

Addis Ababa University
College of Business and Economics
Department of Public Administration and Development
Management

An Assessment of Size of Compliance costs, Tax knowledge and Tax compliance of Medium Enterprises Owned by Category “A” Tax payers: The Case of Lideta Sub city of Addis Ababa City Administration

By: Zekarias Mekonnen

A thesis submitted to the Department of Public Administration and Development Management of Addis Ababa University in partial fulfillment of the requirements for the Degree of Masters in Public Management and Policy (MPMP)

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Addis Ababa, Ethiopia

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By: Zekarias Mekonnen

Advisor: Frehiwot Gebrehiwot (PHD)

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Addis Ababa, Ethiopia

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Department of Public Administration and Development Management

Approval page

This is to certify that the thesis prepared by Zekarias Mekonnen entitled “**An Assessment of The Size of Tax compliance costs, Tax knowledge and Tax compliance of Medium size Enterprises Owned by Category “A” Taxpayers: The case of Lideta sub city of Addis Ababa City Administration**”, which is submitted in partial fulfillment of the requirements for the Degree of Masters in Public management and Policy (MPMP), complies with the regulations of the university and meets the accepted standards with respect to originality and quality.

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_____ Signature _____
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Advisor

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Declaration page

I, the under signed, declare that this thesis is my original work and has not been presented for a degree in any other university and that all sources of materials used for the thesis have been duly acknowledged.

Declared by:

Name_____

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Abstract

The objective of the study is to assess the size of tax compliance cost incurred by medium enterprises that fall under category “A” taxpayers division, the tax knowledge level of the owners of the businesses and the degree of tax compliance that exist among them. The research is quantitative one with a descriptive research design. 140 sample participants were selected randomly from a total population of 220. Data was gathered through self-administered questionnaires that comprised of both closed and open ended questions and the data collection process resulted in a 100% rate of return. Quantitative method of data analysis was carried out with the use of SPSS and Microsoft Excel softwares. The results attained indicate that average tax compliance cost incurred by each firm that outsources its tax affairs amounts to Birr 75953 per year and firms that use in-house staff service to handle their tax affairs incur a cost of Birr 99040 per year. Moreover, the results indicated that the business owners are both highly aware of tax laws and rules and compliant. Even though the results for tax knowledge and tax compliance aspects are desirable, the amount of tax compliance cost incurred by the businesses is not small enough to be ignored. Therefore, it is recommended that ERCA needs to consider the use of E-filing, raising business tax thresholds and train tax payers on efficient use of resources in order to minimize their tax compliance burden.

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Acronyms

ATO: Australian Taxation Office

ERCA: Ethiopian Revenue and Customs Authority

IRS: Internal Revenue Service

SMEs: Small and Medium Enterprises

OECD: Organization for Economic Co-operation and Development

MOFED: Ministry of Finance and Economic Development

SPSS: Statistical Package for the Social Sciences

USA: United States of America

VAT: Value Added Tax

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Chapter One

Introduction

1.1. Background of the study

According to James and Alley (2002:27-42) tax compliance is defined as ‘the voluntary payment of taxes in accordance with the spirit of taxes’ .It occurs when a taxpayer registered with the revenue authority, files the required returns on time, accurately reports tax liability in accordance with the prevailing legislation, pays any outstanding taxes as they fall due, and maintains all records as required (McKercher &Evans, 2009:171-201).

Tax compliance is an important issue for nations around the world as governments search for revenue to meet public needs. Firms are expected to behave ethically and comply with tax laws. However, the level of tax compliance has always been way below down from what is expected (Alon & Hageman, 2013:479-494). In most developing countries the revenue generated by governments is most often less than the expenditures made. For instance, despite the fact that 70% of the total government expenditure is financed by tax revenue that is collected from tax payers in Ethiopia, (Yetsegat & Fjeldstad, 2016) a high level of tax noncompliance is observed which is assumed to be caused by the application of excessive enforcement mechanisms and ignoring to understand the influences of other determinant factors which affect the tax compliance behavior of tax payers (Belay & Viswanda, 2016).This disparity between the levels of government expenditures and revenue generated from tax can be attributed in part to low level of tax compliance by tax payers which in turn leads to low level of government income from revenue. Out of the factors that drive tax noncompliance behavior are heavy tax compliance cost burden (Li,2010:146-177) and lack of ample knowledge on the part of business enterprises about the tax system of the country in which they operate.(Palil, 2010).

Sandford & Hardwick (1989) pointed out that tax compliance costs are incurred exclusively for a tax compliance purpose; in essence, such costs are avoidable when taxation is abolished. Businesses often face heavy costs in the process of preparing, filing, and paying taxes in addition to the burden of tax payments. These compliance costs, added to fines, penalties and the risks of onerous

inspections and demands for bribes, often can lead to low level of compliance. Marcus, Contos & Guytan (2013:833-854) in their study entitled: “Income taxes and compliance costs: How are they related?” have pointed out that there exists a direct relationship between the level of tax compliance costs and tax compliance behavior. Schoonjans, Vancauwenberge, Peekmans & Simoens (2011) add to this fact when they state that SMEs may face economic hardships as a result of proportionately higher compliance costs which in turn leads to lower level of tax compliance.

Just as tax compliance costs can have an impact on tax compliance level of tax payers so does tax knowledge. Knowledge is influenced by many things, among other factors formal education. One’s knowledge about an object contains two aspects: positive and negative. Both of these aspects will determine the attitude of a person. The more positive of the knowledge the more positive aspects of the particular object (Fidel, 2004 cited in Setyorini, 2016). Nugroho (2012) too seems to assert this fact when he states that higher knowledge and understanding of the taxpayer leads to a better conformance with the tax regulations.

From the foregoing, it can be observed that both the size of tax compliance costs businesses incur and the level of tax knowledge their operators do possesses play important role in increasing tax compliance. In other words tax payers who do not understand the tax laws that govern their corresponding businesses and businesses that face heavy burden of compliance costs may not comply with the tax laws as desired.

According to the federal income tax proclamation no.286/2002 of the Federal Democratic Republic of Ethiopia tax payers are categorized in to three categories, namely category “A”, category “B” and category “C” based on their volume of sales and size of business. Subsequently, the tax authority will determine whether the tax payer shall continue in the same category or should be shifted to another category. Category “A” includes any company incorporated under the tax law of Ethiopia having annual turnover of Birr 500,000 and more. Those who are categorized under category “A” are expected to maintain all records and accounts which will enable them to submit a balance sheet and a profit or loss statements that disclose their gross profit, general

administrative expenses, depreciation expenses and provisions and reserves together with supporting documents or vouchers as required by council of ministers regulation number 78/2002: Article 18, sub article 2). Category “A” taxpayers are comprised of medium sized enterprises and large size businesses. Under category B fall businesses whose annual turnover is more than 100,000 Birr but less than Birr 500,000 and category “C” incorporates those businesses whose annual turnover is less than Birr 100000.

The business enterprises considered under this study are medium businesses that fall under category “A” division of taxpayers. The study assesses the size of tax compliance costs incurred by medium enterprises that fall under category “A” division, the level of tax knowledge their owners possess and the degree of tax compliance that exists among them.

1.2. Statement of the problem

Tax noncompliance has been a persistent problem throughout history and is becoming a growing concern for tax authorities and public policy makers of almost every nation as it seriously threatens the capacity of governments to raise public revenue. In general, tax noncompliance has a huge negative effect on the economic growth of every nation as it minimizes the amount of income that goes to the coffers of governments thereby reducing the size and scope of public services that governments can provide for their citizens (Roy & Rafaela, 2011:489-500). Hudson (2000:29-44) emphasizes on this very fact when he stated that tax evasion is the source of a potentially serious loss of revenue to governments resulting in the possible underfunding of public service and an unfair burden on honest and frank taxpayers.

Therefore, dealing with the problem of noncompliance requires an understanding of the factors underlying taxpayers’ decisions about whether to pay or not to pay for a better understanding of tax paying behavior can be expected to place revenue bodies in a stronger position to design and implement effective compliance strategies which contribute to the sustainability of taxation strategies. Besides, it is imperative to understand that no tax system can function

effectively without the cooperation of taxpayers so understanding the factors that affect the level of taxpayers' compliance behavior is important.

Out of the determinant factors that impact on tax compliance of taxpayers and thus leads to tax avoidance/evasion are the level of tax payers' knowledge about the specific tax laws of the country in which he/she operates (Palil,2010) and the burden of tax compliance costs imposed by the tax system of that country (Evans,2008). Taxpayers will readily accept tax systems that are already in place and/or new ones to be introduced if they have ample knowledge that allows them to understand the system (Kassipillai, Norhani, & Noor, 2003). This assumed fact implies that lack of tax knowledge on the part of taxpayers about the overall tax system of the country they operate in would likely leads to low level of tax compliance. Similarly, Nzioki & Peter (2014:1-12) have noted that heavy burden of tax compliance costs do have a significant negative impact on voluntary tax compliance. A higher tax compliance cost incurred to fill out tax return forms, hire a tax agent, and travel for tax purposes etc. can lead to dissatisfaction of tax payers which in turn can entice them not to comply voluntarily.

Even though the Ethiopian tax administration system has undergone several amendments since its advent, the improvements made are not as huge enough to address the aspects of factors that can possibly lead to voluntary compliance. It primarily stresses on legal enforcement as a remedy to ensure tax compliance. For instance, the income proclamation (no.286/2002) has increased the amount of penalties and strengthened the means of enforcement while it states nothing about how to create and increase the awareness of taxpayers and never taking in to account other factors such as tax compliance cost burdens. Moreover, to the best of my knowledge, enough studies have not been conducted up on factors that can influence taxpayers' attitude towards tax compliance such as the tax compliance cost burden, the level of tax knowledge business owners and operators possess and the tax compliance trend that exists among specific business categories.

In a country like Ethiopia where the contribution of tax revenue is believed to be very significant, more local studies on the assessment of tax payers' voluntary compliance and factors that affect tax compliance level such as tax

knowledge of tax payers, the size of the burden of tax compliance costs and other factors is required so as to provide the policy makers who work on the area with an up-to-date and relevant information that can help them in designing the right tax system. This study has therefore tried to assess the size of tax compliance costs incurred, the level of tax knowledge business owners do have and the tax compliance level of tax payers with a special reference to medium enterprises that fall under category “A” taxpayers division.

1.3. Basic research questions

Having the stated problem in mind this research intends to find answers to the following basic research questions:

1. How large is the size of tax compliance costs incurred by medium enterprises of category “A” division that operate in Lideta subcity of Addis Ababa city administration?
2. How much aware are medium business operators of category “A’ division of Lideta sub city about tax laws and other tax related requirements related to their business category?
3. What is the degree of tax compliance level of medium businesses of category “A” division in Lideta sub city of Addis Ababa city administration?

1.4. Objective of the study

The objective of the study is put as follows:

1.4.1. General objective of the study

The general objective of the study is to get an insight in to the size of tax compliance cost medium businesses of category “A” division incur, how aware the owners of the businesses are about the tax laws and rules that govern their businesses and the degree of compliance with tax laws that exists among them.

1.4.2. Specific objective of the study

- To know the size of tax compliance costs incurred by medium enterprises of category “A” division.
- To assess the level of tax knowledge the owners of the medium businesses of category “A” division possess.
- To assess the degree of tax compliance level that exists among medium enterprises of category “A’ division.

1.5. Significance of the study

Even though a lot has been written on determinant factors of tax compliance such as tax compliance costs and tax knowledge in the tax compliance literature, as much research as needed has not been conducted in Ethiopia in general and in Addis Ababa in particular on the area. Tax payers’ attitude towards taxation is influenced by many factors that determine the success of the tax system. Unless these voluntary tax compliance determinants are singled out and addressed properly, it may be difficult to design an efficient and effective tax system that elevates the level of taxpayers’ compliance and serve as an instrument to narrow the existing compliance gap. Hence, this study will have a significance to provide relevant information to policy makers and other concerned parties in addressing voluntary compliance problems by depicting the existing fact about the size of tax compliance costs incurred by medium enterprises of category “A” division, the level of tax knowledge their operators possess and the degree of their tax compliance. Besides, the finding of this study may be used as a springboard for further research by an interested party.

1.6. Scope of the Study

As has already been mentioned this research is intended to assess the size of tax compliance costs (expenditures of time or money in conforming with government tax requirements) medium enterprises of category “A’ division that operate in Lideta sub city of Addis Ababa city administration incur, the level of tax knowledge the owners of the enterprises under study possess and the degree of tax compliance (tax compliance behavior exhibited) that exists among them. To this end, it tried to examine how large the burden of tax compliance costs are, how much knowledge the medium business operators possess regarding tax related laws and regulations which are related to their business category and the degree of tax compliance level that is observed among them.

1.7. Limitations of the study

According to the formula used in this study psychological tax compliance costs which are believed to be one kind of the total incidental tax compliance cost a company can possibly incur (Sapiei & Kasipillai, 2009) are excluded since it was impossible to quantify them.

Chapter two

Literature review

2.1. General overview and Definition of Medium Enterprises

There is no universally accepted definition of Medium businesses since every country has its own classification according to a certain criteria. But usually the categorization of businesses depends on qualitative judgments such as amount of paid up capital, number of employees, total assets owned and the amount of total annual turnover.

Jeff Bloem (2012) pointed out creating and implementing a worldwide, multilateral definition of both medium and small enterprise is a technical and challenging matter. Therefore, definitions vary not only between multilateral institutions like the World Bank and United Nations but also between countries, largely depending on the size and scope of the economy. For instance, in Britain and USA medium scale industries are classified based on yearly gross revenue and the number of workers they employ. Japan classifies both small and medium enterprises (SMEs) manufacturing enterprises with total capital not exceeding 100 million Yen with 300 employees.

According to the Ethiopian Ministry of Trade (1998) medium enterprises are defined as businesses with total capital investment between Birr 500,000 to Birr 1, 000000. The definition includes high technical consultancy businesses but excludes high tech establishments. Therefore, according to this definition Ethiopia's definition of medium enterprises is based on capital invested and nature of the establishment. But the recent (2011) definition of medium enterprises by the Ethiopian government considers human capital and asset owned by the businesses as the main criteria. This definition, unlike the previous one, makes a distinction between the service and industry sectors too. Regarding the human capital aspect it states that firms that have number of workers not less than 32 and not more than 51 and possess assets worth between Birr 1,500,000 and 15000000 are labeled as medium enterprises.

The new definition which was introduced in the year 2011 is based on human capital and asset owned by the enterprises as the main criteria. This definition unlike the previous one makes a distinction between the service and industry sector too. According to this definition a service rendering enterprise shall be

labeled as micro enterprise if it has five (5) or less employees that work for it and owns asset that is worth fifty thousand or less .But If a service rendering enterprise whose number of employees is equal or greater than six (6) and less than or equal to thirty (30) and owns asset that is less than or equal to 500,000 is labeled as small enterprise. For enterprises that operate in the industry sector to be called a micro enterprise they must employ at least one but not more than five (5) workers and possess asset worth a maximum of a 100,000 or less. But if an enterprise that operates in the industry sector can hire a minimum of six (6) employees or a maximum of thirty employees and owns an asset that is worth a maximum of Birr 1.5 million shall be called a small enterprise.

But Jeff Bloem (2012) argues that defining medium enterprises based on either the number of employees they hire or the measure of their asset would be misleading. He insists that the idea that number of employees leads to economic growth is false. He rather believes that it is economic growth that creates more jobs. According to him the idea that a simple measurement of the number of employees with in an enterprise does not indicate the efficiency of the employees. Also, many countries around the world have taxes in place that actually create a disincentive for the hiring of the employees by entrepreneurs. Entrepreneurs looking to expand their business will hire a new employee if and only if the employee can produce more than they cost. Lastly, each country use more labor for production because labor is cheaper than capital. Likewise in some other countries capital is cheaper than labor. In general as technology advances and access increases an economy tends to lean more heavily on capital rather than labor. Therefore, growth in a technological sense is defined by a decrease in employment.

He further goes on to indicate why it would be wrong to define them based on the measure of the asset the enterprise owns on the ground that the definition of an asset is not universally understood and inflation causes an unknown understatement of the true value of an asset. In addition he also points out the possibility that businesses can minimize the total amount of assets reported for tax reasons and a measurement of assets does not indicate capital efficiency as an additional evidence to back up his argument. Having rejected the two criteria he proposed the annual revenue of an enterprise for defining medium

enterprises. This new criterion ignores number of employees and total assets as variables in the definition and focuses on the annual revenue of the enterprise.

Most large companies have their roots in small and medium businesses suggesting that the future large corporations are the small and medium businesses of today that must be nurtured so that they can grow and expand. Small and medium enterprises are generally perceived to be the seedbed for indigenous entrepreneurship and generate all the varied small investments, which would otherwise not have taken place (Aryeetey & Ahene, 2004). In most OECD countries small and medium enterprises represent over 95% of enterprises and generate over 50% of private sector employment (RBZ, 2009). They also play a central role in the economy of developed countries. According to reports of the European commission (2005) SMEs are a major source of entrepreneurial skills, innovation and employment for European countries too. The tiger economies likewise enjoy the benefits of SMEs. A report of the European Commission reveals that 70-80% of the employment opportunity and 40% of their respective GDP is gotten from SMEs.

Countries that are thought to be Africa's economic power house such as South Africa Egypt and Nigeria earn huge benefit from their SMEs just as the previously mentioned countries. The SMEs in these African countries contribute to over 70% in employment and 30-40% to the GDP of their respective countries. Though one might learn by observation that many of Ethiopia's business fall under this category, the current size of their contribution to the nations GDP, the amount of tax collected from them, their export level and total manufacturing is not exactly known yet (EDRI, 2014).

2.2. Medium Enterprises and Tax Compliance

Medium sized enterprises are an important part of the taxpayer population in any country around the globe. Their taxation usually poses a number of challenges. They are numerous but contribute relatively little to the state coffers, while often absorbing a large share of scarce tax administration resources much needed elsewhere in administering the tax system. Moreover, low levels of tax

compliance are observed among medium enterprises, particularly among the self-employed, thus further reducing potential tax collections and increasing the tax administration effort (Engelshak 2004; OECD, 2009; 2014). Many countries address these issues by adopting simplified tax regimes and implementing dedicated compliance strategies (IFC, 2007; OECD, 2009; Crawford & Freedman, 2010). While the primary objective of a well-designed simplified tax regime is to improve efficiency of taxation, by reducing both compliance costs and tax administration effort, the compliance enhancing strategies aim at the inclusion and more efficient use of different administrative instruments that allow more taxpayers to be brought in to the tax net, encouraging existing tax payers to voluntarily fulfill their tax obligation, and ultimately to create a widespread culture of paying taxes.

There are a number of measures that may be used to boost tax compliance but none of the measures give satisfactory results if implemented alone. They are more efficient when used in a mix of complementary instruments.

2.3. The concept and theory of tax compliance

Various scholars have defined tax compliance in varied ways. For instance, according to Andreoni, Erard & Feinstein (1998:818-860) 'tax compliance is a taxpayers' willingness to obey tax laws in order to attain the economy equilibrium of a country.' On the other hand Song and Yarbrough (1978: 442-452) attach a broader meaning to tax compliance when they defined it 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.' Other authorities also define tax compliance after the same fashion as Song and Yarbrough (1978:442-452), i.e. as 'tax payers' ability and willingness to comply with tax laws, declare the right income in each year and pay the right amount of taxes on the right time.' (IRS, 2009; ATO, 2009). Others still term it as 'an act of filing tax returns, declaring all taxable income accurately, and disbursing all payable taxes within the stipulated period without having to wait for follow-up actions from the authority' (ATO, 2009).

The list of definitions does not end here and many more scholars still define it in a number of ways however all the definitions contain similar terms or concepts to explain and state what tax compliance is and its exact limit. For instance in the forgone three definitions provided by different authorities make an emphasis on the words willingness and ability so as to indicate that tax compliance is closely related with the willingness and ability of a tax payer to abide by the tax rules and laws of the country in which the tax payers live in and work. This implies that in order for a government to collect as much tax as it desires to the tax payers must be both willing and able to pay their tax due and/or voluntarily comply with the demands of the taxing authority.

Compliance in pure administrative terms includes registering or informing tax authorities of status as a tax payer, submitting a tax return (if and when required) every year and following the required payment time frames (Ling, Normala & Meera, 2005: 16-23). In contrast, the wider perspective of tax compliance requires a degree of honesty, adequate tax knowledge and capability to use this knowledge, timeliness, accuracy, and adequate records in order to complete the tax returns and associated tax documentation (Singh & Bhupalan, 2001).

2.4. Tax compliance theories

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. The economic deterrence model has been commonly used to examine tax evasion and compliance from a theoretical perspective. Factors that have been examined in the economic deterrence model include: complexity of the tax system. Level of revenue information services, withholding and information reporting, preparer responsibilities and penalties, probability of receiving audit

coverage, progressive and actual level of tax rates, and penalties for non-compliance. The social/fiscal psychological model on the other hand, focuses on psychological variables which include moral values and the perception of fairness of the tax system and the tax authorities. This approach has often been used in empirical research. The elements and characteristics of the two models are outlined as follows.

2.4.1. Economic deterrence model

Economic deterrence models in general are based on the theory that behavior, in a wide range of contexts including tax evasion, is responsive to punishment or sanctions. Economic deterrence models tend to have a narrow, theoretical view of behavior, reducing its dimensions to numerical measures and assigned probabilities from which outcomes can be predicted using calculus. In order to determine behavior in this manner, economic deterrence models tend to rely up on a wide range of fundamental assumptions that are generally unrealistic. For example that all people respond to a change in anyone variable in an identical and predictable manner; that all taxpayers have the same level of risk preference. Although empirical testing has been limited, the theoretical principles of economic deterrence have been widely adopted by tax administration in developing enforcement strategies that rely principally on penalties and the fear of getting caught (McKerchar & Evans, 2009:171-201).

Despite the positive effect of increased sanctions levels on tax payer compliance having been found to hold where relatively low (and realistic) penalty levels are used (Carnes & Eglebrecht, 1995:26-41). Their overall impact has been questionable. Consequently, traditional economic deterrence models which draw up on expected utility theory and deterrence, mainly in the form of sanctions, have been found wanting. Little empirical evidence to support the prediction of economic deterrence models as a whole has surfaced. Researchers (Roth & Scholz,1989) have, therefore, summarized the effect of factors that determine the monetary cost of compliance including the tax rate, detection probability, the level of income and the penalty structure and suggest that, for

all of them, existing empirical evidence provides no firm conclusion(Hasseldine,2000:299-303). Consequently, having considered the economic deterrence model and its deficiencies, it became apparent that further refinements and improvements needed to be developed to address tax evasion and non-compliance.

2.4.2. Social psychology models

Social psychology models are concerned with the prediction and understanding of human behavior, or how people make decisions, using a range of methodological approaches including compositional modeling, attribution theory and equity theory (McKerchar & Evans, 2009:171-201). Compositional modeling is characterized by the view that individuals undertake deliberate and reasoned action according to their personal preferences. This approach assumes that people consider the implications of their actions before they decide, or form an intention, to engage or not engage in a given behavior. Further, this approach assumes that intention directly translates in to behavior, without any further influences. The model then seeks to explain how intention is formed (Azjen & Fishbein, 1980).On the other hand, attribution theory is based on the assumption that individuals rationally interpret and analyze events in order to understand causal structures. People have internal (personal) and external (situational) attributes. In judging the behavior of others, people will generally attribute the outcome as being caused by their own internal attributes. In judging their own behavior, people tend to believe the cause is due to external attributes. Equity theory proposes that individuals are more likely to comply with rules if they perceive the system that determines those rules to be equitable. Where there are perceived inequities, individuals will adjust their inputs to the exchange until equity is restored. Based equity theory, addressing inequities in the exchange relationship between government and taxpayers would result in improved compliance (McKerchar & Evans, 2009:171-201).

2.4.3. Fiscal psychology Models

Fiscal psychology models draw on both the economic deterrence and social psychology models and generally view tax enforcement as a behavioral

problem, one that can be resolved by cooperation between taxpayers and tax collectors. To obtain this cooperation, the role of the tax system itself in providing the positive stimulus is emphasized. This stimulus is then expected to generate a more positive attitude in taxpayers that will in turn impact on their compliance decisions (McKerchar & Evans, 2009:171-201). It has been held that tax mentality; feelings of tax tension and tax morale were the three psyches that together made up a taxpayer's attitude. The more positive the tax payer attitude towards paying tax, the greater the level of cooperation with the tax authority and the greater the willingness to pay tax. However, fiscal ignorance may be a negative influence on a taxpayer's attitude (Lewis, 1979:245-257).

2.5. A review of tax compliance costs

The term tax compliance cost has different definitions, a consensus as to the precise meaning of compliance costs only began to emerge in the literature about 30 years ago when researches on tax compliance cost left its hitherto state of obscurity to a familiar terrain. Evans (2003:64-92) observed that there is now an extensive and varied literature available that deals with issues relating to tax Compliance cost. Sapiei & Kasipillai (2009) argued that that the challenges faced in tax compliance cost research particularly in the definition and measurement of compliance cost remains a critical issue. The absence of well-built consensus to the extra connotation of compliance cost remains a puzzle. However, a preponderance of definitions still abounds in the tax compliance cost literature. For instance, Sandford (1995) defines tax compliance costs as "the costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities. These are costs over and above the actual payment of tax and over and above any distortion costs inherent in the nature of the tax. These costs would disappear if the tax was abolished. They include the costs of collecting, remitting and accounting for tax on the products and profits of the business and on the wages and salaries of its employees, and also the costs of acquiring and updating the knowledge to enable this work to be done, including knowledge or legal obligations and penalties.

Americans for Fair Taxation (2007) sees tax compliance cost as the total time and money spent on filling out tax forms, keeping records, learning tax rules,

and other tax related matters. Compliance costs of taxation are amount of resources expended by taxpayers, in addition to the amount of tax they are required to pay, in conforming to the requirements of the relevant tax legislation. Compliance costs are not only incurred by taxpayers but by all the agents/parties involved in making possible the transfer of funds from the private sector to the government department that controls public money.

Generally, the burden imposed by taxation systems on business taxpayers typically consists of three elements. In the first place there are the taxes themselves. Secondly there are the efficiency costs and finally there are the operating costs of the tax system.

2.5.1 Types of tax compliance costs

2.5.1.1. Administrative costs

Tax compliance costs from the administrative costs perspective, are the costs that exist besides the occurrence of compliance costs that are borne by the business enterprises. The costs are cited as those that the government must also take in to account as a public cost to ensure that the tax legislation is obeyed. These are to some extent substitutable, for example when a country transfers from a system where the tax office calculates the tax owed, to a self-assessment as was the case in some countries like Indonesia.

2.5.1.2. Time spent, cash expenses and psychological costs

Another dimension of tax compliance cost definition is the division of tax compliance cost in to three parts: time spent, cash expenses and psychological costs. The total time spent employee costs (in-house staff) and external costs (fees paid to outside accountants and other tax advisors). Hours by internal staff can be converted in to expenses by means of an average hour rate. The psychological costs refer to the effects up on a taxpayer having to deal with tax affairs. This type of compliance costs include costs that are incurred by a company, but are beyond the control of its management (Bhatnagar et al., 2002; Hijatulah & Pope, 2008).

2.5.1.3. Internal and external costs

In describing tax compliance cost a distinction is often made between internal and external costs (Blumenthal & Slemrod, 1996:411-438). Internal costs are generated by the accounting and administration department of the enterprise. Internal staff will prepare all information and documents for fiscal authorities and consult external advisors when necessary. External costs are generated by the services from lawyers, consultants and other advisors. These external costs are much easier to identify and quantify. Internal costs are more difficult to quantify since they involve subjective estimations of the time spent on different tax activities. Some studies have revealed that in most companies costs are substantially more important than the external (Tran-Nam, Evans, Walpole & Ritchie, 2000; Hijattulah & Pope, 2008).

2.5.1.4. Computational costs and tax planning costs

In describing tax compliance costs there is also the need to distinguish between computational costs and planning costs. The first are inevitable as for example the costs necessary to have a proper accounting system that already prepares the necessary information and calculate the amounts due for tax purposes. They are considered as recurrent administrative costs which cannot be avoided by the company, but which management can only try to fulfill their administrative duty as efficient (Abd Mansor & Hanefah, 2008). Planning costs on the other hand occur when a company tries to lower or avoid tax payments in a legal manner. The activity is part of good management practices designed to optimize the profitability of the company (Tran-Nam, et al.2000:229-252).

2.5.1.5. Commencement and recurrent costs

The compliance costs of taxation can be viewed from commencement and recurrent costs perspective as well. The former may arise as a result of both legislative change and changes in the taxpayer population while the latter are the regular costs. Generally studies tend to note this distinction and recognize that the frequency of legislative and population change makes disentanglement difficult if not impossible to integrate the two in the measurement of tax compliance costs (Kirsten, 2007 cited in Eragbhe & Modugu, 2014)

2.5.1.6. Accounting costs and tax costs

Compliance costs can be classified as accounting costs and tax costs even though it is not that easy to make a difference between the two. This problem is referred to by Evans (2006) as ‘joint cost problems’. Despite careful attempts in most recent studies to separate tax compliance costs from the underlying cost of being in business referred to by Sandford (1995) in Evans(2006) as ‘core accounting costs’, there is almost certainly some overlap between business or accounting costs. There is uncertainty about the extent of overlap and therefore most estimates of taxation compliance costs can only be indicative at best (Kirsten, 2007 cited in Eragbhe & Modugu, 2014).

2.5.2. Measurement of tax compliance costs

There is uncertainty about what should be included in the measurement of tax compliance costs (Evans, 2006). Whilst this is an area in which there will always be theoretical debate, it is possible to identify a ‘hard core’ of costs that are indisputably part of the costs of complying with taxation requirements. Typically they will include: the time taken in compiling receipts and recording data in order to be able to complete a tax return, the costs of labor/time consumed in completion of tax activities and the costs of expertise purchased to assist with completion of tax activities. For instance, Turner, Smith & Gurd (1998) summarized tax compliances cost in to the following categories:

TCC=taxpayer’s and unpaid helper’s time+ tax agent fees incidental expenses.

This method of measuring tax compliance cost is subjected to the problem of quantifying taxpayer’s and unpaid helper’s time in monetary terms. However, for small businesses that can monetarily quantify time spent on tax matters, the method might be appropriate since most SMEs tax compliance costs of collecting, paying and accounting for tax products or profits of the business, and on the wages and salaries of employees together with the costs of acquiring the knowledge to enable this work to be done. On the other hand, Sandford (1995) makes a difference between gross and net compliance costs; where net compliance costs are equal to gross compliance costs less the value of tax compliance benefits. Net compliance cost may thus be written as:

Net compliance costs=Gross compliance costs-Cash flow benefits

Sapiei and Kasipilai (2009) argue against the above approach on the ground of its complexity and proposed a relatively simpler tax compliance formula that is composed of three major theoretical components namely internal cost, external cost and incidental cost where internal costs refer to time spent by the business staff on tax matter, external costs represent fees paid to tax agents and incidental costs mean those overhead costs that encompass miscellaneous items such as costs incurred for travelling, stationary, computer, telephone, court litigation cost and psychological costs.

Thus, according to Sapiei & Kasipillai (2009) total tax compliance cost can be measured as follows:

$$\text{TCC} = \text{internal cost} + \text{external cost} + \text{incidental cost}$$

Following this Tran_ Nam et al (2000) on their part came up with a new model as which they stated as follows:

Tax compliance cost(TCC)= Direct monetary outgoings incurred by tax payers+ imputed costs of time and resources spent by tax payers on their tax affairs-(managerial benefits to tax payers cash flow benefits to tax payers tax deductibility benefits to tax payers)- reduction in tax deductibility due to tax planning. This model is considered to be a robust one that captures compliance cost.

2.5.3. Tax compliance cost drivers

Shaw, Slemrod & Whiting (2008) have identified a number of factors that may determine the magnitude of compliance costs. According to them compliance costs tend to be lower where the tax is simple, i.e. where the tax has one rate or few rates and where it has few borderlines and reliefs. They also note that when looking at the tax system as a whole, the use of common definitions and procedures across different taxes reduces compliance costs for the taxpayers by decreasing the number of calculations that need to be made.

They also indicated that frequency of change can be a significant driver of tax compliance costs. As noted in a KPMG Report (2006:6) ‘‘change creates both cost and uncertainty’. Frequent change in legislation, or the introduction of new legislation, can significantly impact up on the compliance burden.

Another study by Evans (2003) also confirmed that frequency of change is one of the two most significant of the causes of the compliance burden.

According to the literature the nature of tax itself may also be a driver of compliance costs. Compliance with specific taxes can have a significant impact on overall compliance costs for taxpayers. For instance taxes such as VAT are often associated with high compliance costs because they are transaction based taxes that require comprehensive record keeping and periodical reporting and remitting (Sandford, Godwin & Hardwick, 1989).

2.6. Tax knowledge

Tax knowledge may be defined as the level of awareness or sensitivity of the taxpayers to tax legislation. It encompasses the process, by which taxpayers become aware of tax legislation and other tax related information (Hasseldine, 2009). The influence of tax knowledge on compliance behavior has been proved in many researches (Ali & Asri, 2007). Previous studies have evidenced that general tax knowledge has a very close relationship with tax payers ability to understand the laws and regulations of taxation, and their ability to comply with them (Singh, 2003). Hence those tax payers without tax knowledge may not comply to the tax law of their nations because of factors that emanate from their tax illiteracy.

Knowledge can be influenced by many things among other factors formal education. One's knowledge about an object contains two aspects: positive and negative. Both of these aspects will determine the attitude of a person. The more positive of the knowledge the more positive aspects of the particular object

(Fidel, 2004 cited in Ghoni, 2011). According to Nugroho (2012), higher knowledge and understanding of the taxpayers leads to a better conformance with the tax regulations. Tax payers who do not understand the tax laws are not likely to obey the tax. Thus a better understanding of the tax payers' tax rules, will lead more awareness and thus more voluntary compliance.

Tax behavior entails two main typologies: compliance, which can be either voluntary or enforced (Kircher, Hoelzl & Wahl, 2008:210-225); noncompliance, which can be either tax avoidance or tax evasion. According to the literature, one of the sociological factors influencing tax behavior is tax literacy or the level of tax knowledge held by tax payers (Djawadi&Fahr, 2013) namely the amounts of taxes collected by authorities increase significantly when taxpayers know more about the tax law (Palil & Mustapha, 2011:7-32), tax systems (Watricks, 1994:106-123) or become aware of the negative generated by tax evasion (Holler et al. 2008:597-611).

Nowadays when information is doubling in size and markets are globally connected, the level of tax knowledge has become extremely important for both authorities and taxpayers. On one hand, taxpayers need to be connected to the latest advances of the tax law in order to adequately run their activities. Moreover, they must be aware of the effects generated by their tax behavior on state budgets.

To make voluntary tax compliance salient among tax payers, authorities may turn to different strategies for increasing their level of tax literacy. The involvement of formal schooling institutions could be of help in educating potential tax payers (OECD, 2013). Moreover, based on the fact that that behavioral change can be generated directly by media or indirectly via interactions with social systems, tax authorities may design smart media campaigns informing tax payers of the latest changes in the tax law or the importance of financing public good systems via honest taxpaying (OECD, 2013).

In order to pay appropriate taxes small business owners must be knowledgeable about the different compliance measures and requirements. Taxation knowledge is a specific part of the general human potential of entrepreneurs, which

increases the chances of business success (Haber & Reichel, 2007:119-145).The extent of non-compliance arising from knowledge deficits because of the complexity of reporting and returning requirements might be substantial. Similarly, differential taxation, that is, the need to apply differential taxation rules depending on the amount of income or the characteristics of the taxpayer, is an important explanation for non-compliance among small business owners(Joulfaian & Rider,1998:675-687):excluding source reporting(that is, looking at the overall reported income independent of the reported source) decreases non-compliance rates substantially.

Although an increase in opportunity will often be accompanied by increased knowledge requirements, this is not necessarily the case. For example, if the proportion of differentially taxable incomes changes, evading opportunities may be affected while knowledge requirements remain constant. Thus knowledge requirements need to be discussed separately from opportunities.

Navigating through the legal and procedural issues related to taxation is often taxing in itself. In many countries several forms need to be completed, and detailed records need to be kept. Substantial knowledge about the procedural aspects of tax laws is required. This is particularly challenging since tax laws tend to be changed frequently (Chittenden, Kauser & Poutziour, 2003:93-115) and to be more complex and ambiguous than laws in general (Carnes & Cuccia, 1996:190-209).Tax laws are often too complex to be understood by laymen which many SME business owners undoubtedly are. They were shown to have less tax knowledge than business students in an Australian study (Kirchler, 2007) and felt less competent in making their tax filings than employed persons with even less tax knowledge in an Australian study(Ahmed & Braithwaite,2005:539-568).Though small business managers often deal with perceived knowledge deficiencies by seeking the help of practitioners, they tend to handle part of the taxpaying process themselves and will, at least, have to keep the necessary records.Acquiring taxation knowledge is costly in terms of time (e.g. to become informed, to keep the necessary records to fill out the forms) and money (e.g. tax literature and tax practitioners).

Although there has been a trend towards simplification of tax laws and, more importantly, tax administration procedures, compliance costs tend to remain high (Chittenden et al.,2003) and a sufficient level of knowledge necessary to

ensure procedural compliance is more difficult to reach for small than large businesses(Gaetan,2008).Also, tax practitioners acknowledge that the complexity of taxation is making compliance especially difficult to achieve for small businesses(Berkery & Knell,1992).It can be assumed that,sometimes,small business taxpayers are not even sure about whether they are fully compliant or not this might be interpreted as resulting from a lack of taxation knowledge. However, findings on the relation between knowledge and tax compliance are mixed. On the one hand, highly educated groups were shown to agree more with existing fiscal policies than less educated groups (Schmolders, 1960).Indeed, a low perceived complexity of tax laws (.Kirchler,Hoelzl & Wahl,2008:210-225); education concerning taxation (kasipillai, Norhani & Noor, 2003) as well as subjective (Kirchler, Niemiowski & Wearing, 2006 :502-517) and actual tax knowledge (kirchler & maciejovsky, 2001:173-194) were shown to relate positively to compliance. On the other hand, some researchers found that education was negatively related to compliance (Antonides & Robben, 1995:617-640)-also for small business owners (Hite & Roberts, 1992:115-137) whereas again others found no clear pattern, Chan, Troutman & O'Bryan (2000:83-103) found a small positive effect of education on tax compliance in a US sample, whereas in a Hong Kong sample, education and compliance were unrelated.

Although these cumulative finding are contradictory at first sight, a close inspection indicates that the type of knowledge matters; both general knowledge in terms of education as well as tax-specific knowledge tends to lead to an increase in compliance, presumably because to learn about taxes also means to learn about their necessity in society because this specific knowledge is a greater deterrent. Specific knowledge renders tax attitudes more favorable; increase fairness of perception of the tax system; and leads people to perceive tax evasion as more serious (Erisken & Fallan, 1996: 387-440).

To conclude, knowledge requirements for small and medium business owners' tax compliance are relevant. Tax-specific knowledge is necessary in order to enable the taxpayers' comply as well as to increase their willingness to do so.

Chapter 3

Research design and methodology

3.1. Research method and design

A quantitative research method with a descriptive survey research design is used since it meets the objective of this research which is to assess and describe the size of tax compliance cost incurred by medium businesses, the levels of tax knowledge and tax compliance of tax payers under study. According to Kerlinger (1973) “Descriptive research is concerned with the attempt to determine, describe or identify what is.” (Ethridge, 2004) and “casts light on current issues or problems through a process of data collection that enables to describe a situation more completely than was possible without employing this method” (Fox & Bayat, 2007). Therefore, since the purpose of this study is to address the ‘what’ aspect of the variables under consideration(size of tax compliance cost, level of tax knowledge and degree of compliance) descriptive research design is used.

3.2. Target population

The population of this study is medium enterprises that fall under category 'A' tax payers division and operate in Lideta sub city of Addis Ababa city administration. According to the information earned from the Ethiopian Ministry of Trade and Ethiopian Revenue and Customs Authority the total number of medium enterprises that exist and operate in Lideta sub city is 220. The medium enterprises are classified under six major business divisions namely: manufacturing, construction, wholesale and retail, transport, storage and communication works, community, social and private services and financial, insurance, real-estate and other trade divisions.

3.3. Sample design and sampling technique

Sample size was determined based on the Krejcie and Morgan table which was formulated by Krejcie and Morgan (1970) and adopted by the United States National Education Association as an appropriate method or technique for determining smallest possible sample size in social science studies. The scholars mentioned prepared the sample determining table based on the formula that is illustrated below.

$S = \frac{X^2 NP(1-P)}{d^2(N-1) + X^2 P(1-P)}$ where,

S= required sample size

X^2 = the table value of chi-square for 1 degree of freedom at the desired confidence level which is equal to 3.841

N= the population size

P= the population proportion (which is assumed to be 0.5 since this would provide maximum sample size) and

d= the degree of accuracy expressed as a proportion (.05)

Therefore, according to Krejcie and Morgan table (Ibd) the minimum number of sample size was determined as 140. The sample contains business enterprises from all divisions and is composed of 5 manufacturing enterprises, 43 construction companies, 67 wholesale and retail businesses, 12 transport, storage and communication service providers, 8 community, social and private services rendering enterprises and 5 financial, insurance, real estate and other trade conducting firms.

Simple random technique involves taking or selecting a set of n objects from a population of N objects where all members of the population are equally likely to be selected. Besides, the simple random sampling technique is believed to remove bias from the selection procedure and results in representative sample (Gravetter & Forzano, 2009). Its application is justified when all the elements of the population are known and are homogenous (Abate, 2011).

Therefore simple random sampling technique is applied in this study as all the units of analysis are known and exhibit homogeneity in that they belong to the same business size category (medium size businesses) and fall under similar tax payers' category (category 'A' taxpayers). The steps or procedure followed in applying the technique started with making a list of the sampling frame followed by giving a sequential number to them and then numbers were generated by using a random number generator to select the elements that made up the specific sample.

3.4. Source and tools of data collection

Primary data was collected from the respondents using self-administered questionnaires. Most of the questionnaires presented to the respondents were structured questionnaires that contain closed ended questions though unstructured questionnaires with open-ended questions were used as well to gather the desired information. A total of 140 questionnaires were distributed and all of them were returned resulting in a 100% rate of return.

3.5. Data analysis and presentation

A quantitative data analysis was carried out using SPSS version 20 and the excel sheet. Descriptive statistical tools such as percentages, frequencies, averages and charts were used to present the results of the analysis.

Chapter 4

Data analysis and presentation

This chapter presents the results of the study based on the formulated objectives. The chapter is divided in to six major sections. Demographic characteristics of the participants and profile of their respective enterprises are presented in the first and second sections respectively. The third section dwells on analysis and results of participants' responses regarding general tax compliance questionnaires. The fourth section presents the analysis of responses regarding tax compliance costs namely external, internal and incidental tax compliance costs. The fifth and sixth sections present analysis and results of participants' responses regarding tax knowledge and tax compliance level.

4.1. Demographic characteristics of respondents

Table1. Demographic characteristic of respondents

Description	Frequency	Percent
Gender distribution		
Male	99	70.7
Female	41	29.3
Total	140	100.0
Age category		
20-30	25	17.9
31-40	67	47.9
41-50	38	27.1
Above 50	10	7.1
Total	140	100.0
Educational qualification		
High school certificate	42	30
Diploma	53	37.9

BA(BSc) degree	39	27.9
Masters	1	0.7
Other	5	3.6
Total	140	100.0

As can be seen from table1 the gender composition of respondents was 70.7% and 29.3% for male and female respectively. With regard to their age category 47.9% of the respondents fall under the 31-40 age category, 27% of them are between 41-50 years of age, the 20-30 age bracket groups comprises 17.9% of the respondents and the rest 7.1 of the respondents are above 50 years of age. This implies that more than 60% of the respondents are less than or equal to 40 years of age. Regarding the educational qualification of the respondents 30% of them completed high school, diploma and BA (BSc) degree holders comprise 37.9% and 27.9% of participants respectively.0.7% of them is a masters degree holder and the rest 3.6% participants are either high school dropouts or have completed their elementary school study. From this it is easy to infer that majority of the respondents do have a good background of formal education.

4.2. Profile of the business enterprises

4.2.1. Major business division of the enterprises

The enterprises are all medium size businesses that fall under category ‘A’ taxpayers division. The sample contains business enterprises from all divisions and is composed of 5 manufacturing enterprises, 43 construction companies, 67 wholesale and retail businesses, 12 transport, storage and communication service providers, 8 community, social and private services rendering enterprises and 5 financial, insurance, real estate and other trade conducting firms. The tabular presentation of the analysis result is presented in table2.

Table 2. Major division of the enterprises

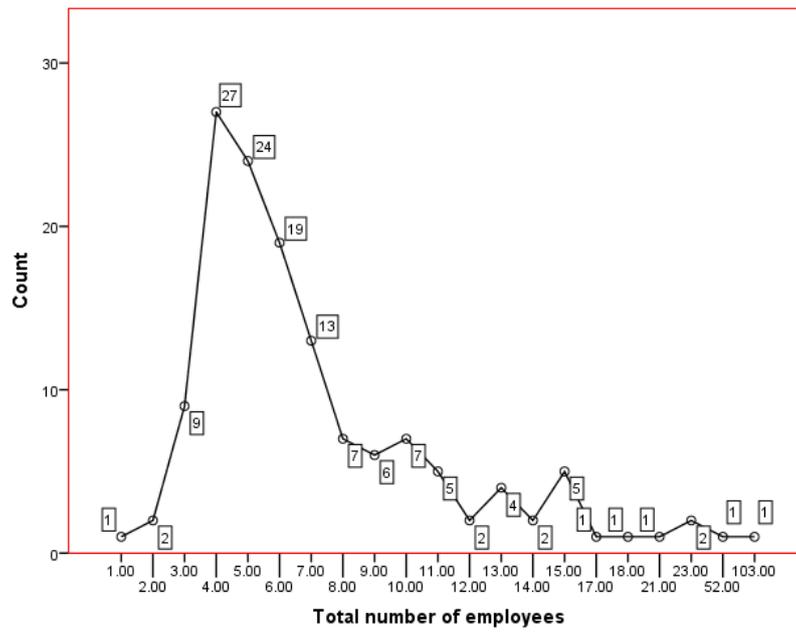
Major business division	Frequency	Percent
Manufacturing	5	3.6

Construction	43	30.7
Wholesale and retail	67	47.9
Transport, storage and communication works	12	8.6
Community, social and private services	8	5.7
Financial, insurance ,real-estate and other trade	5	3.6
Total	140	100.0

4.2.2. Total number of employees

As can be seen from the under presented graph the majority of the enterprises have employee number less than 10.

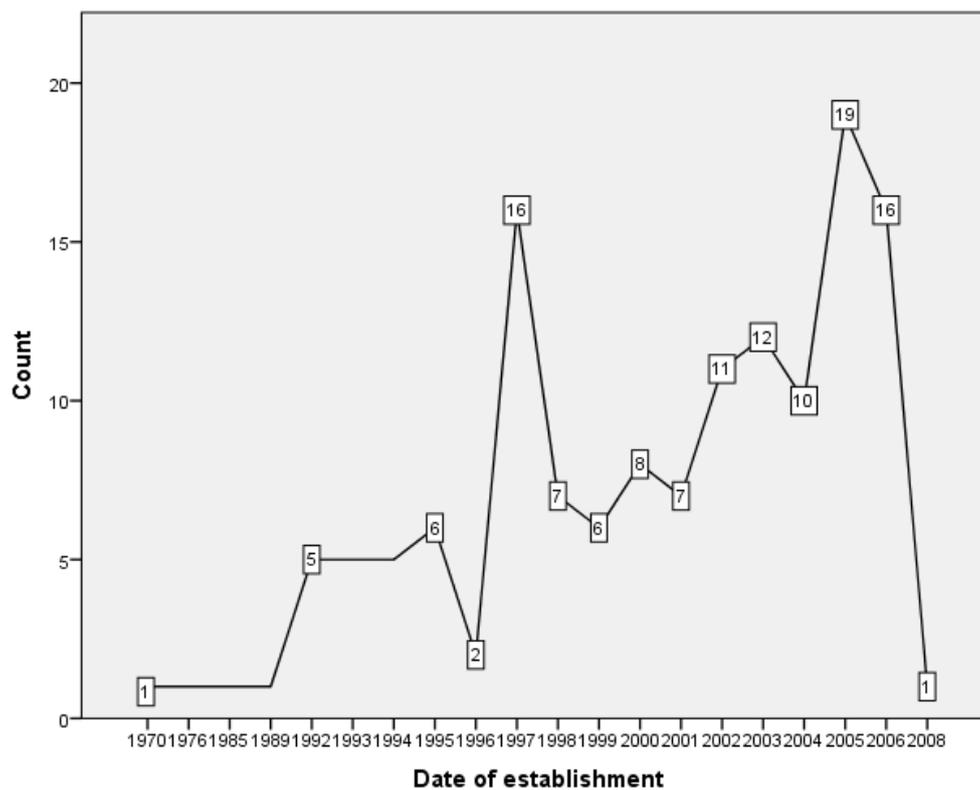
Figure 1. Total number of employees



4.2.3. Date of establishment of the enterprises

The majority of the enterprises have been in business for a longer period of time. As the results of tax knowledge analysis of respondents indicated most of them are well aware of the tax laws that govern and regulate their businesses. This knowledge level might be due to their long time handling of tax matters. Besides the information they provided can be reliable as they have been in the business for longer period of time. The under situated chart illustrates the detailed information about the date of establishment of the businesses

Figure 2.Date of establishment of the enterprises



4.3. Analysis of general tax compliance questions

General questions related to tax compliance costs were presented to the participants of the research so as to know if they hire external agents or use in-house accounting services, what type of accounting method they employ and if they will go on hiring external agents and/or using a computerized accounting system had their businesses been free from all tax charges. The result of their responses are illustrated in the under presented tables.

4.3.1. Analysis of external tax agents hiring practice

The analysis result indicated that 78% of the participants hire external tax agents for handling their tax related affairs. This implies that they neither incur accounting expenses nor spend time to carry out in-house accounting activities. The tax compliance costs they incur are incidental costs and the fees they pay to external tax agents. On the other hand 44.3% of the respondents have indicated that they use in-house accounting service and thus do not hire external tax agents. As such is the case they incur accounting costs, incidental costs and spend time in their act to comply with tax requirements. With regard to the frequency of occurrence of outsourcing, all the outsourcing enterprises, i.e. 55.7% indicated that they hire external agents all the time. Respondents were also asked if they would continue hiring external tax agents had their businesses been free from all tax obligations. The overwhelming majority (75%) of the respondents expressed that they would not hire external tax agents had their business been tax free but the rest 2.1% percent said that they will go on using external agents' service regardless of the absence or presence of tax requirements. This implies that the overwhelming majority of outsourcing enterprises outsource their accounting activities due to compliance requirements.

The summary of respondents' answers on their practice of hiring external tax agents, the frequency of their outsourcing occurrence and the possibility of hiring

external tax agents in the case of absence of tax compliance requirements is illustrated in table 3.

Table3. Summary of respondents' answer about hiring practice of external tax agents

Items	Responses					
	Yes			No		
	Frequency	Percent	Frequency	Percent	Frequency	Percent
	Act of hiring external tax agents or outsourcing	78	55.7%	62		44.3%
Frequency of outsourcing practice occurrence	Responses					
	All the times		Sometimes		None of the time	
	Frequency	Percent	Frequency	Percent	Frequency	Percent
	78	55.7%			62	44.3%
Possibility of hiring external agents had businesses been free from tax compliance requirements	Responses					
	Yes			No		
	Frequency	Percent	Frequency	Percent	Frequency	Percent
	3	2.1%	75		53.6%	

4.3.2. Analysis of respondents' answers regarding the type of accounting methods they employ

As it was shown in the foregone analysis result only 44.3% of the respondents use in-house accounting service and that the rest 55.7% outsource their tax related affair to external tax agents. Out of the total 44.3 respondents that use in-house accounting service only 15% employ paper based accounting method and the rest 29.3% employ computerized accounting system.

Out of the 29.3% respondents who employ computerized accounting method 20.7% indicated that they would have not used computerized accounting method had their businesses been free from meeting tax obligations. This implies that their practice of using a computerized accounting method would have been avoided had they been tax free. But 12% of the respondents have indicated that they would go on using this practice even if they had been free from any tax charge thus indicating that their act of using a computerized accounting system has no a direct relationship with tax compliance requirements.

The results of the analysis of respondents' answers are illustrated in table 4.

Table 4. Summary of respondents' answer about accounting methods employed

Questionnaire	Responses			
	Paper based method		Computerized method	
	Frequency	Percent	Frequency	Percent
Accounting method employed	21	15%	41	29.3%
Will to use computerized accounting system where there is no tax	Responses			
	Yes		No	
	Frequency	Percent	Frequency	Percent
	12	8.6%	29	20.7%

compliance requirement				
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4.3.3. Analysis of respondents' answers regarding the type of taxes for which external costs were incurred

Respondents were asked the type of taxes for which they hire external tax agents and thus incur costs. Analysis of their responses indicated that out of the total 78% of respondents that hire external agents, all (78%) incur costs due to income taxes and 66% pay external costs for both withholding taxes and VAT. As can be seen from the result 12% of the respondents (78%-66%) do not incur external costs for withholding taxes and VAT as they are free from paying VAT and withholding taxes.

Table 5. Type of taxes compliance costs are incurred for

Type of taxes costs are incurred for	Frequency	Percent
Income tax	78	55.7
VAT	66	47.1
Withholding tax	66	47.1

4.4. Analysis of respondents answers on tax compliance costs

Tax compliance costs fall under two categories namely internal tax compliance costs and external tax compliance costs (Blumenthal and Slemroad, 1996). Internal costs refer to those costs that arise from the accounting and administrative department and they include cash expenses and internal time spent on tax related matter. External costs are generated by the services from external tax agents (or accounting firms), lawyers and tax advisors (Walpole & Ritchie).

According to Sapiei and Kasipillai (2009) total compliance costs can be measured based on the following formula:

$TCC = \text{Internal costs} + \text{External costs} + \text{Incidental costs}$, where

Internal costs refer to time spent by the business staff on tax matter

External costs represent fees paid to tax agents and

Incidental costs refer to miscellaneous items such as costs incurred for travelling, stationery etc.

The formula illustrated above is used in this study to measure tax compliance costs incurred by the business enterprises under study.

In this study the internal costs refer to the time spent internally by the business staff on accounting activities in relation to meeting tax compliance requirements and the incidental costs incorporate the following items namely: costs incurred for accounting software, photocopying and fax, postal and telephone, travelling, purchase of tax publications and journals and office supplies. The external costs represent fees paid to external tax agents (external accountants) alone.

Internal time cost corresponds to or equals to the amount of cash outlays made to internal staff.

Here under come the results of the analysis of both external costs and internal costs one after the other.

4.4.1. External compliance cost analysis

As it is already mentioned in the context of this study external cost refers to the amount of total costs outsourcing businesses incur for external tax agents (external accountants). According to responses given by the participants of this study the minimum amount of cost incurred for external agents is Birr 3600 and the maximum amount is Birr 30000. The average amount of cost they incurred per year amounts to Birr 13881. There seems to exist a high degree of variation (Range= 30000-3600=26400) in the amount of cash outlays made for external services hired. This may be because of availability of

external accountants or tax agents that attract more customers based on a low cost strategy or some of them are forced to accept a low payment offer from their hirers as they do lack an official license that certifies their services. A summary of the amount of cost incurred to external tax agents (external accountants) is indicated in table 6.

Table 6. Summary of respondents' answers about external costs incurred

Values of costs incurred in Birr (V)	Frequency (F)	Percent	V*F in Birr
3600	2	1.4	7200
6000	6	4.3	36000
8000	12	8.6	96000
8500	7	5.0	59500
10000	5	3.6	50000
12000	5	3.6	60000
14000	6	4.3	84000
15000	4	2.9	60000
16000	8	5.7	128000
18000	9	6.4	162000
20000	7	5.0	140000
25000	2	1.4	50000
30000	5	3.6	150000
Total	78	55.7	
Total cost incurred			1082700
Average cost incurred			13880

4.4.2. Internal compliance costs analysis

As it is already pointed out internal costs refer to the cost of time spent by business staff in carrying out different activities such as computation of taxes and bookkeeping and recording. The time spent is then quantified and converted in to cash amount. The types of in-house activities that are considered in this study are: computation of taxes, bookkeeping and recording, completing tax return forms, dealing with external tax agents and ERCA and attending tax trainings. The analysis of time spent on each activity is presented both in monthly and yearly bases based up on the responses of the participants. When it comes to computing the cost values of internal time spent, it is assumed that the total cash outlay made for time spent corresponds to the amount of money paid to business staff in the form of salary and allowances.

4.4.2.1. Analysis of internal time spent on various in-house activities

4.4.2.1.1 Internal time spent on tax computing activities

According to participants' responses 38.6% percent of the enterprises use in-house staff to handle their VAT affair. In response to the question "how much time do you spend per month to compute VAT? 22.9% of them replied 1hour, 7.9% responded 2 hours, 5.7% answered 3 hours and the rest 2.1% indicated that it takes them 4 hours to compute VAT per month. As it is indicated in table 5 the average number of hours spent on computing tax amounts to 1.67 hour.

The other type of tax which is computed using in-house staff is withholding tax.38.6% of the respondents have indicated that they take care of its computation on their own. With regard to the time it takes them to compute withholding tax per month their responses were as follows:7.9% replied an hour, 25% responded 2 hours and 5.7 % of them said that it takes them 3 hours to compute withholding tax per month. The average time spent on computing withholding tax is 1.94 hours.

On the other hand all of the firms who use in-house accounting service (44.3% of the entire participants) spend internal time on computing income tax since they are

required to comply with income tax requirements. In response to the question that was presented to them regarding the amount of time they spend per month on computing income taxes, 5% of the respondents answered as 1 hour, 12.1 % stated that it consumes 2 hours and the rest 27.1 % indicated that it takes them 3 hours per annum to compute income tax.

The summary of the analysis of respondents' answers is presented in table 7 which is available in the following page.

Table7. Summary of time spent on computing miscellaneous tax types

Items	Responses (R)	Frequency (F)	Percent	R*F
Time spent on computing VAT	1 hour	32	22.9	32
	2 hours	11	7.9	22
	3 hours	8	5.7	24
	4 hours	3	2.1	12
Total		54	38.6	
Total time spent				90 hours
Average time spent				1.67 hour
Time spent on computing withholding tax	Responses	Frequency	Percent	R*F
	1 hour	11	7.9	11
	2 hours	35	25.0	70
	3 hours	8	5.7	24
Total		54	38.6	
Total time spent				105 hours
Average time spent				1.94 hour
Time spent on computing income tax	Responses	Frequency	Percent	R*F
	1 hour	7	5.0	7
	2 hours	17	12.1	34
	3 hours	38	27.1	114

Total		62	44.3	
Total time spent				155 hours
Average time spent				2.5 hours

4.4.2.1.2. Internal time spent on bookkeeping and recording

Respondents were also asked about the amount of time they spend on bookkeeping and recording activities. Their responses range from 20 hours per month to 100 hours per month. To be more specific their responses were as follows: 10.7% participants answered 20 hours, 10% of them replied as 30 hours, 7.9% stated that it takes them 40 hours, 8.6% of the respondents said 60 hours, another 2.9% answered 80 hours and the remaining 1.4% indicated that they spend 100 hours on bookkeeping and recording. The average time spent on bookkeeping and recording per month is 41.42 hours. As it can be seen from respondents' answers there is a big difference between firms regarding the amount of time they spend to take care of book of accounts and records. This can be attributed to the type of accounting method they employ and/or the volume of their respective business transactions. The summary of the respondents' analysis is tabulated and presented here under in table 8.

Table 8. Summary of time spent on bookkeeping and recoding activities

Item	Responses (R)	Frequency (F)	Percent	R*F
Time spent on bookkeeping and recording	20	15	10.7	300 hours
	30	14	10.0	420 hours
	40	11	7.9	440 hours
	42	4	2.9	168 hours
	60	12	8.6	720 hours
	80	4	2.9	320 hours
	100	2	1.4	200 hours

Total		62	44.3	
Total time spent				2568 hours
Average time spent				41.42 hours

4.4.2.1.3. Internal time spent on completing tax return forms and attending tax trainings

In response to the question: “How long does it take you to complete return forms per month?” the participants gave four type of answers that range from ½ hour a month to 3 hours a month. 26% of them showed that completing tax return forms takes them 1 hour, 1.4% responded 3 hours, 5.7% of them said 2 hours and another 5 of the participants indicated that completing or filling out tax forms takes them ½ a month. It can be seen from their responses that most of the enterprises that fill out return forms in-house spend only an hours to complete the return forms. The average number of hours spent on (average time spent) completing tax return forms is 1.16 hour.

93.6% of the respondents indicated that it takes them 1.33 hours per month to attend tax trainings and the remaining 6.4 % of the respondents stated that it takes them 1.33 -2 hours to attend tax trainings. The average time spent on attending taxes is 1.34 hour per month.

The summary of the details on participants’ responses analysis is presented in table 9.

Table 9. Summary of time spent on completing tax return forms and attending tax trainings

Questionnaire	Responses (R)	Frequency (F)	Percent	R*F
Time spent on completing tax return forms	½ hour	7	5	3.5 hours
	1 hour	37	26.4	37 hours
	2 hours	8	5.7	16 hours
	3 hours	2	1.4	6 hours
Total		54	38.6	
Total time spent				62.5 hours
Average time spent	1.16 hour			1.16 hour
Time spent on attending tax trainings	Responses			
	1.33 hour	131	93.6	174.23 hours
	1.33 hour-2 hours	9	6.4	
Total		140	100.0	
Total time spent				187.6 hours
Average time spent				1.34 hours

4.4.2.1.4. Internal time spent on dealing with ERCA and external agents

The information provided by the participants indicates that the enterprises spend 2-4 hours of time per month in relation to ERCA. The composition of responses was as follows: 17.1% respondents showed that they spend 2 hours, 25% responded as 3 hours and the rest 57.9% of the respondents said that dealing with ERCA takes them 4 hours a month. With regard to dealing external agents' most of the respondents (42.1%) indicated that it takes them 3 hours per month to deal with external tax agents. An analysis of respondents' answers indicates that the minimum time spent on dealing external agents is 2 hours per month which is the case of 8.6% of the respondents. 2.9% percent of them answered as 4 hours and the rest 2.1% expressed that it takes them 6 hours per month to deal with external agents.

The summary of the details of participants' responses is indicated in table 10.

Table 10. Summary of time spent on dealing with ERCA and external agents

Questionnaire	Responses (R)	Frequency (F)	Percent	R*F
Time spent on dealing with ERCA	2 hours	24	17.1	48 hours
	3 hours	35	25.0	105 hours
	4 hours	81	57.9	324 hours
Total		140	100	
Total time spent				477 hours
Average time spent				3.41 hours
Time spent on dealing with external tax agents	Responses			
	2 hours	12	8.6	24 hours
	3 hours	59	42.1	177 hours
	4 hours	4	2.9	16 hours
	6 hours	3	2.1	18 hours
Total		78	55.7	
Total time spent				235 hours

Average time spent				3 hours
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As shown in the foregone part of the analysis time spent on activities such as computation of taxes, bookkeeping and recording, dealing with external agents and ERCA, completing tax return forms and attending tax trainings was indicated. Here under an effort is made to present the summary of the average time spent for all activities on monthly and yearly basis. As can be seen from table 11 Bookkeeping and recording is the activity that consumes most of the time spent and the activity that consumes the least time is completing tax return forms.

Table 11. Summary of average time spent on miscellaneous activities

Activities	Average time spent per month	Average time spent per year
Computing VAT	1.67 hour	20.04 hours
Computing withholding tax	1.94 hours	23.28 hours
Computing income tax	2.5 hour	2.5 hour
Bookkeeping and recording	41.42 hours	497.04 hours
Completing tax return forms	1.16 hour	13.92 hours
Attending tax trainings	1.34 hour	16.08 hours
Dealing with ERCA	3.41 hours	40.92 hours
Dealing with external agents	3 hours	36 hours
Total internal time spent	56.44 hours	677.28 hours
Average internal time spent		56.44 hours

4.4.2.2. Analysis of cost values of internal time spent on in-house compliance activities

The cost value of the time spent by business staff in carrying out activities that are meant to comply with tax requirements corresponds to the amount of cash paid to the staff in the form of salary and allowances since the staff gets paid for his/her time wasted while carrying out those activities. With this in mind respondents were

asked to indicate the amount of accounting personnel salary and allowances expenditures they make to their respective staff. The responses indicated that the amount of salary expenses and allowances paid to staff range from Birr 15,000 (paid by 2.9% of the enterprises) to Birr 60,000 (paid by 0.7 % of the enterprises) per year. Most of the respondents (25.7 %) indicated that their respective enterprises expend Birr 40,000 per year for in-house staff. Salary expenses of Birr 50,000, Birr 24,000 and Birr 30,000 are paid by 2.1% of the enterprises each. Another 2.9% and 1.4% of the respondents showed that they incur Birr 42,000 and Birr 48,000 respectively. The average salary and allowances expense (average time cost) amounts to Birr 36,967. Hence, from this it can be deduced that the average internal time cost amounts to Birr 36,967 as well.

The summary of respondents' answers is indicated in table 12.

Table 12. Summary of respondents' answers about Personnel salary and allowances

Item	Responses (R)	Frequency (F)	Percent	R*F
Cash outlays made for accounting personnel salary and allowances	15,000 Birr	4	2.9	60000 Birr
	24,000 Birr	3	2.1	72000 Birr
	26,000 Birr	6	4.3	156000 Birr
	30,000 Birr	3	2.1	90,000 Birr
	40,000 Birr	36	25.7	1440,000 Birr
	42,000 Birr	4	2.9	168000 Birr
	48,000 Birr	2	1.4	96000 Birr
	50,000 Birr	3	2.1	150000 Birr
	60,000 Birr	1	0.7	60,000 Birr
Total		62	44.3	
Total cost incurred				2,292,000 Birr
Average cost charged				36,967 Birr

4.4.3.. **Incidental costs analysis**

The types of incidental costs that are considered in this study are costs incurred for accounting software, photocopying and fax, postal and telephone, travelling, purchase of tax related journals and publications and office supplies. The amount of the incidental costs are related to costs of complying with tax requirements and do not include the costs that are incurred in the normal course of the businesses under study.

4.4.3.1. **Accounting software and travel costs**

According to respondents' answers out of the total 29% enterprises that employ computerized accounting system 20.7% expend Birr 4800 for accounting software per year, 7.1% spend Birr 5000 and the rest 2.1 % incur Birr 6000 per year. The average cost incurred for accounting software is Birr 4933 per year.

Analysis of the respondents' answers about the amount of travelling expenses they incur per month indicates that a maximum of Birr 3000 (incurred by 7.1% of the enterprises) and a minimum of Birr 500 (incurred by 4.3% of the enterprises) is incurred for travelling per year. Other responses were as follows: 29.3% incur Birr 1000, 13.6% incur Birr 1500, 31.4% incur Birr 2000 and the rest 14.3% percent incur Birr 2000 per year. The average travelling cost incurred per year is Birr 1718. Summary of the analysis is summarized and presented in table 13 which is located in the following page.

Table 13. Summary of responses about travelling & software costs

Items	Responses (R)	Frequency (F)	Percent	R*F
Costs incurred for travelling	500 Birr	6	4.3	3000 Birr
	1000 Birr	41	29.3	41000 Birr
	1500 Birr	19	13.6	28500 Birr
	2000 Birr	44	31.4	88000 Birr
	2500 Birr	20	14.3	50000 Birr
	3000 Birr	10	7.1	30000 Birr
Total		140	100.0	
Total cost incurred				240500 Birr
Average cost incurred				1718 Birr
Costs incurred for accounting software	4800 Birr	29	20.7	139200 Birr
	5000 Birr	10	7.1	50000 Birr
	6000 Birr	3	2.1	18000 Birr
Total		42	29.9	
Total cost incurred				207200 Birr
Average cost incurred				4933 Birr

4.4.3.2. Photocopying and fax costs

According to participants' responses the minimum amount of cost incurred is Birr 2800 per year (only by 0.7 % or 1 enterprise) and the maximum cost incurred is Birr 12000(only by 0.7% or 1 enterprise).The most frequently seen cost value is Birr 6000 which is incurred by 29.3% of the respondents. The average cost incurred for photocopying and fax amounts to Birr 6170 per year. The details of respondents' answers regarding amount of cost their enterprises incur is summarized and presented in table 14.

Table 14. Summary of responses about photocopying and fax costs

Item	Responses (R)	Frequency (F)	Percent	R*F
Cost incurred for photocopying and fax	2800 Birr	1	0.7	2800 Birr
	3000 Birr	14	10.0	42000 Birr
	4000 Birr	11	7.9	44000 Birr
	4500 Birr	1	0.7	4500 Birr
	5000 Birr	15	10.7	75000 Birr
	5500 Birr	4	2.9	22000 Birr
	6000 Birr	41	29.3	246000 Birr
	7000 Birr	19	13.6	133000 Birr
	7500 Birr	2	1.4	15000 Birr
	8000 Birr	16	11.4	128000 Birr
	8500 Birr	7	5.0	59500 Birr
	9000 Birr	1	0.7	9000 Birr
	10000 Birr	6	4.3	60000 Birr
	11000 Birr	1	0.7	11000 Birr
12000 Birr	1	0.7	12000 Birr	
Total		140	100.0	
Total cost incurred				863800 Birr

Average cost incurred				6170 Birr
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4.4.3.3. Postal, telephone and tax publication costs

Analysis of respondents answers indicate that the minimum amount of cost incurred for postal and telephone services is Birr 500 (which is amount incurred by 12.1% of the enterprises) and the maximum postal and telephone cost amounts to Birr 7000 (which is amount incurred by 0.7% of the enterprises only). Responses indicate that the most frequent cost value is Birr 1500 which is incurred by 35.7% of the enterprises. Postal and telephone cost values of Birr 1000 and 2000 are paid by 12.1% and 19.3% of the enterprises respectively. Other cost values indicated were Birr 700, Birr 900 and Birr 2700 by 0.7 % respondents each and Birr 3000 by 25% of respondents. The average cost incurred for postal and telephone services amounts to Birr 1720 per year.

With regard to cost incurred for the purchase of tax journals and publications responses indicate that 73.6 of the entire participants purchase tax journals and publications prepared by ERCA. Respondents' answers indicate that 15% of those who purchase journals spend Birr 720, other 10.7% of them incur Birr 960 and the rest 47.9% spend Birr 2880 per year on tax journals and publications. The average cost incurred for tax journals and publications is Birr 2160 per year.

The summary of the details of respondents' answers regarding the cost their respective enterprises incur is presented in table 15 which is available in the following table.

Table 15. Summary of responses about postal, telephone and tax publications costs

Items	Responses	Frequency	Percent	R*F
postal and telephone costs	500 Birr	17	12.1%	8500 Birr
	700 Birr	1	0.7%	700 Birr
	900 Birr	1	0.7%	900 Birr
	1000 Birr	17	12.1%	17000 Birr
	1500 Birr	50	35.7%	75000 Birr
	2000 Birr	27	19.3%	54000 Birr
	2700 Birr	1	0.7%	2700 Birr
	3000 Birr	25	17.9	75000 Birr
	7000 Birr	1	0.7%	7000 Birr
Total		140	100%	
Total cost incurred				240800 Birr
Average cost incurred				1720 Birr
Tax journals and publication cost				
	720	21	15	15120
	960	15	10.7	14400

	2880	67	47.9	192960
Total cost incurred		103	73.6	222480
Average cost incurred				2160

4.4.3.4. Office supplies cost

Analysis of the responses indicates that all the enterprises incur office supplies cost because of tax compliance activities. According to their responses the minimum cost incurred for office supplies amounts to Birr 3500 per year (incurred by 11.4% of the enterprises) and the maximum cost incurred amounts to Birr 15,000 per year. The average cost incurred for office supplies is Birr 7082.

The summary of the details of respondents' answers and the average costs incurred for each individual item are presented in table 16 and table 17 respectively.

Table 16. Summary of responses about office supplies cost incurred

Questionnaire	Responses (R)	Frequency (F)	Percent	R*F
Costs incurred for office supplies	3500	16	11.4	56000
	4000	14	10.0	56000
	5000	12	8.6	60000
	5500	15	10.7	82500
	6000	17	12.1	102000
	7000	10	7.1	70000
	7500	14	10.0	105000
	8000	7	5.0	56000
	9000	14	10.0	126000
	10000	3	2.1	30000
	12000	6	4.3	72000
	14000	4	2.9	56000

	15000	8	5.7	120000
Total cost incurred		140	100.0	991500
Average cost incurred				7082

Table 17. Summary of average incidental costs incurred

Items	Average cost incurred per year
Accounting software	4933 Birr
Photocopying and fax	7670 Birr
Postal and telephone	1543 Birr
Travelling	1718 Birr
Tax publications and journals	2160 Birr
Office supplies	7082 Birr
Total average incidental cost incurred	62073 Birr

To summarize, as it is indicated at the outset of the compliance cost analysis part the formula used to measure tax compliance costs is the one which was proposed by Sapiei and Kasipillai (2009). According to this formula total tax compliance costs are the sum of internal costs, external costs and incidental costs.

$$\text{TCC} = \text{Internal costs} + \text{External costs} + \text{Incidental costs}$$

Based on the analysis of respondents' answers computations of averages for internal costs, external costs and incidental costs were computed as follows:

Total average compliance cost= average internal costs + average external costs +average incidental costs.

According to the analysis average internal costs were found to be 36967, average external costs amounted to Birr 13880 and average incidental costs amounted to Birr 62073.

As it is also indicated in the outset of the analysis part 78 firms outsource their tax affairs. This implies that these firms do not spend internal time on in-house accounting services. Hence, they do not incur internal costs. All they incur is external and incidental costs. On the other 62 of the enterprises do not outsource their tax affairs and thus employ in-house service. Therefore, external costs are excluded from the computation of average tax compliance.

Accordingly, average tax compliance cost is computed as follows:

1. Average tax compliance cost incurred by an outsourcing enterprise

Average TCC= average external costs + average incidental costs

Average compliance cost= 13880 + 62073 =75953

2. Average tax compliance cost incurred by an enterprise that do not outsource

Average TCC= Internal cost+ incidental costs

TCC= 36967 + 62073 = 99040

As can be seen from the above shown computation each enterprise that outsource its tax affairs to external tax agents incurs an average tax compliance cost of Birr 75953 per year and an enterprise that uses in-house staff service to take care of its tax matters incur an average tax compliance cost of Birr 99040 per year.

Moreover, the total tax compliance cost incurred by all the enterprises (Aggregate cost) per year is computed as follows:

1. Total tax compliance cost incurred by all outsourcing companies

TCC= total external costs paid by all firms + total incidental costs incurred by all firms

$$TCC= 1082700 + 991500=2074200$$

2. Total tax compliance cost incurred by firms that use in-house staff service

TCC= total internal costs paid by all firms + total incidental costs incurred by all firms

$$TCC=2292000+991500=3283500$$

The results of the above computation informs that the total tax compliance cost (aggregate cost) incurred by all the outsourcing enterprises under study amounts to Birr 2074200 and the total tax compliance cost(aggregate cost) for firms that do not outsource amounts to Birr 3283500.

4.5. Tax knowledge

In this study an effort was made to understand the level of tax knowledge among the medium enterprises under study. To this end different questions were presented to the respondents. The questions asked were divided in to two parts and encompassed general tax knowledge questions and questions that test questions to see how deeper the knowledge of the respondents is.

4.5.1. Analysis of responses given to general tax knowledge questions

The number of general tax knowledge questions presented to the respondents were 10 in number and they were all dichotomous questions with ‘yes’ or ‘no’ answer choices. They were meant to understand the level of respondents’ knowledge of Ethiopian tax law and their awareness about business tax obligations, responsibility about accuracy of business tax affairs, relationship between tax and public expenditures, timely payment of tax liability, documents required by ERCA during

conduction of audit, the need to keep record of all business transactions and time and place of tax payment.

Analysis of the respondents answers indicate that out of the entire 140 participants 72.9% indicated that they do know about Ethiopian tax laws and the rest 27.1% said that they do not know about the country's tax law. 100% of the respondents unanimously indicated that they are well aware about their business tax obligations, being held responsible for the accuracy of business tax affairs, the need to pay taxes on time, the need to keep record of all business transactions, time and place of payment and offensiveness of tax noncompliance by selecting the answer choice 'yes'. Moreover, 90% of the respondents indicated that they know about the fact that taxpayers' money are used to finance public expenditures though 10% of the respondents have no idea about that and 98.6% of the research participants are well aware of the tax rates that are applicable to their businesses unlike the 1.4% respondents who showed that they are not aware of the tax rates applicable to their business category. Summary of the responses is presented in table 18.

Table 18. Summary of responses regarding general tax knowledge

Questionnaires	Responses			
	Yes		No	
	Frequency	Percent	Frequency	Percent
Knowledge of Ethiopian tax law	102	72.9	38	27.1
Understanding of business tax obligations	140	100		
Responsibility for the accuracy of business tax affairs	140	100		
Knowledge of the fact that taxes collected are spent on financing Public expenditures	126	90	14	10
Knowledge of the need to pay tax liability within the prescribed period of time	140	100		

Knowledge of documents required by ERCA during audit	114	81.4	26	18.6
Understanding about the need to Keep record of all transactions	140	100		
Awareness about time and place of tax payment	140	100		
Awareness that noncompliance is an offence	140	100		
Awareness about tax rates applicable to the business category	138	98.6	2	1.4

4.5.2. Analysis of responses given to test questions on tax knowledge

As it is pointed out earlier the test questions were meant to test how much detailed knowledge the respondents have about the tax laws and regulations that they are required to comply with. Accordingly an effort is made to know if respondents know what goods/services and/ or businesses turnover and excise taxes are levied, the need to issue VAT invoice to customers and its timing, the length of time a VAT registered person should maintain records and invoices, amount of penalty payable in case of failure to declare tax on time, withhold tax from customers and engaging in understatement engaging in understatement of income. The questionnaires are indicated below.

- Turn over tax is payable on goods sold and services rendered by businesses not registered for VAT.
- A VAT registered business is required to issue the VAT invoice to the purchaser of goods or services up on the supply or rendering, but not later than 5 days after the transaction.
- Excise tax is levied up on luxury goods.

- A VAT registered person shall maintain accounting records, original tax invoice received by the person and copy of all tax invoices issued by the person for 10 years.
- A VAT registered person shall maintain accounting records, original tax invoice received by the person and copy of all tax invoices issued by the person for 10 years.
- A taxpayer who fails to file a timely tax declaration for the first time is liable to pay a penalty of Br.35000.
- A taxpayer is liable for a penalty in the amount of 50% of the understatement if the understated amount of tax is considered substantial.
- An agent failing to withhold tax is responsible for a penalty of Birr 22000 for each instance of failure to withhold the proper amount.

Analysis of responses indicates that the overwhelming majority of the respondents answered the questions correctly thus indicating that they have a detailed knowledge about the tax laws and regulations that govern their respective businesses. Percentage of responses on specific questions were as follows: Regarding the imposition of turnover and excise tax laws 90% and 97.1% of respondents gave right answers. Responses given regarding issuance of VAT invoice and maintenance of accounting records and invoices 85.7% and 92.1. % of the respondents indicated that they are aware by selecting the answer choice 'yes'. Their responses to the questions related to the amount of penalty payable when failing to declare tax on time (83.6% 'no'), engaging in substantial understatement (92.1% 'yes') failing to withhold tax (92.9% 'no') indicate that they do have a detailed knowledge about the tax laws and rules. The summary of the analysis is indicated in table 19 which is available in the following page.

Table 19. Summary of responses to the test questions

Questionnaires	Responses					
	Yes		No		Not sure	
	Frequency	Percent	Frequency	Percent	Frequency	Percent
Imposition of turnover tax law	126	90			14	10
Issuance of VAT invoice up on transaction	120	85.7			20	14.3
Imposition of excise tax law	136	97.1			4	2.9
Maintenance of accounting records, original and copy of tax invoices	129	92.1			11	7.9
Knowledge of amount of			117	83.6	23	16.4

penalty payable for failing to declare tax on time						
Knowledge of amount of penalty payable for engaging in substantial income understatement	129	92.1			11	7.9
Knowledge of amount of penalty payable for failing to withhold tax			130	92.9	10	7.1

To sum up, what is learned from the above analysis of the participants' answers is that operators of the medium businesses that are under study possess a high degree of general tax laws and detailed tax rules and regulations. This may be attributed to their long time stay in the business, educational background or the trainings given by ERCA.

As the result of this research indicated a high level of tax compliance is observed among this enterprises and this may also in part be attributed to the level of knowledge the tax payers possess.

4.6. Analysis of respondents' tax compliance level

As it is discussed in the literature, tax payers are considered to be complying with the tax laws, rules and regulations that govern their businesses when they pay the right amount of tax with the right time (IRS, 2009), complete and file tax returns, declare all taxable income accurately and discharge all their tax liability with in the stipulated period without having to wait for follow-up actions from the tax authority (Roth, 1989). Based on this understanding the participants' were presented with six

questions so as to get an insight in to their tax compliance behavior. The questions were scaled ones with four possible choices namely: 'strongly disagree', 'disagree', 'agree' and strongly agree'. The issues incorporated in the questions included from among others underreporting of income, filling of tax returns and paying taxes on time, claiming undeserved amount of tax deductions and considering tax evasion as an alternative option if tax compliance costs hike up.

Results attained indicate that 100% of the respondents never engaged in underreporting of income. When it comes to filling tax returns and paying taxes on time the composition of the answers attained was 57.9 % agreement, 30.7% strong agreement and 11.4 % disagreement which indicates a high degree of compliance to the requirement. A total of 98% of the respondents replied that they never over claimed tax deductions but 1.4% of the respondents indicated that they did over claim tax deductions. 98.1% of the respondents expressed their disagreement and 1.4% of them expressed their strong disagreement when asked if they would choose paying tax penalty instead of complying with tax requirements due to high ax compliance costs. Their responses indicate they stick to ethically acceptable practices. The remaining two questions were about their experience of being penalized for late compliance and tax nonpayment. Their responses to the late compliance question were expressed by 25% strong disagreement, 62.1% disagreement and 12.9% agreement. This means that a total of 87.1% of the respondents never experienced penalty for late compliance and therefore are highly compliant. Moreover, 28.6% of the respondents expressed their strong disagreement and 60% of them disagreed when asked if they ever experience penalty for noncompliance (failure to pay tax) but 11.4% of the respondents admitted that they experienced penalty for noncompliance.

To summarize, the overall result indicated that there exists a high degree of tax compliance among the medium enterprises under study. When this result of the study is compared to the already discussed findings on tax knowledge of the owners of the businesses, it seems to coincide with the assumption that higher level of tax knowledge can have a positive impact on tax compliance behavior of tax payers

(Nugroho,2012) though further research is required to assert that the reason for the high level of tax compliance observed among the business enterprises under study is solely or partly caused by the high level of tax knowledge observed among their owners.

The summary of participants' responses regarding their tax compliance is indicated in table 20.

Table 20. Summary of responses regarding tax compliance

Items	responses							
	Strongly disagree		disagree		Agree		Strongly agree	
	Frequency	percent	Frequency	Percent	Frequency	percent	Frequency	percent
Non engagement in underreporting of income					75	53.6	65	46.4
Filing tax returns and paying taxes on time			16	11.4	81	57.9	43	30.7

Never claimed undeserved amount of tax deductions			2	1.4	60	42.9	78	55.7
Choosing for tax penalty from higher tax compliance cost	2	1.4	138	98.6				
Experienced penalty for not paying tax on time	35	25	87	62.1	18	12.9		
Experienced penalty for failing to pay tax	40	28.6	84	60	16	11.4		

Chapter 5

Summary, conclusion and recommendation

The previous chapter discussed and analyzed the results obtained based on the responses of the participants of the study. This chapter presents the summary of the findings, the conclusion and the suggested recommendations.

5.1. Summary of the findings

The main objective of the study is to assess the size of tax compliance costs incurred by medium enterprises that fall under category “A’ taxpayers, to understand the level of tax knowledge their owners possess and the general level of tax compliance that exists among them. The results attained based on the analysis of the data collected from the respondents resulted in the following findings:

1. One of the basic research questions was targeted at assessing the amount of tax compliance costs the business enterprises under study incur so as to comply with tax requirements. The attained result indicates that costs incurred vary between

enterprises that outsource their tax affairs and those that employ in-house staff service. Accordingly, each outsourcing company incurs an average tax compliance cost of Birr 75,953 per year and each enterprise that does not outsource its tax affairs incurs a total of Birr 99,040 per year on average. The total sum of amount of tax compliance cost incurred by all outsourcing firms (the aggregate cost) amounts to Birr 2074200 and the total sum of internal tax compliance cost incurred by all the businesses (aggregate cost) amounts to Birr 3283500. The details of the result attained are :

- ❖ Average tax compliance cost incurred by an outsourcing enterprise

Average TCC= average external costs + average incidental costs

$$\text{Average compliance cost} = 13880 + 62073 = 75953$$

- ❖ Average tax compliance cost incurred by an enterprise that do not outsource

Average TCC= Internal cost+ incidental costs

$$\text{TCC} = 36967 + 62073 = 99040, \text{ and}$$

- ❖ Total tax compliance cost incurred by all outsourcing companies

TCC= total external costs paid by all firms + total incidental costs incurred by all firms

$$\text{TCC} = 1082700 + 991500 = 2074200$$

- ❖ Total tax compliance cost incurred by firms that use in-house staff service

TCC= total internal costs paid by all firms + total incidental costs incurred by all firms

$$\text{TCC} = 2292000 + 991500 = 3283500$$

2. The second basic research question focused on assessing the tax knowledge of the medium business owners (operators) and to this end general knowledge questions and test questions were presented to the participants of the study. The attained result which is based on the analysis of the participants' responses indicates the following:

- ❖ Results regarding general tax knowledge questions indicated that 100% of the business owners understand their tax obligations, know that they can be held responsible for the accuracy of their business tax affairs, are aware about the need to pay tax liability within the prescribed period of time, know that they are required to keep record of all their business transactions, are aware of the time and place of tax payment and know that noncompliance is an offence that leads to punishment. Besides, 98.6% and 81.4% of the respondents disclosed that they are aware of the tax rates applicable to their business category and the documents required by ERCA during audit. Results also indicated that 72.9% of the business owners know about the tax laws of Ethiopia and 90% of them are aware that tax money collected from them and other tax payers are used to spend public expenditures. The figures indicate that the medium business owners under study do possess a high degree of general tax knowledge about the tax laws and rules that govern their business category.
 - ❖ Results attained regarding tax knowledge test questions which were targeted at assessing the respondents' detailed tax knowledge level indicated that respective percent of 90% and 97.1% of the business owners are well aware of turnover and excise tax purposes and applications. Responses also indicated that 85.7% and 92.1 % are aware of tax laws regarding legal requirements for issuance of VAT invoice and maintenance of accounting records and invoices respectively. 83.6% of them know about the amount of penalty payable when failing to declare tax on time, 92.1% are aware of the amount of penalty payable for engaging in substantial understatement and 92.9% are aware of the amount of tax payable for failing to withhold tax from customers. The results imply that the majority of tax payers do have detailed tax knowledge of the tax laws and rules that govern their respective businesses.
3. The third basic research question was about getting an insight in to the tax compliance trend that exists among the medium enterprises under study. To

this end, questions that incorporated indicators of compliance such as paying taxes and filling tax returns on time and other ethical concepts were asked. The results indicated that 100% of the respondents never underreported income, 88% of them file tax returns and pay taxes on time, 98% never over claimed tax deductions, 98% confirmed that they would not evade tax even if compliance increase, 87.1% were never penalized late compliance and finally 88.6 % never engaged in noncompliance(they pay taxes always). The result implies that there exists a high degree of tax compliance culture among the medium enterprises under study.

5.2. Conclusion

The overall result of the study revealed that the owners of businesses under study incur a large sum of average compliance costs per year, owners of the businesses possess high level of tax knowledge and that there exists a high degree of tax compliance culture among the medium enterprises under study.

5.3. Recommendations

- ❖ The tax authority (ERCA) needs to consider the use of E-filing system so as to help tax payers minimize the compliance cost they incur. Tax payers spend much time waiting in line to pay their tax liability and file tax returns. The use of E-filing system saves time and is convenient to use as it can be available online 24 hours.
- ❖ The tax authority (ERCA) may need to consider raising business tax thresholds as it can result in reduced number of tax returns a business has

to file, the data it must supply, or the calculations it must make. In short raising thresholds may mean fewer tax matters for a business to deal with.

- ❖ Trainings given by ERCA should not only focus on making tax payers aware of tax laws and rules but also need to show taxpayers possible ways of minimizing their incidental compliance costs.

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Part I General Identification questions

Section A. Background information of respondents

1. Gender

- Male
- Female

2. What is your age bracket?

- 20-30
- 31-40
- 41-50
- Above 50

3. What is your highest level of education?

- High school certificate
- College diploma
- BA degree
- MA
- Other

Section B Questionnaires about background information of the company

1. What is the main business activity of your company?

- Manufacturing
- Construction
- Wholesale and retail
- Transport, storage and communication works
- Community, social and private services
- Transport and storage
- Financial,insurance,real estate and other trade

2. What is the total number of your employees?

Please specify_____

3. When was your company established?

Please specify_____

Part II Survey questionnaires about tax compliance costs

Section A. External tax compliance costs

1. Does your company hire external agents (or tax consultants) to file tax returns?

- Yes
- No

2. If your answer for the above questionnaire is yes, how often does your company hire external agents for filing its tax returns?

- All the time
- Most of the time
- Some of the time
- Rarely

3. What is the amount of your company's tax related expenditures and costs, if any, that was incurred for hiring external tax agents and consultants during the past year_____

4. Which taxes did the amount paid to tax advisors concern?

- VAT
- Income tax
- Turnover tax
- Customs duty
- Excise tax
- Withholding tax
-

5. Had your company been free of all tax charges, would you still pay for these external accounting and consultancy services?

- Yes
- No

Section B Internal tax compliance costs

1. What type of accounting system does your company employ?

- Manual (paper based)
- Computerized accounting software

2. Had your business been tax free, would you still continue using computerized accounting software?

- Yes
- No

3. Have you had an ERCA tax audit during the last 12 months?

- Yes
- N

4. Please specify annual internal time spent on each of the following activities

NO.	Activity	Annual time spent per month
1	Completing tax returns	
2	Bookkeeping and recording	
3	Learning and attending seminars about tax	
4	Dealing with tax authorities(ERCA)	
5	Dealing with external tax advisers	
6	VAT computation	
7	Withholding tax computation	
8	Income tax computation	

5. What was your company's estimated in house (or internal) costs incurred for complying with its tax obligations for the following specific items:

No	Items	Cost incurred in Birr
1	Tax related personnel salary and allowances	
2	Accounting software	
3	Photocopying and fax	
4	Postal and telephone	
5	Travel	
6	Office supplies	
7	Purchase of tax publications and journals	

Part III Survey questionnaires about tax knowledge

Part one

	Statements	Yes	No
1	You are aware of the tax laws of Ethiopia		
2	You have a good understanding of your business tax obligations		
3	You understand that you are responsible for the accuracy of your business tax affairs		
4	You are aware that the tax you pay is used to finance public expenditure		
5	You understand that you should pay taxes within the prescribed period of time		
6	You know what is needed by the tax authority(ERCA) in case of tax audit and enquiries		
7	You keep record of all transactions necessary for tax computation		
8	You know when and where to pay your company's tax liability		
9	You are aware that that non tax compliance is an offence that leads to punishment		
10	You know the income tax rates applicable to your business category		

Tax knowledge questionnaire-Part two

No.	Statement	Yes	No
1	Turn over tax is payable on goods sold and services rendered by businesses not registered for VAT		
2	A VAT registered business is required to issue the VAT invoice to the purchaser of goods or services up on the supply or rendering, but not later than 5 days after the transaction.(Included		
3	Excise tax is levied up on luxury goods		
4	A VAT registered person shall maintain accounting records, original tax invoice received by the person and copy of all tax invoices issued by the person for 10 years.		
5	A taxpayer who fails to file a timely tax declaration for the first time is liable to pay a penalty of Br.35000.		
6	A taxpayer is liable for a penalty in the amount of 50% of the understatement if the understated amount of tax is considered substantial		
7	An agent failing to t withhold tax is responsible for a penalty of Birr 22000 for each instance of failure to withhold the proper amount		

Part IV Tax compliance level

No.	Statements	Strongly disagree	Disagree	Agree	Strongly agree
1	You have never engaged in underreporting of income.				
2	You always file tax returns and pay taxes on time.				
3	You have never claimed an undeserved amount of tax deductions.				
4	You consider paying tax penalty as an alternative option if tax compliance cost becomes higher.				
5	You had been penalized for not complying with your tax obligation on time.				
6	You had been penalized for failing to pay your tax liability				

