

**ADDIS ABABA UNIVERSITY**  
**COLLEGE OF BUSINESS AND ECONOMICS**



**FACTORS CONTRIBUTING TO TAX EVASION: THE CASE  
OF SMALL AND MEDIUM ENTERPRISES IN ADDIS ABABA  
CITY ADMINISTRATION**

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**A Thesis Submitted to the Department of Accounting and  
Finance in Partial Fulfillment of the Requirements for the Award  
of Master of Science Degree in Accounting and Finance**

**Advisor: Degefa Duresa (PhD)**

**Addis Ababa, Ethiopia**

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## **DEDICATION**

I dedicate this thesis manuscript to my father, mother and sister for nursing me with affection and love and for their dedicated partnership in the success of my life.

## **STATEMENT OF DECLARATION**

I, Firehiwot Kebede, declare that this thesis entitled as “Factors Contributing to Tax Evasion: The Case of Small and Medium Enterprises in Addis Ababa City Administration” is my own work. I have carried out independently the research thesis work with the guidance and support of my advisor. This study has not been submitted to any degree/diploma in this or any other institution. It was done for the partial requirement of the Requirements for the Award of Master of Science Degree in Accounting and Finance.

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## **LIST OF ABBREVIATIONS AND ACRONYMS**

ERCA	Ethiopian Revenues and Customs Authority
GDP	Gross Domestic Product
IMF	International Monetary Fund
MoFED	Ministry of Finance and Economic Development
MoR	Ministry of Revenue
OECD	Organization for Economic Co-operation and Development
SD	Standard Deviation
SEM	Structural Equation Modeling
SMEs	Small and Medium Enterprises
SPSS	Statistical Package for Social Science
TA	Tax Audit
TAW	Tax Awareness
TAE	Tax Authority's Efficiency
TAT	Taxpayers' Attitude towards Tax
TCC	Tax Compliance Costs
TE	Tax Evasion
TF	Tax Fairness
TPE	Tax Penalties and Enforcements
VIF	Variance Inflation Factor

## **ABSTRACT**

*The main objective of this study was to identify the factors contributing to tax evasion, focusing on Small and Medium enterprises operating in the sub-cities of Addis Ababa. The researcher outlined a detailed literature review and identified seven variables for the study, four from the economic deterrence theory elements (i.e., tax penalties and enforcements, tax audits, tax authority's efficiency, tax compliance cost) and three from psychological theory factors (i.e., tax fairness, tax awareness and taxpayers' attitude towards tax). Descriptive research designs and a mixed research approach were used in this study to answer the research questions. The taxpayers were stratified into small and medium enterprises. The primary data was collected from 353 owners or managers of SMEs by using questionnaires and from 20 auditors of Ministry of Revenue through structured interviews and analyzed using descriptive statistics. The result of the study showed that negative taxpayers' attitude towards tax and tax compliance costs have positive effect on tax evasion. But tax audit, tax awareness, tax authority's efficiency, tax fairness and tax penalties & enforcements have negative effect on tax evasion respectively. From the seven predictor variables included in this study negative taxpayers' attitude towards tax has the largest positive effect on tax evasion. The study recommended that in order to reduce tax evasion of small and medium enterprises by changing the negative attitude developed by taxpayers toward tax, the tax authority might be able to raise taxpayers awareness through training, improve the behavior of the tax collectors or assessors, and also provide a clear procedures to the taxpayers how tax system works and how their tax is calculated and by how much tax rate.*

**Key Words:** Tax Evasion, Small and Medium Enterprises, Addis Ababa Sub-Cities, Negative Taxpayers' Attitude towards Tax, Tax Compliance Costs

# CHAPTER ONE

## 1. INTRODUCTION

Tax revenue is a valuable source of fund for governments in developed, developing, and emerging countries around the world. However, the amount of money that a government can raise from taxes to fund its spending program is determined by the desire of taxpayers to follow the country's tax regulations (Fjeldstad, 2012). Furthermore, several challenges exist in developing nations, such as poor administration, a failure to collect sufficient tax revenues, tax systems that do not combine tax horizontal and vertical equality considerations, and a lack of government and economic stability (Alemayehu, 2015). Furthermore, demographic, individual, social, economic, and institutional issues all influence tax compliance in most of these countries (Kircher, 2008; Mesfin, 2016). Because each country has its own strategy to controlling tax compliance attitudes, as well as its own set of tax rules and regulations, the factors influencing tax compliance attitudes appear to differ between countries (Rashid, 2020).

Ethiopia, like other developing countries, is having trouble raising income to the level required to promote economic growth by implementing various tax changes aimed at increasing revenue production, boosting tax administration efficiency, and improving tax equity. According to Ayele (2015), the trajectory of tax collection in Ethiopia is inconsistent, oscillating upward and downward due to numerous individual taxpayers, institutional, demographic, social, and economic factors that influence taxpayers' compliance attitude with taxation.

Tax evasion is regarded as a significant loss of government revenue, putting pressure on the government to provide efficient public services. As a result, tax evasion has been a difficult issue for the government and tax authorities to combat in order to boost tax revenue from taxpayers. Tax evasion is described as engaging in illicit activity while paying taxes. It occurs when taxpayers knowingly fail to comply with their tax obligations, whether by failing to file a return, misreporting income, or paying less than the real tax although having the ability to pay (Rashid, 2020). Tax evasion, according to Korndörfer et al. (2014), is an illegal conduct that violates the law and deviates from social norms that require tax payment. Tax evasion, according to Gottschalk (2010), is the deliberate endeavor to overcome or escape the tax legislation in order to illegally lower one's tax liability.

Despite the fact that tax evasion has become a topic of academic research in industrialized countries in recent years, there are few studies on the problem in developing countries (Richardson, 2016; Chan, 2019). It is particularly severe in underdeveloped countries, where tax evasion has been estimated to account for almost 20% of total tax collection on several occasions (Nurunnabi, 2017). According to Angel Gurra, the OECD Secretary-General, poor countries lose three times as much money as to tax fraud as they receive in foreign aid (OECD, 2018).

Similarly, the issue of tax evasion is a serious worry for emerging countries like Ethiopia, as low tax collections can stymie economic development (Amina & Sinya, 2015; Tarekegn, 2015; Gupta, 2017 and OECD, 2018). Yesegat (2016) and Tarekegn (2015) used trend analysis to discover that Ethiopia has the lowest tax to GDP ratio (10.7 percent), significantly below the average for Sub-Saharan African and low-income nations in general, and that tax evasion plays a significant role in this poor performance (Martini, 2014; Bayu, 2016 and Abebe, 2019).

Khelif and Achek (2015) analyzed the existing literature on the contributing causes of tax evasion and divided them into four categories: demographic, cultural and behavioral, legal and institutional, and economic aspects. The taxpayer's behavioral intention toward tax compliance is influenced by both economic and non-economic factors. Non-economic factors include attitude toward tax, personal, social, and national norms, perceived fairness of the tax system, taxpayers' understanding of the tax system, taxpayers' attitude, and the degree of trust, while economic factors include actual income, tax rate, benefits of various forms of taxation, tax audit profanities, fines, and penalties. Fischer et al. (1992) classified the critical factors of tax evasion into four groups, which became known as Fischer's model. These four groups are: (1) Tax system structure, such as tax rate, penalty, detection probability, and tax system complexity; (2) Attitude and perception, such as fairness, ethics, and peer influence; (3) Noncompliance opportunity, such as income level, income sources, and occupation; and (4) Demographic factors, such as age, gender, and education.

In Ethiopia, most business owners, particularly small and medium businesses, lack simplified access to and clarification on tax laws and procedures, lack awareness of tax rules and regulations, and lack a sufficient filing and reporting system, all of which can be considered as a contributing factors on small and medium business tax evasion (Derar, 2016; Kassa, 2021).

As a result, the purpose of this study was to identify factors that can contribute to tax evasion in SMEs of Addis Ababa City Administration.

### **1.1.Statement of the Problem**

Tax evasion is defined as "a taxpayer's deliberate refusal to comply with his or her tax duties" (Fagariba, 2016). It includes, among other things, underreporting of income, overestimation of expenses, and low-benefit announcements. Tax evasion diminishes the number of government-provided public services while increasing the amount of resources accumulated by taxpayers, which has a detrimental influence on economic growth (Roy & Raffaella, 2011). Tax evasion is becoming a growing international and national challenge for tax authorities and policymakers, as it jeopardizes the government's ability to collect revenue, especially in developing countries such as Ethiopia (MoFED, 2010). For a variety of reasons, taxpayers may fail to meet their obligations. A tax revenue gap is created when there are tax evaders, which is defined as the difference between the potential (as intended) tax revenue and the actual amount of tax collected. In most underdeveloped countries, such as Ethiopia, government revenue is far less than government expenditures. This low tax revenue return can only be attributable to the fact that tax provisions are not properly enforced, either due to administration incapacity or taxpayer noncompliance behavior (Adane, 2020).

During the 1970s and 1980s, tax evasion was at an all-time high, accounting for 10.4% of the total GDP in Ethiopia (Tarekegn, 2015). The fast rising economy in the face of stagnant tax collection efforts has resulted in a downward trend in the tax-to-GDP ratio since 2004 (Emrtat, 2010). Ethiopia, with a tax-to-GDP ratio of 9.7%, has one of the lowest tax-to-GDP ratios in Sub-Saharan Africa, compared to approximately 18% for the rest of Africa (MoFED, 2010). It is significantly lower than high-performing countries like South Africa and Namibia, whose tax collection is at 25% and 30.1%, respectively (Tarekegn, 2015).

There is a substantial amount of economic activity in Ethiopia that is not reported and captured by official statistics (36 percent of the documented economy). Tax evasion now accounts for ten percent of the GDP. If small and medium scale firms are to be the driving engines of Ethiopia's transformation, the conclusion has significant implications for tax policy (raising the tax rate versus the tax base) and incentive structure (Emrta, 2010). Furthermore, the Ethiopian Ministry of Revenue (2019) and Amina and Sinya (2015) in Jimma, Tarekegn (2015)

in Dessie, Derar (2016) and Bayu (2016) in Addis Ababa, has discovered serious tax evasion among the business community in several regions of the country. This is a common sign of noncompliance among taxpaying citizens in the country. Addis Ababa city is not immune to tax evasion because it is managed by the aforementioned ministry. This problem needs a thorough investigation into the root causes of the problem, as well as the identification of any further obstacles that have yet to be identified.

The majority of the most influential theories, hypotheses, and empirical research were created in industrialized countries. It has been carried out to some extent in developing nations such as Kenya, Pakistan, India, Malaysia, and Ethiopia. The issue of tax evasion in rich countries, on the other hand, is in no way comparable to that of developing countries (Asaminew, 2014; Martini, 2014 and Aumeerun et al., 2016). To the best of the researcher's knowledge, there are few studies conducted on tax evasion in Ethiopia, these includes a study conducted by Tarekegn (2015), Mekonnen (2016), Muleye (2016), Adane (2020), Kenno (2020), Manaye et al. (2020) and Kassa (2021).

In this study the researcher considered two theories of tax evasion; the economic deterrence theory (which includes factors like tax penalties and enforcements, tax audits, tax authority's efficiency, tax compliance cost and perceptions of government spending) and psychological theory (which includes factors like tax fairness, tax awareness, corruption and taxpayers' attitude towards tax) (Riahi-Belkaoui, 2004; Oladipupo & Obazee, 2016). Some of the previous researches in Ethiopia used only one of the theories of tax evasion factors or other models but none of the studies conducted in Ethiopia used a combination of economic deterrence and psychological theory factors. For example, Kassa (2021) used psychological theory factors like moral obligation, tax fairness, tax awareness, subjective norms and tax payers' attitude towards tax evasion to identify factors influencing taxpayer's engagement in tax evasion of micro, small, and large enterprise in Woldia City Administration. Also Kenno (2020) conducted a study on factors affecting perception of taxpayers towards the seriousness of tax evasion in Bale Robe Town Administration, Oromia, Ethiopia by considering Fischer's Model of tax compliance factors like demographic factors, noncompliance opportunity factor, tax system/structure (institutional factors), attitude and peer influence (Social factor).

Manaye et al. (2020) conducted a study on determinants of tax evasion in Southern Regional State, Ethiopia by considering a combination of Fischer's Model of tax compliance factors and psychological theory factors. These factors include factors like level of income, rate of taxes, probability of audit, tax awareness, fines and penalties, perception of equity and fairness, perception of government spending, referent groups, corruption, compliance cost, role of tax authorities and demographic factors. Beside this the study conducted by Tarekegn (2015) and Muleye (2016) in Dessie Town Administration and Adane (2020) in Bahir Dar City SMEs used the psychological theory factors only. Finally a study conducted by Mekonnen (2016) in Lideta Sub-City of Addis Ababa used the economic deterrence theory factors only.

Therefore as shown above, to the best of the researcher knowledge there are no researches conducted in Addis Ababa by taking SMEs found in more than one sub-city as sample and considering both psychological and economic deterrence theory factors as factors contributing to tax evasion. As a result, the researcher examined factors contributing to tax evasion in SMEs located in Addis Ababa City administration in order to bridge the aforementioned empirical gap and minimize the prevailing challenges faced by the selected SMEs.

Specifically, the study was designed to address the following basic questions:

- a. How does the economic deterrence theory element (i.e., tax penalties and enforcements, tax audits, tax authority's efficiency and tax compliance cost) contribute to tax evasion in SMEs of Addis Ababa?
- b. How does the psychological theory fact (i.e., tax fairness, tax awareness, and taxpayers' attitude towards tax) contribute to tax evasion in SMEs of Addis Ababa?
- c. What needs to be done by the tax authorities in inspiring SMEs to reduce tax evasion and comply with the tax legislations?

## **1.2. Objective of the Study**

### **1.2.1. General Objective of the Study**

The main objective of the study was to identify Factors Contributing to Tax Evasion in Small and Medium Enterprises in Addis Ababa City administration.

### **1.2.2. Specific Objectives of the Study**

The specific objectives of the study were:

- a. To investigate how the economic deterrence theory elements (i.e., tax penalties and enforcements, tax audits, tax authority's efficiency and tax compliance cost) contribute to tax evasion from taxpayers and tax collectors perspectives in SMEs of Addis Ababa.
- b. To examine how the psychological theory facts (i.e., tax fairness, tax awareness, and taxpayers' attitude towards tax) contribute to tax evasion from the taxpayers and tax collectors perspectives in SMEs of Addis Ababa.
- c. To assess efforts that needs to be made by the tax authorities in inspiring SMEs to reduce tax evasion and comply with the tax legislations.

### **1.3. Significance of the Study**

This research is expected to be significant in a number of ways. First of all, the significance of this study would be for the researcher to attain the skills needed to do research and to gain MSc in Accounting and Finance. Second, it provides the owners or managers of the SMEs on the basic awareness of tax evasion and the problems associated with it. Thirdly, understanding these assumptions aid the government (federal, state, and local) and its agencies in formulating and implementing appropriate tax policies in terms of tax revenue administration. Thus the findings of the study would offer policy makers on taxation, the tax authority and others an opportunity to further design and redesign policies that would use to reduce tax evasion and to promote better tax system and to increase tax revenue. Furthermore, it adds further insight for future researchers, academicians through providing further literature on the concept of tax evasion, particularly among small and medium scale enterprises.

### **1.4. Scope of the Study**

This study ultimately dedicated to examine the contributing factors of tax evasion among small and medium scale enterprises that are found in five selected sub-cities of Addis Ababa (i.e., Yeka, Nifas-Silk Lafto, Kolfe, Akaki and Arada sub-cities) from March 2021 to April 2022. Conceptually, the independent variables of the study combined the economic deterrence theory elements and the psychological theory factors (i.e., tax fairness, tax awareness, tax audit, tax penalties and enforcements, tax authority's efficiency, negative taxpayers' attitude towards tax and tax compliance costs) that influences taxpayers to engage in tax evasion (dependent variable) activities collected from different related literatures.

### **1.5. Limitations of the Study**

This study focused on only small and medium enterprise in Addis Ababa. The samples were taken from only small and medium enterprise in Addis Ababa city administration, which excludes large enterprise and other businesses. Also, the other limitation of this study is that all primary data was obtained from respondents through cross-sectional study, which is the case for most academic researches. However, these limitations in the study leave future ground for explorations and research on the subject using longitudinal research. Therefore, any of the analysis and finding of this research confined only to the selected case study area and the results and conclusions in this finding may not be valid to places outside of the case study area. Lid to places outside of the case study area.

### **1.6. Organization of the Study**

This study was organized in five chapters in which the first chapter discussed about the introduction, problems statement, objective, significance, scope, limitations and the organization of the study while the second chapter presents the literature review section which includes theories, empirical evidences, conclusions and knowledge gaps of the study. The third chapter deals with the methodology of the study. Chapter four presented results and discussions from the data collected. Finally, the fifth chapter winds up with conclusions drawn from the fourth chapter thereby forwarding possible recommendations.

## CHAPTER TWO

### 2. REVIEW OF RELATED LITERATURES

Basic notions about tax evasion and elements that influence tax evasion are discussed in this section. It can be divided into two categories: theoretical and empirical.

#### 2.1. What is Tax and Tax Evasion?

Bhatia (1996) defined a tax as a financial obligation imposed on persons, groups of individuals, or other legal entities. It is a financial obligation to pay a specific amount because the persons, groups of individuals, or legal entities have a certain amount of income from certain tangible or intangible property, or because they engage in certain economic activities that are subject to taxation. Tax is defined as a mandatory levy on income, expenditure, or capital assets imposed by the government or another tax-raising authority in exchange for which the taxpayer receives no specified benefit (Lymer & Oats, 2009).

Businesses, governmental entities, and individuals are taxed by the government without having to file a return. Taxes are a government's most important tool and principal source of revenue. The funds will be used to fund common-use facilities and services, such as important programs (such as health care and education), services (such as law enforcement and public utilities), and infrastructure (such as road building and environmental protection) that are critical to society (Mansor & Gurama, 2016). Taxes play a critical part in a country's economic success. It contributes to the country's existence and financial independence, as well as assisting the government in financing social welfare programs and infrastructure development. By restricting imports through high taxes, it aids in the equitable distribution of wealth, the fair and just allocation of resources, the reduction of foreign reliance, and the protection of domestic industry from outsider manufacturers (Awan & Hannan, 2014). Direct and indirect taxes are the two types of taxes. Direct taxes are levied on business profits and individual earnings, whereas indirect taxes are levied on consumer purchases (Aktan, 2006).

When individuals, groups, or businesses fail to pay the required amount to the government, they are committing tax evasion. It is a criminal offense, according to the law, and the entire tax collection procedure faced various challenges, the most prominent of which was tax evasion (Nangih & Dick, 2018). Tax evasion is when a taxpayer violates the tax laws in order

to reduce their tax burden. The taxpayer disregards the official provisions of taxation that become their obligation, falsifies documents, or fills in data with incomplete and wrong information in this activity (Rantelangi & Majid, 2018).

Tax evasion is regarded as a significant loss of government revenue, putting pressure on the government to provide efficient public services. As a result, tax evasion has been a difficult issue for the government and tax authorities to combat in order to boost tax revenue from taxpayers. Tax evasion is described as engaging in illicit activity while paying taxes. It occurs when taxpayers knowingly fail to comply with their tax obligations, whether by failing to file a return, misreporting income, or paying less than the real tax although having the ability to pay (Rashid, 2020). Tax evasion, according to Korndörfer et al. (2014), is an illegal conduct that violates the law and deviates from social norms that require tax payment. Tax evasion, according to Gottschalk (2010), is "the deliberate endeavor to beat or evade the tax legislation in order to illegally lower one's tax liability."

Tax evasion happens when taxpayers obstruct and conceal many records that could be used by tax collectors as proof. Tax evasion is a crime that has the potential to destabilize a country's entire economic, political, and social system. Tax evasion is an economic element that impacts the equitable allocation of income among individuals and businesses, resulting in unfair competition (Aumeerun et al., 2016).

The term "tax evasion" has multiple definitions in finance, as illustrated above. It is commonly known that the taxpayer refuses to pay the required tax by providing financial services with incorrect information. Tax evasion is described as the use of legal or unlawful methods to avoid paying taxes, suggesting that the taxpayer pays the tax and then gets rid of it in part or in full, lowering tax income and negatively impacting the state's treasury (Gravelle, 2016).

### **2.1.1. Types of Tax Evasion**

There are two forms of tax evasions, according to Al Baaj et al. (2018) the first is legal evasion or tax avoidance, and the second is tax fraud which is illegal type of tax.

#### **a) Tax Avoidance**

Tax avoidance, often known as "legal evasion," refers to the removal of the tax burden in whole or in part without making a statement or violating the law's requirements, and because the taxpayer has constitutional rights, he exercises them as any act is legally guaranteed (Zucman,

2014). Tax evasion does not occur outside of the tax system, although it does benefit from its internal and external levels. On an internal level, this means that any financier can put all of his money into a state-issued, tax-free loan to stimulate his subscription. The taxpayer does not pay any tax on his money in this situation. Because of the regional character of the tax system and the differing tax systems of other nations, financiers can avoid certain sorts of taxes at the international or external level, such as corporations that set up shop in countries that do not levy significant taxes on ship and company earnings. Abstaining from acting or disposing of the tax, as well as refraining from the tax-creating event, is how tax avoidance is accomplished (Gallemore & Labro, 2015).

#### **b) Tax Fraud**

Tax fraud, as contrast to legal tax avoidance, is an illegal type of tax in which a taxable entity willfully and intentionally falsifies facts on a tax return in order to reduce the amount of tax liability. Tax fraud entails falsifying information on a tax return in order to avoid paying the full amount due. The procedures utilized by the taxpayer for this purpose must be specified. In most situations, these violations are deliberate and unambiguous, and they involve the taxpayer's intent. To avoid tax collection, the taxpayer may break the law either defining the tax base or when collecting the tax (Saxunova & Szarkova, 2018).

#### **2.1.2. Reasons for Tax Evasion**

Tax evasion occurs for a variety of reasons that cannot be regulated. They are highly dependent on financial regulations, as well as social, economic, and political factors, as well as knowledge and efficiency levels. The following are some of the reasons identified by Mertens and Ravn (2013):

- a. Legislative Motives:** Legislative grounds are the most common causes of tax avoidance. This is most likely due to a lack of tax legislation, a lack of drafting provisions, and the presence of loopholes that allow taxpayers to evade taxes.
- b. Economic Reasons:** One of the most common causes of tax evasion is the taxpayer's perception that the tax deducts a significant portion of his income.
- c. Administrative and Technical Reasons:** Tax administration is a useful executive weapon when the administration's honesty and efficiency are lacking, as this encourages tax evasion.

- d. Social and Ethical Considerations:** In some tax allocations, the society's view of evasion is an admirable view and appreciation given that it was stolen by the state's public treasury through which tax evasion is no longer robbed in reverse in European societies that try and fulfill all of their moral obligations.
- e. Political Reasons:** A country's lack of independence and political stability, as well as its public spending policies, all play a role in tax evasion; in other words, the better the condition of the use of public funds, the less tax evasion by taxpayers.

### **2.1.3. The Effects of Tax Evasion on Taxation**

Tax evasion, in all of its forms, has economic, psychological, and social consequences for society. The lowering of state budget income from financial resources is one of the economic impacts. In this instance, the state is having difficulties fulfilling all of its basic responsibilities to its inhabitants, which has an impact on revenue. Tax evasion erodes society's trust and confidence in the state and its role in providing essential public services to its residents, as well as confidence in financial management, which has a negative impact on the tax and has become a form of moral corruption that impacts taxes (Glaeser et al., 2000). In terms of the societal consequences of tax evasion, they are manifested in the lack of understanding among those responsible with enforcing the ideal of equality and justice. The term "justice" refers to the fact that everyone is subject to the tax. If any of them are exempt from paying taxes, then the overall principle of social fairness has been breached (Mehrra & Farahani, 2016).

## **2.2. Theories of Tax Evasion**

There are many different perspectives on the best techniques to avoid tax avoidance. Many businesses, if given the chance, will refuse to pay taxes unless there is a compelling reason to do so. Some believe that increasing tax incentives is the greatest solution (Riahi-Belkaoui, 2004), while others say that increasing tax penalties is the best solution (Oladipupo & Obazee, 2016). As a result, tax evasion theories can be divided into two categories. The economic deterrence theory and the psychology-based hypothesis are the two theories.

### **2.2.1. The Economic Deterrence Theory**

According to the economic deterrence theory, taxpayers are always economically sensible creatures who will avoid tax if they believe the benefit of evading is greater than the risk of being caught (Hasseldine & Bebbington, 1991). For the purpose of limiting tax evasion

behavior, this theory proposes using audit and legal enforcement to uncover and penalize tax evaders. The deterrence model was discovered by Hasseldine and Bebbington (1991) with the inclusion of two components. To begin, a taxpayer's attitude toward tax evasion is influenced by his or her level of risk aversion. The prospect theory takes into account this viewpoint as well. If a taxpayer is more risk averse, they are less likely to engage in tax evasion while they are in a win situation; instead, they would prefer to take the risk when they are in a loss situation (Ahmed, 2016). Second, taxpayers' understanding of the tax administration's ability to find tax evaders and the power to penalize them has an impact on their compliance behavior. Tax administration inefficiency encourages people to avoid more taxes; otherwise, they will be in a state of uncertainty. This uncertainty stems from a knowledge gap among taxpayers, which makes them hesitant to avoid paying taxes. Furthermore, Chen Loo et al. (2009) stated that tax awareness is essential for long-term compliance. In contrast to a lack of sufficient tax awareness, taxpayers perceive the tax system to be difficult, which leads to noncompliance.

The relationship between the economic deterrence theory and this research is that when tax authorities have high audit probabilities (when the company is audited by competent and independent auditors), enforcement initiative (tax penalties) was high and when the tax authority's efficiency was high will result in reducing the tax evaders (Ahmed, 2016).

### **2.2.2. Psychology Theory**

Cognitive structure theory was identified by Jackson and Milliron (1986) in such a way that a taxpayer's attitude and intention toward tax evasion are directly mirrored in their later action. According to the psychological contract theory, the contract is a critical component of the connection between taxpayers and government, in which taxpayers contribute to government revenue in exchange for government services (Scholz, 2003). Feld and Frey (2007) proposed the psychological tax contract as a way to establish a fair and reciprocal responsibility between the government and taxpayers based on a quid pro quo situation in which one side contributes and the other takes. According to the theory, taxpayers are deterred from paying tax if they believe the government's benefit is less than the amount of tax paid. Furthermore, if taxpayers believe that their governments, as well as tax officers, are unfair, corrupt, or discriminatory in their treatment of them and inconsistency or tax assessment is based on arbitrary decisions, they may regard tax evasion as ethical (McGee et al., 2016).

Psychological variables influence taxpayers' compliance with their tax obligations, according to psychology theory. It focuses on the values and ethics of the taxpayers. According to the theory, a taxpayer may comply even if the likelihood of detection is low. Unlike the deterrence theory which focuses on increasing penalties as a remedy to compliance problems, psychology theory focuses on changing individual attitudes about tax systems. As a result, tax education is one tool for influencing taxpayers' attitudes toward tax issues. Improved tax education is thought to boost tax compliance, and vice versa (Oladipupo & Obazee, 2016).

The relationship between psychological theory and this research is that when the tax officials, are unfair, corrupted, or discriminative nature against the tax payers and when tax payers with less tax awareness will increase the probability of tax evasion (McGee et al., 2016).

## **2.3. Taxation in Ethiopia**

### **2.3.1. Taxation and Tax Reform in Ethiopia**

The contemporary Ethiopian tax system is the result of more than half a century of legislative and tax reform efforts. It lacked a chief lawgiver to direct and steer it from behind, as well as a defined set of overarching policies to govern its decisions. The contemporary Ethiopian tax system has developed and evolved in fits and starts since its humble origins in the 1940s, as income requirements have arisen, administrations have changed, and the economy and international events have shifted. The Ethiopian tax system underwent major alterations and several piecemeal amendments throughout this time period (Tadesse, 2012).

For a long time, Ethiopian tax administration was an afterthought of ministries that lacked administrative specialization in tax determinants and collection. However, in 2008, the Ethiopian Revenues and Customs Institution consolidated three revenue agencies, the Federal Inland Revenue Authority, Ethiopian Customs Authority, and the Federal Government's National Lottery, into one authority, Ethiopian Revenues and Customs Authority (ERCA).

The reorganization of the Federal Tax Administration has shifted tax administration from the ministerial level to an authority; however the reorganization has actually enhanced the Tax Authority's powers. Ethiopian tax administration has undergone a lot of changes as a result of recent tax administration reforms, only a few of which are discussed here for their educational value (Tadesse, 2012).

Changing policies to address insufficient revenue, correcting distortions that impair economic welfare and growth, or actions to reduce inequity are all examples of tax reform. Ethiopia's tax reform effort consists of two parts: updating tax legislation and improving tax administration. The reform aims to create a long-term domestic revenue base, promote trade and investment, and maintain fairness, equity, and openness in tax administration (Yalemtesfa, 2011). However, in underdeveloped nations such as Ethiopia, where there is a huge informal sector, low tax morale, uncontrolled evasion, and complete distrust between tax authority and people, the tax may fail. One of the reasons is the lack of simplified tax administration procedures (Mekonnen, 2016).

#### **2.4. Factors Contributing to Tax Evasion**

Tax evasion is a result of a variety of factors that lead to criminal action on the part of taxpayers. Economic incentives are one of the variables that motivate taxpayers to engage in this activity. Business sanctions, business slowdown, and the level of tax burden are all considered crucial economic issues. Legal considerations, societal elements, demographic factors, mental disorders, and moral considerations, on the other hand, are the most essential variables (Saxunova & Szarkova, 2018).

Kirchler (2008) categorizes the factors that influence tax evasion and divides them into three categories (i.e., social-psychological, political and economic determinants). According to him, social psychological determinants include attitudes, various types of norms, perceptions of fairness, as well as motivational features relating to tax compliance, political determinants such as the complexity of the law and tax system, or fiscal policy, and economic determinants such as the rational decision-making process and the impact of audits, fines, tax rates, and income on tax behavior.

According to Rashid (2020), age, gender, education, income, occupation or status, peers' or other taxpayers' influence, ethics, legal sanction, complexity, relationship with taxation authority, income sources, perceived fairness of the tax system, possibility of being audited, and tax rate are determinants or factors that have influenced tax evasion as discussed by various researchers. A taxpayer's desire to engage in tax evasion is influenced by a number of factors. Some of the factors that are considered in this study are as follows: The following are some of the factors that are taken into account in this study: tax fairness, tax awareness, tax audit, tax

penalties and enforcements, tax authority's efficiency, negative taxpayers' attitude towards tax and tax compliance costs were discussed under.

#### **2.4.1. Tax Fairness and its Effect on Tax Evasion**

Tax fairness is a non-economic factor that influences a country's tax collection. It is an element that pushes taxpayers to engage in tax evasion (Alleyne & Harris, 2017). Fairness is described as the willingness of taxpayers to pay the tax levied and its impact on the fight against tax evasion. The perception of the tax system's fairness is critical among many other elements influencing taxpayers' attitudes toward tax evasion (Rashid, 2020). One of the main principles of the taxation system design is tax equity and fairness, which can be seen in three dimensions: horizontal equity (people in similar income or wealth brackets should pay the same amount of taxes), vertical equity (taxes paid increase with the amount of the tax base or taxable income), and Exchange Equity (expect the same share of public service from government in exchange for paying tax) (Wallschutzky, 1984). The fairness of tax collection systems, concepts, and implementation is widely recognized. Unethical behavior may occur as a result of the injustice of the tax collection method. The tax's fairness may entice taxpayers to pay it. If the tax rate is not acceptable and fair, taxpayers will regret indulging in tax evasion methods, and they will inform authorities of their annual income without denying the specific amount. The maintenance of the taxation system's fairness is aided by taking into account one's ability to pay or acceptable tax rates (Rantelangi & Majid, 2018).

Governments decide how much to tax and who will pay a high rate of tax. The tax rate is a factor that encourages taxpayers to pay less in taxes as a percentage of their income. The tax rate should be reasonable and equitable for all taxpayers (Nangih & Dick, 2018).

The tax rate on payment in Allingham and Sandmo's model might be positive, zero, or negative, suggesting that an increase in the tax rate will cause the tax payment to increase, stay the same, or decrease. Theoretical research does not support the claim that raising the tax rate will lead to an increase in tax evasion (Gravelle, 2016). Because not all taxpayers pay the same amount of tax, tax fairness is a contentious subject (Ahmed & Kedir, 2015). According to Farrar et al. (2018), taxpayers' perceptions of justice lead to increased cooperation and compliance with tax authorities, which reduces tax evasion. According to Richardson (2016), a tax system may lead to tax compliance if the tax administrator treats taxpayers with respect.

Jurney et al. (2017) and Rashid (2020) discovered a negative association between tax fairness and tax evasion in their research.

#### **2.4.2. Tax Awareness and its Effect on Tax Evasion**

Tax awareness gives an awareness of the country's tax structure and rules, and it can be used to persuade taxpayers to refrain from tax evasion (Pui Yee et al., 2017). The level of a taxpayer's knowledge and awareness of tax-related issues has a considerable impact on their attitude, and having tax awareness will offer the taxpayer with an understanding of their rights, obligations, and procedures for paying taxes, as well as the repercussions of non-compliance (Machogu & Amayi, 2013).

For taxpayers to grasp the causes and consequences of tax evasion, they must have a basic understanding of the tax code. Taxpayers who are well informed on tax evasion are less likely to do so; on the other hand, taxpayers who are not well informed are more likely to do so. To strengthen the understanding of taxpayers and authority specialists, tax-related material should be prioritized (Pui Yee et al., 2017). Tax awareness is one way for citizens to contribute to the country's revenue. Taxpayers will be less inclined to engage in tax evasion if the authorities equip them with a variety of tax evasion and other tax-related training (Rashid, 2020). Tax awareness is a deciding factor in whether or not a taxpayer would engage in and continue to engage in tax evasion. When taxpayers go about their regular lives without thinking about taxes, they put themselves at danger of committing tax evasion (Rantelangi & Majid, 2018).

In addition, Tishar and Hasanuzzaman (2019) discovered that those with tax education are less likely to be non-compliant with income taxes. According to Torgler et al. (2008), lower tax awareness is linked to increased income tax return submission uncertainty. It will lower the likelihood of tax evasion because basic tax awareness encourages taxpayers to voluntarily comply with tax regulations (Mohamad et al., 2013). Furthermore, studies conducted by different researchers such as Ahmed (2013), Ndekwa (2014), Saad (2014), and Geletaw (2017) found that tax awareness and education has a negative and significant impact on tax evasion; when a taxpayer's educational background improves, a decrease in tax evasion attitude is expected. Tax awareness was not significantly connected with tax evasion, according to Tadesse and Goitom (2014) and Ahmed and Kedir (2015) studies.

### **2.4.3. Tax Audit and its Effect on Tax Evasion**

According to Kircher (2008), a tax audit is the process of a tax authority inspecting or analyzing an individual's or organization's tax return and assessing MSEs in order to ensure compliance with a country's tax rules, regulations, and directives. Furthermore, he describes tax audit as a method by which tax authorities confirm whether or not their claimed tax returns were made with the consent of the tax laws. According to the OECD (2006), a tax audit is a review of a taxpayer's books of accounts to see if they are appropriately recorded and if the reports accurately reflect the taxpayer's liability. Furthermore, under the self-assess SMEs system, tax audit is one of the key duties of the tax authorities in promoting and encouraging voluntary compliance with tax laws and regulations.

Taxpayer reporting behavior is also influenced by the likelihood of detection by audit. If taxpayers believe they will be one of the taxpayers audited in a given year, they will declare everything (Riahi-Belkaoui, 2004; Richardson, 2008). According to Alm (2019), raising the number of audits, enhancing the quality of inspections, and implementing more structured audit procedures all help to prevent tax evasion. On the other side, Slemrod et al. (2001) looked into the relationship between the likelihood of being audited and taxpayers' attitudes toward tax evasion and discovered that as the likelihood of discovery increased, taxpayers were encouraged to follow tax laws and declare their income properly. According to a study by Gemmell and Ratto (2012), the higher the risk of tax evaders being detected, the lesser the tax evasion. The study by Tilahun and Yidersal (2014), on the other hand, found that the likelihood of being audited has no significant impact on tax evasion.

### **2.4.4. Tax Penalties and Enforcements and its Effect on Tax Evasion**

A fee or penalty is money paid to a government agency as a punishment for committing a crime or other offense (Muoki et al., 2014). Tax fines and enforcement actions are described as steps taken when taxpayers pay less tax than their real responsibilities or fail to file their income tax returns at all. The actions taken by the authority to enforce measures after being audited have a significant impact on taxpayer compliance with a tax system (Calimani & Pellizzari, 2014).

Tax deterrence consequences relating to the possibility of detection and the severity of fines were increased, resulting in lesser non-compliance among taxpayers. Fines and penalties have a favorable impact on tax compliance; the larger the penalty, and hence the risk of an audit,

the stronger the deterrent to potential tax evasion (Muoki et al., 2014; Paper et al., 2016). The rate of tax penalties is statistically significant in influencing tax compliance levels, and the rate of tax penalties has a favorable effect on tax compliance behavior (Paper et al., 2016; Yunus et al., 2017). Furthermore, Helhel and Ahmed (2014), Aemiro et al. (2014), and Ahmed and Kedir (2015) discovered that the size of the penalty is highly associated to tax compliance intents; that is, when taxpayers perceive a large penalty rate for any non-compliance, non-compliance would decrease. According to Alm (2019), tax evasion can be minimized by establishing penalties for tax evasion, as the threat of such penalties makes tax evaders more risk-averse. Chen (2003) discovered that if the enforcement cost is not too high, fines minimize tax evasion; however Deb and Chakraborty (2017) observed that penalties and prosecutions have a considerable impact on taxpayers' willingness to evade taxes. Additionally, according to Mohamad et al. (2013), the higher the amount of legal enforcement in a country, the less likely tax evasion is.

#### **2.4.5. Tax Authority's Efficiency and its Effect on Tax Evasion**

Taxpayers' attitudes toward tax evasion may be influenced by their perceptions of the tax authority, depending on how well the tax authority serves them. According to Cyan et al. (2016), present tax authority inadequacies and dealing with horizontal disparity resulting from administrative weaknesses may contribute to tax evasion. The role of the tax authority in closing the tax gap and boosting voluntary compliance is undeniably important. Tax compliance, according to Dubbin (2004), places the government and the tax authority as the primary parties who must be consistently efficient in managing the tax system in order to reduce tax evasion. Furthermore, Richardson (2016) found that the government's involvement had a considerable favorable impact on deciding attitudes regarding taxes.

The tax authority's friendly treatment of taxpayers, rather than enforcing tax payment, may operate as a psychological component in reducing tax evasion (Nangih & Dick, 2018). Tax morale is better, according to Barone and Mocetti (2011), when taxpayers perceive the tax authority to be efficient, competent, knowledgeable, and willing to help. Mehari et al. (2017) observed that the tax authority's efficiency and effectiveness in enhancing tax assessment and collection had a beneficial impact on tax payers' voluntary tax compliance. Furthermore,

according to Deyganto (2018) and Rashid (2020), the efficiency of the tax authority has a considerable and unfavorable impact on taxpayers' attitudes toward tax evasion.

#### **2.4.6. Negative Taxpayers' Attitude towards Tax and its Effect on Tax Evasion**

In general, the terms attitude and perceptions are used interchangeably in the context of tax evasion because people's attitudes are shaped by their perceptions (Pui Yee et al., 2017). According to Ahmed and Kedir (2015), attitudes are an individual's favorable and negative evaluations of objects, thoughts, or living creatures. The majority of past studies indicated that tax evasion is acceptable when a tax system is unfair, corrupt, or discriminatory (McGee & Tusan, 2008). However, McGee et al. (2016) discovered that while tax evasion cannot be justified in some scenarios, it can be justified in others where the government is complicit in corruption or tyranny.

According to Paper et al. (2016), attitudes toward taxes have a statistically significant impact on tax compliance levels. Palil and Mustapha (2011) and Waithira (2016) found that people have a good attitude toward taxes, which can lead to increased compliance and a reduction in tax evasion. The attitudes of taxpayers toward the tax system have a strong favorable impact on personal income tax compliance, according to Beza (2014), Aronmwan et al. (2015), and Paper et al. (2016). Taxpayers who have a negative attitude toward taxation are less likely to pay their duties to the authority; on the other hand, taxpayers who have a positive attitude toward taxation are more likely to pay their obligations to the authority (Assfaw & Sebhat, 2019).

#### **2.4.7. Tax Compliance Costs and its Effect on Tax Evasion**

Businesses incur fees to comply with tax regulations that are separate from their tax liability. "Tax compliance cost" is defined by Abdul-Jabbar and Pope (2008) as the cost experienced by taxpayers to meet their statutory tax responsibilities in addition to their actual tax debt. The three basic components of tax compliance costs are monetary expenses, time costs, and psychological costs to the taxpayers (Evans, 2008). Expenses for tax specialists (such as tax agents and accountants) as well as taxation guides, books, communication, and other incidental charges are included in monetary costs. The taxpayer incurs time costs, which include time spent keeping records for the purposes of filing the tax return and preparing tax information for tax experts, as well as time spent communicating with the tax authorities. Psychological

costs include things like the stress of dealing with complicated tax issues (Smulders et al., 2012).

According to Amina and Sniya (2015)'s study on tax compliance costs in Ethiopia, tax compliance expenses in Ethiopia in the fiscal year 2011/2012 were rather high. The entire costs of tax compliance are anticipated to be around 5.8 billion Ethiopian Birr, or around 4.5 percent and 1% of tax revenue collection and GDP in the years under consideration, respectively. Smaller enterprises in Ethiopia incur a disproportionately larger weight of tax compliance expenditures, according to the findings of the study. The study's findings also found that compliance costs connected to commercial profit tax, VAT, and TOT accounted for the majority of the costs. Due to the complexities, particularly in connection to the tax regime for relatively smaller enterprises and the frequency of reporting with respect to VAT and TOT, company profit tax compliance expenses are high.

High compliance costs can lead to tax evasion, tax fraud, and investment stifling by lowering the country's competitiveness in terms of taxation attractiveness (Ojeka, 2012). According to Aumeerun et al. (2016), the majority of Kenyan small and medium businesses believe that consulting fees and the cost of recruiting professional employees are prohibitively expensive. Many small businesses use experienced tax advisers to help them meet statutory obligations and computerize their accounting records. All of these efforts come at a cost to the taxpayer. He discovered that compliance costs, such as fees charged by tax advisors, are positively connected with non-compliance and consequently inversely correlated with tax compliance. Most people are obliged to use professional tax counselors due to the perceived technical nature of return filling (Aumeerun et al., 2016). Tax rules and regulations are legal papers with legal terminology that is difficult for regular taxpayers to understand, and given the multiple legal revisions that occur each year, taxpayers lack the experience required to prepare tax returns. Small and medium enterprises can also save time and money by hiring a tax expert to complete their tax returns in the most effective way possible. As a result, tax rules should be simplified to minimize both compliance and administrative expenses, as well as to eliminate taxpayer uncertainty and enhance tax compliance levels (Beza, 2014).

Furthermore, simplifying the tax return, according to Silvani and Baer (1997), will encourage taxpayers to complete the tax return themselves rather than employ a tax professional, cutting

compliance costs and tax evasion. In their study, Giombini et al. (2018) established a relationship between tax system difficulties, tax compliance costs, and tax evasion.

## **2.5. Empirical Review of the Study**

Kassa (2021) did a study in Woldia City administration micro, small, and large enterprise taxpayers to see what variables lead them to engage in tax evasion. To deal with the data analysis, the researcher used a descriptive and explanatory research design, as well as a quantitative research approach. The researcher employed a stratified and simple random selection strategy to acquire primary data from 370 respondents using questionnaires. SPSS was used to analyze the acquired primary data using Pearson correlation and multiple regression analysis. Tax fairness, tax awareness, and moral obligation all significantly influence taxpayers' willingness to engage in tax evasion, whereas moral obligation and subjective norms were not statistically significant in influencing taxpayers' willingness to engage in tax evasion.

Determinants of Tax Evasion in Addis Ababa City Administration: The Case of Bole Sub City Category "A" Taxpayers was the subject of a study by Demle (2019). The researcher employed questionnaires as the major data collection method, and 335 respondents were chosen as a sample size for the study from a total of 1,625 populations, using a stratified and simple random selection procedure. Import, export, wholesaler trade, retail trade, construction, service sector, and manufacturing were the seven strata for category "A" taxpayers (process). Using SPSS, descriptive and inferential statistics (i.e., correlation and regression) were applied to the acquired primary data. Tax rate, income level, chance of discovery, penalty rate, complexity of tax system, perceived role of government, peer influence on tax evasion, age, gender, and educational variables all have statistically significant effects on tax evasion, according to the findings of the study. The researcher also recommended that the tax authority revise perceived high tax rates, launch a national campaign to raise awareness and increase education about the benefits of voluntary compliance, increase the percentage of taxpayers audited, penalize defaulters and "name and shame" them, simplify tax laws, close tax law loopholes, and train tax inspectors in order to reduce tax evasion.

In their study, Yohannis and Zerihun (2013) evaluated the gaps and problems between the business community and the Dire Dawa tax administration. Their findings found that, while

the majority of taxpayers had favorable sentiments regarding general tax principles, they were paying more than they could afford and had little faith in the authority's workers or the overall tax calculation, assessment, and collection systems. Furthermore, they contend that the Dire Dawa City Administration's tax authority failed to make the tax procedure objective, clear, and understandable to taxpayers. As a result, they believe that improving the tax authority's functioning structure and boosting openness will progressively build taxpayer trust in the tax system.

Daniel (2017) performed research on the elements that influence the voluntary compliance of category 'C' taxpayers' attitudes in Arbaminch. He discovered that lack of awareness was the most common reason for non-voluntary compliance among category "C" taxpayers. Efficiency and effectiveness on the part of the tax authority in improving tax assessment and collection procedures, raising awareness, and enforcing tax law have positive effects on taxpayers' voluntary compliance, whereas socio-cultural variables have both positive and negative effects on taxpayer attitudes. Political influences, on the other hand, he claims, had little bearing on the attitudes of taxpayers in his study area.

Mesele and Tesfahun (2016) found issues in Dessie Town related to tax payers and revenue authorities in their article. The findings revealed that tax justice and equity, the tax authority's organizational strength, taxpayer awareness levels, cultural influences, and the government's supply of social services were the issues that taxpayers were confronting. Tax authorities, on the other hand, were dealing with issues such as low tax payer perceptions of the importance of tax payment, taxpayers postponing tax payment and disclosure, beginning a business without a trade license, and old tax collection methods.

Redae and Shailinder (2016) collaborated on a study of taxpayers' perspectives on company taxation in Ethiopia, with a focus on the Tigray Regional State. The goal of their research was to get a thorough picture of business income tax payers' understanding of Ethiopian tax legislation in the case of Tigray state. The findings of their research revealed that educated and younger people in the state were involved in business and were self-employed. However, the majority of business income tax payers were unaware of their classification. Furthermore, this study found that a high percentage of taxpayers were having difficulty preparing all of the necessary paperwork for the purpose of their tax liability due to a lack of business knowledge.

The government ignored raising awareness and increasing tax payer understanding, which made it difficult for individuals to grasp the country's tax system and revenue creation in the region.

Muleye (2016) researched the tax evasion environment and tax payer attitudes in the case of the Dessie town government in his article. By conducting this research, he realized that there was a deep-rooted 'culture' of not paying taxes, which became the most significant impediment to establishing a long-term base. The study also revealed that intentional tax evasion is frequent and increasing, owing to the fact that a huge majority of taxpayers believe tax evasion is a minor crime, despite the fact that they understand it is their civic responsibility to pay their tax liability. In addition to the existing culture, the severity of tax evasion in Dessie was linked to perceptions of tax justice, inefficient use of public funds, and the lack of a punishment.

Rashid (2020) studied factors that influence taxpayers' attitudes toward tax evasion in a developing country, including the moderating effect of demographic parameters on tax evasion in Bangladesh from public, private job holders, and self-employed respondents. The primary data was collected from 481 respondents by using stratified sampling techniques and the data was analyzed using descriptive statistics (i.e., mean, standard deviation, percentage and frequency) partial correlation and structural equation modeling (SEM). According to the study, perceptions of tax fairness, tax awareness, audit, and enforcement measures have a negative impact on taxpayers' attitudes toward tax evasion, but corruption, discrimination, and complexity in the tax system have a positive impact on tax evasion. Furthermore, the study discovered that tax evasion factors influence men, younger, married, graduate, self-employed, and low-income people more than females, older, unmarried, under-graduated, job holders, and high-income people.

A determinant of Tax Evasion in Ethiopia was studied by Manaye et al. (2020). To analyze primary data acquired from 376 respondents using SPSS, the researchers employed an explanatory study design, Spearman's correlation analysis, and ordered logistic regression. Tax rates, tax audit probabilities, role of tax authorities, tax awareness, fines and penalties, perception of equity and fairness, perception of government spending, referent group, compliance cost, outcome favorability, level of income, age, gender, and level of education were all identified as potential determinants of tax evasion in the study. The study found a

statistically significant relationship between gender, educational level, tax rates, audit probability, tax awareness, fines and penalties, opinion of justice and fairness, income level, and tax evasion at ( $p < 0.05$  and  $p < 0.01$ ). The perceptions of equity and income level were found to be the most important drivers of tax evasion, followed by fines and penalties and gender.

Kenno (2020) conducted a study on taxpayers and tax officers of Category “A”, “B” & “C” in Bale Robe town of Oromia Regional State, Ethiopia. To deal with the data analysis, the researcher used a descriptive research design, as well as a quantitative research approach. The researcher employed purposive and simple random sampling techniques and collected primary data by using questionnaires from a sample of 358 taxpayers out of the total target population of 4,160 taxpayers in the town. The result of the study revealed that tax evasion resulted from lack of knowledge about taxation, perceiving tax evasion as culture, trend of tax audit and the degree of detection, perceiving tax evasion as a minor crime and issues related to tax fairness and equity. Kenno (2020) the findings of the study recommend tax authorities and policy makers continuously should work hard in creating awareness and tax knowledge through the provision of trainings and education to taxpayers and should improve unfairness and inequitable trends of tax payment.

**Table 2.1: Summary of the Most Recent Empirical Studies on Tax Evasion**

<b>Authors</b>	<b>Data Source</b>	<b>Analysis Tools</b>	<b>Findings</b>
Kassa (2021)	370 Woldia City administration micro, small, and large enterprise taxpayers	Pearson correlation and multiple regression	Tax fairness, tax awareness & moral obligation significantly influence taxpayers' in tax evasion Moral obligation & subjective norms were not statistically significant in influencing taxpayers' in tax evasion.
Demle (2019)	335 Addis Ababa City Administration Bole Sub-City	Descriptive and inferential statistics (i.e., correlation and regression)	Tax rate, income level, chance of discovery, penalty rate, complexity of tax system, perceived role of government, peer influence on tax evasion, age, gender & educational

	Category "A" Taxpayers		have statistically significant effects on tax evasion
Rashid (2020)	481 respondents from public, private job holders and self-employed in Bangladesh	Descriptive statistics, partial correlation and structural equation modeling (SEM)	Perceptions of tax fairness, tax awareness, audit and enforcement measures have a negative impact on tax evasion, but corruption, discrimination, and complexity in the tax system have a positive impact on tax evasion.
Manaye et al. (2020)	376 Taxpayers of Southern Regional State, Ethiopia.	Spearman's correlation and ordered logistic regression	There was a statistically significant relationship between gender, educational level, tax rates, audit probability, tax awareness, fines and penalties, opinion of justice and fairness, income level, and tax evasion.
Kenno (2020)	358 taxpayers and tax officers of Category "A", "B" & "C" in Bale Robe town	Descriptive Statistics (Frequency, Percentage & Average)	Tax evasion is affected by fairness & equity of tax system, the government spending & penalty rate, probability of being audited, culture & taxpayers' understanding about tax evasion

*Source: Own Survey (2022)*

## 2.6. Conclusion and Research Gap

This chapter discusses the key theories and empirical investigations on tax evasion; there are many different perspectives on the best approaches to avoid tax evasion. If given the opportunity, many businesses will refuse to pay taxes unless there is a compelling reason to do so. Some believe that increasing incentives (Feld & Frey, 2007) is the greatest solution, while others say that increasing penalties is the best solution. Economic and psychological-based theories are two of the most common tax evasion theories.

Economic theories are also known as deterrence theories, because they emphasize incentives. According to the hypothesis, taxpayers are amoral value maximizers, influenced by economic reasons such as profit maximization and detection probability. As a result, they evaluate potential compliance options, such as whether or not to avoid tax, the chance of detection, and the resulting consequences, and then choose the option that maximizes their predicted after-tax returns once risk is taken into account (Oladipupo & Obazee, 2016). They would try to reduce their tax due by underreporting their income, for example, and would benefit from tax savings if they were not discovered by the tax authorities (Hasseldine & Bebbington, 1991).

Tax penalties and enforcements, tax audits, tax authority efficiency, tax compliance cost, and taxpayer views of government spending are all elements that impact taxpayer behavior, according to the economic deterrence theory (Hasseldine & Bebbington, 1991). Few people will avoid taxes if they are likely to be discovered and the penalties are harsh. The expected return to evasion is high when audit possibilities are low and fines are low. The model then forecasts a high level of non-compliance. In terms of taxpayer perceptions of government expenditure in connection to tax compliance, it stands to reason that taxpayers are concerned about how the government spends their money (Ojeka, 2012). According to Ojeka (2012), taxpayers will avoid tax if they believe the government is misusing tax dollars. Also, high compliance costs can lead to tax evasion, and when the tax authority's efficiency is good, the number of tax evaders is reduced (Ahmed, 2016).

Non-economic or psychological theories, on the other hand, are concerned with the taxpayers' morals and ethics. According to the theories, a taxpayer may comply even if the risk of detection is low. Rather of focusing on elements such as increased audits and fines as remedies to tax evasion issues, psychology theories focus on changing individual attitudes toward tax systems (McGee et al., 2016). These psychological theory aspects include tax fairness, tax awareness, corruption, and the attitude of taxpayers toward tax. According to psychological theory, if tax officials are unfair, corrupted, or discriminatory in their treatment of taxpayers, and if taxpayers have little tax awareness, tax compliance costs and the likelihood of tax evasion will rise (McGee et al., 2016).

Past research on tax evasion by business firms in Ethiopia employed either economic deterrence theory elements or psychological theory factors in their studies, not both at the same

time, or incorporated other theory factors such as Fischer's Model of tax compliance factors, according to reviews. Tarekegn (2015) and Muleye (2016) in Dessie Town, Adane (2020) in Woldia City Administration, and Kassa (2021) in Bahir Dar City SMEs, for example, conducted studies based solely on psychological theory aspects. Others, such as Mekonnen (2016) in Addis Ababa's Lideta Sub-City, only used economic deterrence theory factors; Kenno (2020) in Bale Robe Town Administration, Oromia, Ethiopia, only used Fischer's Model of tax compliance factors; and Manaye et al. (2020) in Southern Regional State, combined Fischer's Model of tax compliance factors and psychological theory factors. Aside from that, only a few researches have been undertaken in poor nations such as Ethiopia. More particular, there have been no studies undertaken in Addis Ababa SMEs that incorporate both psychological and economic deterrence theory aspects, to the best of the researcher's knowledge. This motivates the researcher to examine the elements that contribute to tax evasion in SMEs in the Addis Ababa City administration, in order to close the empirical gap and reduce the obstacles that the selected SMEs experience.

## **CHAPTER THREE**

### **3. RESEARCH METHODOLOGY**

This chapter deals with the research design, research approach, data type and source, target population of this study, sample design, data collection method and instrument used for data collection and method of data analysis.

#### **3.1. Research Design**

A research design is a blueprint for performing a study with the greatest amount of control over elements that could skew the results' validity (Saunders et al., 2009). The research design for this study was descriptive. The researcher used descriptive research design to describe the event as it is.

Based on time horizon, the research design can be longitudinal or cross sectional. A cross sectional design focuses on a particular phenomenon at a specific period of time (Saunders et al., 2009). On the other hand longitudinal research focuses on a particular phenomenon that is studied at different period of time. In this study, a cross sectional study was used because data was collected from a cross section managers or owners of SMEs and employees or tax officials of ERCA once and not for different periods of time. Also, according to Easterby Smith et al., (2008) most research projects undertaken by academic researchers were cross-sectional research designs.

#### **3.2. Research Approach**

The research approach of this study was both qualitative and quantitative research approaches for conducting the research because the overall strength of the study is greater when both qualitative and quantitative research approaches are used (Creswell, 2009). A mixed approach or a combination of quantitative and qualitative research approach is used when more than one data collection technique is used with associated analysis techniques (Saunders et al., 2009). For instance in this study questionnaires were used to collect quantitative data and analyzed these data using statistical (quantitative) procedures and data collected from auditors through interviews and document reviews were used to collect qualitative data and analyzed these data using non-numerical (qualitative) procedures.

### 3.3.Data Type and Source

To achieve the objective of the study both primary and secondary sources of data were used. The primary data was collected from the SMEs owners or managers by using questionnaires, and also from auditors of the tax authority or from ERCA through interviews. The secondary data were also collected from the reports, websites, journals and other sources.

### 3.4.Target Population of the Study

The target populations of the study were 4979 taxpayers of small and medium enterprises found in Addis Ababa city as shown in Table 3.1

**Table 3.1: Taxpayers of Small and Medium Enterprises in Addis Ababa**

No	Sub-city Name	Small	Medium	Number of SMEs per Sub-city
1	Yeka Sub City	522	90	612
2	Nifas-Silk Lafto Sub-city	457	191	648
3	Lideta Sub-City	207	37	244
4	Kolfe Sub-city	408	140	548
5	Kirkos Sub-city	221	38	259
6	Gulele Sub-city	339	198	537
7	Bole Sub-city	426	94	520
8	Akaki Sub-city	372	204	576
9	Addis-Ketema Sub-city	252	161	413
10	Arada Sub-city	455	167	622
<b>Total</b>		<b>3,659</b>	<b>1,320</b>	<b>4,979</b>

*Source: Addis Ababa City Job Creation and Enterprise Development Bureau (2021)*

### 3.5. Sample Size and Sampling Techniques

The target population for this study incorporated SMEs taxpayers found in Addis Ababa (i.e., 4,979). To select sample SMEs taxpayers, a sampling technique known as multi-stage were employed. First to identify sample representative for the study top five sub cities out of ten were purposefully selected based on their highest number of SMEs they have; this is because

the number of target population is large and difficult to cover all. Therefore, Yeka, Nifas-Silk Lafto, Kolfe, Akaki and Arada Sub-Cities were selected as a sample representative with a population size of 3,006 SMEs.

Second to identify the target participants or sample size in this study, the researcher used Yamane's (1967) formula because the target population in this study is finite population. Hence, the formula is described as follows:

$$n = \frac{N}{1 + N(e)^2}$$

**Where**

N = target population,

n = sample size,

e = error term

$$n = \frac{3006}{1 + 3006(0.05)^2} \approx 353$$

Thirdly, tax payers were then stratified into two strata according to their categories namely “small” and “medium” enterprises as shown in Table 3.1 above. From the total taxpayers, 2,214 were categorized under level “small enterprises” and the remaining 792 taxpayers were categorized under level “medium enterprises”.

After identifying the sample size using the above equation the researcher allocated the estimated sample size to each stratum in the study area under the study to maximize the predictive power of the model. One method is proportional allocation. Thus the proportional allocation was done using the following formula adopted from (Kothari, 2004) as shown in Table 3.2 below.

$$N_h = \frac{nN_1}{N}$$

**Where:**

$N_h$  = Proportional sample to the strata

n = Sample size determined using the formula provided by (Yamane, 1967)

$N_1$  = Total number of population in each strata

N = Target population

**Table 3.2: Types of SMEs and Sample Size Appropriation**

No	Sub-city Name	Small	Medium	Sample Size
1	Yeka Sub City	$522*353/3006 = 61$	$90*353/3006 = 11$	72
2	Nifas-Silk Lafto Sub-city	$457*353/3006 = 54$	$191*353/3006 = 22$	76
3	Kolfe Sub-city	$408*353/3006 = 48$	$140*353/3006 = 16$	64
4	Akaki Sub-city	$372*353/3006 = 44$	$204*353/3006 = 24$	68
5	Arada Sub-city	$455*353/3006 = 53$	$167*353/3006 = 20$	73
<b>Total</b>		<b>260</b>	<b>93</b>	<b>353</b>

*Source: Addis Ababa City Job Creation and Enterprise Development Bureau (2021)*

For instance from Yeka Sub City small enterprises  $522*353/3006 = 61$  respondents were selected and from medium enterprises  $90*353/3006 = 11$  respondents were selected. By using the same procedures for the rest of four Addis Ababa sub-cities sample respondents were selected as shown in Table 3.2 above. Finally, after dividing the population by level, the researcher applied a simple random sampling technique to select each respondent.

Also 20 auditors from Ministry of Revenue of each Sub-city were purposefully selected for interview questions.

### **3.6. Methods of Data Collection**

Self-administered questionnaires and interviews were the main data collection instrument used in this study. In order to collect the primary data for this study the researcher divided the questionnaires in to two sections, the first section were questionnaires that are going to be answered by managers and owners of SMEs and the second section are to be filled by the tax collector's. The first section of the questionnaires that are going to be filled by managers and owners of SMEs contains three parts: Part I: was about backgrounds of the respondents and their business which includes demographic characteristics of the respondents and background of the SMEs as sub-parts. Part II: was about factors contributing to tax evasion dimensions and Part III: was about tax evasion dimension. The demographic characteristics sub-part consists of gender, age, marital status and educational level of the respondents, and background of the SMEs sub-part consists of SMEs Sectors of business activities, forms of business ownership

and tax experience of SMEs. The second and third parts of the first section contains questions of a 5 point-Likert scale measurement items with a closed-ended structured questionnaire on tax evasion was served for the respondents where one (1) indicates strongly disagree, and five (5) indicates strongly agree. The questionnaire was adapted from McGee et al. (2016) and Rashid (2020) based on the existing literature of tax evasion and translated it into Amharic to make a proper understanding of the local situation. These measurement items included seven (7) variables with thirty-four (34) items and one (1) variable with ten (10) items. The second sections of the question were filled by the tax collectors or by the tax authorities and contain interview questions. The secondary data were collected by reviewing of materials, reports of various government institutions like MoR, MoFED, and IMF database and various journals and literatures.

### **3.7. Method of Data Analysis**

At the end of each field data collecting day and before storage, the questionnaires were verified for completeness and consistency of information to analyze factors contributing to tax evasion in Addis Ababa City Administration SMEs. For the analysis, IBM Statistical Package for Social Science (SPSS) software version 23 was employed. The psychometric properties of the constructs were assessed before to any study by evaluating their reliability and validity values. Descriptive statistics (i.e. frequency, mean, and standard deviation) were developed to display and analyze the data. Descriptive statistics analysis was used to reduce the demographic characteristics of the respondents like gender, age, marital status, level of education, SMEs sectors of business activities, forms of business ownership, tax experience of SMEs and factors contributing to tax evasion dimensions and also tax evasion dimensions in to a summary format by tabulation, frequency, percentage and measure of central tendency (mean and standard deviation). The reason for using descriptive statistics was to compare the different variables used in this study one another.

#### **3.7.1. Reliability and Validity Test**

As stated by Hair et al. (2010), reliability indicates the extents to which a variables or set of variables is consistent in what it supposed to measure. Reliability analysis was used to measure the consistency of a questionnaire. Although there are different methods of reliability test, for this study Cronbach's alpha was considered to be suitable because it is the most common

measure of reliability. As described by Nunnally (1978), the values of Cronbach's alpha with a minimum level of 0.7 are good.

The validity of a scale refers to the degree to which it measures what it is supposed to measure, unfortunately there is no one clear cut indicator of scale's validity and the validation of a scale involve the collection of empirical evidence concerning its use (Hair et al., 2010). From the different types of validity the researcher checked the content validity. The adequacy with which a measure or scale has sampled from the desired universe or realm of content is referred to as content validity. Content validity of the questionnaire was confirmed by extensive review of previous literature on the factors contributing to tax evasion.

### **3.8. Ethical Considerations**

A researcher must follow the principle of voluntary consent, which requires respondents to agree to participate in research voluntarily, according to Mugenda and Mugenda (2003). Informed consent should be based on details such as the study project's purpose, the researcher's name, and any prospective benefits. According to Mugenda and Mugenda (2003), research participation is voluntary, and subjects are free to leave the study at any time without repercussions. Before the study began, the researcher informed the participants of this. Assistants were taught by the researcher to ensure that all respondents understood all aspects of the survey. No one was forced to participate in the study; it was entirely voluntary.

Plagiarism, according to Creswell (2009), is when you pass off someone else's work as your own by claiming credit for something that was done by someone else. It occurs when you borrow someone else's ideas as if they were your own. All work borrowed from other scholars was acknowledged to the best of our ability.

## CHAPTER FOUR

### 4. RESULTS AND DISCUSSIONS

This chapter summarized the findings of the researcher's investigation, which was conducted using the methods outlined in Chapter 3. It covers demographic information about the respondents, background information about the SMEs, a full discussion of the three particular objectives, and descriptive statistics analysis using IBM SPSS version 23. Internal consistency of the overall factors contributing to tax evasion dimensions in SMEs of Addis Ababa City Administration and tax evasion dimensions was checked through Cronbach alpha, and content validity was tested by identifying existing scales from the relevant related literatures of the study. The study's findings were also reviewed in light of the literature review offered in Chapter Two.

#### 4.1. Questionnaire Response Rate

As shown in Table 4.1 below, the study had a target sample size of 353 respondents, with 312 filling out and returning surveys, resulting in an 88.4 percent response rate. This response rate was ideal for drawing conclusions about the study because it served as a representative sample (Mugenda & Mugenda, 2003).

**Table 4.1: Questionnaire Response Rate**

Questionnaires Issued	Fully Returned	Percentage of Return Rate
353	312	88.4%

*Source: Results of Own Survey Data (2022)*

#### 4.2. Reliability and Validity Assessment Results

The dependability of the data collection processes used in the study is measured by how closely they match the expected outcomes. The term "reliability" refers to a measurement of the variables under investigation's consistency. The Cronbach's Alpha test was used to analyze the data reliability against the explanatory factors, as indicated in Table 4.2 below. Cronbach's Alpha Statistics for the explanatory factors exceeded the permissible standard of 0.7 for all variables considered (Hair et al., 2010). This suggests that the data collected for the study was reliable and consistent. Furthermore, validity refers to the credibility of an inquiry (Creswell, 2009). It has to do with determining whether the data collection instruments are an accurate

representation of what they should enumerate. With her supervisor's permission, the researcher was concerned about content validity by merely looking at the substance of information collection tools to determine if they were real. In order to obtain content validity, the researcher followed Cooper and Schindler's (2011) recommendations, which included locating existing scales in the relevant literature.

**Table 4.2: Reliability Analysis Results**

<b>Variables</b>	<b>Number of</b>	<b>Cronbach Alpha</b>
Tax Fairness	5	0.850
Tax Awareness	5	0.860
Tax Audit	4	0.797
Tax Penalties and Enforcements	5	0.894
Tax Authority's Efficiency	4	0.848
Negative Taxpayers Attitude toward Tax	5	0.895
Tax Compliance Costs	6	0.895
Tax Evasion	10	0.944

*Source: Results of Own Survey Data (2022)*

### **4.3. Backgrounds of the Respondents and Their Business**

This section encompasses the demographic characteristics of the respondents and background of the SMEs.

#### **4.3.1. Demographic Characteristics of the Respondents**

The demographic characteristics of the respondent's encompass gender, age, marital status and educational level of the respondents. Frequency and percentage of the owners or managers of SMEs in Addis Ababa City Administration respondents were presented below.

As shown in Table 4.3 below, the gender distribution of the owners or managers of SMEs in Addis Ababa City Administration respondents constituted 242(77.6%) male respondents and 70(22.4%) female respondents. This clearly indicates the males' dominancy in managing the SMEs in Addis Ababa town. On the other hand, as displayed in the Table 4.3 below, more than half of the respondents or 167(53.5%) were within age group between 31 to 40 years. The

remaining 85(24.2%), 51(16.3%) and 9(2.9%) of the owners or managers of SMEs were in the age category of 20 to 30 years; 41 to 50 years and above 50 years age groups respectively. This shows that the young populations manage and own the majority of the SME sector in the town.

**Table 4.3: Demographic Characteristics of the Respondents**

No	Indicators	Category	Frequency	Percent
1	Gender	Male	242	77.6%
		Female	70	22.4%
<b>Total</b>			<b>312</b>	<b>100.0%</b>
2	Age	20-30 years	85	27.2%
		31-40 years	167	53.5%
		41-50 years	51	16.3%
		Above 50 years	9	2.9%
<b>Total</b>			<b>312</b>	<b>100.0%</b>
3	Marital Status	Single	85	27.2%
		Married	168	53.8%
		Divorced	39	12.5%
		Widowed	20	6.4%
<b>Total</b>			<b>312</b>	<b>100.0%</b>
4	Educational Level	Primary School	53	17.0%
		Secondary School	124	39.7%
		Diploma	72	23.1%
		First degree	50	16.0%
		Master's degree and above	13	4.2%
<b>Total</b>			<b>312</b>	<b>100.0%</b>

*Source: Results of Own Survey Data (2022)*

Concerning the marital status of the respondents, as shown in Table 4.3 above, more than half of the respondents or 168(53.8%) were married. The remaining 85(27.2%), 39(12.5%) and 20(6.4%) of the owners or managers of the SMEs were single, divorced and widowed

respectively. This result shows that the majority of the SMEs sector in Addis Ababa City Administration were managed and owned by married people.

Regarding educational background of the respondents as shown in Table 4.3 above, the majority or 124(39.7%) of the SMEs owners or managers were learned up to secondary school level, followed by 72(23.1%) of the respondents were diploma holders, 53(17.0%) of the respondents were learned up to primary school level, 50(16.0%) were first degree holders and lastly only 13(4.2%) of the respondents were master's degree and above holders. The results show that all of the respondents possess the level of literacy required to understand the issues rose on the questionnaire and as such would be able to provide reliable information about the SMEs' tax evasion. Therefore, the tax authority can easily communicate and transmit messages to the taxpayer about the tax laws, rules and regulations.

#### **4.3.2. Background of the SMEs**

This section encompasses the SMEs sectors of business activities, forms of business ownership within the current SMEs and the tax experience of SMEs. Frequency and percentage of the background of the SMEs were presented below in Table 4.4.

Regarding the SMEs sector of business activities as shown in Table 4.4 below, the majority of the SMEs or almost half 146(46.8%) of the SMEs in the Addis Ababa City Administration were operating in the trade sector. Followed by 114(36.5%) of the SMEs in the Addis Ababa City Administration were operating in the service sector, 25(8.0%) were operating in the manufacturing sector, 16(5.1%) were operating in the construction sector and lastly only 11(3.5%) of the SMEs were operating in the urban agriculture sector. This result indicated that the majority of the SMEs operating in Addis Ababa City Administration were trade sectors, this is mainly due to small capital required to start such business. The same cannot be said of manufacturing and construction sectors which require much capital and expertise. This result may help the tax authority to create effective and strategic management of taxpayers in order to avoid tax evasion.

As shown in Table 4.4 below regarding the forms of business ownership, the majority or 207(66.3%) of the SMEs in the study area were owned by sole proprietorships followed by partnership 63(20.2%), private limited companies 27(8.7%) and 15(4.8%) had other forms of business ownership like cooperatives and family owned. This result clearly shows the

dominance by sole proprietorships, controlling more than two third of the enterprises among the SMEs in the Addis Ababa City Administration.

**Table 4.4: Background of the SMEs**

No	Indicators	Category	Frequency	Percent
1	SMEs Sector of Business Activities	Trade	146	46.8%
		Services	114	36.5%
		Urban Agriculture	11	3.5%
		Manufacturing	25	8.0%
		Construction	16	5.1%
<b>Total</b>			<b>312</b>	<b>100.0%</b>
2	Forms of Business Ownership	Sole Proprietorships	207	66.3%
		Partnership	63	20.2%
		Private Limited Companies	27	8.7%
		Other Associations	15	4.8%
<b>Total</b>			<b>312</b>	<b>100.0%</b>
3	Tax Experience of SMEs	Below 5 years	40	12.8%
		5 to 10 years	118	37.8%
		More than 10 years	154	49.4%
<b>Total</b>			<b>312</b>	<b>100.0%</b>

*Source: Results of Own Survey Data (2022)*

Concerning the tax experience of SMEs as shown in Table 4.4 above, the majority of the SMEs or 154(49.4%) of the SMEs had more than 10 years of experience in paying taxes followed by 118(37.8%) of the SMEs had tax experience 5 to 10 years and finally only 40(12.8%) of the SMEs had tax experience less than 5 years. This result indicated that the majority of the SMEs included in this study had tax experience more than 10 years. This can help the tax authorities to easily communicate the causes and effects of tax evasion had on the growth of the country's economy.

#### **4.4. Descriptive Analysis of the Study Variables**

This part of the analysis was made based on survey schedule gathered from 312 owners or managers of the selected SMEs in Addis Ababa by using 5-point Likert's scale with: 1 = strongly disagree, 2 = disagree, 3 = neutral, 4 = agree and 5 = strongly agree. The study has seven independent variables (i.e., tax fairness, tax awareness, tax audit, tax penalties and enforcements, tax authority's efficiency, negative taxpayer's attitude toward tax and tax compliance costs) and tax evasion as a dependent variable. Also, this part of the analysis contains the summary of the data gathered from the interviews of the tax collectors. For a consistent interpretation of descriptive analysis, the result of the scales mean and standard deviation were reassigned as follows to make the interpretation easy and clear; if the mean values lies in between 1 - 1.8 = Strongly Disagree, 1.81 – 2.6 = Disagree, 2.61 – 3.4 = Neutral, 3.41 – 4.20 = Agree and 4.21 – 5 = Strongly Agree (Al-Sayaad et al., 2006).

##### **4.4.1. Factors Contributing to Tax Evasion Constructs**

In order to determine the factors that can contribute to tax evasion, the researcher employed statements to assess the level of the seven variables of factors contributing to tax evasion dimensions in the selected SMEs of Addis Ababa City Administration. The participants were asked to rate how much they agreed with the statements above. The responses were scored on a 5-point Likert scale, with 1 indicating Strongly Disagree, 2 indicating Disagree, 3 suggesting Neutral, 4 indicating Agree, and 5 indicating Strongly Agree.

###### **4.4.1.1. Tax Fairness**

The results in Table 4.5 below indicate that the tax fairness items had scored an average mean value between 2.05 and 2.13 with a standard deviation value between 0.65 and 0.70. This indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration, disagreed on the overall items of tax fairness dimensions because the mean values lie between 1.80 and 2.60 as described by Al-Sayaad et al. (2006). Aside from that, the five questions with a mean response of less than 2.60 and a standard deviation of less than 1 showed that respondents have similar perspectives on the issues. This result indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on non-existence of corruption practice in the tax system, on fairness of tax collection procedures, principles and on non-discriminatory tax assessment. The respondents also disagreed on the

presence of consistency in the tax burden or tax assessment that is not based on arbitrary decisions. The respondents also disagreed on the presence of non-ambiguity of tax regulations that leads to misinterpretation of tax regulations and also they disagreed that a large portion of the money collected is spent on projects that does benefit them.

**Table 4.5: Descriptive Statistics of Tax Fairness**

<b>Code</b>	<b>Statements on Tax Fairness</b>	<b>Mean</b>	<b>SD</b>
<b>TF1</b>	There is no existence of corruption practice in the tax system	2.09	0.68
<b>TF2</b>	The tax collection procedures and principles are fair or there is no discriminatory tax assessment.	2.13	0.67
<b>TF3</b>	There is no inconsistency in tax burden or the tax assessment is not based on arbitrary decisions	2.05	0.70
<b>TF4</b>	There is no ambiguity of tax regulations that leads to misinterpretation of tax regulations	2.13	0.65
<b>TF5</b>	A large portion of the money collected is spent on projects that does benefit me	2.06	0.68
<b>The Overall Mean and SD</b>		<b>2.09</b>	<b>0.68</b>

*Source: Results of Own Survey Data (2022)*

The overall mean = 2.09 and SD = 0.68 also showed that there was unfairness in the tax system, due to existence of corruption practice in the tax system, unfairness of tax collection procedures, principles and discriminatory tax assessment, the presence of inconsistency in the tax burden or tax assessment that is based on arbitrary decisions. The unfairness of tax system was resulted due ambiguity of tax regulations that leads to misinterpretation of tax regulations and also the taxpayers believed that the tax system was unfair because a large portion of the money collected is spent on projects that does not benefit them.

The findings of the interview are almost identical to the findings of the preceding research question: taxpayers are sometimes requested to pay unjustified tax expenses because they do not keep the essential documentation for taxation. This could be owing to the taxpayer's

awareness of the expenses that can be deducted from taxes, as well as timely submission of the required documentation to the tax authority. As a result, tax burdens or assessments may be assigned based on arbitrary determinations, resulting in injustice in the tax system. Some SMEs, according to the interviewed respondents, pay taxes based on arbitrary daily income determinations or average daily revenue estimations, which has prompted criticism from taxpayers who see the tax system as unjust.

Many of the SMEs taxpayers' suspicions were confirmed by the tax officials interviewed, who stated that determining tax liability based on arbitrary daily income decisions or average daily revenue estimates resulted in many of the SMEs taxpayers' suspicions, as businesses engaged in the same activities in the same geographic location were sometimes assessed by different individuals or even different committees. Because the assessment standards lacked objectivity and comparability, different assessors and committees applied them differently. As a result, SMEs taxpayers were biased in determining tax liabilities among taxpayers involved in comparable types of businesses, and they saw the tax system as unjust. Furthermore, the respondents to the survey stated that some wholesalers sell products to retailers without providing receipts, making it difficult for the tax authority to establish the source document for taxes. This also led to the tax authority making arbitrary choices on the taxation of retailers or SMEs, resulting in tax system inequity.

#### **4.4.1.2. Tax Awareness**

As shown in Table 4.6 below the tax awareness items had scored an average mean value between 2.05 and 2.12 with a standard deviation value between 0.66 and 0.74. This indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on the overall items of tax awareness dimensions because the mean values lie between 1.80 and 2.60 (Al-Sayaad et al., 2006). Aside from that, the five questions with a mean response of less than 2.60 and a standard deviation of less than 1 showed that respondents have similar perspectives on the issues. This result indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on knowing well which sources of income they must declare, they are paying their taxes in anticipation of public services and also they disagreed in knowing about criminal penalties for intentional tax evasion. The respondents also disagreed on being well informed about tax and tax evasion and also they

disagreed to the statements that specify the tax authorities provided them different training about tax evasion and other tax-related issues.

The above results also supported by the overall mean = 2.08 and SD = 0.69 as shown in Table 4.6 below and also showed that there was lack of awareness of the tax system by the taxpayers, this was due to lack of knowledge on which sources of income they must declare to the tax authorities, not knowing that tax was paid in anticipation of public services and also not knowing about criminal penalties for intentional tax evasion. Beside this the respondents indicated that they were not well informed about tax and tax evasion and also the tax authorities didn't provided them or the taxpayers with different training about tax evasion and other tax-related issues.

**Table 4.6: Descriptive Statistics of Tax Awareness**

<b>Code</b>	<b>Statements on Tax Awareness</b>	<b>Mean</b>	<b>SD</b>
<b>TAW1</b>	I know well which sources of income I must declare	2.09	0.69
<b>TAW2</b>	Tax is paid in anticipation of public services	2.05	0.74
<b>TAW3</b>	I know about criminal penalties for intentional tax evasion	2.08	0.68
<b>TAW4</b>	I am well informed about tax and tax evasion	2.07	0.67
<b>TAW5</b>	The tax authorities provided me different training about tax evasion and other tax-related issues	2.12	0.66
<b>The Overall Mean and SD</b>		<b>2.08</b>	<b>0.69</b>

*Source: Results of Own Survey Data (2022)*

The tax authority, according to the interviewees, is not adequately providing the necessary tax awareness for SMEs. The tax authorities do not have any ongoing education programs or adequate monitoring procedures in place to ensure that taxpayers have a good and reasonable understanding of tax concerns. According to the respondents, the taxpayer's awareness and attitude are more significant because the effectiveness of tax education is dependent on the taxpayer's readiness, acceptance, and honesty. Furthermore, the examined respondents stated

that SMEs taxpayers will be pushed to engage in tax evasion because they are not adequately informed about the necessity of tax for country development and the damaging effects of tax evasion.

#### 4.4.1.3. Tax Audit

The tax audit items had scored an average mean value between 2.06 and 2.21 with a standard deviation value between 0.59 and 0.64 as shown in Table 4.7 below. This indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on the overall items of tax audit because the mean values lie between 1.80 and 2.60 (Al-Sayaad et al., 2006). Beside this, the four questions with a mean response of less than 2.60 and a standard deviation of less than 1 showed that respondents have similar perspectives on the issues. This result indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on the probability of getting caught by tax audit is high, and also they disagreed that the MSEs have no chance to evade their taxes or filing taxes less than actual obligation due to tax audit by tax authorities. The result also indicated that the respondents disagreed that the audit departments of the government inspect or audit whether the taxpayers are complying with tax laws regularly and also will find out if MSEs do not file taxes documents.

**Table 4.7: Descriptive Statistics of Tax Audit**

<b>Code</b>	<b>Statements on Tax Audit</b>	<b>Mean</b>	<b>SD</b>
<b>TA1</b>	The probability of getting caught by tax audit is high	2.11	0.64
<b>TA2</b>	The MSEs have no chance to evade their taxes or filing taxes less than actual obligation due to tax audit by tax authorities	2.06	0.59
<b>TA3</b>	The audit departments of the government inspect or audit whether the taxpayers are complying with tax laws regularly	2.21	0.57
<b>TA4</b>	The tax authority will find out if MSEs do not file taxes documents	2.13	0.61
<b>The Overall Mean and SD</b>		<b>2.13</b>	<b>0.60</b>

*Source: Results of Own Survey Data (2022)*

The above results also supported by the overall mean = 2.13 and SD = 0.60 as shown in Table 4.7 above and also showed that the probability of getting caught by tax audit was low, the MSEs have chance to evade their taxes or filing taxes less than the actual obligation, the audit departments of the government did not regularly inspect or audit whether the taxpayers are complying with tax laws and also the tax authority did not find out regularly if MSEs do not file taxes documents.

The probability of being discovered by a tax audit, according to the tax officials consulted, determines SMEs taxpayers' tax avoidance. At the same time, the tax official interviewed stated that they have doubts about the tax administration's ability to investigate the accuracy of the reported income by SMEs managers or owners because the number of SMEs tax payers does not correlate well with the number of auditors in the tax authority offices or ERCA of each sub-city in Addis Ababa. As a result, SMEs taxpayers' tax avoidance would increase, and tax evasion will become regular. The tax official also stated that if government audit departments and tax authorities constantly verify whether taxpayers are complying with tax rules and enforce fines and penalties on tax evaders, tax evasion would be greatly reduced.

#### **4.4.1.4. Tax Penalties and Enforcements**

The tax penalties and enforcements items had scored an average mean value between 2.11 and 2.18 with a standard deviation value between 0.69 and 0.71 as shown in Table 4.8 below. This indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on the overall items of tax penalties and enforcements as because the mean values lie between 1.80 and 2.60 (Al-Sayaad et al., 2006). Beside this, the five questions with a mean response of less than 2.60 and a standard deviation of less than 1 showed that respondents have similar perspectives on the issues. This result indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on fines and penalties that are imposed on the MSEs who evade tax and on the adequacy of the currents penalties to make MSEs obey tax laws and also on the capability of the anti-corruption commission in taking action against tax evaders. The respondents also disagreed that the tax authorities punished MSEs who do not file taxes and the tax laws are enforced on those MSEs that are not submitting the income tax return regularly and fairly.

**Table 4.8: Descriptive Statistics of Tax Penalties and Enforcements**

<b>Code</b>	<b>Statements on Tax Penalties and Enforcements</b>	<b>Mean</b>	<b>SD</b>
<b>TPE1</b>	Fines and penalties are imposed on the MSEs who evade tax	2.14	0.71
<b>TPE2</b>	Currents penalties are enough to make MSEs obey tax laws	2.11	0.71
<b>TPE3</b>	The anti-corruption commission is capable of taking action against tax evaders	2.13	0.69
<b>TPE4</b>	The tax authority will punish MSEs who do not file taxes	2.13	0.71
<b>TPE5</b>	The tax laws are enforced on those MSEs that are not submitting the income tax return	2.18	0.69
<b>The Overall Mean and SD</b>		<b>2.14</b>	<b>0.70</b>

*Source: Results of Own Survey Data (2022)*

As shown in Table 4.8 above, the results also supported by the overall mean = 2.14 and SD = 0.70. This result indicated that fines and penalties were not imposed on the MSEs who evade tax, current penalties were not enough to make MSEs obey tax laws and also the anti-corruption commission is not capable of taking action against tax evaders. Besides this the result also showed that the tax authority did not punish MSEs who do not file taxes and also the tax laws were not enforced on those MSEs that are not submitting the income tax return regularly.

These findings are in line with the findings of the respondents who were interviewed. Fines and penalties were not appropriately imposed on SMEs that evaded taxes, and the tax authority did not punish SMEs that did not file taxes and submit income tax returns on a regular basis. This is because SMEs' managers or owners do not keep track of all of their transactions for tax purposes, and they also conduct transactions without receipts. Aside from that, the interviewed respondents stated that the decision to evade tax is based on the level and rate of fines and penalties; if they expect to be caught by the tax authorities, they will be penalized; if they believe they will not be caught by the tax authorities, they will evade their taxes. In other words, if the penalty and fine rates are high, tax evasion will be low.

#### 4.4.1.5. Tax Authority’s Efficiency

The tax authority’s efficiency items had scored an average mean value between 2.11 and 2.18 with a standard deviation value between 0.60 and 0.68 as shown in Table 4.9 below. This indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on the overall items of tax authority’s efficiency because the mean values lie between 1.80 and 2.60 (Al-Sayaad et al., 2006). Beside this, the four questions with a mean response of less than 2.60 and a standard deviation of less than 1 showed that respondents have similar perspectives on the issues. This result indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration disagreed on the tax authority employee’s skills, knowledge and professionalism and willingness to help taxpayers. The respondents also disagreed on the statements that specifies the tax collectors do not harass the taxpayers and also on having and putting a sound and efficient tax system in place by the tax administration.

As shown in Table 4.9 below, the results also supported by the overall mean = 2.15 and SD = 0.65. This result indicated that the tax authority employees did not have the necessary skills, knowledge, professionalism and willingness to help taxpayers. Beside this the result also showed that the tax authority employees or the tax collectors did harass the taxpayers and also the tax administration did not put a sound and efficient tax system in place to collect taxes in SMEs.

**Table 4.9: Descriptive Statistics of Tax Authority’s Efficiency**

<b>Code</b>	<b>Statements on Tax Authority’s Efficiency</b>	<b>Mean</b>	<b>SD</b>
<b>TAE1</b>	The tax authority employees are skilled and professional	2.14	0.60
<b>TAE2</b>	The tax authority employees are knowledgeable and willing to help	2.11	0.63
<b>TAE3</b>	The tax collectors do not harass the taxpayers	2.18	0.68
<b>TAE4</b>	The tax administration has put a sound and efficient tax system in place	2.16	0.67
<b>The Overall Mean and SD</b>		<b>2.15</b>	<b>0.65</b>

*Source: Results of Own Survey Data (2022)*

According to the tax officials interviewed, Ethiopia's tax administration system is inefficient and ineffective due to the revenue authority's non-availability of a database of all taxable individuals, which allowed people to evade tax, a shortage of experienced and highly motivated personnel for tax assessment and tax collection, and ambiguous procedures for tax assessment and tax collection. According to the tax officers interviewed, SMEs taxpayers utilize various tactics to escape taxes as a result of tax authority inefficiency. Non-declaration and under-reporting of income, overstating business costs and deductions, overstating and understating trading stock, and deducting personal expenses as company expenses to mask the real tax due were some of the key strategies used by tax payers to evade and avoid tax.

#### **4.4.1.6. Negative Taxpayers Attitude toward Tax**

The negative taxpayer's attitude toward tax items had scored an average mean value between 3.91 and 4.05 with a standard deviation value between 0.67 and 0.76 as shown in Table 4.10 below. This indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration agreed on the overall items of taxpayer's attitude toward tax because the mean values lie between 3.40 and 4.20 (Al-Sayaad et al., 2006). Beside this, the five questions with a mean response of greater than 3.40 and a standard deviation of less than 1 showed that respondents have similar perspectives on the issues. This result indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration agreed on the tax system being unequal and unfair, the tax administration being inefficient to find out SMEs who declare their income inaccurately and in so doing punish tax evaders and also they agreed that tax evasion was not considered a serious offense. The respondents also agreed that the overall tax system is too complex to understand and considered tax evasion as ethical behavior because social justice is not established all over the country.

**Table 4.10: Descriptive Statistics of Taxpayers Attitude toward Tax**

<b>Code</b>	<b>Statements of Negative Taxpayers Attitude toward Tax</b>	<b>Mea n</b>	<b>SD</b>
<b>TAT1</b>	The tax system is unequal and unfair	3.96	0.70
<b>TAT2</b>	The tax administration is inefficient to find out SMEs who declare their income inaccurately and thereby punish tax evaders	3.93	0.76

<b>TAT3</b>	Tax evasion is not considered a serious offense	3.91	0.71
<b>TAT4</b>	The overall tax system is too complex to understand	4.05	0.67
<b>TAT5</b>	Tax evasion is ethical because social justice is not established all over the country	3.98	0.69
<b>The Overall Mean and SD</b>		<b>3.97</b>	<b>0.71</b>

*Source: Results of Own Survey Data (2022)*

As shown in Table 4.10 above, the results also supported by the overall mean = 3.97 and SD = 0.71. This result indicated that the tax payers considered the tax system being unequal and unfair, the tax administration being inefficient to find out SMEs who declare their income inaccurately and punish tax evaders and also the taxpayers perceived or considered tax evasion not a serious offense or crime. Beside this the respondents indicated that the overall tax system is too complex to understand and considered tax evasion as an ethical behavior because of the social justice all over the country is not established well.

The majority of the tax officers interviewed stated that taxpayers of SMEs do not identify tax with any government-provided social services and just saw tax as a payment to the government. They also stated that the majority of SMEs and even large businesses do not consider social services or wealth distribution while paying taxes, but do so because ERCA requires them to pay. This finding revealed that SMEs taxpayers have a bad attitude toward taxes, but the tax officials interviewed stated that there are just a few loyal taxpayers in the city; therefore such questions cannot be indicative of all taxpayers.

According to the tax officers interviewed, SMEs taxpayers have a decreased tendency to dodge tax if they believe the tax system is fair. Aside from that, the tax officials interviewed said that taxpayers are more likely to comply with their tax system if they believe that the tax rate is not too high, that a large portion of the money collected is spent on worthwhile projects that benefit the taxpayers (infrastructures like electricity, water, security and others), and that the government service is adequate in general. In this case, though, the opposite is true. According to the tax officials interviewed, some of the things SMEs taxpayers do to avoid tax assessment by ERCA officials include: removing or hiding merchandise from shopping shelves to reduce

the average daily revenue estimation cost, providing inaccurate and inappropriate information to tax officials, purposefully closing their businesses to avoid tax assessment, and intentionally leaving inappropriate people in charge of their shops who were unable to provide the necessary information to the tax officials, etc.

#### 4.4.1.7. Tax Compliance Costs

Tax compliance costs items had scored an average mean value between 3.85 and 3.91 with a standard deviation value between 0.67 and 0.77 as shown in Table 4.11 below. This indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration agreed on the overall items of tax compliance costs because the mean values lie between 3.40 and 4.20 (Al-Sayaad et al., 2006). Beside this, the six questions with a mean response of greater than 3.40 and a standard deviation of less than 1 showed that respondents have similar perspectives on the issues. This result indicated that the owners or managers of the selected SMEs of Addis Ababa City Administration agreed that the penalty for not paying tax is lower than their tax saving, the cost of stationaries, computer, cash register machine and its operation, and also the cost of software and internet is high for them. The respondents also agreed that the cost of hiring staff such as accountant and sales man is high for them and therefore most of the time they hire external services (tax consultant) to file tax returns and they pay additional costs.

As shown in Table 4.11 below, the results also supported by the overall mean = 3.88 and SD = 0.72. This result indicated that the tax payers considered the penalty for not paying tax is lower than their tax saving, and also the tax compliance costs like the cost of stationaries, computer, cash register machine and its operation, the cost of software and internet, the cost of hiring staff such as accountant and sales man is high for them. Also the result indicated that the managers or owners of the SMEs most of the time hire external services (tax consultant) to file tax returns and paid additional costs.

**Table 4.11: Descriptive Statistics of Tax Compliance Costs**

Code	Statements on Tax Compliance Costs	Mean	SD
TCC1	The penalty due to not paying tax is lower than my tax saving	3.88	0.67

<b>TCC2</b>	Cost of stationaries, computer, etc. is high	3.91	0.77
<b>TCC3</b>	Cost of cash register machine and its operation is high	3.85	0.71
<b>TCC4</b>	Cost of software and internet is high	3.89	0.77
<b>TCC5</b>	Cost of hiring staff such as accountant and sales man is high	3.88	0.69
<b>TCC6</b>	Most of the time I hire external services (tax consultant) to file tax returns and I pay additional costs	3.89	0.72
<b>The Overall Mean and SD</b>		<b>3.88</b>	<b>0.72</b>

*Source: Results of Own Survey Data (2022)*

The cost of tax services to SMEs is a problematic issue, according to all of the tax officials interviewed. Even though the cost is minimal in comparison to the services delivered, the majority of SMEs are unaware of the value of the services. As a result, they are hesitant to compensate or value the work and effort of tax consultants. Due to the aforementioned reasons, the majority of tax officials stated that the hired tax consultants collect their service fees on time, i.e. as soon as they complete the services but before delivering to the firms. As a result, most SMEs owners hesitate or take time to settle their service fees once the service is provided. Similarly, tax officials stated that the tax consultant's service fee can influence SMEs' tax evasion decisions to some extent, but that the intent to conceal taxes, the procedure for filing returns with the Tax Authority, and accountants' salaries and stationery costs has a greater impact on tax evasion decisions.

Furthermore, the tax officials interviewed said that keeping accounting records is expensive for SMEs since they must engage an accountant, rent an office, and acquire computers, stationery, and software, among other things. Monthly and quarterly tax filing is another expensive process for SMEs since it takes them too long to file monthly or quarterly returns, which can take up to three days or more. According to the survey responses of SMEs managers or owners and the interview results of tax officials, compliance costs such as accountants' salaries, fees to tax consultants, cost of cash register machine & its maintenance, time for filing VAT & TOT and declaration of income, cost of computer, stationaries, and software used in

the record keeping process, and the cost of computer, stationaries, and software used in the record keeping process all affect tax evasion of SMEs profit taxpayers.

#### 4.4.2. Tax Evasion Constructs

As shown in Table 4.12 below, tax evasion dimensions was assessed by ten measurement items which have a mean score value between 3.80 and 3.92 with a standard deviation value between 0.67 and 0.73. This shows that the owners or managers of the selected SMEs of Addis Ababa City Administration agreed that the causes or reasons for taxpayers to involve in tax evasion was due to high rates of income tax, low rates of penalties, a low probability of detection, the complexity and unfairness in the tax system, weakness of the audit system and the inefficiencies of the tax authorities. Also, the owners or managers of the selected SMEs of Addis Ababa City Administration agreed that majority of the MSEs taxpayers do not report all of their income to the authority, and considered tax evasion as ethical behavior because they perceived that a large portion of the money collected by the public authorities is wasted and responded that tax evasion is not considered as serious crime among the society or MSEs taxpayers. As shown in Table 4.12 below, the results also supported by the overall mean = 3.86 and SD = 0.69.

**Table 4.12: Descriptive Statistics of Tax Evasion Dimensions**

<b>Code</b>	<b>Statements on Tax Evasion</b>	<b>Mean</b>	<b>SD</b>
<b>TE1</b>	High rates of income tax are one of the reasons for tax evasion	3.92	0.67
<b>TE2</b>	Low rates of penalties are responsible for causing tax evasion	3.80	0.68
<b>TE3</b>	A low probability of detection may be the cause of tax evasion	3.83	0.73
<b>TE4</b>	The weakness of the audit system is responsible for allowing tax evasion	3.90	0.67
<b>TE5</b>	The unfairness of the tax system is the causes of tax evasion	3.87	0.70
<b>TE6</b>	The inefficiencies of the tax authorities are the causes of tax evasion	3.92	0.67
<b>TE7</b>	Majority of the MSEs taxpayers do not report all of their income to the authority	3.80	0.68
<b>TE8</b>	Tax evasion is ethical if a large portion of the money collected by the public authorities is wasted	3.83	0.73

<b>TE9</b>	Tax evasion is less considered as serious crime among the society or MSEs	3.90	0.67
<b>TE10</b>	The complexity in the tax system is the reason for tax evasion	3.87	0.70
<b>The Overall Mean and SD</b>		<b>3.86</b>	<b>0.69</b>

*Source: Results of Own Survey Data (2022)*

In addition to the preceding closed-ended questions, the ERCA tax officials who were interviewed were given the option to express their opinions utilizing the open-ended questions that were provided. The following is how the questionnaire should be read:

- What suggestion do you have to alleviate tax evasion in the city SMEs or better yet in the country as a whole?

As a result, the majority of ERCA tax officials interviewed responded with their thoughts on how to reduce tax evasion in Addis Ababa City Administration SMEs. Despite the large number of responses, the general themes are almost identical to those mentioned in the closed-ended questionnaire above. As a result, tax evasion by SMEs can be reduced by opening new branches in close proximity to taxpayers, improving internet connections, simplifying tax filing and collection procedures by introducing e-filing and e-payment systems, improving relationships and building trust with taxpayers by communicating tax programs to them, creating awareness through regular training and education on tax laws and procedures, and ensuring fairness in the tax system and by making accessible of any changes to the tax laws and directives to the taxpayers timely.

## **CHAPTER FIVE**

### **5. SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

This chapter consists of the summary of the findings, conclusions drawn from the analysis part and the recommendations forwarded by the researcher in order to improve the factors contributing to tax evasion in SMEs of Addis Ababa City Administration.

#### **5.1. Summary of Findings**

This study was aimed to investigate the factors contributing to tax evasion in SMEs of Addis Ababa City Administration.

The descriptive statistics results of tax fairness items scored an overall mean of 2.09 and SD of 0.68. This showed that there was unfairness in the tax system, due to existence of corruption practice in the tax system, unfairness of tax collection procedures, principles and discriminatory tax assessment, the presence of inconsistency in the tax burden or tax assessment that is based on arbitrary decisions. The interviewed respondents also indicated similar findings and indicated that taxpayers are sometimes requested to pay unjustified tax expenses because they do not keep the essential documentation for taxation, as well as timely submission of the required documentation to the tax authority. As a result, tax burdens or assessments may be assigned based on arbitrary determinations, resulting in injustice in the tax system, which has prompted criticism from taxpayers who see the tax system as unjust.

The descriptive statistics results of tax fairness items scored an overall mean of 2.08 and SD of 0.69. This result showed that there was lack of awareness of the tax system by the taxpayers, this was due to lack of knowledge on which sources of income they must declare to the tax authorities, not knowing that tax was paid in anticipation of public services and also not knowing about criminal penalties for intentional tax evasion. The interviewed respondents also indicated similar findings and indicated that the tax authority is not adequately providing the necessary tax awareness for SMEs and do not have any ongoing education programs or adequate monitoring procedures in place to ensure that taxpayers have a good and reasonable understanding of tax concerns.

The results of the descriptive statistics of tax audit items scored an overall mean of 2.13 and SD of 0.60. This indicated that the probability of getting caught by tax audit was low, the MSEs have chance to evade their taxes or filing taxes less than the actual obligation, the audit departments of the government did not regularly inspect or audit whether the taxpayers are complying with tax laws and also the tax authority did not find out regularly if MSEs do not file taxes documents. Beside this the tax official interviewed stated that they have doubts about the tax administration's ability to investigate the accuracy of the reported income by SMEs managers or owners because the number of SMEs tax payers does not correlate well with the number of auditors in the tax authority offices or ERCA of each sub-city in Addis Ababa.

The results of the descriptive statistics of tax penalties and enforcements items scored an overall mean of 2.14 and SD of 0.70. This indicated that fines and penalties were not imposed on the MSEs who evade tax, current penalties were not enough to make MSEs obey tax laws and also the anti-corruption commission is not capable of taking action against tax evaders. Also the interviewed respondents stated that fines and penalties were not appropriately imposed on SMEs that evaded taxes, and the tax authority did not punish SMEs that did not file taxes and submit income tax returns on a regular basis. This is because SMEs' managers or owners do not keep track of all of their transactions for tax purposes, and they also conduct transactions without receipts.

The descriptive statistics results of tax authority's efficiency items scored an overall mean of 2.15 and SD of 0.65. This result showed that the tax authority employees did not have the necessary skills, knowledge, professionalism and willingness to help taxpayers and also the tax authority employees harass the taxpayers and the tax administration did not put a sound and efficient tax system in place to collect taxes in SMEs. Beside this the interviewed tax officials indicated that Ethiopia's tax administration system is inefficient and ineffective due to the revenue authority's non-availability of a database of all taxable individuals, which allowed people to evade tax, a shortage of experienced and highly motivated personnel for tax assessment and tax collection. Also the tax officers interviewed indicated that SMEs taxpayers use various tactics to escape taxes as a result of tax authority inefficiency. Non-declaration and under-reporting of income, overstating business costs and deductions, overstating and understating trading stock, and deducting personal expenses as company expenses to mask the real tax due were some of the key strategies used by tax payers to evade and avoid tax.

The descriptive statistics results of negative taxpayer's attitude toward tax items scored an overall mean of 3.97 and SD of 0.71. This result showed that the tax payers considered the tax system being unequal and unfair, the tax administration being inefficient to find out SMEs who declare their income inaccurately and punish tax evaders and also the taxpayers perceived or considered tax evasion not a serious offense or crime and also the overall tax system is too complex to understand. Similarly, the tax officers interviewed stated that taxpayers of SMEs do not identify tax with any government-provided social services and just saw tax as a payment to the government. They also stated that the majority of SMEs and even large businesses do not consider social services or wealth distribution while paying taxes, but do so because ERCA requires them to pay. According to the tax officials interviewed, some of the things SMEs taxpayers do to avoid tax assessment by ERCA officials include: removing or hiding merchandise from shopping shelves to reduce the average daily revenue estimation cost, providing inaccurate and inappropriate information to tax officials, purposefully closing their businesses to avoid tax assessment, and intentionally leaving inappropriate people in charge of their shops who were unable to provide the necessary information to the tax officials, etc.

The descriptive statistics results of tax compliance costs items scored an overall mean of 3.88 and SD of 0.72. This result indicated that the tax payers considered the penalty for not paying tax is lower than their tax saving, and also the tax compliance costs like the cost of stationaries, computer, cash register machine and its operation, the cost of software and internet, the cost of hiring staff such as accountant and sales man is high for them. Also the result indicated that the managers or owners of the SMEs most of the time hire external services (tax consultant) to file tax returns and paid additional costs. Furthermore, interviewed tax officials indicated that keeping accounting records is expensive for SMEs since they must hire an accountant, rent an office, and acquire computers, stationery, and software, among other things. Monthly and quarterly tax filing is another expensive process for SMEs since it takes them too long to file monthly or quarterly returns, which can take up to three days or more all affect tax evasion of SMEs profit taxpayers.

## **5.2. Conclusions**

The objective of the study was to identify the factors contributing to tax evasion in SMEs of Addis Ababa City Administration. Seven potential factors contributing to tax evasion were

analyzed in this research namely: tax fairness, tax awareness, tax audit, tax penalties & enforcements, tax authority's efficiency, negative taxpayers' attitude towards tax and tax compliance costs.

The following conclusions about tax evasion were obtained from descriptive statistics results and from the qualitative data collected through interviews and the researcher's triangulation. According to the tax officials interviewed, the tax imposed is not fair and reasonable because it is sometimes based on average daily revenue forecasts. Tax compliance expenses were particularly high for SMEs, because keeping accounting records is expensive because they need to engage an accountant, rent an office, and buy computers, stationery, and software, among other things. There are also mismatches between the number of SMEs tax payers and the number of auditors in tax authority offices or ERCA, resulting in a lower likelihood of getting caught by a tax audit. As a result, it decreases one's will to comply voluntarily and boosts tax evasion. Tax awareness is a cornerstone for better voluntary compliance and lowers tax evasion, according to the interview and quantitative findings. Tax evasion will be minimal, according to the interviewed respondents, if the rate of fines and penalties is high.

According to the tax officials interviewed, SMEs taxpayers were able to evade taxes by not declaring and under reporting income, overstating business expenses and deductions, overstating and understating trading stock, and deducting personal expenses as business expenses to hide the exact tax liability. This revealed that SMEs have formed a negative attitude toward taxation because they believe that a big percentage of the money collected is wasted on unworthy projects that do not help the taxpayers.

Finally the interviewed ERCA tax officials indicated that in order to minimize the tax evasion of SMEs, ERCA should open new branches to the vicinity of the taxpayers, improve internet connections, simplify tax filing and collection procedures by introducing e-filing and e-payment systems, improving relationships and building trust with the taxpayers by communicating the tax programmes with the taxpayers, create awareness through regular training and education on tax laws and procedures, ensure fairness in the tax system and by making accessible of any changes to the tax laws and directives to the taxpayers timely.

### **5.3. Recommendations**

Based on the findings of this study, the researcher came up with several recommendations to discourage tax evasion among SMEs. These include:

- Tax proclamations, guidelines, and any changes thereto could be made available to SMEs business profit taxpayers, and timely and necessary tax training about tax rates and systems should be provided using various media such as television, radio, various publications, magazines, and ERCA training activities. As a result, taxpayer awareness will improve, tax evasion problems will be reduced, and SMEs company profit taxpayers will be able to pay their taxes on time.
- ERCA could increase the tax enforcement team to monitor informal suppliers dealing without using legal receipts and to incorporate all SMEs businesses in the tax system, as the presence of those who do not pay taxes has a negative impact on taxpayers' attitudes about taxes. To ensure uniform implementation of tax regulations and procedures and a fair tax system among similar enterprises, the frequency and scope of supervision can be strengthened.
- The principal job of the tax authority is to ensure that the tax system is followed or to prevent or reduce tax evasion. Simultaneously, they must ensure that the tax system is straightforward and transparent in order to reduce the cost of tax compliance. As a result, tax authorities might make tax returns and forms, as well as tax computation and payment dates, as simple as possible to encourage taxpayers to file tax returns and calculate their due without the assistance of tax agents or other bodies. To put it another way, the tax return, system, and forms might be less complicated, and the tax procedures should be straightforward. Taxpayers might also be supplied with tax rules and regulations in a language that they can understand. Consultations with SMEs company taxpayers should be done in particular when amending the tax law (system).
- In terms of SMEs' tax systems, the findings of the study indicated that the majority of SMEs taxpayers in Addis Ababa, Ethiopia, had formed a negative attitude about taxes in terms of an equal and fair tax system. This factor can be used to reduce SMEs' tax evasion by modifying the unfavorable attitude that taxpayers have toward taxes. As a result, negative attitude towards tax can be reduced by raising taxpayers awareness

through training or other methods, improving the behavior of the tax collectors or assessors, and also providing a clear procedures how the taxpayers tax system works and how their tax is calculated and by how much tax rate. As well as the government may communicate with taxpayers about tax programs in order to promote the benefits of paying taxes and prevent tax evasion.

- Only with society's voluntary cooperation can tax evasion be avoided or mitigated. Relying solely on the stick approach or strategy has no long-term consequences. As a result, the tax authority must encourage taxpayers to discharge their tax obligations as freely as possible.
- The tax authorities can do a better job of raising awareness. The focus may not just be on the laws and penalties, but also on the needs and arguments for taxation. Furthermore, taxpayers have a right to get up-to-date information on how the tax system works, as well as how their tax is calculated and their tax rate. The complexity of the situation may be reflected in all information offered to taxpayers, allowing them to better comprehend their tax problems. To accomplish this requirement, the authorities may utilize a variety of methods.

#### **5.4.Direction for Further Research**

Any research project will inevitably have some limits. As a result, the current study had several limitations. Initially, it concentrated solely on variables that contribute to tax avoidance in Addis Ababa City Administration SMEs. As a result, the findings of this study can be applied to SMEs taxpayers in the Addis Ababa City Administration, but it may be difficult to apply this finding to all SMEs taxpayers in Ethiopia or at the national level. In order to generate useful and inclusive studies, future researchers should compare factors leading to tax evasion of taxpayers in different business sectors and focus on other taxpayer categories and cover broader geographical areas. Future researchers can also incorporate other elements that contribute to tax evasion that were not addressed in this study because only seven components were investigated. Furthermore, this study's data analysis was based on cross-sectional data, which is presumed to be static rather than dynamic. As a result, future researchers may want to consider doing longitudinal studies to gain a better understanding of the elements that contribute to tax evasion over time.

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# APPENDIX

## Appendices A: Research Questionnaires

Addis Ababa University

College of Business and Economics

Department of Accounting and Finance

**Dear respondent,**

I am Firehiwot Kebede, a master's degree student in Accounting and Finance at Addis Ababa University, will perform this research as part of his degree requirements. At the moment, I'm working on a study called "Factors Contributing to Tax Evasion: The Case of Small and Medium Enterprises in Addis Ababa City Administration."

I'd like to congratulate you on being one of the most qualified and trustworthy responders chosen for this survey.

Please help me provide accurate and complete information so that I can provide a representative finding on the current situation of Factors Contributing to Tax Evasion: The Case of Small and Medium Enterprises in Addis Ababa City Administration. The survey is completely anonymous, and your participation is entirely voluntary.

Finally, I'd want to assure you that any information you share with me will be kept private and utilized just for scholarly purposes. Individual comments will not be identified, and respondents' identities will not be published or shared.

Regards, Sincerely,

Firehiwot Kebede

### **Instructions**

1. There is no need to write your name.
2. For five point Likert scale type statements put a check mark (√) in the appropriate block and multiple choice questions indicate your answers by encircling the letter of your choice.

N. B. If you have any additional comments, clarifications, information, and suggestions, you can contact the researcher in the following addresses:

Name: Firehiwot Kebede

Mobile: 0925084734

E-mail: [Fere.kebede23@gmail.com](mailto:Fere.kebede23@gmail.com)

Thank you in advance for your invaluable cooperation and dedicating your time.

## **Part I: Backgrounds of the Respondents and Their Business**

**Instructions:** Please encircle the letter of your choice.

1. Gender
  - a. Male
  - b. Female
2. Age
  - a. 20 – 30 years
  - b. 31 – 40 years
  - c. 41 – 50 years
  - d. Above 50 years
3. Marital status
  - a. Single
  - b. Married
  - c. Divorced
  - d. Widowed
4. Educational Qualification
  - a. Primary School
  - b. Secondary School
  - c. Diploma
  - d. First Degree
  - e. Master's Degree and above
5. SMEs Sectors of business activities
  - a. Trade
  - b. Service
  - c. Urban Agriculture
  - d. Manufacturing
  - e. Construction
6. Forms of Business Ownership
  - a. Sole Proprietorships
  - b. Partnership
  - c. Private Limited Companies (PLC)
  - d. Other Associations
7. Tax Experience of SMEs
  - a. Below 5 years
  - b. 5 to 10 years
  - c. More than 10 years

## **Part II: Factors Contributing to Tax Evasion**

The following are the primary factors that contribute to tax evasion in SMEs according to the Addis Ababa City Administration. Please rate how much the Factors Contributing to Tax Evasion are affecting your organization. After reading each of the Factors Contributing to Tax Evasion, assess them in relevance to your organization, and then mark the options with a check mark (✓). Where 5 indicate Strongly Agree, 4 indicate Agree, 3 indicate Neutral, 2 indicates Disagree, and 1 indicates Strongly Disagree.

**Overall Factors Contributing to Tax Evasion**

<b>Code</b>	<b>Tax Fairness</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>TF1</b>	There is no existence of corruption practice in the tax system					
<b>TF2</b>	The tax collection procedures and principles are fair or there is no discriminatory tax assessment.					
<b>TF3</b>	There is no inconsistency in tax burden or the tax assessment is not based on arbitrary decisions					
<b>TF4</b>	There is no ambiguity of tax regulations that leads to misinterpretation of tax regulations					
<b>TF5</b>	A large portion of the money collected is spent on projects that does benefit me					
<b>Code</b>	<b>Tax Awareness</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>TAW1</b>	I know well which sources of income I must declare.					
<b>TAW2</b>	Tax is paid in anticipation of public services					
<b>TAW3</b>	I know about criminal penalties for intentional tax evasion.					
<b>TAW4</b>	I am well informed about tax and tax evasion					
<b>TAW5</b>	The tax authorities provided me different training about tax evasion and other tax-related issues					
<b>Code</b>	<b>Tax Audit</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>TA1</b>	The probability of getting caught by tax audit is high.					
<b>TA2</b>	The MSEs have no chance to evade their taxes or filing taxes less than actual obligation due to tax audit by tax authorities.					
<b>TA3</b>	The audit departments of the government inspect or audit whether the taxpayers are complying with tax laws regularly.					
<b>TA4</b>	The tax authority will find out if MSEs do not file taxes documents.					
<b>Code</b>	<b>Tax Penalties and Enforcements</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>TPE1</b>	Fines and penalties are imposed on the MSEs who evade tax.					
<b>TPE2</b>	Currents penalties are enough to make MSEs obey tax laws.					
<b>TPE3</b>	The anti-corruption commission is capable of taking action against tax evaders.					
<b>TPE4</b>	The tax authority will punish MSEs who do not file taxes.					
<b>TPE5</b>	The tax laws are enforced on those MSEs that are not submitting the income tax return.					
<b>Code</b>	<b>Tax Authority's Efficiency</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>TAE1</b>	The tax authority employees are skilled and professional.					
<b>TAE2</b>	The tax authority employees are knowledgeable and willing to help.					
<b>TAE3</b>	The tax collectors do not harass the taxpayers.					
<b>TAE4</b>	The tax administration has put a sound and efficient tax system in place.					
<b>Code</b>	<b>Negative Taxpayers Attitude toward Tax</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>TAT1</b>	The tax system is unequal and unfair.					

<b>TAT2</b>	The tax administration is inefficient to find out SMEs who declare their income inaccurately and thereby punish tax evaders.					
<b>TAT3</b>	Tax evasion is not considered a serious offense.					
<b>TAT4</b>	The overall tax system is too complex to understand.					
<b>TAT5</b>	Tax evasion is ethical because social justice is not established all over the country.					
<b>Code</b>	<b>Tax Compliance Costs</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>TCC1</b>	The penalty due to not paying tax is lower than my tax saving					
<b>TCC2</b>	Cost of stationaries, computer, etc. is high					
<b>TCC3</b>	Cost of cash register machine and its operation is high					
<b>TCC4</b>	Cost of software and internet is high					
<b>TCC5</b>	Cost of hiring staff such as accountant and sales man is high					
<b>TCC6</b>	Most of the time I hire external services (tax consultant) to file tax returns and I pay additional costs.					

### Part III: Tax Evasion Dimensions

The dimensions of tax evasion in Addis Ababa City Administration SMEs are described below. Please describe the extent to which these issues influence your organization's tax payment process. After reading each of these variables, evaluate them in respect to your organization, and then mark the options below with a check mark (✓). Where 5 indicate Strongly Agree, 4 indicate Agree, 3 indicate Neutral, 2 indicates Disagree, and 1 indicates Strongly Disagree.

#### Tax Evasion Dimensions

<b>Code</b>	<b>Tax Evasion</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
<b>TE1</b>	High rates of income tax are one of the reasons for tax evasion					
<b>TE2</b>	Low rates of penalties are responsible for causing tax evasion					
<b>TE3</b>	A low probability of detection may be the cause of tax evasion					
<b>TE4</b>	The weakness of the audit system is responsible for allowing tax evasion					
<b>TE5</b>	The unfairness of the tax system is the causes of tax evasion.					
<b>TE6</b>	The inefficiencies of the tax authorities are the causes of tax evasion.					
<b>TE7</b>	Majority of the MSEs taxpayers do not report all of their income to the authority.					
<b>TE8</b>	Tax evasion is ethical if a large portion of the money collected by the public authorities is wasted.					
<b>TE9</b>	Tax evasion is less considered as serious crime among the society or MSEs.					
<b>TE10</b>	The complexity in the tax system is the reason for tax evasion.					

***Thank you once again!!***

## **Appendices B: Interview Questions for the Tax Collectors**

### **Addis Ababa University**

### **College of Business and Economics**

### **Department of Accounting and Finance**

Questions prepared to assess the evaluation and observation of operational officials about tax evasion the case of SMEs in Addis Ababa City Administrations sub-cities small and medium tax payer's revenue and customs branch office are listed below:

1. How do you describe/evaluate the factors contributing to tax evasion opportunities in the SMEs in your sub-cities and tax office?
2. How do you describe the tax fairness of the tax system for SMEs and your office as a whole?
3. How do you evaluate the tax awareness of the taxpayers and the tax office?
4. How do you evaluate the tax audit performance of your office in minimizing tax evasion of the taxpayers?
5. What look like the tax penalties and enforcements levels of your office towards SMEs tax evaders in your sub-city?
6. How do you evaluate your offices efficiency in fighting tax evasion of SMEs in your sub-city?
7. How do you evaluate the negative tax payers' attitude towards tax in SMEs found in your sub-city?
8. How do you describe the tax compliance cost Of the taxpayers and also the tax office workers?
9. What suggestion do you have to alleviate tax evasion in the city SMEs or better yet in the country as a whole?