



St. MARY'S UNIVERSITY
SCHOOL OF GRADUATE STUDIES

ASSESSMENT OF TAX EVASION CASE OF LIDETA SUB CITY
SMALL TAXPAYERS ETHIOPIAN REVENUES AND CUSTOMS
AUTHORITY BRANCH OFFICE

By
WORKU MEKONNEN

A THESIS SUBMITTED TO ST. MARY'S UNIVERSITY
SCHOOL OF GRADUATE STUDIES IN PARTIAL FULFILLMENT OF
THE REQUIREMENT FOR THE DEGREE OF MASTERS OF
BUSINESS ADMINISTRATION

ADVISOR
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JANUARY, 2016
ADDIS ABABA ETHIOPIA

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DECLARATION

I, the under signed, declare that this thesis is my original work, prepared under the guidance of Alem Hagos (PhD). All source of materials used for the thesis have been duly acknowledged. I further confirm that the thesis has not been submitted either in part or in full by any other higher learning institution for the purpose of earning any degree.

Name

Signature & Date

ENDORSEMENT

This is to certify that this thesis entitled “**Assessment of tax evasion case of Lideta Sub City Small Taxpayer’s Ethiopian Revenue and Customs Authority branch office**”, undertaken by Worku Mekonnen for the partial fulfillment of Master of Business Administration [MBA] at St. Mary’s University is an original work and not submitted earlier for any degree either at this University or any other University.

Research Advisor:

Signature & Date

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AKNOLEDGMENT

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ABSTRACT

Tax administration in Ethiopia as in some other developing countries is characterized by low tax compliance level. From an economic point of view, legal considerations apart, tax evasion has negative effects, namely a reduction of revenue yields. The voluntary compliance behavior of the taxpayers is determined by various factors and identifying these factors and treating them accordingly should be the central duty of any tax system in order to maintain voluntary compliance at reasonable level. A number of determinant factors have been identified in the literature to tender explanation for such phenomenon. Therefore, the overall objective of this study is to investigate determinant of tax evasion the case of tax payers with the absolute focus on Lideta Sub City small taxpayer's revenue and customs branch office of Ethiopian revenue and customs authority. Descriptive statistics and inferential statistics used to identify factors that determining the tax evasion the case of tax payers in the study area. Ten tax evasion Determinants were examined namely age, gender, education, income, attitude and perception, law abidance, sanction /cost/, tax knowledge, opportunities/rewards/ and probability of being caught. From the survey of 186 respondents, the result revealed that among these variables probability of detection and cost of tax evasion are significant to determine tax evasion of tax payers while the other variables considered are insignificant to determine tax evasion in this study. The results of this study can inform the tax authority in what ways the Determinants can affect tax compliance behavior. It also provides an indicator for tax administrators of the relative importance of tax knowledge in assisting with the implementation of tax regulations and rules, simplifying tax systems and developing a wider understanding of taxpayers' comprehensive behavior.

Key words: evasion, avoidance and tax compliance

ACRONYMS

ERCA	Ethiopian Revenue and Customs Authority
GDP	Gross Domestic Product
MoFD	Ministry of Finance and Economic Development
SPSS	Statistical Package for Social Science
TCMP	Taxpayer compliance Measurement program

Chapter one

Introduction

1.1. Background of the study

No government can announce a tax system and then rely on taxpayers' sense of duty to remit what is owed that is why some dutiful people will undoubtedly pay what they owe, while many others will not. Through time the amount of the dutiful people will shrink because of they see how they are being taken advantage of by the others. Therefore, paying taxes must be made a legal responsibility of citizens with penalties attendant on noncompliance. But even substantial tax evasion exists and always has though those penalties are practiced (slemord, 2007).

Tax evasion and avoidance is a universal phenomenon that takes place in all societies and economic systems including both developed and developing countries (Chau and Leung, 2009). Tax Evasion includes acts in flouting of the law where by parsons pay a lesser amount of tax than they would otherwise be bound to pay by concealment of all or part of their legitimate or illegal economic activities from the tax authorities (Ian and veerinderjeet, 1995). Tax avoidance on the other hand is used to describe acts in line with the law but not with in its sprits where by persons pay less tax than they would otherwise be bound to pay (Tracey, 2009). Thus, the failure to follow the tax provisions and regulations suggest that a taxpayer may be committing an act of noncompliance (Kirchler, 2007).

Most authors trying to measure this shadow economy face the difficulty of how to define it. As Schneider and Buehn (2007) described One commonly used working definition is all currently unregistered economic activities that contribute to the officially calculated (or observed) Gross National Product. The shadow economy includes all market-based legal production of goods and

services that are deliberately concealed from public authorities for the following reasons:- to avoid payment of income, value added or other taxes, to avoid payment of social security contributions, to avoid having to meet certain legal labor market standards, such as minimum wages, maximum working hours, safety standards, etc., and to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms. The average size of the shadow economy (as a percent of “official” GDP) in 2004/05 in 76 developing countries is 35.5%, in 19 Eastern and Central Asian countries 36.7% and in 25 high income countries 15.5%. An increased burden of taxation and social security contributions, combined with labor market regulations are the driving forces of the shadow economy (Schneider and Buehn, 2007).

1.2. Background of the Organization

In Ethiopia, tax evasion has been important source of tax leakage. This has created inability to generate enough tax revenue to meet the growing expenditure of the government (Emerta, 2010). The Ethiopian Revenues and Customs Authority are responsible for overseeing the various reforms and collecting taxes and customs duties among other things. Ethiopian revenue and customs authority was reestablished in 2008 (by proclamation number 587/2008) through the merger of the former Ministry of Revenues, Federal Inland Revenue Authority and the Ethiopian Customs Authority. The formation of Ethiopian revenue and customs authority signals the Ethiopian government’s commitment to establishing a modern tax and customs administration system. Thus, Lideta Sub City Small Tax Payers Revenue and Customs Office established as a branch office of the authority following the above proclamation and the authority’s structuring approach in the capital city of Addis Ababa.

In Lideta Sub City Small Tax payers Revenue and Customs Branch Office the scale of tax evasion has never been assessed scientifically, however considering

a number of audit reports made on tax payers and assessment results justified that there is tax evasion and avoidance.

1.3. Statement of the Problem

With serious economic consequences tax evasion and fiscal corruption have been a general and persistent problem throughout history. In general, tax evasion and corruption can have ambiguous effects on economic growth: tax evasion increases the amount of resources accumulated by entrepreneurs, but it also reduces the amount of public services supplied by the government, thus leading to negative consequences for economic growth (Roy and Raffaella, 2011). Due to the problem of tax avoidance and evasion is inherent in all tax systems tax compliance is growing international concerns for tax authorities and public policy makers as tax evasion seriously threatens the capacity of government to raise public revenue (Chau and Leung, 2009).

As Hudson (2002) stated tax evasion is the source of a potentially serious loss of revenue to governments, resulting in the possible underfunding of public service and an 'unfair' burden on frank taxpayers. Thus, as Cobham (2005) studied, who estimates that developing countries lose \$ 285 billion per year due to tax evasion as far as the domestic shadow economy is concerned. This is why Chau and Leung (2009) stated that this concern is particularly severe for developing countries given the rapid growth of investment in their economies and their lack of adequate experience in dealing with this problem

As Emerta (2010) stated Ethiopian taxation system is not an exception. By depriving national governments of vital revenue, tax evasion and avoidance can cause a fiscal deficit or aggravate an existing deficit; force government to decrease expenditure, increase tax rates or initiate new rates. Sometimes government is often tempted to borrow funds in order to bridge the tax 'gap'. In practice tax avoidance and evasion cannot be eliminated but can be minimized. According to the data of MoFED (2010), tax to GDP ratio in Ethiopia is 9.7% which is one of the lowest in sub Saharan Africa. Studies have indicated that

tax evasion and avoidance are one of the factors for this low tax revenue (Emerta, 2010). As Addisu (2011) stated that the tax administration lacks the institutional capacity to handle modern operational and enforcement practices to deliver efficient and quality service. That is why Weak enforcement is a cause for concern since personal income tax compliance tends to be lower. In order to comply with the tax rule these tax payers were bares a number of costs that is called compliance cost. Consequently, they appear to be continuously finding a loophole to depart from.

As per the report (2014) Lideta Sub City Small Taxpayers Revenue and Customs Branch Office are required to file a correct and complete return, failing which penalties and fines will be imposed, required to keep records of all transactions and report accordingly failing which penalties and fines will be imposed and finally make payments on the taxes due. However, there is still evidence that tax compliance is not at the expected target rate that justifies tax evasion and avoidance is practiced.

The branch office statistical report displayed that taxpayers' noncompliance in filing their returns and incidents of underreporting which were found when audit and assessments conducted on taxpayers' file. Table 1 shows that tax assessments and tax audit conducted for the years of 2012; 2013 and 2014 by office on taxpayer files and the revenue difference between what the tax payers have reported and what actually is found. As Mansan (1988) stated the Common practices of tax evasion include: under-reporting of income, over-statement of expenses, non-recording of sales, and others. This also supported by Slemrod and Yitzhaki (2000) in which tax evasion refers to an illegal reduction of tax payments such as underreporting income or by stating higher deduction-rates.

Tax assessments and tax audit are among the mechanisms that the branch office uses to inspect and cross-check taxpayers for what they declare and report. Hence, the below table one justifies that there was tax evasion and

avoidance in the branch office in which there are revenues collected through audit and assessments which was not declared or under reported by the tax payers for the consecutive years. So the main purpose of this research is to investigate the assessments of tax evasion Lideta Sub City Small Tax payers Revenue and Customs branch office.

Table 1; Revenue found from tax assessments and audit on taxpayers in Lideta Sub City Small Taxpayer's revenue and customs branch office, 2014

<i>Years</i>	<i>Number of files</i>		<i>Revenue found from assessments and audit in birr</i>	
	<i>Assessed files</i>	<i>Audited files</i>	<i>Assessment</i>	<i>Audit</i>
<i>2012</i>	<i>1759</i>	<i>38</i>	<i>1,306,100.23</i>	<i>1,654,103.66</i>
<i>2013</i>	<i>1686</i>	<i>19</i>	<i>1,034,800.42</i>	<i>5,000,053.00</i>
<i>2014</i>	<i>1877</i>	<i>27</i>	<i>5,295,000.05</i>	<i>8,351,468.5</i>
<i>Total</i>			<i>7,635,900.70</i>	<i>15,005,625.16</i>

Source: Lideta Sub City Small Taxpayers revenue and customs branch office report, 2014

Note: this constitutes only the business income tax, value add tax, withholding and dividend.

1.4. Research questions

Given the above situation of tax evasion in the tax branch office, this study is expected to give answers to the following specific questions;

1. Do noncompliance opportunities such as income, opportunities of reward or cost and law abidance determine tax evasion?
2. Do tax system/structure such as probability of detection/caught and penalties determine tax evasion?
3. To what extent do moral attitudes and perception to tax evasion and local knowledge of evasion influence tax payers to be non compliance or to evade tax?
4. Do a demographic variable such as marital status, age, gender and education determine tax evasion?

1.5. Objective of the study

1. General objective;

The general objective of this thesis is to investigate the assessment of tax evasion of tax payers at a branch office level;

2. Specific objectives;

In addition to the above general objective the study has the following specific objectives;

To identify if noncompliance opportunities such as income level, opportunities of reward or cost and law abidance determine tax evasion in the branch office.

To investigate whether tax system/structure such as probability of detection/caught and penalties determine tax evasion in the branch office.

To assess to what extent do moral attitudes to tax evasion and local knowledge of evasion determine tax payers to be non compliance or to evade tax in the branch office.

To identify the determination of demographic variables such as age, gender, marital status and education on tax evasion of tax payers in the study area.

1.6. Significance of the study

The study is expected to contribute some findings to the noncompliance situation of the branch office tax payers by examining the assessment of tax evasion in the study area. By identifying the assessment of tax evasion of tax payers focusing on the branch office the study would help to point out specific and efficient methods of limitation tax evasion that would maximize tax revenue in the branch office and create compliance tax payers and also it would give some highlights to the Ethiopian revenue and customs authority regarding what factors are affecting tax payers to evade and avoid tax in the branch office. In addition, this study would help as a reference material for further studies.

1.7. Scope of the study

The research will only cover Lideta Sub City Small Taxpayer's revenue and customs branch office from Addis Ababa branch offices indicates the highest report on tax evasion obtained from ERCA.

The study uses qualitative and quantitative research methodology. Interaction effect of the independent variables is not considered in the study because this is beyond the purpose of the study.

Private limited companies, share companies and cooperatives are included in the study while governmental organizations, joint venture and nongovernmental organizations are excluded due to the compliance nature of the companies. As the audit report of the branch office illustrates these companies are more compliant than the other companies. Hence, these companies are not relevant with the research objectives.

The research only covers the profit tax, value added tax, dividend and withholding tax collected by the branch office whereas personal income tax, turn over tax, custom duty and excise tax type are excluded from the study. The selection of this four tax type is on the basis of accessibility and adequacy of sample units and the ability to manage within the specified time period for the study work.

1.8. Limitation of the study

As the research sample is constituted of tax payers they were hesitating to disclose their tax evasion problems assuming that it would endanger their possibility to receive service from the office and being claimed to crime. However, the researcher believes that these limitations were not a block from conducting the intended research and convinced them by using some confidentiality assurance mechanisms such as not displaying any data by the name of the taxpayer and using indirect questions.

As it is observed from different researches there is a problem of tax evasion in Ethiopian revenue and customs authority. However, due to the time and financial constraints of the researcher, this thesis concentrated on the specified Lideta Sub City Small Taxpayer's revenue and customs branch office excluding the rest branch offices.

1.9. Organization of the paper

This research paper is organized in six chapters each incorporated topics and subtopics. Chapter one provides the necessary background of the study. It

states the problem, raises the research questions. It also describes the objectives, scope, significance and limitations of the study. Chapter two sets the foundation of the study. It reviews existing literature on assessment of tax evasion related issues to extract useful and relevant information and concepts. It also forms the theoretical basis and constructs an analytical framework drawn from the theoretical concepts. Chapter three deals with research area description, methodology such as research strategy, sample size and sampling techniques. It also describes the tools for sources of data, data type and data analysis techniques. Chapter four presents the data collected through applicable software models and statistical analysis which is the sole of the study. Chapter five, in which the researcher finalizes the study with final concluding points and by drawing some recommendation.

Chapter two

Related literature reviews

2.1. Theoretical background

Understanding taxpayer behavior is crucial for policy makers to develop strategies to overcome problems of noncompliance among individual taxpayers' and prevent evasion. Two most commonly known models are the Becker (1986) and Fisher (1992) which have contributed to taxation literature in understanding taxpayer behavior. Chan, Troutman and O'Bryan (2000) have incorporated important constructs namely demographics, noncompliance opportunity, attitudes and perceptions and the tax structure / system, in the Fisher (1992) model.

Many other researchers described that tax compliance is operationally considered as complying with tax laws in the act of true reporting of the tax base, correct computation of the tax liabilities, timely filing of tax returns and timely payment of the amount due as tax (Chatopadhyay and DasGupta, 2002; Franzoni, 2000: cited in Alabede et al., 2011). Any behavior by the taxpayer contrary to the foregoing statement is noncompliant. Noncompliance with tax laws comes in different forms. It may be intentional noncompliance in which the taxpayer deliberately undermines the tax rules and regulations in order to have personal gains. The second is in the form of unintentional noncompliance that may be as result of ignorance, oversight or mistake in applying tax laws. Any noncompliance act committed by taxpayer that results to non declaration / underreporting/ of taxable income leading to non-

payment or underpayment of tax is regarded as tax evasion (Alabed et al., 2011).

Tax structure is a major determinant of tax compliance behavior. Thus, the factors that determine the effectiveness of the tax system/structure of any country includes such as probability of detection, penalty, tax rate and complexity of tax system (Fischer et al., 1992). Taxpayers committing noncompliant act may be detected through the process of tax audit and investigation. That is why the primary aim of tax audit is to detect taxpayers not complying with the submission of income tax returns and the payment of income tax (Jackson and Milron, 1986).

Researchers (e.g., Jackson and Milliron, 1986; Hanno and Violette, 1996) have studied the influence of demographic variables such as age and gender on behavior of taxpayers. Vogel (1974), Fallan (1999), and Christen, Weihrich, and Gerbing (1994) also explored other variables on noncompliance opportunities such as level of income, occupations status and education levels. Furthermore, an individual's attitude towards the tax system may predict his tax compliance behavior. Theoretically, Ajzen (1991) claimed that attitude is an indication of behavior. Attitude towards an event, object, function or person may be favorable or unfavorable. Kirchler, Hoelzl and Wahl (2008) stated that a taxpayer with a favorable attitude towards tax evasion is expected to be less compliant and equally a taxpayer who has an unfavorable attitude is likely to be more compliant.

Taxpayers may also choose to evade taxes and pay tax on their declared income. When enforcement becomes stricter, voters have two ways to react: by changing evasion and by changing the tax rate. For given tax rate, taxpayers

would evade less. However, the equilibrium tax rate will change as well. If richer individuals evade particularly large amounts, stricter enforcement puts a larger burden on them. Hence, lower income voters may prefer higher taxes since the tax system becomes more progressive. In this case, while stricter enforcement in itself reduces evasion but the effects of the increased tax rate (and transfer) may offset this effect, since higher taxes and transfers would make evasion more attractive (Borck, 2004).

Despite the many studies as discussed above, much work remains to be done if we would like to develop fully understanding of this intrinsically complex subject and the means of promoting tax compliance. Many researchers such as Alabede et al. (2011), Fischer (1992) and Chau and Leung (2009) suggested that extant literature on the compliance including both analytical and empirical studies mainly focused on individual noncompliance. There is little or no research on corporate tax noncompliance. Greater attention should be paid to the complex corporate noncompliance.

2.2. Determinants of tax evasion

The general framework to be adopted for the literature review of Determinants of tax evasion is the one given by Orviska and Hudson (2002) as depicted below. The Determinants are generally classified as Tax noncompliance opportunities such as income level, opportunities of reward or cost and law abidance determine tax evasion, tax system/structure such probability of detection or audit and penalties determine tax evasion, moral attitudes to tax evasion and local knowledge of evasion influence tax payers to be non compliance or to evade tax and demographic variables such as age,

gender, marital status and education and point out the influence on tax evasion of tax payers in the study area.

2.2.1. Demographic variable

The relationship between demographic variables and tax compliance has long been of interest (Tittle, 1980). Three major personal characteristics for which there is evidence of a relationship are age, gender and education (Jackson and Milliron, 1986). The Fischer model suggests that demographic variables indirectly affect taxpayer compliance by their impacts on noncompliance opportunities and attitudes and perceptions (Chau and Leung, 2009).

a) Age

A common demographic variable is the taxpayers' age. A positive link between age and taxpayer compliance is reported (Jackson and Miliron, 1986). Noncompliance is significantly less common and of lower magnitude among householders in which either the head or the head's spouse is over age 65 (Andreoni et al., 1998: cited in chau and leung, 2009). In general, young taxpayers are more willing to take risks and are less sensitive to sanctions (chau and leung, 2009).

b) Gender

Early research (Tittle, 1980: cited in Jackson and Milliron, 1986) testing the tax compliance level of males versus females reports that females are more likely to tax compliance. Traditionally, females have been identified with conforming roles, moral restraints and more conservative life pattern (Jackson and Milliron, 1986). All these attributes may promote higher tax compliance. Experimental study conducted by Baldry (1987) Also finds that females tend to tax compliance by more than males do. Jackson and Jaouen (1989) also revealed a significant gender difference by treatment group from a pool of potential jurors. However, the study by Houston and Tran (2001) indicates a higher proportion of tax evasion committed by women than men.

c) Education

Education, as a demographic variable relates to the taxpayers' ability to comprehend and comply or not comply with the tax laws (Jackson and Milliron, 1986). Two aspects of education have been distinguished: "the general degree of fiscal knowledge and the degree of knowledge involving evasion opportunities". This knowledge is considered to be important for attitudes towards tax compliance (chau and leung, 2009). Chan et al. (2000)

also reveal that higher education is directly linked to an increased likelihood of tax compliance.

2.2.2. Non-compliance opportunity

In the Fischer model, noncompliance opportunity can affect taxpayer compliance directly through income level, income source and occupation and indirectly through attitudes and perceptions (chau and leung, 2009).

a) Income

According to Andreoni et al. (1998) most of the theoretical models indicate that as income increases, tax compliance should decrease. Studies have proved this assertion (Chau and Leung, 2009; Ritsema and Thomas, 2003). Houston and Tran (2001) also reveal the respondents in the lower income group tend to have a lower proportion of tax compliance by under-reporting income and by over-claiming expenses than their counterparts in the higher income group.

b) Law abidance

Tyler (1990) argues that citizens may comply with the law because they view the legal authority as having a legitimate right to dictate their behavior. He specifically distinguishes between this and an 'internalized obligation' derived from people's desire to behave in a way consistent with their own sense of

'personal morality'. This latter concept appears closely related to civic duty. Tyler briefly mentions tax evasion as an area where these concepts may be relevant. However, he goes into more detail when discussing illegal use of drugs, where he argues that law abidance, personal morality (equivalent, as we have said, to civic duty), the fear of punishment and the fear of friends' disapproval are the major Determinants of behavior.

According to legal positivists, laws are norms or rules determining how a person ought to conduct themselves in the community (MacCormick, 1991). This normative view of law sees advantages to individuals in obeying laws, although it does leave the door open to moral objections to such obedience. It also recognizes that not everybody in society will be bound by the desire of the majority, and hence, sanctions must be employed against the minority of law breakers. For the majority, however, a tendency to obey the law must be a significant factor in determining their view on whether to comply with any law including those in the domain of public law such as tax compliance (Marta, and John, 2002).

c) Penalty

Doran (2009) stated that tax penalties remain important for the following reasons. For the norm model assumes that certain taxpayers will not comply

with tax obligations and those taxpayers must be deterred by the threat of legal sanctions and, for, taxpayers who complied must be assured that noncompliant taxpayers will be sanctioned. Similarly, Chau and Leung (2009) argued that tax penalty is an important factor affecting tax evasion and that the idea is that the fear of penalty will prohibit the noncompliance tendency.

d) Costs and benefits of tax evasion

As Torgler and Schneider (2005) assumed that taxpayers are rational economic evaders who likely would assess the costs or benefits of evasion. They would attempt to minimize their tax liability, for instance, by intentionally under reporting their income and would enjoy tax savings if they were not detected by the tax authorities. But they would be willing to pay more, adding a penalty, if they were caught.

2.2.3. Attitudes and perception

The Fischer suggests two major considerations for altering taxpayers' attitudes and perceptions to tax compliance are the fairness of the tax system and peer influence (Chau and Leung, 2009). Thus, individual evaluates an event or object positively or negatively and positive and negative evaluation is the main dominant characteristic of an individual's attitude (Alabede et al, 2011). This also supported by Kirchler et al. (2008) who suggested that

taxpayer who has favorable attitude towards tax evasion is expected to be less compliant and equally taxpayer with unfavorable attitude is likely to be more compliant.

With regard to distributive justice, comparisons are made on the basis of individuals, groups and societal level and at individual level; taxpayers will be interested in the fairness of his tax burden, if it is perceived to be too high compare to other individuals' tax burden, his rate of compliance is likely to decrease. At the group level, the taxpayers are interested on the fairness of treating their groups compare to other groups, when a group perceived that it is not fairly treated in respect to tax burden in relation to other groups that may lead tax noncompliance in the group (Alabede et al, 2011).

Attitudes represent the positive and negative evaluations that an individual holds of objects. It is assumed that attitudes encourage individuals to act according to them. Thus, a taxpayer with positive attitudes toward tax evasion is expected to be less compliant than a taxpayer having negative attitudes (Kicheler et al., 2008)

2.2.4. Tax system/structure

It is widely acknowledged that the extent of tax compliance in many developing countries has been decreasing through time. The underdeveloped

tax system/structure is one of the major causes for this decreasing trend. In the Fischer Model, the effectiveness of tax system is affected by complexity of tax system, penalties and tax rates and probability of detection or caught (Chau and Leung, 2009).

a) Probability of detection and penalties

The other 'direct' factors impacting on tax evasion are the opportunities for evasion, which determine the costs and the potential gains. In the empirical study that follows, the opportunities for and costs of tax evasion, the probability of being caught and any fine, are all constant across individuals. Socio-economic variables impact on the fear of moral censure and will proxy this variable in the empirical analysis (Mart, and John, 2002). In general, higher audit probabilities and strict penalties encourage tax compliance. Probability of detection refers to the likelihood that the tax authorities may discover an individual's noncompliance and seek to remedy the evasion (Chau and Leung, 2009).

Audit rates and the thoroughness of the audits could encourage taxpayers to be more careful in completing their tax returns, declare all income and claim the correct deductions to ascertain their tax liability. In the other hand,

taxpayers who have never been audited might be tempted to under report their actual income and claim false deductions (Palil and Mustapha, 2011).

Another important factor affecting tax compliance is the relationship between tax compliance and the strictness of sanctions. The issue is that fear of penalties prohibits tax noncompliance behavior. Establishing an effective system to penalize tax evaders is an important measure to encourage tax compliance. Taxpayers will be more seem to comply if noncompliance may result in strict penalties (Chau and Leung 2009). This also supported According to the theoretical work conducted by Allingham and Sandmo (1972), tax compliance can be increased by increasing the penalties levied on tax evasions which are already discovered. To be effective, penalties must be applied speedily and forcefully.

2.3. How to Measure Tax Evasion

The Taxpayer compliance Measurement program data consist of line-by-line information about what the taxpayer reported and what the examiner concluded was correct. The primary purpose of the TCMP was to improve the process for selecting returns for operational audits. Rather than to estimate the tax gap Measuring a behavior that individuals attempt to hide is inherently one of the more challenging problems faced by social scientists. Social

scientists therefore rely on both direct and indirect approaches for measuring what is commonly referred to as the “Underground economy.” Joel Slemrod (2007).

Andreoni, Erard, Feinstein(1998, p.836) claim that the most reliable information about noncompliance is based on actual tax return information that has been thoroughly examined by auditors as part of the IRS Taxpayer Compliance Measurement program (TCMP) which attempts to measure “unreported income” and the national ‘tax gap”.

Another direct approach is based on survey evidence, in which individuals are asked about their evasion behavior. Still another direct approach uses tax amnesty data, in which declarations of income by amnesty participants are used as an exact measure of evasion. More “indirect” methods look for traces of evasion behavior that are left in various indicators that can be identified, so that evasion is not measured directly but rather indirectly via these measureable traces. There are several indicators that have often been used.

One approach

Another indirect approach looks for traces of evasion in transactions financed by currency, on the assumption that the “true” level of economic activity can

be estimated via a Fisherian relationship between money and its velocity. The gap between this predicted level of economic activity and the official national accounts level gives a measure of the so-called “shadow economy”, which can then be used as a proxy for the amount of tax evasion.

A related and more commonly used method is the currency demand approach, which estimates the demand for currency as a function of conventional factors (e.g., income, interest rates) and also as a function of factors that are assumed to motivate individuals to engage in evasion activities (e.g., the direct and indirect tax burden, government regulation, the complexity of the tax system). Any “excess” in currency demand, or the amount unexplained by the explanatory variables, is then attributed to the shadow economy and, by extension, the amount of tax evasion.

2.4. Empirical Literature

Empirical work has also focused on the link between tax evasion and socio-economic characteristics. There is evidence that evasion declines with age, and is more common among men and in households in which the head is married (Clotfelter, 1983; Feinstein, 1991). There is also evidence from the USA that evasion varies between occupations, with car dealers, stores and

restaurants evading the most (understating taxes by 39%) while those in finance, insurance and agriculture the lowest evaders (Andreoni et al., 1998).

The empirical analysis of the deterrent effects of audit probability and fines or penalties is complicated by the potential endogeneity of both of these variables, which necessitates the use of simultaneous equation techniques that integrate social norms within a model of tax evasion (Hudson, 2002).

Tax evasion is examined in East Asian economies, where some economies have a severe tax evasion problem and others do not as Summers and Heston (1991) indicate that East Asian tigers have performed equally well and extraordinarily better than all other areas in the past two decades. These above stylized facts seem to indicate that policies leading to more severe tax evasion do not necessarily hurt economic growth in East Asia (Chen, 2003).

Tax evasion concern is particularly severe for developing countries given the rapid growth of investment in their economies and their lack of adequate experience in dealing with this problem. In China, the tax evasion by multinationals resulted in revenue loss amounted to US\$ 3.88 billion each year. In Hong Kong, the Inland Revenue department reported that about US \$ 1.15 billion was collected from 2003 - 07 back tax and penalties (Chau and Leung, 2009).

Schneider (2007) provides estimates of the shadow economy as a percent of gross domestic product (GDP) for 145 countries over different times. The average size of this metric ranged from 16.1% for Organization for Economic Cooperation and Development countries to 40.1% for developing and in transition countries.

Tax evasion is both personally sensitive and potentially incriminating, self-reports are vulnerable to substantial underreporting (Baumeister, 1982). Moreover, the dividing line between illegal tax evasion and legal tax avoidance is blurry. Under u.s. law, tax evasion refers to a case in which a person , through commission of fraud, unlawfully pays less tax than the law mandates. Tax evasion is a criminal offense under federal and state statutes, subjecting a person convicted to a prison sentence a fine, or both.

Thus, National accounts cover only limited economic activities in their premise since complete coverage is challenging as there are a wide range of economic activities in reality. Some of these activities are deliberately concealed by businesses to avoid taxes while others are missed because survey frames exclude small businesses or very new ones. Hence some will remain actually unrecorded (Emrta, 2010)

Tax audits, audit rates and prior audit experience have been ambiguously discussed in relation to tax compliance. Some studies declared that audits have a positive impact on tax evasion (Jackson and Jaouen, 1989; Shanmugam, 2003; Dubin, 2004: cited in Palil and Mustapha, 2011). These findings suggest that in self Determinants systems, tax audits can play an important role and their central role is to increase voluntary compliance.

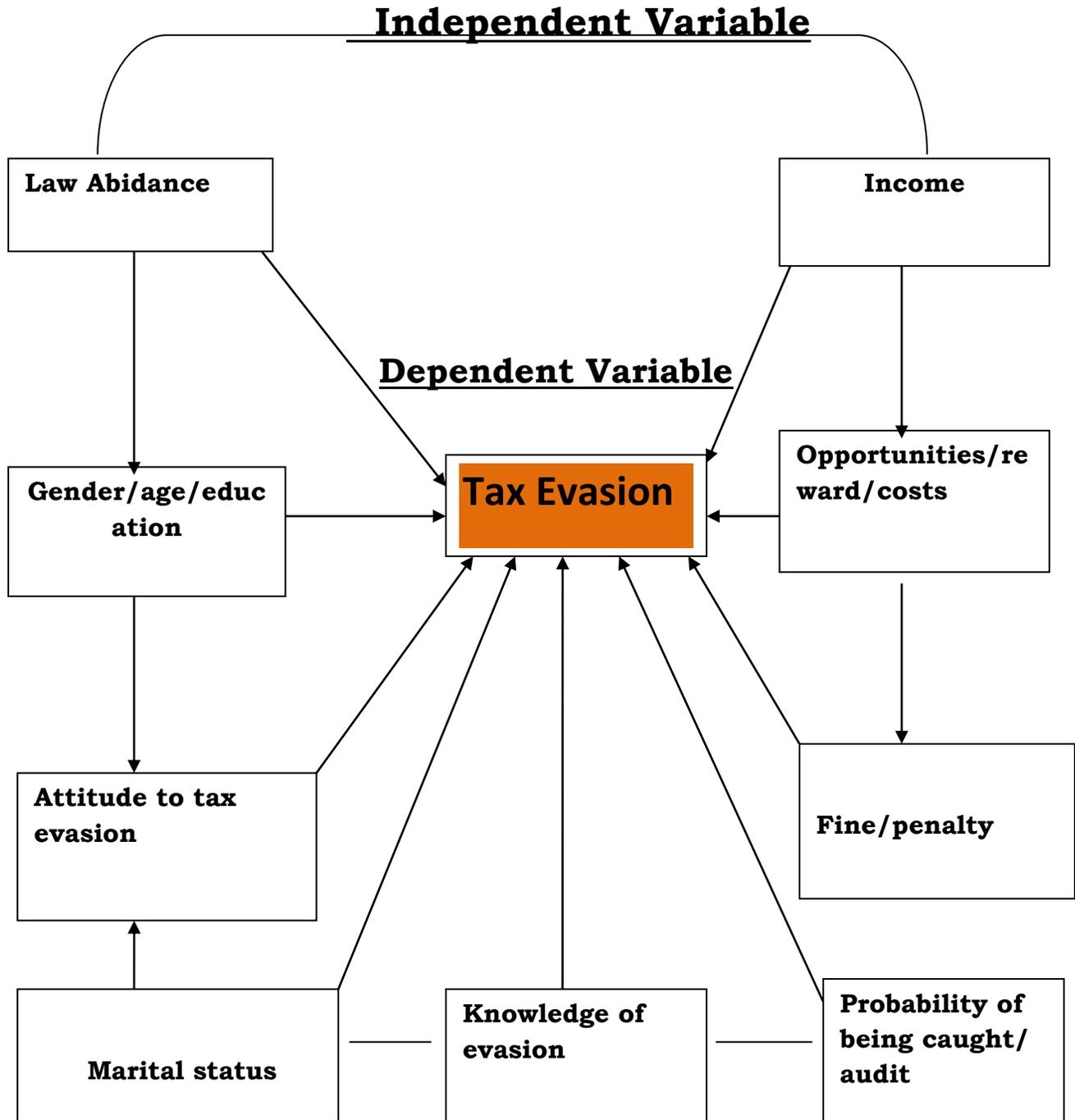


Figure1; Conceptual framework of tax

Source: Orviska, M. and Hudson, J. 2002 p. 89

3. Tax evasion in Ethiopia

3.1. Taxation and tax reform in Ethiopia

The modern Ethiopian tax system is a product of more than half a century of experimentation in legislation and tax reform. It had neither the grand lawgiver to guide and direct it from behind nor a clear set of over arching policies to inform its directions. Since its humble beginnings in the 1940s, the modern Ethiopian tax system has developed and evolved by fits and starts as the needs for revenue arise, as governments change and as the economy and international situations shift. Over the course of this period the Ethiopian tax system went through some major revisions and numerous piecemeal amendments (Tadesse, 2012).

For a long period of time, tax administration in Ethiopia was an appendage of ministries that did not have administrative specialization over the Determinants and collection of taxes. But the most recent reorganization and restructuring of tax administration, which occurred in 2008, merged three revenue agencies which are Federal Inland Revenue Authority, Ethiopian Customs Authority and National Lottery of the Federal Government into one authority, Ethiopian Revenues and Customs Authority (ERCA).

The reorganization of Federal Tax Administration has relegated the task of tax administration from ministerial level to an authority but in substance, the reorganization has in fact strengthened the powers of the Tax Authority. Recent tax administration reforms have introduced a number of changes to Ethiopian tax administration, only some of which are mentioned here under for their instructive value (Tadesse, 2012).

Tax reform includes changing policies to address insufficient revenue, to correct distortions that reduce economic welfare and growth, or measures to reduce inequities. The tax reform program in Ethiopia has two components:

overhauling of the tax legislation and improving the tax administration. The reform aims at establishing a sustainable domestic revenue base, encouraging trade and investment, ensure fairness, equity and transparency in the administration of the tax laws (Ylmatesfa, 2011). However, developing countries like Ethiopia, where there is a large number of informal sector, low tax moral, uncontrolled evasion, and total distrust between tax administration and taxpayers may not make the tax successful. One of the reasons is lack of simplified procedures for the tax administration (Tekulu, 2011).

3.2. Tax evasion in Ethiopia

In Ethiopia there is a significant amount of economic activity (36% of the recorded economy) that is not reported and captured by the official statistics. The amount of tax evasion reached 10% of the economy. The result has important implication for tax policy (increasing the tax rate versus the tax base) and incentive structure towards the small and medium scale enterprises if these sectors are to be the deriving engines of Ethiopia's transformation (Emrta, 2010).

In most developing countries, like Ethiopia, the revenue generated by the government is quite less than the expenditures spent. This low revenue yield of taxation can only be attributed to the fact that tax provisions are not properly enforced either on account of the inability of administration due to the noncompliance behavior of taxpayers (Abdella and Clifford, 2010).

Tax evasion was higher during the 1970's and 1980's reaching as high as 10.4% of the recorded economy. Although the share as percentage of GDP is declining recently, it is growing on average by about 19 percentage points in nominal terms since 2000. It remained high but declining since 1991 while tax revenue to GDP ratio start to increase before it start to bend downward since 2004. The declining trend in tax-to-GDP ratio since 2004 is mainly due to the rapidly growing economy in the face of stagnated tax collection efforts (Emrtat,

2010). Note that tax-to-GDP ratio in Ethiopia is one of the lowest in sub-Saharan Africa which is 9.7% (MoFED, 2010) as compared to over 18% for the rest of Africa. It is even much lower than good performers such as South African and Namibia where tax revenue reaches 25% and 30.1%, respectively (Volkerink, 2009).

In Ethiopia the informal economy was widespread between 1977-1991 when the country was under continuous civil war and instability providing a favorable condition for the development of the underground activities. During this period, it reached an average size of 41.5% of the recorded economy. After the reform packages since 1993, the size of the informal economy declined to 30% (1998-2006 average) of the official economy. Informality seems to revive again recently and reached to a high level of 33.3% during 2007-2008 (Emrta, 2010).

Tax administration is a component of public administration designed to control the processes and operations of public revenues in accordance with new public management approaches which focuses on efficiency, performance measurement and requirements of good governance. Governments require tax administration and compliance to produce revenue from private entities to provide public goods and services. Ethiopia needs to use domestic based resources mainly obtained from domestic tax (Tekulu, 2011).

The evaded tax due to the prevalence of unreported economy would have been an important resource for infrastructural and public service developments in the country. Bringing the unreported economy to the tax net remained as a challenge for the responsible body with significant implication on tax policy of the country (Emrta, 2010).

Chapter three

Study area and methodology description

3.1. Research area description

The research area of the study is only one of the branch offices in Ethiopian revenue and customs authority that is Lideta Sub City Small Taxpayer's branch office in which there are 210 employees and structured with having headed by one general manager and two deputy managers located in the Lideta Sub City Small Taxpayer's branch office. As the branch office report (2013, 2014) shows it has collected annual revenue of 3.8 billion birr and 2.7 billion birr in the years of 2013 and 2014 respectively.

3.2. Research methodology

3.2.1. Research design

The researcher used descriptive type of research with the rationale of describing the prevailing problems in relation to tax evasion, This was also preferred to explain the roles of Tax Administration office and, as well as, towards combating tax evasion problems. The research also adopted qualitative and quantitative research approaches. Qualitative approach was used to explain and discuss respondents' and interviews' opinions with regards to the tax collection status, tax evasion problems in small taxpayers of Lideta sub city. From the quantitative approach, the study uses self administered survey. The sampling designs for this population are tax payers, Supervisors and team leaders of Lideta ERCA small taxpayer's branch office. Thus, descriptive research design is used to conduct this research.

3.2.2. Sources and type of data

The data for this study is collecting from both primary and secondary sources. Primary data is collect through structured questionnaire survey in which respondents of the questionnaire are tax payers of the branch office and interview from the tax office employee. Secondary data has been drawn from the existing official documents and reports. The secondary data collect from official sources is mainly to validate the information gives by the employees and to get the data that cannot be directly acquire from the respondents through questionnaire. Hence, the source for the cross sectional data was the primary data from the structured questionnaire.

The study constituting three tax payer types which are Private limited Company, Share Company and Cooperatives with four type of tax that are business income tax, value add tax, dividend and withholding in which the businesses had an experience any period of time a kind of cross-sectional data is considered for analysis.

3.3. Sampling technique

The selection of entities is bases on non random sampling technique due to the difficulty of accessing all the entity type and the inconvenience to meet all within the specific time period. Thus, non random sampling technique is employs to acquire the needed information through structured questionnaire from the selecting entity type. Why the researcher has used the non random sampling technique on the identifying tax payer type is that they have almost similar grounds and tax behavior. Thus, the researcher believes that the analysis which is gives bases on the non random sampling represents the whole population.

Table 2; sampling frame of taxpayers in Lideta Sub City Small Taxpayer’s revenue and customs branch office, 2014

<i>type of taxpayer</i>	<i>Sample unit</i>	<i>Sample size</i>
<i>Private limited company</i>	<i>579</i>	<i>103</i>
<i>Share Company</i>	<i>30</i>	<i>19</i>
<i>Cooperative</i>	<i>112</i>	<i>64</i>
<i>Total</i>	<i>721</i>	<i>186</i>

Source: Lideta Sub City Small Taxpayer’s revenue and customs branch office, 2014

The researcher used published table which is developed by Batlett, kotrlik and higgins (2001: p.48) to determine the sample size in which survey was conducted using the structured questionnaire.

3.4. Data collection method and instruments

In this study, the unit of analysis is made at company level; whereas, the unit of data collection is the manager of the company or owners. To collect primary data, the researcher has utilized a structured questionnaire which is pre-tested on some taxpayers who were paying the already specified tax type to the branch office supported by extensive document analysis a total of 186 questionnaires were distributed to the taxpayers. Out of these 19 of them are not returned. This means that the rate of return were 90%. The remaining 167 questionnaires were analyzed and interpreted. To collect primary data, the researcher has utilize a structured questionnaire for taxpayers who were paying the already specified tax type to the branch office supported by extensive document analysis and unstructured interview conducted with 10% of the operational employee of the branch office for the sake of triangulation. No direct question about tax evasion is asking in both the questionnaire and

interview because of the sensitivity of this topic. Instead, various indirect questions using as a basis for gathering information about tax evasion.

The data collection activity preceding with the distribution of questionnaires via personal contact using the enumerators and direct contact/face to face by using enumerators/ data collectors/ is using as data collection instrument. The secondary data is collecting from the branch office reports via direct contacts of the concerned bodies.

3.5. Data processing and analyzing

Statistical applications such as SPSS (version 20) software packages in combination with excel spreadsheet uses by the researcher to process the data acquire from the structured questionnaire. Both descriptive statistics and inferential statistics are using to analysis the significance of independent variables on the dependent variable.

The researcher uses percentage distribution for the categorical data which are obtain from the questionnaire and logistic regressions is used to measure the significance of data obtain from the likert scale of the explanatory variables. Taxpayers were unit of analysis and the mangers or owners of every organization which are element of the sample size were unit of observation for the research.

Tax evasion determinant variables which are independent and dependent are considered by the researcher in which the researcher has investigating the independent variables determination on tax evasion using descriptive statistics. The researcher collects the quantitative type of data by the structured questionnaire and the qualitative type of data by unstructured interview.

OPERATIONAL DEFINITION OF VARIABLES

Dependent variable

1. **Evasion:** Tax Evasion includes acts in flouting of the law where by persons pay a lesser amount of tax than they would otherwise be bound to pay by concealment of all or part of their legitimate or illegal economic activities from the tax authorities (Ian and veerinderjeet, 1995). Common practices of tax evasion include: under-reporting of income, over-statement of expenses, non-recording of sales and late filling. Penalized tax payers: penalized respondents are tax evaders where as not penalized are not tax evaders/compliant/.

Independent variable

Tax system/structure, attitudes to tax evasion and tax knowledge, demographic variables such as marital status, age, gender and education and noncompliance opportunities such as income, opportunities of reward or cost and law abidance determine the tax evasion described and hypothesized below as explanatory variables;

1. **Age:** is a continuous variable expected to positively influence tax evasion of taxpayers. Tax evasion is significantly less common and of lower magnitude among householders in which either the head or the head's spouse is over age 65. Young taxpayers are more willing to take risks and are less sensitive to sanctions.
2. **Gender:** This is a dummy variable, which takes 1 if sex of respondent is female, 0 otherwise. Females are more likely not tax evaders.
3. **Education:** it will be measured as the number of year staying in school. Higher education is directly linked to an increased likelihood of tax compliance. It is expected to have positive impact on tax evasion.
4. **Income:** it is a categorical variable and expected to have a negative linkage with tax evasion. The respondents in the lower income group tend to have a lower proportion of tax compliance by under-reporting

income and by over-claiming expenses than their counterparts in the higher income group.

- 5. Attitude:** this is a categorical variable which is expected to have a linkage of taxpayer who has favorable attitude towards tax evasion is expected to be positive with tax evasion and equally taxpayer with unfavorable attitude is likely to be negative with tax evasion.
- 6. Law abidance:** is a likert scale variable in which the legal positivists are expected to negative influence tax evasion unlike that of legal negativists.
- 7. Sanctions or costs:** is categorical variable which is expected to have negative linkage with tax evasion. It is expected that fear of penalty will prohibit the tax evasion tendency.
- 8. Tax Knowledge:** this is categorical variable that is expected to have negative influence on tax evasion. As the tax knowledge of the tax payers is improved the probability to commit tax evasion gets decline but as the knowledge is less the probability to evade tax gets increased.
- 9. Opportunity/rewards:** this is likert scale variable that is expected to have positive linkage with tax evasion. Taxpayers attempt to minimize their tax liability by intentionally and would enjoy tax savings if they were not detected by the tax authorities. On the other hand, they would be willing to pay more, including a penalty, if they were caught.
- 10. Probability of being caught or audited:** this is a categorical variable that is expected to have a negative linkage with tax evasion. Higher audit probabilities and severe penalties minimizes tax evasion but if there is low probability of audit tax payers encouraged to evade tax.

Chapter five

Data discussion and analysis

5.1 Participant information and business profile

5.1.1 Age, year of schooling and work experience

As the result in table 3 shows that the age mean of respondents is 41 with a standard deviation of ± 8.620 . This indicates that there are young ages of respondents. As Chau and Leung (2009) reported in their findings that young taxpayers are more willing to take risks and are less sensitive to sanctions. Therefore, this is an indication of tax payers possibilities to evade tax because of their age distribution is young dominated.

The mean of year of schooling of the respondents (mean= 13 with a standard deviation of ± 2.785) which can be said that the respondents are educated and as Chan et al. (2000) also reveal that higher education is directly linked to an increased likelihood of tax compliance. This is an indication of tax payers in the branch office are educated and less expected to involve in tax evasion practices. A study made by Marti (2010) in Kenya the town of Kerugoya 98% of the respondents were able to read and write as similar as majority of the respondents were educated in this study. This is a clear clue that the taxpayers can understand, interpret the tax laws, and at the same time keep correct books of account and records. Education, as a demographic variable relates to the taxpayers' ability to comprehend and comply or not comply with the tax laws (Jackson and Milliron, 1986). As a result, the population of the tax payers in the branch office is expected to be tax complaints.

The mean of work experience of the respondents is 7 with a standard deviation of ± 4.558 . Therefore, the work experience of respondents can indicate that the tax payers have tax knowledge and they know tax rules and regulations as a

result of their experience. This can justify that tax payers in the branch office are less expected to evade tax due to their tax knowledge and there may not be tax evasion practices because of tax knowledge gap. But there is lack of professional skill of tax officials in the branch office as some participants said in the interview. One participant in the office (female, 29 years old) said that *“there is lack of professional skill of tax officials and there are not sufficient skill developing trainings in the tax office in which tax officials can develop their tax knowledge time up to time.”* In addition to this one participant in the office (male, 34 years old) said that *“tax expertise of tax officials is less developed more over the works done by the tax office to enhance the tax expertise is not sufficient.”* This can indicate that the lack of professional skill of tax officials may be a favorable opportunities for tax payers to evade tax.

Table 3; Age, year of schooling and work experience of respondents

Variable (N=167)	Minimum	Maximum	Mean	Std. Deviation(±)
age of respondent	21	63	40.63	8.620
Year of schooling	7	17	13	2.785
work experience in the same business	1	21	7.11	4.558

5.1.2 Gender

From the result in figure 2 majority 140(83.8%) of the respondents were male where as 27(16.2%) of them were female. This finding clearly shows that gender distribution among tax payers of the office is men dominated and females are fewer participants in the trade sector. As many researchers; Jackson and Milliron(1986), Baldry (1987) and Jackson and Jaouen (1989) identified that females are better complaint than males due to that females are conforming roles, moral restraints and more conservative in their life. Thus, there is a higher probability of tax evasion practices among tax payers due to the gender distribution is male dominated.

As a study conducted in Nigeria by Alabede et al. (2011) indicates that 61% of the respondent were male and 39% of them were female, a study conducted in Dradawa by Lemessa (2007) indicates that 20% of the respondent were female and a study made by Marti et al. (2010) in Kenya the town of Kerugoya shows that 38% of the respondent were females while the rest are males which is similar with this study. Therefore, there is poor gender distribution among the tax payers in all the above cases. This could be due to the political, cultural and economic imposition on female that restraint to participate in the trade sector and activities because of women were less empowered in this context for a long period of time.

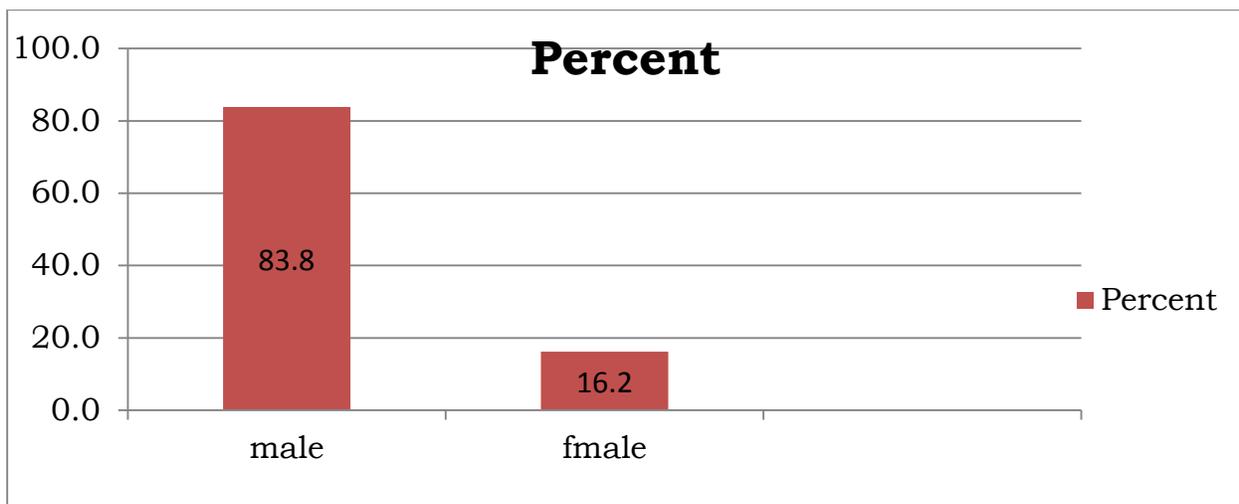


Figure 2; Gender distribution of respondents

5.1.3 Marital status

From the result in figure 3 majority of the respondent 106 (68.9%) were married where as 37(22.2%) of the respondents were single. This can indicate that married tax payers are less risk takers than those of single tax payers in which single tax payers are more expected to evade tax as compared to married tax payers.

A study conducted by Palil and Mustapha (2011) in Malasyia showed that 72% of the respondents were married whereas 28% were single which is similar with

this study and this can show that the social affiliation in both case is similar. Thus, the married tax payers are expected not to evade tax as compared with single tax payers.

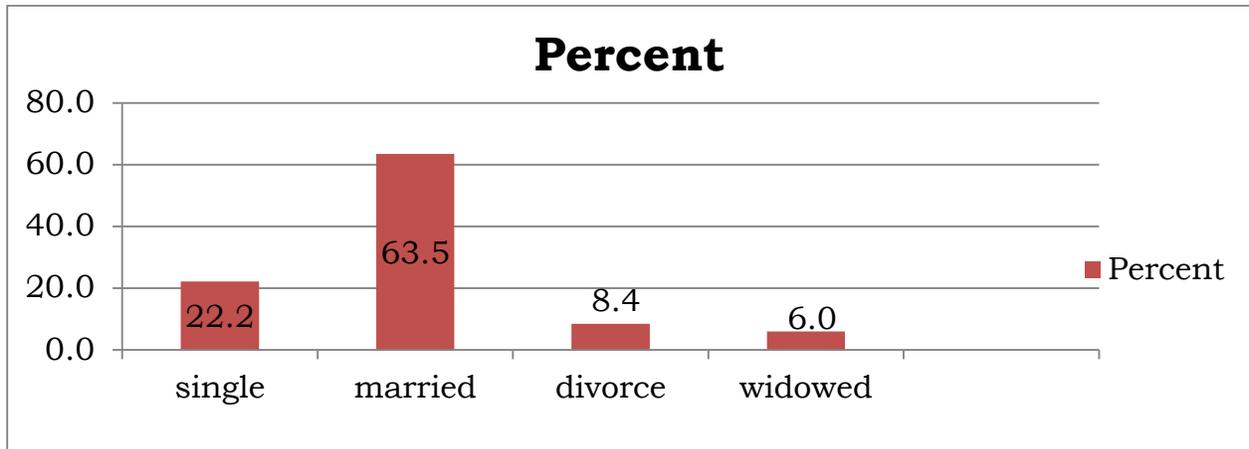


Figure 3; Respondents’ marital status

5.1.4 Position and business profile of taxpayers

From the result in table 4 regarding to Position/status in the business company of the respondents 73(43.7%) were owners as 47(28.1%) of them were managers who do not have possession of the business company. This can indicate that most business companies are being headed by owners who may be less oriented with managerial and professional business skill. This can imply that there is an opportunities of tax payers to evade tax due to lack of managerial and professional business skill to comply with the tax law and regulations.

From the result in this table respondents 96(57.5%) business entity were private limited company that constitutes the majority of the respondents as 55(32.9%) of the respondents’ have cooperative business entity. This can designate the legal entity of the taxpayers in the branch office which is less expected to evade tax as compare with individual and sole proprietorship business entities in which business decision may depend on personal interests.

From the same table below 151 (90.4%) of the respondents were paying business income, value add and withholding tax at the same tax year where as 16(9.6%) of the respondents pay Dividend and withholding tax only at the same tax year [Table 4]. This is an implication of a tax payers who pay many tax type are expected to evade tax more than those who pay fewer tax type as Torgler and Schneider (2005) assumed that taxpayers are rational economic evaders.

Table 4; Respondents' position and business profile of taxpayers

Variable(N=167)	Frequency	Percentage
Position/status in the business company		
Owner	73	43.7
Manager	47	28.15
Owner and manager	47	28.15
Total	167	100
Business entity		
private limited company	96	57.5
Cooperative	55	32.9
share company	16	9.6
Total	167	100
Type of tax you pay		
Income tax, value add tax and withholding tax	151	90.4
Dividend & withholding tax	16	9.6
Total	167	100

5.1.5 Penalty

As shown from the result in figure 4 61 (39.5%) of the respondents were not penalized of any tax evasion practice in the branch office whereas majority 101(60.5%) of the respondent were penalized due to tax evasion practices in the tax office. This finding shows that majority of the respondents (tax payers) in the branch office are tax evaders due to either of under-reporting of income, over-statement of expenses, non-recording of sales and late filling which are common practice of tax evasion while relatively fewer of the respondents are tax complaints or not evaders.

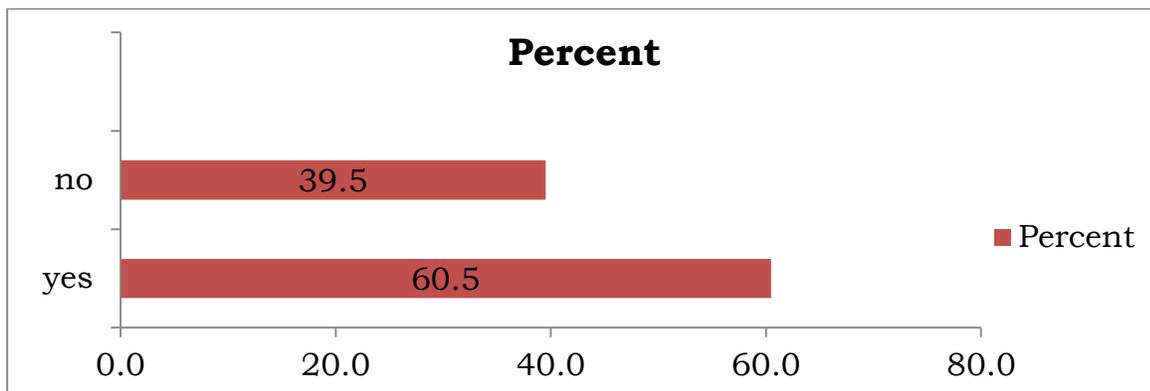


Figure 4; penalty of tax payers in Lideta Sub City Small Taxpayer’s revenue and customs branch office, 2014

5.2 Noncompliance opportunities of tax payers

5.2.1 Income

In the below table majority 137(82%) of the respondents’ annual income were increasing as 30(18%) of the respondents’ income were decreasing. Majority 103(61.7%) of the respondents’ annual income were higher where as 64(38.3%) of them were lower income [table 5]. This is a clear indication that tax payers are making sufficient profit and not expected to evade tax due to their increasing income trend.

Studies have proved this assertion Chau and Leung (2009), Ritsema and Thomas (2003) and Houston and Tran (2001) revealed that the respondents in the lower income group tend to have a lower proportion of tax compliance because they tend to under-reporting income and by over-claiming expenses than their counterparts in the higher income group this is also supported by Andreoni et al. (1998) most of the theoretical models indicate that as income increases, tax non compliance should be decrease. Thus, as income increases, tax non compliance should be decrease. But a study conducted by Alabede et al. (2011) in Nigeria 66% of the respondent had low income. This can display that the tax payers in this study make better profit than in Nigeria.

Table 5; Annual income of tax payers in Lideta Sub City Small Taxpayer’s revenue customs branch office, 2014

Variables(N=167)	frequency	percent
Your annual income is		
Increasing	137	82
Decreasing	30	18
Total	167	100
Do you think your annual income is		
Higher	103	61.7
Lower	64	38.3
Total	167	100

5.2.2 Descriptive analysis of non compliance opportunities

From the result in table 6 most respondents agreed (mean=4, and the standard deviation is ± 1.168) that they pay tax because fear of punishment for their offences. This can imply that most respondents are not willing to pay tax unless punishment is imposed for their tax offences. Therefore, there may be a tendency of tax evasion practices relative to the possible punishments for their non compliant behavior.

A study conducted by Marti et al. (2010) in Kenya the town of Kerugoya showed the most respondents are indifferent (mean=3, and the standard deviation is insignificant) that paying tax because fear of punishment. This shows that paying tax is not because fear of punishment in Kenya unlike that of in this case.

Most respondents agreed (mean=4, and the standard deviation is ± 0.393) that they believe tax law should be respected. In addition to this the in-depth interview supports this finding. One participant from the tax office (male, 42 years old) said that *“there are many tax payers who respect tax law.”* One participant also (female, 33 years old) said that *“tax payers want to respect tax laws but there is lack of sufficient tax law and regulations orientations by the tax office given to tax payers.”* This is an indication of tax payers’ readiness towards tax law and regulations’ respecting instead of becoming tax complaint with stick for their tax offences.

From the result in this table majority of the respondents agreed (mean=4, and the standard deviation is ± 1.282) that the government spends a reasonable amount on welfare; tax penalty prohibits noncompliance tendency, and believe their friends do not comply with the tax law and they have never been penalized. This can indicate that if most tax payers agreed that government spends a reasonable amount on social welfare they do not expected to evade tax but if they believed that their friends do not comply with tax laws but are

not penalized they may be motivated to evade tax. And also taxpayers' believe on tax penalty may be prohibit them from evading tax [table 6].

From the result in the same table most of the respondents agreed (mean=4) that tax penalties are important; and underreporting costs too high if they were caught by the tax office. This can imply that most respondents believe tax compliance depends on tax penalty and the probability of being undiscovered for evaded tax. Thus, they may evade tax if they assumed that the probability of being discovered by the tax office for undeclared income is less [table 6].

From the result in table 6 most of the respondents disagreed (mean=2) that there are a number of government services, facilities and infrastructures for which they are thankful; by paying right amount of tax they believe that other people especially the poor will get the benefit; they pay about the same amount of taxes as others making the same income, and believe that the penalty is lower than their tax savings due to not complying with tax law. This clearly indicates that the respondents believe that government do not spend sufficient on infrastructure for which they are thankful and motivated to pay tax in addition to this their tax payment helps nothing for the poor. Moreover, the respondents blame for tax payers who make the same business but do not pay the same amount of tax. Therefore, this is a clear evident that they can evade tax due to their perception. But also the respondents believe that tax penalty is much more than their savings from the tax already evaded. Thus, the respondents do not expect to evade tax in such away. In addition to this the in-depth interview supports this finding. One participant from the office (Male, 32 years old) about non compliance opportunities said that *“those who evade tax but not discovered by the tax office save much more than those who comply with the tax law but tax payers who possibly discovered by the tax office pay much more than they can save due to tax penalties.”* And one participant (male, 42 years old) also added that *“tax penalties by the office for undeclared income or other type of evasion is highly exaggerated and really discouraging to tax payers not to come with similar tax non compliance practice again .”*

From the result in table 6 most of the respondents are indifferent (mean=3) that one's tax penalty affects others not to underreport income; the tax office has limited capacity to investigate all offences; cost of complying with tax law is too high; cost of complying with tax law is too high, and to hide tax liability costs too high. This shows that tax payers are not sensitive for other tax payers' penalty which is expected to have influence on similar tax payers so they can evade tax though other tax payers got tax penalty for their evasion. The respondents' believe that the tax office has limited capacity to investigate all offences can motivate them to evade tax and also they can evade tax because they are not sensitive to hid tax costs too high.

As similar as with this study, a study by Marti et al. (2010) in Kenya reported that the taxpayers have partially complied in terms of keeping up to data records and books of accounts that can show where the level of law abidance among tax payers is expressed. This can display that law abidance in this study for tax payers is as indifferent as in Kenya because of may be the tendency to cheat tax liabilities is similar in both cases.

Table 6; non compliance opportunities of tax payers

Descriptive Statistics								
Variables (N=167)	Number of respondents under each weight					Weighted average (mean)	Std. (±)	
	Weight							
	5	4	3	2	1			
I pay tax because fear of punishments	37	86	8	25	11	3.68	1.168	
I believe tax law should be respected	20	141	6	-	-	4.09	0.393	
I believe that the tax office has the capability to investigate all income reported to the office	19	99	-	36	13	2.73	1.282	
I believe tax law should be strengthen	20	30	32	55	30	3.34	1.171	
the government spends a reasonable amount on welfare	76	43	14	20	14	3.88	1.330	

there are a number of government services, facilities and infrastructures for which i am thankful	27	24	9	40	67	2.43	1.523
by paying right amount of tax I believe that other people especially the poor will get the benefit	9	21	7	46	84	1.95	1.241
I pay about the same amount of taxes as others making the same income	22	26	19	38	62	2.44	1.442
The overall weight (mean) for the law abidance						24.54	
Tax penalty prohibits your noncompliance tendency	20	89	23	26	9	3.52	1.069
one's tax penalty affects others not to underreport income	5	84	23	50	5	3.22	1.001
Tax penalties are important	12	117	10	23	5	3.63	0.915
I believe that the penalty is lower than my tax savings due to not complying with tax law	20	29	16	35	67	2.40	1.456
my friends do not comply and they have never been penalized	73	44	15	25	20	3.63	1.424
The overall weight (mean) for penalty						16.4	
The tax office has limited capacity to investigate all offences	25	94	16	25	7	3.45	1.051
cost of complying with tax law is too high	14	67	17	51	18	3.05	1.216
Underreporting costs me too high if you were caught	19	106	13	23	6	3.59	0.919
To hide tax liability costs me too high	10	74	23	54	6	3.17	1.062

5.3 Attitudes and perceptions of tax payers

5.3.1 Tax payers' tax attitude

From the result in the below figure 5 most of the respondents 89(53.3%) have replied public attitude towards taxation is poor while 31(18.6%) of them have

replied is good. This can indicate that the public cannot help during the tax system implementation and as a result tax evasion cannot be condemned by the public at a large and more than anything this could be a bottleneck to the branch office during its tax compliance creation strategy.

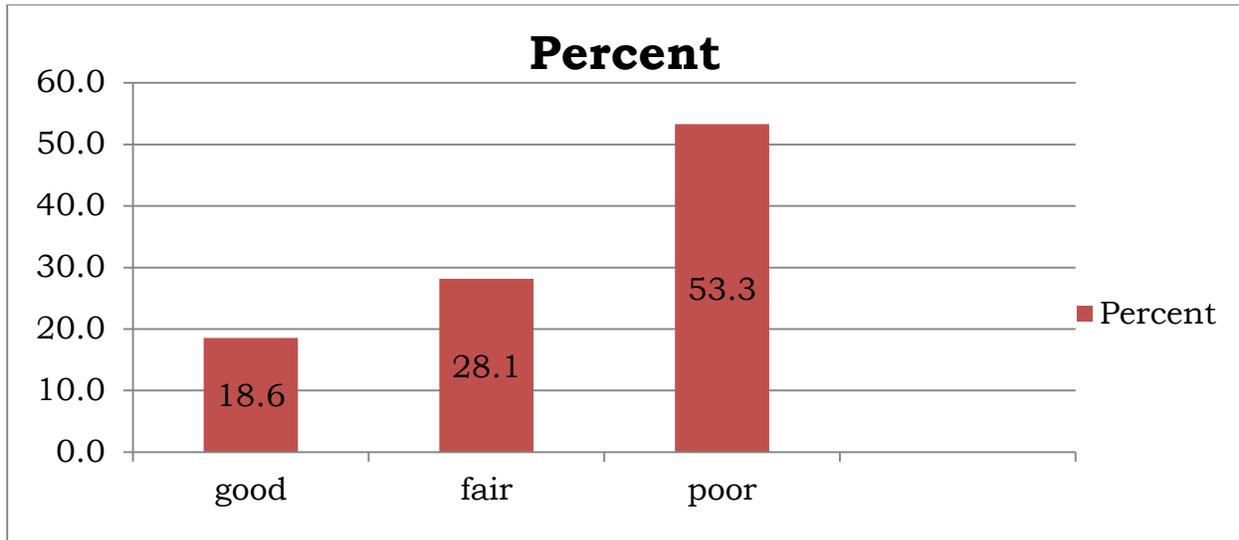


Figure 5; Attitude of respondents about taxation

5.3.2 Tax payers' loyalty

From the result in figure 6 83 (49.7%) of the respondents have evaluated that the loyalty of tax payers to tax system is fair and 52(31.1%) of them also have evaluated it is good. This indicates that most respondents' perception to the other tax payers' loyalty can motivate them to evade tax. But as compared with Marti's (2010) study in Kenya most of the respondents disagreed that the tax payers are loyal to pay tax liabilities. This may be due to the taxpayers loyalty is better in this study than in Kenya.

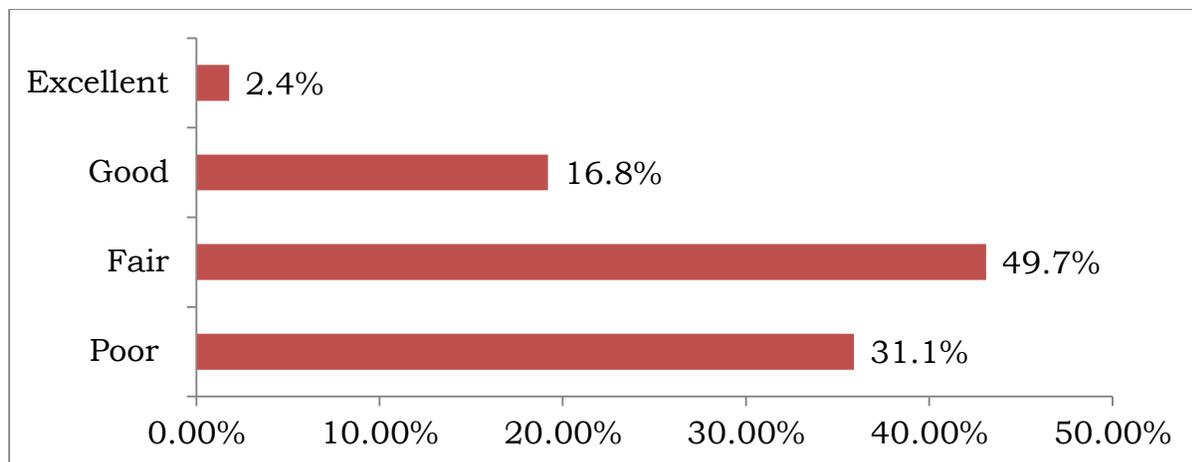


Figure 6; Loyalty of tax payers

5.3.2 Descriptive analysis of attitudes and perceptions of tax payers

From the result in table 7 most respondents disagreed (mean=2) that to evade tax is favorable; the tax they pay is based on their ability to pay and their tax burden is as similar as others in the same business. This can show that respondents cannot evade tax because of their disagreement with that of to evade tax is favorable. But also they can motivate to evade tax to compensate tax that they are asked to pay by the tax office which is more than their capability to pay and due to their perception of different burden for the same business.

A study by Alabede et al. (2011) in Nigeria with a mean score of 4 and standard deviation of ± 0.90 the respondents had an unfavorable attitude towards tax evasion which is similar with this case. This finding was also consistent with a study done in Kenya the town of Kerugoya by Marti et al. (2010) that most respondents disagreed with a Mean score of 2, and the standard deviation of ± 0.26165 that they are paying a fair share of tax; that their neighbors and friends are reporting and paying tax honestly.

Majority of the respondents agreed (mean=4) that paying tax is their responsibly. This implies that tax payers clearly know that they have not to evade tax instead paying tax is their responsibility [table 7].

Majority of the respondents are indifferent (mean=3) that the tax system is unfair; their friends and relatives action affect their decision not to reduce tax liability; not paying tax is due to expecting government can make tax amnesty; most of other tax payers are non compliant, and they pay their debts and basic needs first rather than paying their business income tax but one participant in the office (male, 37 years old) said that *“the willingness of tax payers to pay for legitimate tax liabilities is poor and almost all taxpayers perceive that paying tax is like giving money to the government from their bucket.”* This can be an evident to judge that tax payers are not sensitive to whether the tax system is fair or unfair, their relatives’ action, government tax amnesty and priority of paying their tax. Therefore, they can motivate to evade tax what so ever their environment looks like, they only headed as per their perception and attitude towards taxation.

Table 7; tax attitude and perceptions of tax payers

Descriptive Statistics							
Variables(N=167)	Number of respondents under each weight					Weighted average (mean)	Std. (±)
	weight						
	5	4	3	2	1		
To evade tax is favorable	6	27	12	83	39	2.27	1.100
The tax system is unfair	21	79	12	40	15	3.31	1.221
The tax I pay is based on my ability to pay	5	26	9	70	57	2.11	1.132
my tax burden is as similar as others	8	27	12	58	62	2.17	1.225
Paying tax is my responsibility	28	112	15	11	-	3.94	0.726
my friends and relatives action affect my decision not to reduce my tax liability	22	49	26	44	26	2.98	1.310
Not paying tax is due to expecting government can make tax amnesty	10	36	20	72	29	2.56	1.180
Most of other tax payers are non compliant	21	61	18	48	19	3.10	1.262

I will pay my debts and basic needs first rather than paying my business income tax	40	22	32	20	53	2.86	1.579

5.4 Tax system /structure of the participants

5.4.1 Tax audit

From the result in table 8 the taxpayers in the branch office have been audited 3 times (mean =3, and standard deviation is ± 0.903) which clearly shows that the frequency of the tax audit in Lideta Sub City Small Taxpayer's revenue and customs branch office to make sure that if tax payers are evading tax or not is high frequent as per the income tax proclamation no 286/2002 annual Determinants for tax payers is once a year. Thus, the probability of tax payers to evade tax is low because of an investigation by the tax office is high frequent.

Table 8; audit frequency of tax payers in Lideta Sub City Small Taxpayer's revenue and customs branch office, 2014

Variable(N=167)	Descriptive Statistics			
	Minimum	Maximum	Mean	Std. Deviation
how often you have been audited by the tax office	1	4	2.62	0.903

5.4.2 Tax audit effectiveness

From the result in figure 7 most of the respondents 68(40.7%) replied that tax audit effectiveness of the office is fair while 42(25.1%) of them responded that good and poor. This is a clear indication of tax payers can be motivated to evade tax because they believe that tax effectiveness in the office is fair not excellent. In addition to this the in-depth interview supports this finding. One participant from the office (female, 33 years old) said that "*non compliance opportunities depend on the audit effectiveness that could be said less effective*

in the branch office.” In addition to this other participant from the office (male, 27 years old) said that “tax audit knowledge and experience of tax auditors in the branch office is not in a satisfactory level. Therefore, tax payers can motivate to evade tax by hiring better experienced tax officials from the market.”

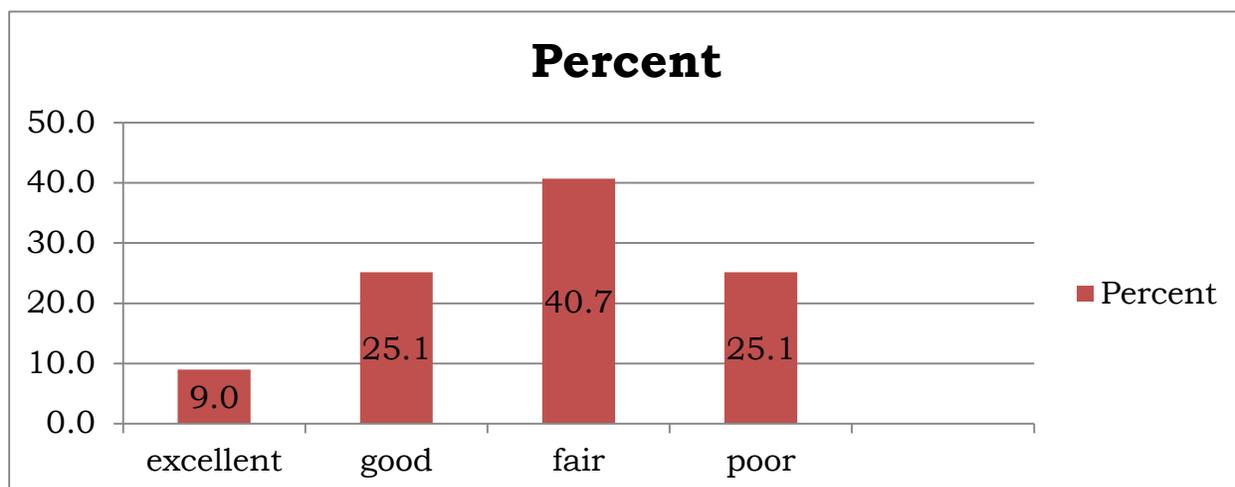


Figure 7; tax audit effectiveness of the office

5.4.2 Descriptive analysis of tax system/structure

From the result in table 9 most respondent agreed (mean=4) that Tax system/structure is too complex in addition to this an in-depth interview supports this finding. One participant from the office (male, 28 years old) said that *“tax rules and regulation are too complex.”* Therefore, this can indicate that as there are probabilities of under reporting income that comply with the tax law and the tax office is tolerable to tax offences due to the impossibility to discover for undeclared tax liabilities. Hence, this can encourage tax payers to evade tax.

Most of respondents are indifferent (mean=3) that penalties and sanctions are too severe in the tax office for tax evasion practices, and probability of being detected by the tax office for not declaring the exact income is too high. This can imply that tax payers are not sensitive to penalties’ and sanctions’ severity and probability of being detected by the tax office for undeclared tax; therefore, they can evade tax [table 9]. In addition to this the in-depth interview

supports this finding. On participant from the office (male, 27 years old) said that “*tax penalties and sanctions by the tax office are neither severe nor poor in addition to this legal enforcement are not best practiced that is why there are much tax liabilities which are not collected on time.*” But one participant from the office contrary to this finding (female, 36 years old) said that “*tax penalties and sanctions are too severe and legal enforcements are getting improved.*”

From the result most respondents disagreed (mean=2) that the probability of being audited by the tax office is too low which is paradox with the result in table 8. This can encourage tax payers to evade tax as they believe that probability of being audited is too low [table 9].

Table 9; the tax system in Lideta Sub City Small Taxpayer’s revenue and customs branch office, 2014

Variables(N=167)	Descriptive Statistics					Weighted average (mean)	Std. (±)
	Number of respondents under each weight						
	weight						
	5	4	3	2	1		
Tax system/ structure is too complex	47	63	5	30	22	3.50	1.405
Penalties and sanctions are too severe	14	34	17	67	35	2.57	1.273
Probability of being detected by the tax office for not declaring the exact income is too high	35	45	17	51	19	3.16	1.362
There are probability of under reporting income that comply with the tax law	36	79	5	29	18	3.51	1.298
The tax office is tolerable to your tax offences	41	74	7	25	20	3.54	1.329
Probability of being audited is too low	3	41	3	100	20	2.43	1.038

Chapter six

Conclusion and Recommendation

The existing literatures have outlined numerous factors that can determine tax evasion. These Determinants are demographic variables, non compliance opportunities, attitudes and perception and tax system /structure. Theoretical framework was developed to show clearly the various Determinants of tax evasion of tax payers in the branch office though it did not include the relationship among these Determinants and their effect to tax evasion of taxpayers.

Given the research questions, do noncompliance opportunities, tax system/structure, attitude and perception and demographic variables determine tax evasion of tax payers, have been measured as similar as many other researchers tried to measure it in their different carries of study.

6.1 Conclusion

This study was aimed at investigating a sample of taxpayers' factors that determine tax evasion of tax payers in Lideta Sub City Small Taxpayer's revenue and customs branch office. The demographic variable such as age, marital status, gender and educational back ground were found insignificant to determine tax evasion of tax payers though the majority of the taxpayers were found male, married, aged young and educated.

Even though majority of the respondents pay tax due to fear of punishment and believe tax law should be respected, the study clearly indicates that majority of the respondent were penalized due to tax evasion practices but law abidance was found insignificant to determine tax evasion of tax payers in the branch office. This can imply that tax payers in the branch office can evade tax regardless of the strength of the tax law.

As the majority of the taxpayers agreed with minimizing tax liability enjoy tax savings, cost of complying with tax law is too high, underreporting costs too high if detected and to hide tax liability costs too high, cost to evade tax/non compliance opportunity/ was found significant to determine tax evasion of tax payers. Thus, the possibility of being penalized for tax payers those who believe to evade tax costs low increases by 28.47% as compare to their counterpart. However, majority of the tax payers agreed that the branch office has limited capacity to investigate all offences possibly made. This can motivate them to evade tax liabilities.

The probability of detection was found significant to determine tax evasion of tax payers as possibility of being penalized for tax payers those who believe the probability of detection is high for tax evasion decreases by 13.64% as compare to their counterpart. This clearly indicates that the capacity of the tax office to investigate tax evasions can discourage to hide tax liabilities.

The study found that the public attitude towards taxation is poor but the majority respondents believed that loyalty of taxpayers to the tax law is fair. However, attitude was found insignificant to determine tax evasion. Therefore, the attitude and perception of tax payers towards tax evasion cannot influence them if they are to evade tax.

As the majority of tax payers believe that audit effectiveness of the branch office was poor, tax system is too complex and the availability of probability of underreporting income that comply with tax law. However, Audit effectiveness and law abidance were found insignificant to determine tax evasion of tax payers. This is a clear indication of that tax payers in the branch office are less sensitive to audit effectiveness.

6.2 Recommendations

With this research finding the researcher would be keen while putting the following remarks;

- The branch office needs to implement strong tax assessment and has to have satisfactory audit coverage to deliver the aspiration of helping customers to pay the right tax at the right time and with the minimal administrative and compliance cost to both the tax office and customers. Therefore, high probability of detection and its effectiveness could encourage tax compliance and prohibit tax evasions.
- In order to create an efficient tax administration, the tax office needs to strengthen itself by educating and training its employees, by computerizing and system support its operations, and devoting additional resources. Training should include customer service training and cross functional training for employees. As a result they can come up with a satisfactory understanding of the entire tax administration system.
- One set of responses is to improve the tax administration to facilitate detection and successful prosecution of certain classes of tax evasion. Another possible response is to strengthen the penalties and implement severely on tax evasion that are detected. Furthermore, there should not be any benefits that possibly the tax payer can enjoy because of their ability to evade tax liabilities, instead higher costs should be put in place for detected tax evasions. Thus, tax compliance of taxpayers would be improved sustainably and effectively.
- Taxpayers tend to evade tax to the extent they feel that the tax office is weak and unable to enforce the law. This directly hinders the compliance behavior of compliers and motivates non compliers to continue evading tax. Therefore, the branch office needs to be strong enough in order to

implement the tax law effectively and efficiently. Functions such as tax audit, awareness creation and enforcement has to perform effectively and efficiently, so that it will be perceived as strong and powerful by the taxpayers. In addition to this as one participant in the office (male, 35 years old) suggested that *“the tax office should work much to enhance tax knowledge among tax payers to mitigate tax evasions.”* And other participant in the office (female, 29 years old) suggested that *“legal enforcement should be implemented strongly to control tax evaders as well as to facilitate tax complaints in order to mitigate tax evasion in the tax office.”*

- Efficient service delivery to taxpayers is a key factor against which the strength of the branch office is judged. Thus, the tendency to evade tax by taxpayers due to the perception that the branch office has not capacity to investigate all offences would be minimized.

- The branch office needs to do much on creating compliant attitude and perceptions among the tax payers in which it could put in to practice that self assessment, self payment and law abidance by tax payers to its maximum level. Moreover, tax payers need to have positive attitude towards the tax system and tax rules, regulations and proclamations that the branch office is responsible to implement.

Generally, in order to increase tax compliance, governments must adopt a comprehensive strategy, beginning with the writing of the tax laws in easy and understandable terms to enforce. In the light of changing social and economic conditions, the tax office must take a sustainable comprehensive look at their tax administration in order to assess how they can increase compliance and minimize the problems existing in the tax noncompliance. In addition one participant also (male, 34 years old) suggested that *“modern tax system should be implemented and improved time to time and also skill of tax officials should be improved as per the time demands to tackle tax evasions in the office.”*

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Appendix 2; Questionnaire prepared for sample of tax payers

Questionnaire on “Assessment of tax evasion case of Lideta sub city
small tax payers revenue and customs branch office”

St. Mary’s University

Dear valued respondent

This questionnaire is prepared by a student of master of business administration, at St. Mary’s University. The purpose of this questionnaire is to find out theDeterminantsof tax evasion and avoidance of tax payers in Lideta sub city small tax payers revenue and customs branch office. Your response will be kept strictly confidential and it will be used for this research purpose only.

- The questionnaire should be filled by either business owners or business managers.
- In all cases where answer options are available please tick (x) in your response box.
- It would be greatly appreciated if you could answer all questions.

Thank you for your cooperation

Part 1- Participant information and business profile

1. Sex; male 1 female 2
2. Age _____ (in year):
3. Marital status ;
Single 1 married 2 divorced 3 widowed 4
4. Educational level _____(year of schooling)
5. Type of Business entity you are running now _____
6. Type of Tax you pay?
Income tax 1 dividend 2
Value add tax 3 with bolding tax 4
7. Your status/position in the business company _____

8. Your work experience in the same business _____(in years)

9. Have you penalized by the tax office?

Yes 1 No 2

Part 2- Non-compliance Opportunity

10. Your annual income is

Increasing 1 decreasing 2

11. Do you think your annual income is

Higher 1 lower 2

12. Have you penalized by the office due to

Under reporting income 1 late tax payment 2

Over claiming of deductions 3 not at all 4

13. Give your response for the following questions according the instruction given below.

Strongly agree= 5; Agree =4; undecided = 3; Disagree = 2; strongly Disagree = 1

Questions		Tick x mark in your response				
		5	4	3	2	1
Law abidance	I pay tax because of fear of punishments					
	I believe tax law should be respected					
	I believe tax law should be strengthen					
	I believe that the tax office has the capability to investigate all income reported to the office					
	The government spends a reasonable amount on welfare					
	There are a number of government services, facilities and infrastructure for which I am very thankful					
	By paying right amount of tax, I believe that other people especially the poor will get the benefit					

	I pay about the same amount of taxes as others making the same income					
Penalty	Tax penalty prohibits your noncompliance tendency					
	One's tax penalty affects others not to underreport income					
	Tax penalties are important					
Costs and benefits	I believe that the penalty is lower than my tax saving due to not complying with tax laws					
	My friends do not comply and they have never been penalized					
	The tax office has limited Capacity to investigate all offences					
	Cost of complying with tax law is too high					
	Underreporting costs too high if you were caught					
	To hide tax liability costs you too high					

Part 3- Attitudes and perceptions

14. What do you think about the public attitude towards taxation?

Excellent 1 Good 2 fair 3 poor 4

15. How do you evaluate the loyalty of tax payers to the tax system?

Excellent 1 Good 2 fair 3 poor 4

16. Give your response for the following questions according the instruction given below.

Strongly agree=5; Agree=4; undecided =3; Disagree= 4; strongly disagree =1

Questions		Tick x mark in your response				
		5	4	3	2	1
Attitudes and perceptions	To evade tax is favorable					
	The tax system is unfair					
	The tax I pay is based on my ability to pay /rightful					
	My tax burden is as similar as others					
	Paying tax is my responsibility					
	My friends and relatives action towards tax affect my decision not to					

	reduce my tax liability					
	Not paying tax is due to expecting government can make tax amnesty					
	Most of other tax payers are non compliant					
	I will pay my debts and basic needs first rather than paying my business income tax					

Part 4- tax system / structure

17. How often you have been audited by the tax office? _____Times per year

18. Tax audit effectiveness of the office is

Excellent 1 Good 2 fair 3 poor 4

19. Give your response for the following questions according the instruction given below.

Strongly agree=5; Agree=4; undecided =3; Disagree= 4; strongly disagree =1

Questions		Tick x mark in your response				
		5	4	3	2	1
Probability of detection and penalties	Tax system/ structure is too complex					
	Penalties and sanctions are too severe					
	Probability of being detected by the tax office for not declaring the exact income is too high					
	There are probability of under reporting income that comply with the tax law					
	The tax office is tolerable to your tax offences					
	Probability of being audited is too low					

Thank you

Appendix 3; Interview questions the tax office officials Unstructured Interview

Questions prepared to assess the evaluation and observation of operational officials about tax evasion the case of Lideta sub city small tax payer's revenue and customs branch office

1. How do you describe/evaluate the non compliance opportunities in the tax office?

2. How do you evaluate the penalty and legal enforcement of the tax office?

3. What do you observe about the law abidance of the tax payers?

4. What do you observe the tax awareness/knowledge of the tax payers?

5. How do you evaluate the tax system of the tax office as a whole?

6. How do you evaluate the willingness of the tax payers to pay for legitimate tax liabilities?

7. What do you judge about the skill of the officials in the tax office?

8. What suggestion do you have to mitigate tax evasion in the branch office?
