tax" OR "Goods and Services Tax" ) AND ( "threshold*" OR "registration limit" OR "exemption*" OR "turnover limit" OR "small business*" OR "SME*" ) AND ( "equity" OR "fairness" OR "distort*" OR "bunching" OR "cluster*" OR "split*" OR "fragment*" OR "compliance*" OR "evasion" OR "avoidance" OR "informal*" OR "shadow economy" OR "behavior*" OR "moral*" ) )
```

2.2. Inclusion and Exclusion Criteria To ensure the relevance and quality of the selected literature, several inclusion and exclusion criteria were applied during the screening process:

Subject Area: The search was limited to Economics, Econometrics and Finance; Business, Management and Accounting; and Social Sciences to filter out technical or engineering-related papers.

Document Type: Only peer-reviewed journal articles were included to maintain academic rigor. Conference papers, book chapters, and reviews were excluded.

Language: The selection was restricted to articles published in the English language.

Accessibility: The search was initially limited to Open Access articles to ensure full-text availability for in-depth analysis.

Result and Discussion

3.1. Search Results and Selection Process

Search Results and Selection Process The literature selection process is summarized in the PRISMA flow diagram (Figure 1). The initial search in the Scopus database yielded a total of 338 documents.

To ensure the relevance and quality of the dataset, a multi-stage screening process was implemented. Initially, restricting the search to the fields of Economics, Business, and Social Sciences reduced the pool to 164 documents. This was further refined by filtering for 'Articles' only, which brought the total to 143. Subsequently, limiting the results to English-language publications left 137 documents. In the final stage, the application of an 'Open Access' filter distilled the list to a final selection of 44 documents.

3.2. Manual Review and Final Synthesis

Following the initial filtering, the remaining 44 articles underwent a rigorous manual full-text review to evaluate their eligibility based on the primary research questions (RQ1, RQ2, and RQ3). During this critical assessment phase, 17 articles were excluded from the sample. Specifically, six papers were deemed irrelevant as they did not focus on the impact of VAT thresholds concerning equity or compliance behavior. Additionally, 11 articles had to be removed due to accessibility constraints, such as mislabeled open-access status or broken links which prevented a comprehensive full-text analysis.

Consequently, a total of 27 articles were selected for the final synthesis. These articles form the basis of the analysis regarding business splitting, economic impacts, and voluntary compliance perceptions.

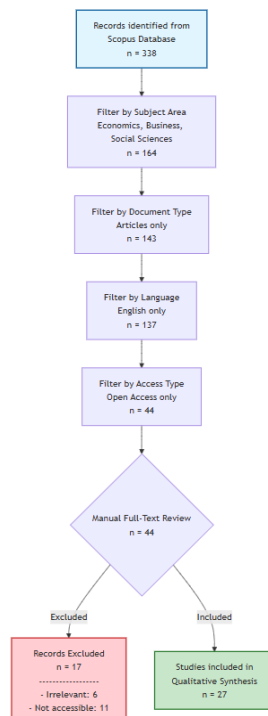


Figure 1. PRISMA flow diagram

3.3 The implications of the findings

Based on the synthesis of the twenty-seven selected studies, this section discusses the implications of the findings regarding the design and impact of VAT thresholds. The discussion is categorized into three main themes corresponding to the research questions: (1) strategic behavioral distortions, (2) the economic impact on SME growth, and (3) the role of perceived fairness in voluntary compliance.

Table 1. Synthesis Matrix of Selected

study ID	RQ1: Business Decision Distortion (Splitting/Bunching)	RQ2: Economic Impact & SME Compliance	RQ3: Perceived Fairness & Voluntary Compliance
Ghiur Rodica et al. 2020	The EU VAT package aims to reduce competitive distortions for SMEs operating across borders.	Simplification of rules is expected to suppress compliance costs and support SME growth.	Encourages voluntary compliance through procedural simplification and fairer treatment.
Marsida Harremi 2014	A large tax gap reflects a high informal economy (distortion) which harms formal businesses.	-	-
Azzam Hannoon 2019	-	Adoption of accounting systems is influenced by compliance cost efficiency and relative benefits for SMEs.	-
Vladimir Victorovich Kuzmenko et al. 2015	Suboptimal tax design causes economic distortions.	Tax transformation must consider the burden on businesses to be economically feasible.	-
Gianpaolo Araci et al. 2025	-	-	Finds that tax morale and perceived fairness are key factors in voluntary compliance.
Susanne Wallman Lundasen 2012	Harmonization can reduce competitive distortions between non-profit and commercial sectors.	High administrative burdens hinder the activities of small organizations.	Issues of fairness in tax treatment for the non-profit sector compared to the business sector.
Abigail Padi et al. 2025	High VAT rates negatively affect compliance, indicating behavioral distortion due to economic burden.	Compliance costs were not found to significantly affect compliance, but tax knowledge has a positive effect.	Procedural and distributive justice, as well as trust in government, have a significant positive effect on voluntary compliance.
Keshav Choudhary, Bhanu	Strong empirical evidence of firms 'bunching' just below the registration	Tax thresholds create distortions that hinder firm growth ('stay small') to avoid compliance costs	-

Andhika, Maulana, Vernanda

VAT Threshold Effectiveness: Behavioral Distortions, SME Growth Traps, and Perceived Fairness

Gupta 2025	threshold to avoid tax obligations.	associated with entering the tax net.	
Manaf Al-Okaily et al. 2022	-	Tax knowledge and technology have a significant positive effect on compliance cost efficiency.	-
Endrit Lami, Drini Imami 2019	Decline in tax performance before elections indicates political distortion in tax enforcement.	-	Perceptions of political manipulation of taxes can lower public trust and voluntary compliance.
Neba Bhalla et al. 2022	-	Tax reform and firm characteristics significantly affect the financial performance of micro-enterprises.	-
Obert Matarirano et al. 2019	-	Identifies turnover and system complexity as key drivers of high compliance costs for small construction businesses.	-
M.T. Espinosa - Jaramillo 2025	Exemptions and tax benefits in the VAT system create distortions that limit tax efficiency.	-	-
Andrea Ricci, Mattia Fochesato 2024	-	-	Perceptions of distributive justice can be improved through differential VAT rate policies.
Katarzyna Kopec 2020	-	-	-
Xisco Oliver et al. 2022	-	-	VAT personalization (e.g., cashback for the poor) can improve the system's perceived fairness.
Mark Goodchild et al. 2022	Finds evidence of production fragmentation by small manufacturers to stay below the tax exemption threshold.	Differential tax systems create significant market distortions and high health cost externalities.	Discusses perceived horizontal inequity between the formal sector (high tax) and the informal/small sector (low tax).
Olena Tymchenko, Yuriy Sybiryansky 2025	Reform aims to minimize artificial business splitting practices used to minimize tax liabilities.	The current system is exploited by large businesses, hindering genuine SME growth and distorting competition.	-

Andhika, Maulana, Vernanda

VAT Threshold Effectiveness: Behavioral Distortions, SME Growth Traps, and Perceived Fairness

Eragbhe E., Omoye, A.S 2014	-	SME characteristics were not found to significantly affect compliance costs, but compliance costs are acknowledged as a burden.	-
Grzegorz Mentel et al. 2025	Excessively high tax rates trigger tax evasion (behavioral distortion) and suppress economic activity.	-	Taxpayers are more compliant if the system is considered equitable. Horizontal equity encourages voluntary compliance.
Sijbren Cnossen 2022	Numerous exemptions and dual rates in the EU VAT system create significant economic decision distortions.	Complexity of the EU VAT system burdens cross-border businesses with high compliance costs.	-
Sung Man Yoon 2018	-	Compliance costs (transaction fees) of the Reverse Charge System are perceived as burdensome.	-
Ross Warwick et al. 2022	VAT exemptions distort consumption/production decisions.	-	Discusses distributive equity of VAT systems versus social assistance systems.
Anculien Schoeman et al. 2022	Empirical evidence of 'bunching' around the VAT registration threshold to avoid tax obligations.	High compliance costs and administrative burdens (especially for new businesses) can hinder growth.	-
Xoliswa H. Mqaba 2024	-	Current VAT registration thresholds are seen as hindering SME growth because of the high compliance burden.	-
Olajumoke Ogunniyi et al. 2023	Widespread tax avoidance behavior leads to significant market distortions and unfair competition.	High compliance costs and VAT administrative complexity are major hurdles for SMEs.	-
Giacomo Brusco, Tejaswi Velayudhan 2025	Finds evidence of bunching around registration thresholds, especially following tax rate hikes.	Exemption thresholds can hinder SME growth by creating a size-based informal sector.	-

3.3.1. Business Decision Distortions Resulting from Horizontal Inequity (RQ1)

The imposition of a Value Added Tax (VAT) registration threshold creates a distinct discontinuity in the tax schedule, often referred to in public finance literature as a "notch." Theoretical models suggest that such discontinuities create strong incentives

for firms to modify their behavior to remain below the threshold, thereby avoiding the administrative and financial burdens of entering the tax net. The synthesis of the selected literature confirms that this theoretical prediction manifests empirically in two primary forms of distortion: bunching (turnover suppression) and business splitting (fragmentation).

The most direct evidence of behavioral distortion is the phenomenon of "bunching," where a disproportionate number of firms report annual turnover just below the VAT registration threshold. Choudhary and Gupta (2025) provide one of the most compelling empirical analyses of this behavior using administrative tax data from India. Their study reveals that firms do not merely stagnate; they actively manage their reported revenue to avoid crossing the regulatory boundary. Specifically, they find that firms slow down their reported revenue growth by approximately 14 percentage points—or roughly 42% of average growth—as they approach the threshold. Crucially, Choudhary and Gupta argue that this slowdown is not accompanied by a corresponding reduction in input costs, suggesting that the behavior is likely evasion (under-reporting) rather than a real reduction in economic activity. This finding challenges the "compliance cost" hypothesis alone and points towards "audit avoidance" as a primary driver; firms fear the increased scrutiny that comes with formal VAT registration.

This strategic behavior is corroborated by Schoeman et al. (2022) in the context of South Africa. Their experimental study indicates that changes in tax rates significantly influence the decision to register. When the VAT rate increases, the value of the "notch" (the sudden jump in tax liability) increases, thereby strengthening the incentive for firms to bunch below the threshold. Schoeman et al. highlight that this is a rational economic decision: for a small business with low input tax credits (e.g., labor-intensive service firms), the marginal tax rate of crossing the threshold can exceed 100% of their profit margin. Consequently, the threshold acts as a hard barrier, incentivizing firms to artificially cap their scale of operations or divert sales into the shadow economy.

While bunching represents a suppression of reported turnover, business splitting represents a structural distortion where a single economic entity is legally or artificially divided into multiple smaller units to multiply the benefit of the threshold exemption. Goodchild et al. (2022) provide a stark illustration of this in the Indian bidi (cigarette) industry. Their research found that manufacturers engage in widespread production fragmentation to ensure that each unit remains small enough to qualify for tax exemptions. This "fragmentation" does not only result in revenue loss for the state but also creates significant negative externalities, such as the inability to regulate health standards and labor conditions effectively in these fragmented, semi-informal units.

The aggregate effect of these individual distortions is a compromised tax system characterized by high levels of informality. Harremi (2014) analyzes the "tax gap" in the Balkan region and concludes that a significant portion of the gap is attributable to the shadow economy, which is partially sustained by high thresholds and weak enforcement. When the threshold is set too high, it effectively legalizes a large untaxed sector; when it is set too low but enforcement is weak, it encourages firms to operate entirely off the books.

Brusco and Velayudhan (2025) add a nuance to this discussion by analyzing VAT incidence. They find that even firms that are exempt (below the threshold) are affected by the VAT system through the prices of their inputs. However, because these firms

cannot claim input tax credits, they are stuck in a "double distortion": they are competitively disadvantaged if they buy from formal suppliers (due to embedded VAT), but they are incentivized to buy from informal suppliers to avoid tax entirely. This severs the VAT chain and perpetuates a dual economy—one formal and taxed, one informal and untaxed.

Cnossen (2022) frames this within the concept of "C-inefficiency" in the EU VAT system. He argues that policy gaps, including broad exemptions and thresholds, create a fractured system where economic decisions are driven by tax optimization rather than market efficiency. The "policy gap"—revenue lost due to legal exemptions—often dwarfs the "compliance gap" (illegal evasion). This suggests that the distortion is not merely a failure of enforcement, but a failure of design.

In conclusion, the literature confirms that RQ1 is answered affirmatively: VAT thresholds induce significant behavioral distortions. These range from the dynamic suppression of growth (bunching) to the structural reorganization of firms (splitting). These behaviors are not merely tax evasion; they represent a fundamental alteration of business strategy driven by the incentives inherent in the threshold design. The "fiscal cliff" forces firms to choose between stagnation (staying small) or complex evasion strategies, both of which are detrimental to long-term economic productivity.

3.3.2. Economic Impacts on Compliance Behavior (RQ2)

The second research question investigates the economic impact of VAT thresholds on Small and Medium Enterprises (SMEs), specifically focusing on compliance costs and growth trajectories. The synthesized literature reveals a concerning paradox: while thresholds are intended to protect small firms from the burden of taxation, the "cliff edge" they create often acts as a "growth trap," discouraging transition into the formal economy and inhibiting organic business expansion.

A dominant theme in the reviewed studies is the disproportionately high cost of VAT compliance for small businesses. Matarirano et al. (2019), focusing on the construction industry, identify turnover volume and tax system complexity as the primary drivers of compliance costs. Their findings suggest that the complexity of the VAT system—specifically the requirement to track input and output tax, manage invoices, and file frequent returns—creates a barrier to entry. Firms perceive the transition from "exempt" to "registered" not just as a financial cost (paying tax), but as an operational shock that requires a fundamental change in how they do business.

The systemic complexity of the tax environment exacerbates this trap. Espinosa-Jaramillo (2025) and Cnossen (2022) illustrate how systemic complexity exacerbates this trap. In jurisdictions like Ecuador and the EU, the existence of multiple VAT rates, exemptions for specific goods, and special schemes creates a labyrinthine system. For an SME, determining the correct tax treatment for every transaction is administratively costly. Cnossen (2022) highlights that in the EU, cross-border VAT compliance is so burdensome that it effectively prevents many small firms from participating in the Single Market, limiting their growth potential to domestic markets only.

While the compliance burden creates a barrier, literature suggests that technology offers a pathway to mitigation. Hannon (2019) supports this view in the context of VAT-compliant accounting system adoption. He finds that while the initial adoption cost is a barrier, the long-term efficiency gains can outweigh the compliance

burden. This suggests that the "growth trap" may be less severe when firms are able to modernize their internal systems, transforming compliance from a manual burden into an automated process.

Finally, Brusco and Velayudhan (2025) highlight an economic nuance regarding "voluntary registration." They note that some SMEs choose to register even if they are below the threshold to claim input tax credits, particularly if they sell to other VAT-registered businesses (B2B). However, for B2C firms (retailers), the threshold remains a hard barrier. If a retailer registers, they must increase prices for final consumers, making them uncompetitive against unregistered rivals. This creates a dual-speed economy where B2B SMEs may grow and formalize, while B2C SMEs remain trapped in informality/smallness to maintain price competitiveness.

In summary, regarding RQ2, the literature indicates that VAT thresholds currently hinder SME growth by imposing a regressive compliance burden that creates a disincentive to formalize. The economic impact is the stagnation of the SME sector and the perpetuation of a dual economy. However, the emerging digitalization of tax administration offers a promising pathway to dismantle this trap, transforming compliance from a barrier into a manageable operational routine.

3.3.3. Influence of Perceived Horizontal Inequity on Voluntary Compliance (RQ3)

The third research question explores the psychological and sociological dimensions of taxation. The synthesis of the selected studies strongly suggests that "tax morale"—the intrinsic motivation to pay taxes—is heavily influenced by perceived fairness. The literature shifts the focus from a purely economic model of compliance (deterrence via audits and penalties) to a behavioral model rooted in Horizontal Equity and Procedural Justice.

Horizontal Equity refers to the principle that equals should be treated equally. Several studies highlight that VAT thresholds inherently violate this principle in the eyes of compliant taxpayers. Goodchild et al. (2022) illustrate this vividly in the Indian context. The differential tax treatment between large, formal cigarette manufacturers and small, informal bidi producers creates deep market distortions. The formal sector views the exemption of the small sector not as a valid social policy, but as an unfair subsidy that rewards inefficiency and informality. This sentiment aligns with Harremi (2014), who links the high tax gap in the Balkans to a general erosion of trust in the fairness of the system.

Beyond the specific design of the threshold, Padi et al. (2025) provide crucial evidence from Ghana regarding Procedural Justice. Their multi-dimensional analysis finds that "trust in government" and the perception of fairness in how taxes are administered are significant drivers of voluntary compliance—often more significant than the fear of penalties. When taxpayers believe that the tax authority is fair, transparent, and respectful, they are more likely to comply voluntarily. Conversely, if the administration is viewed as corrupt or arbitrary, compliance plummets.

This political dimension is further explored by Lami and Imami (2019), who document "electoral cycles" in tax performance. They find that tax enforcement often relaxes before elections for political gain. Such manipulation sends a signal to taxpayers that tax enforcement is political and arbitrary, rather than rule-based. This cynical view undermines the social contract and reduces the stigma associated with non-compliance.

Espinosa-Jaramillo (2025) echoes this in Ecuador, noting that perceptions of corruption and the misuse of public funds directly lower the moral cost of evasion.

The literature also discusses Distributive Justice—the fairness of the outcome. Warwick et al. (2022) examine the use of VAT for redistribution. While VAT is often criticized as regressive (burdening the poor more), these authors argue that exemptions are a blunt and inefficient tool for equity. Warwick et al. show that cash transfers are far more effective at helping the poor than VAT exemptions, which often leak benefits to the wealthy.

However, removing exemptions (and potentially lowering thresholds) is politically difficult. To address this, Oliver et al. (2022) propose "Personalized VAT" systems, such as real-time cashback for low-income households. Such mechanisms can enhance the perceived fairness of the tax system. If taxpayers see that the system actively protects the vulnerable without creating loopholes for tax cheats (like broad exemptions do), the overall legitimacy of the system increases.

Finally, Yoon (2018) highlight the role of transparency. Yoon's study on the Reverse Charge System (RCS) in Korea shows that while the system increased compliance costs, it also increased transparency in trade. Surprisingly, this transparency improved the perceived fairness of the market by making it harder for fraudulent traders to undercut legitimate businesses. Similarly, Araci et al. found that in the tourism sector, the use of FinTech increased transparency, which in turn positively influenced tax morale. When technology makes it harder to cheat, it paradoxically makes honest taxpayers feel better, as they know they are not being "chumps" for complying while others evade.

In conclusion for RQ3, the literature confirms that perceived fairness is a prerequisite for voluntary compliance. The VAT threshold, while administratively convenient, often creates horizontal inequities that damage tax morale. To maintain high levels of voluntary compliance, tax authorities must go beyond enforcement; they must demonstrate that the system is fair, that exemptions are not loopholes for the dishonest, and that the revenue collected is used transparently. Without this "psychological contract," the threshold will remain a source of friction and evasion.

Conclusion

This systematic literature review has synthesized empirical evidence from twenty-seven global studies to evaluate the multifaceted impact of VAT thresholds. By analyzing the interplay between tax policy design and taxpayer behavior, this study draws the following conclusions regarding business distortions, economic impacts, and the psychological dimensions of compliance.

4.1. Synthesis of Findings

Response to RQ1: Extent of Business Decision Distortions Global literature provides extensive and robust evidence that VAT thresholds create significant business decision distortions driven by horizontal inequity. The threshold acts as a "fiscal cliff," generating a disparity in tax treatment between similar firms. Consequently, firms engage in strategic behaviors to remain on the favorable side of this inequity. The

review confirms that business splitting (fragmentation) is not an isolated occurrence but a structural response, particularly in sectors where the tax burden difference between formal and informal operations is high (Goodchild et al., 2022). Furthermore, bunching behavior—where firms artificially suppress turnover growth to avoid registration—is a pervasive global phenomenon, evidenced strongly in emerging economies like India and South Africa (Choudhary & Gupta, 2025; Schoeman et al., 2022). These findings demonstrate that horizontal inequity at the threshold does not merely affect tax revenue but fundamentally alters business organization and growth strategies.

The economic impact of VAT thresholds on Small and Medium Enterprises (SMEs) is characterized by a regressive compliance burden. The literature reveals that the fixed costs of compliance (administrative complexity, technology, and audit risk) weigh disproportionately on small firms. This economic pressure drives a specific compliance behavior: stagnation. Instead of leveraging the threshold as a stepping stone for growth, many SMEs view it as a "growth trap," choosing to limit their economic activity to avoid the high marginal cost of formalization.

The study concludes that perceived horizontal inequity is a corrosive factor for voluntary compliance. Tax morale is not solely determined by economic rationality but is deeply rooted in the perception of fairness. When small entrepreneurs observe competitors operating tax-free due to threshold exemptions (or abuse thereof), their intrinsic motivation to comply diminishes. The literature establishes a clear causal link: high perceived horizontal inequity leads to lower tax morale and increased justification for evasion (Mentel et al., 2025). Conversely, when tax systems are perceived as procedurally fair and transparent—where the "rules of the game" apply equally to all—voluntary compliance improves significantly (Padi et al., 2025; Yoon, 2018).

4.2. Policy Implications

Based on these conclusions, three key policy recommendations emerge:

- a. Mitigating the "Cliff Effect": Policymakers should consider smoothing mechanisms, such as transitional tax regimes for firms slightly above the threshold, to reduce the sharp horizontal inequity that incentivizes bunching and splitting.
- b. Digital Facilitation: Governments must actively subsidize or mandate the adoption of digital compliance tools for SMEs. Reducing the administrative cost of compliance is the most effective way to dismantle the "growth trap."
- c. Restoring Fairness: To enhance voluntary compliance, tax authorities must address the perception of inequity. This requires stricter enforcement against artificial business splitting and transparent communication regarding how tax revenues are utilized to benefit the broader business ecosystem.

4.3. Limitations and Future Research

This review acknowledges that compliance behavior is context-dependent. While the economic mechanisms of the "growth trap" appear universal, the cultural drivers of tax morale vary between regions (e.g., the Balkans vs. Scandinavia). Future research should focus on longitudinal studies to measure the long-term impact of digitalization on threshold-related distortions.

References

- Brusco, G., & Velayudhan, T. (2025). VAT incidence in real VAT systems. *Journal of Public Economics*, 249. <https://doi.org/10.1016/j.jpubeco.2025.105447>
- Choudhary, K., & Gupta, B. (2025). Dynamics of evasion around tax thresholds: Evidence from Indian firms. *Journal of Public Economics*, 252. <https://doi.org/10.1016/j.jpubeco.2025.105535>
- Crossen, S. (2022). The C-inefficiency of the EU-VAT and what can be done about it. *International Tax and Public Finance*, 29(1), 215–236. <https://doi.org/10.1007/s10797-021-09683-0>
- Espinosa-Jaramillo, M. T., Ramírez Lafuente, C. A., de Los Ángeles Cárdenas-Pérez, A., & Zuta, M. E. (2025). Fiscal deficit and value-added tax collection in Ecuador: Trends and tax effectiveness. *Revista de Ciencias Sociales*, 31(4), 274–287. <https://doi.org/10.31876/rcs.v31i4.44853>
- Fadillah, L., Gunarto, M., & Helmi, S. (2025). Evaluating the Impact of Value-Added Tax on Economic Growth, Inflation, Unemployment, and Consumer Behaviour in Developing Countries: Evidence from Indonesia. *Proceedings International Conference on Business, Economics & Management*, 2, 200–208. <https://doi.org/10.47747/icbem.v2i2.2615>
- Farrar, J., & Thorne, L. (2012). The Individual Impact of Tax Fairness Dimensions on Tax Compliance: Canadian Evidence. *Social Science Research Network*. <https://doi.org/10.2139/SSRN.1980704>
- Fathoni, M. I. (2025). Indonesia's Value Added Tax (VAT) Reform: Fiscal Benefits and Sectoral Impacts. *Jurnal Syntax Admiration*, 6(1), 530–548. <https://doi.org/10.46799/jsa.v6i1.2039>
- Goodchild, M., Munish, V. G., Sinha, P., Tullu, F. T., & Paul, J. (2022). Revisiting the tax treatment of bidis in India. *Tobacco Control*, 31(3), 432–437. <https://doi.org/10.1136/tobaccocontrol-2020-056056>
- Hannoon, A. (2019). Assessing the role of factors affecting the adoption of vat-compliant accounting systems. *Management Science Letters*, 9(9), 1439–1450. <https://doi.org/10.5267/j.msl.2019.5.007>
- Harremi, M. (2014). A simple analysis of the tax gap Balkan region. *Mediterranean Journal of Social Sciences*, 5(19), 365–372. <https://doi.org/10.5901/mjss.2014.v5n19p365>
- Kanbur, R., & Keen, M. (2014). Threshold, Informality, and Partitions of Compliance. In *Research Papers in Economics*.
- Lami, E., & Imami, D. (2019). Electoral Cycles of Tax Performance in Advanced Democracies. *CEifo Economic Studies*, 65(3), 275–295. <https://doi.org/10.1093/cesifo/ifz008>
- Liu, L., Lockwood, B., Almunia, M., & Tam, E. H. F. (2019). VAT Notches, Voluntary Registration, and Bunching: Theory and UK Evidence. *IMF Working Papers*, 19(205). <https://doi.org/10.5089/9781513513812.001>
- Maharani, A. P. (2024). Optimizing VAT threshold: The key to improving VAT performance. *Educoretax*, 4(10), 1241–1250. <https://doi.org/10.54957/educoretax.v4i10.1116>
- Marshall, M. E., Farrar, J., Massey, D., Thorne, L., Wu, A., & Bui, T. (2023). In All Fairness: A Meta-Analysis of the Tax Fairness–Tax Compliance Literature. *Behavioral Research in Accounting*. <https://doi.org/10.2308/bria-2022-040>
- Matarirano, O., Chiloane-Tsoka, G. E., & Makina, D. (2019). Factors driving tax compliance costs of small businesses in the South African construction industry. *Acta Commercii*, 19(1). <https://doi.org/10.4102/ac.v19i1.687>

- Mittal, S. (2019). Red Tape? The Revenue Impact of the VAT Filing Thresholds. *Social Science Research Network*. <https://doi.org/10.2139/SSRN.3348777>
- Muthitacharoen, A., Wanichthaworn, W., & Burong, T. (2021). VAT threshold and small business behavior: evidence from Thai tax returns. *International Tax and Public Finance*, 28(5), 1–34. <https://doi.org/10.1007/S10797-021-09672-3>
- Naslia, F. A. P., & Yulianti, Y. (2024). Tax Fairness and Public Perception: A Comparative Literature Review. *Advances in Taxation Research*, 2(2). <https://doi.org/10.60079/atr.v2i2.294>
- Nathan, B., Pérez-Truglia, R., & Zentner, A. (2024). *Paying Your Fair Share: Perceived Fairness and Tax Compliance*. <https://doi.org/10.3386/w32588>
- Oliver, X., Encabo, I., Padilha, G., & Piccoli, L. (2022). Reducing the regressivity of indirect taxation in Brazil through a personalized value-added tax. *Journal of Policy Modeling*, 44(5), 903–919. <https://doi.org/10.1016/j.jpolmod.2022.09.002>
- Padi, A., Musah, A., Blay, M. W., Okyere, D. O., & Baidoo, J. M. (2025). Drivers of value added tax compliance among small and medium scale enterprises in Ghana: a multi-dimensional approach. *Journal of Economic Criminology*, 9. <https://doi.org/10.1016/j.jeconc.2025.100181>
- Rauhanen, T., Harju, J., & Matikka, T. (2016). The effects of size-based regulation on small firms: evidence from VAT threshold. *Social Science Research Network*. <https://doi.org/10.2139/SSRN.2795920>
- Safrizal, S., & Astuti, F. I. N. (2024). Implementasi Peraturan Pemerintah Nomor 55 Tahun 2022 tentang Penyesuaian Pengaturan di Bidang Pajak Penghasilan (Dampak Penghapusan Pajak Final terhadap Keberlanjutan dan Pertumbuhan Usaha Mikro, Kecil, dan Menengah). *JIP (Jurnal Industri Dan Perkotaan)*. <https://doi.org/10.31258/jip.20.1.18-24>
- Satterthwaite, E. A. (n.d.). *On the Threshold: Smallness and the Value-Added Tax*. <https://doi.org/10.7916/d8tx4xgr>
- Schoeman, A. H. A., Evans, C. C., & Du Preez, H. (2022). To register or not to register for value-added tax? How tax rate changes can influence the decisions of small businesses in South Africa. *Meditari Accountancy Research*, 30(7), 213–236. <https://doi.org/10.1108/MEDAR-05-2021-1309>
- Warwick, R., Harris, T., Phillips, D., Goldman, M., Jellema, J., Inchauste, G., & Goraus-Tańska, K. (2022). The redistributive power of cash transfers vs VAT exemptions: A multi-country study. *World Development*, 151. <https://doi.org/10.1016/j.worlddev.2021.105742>
- Yoon, S. M. (2018). The effects of the RCS's application in the value added tax collecting process on the perception of SME taxpayer in Korea's trade activity: Transparency and fairness in trade. *Sustainability (Switzerland)*, 10(11). <https://doi.org/10.3390/su10114132>