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St. Mary's University, Ethiopia

FACTORS AFFECTING TAX PAYERS COMPLIANCE WITH THE TAX SYSTEM: CATEGORY "A" TAX PAYER'S IN ADDIS ABABA

BY

MEAZA WUDENEH

DECEMBER 2018

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A THESIS SUBMITTED TO ST.MARY'S UNIVERSITY SCHOOL OF GRADUATE STUDIES IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF DEGREE OF MASTERS OF BUSINESS ADMINSTRATION IN ACCOUNTING AND FINANCE

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APPROVED BY THE BOARD OF EXAMINERS

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DECLARATION

I, the undersigned, declare that this thesis is my original work, prepared under the guidance of Abraham Gebregiorgies (Asst.Prof.). All sources 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 to any other higher learning institution for the purpose of earning any degree.

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Name   Signature& Date

ENDORSEMENT

This thesis has been submitted to St. Mary's University, School of Graduate studies for examination with my approval as a university advisor.

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Advisor   Signature& Date

ACKNOWLEDGEMENT

ABSTRACT

The objective of this study is to examine factors affecting category "A" tax payers in Addis Ababa. A conceptual framework was adopted based on the economic, social, individual and demographic factors. The study adopted a quantitative research approach to test the hypotheses and answer research questions. The data collected from 120 Category "A" tax payers in Addis Ababa through distributing self-administered questionnaires. Date was analyzed using STATA. Two analysis methods were used, descriptive statistics and ordered probit model to examine significant determinant factors of tax compliance. The result founds that majority of tax payers were not compliant. It also revealed that education level, tax audit, government spending, the influence of referent group, personal financial constraint, awareness on offences and penalty rate, and tax knowledge are significant factors of tax compliance. Others factors considered under this study, age, gender, income level, equity and fairness, government policy were found to be insignificant. Finally the study suggests that the government has to improve public services to enhance tax compliance behavior. Following this it is mandatory to create awareness about benefits of paying tax, conducting preventive education to the public and conduct through audit to discourage non compliance behavior. In addition it would be helpful if further study is conducted on influence of referral group on compliance behavior since social norms and ethical values will create different incentives for tax compliance.

Key Words; Tax Compliance, Ordered probit, Category "A" tax payers

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ACRONYMS

ERCA   Ethiopian Revenues and Customs Authority and tax payers

GDP   Gross Domestic Product

GAAP   Generally Accepted Accounting Principles

CHAPTER I

Introduction

1.1   Background of the Study

Taxation in developing countries is a challenging topic and has attracted increasing attention in the last two decades. During this period, many problems observed like poor administration, failing to collect sufficient tax revenues, lack of government and economic stability (Vadde and Gundarapu, 2012). As stated by Vadde and Gundarapu (2012), Ethiopia, like any other developing countries, has faced difficulty in raising revenue to the level required for the promotion of economic growth. The revenue of the Ethiopian government comes from different sources such as tax, Public borrowing, sales of public assets, and transfer payments (Asaminew, 2011).

Taxes are fundamental to the existence of governments, for the tax revenues help to finance the bulk of services that governments provide including education, welfare, public safety, infrastructure and other basic public services (Tilahun andYidersal, 2014). These public expenditures are meant for public goods and services that are very essential for the development and wellbeing of the society (Asamnew, 2011). Improved tax compliance amplifies the revenues available for supporting public services without increasing the current tax burden on compliant taxpayers (Bird, 1998). Thus, tax compliance has been an important subject of research in a large number of developed and a number of developing countries (Tilahun andYidersal, 2014). Since each country has its own approach to managing tax compliance levels and each has different tax laws and regulations, the factors impacting tax compliance behavior appear to vary among countries (Palil, 2010).

To escape from aid dependency and from poverty, it is essential that Ethiopian Revenues and Customs Authority offices have the capacity to collect taxes efficiently and in ways that are just and equitable. This requires measures both to enhance internal tax collection and also to reduce the barriers that are quite simply not fit for their intended purposes, educating the taxpayers, counseling service to taxpayers on tax rules and procedures and increasing audit coverage (Gebrewahid, 2012).

Most developing countries are currently dependent more on external financial resources to fund their development activities. As Akalu (2016) noted, in Ethiopia the tax contribution to GDP ratio remained consistently low and is relatively shrinking due to low tax compliance. Taxpayers' resentment and noncompliance may be due to taxpayers' perceptions and attitudes on paying taxes (Yesegat and Fjeldstad, 2016). Hence, dealing with the problems of tax compliance requires a detailed understanding of the factors affecting the tax payer's decision either to pay or evade taxes.

Therefore, the objective of this study is to examine the factors affecting business taxpayers' compliance on Category "A" tax payers in Addis Ababa. The results of the study are expected to give an insight for policy makers and tax authority in addition to a reference for further study.

1.2   Statement of the Problem

Ethiopia is low performing country in terms of tax to GDP ratio. It is approximately 13 percent; this is lower than the average for low-income countries (Yesegat and Fjeldstad, 2016). According to Akalu(2016), tax payers fails to fulfill income tax requirements and a number of them face prosecution for failing to pay taxes on time.

Empirical evidence in Kenya shows there has been hostility between the taxpayers and tax collectors on issues relating to tax compliance and outward resistance from taxpayers for example the recent protest by taxpayers over implementation of Electronic Tax Register.Hostile taxpayers behavior implies that given a chance taxpayers would not comply with tax laws(Lumumba, Migwi and Obara, 2010).Likewise, Ethiopia also facing similar protest by tax

payers on the year 2016.It has been reported by different Medias about the hostility between Ethiopian Revenue and Customs Authority and tax payers (ERCA, 2016).

ERCA(2016) noted that, the authority investigates tax evasion by the tax payers frequently and prosecues those that evade taxes, Investigation thus far points out that the suspects were involved in issuing illegal receipts and misusing the fisical memory installed on the sales machines that leads to the destrution of government revenue.

There are anumber of factors leads tax payers to evade taxes. According to Kirchler (2007) and Loo (2006), tax compliance determinants are classified in four categories based on an interdisciplinary perspective representing a wider perspective of tax compliance determinants compared to other researchers. The four categories are 1) economic factors (tax rates, tax audits and perceptions of government spending); 2) institutional factors (the role of the tax authority, simplicity of the tax returns and administration and probability of detection); 3) social factors (ethics and attitude, perceptions of equity and fairness, political affiliation and changes on current government policy, referent groups); and 4) individual factors (personal financial constraints, awareness of offences and of penalties). On the other hand, Nicoleta (2011) reveal that tax compliance determinants classified into Economic (level of actual income, tax rate, fines, penalties, tax benefits and tax audit probabilities) and Non-economic (attitude towards taxes, personal, social and national norms and perceived fairness of tax system)factors. Singh (2003) and Kasipillai, Norhani, and Noor (2003) also identified enumerated factors that influenced tax compliance behavior such as demographic, income, compliance cost, and tax agents, in addition to moral or ethical factors .

Emperical studies have been conducted in Ethiopia on determinants of tax compliance focusing on various factors. Yesegat and Fjeldstad (2016) examine factors that determine business people's attitudes towards paying taxes in Ethiopia using ordered probit model founds a statistically significant relationship between tax-compliance attitude and factors such as the perception of probability of audit, corruption, satisfaction with the tax administration, peer influence, gender and education. Akalu (2016) examined determinants of tax compliance behavior of large corporate taxpayers in Ethiopia with ten potential determinants of tax

compliance namely; tax compliance cost, business sector, business size, tax liability, business age, sector, length, and tax attitudinal aspects such as tax complexity, tax rate structure, tax deterrence sanctions, fairness in the tax rate/ tax system and perceived level of psychological costs. Additional researches have been conducted on factors affecting tax compliance by Tadesse and Goitom, (2014) at Bahirdar and Tilahun and Yidersal (2014) at Mekelle cities. Apart from that their methodologies and findings were not consistent and they recommend further study on this regard. For example, Tadesse and Goitom, (2014) recommended further study at a national level to gain a better understanding on compliance determinates in the country. In addition, Yesegat and Fjeldstad (2016) indicated that, understanding taxpayers' behavior and taking corrective measures is important in order to enhance domestic revenue mobilization and sustain Ethiopia's recent growth.

As it is mentioned above studies have been conducted in different areas on determinants of tax compliances, However, tax compliance behavior is a function of culture as a result their findings were different. Roth, Scholz, & Dryden-Witte (1989, 162) claim that the various cultural contexts which shape a person's interpretation of events may assist in influencing his or her attitude toward tax evasion. They argue that culture is reflected to varying degrees in general values and specific behavioral norms.

In view of the inadequacies in the institutional framework and insufficient expertise and resources to monitor the intricacies of the tax compliance problems, developing countries are particularly vulnerable to tax noncompliance. Ethiopia is one of the developing countries having many development plans but the government is reporting low tax revenue collection. Results of Empirical studies on determinants of tax compliance recommended that further studies and investigations will lead to a better compliance level. In addition, Studies were not conducted on determinants of tax compliance in the case of category "A" tax payers in Addis Ababa and all factors of tax compliance were not included in the previous studies .

So based on the gap on this field area the researcher is interested to examine factors of tax compliance in the case of category "A" tax payers at Addis Ababa and put its own contribution to alleviate non compliance problem.

1.3 Research Objective

The General objective of this study is to examine factors affecting tax payers 'compliance with the tax system in the case of category "A" tax payers in Addis Ababa. The specific objectives of this study are

1. To assess compliance level of Category "A" tax payers in Addis Ababa.
2. To examine the perception of tax payer's tax compliance towards economic, social, individual and demographic factors of category "A" tax payers in Addis Ababa.

1.4. Research Questions

Specific research questions under this study are to examine;

1. What is the impact of economic factors on tax payer's compliance with the tax system
2. What is the impact of social factors on tax payer's compliance with the tax system
3. What is the impact of individual factors on tax payer's compliance with the tax system
4. What is the impact of demographic factors on tax payer's compliance with the tax system

1.5. Significance of the Study

The findings of this study will contribute in enhancing the tax revenue of the government by identifying factors affecting tax payer's compliance. From policy makers perspectives, this information will assist tax authority to develop appropriate strategies in order to minimize tax compliance problem so as to improve tax collection. ERCA, policy makers and tax collectors

will get better understanding about factors affecting tax compliance and take the necessary action to enhance level of compliance. It will also be used as a reference for those who need to conduct further study in the field.

Last but not least it will fill the gap identified under this study and will enhance the level of tax revenue which is very important to successfully deliver public services, achieve growth and development plans of the country.

1.6. Scope of the Study

There are multiple factors that affect tax compliance however this study limited to examine only twelve factors (tax audit, government spending, perception on equity and fairness, changes to government spending, referral group, personal financial constraint, awareness on penalty and offence, tax knowledge, age, gender, education and income level) which will affect tax payers' compliance. In addition, the study would be more comprehensive if it embraces all Categories of tax payers in Addis Ababa. However, large scale study requires much resources, time and man power. Due to this to make the study manageable, it is delimited to Category "A" tax payers in Addis Ababa.

1.7. Limitations of the Study

The methodology applied in this research has limitations. Firstly, determinant factors of tax compliance were analyzed only based on a limited coverage of the Income Tax law. However, the results might be different if a wider scope of tax rules were used. A wider coverage of tax law would not be able to be conducted in this study as doing so would make the questionnaire lengthy and cumbersome and it thus might be potentially disregarded by the respondents and therefore the response rate might decrease.

Secondly, the compliance measure is a judgment based measure using hypothetical situations. As tax evasion is a sensitive issue, respondents may not feel comfortable answering the questions without any control or direct contact. Actual behavior of the subjects may vary from the

responses given. Acknowledging this constraint, however, it is believed that this is the most suitable way to predict taxpayers' compliance behavior, as direct questions might lead respondents to answer the questions dishonestly and could be potentially embarrassing for respondents.

1.8. Organization of the paper

The thesis is structured as follows: Chapter two contains a review of the literature of the definitions of tax, taxation in Ethiopia, tax compliance, and conceptual framework of the study. The research design and methodology are presented in chapter three. Specifically, this chapter presents sampling techniques, data sources, data collection instruments and research model. Chapter four presents the results of survey subsequently followed by an analysis of the results of the different methods. Finally, chapter five presented conclusion and recommendations.

CHAPTER II

Literature Review

2.1 Definition of Tax

According to Bhatia (1996), "a tax is a liability imposed up on the tax assesses who may be individuals, groups of individuals, or other legal entities." It is a liability to pay an amount on account of the fact that the tax assesses have income of a minimum amount and from certain tangible or intangible property, or that they carry on certain economic activities which have been for taxation. Tax is defined as 'a compulsory levy, imposed by government or other tax raising body, on income, expenditure, or capital assets, for which the taxpayer receives nothing specific in return' (Lymer and Oats, 2009).

A tax is a compulsory levy and those who are taxed have to pay the sums irrespective of any direct corresponding return of services or goods by the government. Government needs financial resources to act as a government and play a role that is expected from it by the public (James and Nobes, 2000).

Taxes are fundamental to the existence of governments, for the tax revenues help to finance the bulk of services that governments provide including education, welfare, public safety, infrastructure and other basic public services. Improved tax compliance amplifies the revenues available for supporting public services without increasing the current tax burden on compliant taxpayers (Bird & Casanegra, 1992).

The main objective of imposing certain taxes on the public is to generate revenues for the government for public expenditure (Singh, 1999; Shanmugam, 2003; Lymer and Oats, 2009). However, there are other functions of taxes as suggested by Lymer and Oats (2009) including to reduce inequalities through a policy of redistribution of income and wealth so that income gap between the rich and the poor is not as significant. Tax systems are also designed for social purposes, such as discouraging certain activities which are considered undesirable and protecting the environment. For instance, the excise taxes on alcohol and tobacco are (at least partly) exercised to decrease consumption and thus encourage a healthier lifestyle (Lymer and Oats, 2009).

2.2 Taxation in Ethiopia

The 1995 Constitution of the Federal Democratic Republic of Ethiopia (FDRE) classifies taxation power into three: as those assigned exclusively to the federal government, regional states, and concurrently to both regional and federal governments. As per the constitution, regional states have the power to levy and collect taxes from sources assigned to them. Ethiopian Revenue and Customs Authority (ERCA) is responsible for administration of revenues that belong exclusively to the federal government and those concurrently owned by both. Regional revenue authorities are entrusted with the responsibility of administering taxes assigned to them (World Bank Group, 2016)

2.2.1 Business Categories in Ethiopia

The law has classified the business income tax payers in to three major categories with respect to their legal personality and gross income. According to Federal Income tax proclamation No. 976/2016;

1) Category "A" tax payer being
   a. A body; or
   b. Any person having an annual gross income of birr 1,000,000 or more

2) Category "B" tax payers being a person, other that a body , having an annual gross income of birr 500,000 or more but less than 1000,000

3) Category "C" tax payer being a person other than a body having annual gross income of less than birr 500,000

According to this legislation, there are four schedules of income, namely: income from employment (schedule A), income from rental of buildings (schedule B), business profit (Schedule C) and other income (schedule D). A further look at the income tax under schedule C (business profit tax) shows that the tax is imposed on profit obtained from an entrepreneurial activity. It is chargeable at rates ranging from 10 to 35 percent if the taxpayer an individual (unincorporated entity) and 30 percent on profits earned by a body (an incorporated entity) (World Bank Group, 2016).

2.2.2 Declaration of Business income

Categories A and B the tax is assessed based on the profit and loss statement prepared in accordance with the Generally Accepted Accounting Principles (GAAP) subject to the specific rules as provided in the income tax legislation (World Bank Group, 2016).

In accordance with income tax proclamation no 979/2016, category "A" tax payers shall prepare and submit balance sheet and profit and loss statement within 4 month from the end of the tax payers tax year. Category "B" tax payers within 2 months from the tax payers' tax years. Category "C" tax payers within 1 month from the tax payers tax year.

2.3. Tax Compliance

2.3.1. Definition of tax Compliance

According to James and Alley (2002), tax compliance refers to the willingness of individuals to act in accordance with both the spirit and the letter of the tax law and administration without the application of enforcement activity.

Tax compliance is defined as the accurate reporting of income and claiming of expenses in accordance with stipulated tax laws. Thus, the failure of corporations to accurately report or pay tax is considered corporate tax non-compliance (Noor, Jeyapalan and Uchenna, 2014).

 A wider definition of tax compliance, tax compliance should be defined as taxpayers' ability and willingness to comply with tax laws which are determined by ethics, legal environment and other situational factors at a particular time and place (Kirchler, 2007)

Tax compliance, simply put, means adherence to tax reporting requirements; that is, that the taxpayer files all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the tax laws, regulations, and court decisions applicable at the time the return is filed (Roth, Scholz and Witte 1989)

2.3.2. Theoretical Approaches of Tax Compliance

As Devos (2014) noted the main theoretical approaches to tax compliance have commonly been divided into the 'economic deterrence' approach, and the wider 'behavioral' approach which incorporates both social and fiscal psychological approaches.

There are two broad approaches which researchers have used to explain evasion behavior, namely, Fiscal psychology Models and economic deterrence models (Trivedi & Shehata, 2005). An economic based theory emphasizes incentives where as psychology based theories emphasize attitude (Trivedi & Shehata, 2005).

James, Hasseldine, Hite and Toumi (2001) reported that there are two main approaches to understand tax compliance issues: the economic approach and behavioral approach. The economic approach is premised on the concept of economic rationality, while the behavioral approach applies concepts from disciplines such as psychology and sociology.

2.3.2.1 Economic Based Theories

The economic deterrence theory states that taxpayers' behavior is influenced by factors such as the tax rate determining the benefits of evasion, and the probability of detection and penalties for fraud which determine the costs (Sandmo, 1972).

Economic factors which is also referred as deterrence theory (tax rates, tax audits and perceptions of government spending) in relation to tax compliance refer to actions which are associated with the costs and benefits of performing the actions (Loo, 2006).

According to Trivedi and Shehata (2005), economic theories suggest that taxpayers "play the audit lottery," i.e. they make calculations of the economic consequences of different compliant alternative, such as whether or not to evade tax; the probability of detection and consequences thereof, and choose the alternative which maximizes their expected after tax- return/profit (possibly after adjustment for the desired level of risk).

2.3.2.2. Psychology Theories

The social/fiscal psychological model focuses on psychological variables which include moral values and the perception of fairness of the tax system and the tax authorities (Devos, 2014).
As Yesegat and Fjeldstad (2016) noted, the social psychology model, unlike the economic deterrence model, pertains to the relationship between tax compliance and social interactions and conventions. An aspect of this theory says that perceptions and attitudes towards a tax system and compliance behavior may be affected by the behavior of an individual's peer groups. The compliance behavior of peer groups like friends, neighbors and relatives is expected to impact on the perceptions and compliance decisions of others. More specifically, noncompliant decisions by peer groups may reduce the level of tax compliance by others.

According to Trivedi and Shehata (2005) Psychology theories of tax compliance assume that psychological factors including moral and ethical concerns are also important to tax payers and tax payers may complay even when the risk of audit is low.As it is noted their Psychology studies deemphasizes audits and penalities and insteed foucs on changing individual attitudes towards tax system.

Compliance is also affected by demographic factors. For instance, there may be differences in perception about taxation between age groups, urban–rural location, gender, education levels, occupation, ethnicity, religion, and so on (Fjeldstad et al. 2012).

The classifications of factors as identified by scholars include the social, economic, and psychological factors (Jackson & Millron, 1986; Fischer, Wartick & Mark, 1992; Fischer, 1993; Alm, 1999; Kirchler, 2007; Devos, 2008). To resolve the issues of non-compliance of tax, appreciating the factors that determine tax compliance is of paramount importance towards influencing individual tax payer's decision to comply with the provision of the tax laws. The early researches on tax compliance were more of economic factors inclined and which they paid attention to tax rate, penalty and detection probability as the main determinants of the tax payers' compliance behavior (Allingham & Sandmo, 1972).

Recent studies have identified some new factors that have significant influence on the tax payers' decision making; and these new factors were the social and psychological factors, which the following studies were known to incorporate the identified factors (Jackson & Millron, 1986; Fischer, 1993; Wenzel, 2004; Jabbar, 2009).

2.4. Determinants of tax compliance

Tax compliance determinants from a social perspective relates to taxpayers' willingness to comply with tax laws in response to other people's behavior and their social environment (i.e. the government, friends and family members) (Torgler, 2007). On the other hand, Kirchler (2007) suggested that social factors should be viewed in a broader sense than Torgler's perspective; this includes the psychology of the taxpayers.

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Jackson and Milliron (1986), in their earlier review of tax compliance studies undertaken identified fourteen key variables of compliance behavior, which include: age; gender; education; income level; income source; occupation; peer influence; ethics; fairness; complexity; tax authority contact; sanctions; probability of detection; and tax rates.

Previous studies revealed that probability of being audited; perception on government spending; perception on equity and fairness of the tax system; penalties; financial constraint; changes on current government policies; and referral group (friends, relatives etc.) are also important factors in assessing tax compliance behavior (Palil,2010; Troutman,1993; Chan et al, 2000).

According to Kirchler (2007) and Loo (2006), tax compliance determinants are classified in four categories based on an interdisciplinary perspective representing a wider perspective of tax compliance determinants compared to other researchers. The four categories are 1) economic factors (tax rates, tax audits and perceptions of government spending); 2) institutional factors (the role of the tax authority, simplicity of the tax returns and administration and probability of detection); 3) social factors (ethics and attitude, perceptions of equity and fairness, political affiliation and changes on current government policy, referent groups); and 4) individual factors (personal financial constraints, awareness of offences and penalties).

2.4.1 Tax Audit

Audit rates and the thoroughness of the audits could encourage taxpayers to be more prudent in completing their tax returns, report all income and claim the correct deductions to ascertain their tax liability. In contrast, taxpayers who have never been audited might be tempted to under report their actual income and claim false deductions (Mohd et al., (2011).

Jackson and Jaouen, (1989), Shanmugam, (2003) , Dubin,(2004) in their findings suggest that in self assessment systems, tax audits can play an important role and their central role is to increase voluntary compliance

Friedland et al., (1978) found that a higher (random) audit rate leads to more compliance. However Alm et al., (1992) find that this impact appears to be small and nonlinear, so that the deterrent effect of a higher audit rate eventually disappears. They also find that many subjects appear to substantially overweight the probability of an audit, so that there is far more compliance than is predicted by expected theory.

Previous studies have evidenced that tax audits play an important role in increasing voluntary compliance. For instance Butler (1993) and Witte and Woodbury (198) found that audits rates and the thoroughness of the audits could potentially encourage taxpayers to be more prudent in completing their tax returns.

The perception of audit probability was found to have a statistically significant association with compliance attitude (Yesegat and Fjeldstad, 2016).

Currently, the Government of Ethiopia is taking a number of measures which are expected to enhance the administration capacity of revenue authorities, including continued capacity-building programmes in various areas including audit. Measures are also being taken against tax officials who are suspected of being corrupt. These and similar measures are likely to contribute to the observed perception of taxpayers on tax audit (Yesegat and Fjeldstad, 2016).

2.4.2. Perception of Government Spending

Roberts, Hite and Bradley (1994) indicated that if the government is wisely spending the national revenue, for example for basic facilities like education, health and safety and public transportation, it is likely that voluntary compliance will increase. In contrast, if taxpayers perceive that the government is spending too much on something considered unnecessary or unbeneficial to them then taxpayers will feel betrayed and attempt to evade.

According to the political legitimacy theory, tax compliance is influencedby the extent that citizen trust their government (Tayler 2006;Kirchler.et.al.2008; Fauvelle&Aymar1999).As per these studies legitimacy could be described as belief or trust in the authorities, institutions, and social arrangements to be appropriate, proper, just and work for the common good.

2.4.3. Perceived equity and fairness of the tax system

Fairness is another factor that can affect tax compliance. An unfair tax system could enhance the incentives to rationalize cheating. A number of survey research studies have reported positive correlations between perceptions of fiscal inequity and tax evasion (Spicer, 1974).

Spicer M. and Becker, L, (1980), in experimental research found that the amount of tax evaded increases when people are told that their tax burden is higher than that of the rest of the group. Nevertheless, there is no agreement regarding the empirical evidence on fairness.

One of the main principles of the taxation system design is equity or fairness, which can be perceived via three dimensional views – horizontal equity (people with the same income or wealth brackets should pay the same amount of taxes), vertical equity (taxes paid increase with the amount of the tax base) and Exchange Equity (Wallschultzky 1984; Richardson, 2006). The perceived fairness of the tax system also has an influence on the inclination towards tax evasion (Jackson and Milliron, 1986; Richardson, 2008).

Alm J. , (1992) suggest that compliance occurs because some individuals value the public goods as their tax finance. If there is an increase in the amount individuals receive from a given tax payment, their compliance rate increases. Individuals then pay taxes to receive government services even when there is no chance to be detected or punished when evading. Cowell (1992), shows that taxpayer will reduce tax evasion when perceiving equity. Falkinger (1995) has pointed out concrete economic situations in which individuals reduce evasion if the socio-economic system is considered to be relatively equal and fair. The fairness of a system in which a person lives may result in bad reputation for evaders if people consider evasion to be blame-worthy, so that risk aversion will increase with perceived equity.

Wenzel (2003) suggested three areas of fairness from the taxpayers' point of view (social psychology): namely distributive justice which refers to the exchange of resources, i.e. benefit and cost; procedural justice which refers to the process of resource distribution; and retributive justice which refers to the appropriateness of sanctions when norm-breaking, occurs.

In distributive justice, an individual is concerned about the fairness of their actions and wants to be treated in relation to his merits, efforts and needs (Kirchler et. al., 2008).If he feels that his tax

burden is higher than other people within the same income group, his tax compliance probably decreases more widely at group levels; taxpayers want a fair treatment of their group relative to other income groups

With regard to procedural justice, the main elements for perceived fairness are neutrality of procedures used, trustworthiness of the tax authorities, and the polite, dignified, and respectful treatment of taxpayers as individuals or groups (Tyler and Lind, 1992).

On the other hand, Retributive justice, unreasonable gand intrusive audits and unfair penalties lead to stressful and dissatisfied taxpayers (Spicer and Lundsted, 1976). Unfavorable retributive justice perceptions could lead to non compliant behaviour and consequently increase tax evasion and inflate the tax gap.

Similarly Spicer M. W., (1980) examined the relationship between fiscal inequity and tax evasion. The study revealed that high income groups ("high-tax group") had the highest percentage of tax evasion cases compared to other groups ("low tax and medium tax group"). They suggested that tax evasion increases when taxpayers perceive fiscal inequity (equity) because they feel to be victimized by an imbalance of income redistributions. The perceived fairness of the tax system also has an influence on the inclination towards tax evasion (Richardson, 2008).

2.4.4. Changes on current government policy

Political stability and the ruling government party in a country might play a significant role in determining tax evasion behaviour. For instance, if an individual favours the current ruling government party, he might choose to be compliant because he believes that the government is trusted, efficient and equitable. Conversely, a taxpayer from the opposition party might be more noncompliant because he perceives that the government is not on his side. Hasseldine and Hite (2003) examined two potential influences on taxpaye attitudes, namely political party affiliation and attribute framing. Since tax attitudes may be influenced by one's political preferences. Hasseldine and Hite (2003) concluded that firstly, political party affiliation has a significant impact on taxpayers' behaviour; secondly, the more closely identified the tax provision is to a

specific party, the more favorably it will be received by members of that party relative to taxpayers with other political party affiliations.

2.4.5. Referent group

Researches on as tax compliance have evidenced that the influence of friends and family members in making decisions may be important. Decisions either to evade or not to evade tax sometimes are influenced by family members or friends (i.e. according to Allingham and Sandmo, (1972) although the extent of the influence was not clearly stated in this research. Clotfelter (1983) also claimed that referent groups play a significant role in evasion although it was also not clearly discussed which was stronger (family members or friends) in this paper. Hasseldine, Kaplan and Fuller (1994) report that the numbers of evaders known to the respondent made the largest contribution to the model of under reporting income which means that the more respondents know the evaders, the more under reporting of income may happen.

2.4.6. Personal financial constraint

Mohani and Sheehan (2004) and Mohani (2001) reported that Personal financial constraints are believed to have an impact on tax evasion as financial distress faced by an individual may encourage him to prioritise what has to be paid first as basic survival needs (foods, clothing, housing etc.) or where immediate demand on limited income is enforced (i.e perceived threat of action from money lenders etc.) rather than tax liabilities.Accorging to the studies people who face personal financial problems are likely to be more prone to evade tax when compared to people in less financial distress.

Conversely, however Vogel (1974) and Warneryd and Walerud (1982) illustrate that people with no financial distress also exercise tax evasion and surprisingly, the level of evasion they exhibit can be more serious than people in financial distress. Vogel (1974) presumed that this situation is related to economic status rather than personal conditions.

2.4.7. Tax Knowledge

The researches illustrated the importance of tax knowledge in a tax system for example ; Eriksen and Fallan (1996) ,Mohamad Ali et. al., (2007), Singh, (2003). Eriksen and Fallan (1996) claimed that 'knowledge about tax law is assumed to be important for preferences and attitudes towards taxation.

Mohamad et al (2007) examine the influence of tax knowledge on compliance behaviour by dividing the tax knowledge in to groups those are, knowledge explicitly focused at possible opportunities to evade tax and knowledge gained through formal education. Study result indicated that, regarding the rules and regulation of the taxation, the level of education received by taxpayer' is an important factor that contributes to the general understanding.

Mohd (2010) presents taxation knowledge is necessary to increase public awareness especially in areas concerning taxation laws, the role of tax in national development, and especially to explain how and where the money collected is spent by the government.

Eriksen and Fallan (1996) suggested that a taxpayer should be given better tax knowledge to improve perceptions of fairness, tax ethics and attitudes to others tax evasion and thus suggesting that a successful means of preventing tax evasion is to provide more tax knowledge to larger segment of society in order to improve tax .

2.4.8. Awareness of offences and penality

A theoretical economic model introduced by Allingham and Sandmo (1972) has clearly indicated that penalties as well as audit probability have an impact on tax compliance.

Various arguments arise regarding the impact of fines and penalties on tax compliance to explain this lack of a clear impact relationship. For example, fines that are too low could be perceived as an indicator that the authorities are weak and unable to control non-compliant taxpayers, thereby undermining trust among honest taxpayers and leading to a lack of encouragement to comply with tax law.Paul & Osebe (2014) employed in their study that fines and penalties play a vital role in improving tax compliance. Specifically, for a tax system with fair tax rates of fines and penalties, tax compliance is likely to be improved.

Higher fines simply make evading taxes more hazardous for taxpayers and should deter from evasion. Empirically the deterrent effect of fines could not always be supported. The observed effects were weaker than expected and some studies even suggest that an increase of penalties can have undesirable effect and result in more tax avoidance (Kirchler et al, 2007). Virman (1989) indicated that penalty rates had a positive association with evasion, meaning that higher rates did indeed encourage people to cheat.

Fines and and audit rates may substitute each other due to their multiplicative linkage as long as neither of them is set to zero (Kirchler et.al 2007). The most extreme penalties will have no effect, if it is common knowledge that audits virtually do not occur. The increasing tax avoidance and tax resistance due to an increase of fines puts into question how fines should be assessed to be effective. On the one hand fines should be high enough to decrease the expected value of tax evasion and to assure its deterrent effect on tax payers. On the other hand, if fines are too high, the tax system would be perceived as unjust and unfair and taxpayers would use any possibility to legally avoid taxes (Kirchler et al., 2007).

2.4.9. Age

Demographic factors such as age have long been studied by researchers; however the findings from different studies remain inconclusive. For example Tittle (1980), Warneryd and Walerud (1982) and Wahlund (1982) posit a negative association i.e older people are less compliant. In contrast, Clotfelter (1983), Dubin and Wilde (1986) and Beron et. al. (1992) argued that age was positively related with compliance. However, there have been a significant number of studies that have found no relationship between age and tax compliance (Spicer and Lundstedt (1976), Spicer and Becker (1980) and Porcano (1988)).

2.4.10. Gender

The association between gender and tax compliance has received some attention in prior literature however, findings vary across studies. Some studies found that males are more

compliant but others found the other way around. Vogel (1974), Kinsey and Grasmick (1993), and Tittle (1980) founds in their study that males are more compliant while Friedland, et.al. (1978), Hasseldine and Hit (2003) and Mohamad Ali (2007) explained that females are more compliant than males.

The impact of gender on tax compliance is inconsistent, and recent studies by Richardson (2008) continue to find no association between gender and compliance.

2.4.11. Education

Chan et. al.(2000)   postulate that greater education is directly linked to a likelihood of compliance. They argue that educated taxpayers may be aware of non compliance opportunities, but their potentially better understanding of the tax system and their higher level of moral development promotes a more favorable taxpayer attitude and therefore greater compliance.

Mohani (2001) suggested that one of the measures to increase voluntary compliance is by assuring that taxpayers have a certain level of qualifications, ability and confidence to exercise their tax responsibility. In contrast, the most recent study, by Richardson (2008) also revealed that there is a negative association between education and compliance.

2.4.12. Level of Income and Compliance

Predictions of the standard economic model in regards to income effects on tax compliance are ambiguous. Though wealthier citizens are more likely to evade taxes since the level of absolute risk aversion decreases with income, it is not clear if severity of evasion is an increasing or decreasing function of income (Kirchler et al., 2007).Once taxpayers have decided to evade taxes, the degree of underreporting depends on the relative risk aversion. The relation of income and relative risk aversion is not unique and consequently Allingham and Sandom (1972) conclude, that when actual income varies, the fraction of income declared increases, stays constant or decreases accordingly as relative risk aversion is an increasing, constant or decreasing function of income"

Chau and Leung (2009) 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 counter parts in the higher income group.

Jackson B. R (1986), found that income level has a mixed and unclear impact on compliance, and some later research agrees with that statement. Although (Jackson B. R., 1986) did not clearly mention the reason, it is presumed that endogenous tax regulations among countries might contribute to inconsistent findings. For example, progressive tax rates might encourage the higher income group to evade rather than the lower income group because their (higher income group) tax rates and taxable income are high, thus, making the tax liabilities much higher than lower income group. In a country where income redistribution is not satisfying, the higher income group tends to evade more (Mohani A. 2001) because the high income earner might feel betrayed and unfairly treated.

2.5. Empirical Studies and Knowledge Gap

Fjeldstad et.al (2012) in their study explore factors that determine citizens' tax compliance behavior in Kenya, Tanzania, Uganda and South Africa using survey method for data collection. Results from the probit regression provide that individuals are more likely to express tax compliant attitude if they perceive that enforcement makes evasion more difficult in South Africa and Kenya. This is in line with the prescription of the standard economic theory of deterrence. The analysis also finds evidence that those who are more satisfied with public service provision are more likely to support the government's right to tax in all the four countries, supporting certain elements of the fiscal exchange theory. However, the link between tax compliance attitude and public service provision depends on the specific service in question and differs between countries.

Noor sharoja, (2014) conducted a research on determinants of taxpayer compliance behavior with respect to corporate income tax reporting requirements in Malaysia. A researcher administered questionnaire survey method for data collection. The findings of this study reveal that business age, tax liability and tax complexity consistently influence the likelihood of tax

non-compliance behavior in the areas of under-reporting income, over-claiming expenses and overall non-compliance. Nonetheless, the tax compliance costs have an insignificant relationship with the non-compliance behavior of corporate taxpayers.

Taddese and Goitom ((2014) studied Factors Influencing taxpayers' compliance with the tax system in Mekelle City, Ethiopia. The study used a cross-sectional survey method of research design. Given the scaled ranking information of the dependent variable (tax compliance), an ordered probit was applied to examine determinants of tax compliance in Mekelle city, Ethiopia. The study results from the survey conducted in Mekelle using 102 respondents indicate that tax compliance was influenced by the probability of being audited, financial constraints, and changes in government policy. The result also revealed that other variables such as perception of government spending, perception of equity and fairness, penalties, roles of the tax authority and tax knowledge were not significantly correlated with tax compliance at the time of this study.

Tilahun and Yidersal (2014) investigated determinants of Tax Compliance Behavior in Ethiopia: using one-way ANOVA, two samples and one sample T- test, this study examined the determinants of tax compliance behavior in Ethiopia particularly in Bahir Dar city administration. The data was collected using structured questionnaire. The results revealed that perception on government spending; perception on equity and fairness of the tax system; penalties; personal financial constraint; changes on current government policies; and referral group (friends, relatives etc.) are factors that significantly affect tax compliance behavior. However, gender and probability of being audited have no significant impact on tax compliance behavior. Finally, the findings show that older people will comply less if there is no equity and fairness in the tax system and any changes in government policy on fuel prices, electricity and water rates are not favorable.

Yesegat and Fjeldstad, (2016) examined factors that determine business people's attitudes towards paying taxes in Ethiopia. Based on data obtained from a survey of business taxpayers in Addis Ababa, the study finds a statistically significant relation between tax-compliance attitude and factors such as the perception of probability of audit, corruption, satisfaction with the tax administration, peer influence, gender and education. The study emphasizes the need for better

understanding of why taxpayers are dissatisfied with the tax administration, including perceptions of corrupt practices.

Akalu (2016) conducted a survey on determinants of tax compliance behavior of large corporate taxpayers in Ethiopia. The data required for this research was collected from both primary and secondary sources. Primary data were collected directly from tax payers through researcher-administered questionnaire survey method and focus group discussion. Secondary data collected from relevant legislation enacted in connection with the topic, tax journals, as well as published articles. In addition, the researcher also applied his personal knowledge he gained from working in ERCA. The results revealed that business size, business age and tax psychological cost consistently influence the likelihood of tax non-compliance behavior in the areas of under-reporting income, over-claiming expenses and overall non-compliance. Nonetheless, business sector, tax complexity, fairness in the tax rate/ tax system and tax deterrence sanctions have an insignificant relationship with the non-compliance behavior of corporate taxpayers. Tax liability, compliance cost and tax rate structure are significant determinants in at least one type of non-compliance behavior.

Studies have been conducted in different parts of Ethiopia to asses determinants of tax compliance targeting a specific group of tax payers .However, the models used and results of those studies were not consistent which a researcher consider it as a gap in this field. Culture is considered to be a powerful environmental factor that affects the taxpayer's compliance. Different social norms and ethical values will create different incentives for tax compliance (Chau and Leung, 2009).

A study by Yesegat and Fjeldstad, (2016) on business people's attitudes towards paying taxes in Ethiopia incorporate government services; perception of tax rates, penalty and audit; perception of others/peer compliance; perception of government treatment of taxpayers (perception of discrimination by the tax administration); trust in the administration; satisfaction with the tax administrative. However, this particular study gives emphasis on institutional factors rather than individual factors.

In addition, as it is compared to studies in other developing countries, researches on determinants of tax compliance are very limited in Ethiopia which needs further investigation to eliminate noncompliance behavior.

2.6. Conceptual Framework

This study assumes that the factors under discussion have a direct influence on tax compliance among Category A tax payers in Addis Ababa. The relationship between the dependent and the independent variables in the conceptual framework is illustrated bellow based on the literature .
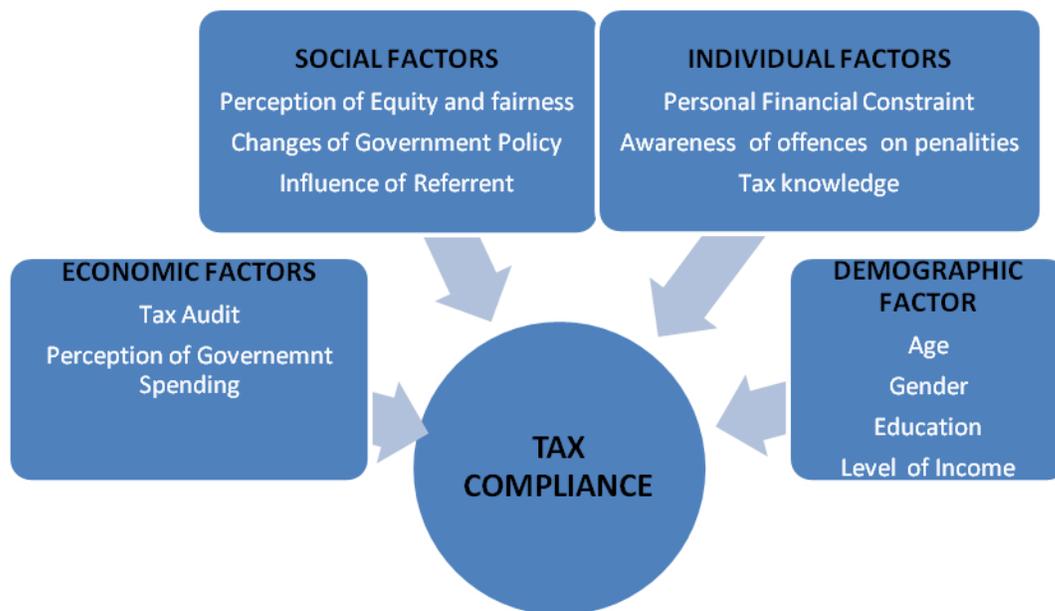
Figure 1 Factors affecting compliance behaviour

Source: Kirchler (2007) and Loo (2006)

CHAPTER III

Research Methodology

The purpose of this chapter is to present the underlying principles of research methodology and the choice of the appropriate research method for the thesis. The chapter arranged as follows; Section 3.1 design of the study and Section 3.2 presents the research approaches. This is followed by the philosophy of quantitative (section 3.2.1), qualitative (section 3.2.2), and mixed methods (along with discussion of the choice of the appropriate method for the current research) (section 3.2.3) approaches. Then, the research methods adopted in this study in section 3.3.

3.1 Design of the Study

The study employed based on explanatory approach using survey method which helps the researcher to gather a large variety of data related to the problem under consideration. Explanatory research is conducted in order to identify the extent and nature of cause and effect relationships between variables. It identifies reasons behind a wide range of processes, as well as assessing the impacts of change on existing norms, processes (Zikmund, 2012). Surveys are used when researcher want to gather data from a large number of people and when it is impractical to meet them all face (Noor sharoja, 2014). The survey strategy allows you to collect quantitative data which you can analyze quantitatively using descriptive and inferential statistics. In addition, the data collected using a survey strategy can be used to suggest possible reasons for particular relationships between variables and to produce models of these relationships (Saunders et al.,

2012).Therefore, Survey was appropriate for this study to examine factors affecting tax compliance of Category "A" tax payers in Addis Ababa.

3.2 Research Approach

There are three approaches available for researchers to design their research methodology namely quantitative, qualitative and mixed methods research approaches (Creswell, 2003).
The inquiry paradigm used in research is generally influenced by a researchers ontological and epistemological beliefs. These beliefs represent how the researcher views and seeks to understand the world. The two extremely contradicting paradigms are positivism and constructivism. Thus, positivist researchers normally adopt quantitative methods and constructivist researchers adopt qualitative methods. The other paradigm is combination of positivism and constructivism (that is mixed method) (McKerchar, 2010).

3.2.1 Quantitative approach

In this approach, an investigator relies on numerical data (Creswell, 2009). Researcher uses postpositive claims for developing knowledge, such as cause and effect thinking, reduction to specific variables, hypotheses and questions, use of measurement and observation, and the test of theories.

Quantitative research is the systematic and scientific investigation of quantitative properties and phenomena and their relationship. Creswell (2009) noted that quantitative research is one in which the investigator primarily uses positivist claims for developing knowledge. The positivism

approach views that the world as objective realism and therefore suggested that knowledge created by deductive reasoning where by a precise and systematic process is adopted (McKerchar, 2010).

The main advantage of this approach is that numbers are easy to work with data are readily collected, coded, summarized, and analyzed. In addition, data collection is relatively quick and less time consuming and free from bias. But, in this approach researchers know much about the collective or average experience of research participants, and focus on theory or hypothesis testing rather than on theory or hypothesis generation (Creswell 2009). In view of this, quantitative approach is best for examining factors that influence tax compliance of Category "A" tax payers.

3.2.2 Qualitative approach

Qualitative research, is an inquiry process of understanding where the researcher develops a complex, holistic picture, analyzes words, reports detailed views of informants, and conducts the study in a natural setting (Creswell, 2009). In this approach, the researcher makes knowledge claims based on the constructivist perspectives (Creswell 2009).This has advantage of design results mainly from its flexibility to follow unexpected ideas during research and to explore processes effectively. However, knowledge produced may not be generalized to other people or other settings and it is also difficult to make quantitative predictions and to test hypotheses and theories. Leedy and ormrod (2005) explains that a study categorized as qualitative, if its purpose is primarily to describe a situation, phenomenon, problem, or event. i.e., the information is gathered using variables measured on nominal or ordinal scales (that is, qualitative measurement scales); and an analysis is done to establish the variation in the situation, phenomenon or

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problem without quantifying it. In addition qualitative approach views as the world based on researchers interpretation, which may influenced by the researcher own views, beliefs, experiences, and existing knowledge (McKerchar, 2010).

3.2.3 Mixed method approach

The third research methods approach is mixed method approach in which the researchers build the knowledge on pragmatic grounds (Creswell, 2003). A major tenet of pragmatism is that quantitative and qualitative methods are compatible which can help better understanding of the research problem.

Other inquiry paradigms lie between positivism, and constructivism known as critical realism and pragmatism. These two paradigms generally combine both orientations of positivism (quantitative) and constructivism (qualitative) research approach. Researchers adopting these paradigms view the world as complex and therefore difficult to understand simply through empirical realism (McKerchar, 2010).

3.3 Research Methods Adopted

Every research requires a research design that is carefully tailored to the exact needs of the problem under investigation (Creswell, 2009). If the study relies on numerical data and deals with cause and effect relation of variables quantitative methods are appropriate (Creswell, 2003). Accordingly, this study used quantitative design, since the study is examining cause and effect relationship between variables.

3.4 Source of Data

The adoption of the survey instrument would helpful to represents a wide target population, and generates numerical data as well as to gather information that would not available from archive

records. Babbie (1990) noted that the survey as the preferred type of data collection procedure for study because it is used to generalize from a sample to a population.

Primary data is preferred because it is original and relevant for the topic especially when the researcher is interested in primary data about demographic characteristics, attitude/opinion/interest, awareness/knowledge, intentions, motivation and behavior (Noor Sharoja, 2014). Therefore the data required for this research was collected mainly from primary sources through self-administered questionnaire.

3.5 Research Instruments

The primary data was collected through structured questionnaire. Questionnaires were dispatched to volunteer tax payers face to face. Questions were well structured Likert-type items which used to assess factors affecting the tax compliance of category "A" taxpayers in Addis Ababa. The questions were adapted from Noor Sharoja, (2014) which is validity-tested in previous studies with some modifications that suits to this study.

3.6 Date Collection

Data collection for this study utilized the researcher-administered questionnaire survey method. This method of data collection was employed as a measure to obtain more reliable survey responses with a possibility of achieving a higher response rate, thus improving the validity of this study. In most cases, questionnaires were personally distributed to ascertain the person's willingness to participate in this study. This arrangement also provided the opportunity for researchers to explain verbally on the importance of the study. Researchers might cautiously provide some clarifications and/or examples, when required, with respect to certain difficult, sensitive or important questions. To avoid bias in this study, however, the researchers only got involved when respondents asked for clarification.

3.7 Target Population

The target population of the study were Category "A" tax payers in Addis Ababa for the fiscal year 2016/17. A population is a large pool of cases of elements from which the researcher draws a sample and results generalized from the drawn sample (Leedy & Ormrod, 2013). According to ERCA (2017), the total population of Category "A" tax payers in Addis Ababa as of March 2017 was 61,550.

3.8 Sampling size and Sampling Technique

It is impossible to consider the population as respondents to this survey due to impracticality, time and cost. The choice of a sample size has a bearing on the reliability of a study. However, this does not mean that large sample size always leads to high level of accuracy rather it is to indicate that sample size is one of the factors that contribute to the credibility of a survey estimate. For the choice of sample size, different researchers give different ideas. For example, Alreck and Settle (1995) noted that the choice of sample size is normally made after considering statistical precision, practical issues and available resources (e.g. cost and time). Fowler (1984) noted that there is no a single precise way for the determinations of sample size hence there are a number of inadequacy for deciding on sample size. Therefore, it is better if to see the sample size used by other researchers. In this regard, taking the available resources, time, budget, data, and geographic distances into account, a sample size of 120 were considered feasible from the 61,550 category "A" tax payers in Addis Ababa and sampling technique used was conviniant sampling.

3.9 Data analysis

Questionnaires collected from respondents were tallied, organized, coded and structured systematically. Both descriptive and inferential tests used in the analysis. Data were described or summarized using descriptive statistics such as, cross tabulation, frequencies and mean, which helps in meaningfully describing the distribution of responses. Inferential statistics method used to infer population characteristics from the sample.

Model Specification

Since the data set in this study is ordinal, ordered robit model was preferred to examine factors of tax compliance like previous studies on similar topic. A research by Torgler (2006) and Alm and Torgler (2006) use a dataset with a wide sample of countries. Given that tax morale is an ordered categorical variable, measured with survey questions, ordered probit or logit regression models are the rule.

The general equation for the model used to test is shown below:

$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \mathcal{E}$

Where;

Y – Tax Compliance

α   - Constant

Ɛ - Error term

X1,X2….X12 Factors of compliance

Substituted Coefficients

Tax Comp= $\alpha + \beta_1$ Prob_Audi + β_2 Gov_Spend + β_3 Equity_Fair + β_4 Gov_Policy + β_5 Ref + β_6 Fina_Cons + β_7 Penalty + β_8 Tax_knowldge + β_9 Gender + β_{10} Income + β_{11} age + β_{12} Educ + $\mathcal{E}$

X1- tax audit, X2- perception of government spending, X3- Perception of Equity and Fairness, X4- Changes to current government policies,   X5- Referent groups (family and friends), X6- Personal financial constraint, X7- Awareness of offences and penalties, X 8- tax knowledge, X 9 - Gender, X10- level of income, X11- Age, and X 12- Education are Factors of tax compliances or independent variables.

In addition, the β coefficients for each independent variable generated from the model β1- tax audit, β2- perception of government spending, β3- Perception of Equity and Fairness, β4- Changes to current government policies, β5- Referent groups (family and friends), β6- Personal financial constraint, β 7- Awareness of offences and penalties, β 8- tax knowledge, β 9 - Gender, β10- level of income, β11- Age, and β 12- Education are Coefficients indicating rate of change of tax compliances with respect to independent variables.

3.10 Variables Definition

3.10.1 Dependant Variable: Tax compliance

Two alternate measures were used to capture tax compliance direct and indirect questions using hypothetical questions. The use of hypothetical questions can increase reliability of results and minimizes respondents' dishonesty when answering the questionnaire (Troutman, 1993). First, it was used responses to a more direct question: 'One should honestly declare all income on one's tax return'. The responses range from 'strongly agree' = 5 to 'strongly disagree' = 1. Secondly, it was used an indirect question to measure tax compliance: The respondents were asked to rate each hypothetical question whether as a taxpayer they would undertake the same action if they faced the same situation.

3.10.2 Independent Variables

3.10.2.1. Economic Factors

Tax Audit

Tax audits, audit rates and prior audit experience have been ambiguously discussed in relation to tax compliance. Some studies claimed that audits have a positive impact on tax evasion (Jackson and Jaouen, 1989; Shanmugam, 2003; Dubin, 2004). These findings suggest that in self assessment systems, tax audits can play an important role and their central role is to increase voluntary compliance. Audits rates and the thoroughness of the audits could encourage taxpayers to be more prudent in completing their tax returns, report all income and claim the correct deductions to ascertain their tax liability. In contrast, taxpayers who have never been audited might be tempted to under report their actual income and claim false deductions.Butler (1993) also found that tax audits can change compliance behavior from negative to positive. The following hypothesis was proposed on compliance based on the extant literature.

Hypothesis 1: Probability of being audited is positively associated with tax compliance.

Perceptions of government spending

Trust in government is recognized by Jackson and Milliron (1986) as another determinant of tax evasion. Levi (1998) claims that if individuals believe that the government will act in their interests, that its procedures are fair, and that their trust of government and others is reciprocated, they are more likely to become "contingent consenters" who cooperate in paying taxes. More trust in government enhances the incentive for individuals to commit themselves to obedience and comply with tax laws (Feld and Frey, 2002).

Hypothesis 2 ― Positive perception of government spending is positively associated with tax compliance.

3.10.2.2. Social Factors

Perceptions of equity or fairness

As Smith (1776) mentioned, one of the main principles of the taxation system design is equity or fairness, which can be perceived via two dimensional views horizontal equity (people with the same income or wealth brackets should pay the same amount of taxes) and vertical equity (taxes paid increase with the amount of the tax base). The driving principle behind vertical equity is the notion that those who are more able to pay taxes should contribute more than those who are not.The perceived fairness of the tax system also has an influence on the inclination towards tax evasion (Jackson and Milliron, 1986; Richardson, 2008).

Hypothesis 3 ― Positive perception of equity in the tax system positively associated with tax compliance.

Changes to current government policies

Political stability and the ruling party in a country might play a significant role in determining tax evasion behavior. For instance, if an individual favors the ruling party, he might choose to be compliant because he believes that the government is trusted, efficient and equitable. Conversely, a taxpayer from the opposition party might be more non-compliant because he perceives that the government is not on his side. Studies have disclosed that the government decisions and changes to policies in accordance with the economic and political situation have a significant impact on compliance. For example, a positive move made by the government such as an increase in tax rebate (Hasseldine and Hite, 2003) is likely to increase taxpayers' compliance. Hypothesis 4 — unfavorably perceived changes to current government policies are negatively associated with tax compliance.

Referent groups (family and friends)

Allingham and Sandmo (1972), Clotfelter (1983) also claimed that referent groups play a significant role in evasion although it was also not clearly discussed which was stronger. Therefore, the influence of referent groups is seemingly important in making a decision, particularly involving monetary aspects and the obedience to laws (tax compliance).

Hypothesis 5—The influence of referent group is positively associated with tax compliance.

3.10.2.3. Individual Factors

Personal financial constraints

Personal financial constraints are believed to have an impact on tax evasion as financial distress faced by an individual and may encourage him to prioritize what has to be paid first as basic survival needs (foods, clothing, housing etc.) or where immediate demand on limited income is

enforced (for example, perceived threat of action from money lenders etc.) rather than tax liabilities. People who face personal financial problems are likely to be more prone to evade tax when compared to people in less financial distress (Mohani and Sheehan, 2004; Mohani, 2001).

Hypothesis 6 — Personal financial constraint is negatively associated with tax compliance.

Awareness of offenses and Penalties

A theoretical economic model introduced by Allingham and Sandmo (1972) has clearly indicated that penalties as well as audit probability have an impact on tax compliance. Davis and Jung (1991) and Becker, Buchner and Sleeking (1987) found that penalty rates affect tax compliance. The higher the penalty and the potential audit probability the greater the discouragement for potential tax evasion. If the taxpayers are aware of the offences they are committing when evading tax and the consequences of being non compliant taxpayers, they might reduce their tendency to evade tax.

Hypothesis 7 — Awareness of penalty is positively associated with tax compliance.

Tax knowledge

The influence of tax knowledge on compliance behavior has been described in various researches. The level of education received by taxpayers is an important factor that contributes to the understanding about taxation especially regarding the laws and regulations of taxation (Eriksen and Fallan, 1996). Previous studies have evidenced that tax knowledge has a very close relationship with taxpayers' ability to understand the laws and regulations of taxation, and their ability to comply (Singh and Bhupalan, 2001).

Hypothesis 8 — Tax knowledge is positively associated with tax compliance.

3.10.2.4. Demographic factors

Gender (male as a reference)

Some studies found that males are more compliant though other studies revealed contradictory results or no significant difference at all. As agreements on the findings still maintain, the need to explore current results is relevant. Hasseldine and Hite (2003) found that female taxpayers were more compliant than males. However, the study reported that males were more compliant compared to females when a negatively framed message was used, and females were more compliant than males when a positively framed message was used. In contrast, Richardson (2006) suggested that gender has no significant impact on compliance across a study of 45 countries.

Hypothesis 9— Male tax payers are more tax compliant.

Age

Researchers come up with different results on the relationship between age and tax compliance. For example Tittle (1980), Warneryd and Walerud (1982) and Wahlund (1992) posit negative association, older people are less compliant. In contrast, Dubin, Graetz and Wilde (1987), Chung and Trivedi (2003) and Beron, Tuachen and Witte (1992) argued that age was positively related with compliance. However, there have been a significant number of studies which found no relationship between age and compliance (Spicer and Becker, 1980 and Porcano, 1988). Mohani (2001) also found that older people are more compliant.

Hypothesis 10 — Older tax payers are tax compliant.

Income

Jackson and Milliron (1986) found that income level has a mixed and unclear impact on compliance. Although Jackson and Milliron (1986) did not clearly mention the reason, it is

presumed that endogenous tax regulations among countries might contribute to inconsistent findings. For example, progressive tax rates might encourage the higher income group to evade rather than the lower income group because their (higher income group) tax rates and taxable income are high, thus, making the tax liabilities much higher than lower income group. In a country where income redistribution is not satisfying, the higher income group tends to evade more (Mohani, 2001) because the high income earner might feel betrayed and unfairly treated.

Hypothesis 11 ─ higher income level is positively associated with better tax compliance.

Education

Previous literature supports the direct, positive relationship between educational level and taxpayer compliance (Jackson and Miliron, 1986). Chan, Troutman, and O'Bryan (2000) also postulate that education level is directly linked to a likelihood of compliance. Educated taxpayers may be aware of non- compliance opportunities, but their potentially better understanding of the tax system and higher level of moral development promote a more favorable taxpayer attitude and greater compliance.

Hypothesis 12 ─ Educational level has direct relationship with tax compliance.

Table 1 Variables description and expected associations with the level of tax compliance

Variable	Symbols	Unit of measurement	Expected signs/hypotheses
Dependent Variable			
Level of compliance	TCP	(1-5) likert scale Ordinal	+ (high probability and high frequency, high compliance)
Independent Variables			
Probability of Auditing	Prob _ Audi	(1-5 Likert Scale) Ordinal	+(high probability, high compliance)
Perception of Government Spending	Gov_Spend	(1-5 Likert Scale) Ordinal	+ (good perception, high compliance)
Perception on Equity and fairness	Equity_Fair	(1-5 Likert Scale) Ordinal	+ (good perception, high compliance)
Referent group	Ref	(1-5 Likert Scale) Ordinal	+ (high influence, high compliance)
Changes on current government policy	Gov_Policy	(1-5 Likert Scale) Ordinal	- (Changes to government policies, lower compliance)
Penalty rates and enforcement	Penalty	(1-5 Likert Scale) Ordinal	+ (High penalty, high compliance
Personal_financial constraint	Fina_Cons	(1-5 Likert Scale) Ordinal	- (crucial financial problem, low compliance)
Tax knowledge	Tax_knowldge	(1-5 likert scale) Ordinal	+ (high tax knowledge, high compliance)
Gender	Gender	(1-2) Nominal	- (Male= 1, higher compliance)
Income Level	Income	$(1-4)$ Nominal	+ (High income, Higher Compliance)
Age	Age	$(1-4)$ Nominal	+ (Older tax payers, Higher Compliance)
Education level	Educ	$(1-5)$ Nominal	+ (Educated tax payers, Higher Compliance)

CHAPTER IV

4. Results and Discussion

This chapter describes the results of the study starting with respondents' profile. The remaining part of this chapter will then be divided into the two sections: The first section covers descriptive analysis of determinants factors of tax compliance behavior and the seconded section presents inferential statistics analysis of dependent and independent variables.

The study sampled 120 Category "A" tax payers in Addis Ababa resides in different sub cities. The responses of taxpayers gathered through questionnaire were encoded in STATA version 24 software.

4.1 Respondents general back ground

This section describes respondents' general information such as Gender, Age, Educational level and Income Level.

Table 2 illustrates gender of respondents which shows that 58.3% of the respondents were males and 41.7% were females. This shows that the majority of   Category "A" tax payers' are males (Table 2).

Table 2 Respondents general back ground – Gender

SEX		
Variable	Frequency	Percent
Sex		
Male	70	58.3
Female	50	41.7
Total	120	100.0

Sources: Survey 2017 result

Table 3 shows the age groups of the respondents. Since the study emphasized business taxpayers, a minimum age of 21 years old was considered as reasonable. There were four age groups involved in this study with a 10-year range in each group except for above 51 years old. The largest group of the respondents was between age of 31 – 40 and 41 – 50; both having 30% each. The next large group was between the age of 21 – 30 representing 26.7% of the total respondents. Respondents in the group of above 51 years old were the lowest number with 16 responses 13.3%. Generally, respondents within the age group of 31 and 50 and made up with 60% of the total respondents (Table 3).

Table 3 Respondents general back ground - Age

AGE		
AGE	Frequency	Percent
21 -30	32	26.7
31-40	36	30.0
41-50	36	30.0
above 51	16	13.3
Total	120	100.0

Sources; Survey 2017 result

It is believed to be that the ability to read and write influences one's ability to understand and interpret the tax laws. With this regard the survey collected the educational background of the respondents and table 4 indicated 10% respondents had lower level of educational qualification in the sample (10/12th grade completed); 17.7% of the total respondents had diploma. On the other hand, the numbers of respondents who were first degree holders were 50%; the remaining 23.7% of the respondents had masters and above qualifications. Cumulatively, all of the respondents were in possession of at least reading and writing and none of the respondents were bellow high school. This indicates that the majority of business taxpayers were well educated to know the need for taxation and they can understand and interpret the tax law as well (Table4)

Table 4 Respondents general back ground- Education Level

Education Level	Frequency	Percent
10th/12th grade complete	12	10.0
Diploma	20	16.7
Degree	60	50.0
2nd degree and above	28	23.3
Total	120	100.0

Sources: Survey 2017 result

Table 5 illustrates respondent's level of income their company had for the year of 2016/17 (2009 E.C). Majority of respondents 36.7%had earned Income between 500,000 – 1,000,000.While 30% of companies indicated that their income ranges between 1,000,000 – 5,000,000and 16.7%of companies had annual income above 10,000,000 (Table 5).

Table 5 Respondents general back ground **-** Income Level

Annual sales turn over	Frequency	Percent
500,000 - 1,000,000	44	36.7
1,000,001 - 5,000,000	36	30.0
5,000,001 - 10,000,000	20	16.7
Above 10 million	20	16.7
Total	120	100.0

Sources: Survey 2017 result

4.2 Descriptive Analysis of Tax Compliance

This section provides descriptive analysis of the variables of this study, namely Economic, Social, Individual, Demographic factors and tax compliance.

4.2.1 Tax Compliance

As discussed earlier dependent variable have been measured using indirect and hypothetical questions which was recommended on previous studies to fetch genuine data in the most confidential information. According to Yesegat and Fjeldsta (2016) tax noncompliance is illegal and a concealed activity. Gathering data on the compliance behavior of taxpayers through field data collection methods such as questionnaires suffers from the unwillingness of respondents to reply honestly to questions about their own compliance.

In this study, tax compliance behavior was measured by gathering responses from hypothetical tax scenarios. This scenario was introduced to mitigate the sensitive nature of the questions involved so that respondents would be more likely to provide truthful responses. As most corporations would have strong incentives to avoid revealing their non-compliance decisions, any direct measures would invariably suffer from substantial measurement errors (Recker.k, 1988).

With the indirect survey question about tax noncompliance, responses are categorized as 'very frequently', 'frequently', 'not so often', 'sometimes' and 'never'. Never used as a cut-off point, and treat it as a measure of compliant attitude; responses indicating the existence of evasion in different levels of frequency are considered as measures of a noncompliant attitude.
Compliance attitude on the first senario is composite factor from responses to statements: How frequently do you think taxpayers evade taxes?' How frequently do you think taxpayers under report their income? And how frequently do you think taxpayers over state their deductable expenses?

The questions measure the frequency of tax payer's tax evasion (embedding themselves) responses ranging from "very frequently"=5 through "Never"=1.

Table 6 describes respondent's tax compliance attitude based on their response to "How frequently do you think tax payers evade taxes? Underreport their income? & overstate their deductable expenses? Only 31.7% of the total respondents never evade taxes while the rest 68.3% evade taxes either by underreporting income or overstating expenses. This implies that majority of category "A" tax payers do not comply with the tax law (Table 6).

Table 6 Tax compliance attitude

Tax compliance attitude		N	Percent
How Frequently tax payers evade tax [a]	Never	114	31.7%
	Sometimes	80	22.2%
	Not so often	64	17.8%
	Frequently	48	13.3%
	Very frequently	54	15.0%
Total		360	100.0%

[a] group

On the seconded scenario the respondents were requested to read a scenario about tempt to under-report income. Compliance level measured using composite factor from responses to statements "To what extent do you agree with Mr Abebe's possible action of not reporting that cash sale of ETB100, 000 as his business income? " and "To what extent do you agree with Mr Abebe's possible action if he reports only part of the ETB 100,000 as business income?" .The extent of agreement with the under-reporting of income was measured via a five-point Likert scale ranging from strongly agree=5 to strongly disagree=1. Higher scores would indicate likely non-compliance behavior and vice-versa.

As shown below in Table 7, 14.2% and 2.5 % of respondents agree and strongly agree with income under reporting respectively while 35.8% and 20% were strongly disagree and disagree. The rest 27.5% remain neutral. Overall result of this scenario indicates majority of category "A" tax payers do not agree with non compliance attitude.

Table 7 Non Compliance attitude

Non Compliance attitude		N	Percent
Do you agree with partial/full evasion?[a]	strongly disagree	86	35.8%
	Disagree	48	20.0%
	Neutral	66	27.5%
	Agree	34	14.2%
	Strongly agree	6	2.5%
Total		240	100.0%

[a] group

4.2.2 Descriptive Analysis of Independent variables

4.2.2.1 Demographic Factors

Since Never is taken as a cutoff point, compliance attitude was classified under compliant (Never) and non compliant (very frequently, frequently, often & sometimes). Table 8 summarizes demographic factors against compliance attitude.

Demographic factors that previous research has illustrated may affect tax compliance behavior. These include age, gender, general level of education and income level. These are the most common variables used in tax compliance research (Devos, 2005).

The results in table 8 shows that Females are more compliant than males and compliance attitude increases as tax payers get older. On the other hand number of complaints increases as education level of tax payers increases. However, Level of income didn't show linier relation with compliance attitude of category "A" tax payers (Table 8).

Table 8 Demographic factors

Demographic factors		Tax compliance		Total
		Compliant	non-compliant	
SEX	Male	4	66	70
	Female	10	40	50
Total		14	106	120
AGE	21 -30	0	32	32
	31-40	4	32	36
	41-50	4	32	36
	above 51	6	10	16
Total		14	106	120
Education Level	10th/12th grade complete	0	12	12
	Diploma	0	20	20
	Degree	4	56	60
	2nd degree and above	10	18	28
Total		14	106	120
Annual sales turn over	500,000 - 1,000,000	4	40	44
	1,000,001 - 5,000,000	4	32	36
	5,000,001 - 10,000,000	6	14	20
	Above 10 million	0	20	20
Total		14	106	120

4.2.2.2 Economic, Social and Individual Factors

The description of variables in this paragraph is based on responses to statements in the survey that range from 'strongly disagree' = 1 to 'strongly agree' = 5. As table 9 summarizes respondents agree ($\overline{x}$ = 2.67, σ = 1.34) that the tax authority has limited capability to investigate all income reported and they believe they have an opportunity to escape from audit. The result of the survey is in line with previous literature e.g. Allingham and Sandmo (1972) claimed that taxpayers will always declare their income correctly if the probability of detection is high.

Respondents agree with the government spends a reasonable amount on welfare ($\overline{x}$ = 2.62, σ = 1.44) and very thank full about government services, facilities and infrastructure ($\overline{x}$ = 2.58, σ = 1.33).However, they disagree with the government does not waste too much money ($\overline{x}$ = 2.22, σ = 1.25). Over all result showed that respondents disagree with fairness of government spending ($\overline{x}$ = 2.47).This May be the reason why most tax payers did not complying with tax system. Studies showed that if taxpayers perceive that the government is spending too much on something considered unnecessary or unbeneficial to them then taxpayers will feel betrayed and attempt to evade (Roberts, 1994).

With regard to Principle of equity and fairness respondents replied higher income earners should pay more taxes ($\overline{x}$ = 2.70, σ = 1.53) and believe they are paying the same taxes as others making similar income ($\overline{x}$ = 2.63, σ = 1.28).In addition majority of respondents agreed that paying the right amount of income tax will benefit other people especially the poor ($\overline{x}$ = 3.27, σ = 1.5). They also agreed with the statement government policy is in favor of their business, and have tax advantage on their business area with ($\overline{x}$ = 3.20 &3.00, σ = 1.14 & 1.06) respectively. When we sum up responses on perception of equity fairness, results indicated that most tax payers agree about equity and fairness of the tax system ($\overline{x}$ (composite) = 2.87).

Survey result on government policy explained by the statement 'Government policy is in favor of my business"; "I have tax advantage in my business area" and "I believe that the ruling party has fair policies for Category "A" tax payer". Weighted mean for those questions is 3.06 which

implies that respondents agree with government policy. Hasseldine and Hite's (2003) study examined two potential influences on taxpayer attitudes, namely political party affiliation and attribute framing.

Regarding the referral group respondents do not comply because their friends and parents did not compile and never been penalized ($\bar{x}$ = 2.70, σ = 1.22) ($\bar{x}$ = 2.72, σ = 1.2) respectively. In line with previous literature tax payers agreed that they are influenced by referral group ($\bar{x}$ (composite) = 2.72). Research in ascertaining the importance of referent groups i.e family members and friends in tax compliance is limited although Ajzen (1988) and Ajzen and Fishbein (1980) (in their Theory of Reasoned Action (TRA) and Theory of Planned Behavior (TPB)) theorized that referent groups play a significant role in determining people's intentions and behavior.

According to the survey result most respondents agreed that their expenditure always exceeds their income ($\bar{x}$ =3.08, σ = 1.26), and the price of basic needs keep on increasing ($\bar{x}$ = 3.02, σ = 1.21).Majority of the respondents pay their debt & basic needs first rather than tax liabilities ($\bar{x}$ = 2.63, σ = 1.28). In general tax payers agreed that personal financial constraint affects their compliance behavior ($\bar{x}$ =3.08 (composite= 2.91).

In respect of the awareness of offences and penalty majority of respondents disagree with the statement penalty rates are very low and can afford to pay the penalty ($\bar{x}$ = 2.02, σ =0 .99), The survey result also show their disagreement with enforcement is very weak ($\bar{x}$ = 2.17, σ = 1.1) and tax authorities tolerance towards their offence ($\bar{x}$ = 2.02, σ = 1.01).Most respondents disagree with the statement I have no idea about penalty rates and offences ($\bar{x}$ = 2.02, σ = 0.89).The sum of responses towards awareness on offences and penalty is inclined to disagreement ($\bar{x}$ (composite)= 2.05) .So majority of them know about the penalty rates and the quencequence of offence acts.

In terms of tax knowledge, tax payers are more inclined towards strongly agree with the statement I know how to declare actual income received ($\bar{x}$ = 3.77, σ = 1.19), how to keep records/documents pertaining to income and expenditure ($\bar{x}$ = 3.87, σ = 1.05) and understand that

they should pay taxes due within the prescribed period ($\bar{x}$ = 4.12, σ = 0.92). The sum of results towards tax knowledge is ($\bar{x}$ (composite)= 3.92) which implies that majority of tax payers has knowledge about tax system.

Table 9 Descriptive statistics of Economic, Social & Individual factors

Descriptive Statistics	N	Min.	Max.	Mean	Std.Dev.
Tax authority has limited capability to investigate all income reported , so I have an opportunity to escape	120	1	5	2.67	1.343
Sum of Government spending				**2.47**	
The government spends a reasonable amount on welfare	120	1	5	2.62	1.445
I am very thank full about government services, facilities and infrastructure	120	1	5	2.58	1.326
The government does not wastes too much money	120	1	5	2.22	1.245
Sum of Equity and Fairness				**2.87**	
Higher income earners should pay more taxes	120	1	5	2.70	1.537
I pay about the same amount of taxes	120	1	5	2.63	1.283
paying right amount of income tax, I believe that other people especially the poor will get the benefit	120	1	5	3.27	1.510
Sum of Government Policy				**3.06**	
Government policy is in favor of my business	120	1	5	3.20	1.142
I have tax advantage in my business area	120	1	4	3.00	1.069
believe that the ruling party has fair policies for Category "A" tax payers	120	1	5	2.98	1.108
Sum of Referral group				**2.71**	
My friends do not comply and they have never been penalized	120	1	5	2.70	1.220
My parents and relatives do not comply and they have never been penalized	120	1	5	2.72	1.204
Sum of Financial Constraint				**2.91**	
My expenditure always exceeds my income	120	1	5	3.08	1.261
The price of basic needs is keep on increasing	120	1	5	3.02	1.209
I will pay my debts and basic needs first	120	1	5	2.63	1.270
Sum of Penalty and Offences				**2.05**	
The penalty rates are very low and I can afford to pay the penalty	120	1	4	2.02	0.979
The enforcement is very weak	120	1	4	2.17	1.103
I believe that the tax authority is tolerant towards my offence	120	1	4	2.02	1.012
I have no idea about penalty rates and offences	120	1	4	2.02	0.889
Sum of Tax Knowledge				**3.92**	
I know how to declare actual income received	120	1	5	3.77	1.193
I know how to keep records/documents pertaining to income and expenditure	120	2	5	3.87	1.045
I understand that I should pay taxes due within the prescribed period	120	2	5	4.12	0.918

4.3 Determinants of tax compliance – Ordered probit model

This section presents the result of ordered probit analysis through significant test using STATA. There were a number of significant correlations between level of tax compliance and independent variables. Based on Table 4.9 , ordered probit analysis result significant factors affecting tax compliance were Education, tax audit, government spending, referral group, financial constraint, awareness of penalty and offence and tax knowledge, Whereas Gender, age, income, equity and fairness and government policy were not significant factors to determine tax compliance behaviors.

Personal financial constraints appear to be the main factor in determining tax compliance behavior followed by tax knowledge, awareness of penalty and offence, government spending, referral group and education. Results evidenced that taxpayers who had crucial financial constraint tend to be less compliant (negative association) because a person with financial distress will be forced to give priority for personal needs rather than tax liability, subsequently Hypothesis 6(Personal financial constraint is negatively associated with tax compliance) was accepted.

It has been described in previous study that tax knowledge has strong relationship with taxpayers' ability to understand the laws and regulations of taxation, and their ability to comply. Table 4.9 also revealed that tax knowledge has positive relation with compliance behavior supporting Hypothesis 8 (Tax knowledge is positively associated with tax compliance).

Supporting Hypothesis 7 (Awareness of penalty is positively associated with tax compliance) and Hypothesis 1(Probability of being audited is positively associated with tax compliance), and the result also showed awareness of offences and penalties and tax audit has positive relation with compliance. The higher the penalty and the potential audit probability the greater the discouragement for potential tax evasion. Probability of audit detection will enhance compliance behavior of tax payers since they might afraid to be spotted for penalty.

In line with Hypothesis 2 (Positive perception of government spending is positively associated with tax compliance) ordered probit analysis result indicated government spending has positive relation with tax compliance. If the government is wisely spending the national revenue, for example, for basic facilities like education, health and safety and public transportation, it is likely that voluntary compliance will increase.

Among social factors only referral group influence has significant relation with tax compliance. If tax payers perceive that peers are noncompliant and never been penalized they will decide to commit the same. The study also suggests that friends and family members are of significant influence to taxpayers' behavior. The influence of referent groups tends to be important as taxpayers are keen to refer their tax matters to their immediate family members, as result Hypothesis 5(The influence of referent group is positively associated with tax compliance) was accepted.

Supporting Hypothesis 12 (Educational level has direct relationship with tax compliance) the survey result indicated that education was positively associated with tax compliance. This is due to the fact that tax payers' education level will help them to understand the tax system easily and act accordingly.

Table 10 Determinants of tax compliance — Ordered probit regression result

TAX_COMP	Coef.	SE	P>|z|
GENDER	.91	.285197	0.154
AGE	.12	.145	0.401
EDUC	.27	.1526521	0.075 *
INCOME	.11	.131835	0.381
TAX_AUD	.23	.1002571	0.017**
GOV_SPEN	.27	.106214	0.006 **
EQUI_FAIR	.09	.0936102	0.323
GOV_POLICY	.29	.1419631	0.722
REFER	.28	.1156123	0.016**
FIN_CONS	-.48	.128683	0.000 ***
PENAL	.41	.1634631	0.012 ***
TAX_KNOWL	.48	.1422776	0.001 ***
Prob > chi2 = 0.0000		Pseudo R2 = 0.2122	

Note: * Significant at p < 0.10 ** Significant at p < 0.05 *** significant at p < 0.001

CHAPTER V

5. Conclusion and Recommendation

This chapter presents the conclusions and recommendations. The purpose of the chapter is to review the whole thesis and highlight future research directions. Accordingly, section one presents overview of the thesis and its major findings while the second section presents the recommendations with future research directions.

5.1 Conclusion

Based on the presiding analysis the paper finally drawn the following conclusions/findings

- The research measures tax compliance attitude using indirect and hypothetical questions and the result of descriptive analysis of both scenarios indicated majority of them were not compliant. This is an implication for the government to work on determinant factors to improve tax revenue. In the second scenario majority of respondents replied they are compliant, this might be due to the sensitive nature of compliance behavior as discussed in limitation section of this paper. As a result this scenario was disregarded from further analysis.

- Personal financial constraints are believed to have an impact on tax evasion as financial distress faced by an individual may encourage him/her to prioritize what has to be paid first as basic survival needs (foods, clothing, housing etc.) or where immediate demand on limited income is enforced (i.e perceived threat of action from money lenders etc.). In line with previous studies the result of analysis on this paper indicated that personal financial constraint leads to non compliance behavior of tax payers. (Mohani and Sheehan, 2004; Mohani, 2001).

- This work was aimed to study a comprehensive overview of business income tax payers' knowledge towards the tax law focusing on category "A" tax payers in Addis Ababa. The result of the study revealed tax payers who know and understand tax rule and regulation meet their obligation. Tax attitudes can be improved through better tax knowledge' (Tax attitudes can be improved through better tax knowledge' (Eriksen and Fallan, 1996).

- Tax audit and awareness on penalty and offence were identified as significant factors to determine compliance behavior of tax payers'. Fines and Audit rates may substitute each other due to their multiplicative linkages as long as neither of them is set to zero (Kirchler et al 2007). Higher fines simply make evading taxes more hazardous for taxpayers and should deter from evasion. Empirically the deterrent effect of fines could not always be supported. The observed effects were weaker than expected and some studies even suggest that an increase of penalties can have undesirable effect and result in more tax avoidance (Kirchler et al, (2007).

- Most taxpayers were conditioned by fairness of government spending and they are keen to know where their tax contribution will be spent. The analysis also finds evidence that those who are more satisfied with public service provision are more likely to comply with tax rule. Those who engage in tax evasion often justify such behavior by suggesting that the government wastes tax revenue and spends unwisely; such arguments can decrease voluntary compliance in the long run (Braithwaite et. al. 2009).

- Most of the respondents confirmed in both descriptive and ordered probit analysis result that they are influenced by Family or a friends' experience of noncompliance act. Allingham and Sandmo (1972), Clotfelter (1983) also claimed that referent groups play a significant role in evasion although it was also not clearly discussed which was stronger(family members or friends)

- We can draw the conclusion that education level has an impact on compliance. The result of descriptive analysis confirmed that as education level increases number of compliant tax payers' increase. This is because of educated taxpayers may be aware of non compliance

opportunities, but their potentially better understanding of the tax system and their higher level of moral development promotes a more favorable taxpayer attitude and therefore greater compliance. Chan et. al. (2000) also postulates that greater education is directly linked to a likelihood of compliance

5.2 Recommendations

Based on the findings of this study, the researcher came up with the following recommendations to enhance tax compliance of category "A" taxpayers'.

➢ With regard to economic factors, category "A" tax payers' will tempt to evade taxes if they believe that the probability of audit detection is low. This study revealed that if the government is wisely spending the national revenue, for example for basic facilities like education, health and safety and public transportation, it is likely that voluntary compliance will increase. In contrast, if taxpayers perceive that the government is spending too much on something considered unnecessary or unbeneficial to them then taxpayers will feel betrayed and attempt to evade. Therefore to avoid inefficiency of tax collection, the government officials and policy makers have to think about the thoroughness of audit practice and reasonableness of government spending.

➢ With regard to social factors, the influence of referral group is critical because as much literature describes, decisions either to evade or not to evade tax sometimes are work on social norms and ethical values and will create different incentives for tax compliance.

➢ Individual factors also play a key role in determining compliance behavior of category "A" tax payers. Personal circumstantial factors like personal financial constraints, awareness on penalties and offences and tax knowledge are likely to have a significant impact on taxpayer compliance behavior. Since Personal financial constraint was identified as the most significant determinant factor of compliance ERCA and policy makers has to regulate the economy to enable tax payers fulfill their obligation. It is also important for the ERCA to be

kept informed of taxpayers' level of knowledge so that it can effectively and efficiently communicate (i.e. current changes in tax laws) and design tax policies (for example, Reporting, filing requirements, penalties etc.).

➢ Finally the thesis suggests a series of measures, which could be taken by the government in general, and tax authorities in particular; improving thoroughness of audit, educating the taxpayers and conducting awareness creation and providing all necessary social services to the public will enhance compliance level. Awareness creation should go beyond simply giving tax education to taxpayers it should extended to having consultative sessions. There should be more preventative education for the public and increased awareness of tax responsibilities in schools. In addition further studies and investigations on this topic will help to analyze significant factors from different perspectives and increases compliance level by exploring the factors that make people to comply.

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ANNEXES

Annex 1: Taxpayers survey instrument (English version)

Saint Mary's University

Department of Accounting & Finance

Dear Respondents,

This study entitled "Factors Affecting tax compliance of Category "A" tax payers in Addis Ababa" and will be conducted for partial fulfillment of Masters of Business Administration in Accounting and Finance at Saint Mary's University. Its main objective is to examine determinant factors of tax compliance in the case of Category "A" tax payers at Addis Ababa.

Your cooperation of filling the questionnaire is very important to this study because it represents a number of others who are not included in the sample. The information provided is purely for academic purpose and I would promise that all information you provide would be strictly confidential. In order to accomplish this study, you are kindly requested to answer every question and your kind cooperation is highly appreciated.

I thank you very much in advance for your cooperation

Meaza Wudeneh

Phone number: 0947650143

 E-mail address: meskiwud.2004@gmail.com

REQUEST FOR THE COMPLETION OF QUESTIONNAIRE

General Instruction

This close ended questionnaire has three parts, part I is regarding respondents' general back ground ,the second (II) part of the questionnaire contains questions on the degree of tax payers' compliance towards the tax law .Finally questions about the factors of tax compliance presented in part III.

PART I: Tax payers' general information

Kindly tick (√) on the choice you do believe that it is the most appropriate response.

1) Gender ☐ Male ☐ ale

2) Age

☐ From 21-30 ☐ From 41 – 50

☐ From 31 – 40 ☐ Above51

3) Education level

Education Level	Please tick (√) one
Bellow 10	
10th /12th complete	
Diploma	
Degree	
MA and above	

4) How much was your annual turnover for the year 2016/17 (2009 E.C)?

☐ 500,000 – 1,000,000   ☐ 5000,001 – 10,000,000

☐ 1000,001 – 5000,000   ☐ Above 10 million

PART II; Tax compliance

Questions on part II are used to examine tax compliance of Category "A" tax payers.

2.1 Please read the following and kindly indicate your opinion and put a tick mark (√)

Very frequently VF) = 5, 'Frequently (F) = 4, Not so often (O) = 3, Sometimes (S) = 2, and Never (N) = 1.

Ser. No	Statements	N 1	S 2	O 3	F 4	VF 5
1	How frequently do you think taxpayers evade taxes?'					
2	How frequently do you think taxpayersunder report their income?					
3	How frequently do you think taxpayers over state their deductable expenses?					

2.2. Please read the following scenario and kindly indicate your opinion based your experience
Strongly agree (SA) = 5, Agree (A) = 4, Neutral (N) = 3, Disagree (DA)= 2, and strongly disagree (SD)= 1.

"Mr Abebe, a self-employed businessman is considering not disclosing a cash sale of ETB100,000 as business income in his 2017/18 tax return. Legally, the cash receipts of ETB100,000 should be included as a business income. However, he is almost certain that the tax authority will not audit him and would not know if the amount is not disclosed".

Ser. No	Statement	SD 1	DA 2	N 3	A 4	SA 5
1	To what extent do you agree with Mr Abebe's possible action of not reporting that cash sale of ETB100,000 as his business income?					
2	To what extent do you agree with Mr Abebe's possible action if he reports only part of the ETB 100,000 as business income?					

PART III; Factors affecting tax compliance

Questions on part III will be used to assess determinant factors of tax compliance. Please kindly respond to the following statements to depending on degree of agreement or disagreement to each of the statements. There are no right and wrong answer. (Please tick (√) from the given 5 scale boxes.

Strongly disagree (SD)= 1. Disagree (DA)= 2, Neutral (N) = 3, Agree (A) = 4, and Strongly agree (SA) = 5

3.1. Tax audit

I wish NOT TO COMPLY with tax laws for the following reasons:

S.N	Statement	SDA 1	DA 2	N 3	A 4	SA 5
1	I believe the tax authority has limited capacity to investigate all income reported , so I have an opportunity to escape from auditing of my under reporting income					

3.2. Perception of Government Spending

I wish to comply because;

S.N	Statement	SD 1	DA 2	N 3	A 4	SA 5
1	The government spends a reasonable amount on welfare					
2	There are a number of government services, facilities and infrastructure for which I am very thankful					
3	The government does not waste too much money					

3.3. Principle of Equity and Fairness

I wish to comply because;

S.N	Statement	SD 1	DA 2	N 3	A 4	SA 5
1	Higher income earners should pay more taxes than lower income earners					
2	I pay about the same amount of taxes as others making the same income					
3	By paying right amount of income tax, I believe that other people especially the poor will get the benefit					

3.4. Changes to government policy

I wish to comply because;

Ser. No	Statement	SD 1	DA 2	N 3	A 4	SA 5
1	Government policy is in favor of my business in many aspects					
2	I have tax advantage in my business area					
3	I believe that the ruling party has fair policies for Category "A" tax payers'					

3.5. Referral group (Friends, Relative Etc.)

I wish NOT TO COMPLY with tax laws for the following reasons:

Ser. No	Statement	SD 1	DA 2	N 3	A 4	SA 5
1	My friends do not comply and they have never been penalized					
2	My parents and relatives do not comply and they have never been penalized					

3.6. Personal financial constraint

I wish NOT TO COMPLY with tax laws for the following reasons:

Ser. No	Statement	SD 1	DA 2	N 3	A 4	SA 5
1	My expenditure always exceeds my income					
2	The price of basic needs is keep on increasing					
3	I will pay my debts and basic needs first rather than income tax					

3.7. Awareness of offences and penalty

I wish NOT TO COMPLY with tax laws for the following reasons:

Ser. No	Statement	SD 1	DA 2	N 3	A 4	SA 5
1	The penalty rates are very low and I can afford to pay the penalty					
2	The enforcement is very weak					
3	If I detected not reporting my exact income, I believe that the tax authority is tolerant towards my offence and most probably it will escape without any punishment.					
4	I have no idea about penalty rates and offences					

3.8. Tax knowledge

I wish to comply because;

S.N	Statement	SD 1	DA 2	N 3	A 4	SA 5
1	I know how to declare actual income received from all sources to the tax authority					
2	I know how to keep records/documents pertaining to income and expenditure for a required period of years after submission of the tax return					
3	I understand that I should pay taxes due within the prescribed period from the date of issue of the Notice of Assessment or within the stipulated period					

Annex 2 : Tax payers survey instrument (Amharic Version)

ክፍል አንድ፤ የግብር ከፋዮች አጠቃላይ መረጃ

1. ጾታ ☐ ወንድ ☐ ሴት

2. እድሜ

☐ ከ 22 - 30 ☐ ከ 41 - 50
☐ ከ30 – 40 ☐ ከ 51 በላይ

3. ትምህርት ደገጃ

☐ ከ10ኛ ክፍል በታች ☐ ድግሪ
☐ 10ኛ/12ኛ ክፍል ያጠናቀቀ ☐ 2ኛ ዲግሪ እና ከዚያ በላይ
☐ ዲፕሎማ

4. የድርጅትዎ ሽያጭ በ 2009 ወይም 2016/17 በብር በምን ያህል ይገመታል

☐ ከ500,000 – 1,000,000

☐ ከ1,000,001 – 5,000,000

☐ ከ5,000,001 – 10,000,000

☐ ከ10 ሚሊዮን በላይ

ክፍል ሁለት ግብር ከፋዮች ለግብር ለህጉ ያላቸውን ተገዥነት የሚገመግም የመጠይቅ ክፍል ነዉ፡፡

2.1. እባክዎ በሚቀጥለዉ ስንጠረዥ ዉስጥ ላሉት ሃሳቦች በተሰጠዉ መለኪያ መሰረት አስያየተዎን ያስቀምጡ፡፡ በፍፁም (1) ፤
አልፎ አልፎ (2) ፤ ብዙ ጊዜ (3) ፤ በተደጋጋሚ (4)፤ በጣም በተደጋጋሚ (5)

ተ.ቁ	ሃ ሳ ቦ ች	በፍፁም 1	አልፎ አልፎ 2	ብዙ ጊዜ 3	በተደጋጋሚ 4	በጣም በተደጋጋሚ 5
1	ግብር ከፋዮች በምን ያህል ድግግሞሽ ግብራቸዉን ይደብቃሉ					
2	ግብር ከፋዮች በምን ያህል ድግግሞሽ ገቢያቸዉን ያሳንሳሉ					
3	ግብር ከፋዮች በምን ያህል ድግግሞሽ ወጪያቸዉን ያጋንናሉ					

2.2. የሚከተለዉን ፅሁፍ ካነበቡ በሁዋላ እባክዎ ቀጥሎ ላሉት ጥያቄዎች ትክክለኛዉን አስተያየት ያስቀምጡ፡፡

በጣም አልስማማም (1)፤ አልስማማም (2)፤ ገለልተኛ ነኝ (3)፤ እስማማለሁ (4)፤ በጣም እስማማለሁ (5)

*"አቶ አበበ በግል ስራ ላይ የተሰማሩ ነጋዴ ናቸዉ፡፡ አቶ አበበ በ2009 የግብር አመት የ100,000 ብር ሽያጭ ነበራቸዉ
ሆኖም ግን ለግብር ሰብሳቢዉ መስሪያ ቤት ላለማሳወቅ ወስነዋል ፡፡ በግብር ህጉ መሰረት የ100,000 ብር እጅ በእጅ ሽያጭ
ገቢያቸዉ ሪፖርት መደረግ አለበት፡፡ ነገር ግን አቶ አበበ ግብር ሰብሳቢዉ መስሪያ ቤት ኦዲት እንደማያደርጋቸዉ እና
ያላሳወቁትን ገቢ እንደማይገኝባቸዉ እርግጠኛ ናቸዉ፡፡"*

ተ.ቁ	ሃሳቦች	በጣም አልስማማም 1	አልስማማም 2	ገለልተኛ ነኝ 3	እስማማለሁ 4	በጣም እስማማለሁ 5
1	አቶ አበበ የ100,000 እጅ በእጅ ሽያጭአቸዉን ሙሉ ለሙሉ ላለማሳወቅ ቢወስኑ ምን ያህል በአቶ አበበ ሃሳብ ይስማማሉ					
2	አቶ አበበ የ100,000 ብር እጅ በእጅ ሽያጭአቸዉን በከፊል ለማሳወቅ ቢወስኑ ምን ያህልበአቶ አበበ ሃሳብ ይስማማሉ					

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ክፍል ሶስት ግብር ከፋዮች ለግብር ህጉ ያላቸዉን ተገዥነት የሚወስኑ ምክንያቶች

እባክዎ በሚቀጥለዉ ሰንጠረዥ ላሉት ሃሳቦች በተሰጠዉ መለኪያ መሰረት አስያየተዎን ያስቀምጡ

3.1. የግብር ምርመራ (ኦዲት)

በሚከተሉት ምክንያቶች ለግብር ህግና ደንቡ ተገዥ አለመሆንን እምርጣለሁ

ተ.ቁ	ሃሳቦች	በጣም አልስማማም 1	አልስማማም 2	ገለልተኛ ነኝ 3	እስማማለሁ 4	በጣም እስማማለሁ 5
1	ግብር ሰብሳቢዉ መስሪያ ቤት ትክክለኛ ገቢየን መርምሮ የማሳወቅ ብቃቱ ዉስን ስለሆነ የገቢየን አሳንሶ የማሳወቅ እድል አለኝ					

3.2. በመንግስት ወጭዎች ላይ ያለ ምልከታ

በሚከተሉት ምክንያቶች ለግብር ህግና ደንቡ ተገዥ መሆንን እምርጣለሁ

ተ.ቁ	ሃሳቦች	በጣም አልስማማም 1	አልስማማም 2	ገለልተኛ ነኝ 3	እስማማለሁ 4	በጣም እስማማለሁ 5
1	የመንግስት ወጭዎች ለመሰረታዊ አገልግሎት የሚዉሉ እና ምክንታዊ ናቸዉ ብዬ አምናለሁ					
2	መንግስት በተገቢዉ መንገድ የመሰረት ልማት አገልግሎቶች ያቀርባል ብዬ አምናለሁ					
3	መንግስት ያለ አግባብ ገንዘብ አያባክንም ብዬ አምናለሁ					

3.3. የግብር ህጉ እኩልነት እና ፍትሃዊነት

በሚከተሉት ምክንያቶች ለግብር ህግና ደንቡ ተገቢኑ መሆንን እመርጣለሁ

ተ.ቁ	ሃሳቦች	በጣም አልስማማም 1	አልስማማም 2	ገለልተኛ ነኝ 3	እስማማለሁ 4	በጣም እስማማለሁ 5
1	ከፍትኛ ገቢ ያላቸዉ ግብር ከፋዮች አነስተኛ ገቢ ካላቸዉ የበለጠ ግብር ስለሚከፍሉ					
2	እኔ የምከፍለዉ ግብር ተመጣጣኝ ገቢ ካላቸዉ ጋር ሲነፃፀር እኩል ስለሆነ					
3	ተገቢዉን ግብር በመክፈል ደሃዉ ህብረተሰብ ተጠቃሚ ይሆናል					

3.4. የመንግስት ህግ እና ደንብ ለዉጥ

በሚከተሉት ምክንያቶች ለግብር ህግና ደንቡ ተገቢኑ መሆንን እመርጣለሁ

ተ.ቁ	ሃሳቦች	በጣም አልስማማም 1	አልስማማም 2	ገለልተኛ ነኝ 3	እስማማለሁ 4	በጣም እስማማለሁ 5
1	በተለያየ መንገድ የመንግስት ህግ እና ደንብ እኔ ለምሰራዉ ንግድ ጠቃሚ ነዉ.					
2	የግብር ህጉ እኔ የተሰማራሁበትን የንግድ ዘርፍ ይደግፋል					
3	አሁን በስልጣን ላይ ያለዉ ፓርቲ ለደረጃ "ሀ" ግብር ከፋዮች የተለየ አተኩረት አለዉ.					

3.5. የቤተሰብ ተፅእኖ (ወላጅ፤ ዘመድ፤ ጉዋደኛ…ወ.ዘ.ተ.)

በሚከተሉት ምክንያቶች ለግብር ህግና ደንቡ ተገዥ አለመሆንን እመርጣለሁ

ተ.ቁ	ሃሳቦች	በጣም አልስማማም ፤	አልስማማም ፤ 2	ገለልተኛ ነኝ ፤ 3	እስማማለሁ ፤ 4	በጣም እስማማለሁ ፤ 5
1	የቅርብ ጓደኞቼ ለግብር ህጉ አይገዙም ነገር ግን ቅጣት ተጥሎባቸዉ አያዉቅም					
2	ወላጆቼ እና ዘመዶቼ ለግብር ህጉ አይገዙም ነገር ግን ቅጣት ተጥሎባቸዉ አያዉቅም					

3.6. የገንዘብ እጥረት

በሚከተሉት ምክንያቶች ለግብር ህግና ደንቡ ተገዥ አለመሆንን እመርጣለሁ

ተ.ቁ	ሃሳቦች	በጣም አልስማማም ፤	አልስማማም ፤ 2	ገለልተኛ ነኝ ፤ 3	እስማማለሁ ፤ 4	በጣም እስማማለሁ ፤ 5
1	ሁልጊዜ ወጭየ ከገቢየ ስለሚበልጥ					
2	የእለት ፍጆታ ወጭየ በየጊዜዉ የዋጋ ግሽበት ስለሚያሳይ					
3	የእዳ ክፍያዎቼን እና የእለት ፍጆታየን ከግብር እዳዬ ስለማስቀድም					

3.7. ስለቅጣት ያለ ግንዛቤ

በሚከተሉት ምክንያቶች ለግብር ህግና ደንቡ ተገዥ አለመሆንን እመርጣለሁ

ተ.ቁ	ሃሳቦች	በጣም አልስማማም ፤	አልስማማም 2	ገለልተኛ ነኝ 3	እስማማለሁ 4	በጣም እስማማለሁ 5
1	የቅጣት መጠኑ አነስተኛ ስለሆነ መከፈል እችላለሁ					
2	የህጉ ተፈፃሚነት አነስተኛ ስለሆነ					
3	የታክስ ህጉን ባላከብርም ግብር ሰብሳቢ መስሪያ ቤቱ አይቶ እንዳላየ ያልፈኛል እና ያለቅጣት ያልፈኛል					
4	ቅጣትን በተመለከተ ምንም አይነት ግንዛቤ የለኝም					

3.8. የግብር ህግ እዉቀት

በሚከተሉት ምክንያቶች ለግብር ህግና ደንቡ ተገቢ መሆንን አመርጣለሁ

ተ.ቁ	ሃሳቦች	በጣም አልስማማም ፤	አልስማማም 2	ገለልተኛ ነኝ 3	እስማማለሁ 4	በጣም እስማማለሁ 5
1	ገቢያን እንዴት ለግብር ሰብሳቢዉ መሰሪያቤት እንደማሳወቅ በቂ ግንዛቤ አለኝ					
2	ወጪ እና ገቢያን እንዴት መመዝገብ እንዳለብኝ እና ለምን ያህል ጊዜ የሂሳብ ሰነድ ማስቀመጥ እንዳለብኝ አዉቃለሁ					
3	የሚጠበቅብኝን ግብር በተሰጠኝ የጊዜ ገደብ መከፈል እንዳለብኝ አዉቃለሁ					

Appendices 3: Number of large tax payers in Addis Ababa

No.	Sub city	Total Tax payers	Category "A"	Category "B"
1	Ledeta Sub city	4,018	1,906	2,112
2	Arada Sub city	6,409	4,262	2,147
3	Gulele	6,217	4,111	2,106
4	Nefas Silk	14,450	6,064	8,386
5	Bole	11,024	5,813	5,211
6	Yeka	11,119	4,857	6,262
7	Kirkos	9,834	6,100	3,734
8	Akaki Kality	7,088	2,329	4,759
9	Addis Ketema	5,952	2,358	3,594
10	Kolefe Keranyo	8,110	4,091	4,019
11	Merkato 1 Branch	6,460	3,566	2,894
12	Merkato 2 Branch	8,101	6,691	1,410
13	Addis Ababa 1 አ/አ/ቁ 1/መ/ግ/ከ/ቅ/ፅ	4,295	4,295	-
14	Addis Ababa 2 አ/አ/ቁ 2/መ/ግ/ከ/ቅ/ፅ	5,107	5,107	-

Source: Ethiopian Revenue and Customs Authority Large tax payers' office, Tax payers Report March, 2017