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ADDIS ABABA UNIVERSITY

COLLEGE OF LAW AND GOVERNANCE STUDIES

SCHOOL OF LAW

**Incentives to Compliant Taxpayers under Ethiopian Tax Laws:
Legal and Practical Analysis**

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May 12, 2025

Addis Ababa, Ethiopia

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Legal and Practical Analysis**

SENIOR THESIS SUBMITTED TO ADDIS ABABA UNIVERSITY, COLLEGE OF
LAW AND GOVERNANCE STUDIES, SCHOOL OF LAW IN PARTIAL
FULFILLMENT OF LL.M IN BUSINESS LAW

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Declaration

I, Serkalem Assefa Temi, declare that this thesis is my original work and has never been submitted in any other institution. I also declare that all sources used for the thesis have been duly acknowledged.

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Acronyms

IMF	International Monetary Fund
NBE	National Bank of Ethiopia
OECD	The Organization for Economic Co-operation and Development
TOT	Turnover Tax
UN	United Nation
VAT	Value Added Tax
WBG	World Bank Group

Abstract

This paper critically examines whether the tax laws currently in place in Ethiopia incentivize compliant taxpayers, analyzing both their legal framework and practical implementation. Although tax compliance is vital for increasing domestic revenue and promoting national development, incentivizing compliance through granting positive rewards is a relatively underexplored area in Ethiopia. The current legal regime in Ethiopia including the Federal Income tax, Federal Tax Administration Proclamations, Customs proclamation, and Excise Tax Proclamation demonstrated to be inadequate to effectively incentivize compliant taxpayers. These regulations don't provide a framework that addresses incentives for compliant taxpayers to promote voluntary compliance. Through doctrinal legal analysis and practical evaluation supported by questioner and interview with stakeholders, the research identifies the absence of detailed provisions and a coherent enforcement mechanism undermines the effectiveness of compliant taxpayers' incentive scheme. To address these gaps, the author recommends that Ethiopia shall re assess its tax law legal framework to ensure that tax compliance is not only enforced but also rewarded in a meaning full manner with a view to promote voluntary tax compliance which will reduce the cost of tax administration.

CHAPTER – ONE

1. Introduction

1.1. Background of the Study

Incentives play a significant role for economic growth and development.¹ Incentive is an essential tool to maximize the compliance level of taxpayers. Promoting the compliance level of taxpayers is an important concern of revenue mobilization in any jurisdiction.² A specific nation may promote taxpayers' compliance levels by engaging them in an incentive scheme to reward their decent reactions to tax obligations. In countries with undeveloped tax systems like Ethiopia, non-compliance to the tax obligations in one side and lack of proper incentive schemes for compliant taxpayers on the other side is not uncommon even in the new era of modern taxation. Lack of incentives and non-compliance of taxpayers create a major drawback for an efficient revenue collection.

Tax compliance refers to adhering to the tax laws, regulations, and directives in the form of correctly reporting income taxes, expenses, and other financial details to the relevant tax authorities. It also involves a free and complete fulfillment of all tax responsibilities³ timely in a correct amount. In a more extended approach tax compliance may demand staying informed about tax laws, regulations, and directives which often change.⁴ In a situation where there are taxpayers who discharge their tax obligations properly, and others who do not fulfill their tax obligations, the tax law needs to provide differentiated treatment among these two categories of persons to create fairness in taxation.

The types of benefits from tax incentives for investors are the benefits commonly associated with foreign direct investment, including increased capital, knowledge and technology transfers, increased employment, and assistance in improving conditions in less developed areas.⁵ According to commentators, the common incentive schemes for taxpayers are, among others, tax

¹ Alexander Trepelkov and Márcio Verdi, Design and Assessment of Tax Incentives in Developing Countries, (United Nations New York, 2018)5.

²Ibid. 12.

³BennoTorgler, Tax Compliance And Tax Morale(Edward Elgar Publishing Limited, 2017).

⁴Esmael Abdu and Mohammad Adem, Tax compliance behavior of taxpayers in Ethiopia: A review paper (Cogent Economics & Finance 11: 2189559) 2023, <https://doi.org/10.1080/23322039.2023.2189559>

⁵Trepelkov and Verdi (n 1) 14.

holidays, tax returns, income tax exemptions, reduced tax rates, deferral of tax liabilities, tax credits, customs duty exemptions, duty-free privilege, simplified customs procedure,⁶ certification, training grants, non-fiscal privileges, and others. These are incentives for investment and export platforms where the competition may be global, among countries, or regions within a particular country. The form of incentives this research wants to pursue is not incentives targeting to attract investment, but incentive schemes for compliant taxpayers with a view of collecting the maximum possible revenue from the economy by creating a fertile ground of compliance. This helps to pull the non-compliant character of taxpayers towards compliant behavior. Boosting the compliance level of taxpayers in turn escalates the tax collection efficiency of the tax authorities in a less costly manner. Eventually, an efficient way of tax collection from the economy greatly contributes to the socio-economic development of a country. In this regard, designing a certain mode of incentive scheme to compliant taxpayers as opposed to non-compliant taxpayers can converge the attitude of the later towards a positive end. Converging most taxpayers to the same destination of compliance will have a holistic advantage in avoiding tax enforcement costs of a country. For countries like Ethiopia that engage in many developmental endeavors, having a predictable tax system is significantly important. However, having a predictable legal framework alone is not sufficient. This legal framework in taxation has to be accompanied by a meaningful collection of taxes which the economy generates efficiently and easily. In that case, employing the proper modalities of incentive schemes that can contribute in bringing ease of doing business and economic growth of the country has no alternative.

Most Governments around the world are seriously concerned with generating revenues for their treasuries to finance governmental duties.⁷ In generating revenues, some scholars argue that the function of duties and taxes remains the most important solution if a government has to cope with increasing expenditures and resulting fiscal constraints.⁸ According to this argument, revenues from all types of taxes are the uppermost financial source of governments to engage in

⁶Customs Proclamation No. 859/2014, *Federal NegaritGazeta*, 20th Year No. 82, ADDIS ABABA 9th December 2014, Art. 84.

⁷Charles H. Gustafson, 'The Role of International Law and Practice in Addressing International Tax Issues in the Global Era', 56 VILL. L. REV. 475 (2011). Available at: <https://digitalcommons.law.villanova.edu/vlr/vol56/iss3/5>

⁸ OECD, Addressing the Tax Challenges of the Digital Economy, OECD/G20 Base Erosion and profit shifting project (OECD publishing, Paris 2014) 9. <https://doi.org/10.1787/9789264218789-en>.

infrastructural services. Yet, the question lies on how the maximum possible revenues can be collected efficiently given the government has limited enforcement machinery. This contradiction is a perfect trade-off through proper employment effective approaches, *inter alia*, one of the essential means can be an incentive scheme for compliant taxpayers. In the contemporary era of taxation, there are sophisticated ways of tax evasion, tax avoidance, and some other ways non-compliance behavior of taxpayers. These activities of taxpayers cannot be effectively controlled by the ordinary operation of the law unless an alternative task of changing taxpayers' behavior is not properly maintained. At the same time, incorporation of incentive schemes for compliant taxpayers can serve as a spring board to non-compliant ones to come to the same stage of compliance.

Taking the aforementioned points in mind, this study focuses on the legal dimension of incentives particularly for compliant taxpayers, forms of incentive schemes, parameters of setting compliance level under Ethiopian tax laws, merits of incentives for both the government and compliant taxpayers, general implications of incorporating incentives, current challenges and future prospects of inclusion of different forms of incentive schemes for compliant taxpayers under Ethiopian tax laws are thoroughly discussed.

1.2. Statement of the Problem

Establishing a legal system that incentivize taxpayers in general and compliant taxpayers, in particular, plays a significant role in mobilizing revenue for a government. In the first place, mobilizing revenues to a government efficiently from the economy requires setting a workable tax system reform.⁹ Due to its infant socio-economic developments, Ethiopia has no modern tax system.¹⁰ For the lack of well-designed tax system reform, effective mobilization of taxes from the economy has become a chronic problem to the Government of Ethiopia.¹¹ Given there are various tax incentives schemes for both foreign and domestic investors, the amount of collectible tax to the Government treasury is usually much lower than it would have been collected due to

⁹ George Rapsomanikis, *The economic lives of smallholder farmers: An analysis based on household data from nine countries* (Food and Agricultural Organization of the United Nations, 2015, Rome) 5.

¹⁰Michael, Seifu, "[Equity potentials in Tax Reform Ethiopia](#)," ([Ethiopian Journal of Economics](#), Ethiopian Economics Association, vol. 8(2), July 2003) 1.

¹¹ *ibid.*,4.

low compliance level of taxpayers to their tax obligations.¹² Despite the availability of incentives to taxpayers in general, a particular incentive for compliant taxpayers to discharge their tax obligations seems to have given little space. The first question to answer when designing a tax incentive scheme to compliant taxpayers is what type of taxpayers the incentives are intended to attract. Tax incentives for compliant taxpayers are departures from the benchmark system that are granted only to those compliant taxpayers who satisfy prescribed conditions. Granting incentives to compliant taxpayers attracts a spillover effect in pulling non-compliant taxpayers to a common playfield.

As a segment of the lack of proper tax system reform that incorporates incentives to compliant taxpayers in discharging their tax obligations, non-compliant taxpayers may not have the courage to be loyal to their tax liabilities as required. Naturally, the treatment of compliant taxpayers should not fall in the same stage with the treatment of non-compliant taxpayers. The law must have some form of monitoring and encouraging mode for continuing compliance. Even though, non-compliant taxpayers are subject to penalties for a failure to comply with tax obligations, compliant taxpayers should be entitled to meaningful incentive schemes. The existence of incentives treating compliant taxpayers positively as opposed to non-compliant taxpayers or others further establishes installment of neutrality and fairness as major principles of tax policy.¹³ Treatment of different categories of taxpayers in their compliance level equally to let them discharge their tax obligations threatens the very principle of fairness in taxation. Tax incentives can play a useful role in encouraging both domestic and foreign investment.¹⁴ Given a tax incentive has such an advantage, most importantly, no tax incentive should be considered permanent,¹⁵ but to achieve a targeted socio-economic goal only. If the tax system of a country is well-designed in a way that incentivizes compliant taxpayers, becomes practically feasible, and is free from possible abuses, the outcome will have a direct positive impact on economic development.

Regardless of the advantages of having incentive schemes for complaint taxpayers, the Ethiopian tax laws overemphasize penalties¹⁶ targeting non-compliant taxpayers for failure to discharge

¹²ibid., 6.

¹³Gustafson(n 7).

¹⁴Trepelkov and Verdi (n 1) 42.

¹⁵ibid 43.

¹⁶Elias N. Stebek (2016), 'The Constitutional Right to Enhanced *Livelihood* in Ethiopia: Unfulfilled Promises and

tax-related obligations though the practice may face technical problems. This again creates room for the outflow of compliant taxpayers from the tax system that is unwelcoming effect of not having incentive schemes for compliant taxpayers in the tax laws.

As part of the changing world, the Ethiopian Government needs to have a system that encourages taxpayers to honestly comply with the pertinent tax laws of the country. Incorporation of such tools can impact compliant taxpayers and motivate the rest to become compliant taxpayers as well. Due to the inherent problems associated with weak tax system reform and practical challenges in incentivizing compliant taxpayers, administrative and legal enforcement costs of revenue mobilization have become extremely high¹⁷ in Ethiopia. Incorporating incentive schemes and making such incentives practically feasible can help to minimize heavy administrative and legal proceeding costs although misuse of such incentives may lead to a burden to the Government unless consciously articulated.¹⁸ Normally, trying to enforce tax laws through administrative and judicial procedures entails negative role to the principle of *efficiency* in taxation. Therefore, Ethiopia needs to have a tax law that incentivizes compliant taxpayers as it punishes disobedient taxpayers.

The research works so far conducted relate to the desirability of incentives to attract new investments and export trades. The need to have incentive schemes for complaint taxpayers to attract compliance levels of non-compliant taxpayers to realize efficient tax collection from the economy seems overlooked. The practice regarding incentives to compliant taxpayers in Ethiopia is highly ceremonial accompanied by issuance of certificates to the person concerned¹⁹ and getting a real benefit out of the certificate is hardly possible for the taxpayer. Hence, introducing the need to have incentive schemes that hold real benefits for compliant taxpayers in Ethiopian tax laws requires closer scrutiny and going through legal research to fill existing gaps.

the Need for New Approaches', *Mizan Law Review*, Vol. 10, No. 1, pp. 126-176. <<http://dx.doi.org/10.4314/mlr.v10i1.5>>

¹⁷Yesegat,Wollela; Vorontsov,Denis E.; Coolidge,Jacqueline; Corthay,Laurent Olivier, *Tax compliance cost burden and tax perceptions survey in Ethiopia (English)*, (Washington, D.C.: World Bank Group March 2016)42. <http://documents.worldbank.org/curated/en/761151467995397531/Tax-compliance-cost-burden-and-tax-perceptions-survey-in-Ethiopia>

¹⁸Ibid 44.

¹⁹ Ministry of Revenue of Ethiopia Website: <http://www.mor.gov.et/>
Official face book page of ministry of revenue of Ethiopia:
<https://www.facebook.com/share/v/5LztvQCEpAJ3QgE/?mibextid=oFDknk>

Therefore, this research will examine the significance of incorporating incentive schemes to compliant taxpayers under Ethiopian tax laws for a better mobilization of revenues from the economy. At the same time, the need to have incentives will be evaluated from the perspective of the efficiency principle of taxation. This directly relates to how easily and with a minimum possible cost taxes may be collected in a situation where compliance of taxpayers avoids heavy tax enforcement costs and procedures. Thus, the research will eventually fill the gap of collecting a lesser volume of revenue from the economy that would not otherwise have occurred had it not been for the incorporation of incentives to compliant taxpayers.

1.3. Research Questions

The main focus of this study is assessing the existence of incentives to compliant taxpayers under the Ethiopian tax laws (if any). At the same time, the research examines whether the existing incentives are effective in promoting compliance level of taxpayers or not. Along the way, the research evaluates the need to have more incentives that can create trust based compliance and modern society. In doing so, these assertions came up with proper answers to the main questions. Thus, the study dwells on addressing the following sub questions to address the main research questions.

- Should there be incentives for compliant taxpayers?
- What kinds of incentives are given for compliant taxpayers?
- Are there any incentives for compliant taxpayers under the Ethiopian tax laws?
- What does the practice look like in implementing such incentives to compliant taxpayers in Ethiopia?

1.4. Objective of the Study

The general objective of this study is to analyze the desirability or otherwise of incentive schemes for compliant taxpayers under Ethiopian tax laws. Most importantly, the study shed light and investigates the practicability of incentive schemes for compliant taxpayers in reality beyond the mere presence of the law under Ethiopian tax laws and suggests the importance of having effectively practicable incentive schemes to promote the level of compliance. At the same time, the study equally investigates whether incentives are a tool for specific objectives like

boosting compliance or a source for differentiated treatment between similar taxpayers. Again, this paper also compares among the best practices of different jurisdictions in exercising incentives for their compliant taxpayers and recommend for Ethiopia.

In doing so, the study in depth analyses the desirability of incentives to compliant taxpayers under Ethiopian tax laws, examine how the practice looks like, and compare Ethiopia's case with the best practices in other jurisdictions to suggest the commendable approach from the lists. Having the aforementioned general objectives in mind, the study aimed at the following specific objectives:

- Assess if there should be incentives for compliant taxpayers,
- Identify the kinds of incentives given for compliant taxpayers,
- Examine if there are incentives for compliant taxpayers under the Ethiopian tax laws,
- Assess what the practice looks like in Ethiopia.

1.5. Methodology of the Study

In order to enable the researcher or others to evaluate the research results, the researcher discusses the rationale behind the methods employed in the context of the study in this section. The researcher also explains why a specific method or technique is employed and why other ways aren't used.

1.5.1. Research Design

A research design is a work plan that outlines the intended objectives of the study, how those goals will be met, from where information will be gathered, and what kinds of tools will be employed.²⁰ Doctrinal research is defined as research conducted on a legal proposition by the application of reasoning and logic to an analysis of existing legislation and case laws.²¹ Therefore, as the research is mainly carried out by assessing the Ethiopian tax laws, it is a doctrinal research. However, as the researcher conducted this research through gathering data or information by a firsthand study into the universe, which is from compliant taxpayers and officers of the tax authority, the research will not be purely doctrinal but also empirical or non-

²⁰Dereje Tilahun, The Challenges of Tax Incentives on Government Revenue: The Case of ERCA (MA thesis, Addis Ababa University, July 2017) 30.

²¹ CHUNURAM SOREN, Legal research methodology: an overview, (October, 2021) 453.

doctrinal as well. The research is both doctrinal and non-doctrinal research so as to enable the researcher approach the issues from many angles and achieve the objective of the study. It is selected because, when combined, the two forms of legal research offer a more comprehensive comprehension of the research problem than when conducted alone.

1.5.2. Sample Design

A sample is a subset of data that a researcher selects using a pre-defined selection method from a larger population.²² Most of the time, it is expensive, not feasible, and time-consuming to conduct population-wide research.²³ As a result, studying the sample gives the researcher information that may be applied to the total population. Sample design refers to the method or process the researcher is going to employ to choose items from the sample.²⁴

The population of the study is 400 taxpayers who have been recognized by ministry of revenue as loyal, transparent and highest taxpayers of the 2021/2022 fiscal year. Since all of the population are believed to be the focal person for incentives to compliant taxpayers 10 compliant taxpayers are randomly selected for the questioner. Because in simple random sampling technique, the objects of the study have an equal chance of being selected because they are chosen simply on a random basis.²⁵

1.5.3. Method of Data Collection

There are two sorts of data that a researcher should consider while choosing the data collecting strategy for the study, which are primary and secondary sources of data collection.²⁶ To conduct this research both primary and secondary data from different sources are employed. The primary data is collected from taxpayers who have been recognized as loyal taxpayers of the 2021/22 budget year through questioner data collection instruments. Questionnaire is the main instrument to collect information from the target compliant taxpayers and it comprises both close ended and open ended questions. Furthermore, unstructured and structured interview is conducted with officers of Ministry of Revenue of Ethiopia and Ethiopian Customs Commission. In addition, Ethiopian tax laws including but not limited to the Federal income tax proclamation

²²ibid, 458.

²³ ibid.

²⁴C.R.Kothari , Research methodology: methods and techniques (2nd edition, 2004) 55.

²⁵SOREN (n 21) 459.

²⁶Kothari (n 24)495.

No.979/2021, Federal Tax Administration Proclamation No.983/2016, Excise Tax Proclamation No. 1186/2012, VAT Proclamation No. 1341/2016, and Customs Proclamation No.859/2014 (Proclamation No. 1160/2011 as amended) are analyzed. Moreover, the tax laws of different jurisdiction who have best practice in the area will is analyzed as they contribute much for the analysis of matters in the study. On the other hand, regarding secondary data sources of the study, other sources such as different kinds of published and unpublished materials, books, journals, court cases, internet sources, researches and other relevant materials are used in the study.

1.5.4. Methods of Data Analysis

The sample population for this research is not big. Therefore, there is no use of data analysis software. Rather, the raw data collected from the sample population is analyzed in light of the existing law which deals with incentives to the compliant taxpayers. In doing so, the analysis takes place in a form of making sure as to the existence of a proper practice to incentivize compliant taxpayers or not. This is done by consulting the Ethiopian tax laws and comparing the practices from the data collected through questionnaire and interview. Therefore, the method used to analyze the data collected is a critical legal analysis of the Ethiopian tax laws.

1.6. Scope of the Study

This research is limited to assessing incentives to compliant taxpayers under Ethiopian tax laws and its practical dimension. There are several rights of taxpayers recognized under Ethiopian tax laws; however, this study is limited to incentives to compliant tax payers only and indicates possible measures to be taken to mitigate the gap. The scope of the study is delimited to taxpayers who have been nationally recognized by the Ministry of Revenue as loyal, transparent and highest tax payers of the 2021/2022 fiscal year.

1.7. Limitation of the Study

The study was faced certain limitations like lack of credible sources in the area and time constraint to cover the expected depth about the matter. In getting the direct voices of all compliant taxpayers, unwillingness of respondents and interviewees to cooperate or provide

complete and honest information was one of the major challenges the researcher encountered during this study, which may have affected the depth and breadth of the data collected.

1.8. Organization of the Study

This study is composed of four chapters. Chapter one addresses the introductory part of the research. It discusses the background of the study, statement of the problem, objectives of the study, research questions, significance of the study, scope of the study, limitation of the study, methodology of the study and organization of the study. Chapter two covers review of literatures related to incentives to compliant taxpayers. It covers the definition, historical perspective, the types, justifications and all the basics about incentives to compliant taxpayers and discuss about the legal regime and jurisprudence of other jurisdictions covering incentives to compliant taxpayers. Chapter three is the main body of the study and in this particular chapter the legal regime regulating incentives to compliant taxpayers under the Ethiopian tax laws and its practical dimension is assessed thoroughly. Finally, Chapter four is devoted for conclusions and recommendations.

CHAPTER TWO

Literature Review

2.1. Introduction

This chapter of the study presents a comprehensive review of the theoretical frameworks on incentives applicable to compliant taxpayers and their relation with tax compliance. The study starts by exploring the fundamental concepts of tax compliance, tax incentives, their rationale, and the qualifying parameters that define tax compliance. The literature review further delves into the various arguments surrounding the implementation modality of tax incentives, considering both their advantages and potential drawbacks and limitations that may undermine the effectiveness of tax incentives for compliant taxpayers. In addition, it will address the different types of tax incentives and examine their alignment with the core principles of taxation. A critical evaluation of the costs and benefits associated with tax incentives in creating compliant taxpayers will be provided. By assessing these topics, this chapter aims to establish a solid theoretical foundation for understanding the role and impact of tax incentives for compliant taxpayers in fostering the level of tax compliance.

2.1.1. Definition and Concepts of Incentives and Tax Compliance

2.1.1.1. Definition and Concept of Incentives

Incentive in tax is a deviation from the general tax structure to offer preferential treatments for taxpayers who are eligible for those specific incentives.²⁷ Incentives serve as a useful tool by which governments try to shape economic activities and attract desirable behaviors.²⁸ They operate on the principle of influencing individual and company decisions by adjusting the financial effect of specific actions. In essence, incentives target to make specific alternatives more attractive by avoiding or reducing the burden associated with those choices.²⁹ Therefore we can say that incentives are the concessions in tax laws that mean a deliberate loss of government

²⁷Duanjie Chen, *The Framework for Assessing Tax Incentives: A Cost Benefit Analysis Approach* (UN, 2015, New York) 3.

²⁸ OECD, *Tax Incentives and the Global Minimum Corporate Tax: Reconsidering Tax Incentives after the Globe Rules* (OECD Publishing, 2022, Paris <https://doi.org/10.1787/25d30b96-en>) 11.

²⁹Dereje Tilahun, (n 20)7.

revenue in return for attaining desired behavior of taxpayers.³⁰ Mostly they are intended by government authorities to encourage specific types of behaviour and/or to favour specific individuals or groups.³¹

As we can refer from different literatures, this strategic approach can take different forms ranging from allowing deductions for certain types of expenditures to providing tax credits for charitable donations or employing tax holidays for a limited duration to lure foreign investment or reduced import tariffs or customs duties.³² By altering the tax system to encourage certain activities, governments aim to promote social responsibility, stimulate economic development, or accomplish multiple policy objectives.

To attain policy objectives such as increasing tax compliance, different countries have adopted a strategy of rewarding tax compliance.³³ As psychologists and economists agree incentives can encourage desired behaviors or activities by reducing burden³⁴ on individuals or corporate entities, such incentives must have tangible pattern and user friendly nature. Both developing and developed countries widely employ incentives as a tool to promote tax compliance and increase government revenue.³⁵ They may take the form of certificates awarded to compliant taxpayers, privilege cards for special treatments and discounts, lotteries in which only compliant taxpayers can participate and the like.³⁶

In the study of tax compliance and revenue generation, having a deep understanding of the underlying mechanics of tax incentives is important. Although they serve as a potent tool for

³⁰ Hania Kronfol and Victor Steenbergen, Evaluating the Costs and Benefits of Corporate Tax Incentives: Methodological Approaches and Policy Considerations, (World Bank Group, 2020)2

³¹ *ibid* 6.

³² Chen, Duanjie, Zolt, Eric M. and Peter A. Harris, Design and Assessment of Tax Incentive in Developing Countries: Selected Issues and Country Experience (United Nations, New York, 2018) 5.; Marina Bornman and E M (Lilla) Stack, 'Specific rewards for tax compliance: Responses of small business owners in Ekurhuleni', South Africa, (e Journal of Tax Research, Volume 13, Number 3, December 2015) 799.

³³ Marina Bornman and E M (Lilla) Stack, 'Specific rewards for tax compliance: Responses of small business owners in Ekurhuleni', South Africa, (e Journal of Tax Research, Volume 13, Number 3, December 2015) 799.

³⁴ Dereje Tilahun (n 20) 8.

³⁵ OECD, (n28) p 11

³⁶ Marina Borman and E M(Lilla) (n 33), 799.

shaping a certain behavior, their effectiveness relies on careful design and implementation to prevent undesired consequences.³⁷

2.1.1.2. Definition and Concept of Tax Compliance

Various authors have tried to define the concept of tax compliance in different ways. The concept of tax compliance is multifaceted and goes beyond merely payment of all taxes levied.³⁸

According to Kirchler, tax compliance could be classified into voluntary and enforced compliance.³⁹ Voluntary compliance is a willingness of a taxpayers by his/her own initiation (without being forced by the tax authority) to comply with the entire tax system.⁴⁰ It is achieved by the trust and cooperation of both parties (taxpayer and tax authority). On the contrary, in the absence of trust between them the tax authority will proceed to enforcing compliance through threat, using audit, fine⁴¹ and other law enforcement mechanisms in order to make taxpayers discharge their obligations. Because unlike the existence of taxpayers who are ready to voluntarily comply with the tax system, there are some who needs to be pushed.⁴² Penalties will be imposed on late filing of tax returns, late tax payments and also on incorrect declaration of income and expenses.⁴³

On the other hand, tax compliance can be defined as adherence to a tax obligation through filing tax returns accurately and completely, providing all necessary documentation and supporting evidence and accurately calculating and paying the correct amount of tax on time following the provisions of the law and judgment of courts⁴⁴. This refers to the completeness of taxpayers in

³⁷IMF Staff of IMF, OECD, World Bank Groups and UN collectively, Options For Low Income Countries' Effective And Efficient Use Of Tax Incentives For Investment: A Report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank (IMF, Washington DC, 2015) 19.

³⁸ Shimels Desalegn, 'Factors Affecting Tax compliance Behavior of Merkato Number 2 Medium Taxpayers Branch Office', (Masters' thesis, St. Mary University) January 2023, 7.

³⁹Kirchler, E., *The Economic Psychology of Tax Behaviour*, (Cambridge University Press, 2007).

⁴⁰TilahunAemiro and YidersalDagnaw, 'Determinants of Tax Compliance Behavior in Ethiopia: The Case of Bahir Dar City Taxpayers' 2014 *Journal of Economics and Sustainable Development*, Vol.5, No.15, 269. <<https://www.iiste.org/Journals/index.php/JEDS/article/view/15327>> accessed March 16, 2025

⁴¹ibid.

⁴²MphagahleleO.Ndlovu and DanieSchutte, 'The Influence of Penalties on the Tax Compliance Behaviour of Small Business Owner' 2023 UNISA Press Vol. 26, p.3.<<https://doi.org/10.25159/1998-8125/12573>>

⁴³ ibid

⁴⁴Alm, J., 'A Perspective on the Experimental Analysis of Taxpayer Reporting' July 1991 *The Accounting Review*, Vol. 66 No.3, 577<<https://www.proquest.com/scholarly-journals/perspective-on-experimental-analysis-taxpayer/docview/218529251/se-2>> accessed September 16, 2024; Jackson, B. and Milliron, V., 'Tax compliance research: Findings, problems, and prospects'(1986) *Journal of Accounting Literature*, 5, 125-165.

managing payment of taxes. In that case, the completeness not only goes to paying the exact amount of tax payable, but also filling forms properly, paying taxes timely, reporting correct data to the tax authority and adherence to others requirements.

As stated by McBarnett 2003, compliance can be defined in three dimensions namely; committed compliance, capitulatory compliance and creative compliance.⁴⁵ Committed compliance refers to a voluntary discharge of a tax obligation by a taxpayer without objecting or complaining whereas, capitulative compliance is the reluctant in discharging of tax obligation.⁴⁶ Creative compliance (tax avoidance) is any act by a taxpayer targeted at reducing taxes by redefining income and deductible expenditure within the limits of the law.⁴⁷

As an extension of defining the concept of tax compliance, it is very important to briefly discuss the counterpart (tax noncompliance). As long as there is a compliance behavior of taxpayers, there is also noncompliance behavior. Conceptually, tax noncompliance is an intentional or accidental failure of a taxpayer to fulfill his/her tax obligations.⁴⁸ It is also broadly defined by authors as not filing a tax return, underreporting taxable income, inflating tax claims, including exemptions and deductions, and not paying taxes on time.⁴⁹ As the recent studies by Tilahun and Yidersal⁵⁰ briefly noted out the definition of tax noncompliance is set as follows. *“Tax noncompliance is defined as failure to comply with tax laws and/or report incorrect income, the act of claiming incorrect deductions and exemptions and/or paying the incorrect amount of tax beyond the stipulated time frame.”*⁵¹

2.1.2. Theoretical Frameworks of Incentives for Compliant Taxpayers

Incentives for compliant taxpayers play a vital role in shaping tax behavior.⁵² Understanding the overall theoretical frameworks that inform taxpayers’ decision making pattern is very essential in helping policy makers develop effective policies and structures. In this section, the researcher

⁴⁵Tilahun and Yidersal (n 40) 269

⁴⁶Ibid.

⁴⁷Ibid.

⁴⁸Esmael and Mohammad, (n 4), 8.

⁴⁹Soos, P., Self-employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues (Harvard Law School Vol. 24, 1990, p.107); Kirchler (2007).

⁵⁰Tilahun and Yidersal (n 38) 268-240

⁵¹ibid 269.

⁵²EriskaWidyastuti, RuklieAbadi and IkaPurwanti, ‘The Influence of Tax Incentives, Tax Justice, Profitability, And Ethical Leadership on Tax Compliance’ (JurnalEkonomidan Pembangunan Indonesia Vol.1 No.2, May 2023) 1.<<https://doi.org/10.61132/jepi.v1i2.479>> Accessed June 2024

discusses various theories that elucidate the complexity of tax compliance. These include Rational Choice Theory, Theory of Social Interactions, Economic Deterrence Theory, Social Psychology Model, and Fiscal Psychology Model. Each of these frameworks offers unique insight about the general behaviors and motivations of taxpayers by providing a foundation for understanding how to maximize compliance level in a more effective manner.

2.1.2.1. Rational Choice Theory

Tax compliance was first modeled economically by Allingham and Sandmo and is rooted in rational choice theory, as it claims that each taxpayer decides how much income to declare through assessment of the benefits of concealing it and the costs of being caught⁵³. Therefore Rational Choice Theory mainly focuses on how individuals make decisions based on weighting cost and benefits of complying with tax laws.

There are costs and benefits to being a compliant taxpayer. Tax compliance costs can be defined as costs incurred by taxpayers in meeting the requirements laid on them by different tax legislative and revenue authorities,⁵⁴ costs which would disappear if the tax was abolished.⁵⁵ This includes costs over and above actual payments of tax⁵⁶.

Tax compliance costs include costs such as direct monetary costs, which mean giving a portion of profit to the state, other costs which might not be so direct and obvious, such as time spent for tax-related matters by the taxpayer itself or employees, psychological burdens causing frustrations and anxiety⁵⁷ and other related costs. According to the survey made by World Bank Group the tax compliance cost in Ethiopia in 2012/2013 tax year is between 4.5 and 5.8 percent of the country's total government revenue collected in the same year, which is nearly 1 percent of Ethiopia's GDP in the mentioned tax year.⁵⁸ Usually, these burdens are regressive in relation

⁵³ Michael G. Allingham & Agnar Sandmo, 'Income tax evasion: A Theoretical Analysis' (Journal of Public Economics 1, 1972) 323–338. <[https://doi.org/10.1016/0047-2727\(72\)90010-2](https://doi.org/10.1016/0047-2727(72)90010-2)> Accessed June 2024

⁵⁴ Grigorios Lazos, Michail Pazarskis, Alkiviadis Karagiorgos, and Andreas Koutoupis, 'The Tax Compliance Cost For Businesses and Its Key Determinants: Evidence From Greek Businesses' (Journal of Tax Administration Vol. 7:1 2022) 2. <<https://jota.website/jota/article/view/37>> Accessed July 2024

⁵⁵ Cedric Sandford, Tax Compliance Costs: Measurement and Policy (Fiscal Publications 1995)

⁵⁶ *ibid.*

⁵⁷ Andrew Lymer and John Hasseldine, The International Taxation System (Kluwer Academic Publishers 2022) 274.

⁵⁸ World Bank Group, Tax Compliance Cost Burden and Tax Perceptions Survey in Ethiopia (May 2015) 18.

to the business sizes⁵⁹; in addition a huge number of small businesses reported tax compliance is more tiresome than the actual tax burden⁶⁰. These trends are not limited to Ethiopia only. They are also common in other countries.⁶¹ From the mentioned facts, it is apparent that tax compliance costs include economic resources and opportunity costs, as the time and energy invested in complying with tax laws can be invested in the economy to bring profit.

On the contrary, the benefit of being a compliant taxpayer is that it saves taxpayers from being sanctioned as a result of noncompliance with tax laws. If a taxpayer does not comply with tax law there will be consequences like risking the tax payer's reputation, negatively impacting the day-to-day operation by invasive audits which might lead to limitation in the expansion of a business, and in worst case scenarios entail financial and potential criminal liabilities.

Rational people are expected to pay taxes because the costs of getting caught are larger than the costs of compliance. They are not internally motivated and will pay tax if they do not feel enforced. Rationality is expected to be positively correlated to enforced tax compliance⁶².

Therefore taxpayers have to keep in mind that the tax authorities assess criminal liability, impose civil tax offences, and forcibly collect any unpaid tax⁶³.

2.1.2.2. Theory of Social Interactions

This theory focuses on the connection between social interaction and a nation's taxation system. According to this principle, a nation's tax laws must be equally applied to all of its citizens, if taxpayers perceive the tax system as unfair compliance may decrease. Individuals' tax payments and tax compliance grow depending on how equitable tax laws are applied to the taxpayer. According to Gangl, a fair system increases tax compliance, which in turn increases tax revenue by ensuring tax confidence⁶⁴. Consequently, accountability and openness increase tax income

⁵⁹ Chris Evans, Australian Taxation Office. Revenue Analysis Branch, A Report into incremental Costs of Taxpayer Compliance: A Report Prepared for the Revenue Analysis Branch of the Australian Taxation Office (Australian Government Pub. Service 1996).

⁶⁰ World Bank Groups (n 30), 17.

⁶¹ *ibid* 18.

⁶² Isabelle Knaap, Are Self-interest and Rationality Determinants of Tax Compliance? (Master's thesis, Tilburg University, 2019/20) 13.

⁶³ Allen Madison, 'The Legal Consequences of Non compliance with Federal Tax Laws' (Tax Lawyer Vol.70, No.1, p. 367, 2016) <<https://ssrn.com/abstract=2914617>> accessed December 2024.

⁶⁴ Gangl, K., Hofmann, E., & Kirchler, E., 'Tax Authorities' Interaction with Taxpayers: A Conception of Compliance in Social Dilemmas by Power and Trust' (Elsevier Ltd Vol. 37, 2015), 13-23. <<https://doi.org/10.1016/j.newideapsych.2014.12.001>> Accessed November 2024

and compliance at the governmental level. This highlights the relationship qualities and the level of trust is vital in determining tax compliance, especially in this time and era where digitalization is becoming mandatory. The factors like effective communication, simplification of tax procedures, clarity of the legislation, and digitalization of the service⁶⁵ play a significant role in fostering positive connection with tax revenue authorities in making taxpayers more compliant.

Without a material benefit, compliance becomes less assured⁶⁶. Even if it is hard to calculate accurately the exact value they receive from government, they want to see the impacts and attitudes regarding their trade with government⁶⁷. Therefore, to constantly comply with the existing tax laws, there should be a constant improvement of infrastructures and social welfare of the existing economy. Studies show that the connection between public goods provision and tax compliance can be relevant⁶⁸. On an individual level, voluntary motives to comply with tax laws require some kind of trust in the tax authorities and the government. The opposite is also true that taxpayers' view of corruption and abuse of tax revenue in the government system discourage taxpayers from performing their tasks and duties to make themselves eventually compliant.

The “slippery slope” framework developed by Kirchler, predicts that compliance will be highest when both enforcement power and trust are high⁶⁹. Given that providing a public good seems to affect the relationship between the taxpayer and the government, public goods targeting may have implications beyond taxation: it may help improve other outcomes such as increasing trust, and reducing corruption and crime.

⁶⁵Belahouaoui, R. and Attak, E.H., ‘Exploring the Relationship between Taxpayers and Tax authorities in the digital Era; Evidence on Tax Compliance Behavior in Emerging Economics’ (Emerald Publishing Limited, International Journal of Law and Management 2024) <<https://doi.org/10.1108/IJLMA-02-2024-0064>> Accessed March 2024

⁶⁶Desta Kassa Weldegiorgis, ‘Assessment of taxpayers’ voluntary compliance with taxation: A case of Mekelle City, Tigray, Ethiopia’ (Master’s thesis, Mekelle University 2010)22.

⁶⁷VedP.Gandhi, Liam P.Ebrill, SomchaiRichupan et al, Supply Side Tax policy: Its Relevance to Developing Countries (International Monetary Fund, Chapter 6, June 1987) <https://doi.org/10.5089/9780939934911.071> Accessed February 2025

⁶⁸Marco Gonzalez-Navarro and Quintana-Domeque, Local Public Goods and Property Tax Compliance: Evidence from Residential Street Pavement, Working Paper WP15MG1, (Lincoln Institute of Land Policy 2015).

⁶⁹Erich Kirchler, Erik Hoelzl, and Ingrid Wahl, ‘Enforced versus Voluntary Tax Compliance: The ‘Slippery Slope’ Framework’ (ElsevierB.V.,Journal of Economic Psychology Vol.29 (2) 2007) 210–25.

2.1.2.3. Economic Deterrence Theory

According to the theory of economic deterrence taxpayers are considered as rational beings who calculate pros and cons before any action and immoral utility maximizers who are influenced by commercial concerns containing chances of discovery and profit maximization.⁷⁰

Based on this theory, tax rate, chance of being discovered, and fines for tax fraud affect the behaviors of the taxpayers.⁷¹ Despite claims that deterrence strategies lack effectiveness in managing tax noncompliance, there is some evidence to the contrary⁷². This shows that if there is an incentive, there is a higher chance of deterrence in correcting the behaviors of taxpayers to comply with tax laws. In relation to tax, compliance refers to actions that are associated with the costs and benefits of performing tax obligations⁷³.

2.1.2.4. Psychological Theories

Psychological theory of tax compliance focuses on understanding the impact of social norms and moral obligations on compliance.⁷⁴ According to this view of tax compliance, taxpayers may comply even in situations when there is little chance of an audit because psychological considerations, such as moral and ethical concern, are important to them.⁷⁵ As it is noted, their Psychology studies deemphasize audits and penalties and instead focus on changing individual attitudes towards tax system⁷⁶. The social/fiscal, psychological model focuses on psychological variables which include moral values and the perception of fairness of the tax system and the tax authorities⁷⁷. These psychological theories can have the social psychology and the fiscal psychology models as briefly discussed below.

⁷⁰ Lake AyalewAnteneh, Factors Affecting Tax Compliance in Ethiopia: A Case Study on Large Taxpayers of the Large Taxpayers' Branch Office in the Ministry of Revenues, (Master's thesis, International Institute of Social Studies, The Hague, The Netherlands, November2023)12

⁷¹ Allingham, M. and Sandmo, A. (n 53).

⁷² Lake Ayalew(n 70) 12.

⁷³ Loo, E.C., 'The Influence of the Introduction on Self-assessment on Compliance Behavior of Individual Taxpayers in Malaysia' (PhD thesis, University of Sydney, 2006).

⁷⁴ MeazaWudeneh, 'Factors Affecting Tax Payers Compliance with the Tax System: Category "A" Tax Payer's In Addis Ababa' (Master's thesis, St.Mary's University December 2018) 12.

⁷⁵ ibid 13.

⁷⁶ Trivedi, VU.,Shehata, M. and Mestelman, S, 'Attitudes, Incentives, and Tax Compliance' (Canadian Tax Journal'52, 2005) 29-61.

⁷⁷ Ken Devos, 'Factors Influencing Individual Taxpayer Compliance Behavior' (Springer Science & Business Media Dordrecht 2014)

2.1.2.5. The social psychology model

Unlike the economic deterrence model, social psychology model pertains to the relationship between tax compliance, social interactions, and conventions⁷⁸. The compliance behavior of peer groups like families, friends, and neighbors is expected to impact on the perceptions and compliance decisions of others.⁷⁹ By the same token, noncompliant decisions by peer groups may reduce the level of tax compliance by others.

It also explores factors like fairness perception, trust in government, and individual attitudes toward tax. The socio-psychological theory of tax compliance model, built on the grounds of socio-psychological determinants, taxpayers are seen no longer as selfish utility maximizers, as the above-mentioned theories rather as human beings who are motivated to pay taxes based on different attitudes, norms, beliefs, perceptions, feelings, social characteristics, including cultural background, age, gender, religion, and other factors⁸⁰.

According to this theory, an individual's intention is a function of two basic determinants.⁸¹ One is the social influence, which is the subjective norm or the individual's perception of social pressure and the other is personal in nature which is a positive or negative attitude towards a behavior which complies with tax laws.

More recent research, has proven that noneconomic social factors have the capacity to influence taxpaying behavior; for example, political institutions, ethics, perceptions of others' compliance, and many others⁸².

2.1.2.6. Fiscal Psychology Model

Fiscal psychology models reflects both the social psychology and the economic deterrence models and considers tax enforcement as a behavioral problem, which can be resolved by co-

⁷⁸MeazaWudneh (n 74)12

⁷⁹ Lake AyalewAnteneh(n 70) 13.

⁸⁰M.A Fishbein&IcekAjzen, Belief, Attitude, Intention and Behavior: An Introduction to Theory and Research (Reading: Addison-Wesley 1975); R.F. Meier & W.T. Johnson, 'Deterrence as Social Control: The Legal and Extra-legal Production of Conformity' (American Sociological Review, Vol.42 (2) 1977) 292-304.

⁸¹Jeffrey A. Roth and John T. Scholz, Taxpayer Compliance: Social Science Perspectives (University of Pennsylvania Press, Volume 2 (1989) 200-227. <https://doi.org/10.9783/9781512806281-008>

⁸²Mariam Abdel Nabi, KhedrWanas and Sarah Mansour, 'How Can Tax Compliance be Incentivized? An Experimental Examination of Voice and Empathy' (Emerald Publishing Limited, vol.7 Issue2 2021) <<https://www.emerald.com/insight/2631-3561.htm>> Accessed November 2024

operation between the tax authority and taxpayers.⁸³ To establish this cooperation the role of the tax system in introducing positive stimulus or incentives such as reducing penalty are emphasized.⁸⁴ This stimulus is then expected to generate a more positive attitude in taxpayers that will in turn impact their compliance decisions⁸⁵.

Taxpayers' attitude is made up of tax mentality, feelings of tax tension, and tax morale. The more positive the taxpayers attitude towards tax, the more they cooperates with tax authorities and be voluntarily willing to pay⁸⁶. Different studies also suggest that the threat of sanction creates a negative attitude and influences on taxpayers in low socio-economic groups⁸⁷

Countries have large differences in economic and political structures and apparently different countries face different constraints and priorities.⁸⁸ Even for those jurisdictions that pursue a growth-oriented tax policy, a tax structure that might be favorable for one may not be for the other⁸⁹ which makes the concept of international best practice unlikely to be meaningful.⁹⁰ The above discussed theories are not the only theories discussed by scholars but some, to help bring the best possible policy options. In the context of incentives to compliant taxpayers, best practices based on optimal tax theory and the experience of developed countries that go with the reality of a particular jurisdiction should be considered with caution for most developing countries.⁹¹

In conclusion, the examination of theoretical frameworks, Rational Choice Theory, the Theory of Social Interactions, Economic Deterrence Theory, The Social Psychology Model, and Fiscal Psychology Models show the multifaceted nature of tax compliance. By understanding the

⁸³ McKerchar, Margaret A. and Evans, Christopher Charles, 'sustaining Growth in developing economics through improved taxpayer compliance: Challenges for Policy Makers and Revenue Authorities', (UNSW Law Research Paper No. 2009-17)8 <<https://dx.doi.org/10.2139/ssrn.1415164>> Accessed January 2024

⁸⁴ Ibid.

⁸⁵ Ibid.

⁸⁶ Schmoldes, G., "Survey Research in Public Finance- A Behavioral Approach to Fiscal Theory" (Public finance, Vol. 25 No.2 1970) 300-306

⁸⁷ Schwartz, R. and S. Orleans, 'On Legal Sanctions' (University of Chicago Law Review, Vol.34 Issue2 Article 3 1967) 274-300

⁸⁸ International Monetary Fund, 'Growth and Institutions', August 2022) 177. https://www.imf.org/-/media/Websites/IMF/imported-flagship-issues/external/pubs/ft/weo/2003/01/pdf/_chapter3pdf.ashx Accessed on May 2025

⁸⁹ Joosung Jun, Tax incentive and tax base protection in developing countries, (United Nation Economic and Social commission for Asia and the Pacific), April 2017, 3.

⁹⁰ ibid.

⁹¹ ibid.

behaviors, decision-making process, and motivations policymakers can design incentives not solely to encourage compliance but also to install a culture of integrity and responsibility within the tax system which ultimately lead to policies that benefit both taxpayers and tax revenue authorities.⁹²

2.1.3. Duty to Pay Tax vs. Incentivizing compliant taxpayers: Arguments

Taxes play a vital role in funding government actions.⁹³ The use of taxes includes providing public goods, Protection against foreign aggression, aid the national defense system, law enforcement, and other major infrastructures.⁹⁴ Taxes help the government to intervene in the economy to make redistribution, since markets are not perfect market failures might occur hence, governments' intervention may be necessary via the instrumentality of taxes.⁹⁵ Private goods are taxed in order to finance public goods.⁹⁶ Since tax is a compulsory levy those who are taxed have to meet their obligations irrespective of any direct corresponding return of service or good from the government because the government needs finances to play its role as a government.⁹⁷

Incentives in a tax system are among the arguable issues within scholars some are against the idea of incentives with their own supporting arguments, and others highly recommending incentives. Taxpayers have the legal obligation to contribute to the funding of public goods and services which is grounded in the social contract between the state and the individuals.⁹⁸ However the introduction of tax incentives has become a popular system used by tax revenue authorities to increase compliance and promote a particular economic goal.⁹⁹ This sub topic is dedicated to

⁹²Hunar Mohammed and Anita Tangl, 'Taxation Perspectives: Analyzing the Factors behind Viewing Taxes as Punishment—A Comprehensive Study of Taxes as Service or Strain' (journal of risk and financial management, December 2023) 2.

⁹³ Misganaw Gashaw, Zerihun Asegid, et al, Ethiopian Tax Law Text book (Ethiopian Law Schools Association 2022)31

⁹⁴ibid 3-6

⁹⁵ Investopedia Team, Market Failure: What It Is in Economics, Common Types, and Causes(Investopedia April 3, 2025) <https://www.investopedia.com/terms/m/marketfailure.asp> Accessed on May 2025

⁹⁶ Nathan w. Chan and Matthew J.Kotchen, 'Funding Public Goods Through Dedicated Taxes On Private Goods' (Yale University 2021) 1-17

⁹⁷Simon James and Christopher Nobles, The Economy of Taxation; Principles, Policy, and Practice (Srentice Hall 7th edition, 2000)

⁹⁸Jason Lakin, 'To Contract or Not to Contract: Thinking Through Narratives of Tax and Spend' (International Budget Partnership August 2021)3.

⁹⁹Alexander Trepelkov and Márcio Verdi, (n 1), iii

explore the dichotomy between the moral obligation to pay tax and the forces of tax incentive by discussing arguments both in favor of and against the need for tax incentives.

2.1.3.1. Arguments Supporting Incentives for Compliant Taxpayers

Those who argue in favor of incentives or positive rewards strongly support that incentives are helpful to significantly increase tax revenue by encouraging taxpayers to comply.¹⁰⁰ Especially in lower and middle-income countries the share of tax revenue in the country's GDP is only 15 to 20% and this number increases to 20% and above in upper-income countries showing that developing countries have less tax revenue to spend and to increase the revenue increasing the number of compliant taxpayers is very important.¹⁰¹ Therefore eliminating evasion and informal activity should be the main concern of developing countries' tax policy.¹⁰²

As incentives attract foreign and domestic investments the existence of incentives attracts more taxable incomes to circulate in the economy.¹⁰³ Higher compliance translates to higher revenue, which can be used for development of a country, and many countries have lost large amounts of tax revenues largely as a result of tax non-compliance.¹⁰⁴ If there are measures that reduce the tax imposed, they leave compliant taxpayers with a higher net rate of return.

In situations in which tax compliance incentives are weak, there are incentives to free ride and self centered individuals who may opt not to pay or to evade taxes.¹⁰⁵ As a result, incentives are significant in enforcing taxation, which includes offering a reward for timely filing their tax return, accurately declaring all taxable income and timely payment of all payable taxes without the need to wait for the follow up action of the tax authority¹⁰⁶ Although the fundamental purpose of taxation is to raise revenue, the tax system inherently affects some other non-economic aspects. It is therefore a convenient, practical, and flexible means for influencing

¹⁰⁰ Hilke Brockmann, Philipp Genschel And Laura Seelkopf, Happy Taxation (Journal of Public Policy, Cambridge University Press, Vol. 36, No. 3, September 2016, 392. URL: <https://www.jstor.org/stable/10.2307/26775347>

¹⁰¹ Pierre Bachas, Florence Kondylis&JhonLoeser, 'Increasing Tax Revenue in Developing Countries' (Published on Development Impact) February 2021.

¹⁰²Joosung Jun, (n 89) 4

¹⁰³George E. Lent, 'Tax Incentives for Investment in Developing Countries' (International Monetary Fund) January 1967, 249 <https://www.elibrary.imf.org/view/journals/024/1967/002/article-A003-en.xml> Accessed on May 2025

¹⁰⁴ Esmael and Mohammad (n 4)

¹⁰⁵ TewachewMolla&YosefWorkeluele, 'Examining Tax Administration Law of Ethiopia in Light of the Tax Compliance Theories' (Mizan Law Review Vol.16, No.2 2022) 285, DOI <http://dx.doi.org/10.4314/mlr.v16i2.2> Accessed March 2025

¹⁰⁶ibid, 285.

incentives in a direction that contributes to other specific policy objectives¹⁰⁷ such as being compliant with tax laws, by changing the behavior and mentality of taxpayers.

Additionally, incentives are important to enforce taxation, and also helpful in addressing noncompliance by preventing firms from shifting into the informal sector or evasion-prone activities.¹⁰⁸ Noncompliance is does not always occur by the intentional act to evade but it may result from taxpayer ignorance, inability to pay, or transaction costs that tip the scales against compliance.¹⁰⁹ Taking into account this and other reasons and incorporating them inside tax policy can help understand the existing situations and make the best use of them through incentive schemes.

Tax incentives can maximize economic, fiscal, and social benefits.¹¹⁰ Incentives can target high needs, understand existing equality and make tax policies to incentivize specific strategic goals.¹¹¹ Incentive can address inequalities in the tax system by giving a reward for compliant taxpayers. Additionally, incentivizing compliant taxpayers has the ability to shift attention from punishment to reward, which promotes voluntary compliance and saves the time and energies that possibly will be exerted by the tax authorities.¹¹²

2.1.3.2. Arguments against Incentives for Compliant Taxpayers

Those against incentivizing compliant taxpayers argue that tax is an obligation and as with any other obligation nothing in return should be expected.¹¹³ Positive rewards can bring moral hazard, reliance on incentives undermines the inherent duty to pay taxes and shift the social contract mentality that peoples have with their government and leads to an inclination that taxes

¹⁰⁷Dr. Bruce Bolnick, 'Effectiveness and Economic Impact of Tax Incentives in the SADC Region: Technical Report, Submitted To USAID/RCSA SADC Tax Subcommittee, SADC Trade, Industry, Finance and Investment Directorate (February 2004) 3-2

¹⁰⁸ Joosung Jun, (n 89), 2.

¹⁰⁹Anna Custers, Stephen Davenport, and Wilson Prichard, Innovations In Tax Compliance: Building Trust, Navigating Politics, and Tailoring Reform Roel Dom, (The World Bank Group) 2022, 11.

¹¹⁰ Alexander Trepelkov and Márcio Verdi, (n 1)13.

¹¹¹ Lourdes German and Joseph Parilla, How Tax Incentives Can Power More Equitable, Inclusive Growth", May/5/2021 <<https://www.brookings.edu/articles/how-tax-incentives-can-power-more-equitable-inclusive-growth/>> Accessed January 2025

¹¹² Hilke Brockmann (n 100)382.

¹¹³ Misganaw Gashaw Zerihun Asegid et al, (n 93) 31.

can be calculated based on business decisions.¹¹⁴ Incentives can distort market forces which means business decisions will be based on benefits.¹¹⁵

In addition monetary incentives for compliant taxpayers can incur distortions in resource allocation, complicate tax administration, and provide opportunities for corruption and rent-seeking behavior.¹¹⁶ Designing, legislating and monitoring incentives also require complex and costly procedures, departments and staff members, any resources spent on these aspects can be used to other public service or other government expenditures;¹¹⁷ It includes costs incurred from the initial grant of the incentive and the costs incurred in monitoring compliance: who is receiving compliance, what are the qualification requirements and enforcing any recapture provisions upon termination or failure to continue to qualify¹¹⁸. If the incentive regime is complex, there will be potentially higher enforcement and compliance costs¹¹⁹. If the incentive schemes for compliant taxpayers have many beneficiaries there will be more difficulty compared to smaller beneficiaries.¹²⁰ Furthermore, Tax reform should be guided by economic principles that lead to well-designed incentives which maximize tax revenue additionally, minimize windfall gains, and ensure that their benefits outweigh their costs¹²¹. On the other hand, revenue cost of tax incentives results from erosion of the revenue base due to taxpayers abusing the tax incentive regimes to get the privileges offered to compliant taxpayers.¹²² The moment a benefit is created for some taxpayers, it provides an opportunity for those who do not qualify to abuse the system. Policymakers seek to target incentives to achieve the greatest possible benefits for the lowest cost.¹²³

Corruption usually occurs when there is no clear, simple, and transparent guideline as a result several recent scholars have implied the possibility of corruption and other rent-seeking behavior in relation to the granting of incentives.¹²⁴ The possibility of corruption is higher for tax

¹¹⁴ Hania Kronfol and Victor Steenbergen, 'Evaluating the Costs and Benefits of Corporate Tax Incentives: Methodological Approaches and Policy Considerations', (The World Bank Group) 2020, 4.

¹¹⁵ Victor Thuronyi, Tax law design and drafting, (International Monetary Fund, volume 2 1998) 3-4.

¹¹⁶ Alexander Klemm, Causes, Benefits, and Risks of Business Tax Incentives (IMF working paper 2009) 11.

¹¹⁷ Victor Thuronyi, Tax law design and drafting, (International Monetary Fund, volume 2 1998)3-4

¹¹⁸ Chen, Duanjie, Zolt, Eric M. et al (n 30)17

¹¹⁹ Joel, C., 'Tax Incentives in Central American Development. Chicago' (The University of Chicago Press 2012)

¹²⁰ Ibid.

¹²¹ OECD (n 8)48-49

¹²² Ibid, Eric Zolt, (n 30) 14.

¹²³ Chen, Duanjie, Zolt, Eric M. et al (n 30)15.

¹²⁴ DerejeTilahun (n 20)13.

incentive regimes in which officials have a large amount of discretion in determining who gets favorable treatment. Economic development incentives have been given to some targeted sectors but it is well known that some incentives are granted on the basis of political considerations rather than careful cost benefit analysis of proposals¹²⁵. A study in Nigeria shows if corruption perception and feeling of ethnic marginalization increase by one unit, tax compliance behavior reduces by 8.3% and 14% respectively¹²⁶. As a result, corrupted compliance incentives lead to the reduction of compliance regardless of many costs incurred by the revenue authority.¹²⁷

Moreover, opponents of incentives to compliant taxpayers advocate that incentives can create unequal burdens, which in turn creates unequal system and undermine trust in government.

In conclusion, the interplay between tax being seen as a duty and the legal frameworks of incentives for compliant taxpayers presents challenges and opportunities for legislators. Nevertheless the costs, incentivizing compliance is an effort worth to try in order to simplify a countries tax system, eliminate tax distortions, remove unnecessary administrative and compliance costs, increase transparency and improve government's capacity to generate revenue.¹²⁸ While tax incentive can help as an efficient tool to increase compliance and encourage economic activity where as it can also have the potential to risk the fundamental moral obligations every taxpayer should hold.¹²⁹ Balancing the arguments raised for and against tax incentives is crucial to have fair and efficient tax system. This study emphasizes the need for balanced approach recognizing the taxpayers' obligations while incorporating the potential benefits of well-designed incentives to compliant taxpayers through well integrated frameworks.

¹²⁵ Richard M. Bird and Jorge Martinez-Vazquez, 'Taxation and Development: The Weakest Link?' (Edward Elgar Publishing Limited, 2014)434 <https://ideas.repec.org/b/elg/cebook/15750.html> Accessed January 2025

¹²⁶Ebele S. Nwokoye, Clement I. Igbunugo, et.al, (n 102)20 <<http://hdl.handle.net/10419/262074>>

¹²⁷ ibid

¹²⁸OECD (n 169)243.

¹²⁹ Lars P. Feld, Bruno S. Frey and Benno Torgler, 'Rewarding Honest Taxpayers? Evidence On The Impact Of Rewards From Field Experiments', (The Hague Boom Legal Publishers) April 9-11, 2006, 4-8

2.1.1. Types of Incentives for Compliant Taxpayers and experience of other countries

Many studies show that traditional enforcement through audit and penalties have a weak relation with tax compliance.¹³⁰ As a result it is not easy to ensure tax compliance unless the tax administrator is under every bed following all of the taxpayers.¹³¹ Researchers proved that fear of audit and penalty is not the primary reason that taxpayers fail to comply with their tax obligation and suggests for authorities to turn their attention into positively rewarding compliant taxpayers for being consistently loyal to the tax laws.¹³² It is therefore a better approach suggested for authorities to exercise their power through giving reward for compliant taxpayers as a way of motivating individuals to improve their compliant behavior.¹³³ As a result governments around the world are incorporating incentives for compliant taxpayers through different means.

According to literature, Incentives for compliant taxpayers may have either financial or non-financial forms in nature.¹³⁴ Monetary incentives may only work through financial incentives.¹³⁵ They are direct; either they are monetary benefits or reductions in tax liabilities to motivate taxpayers to comply.¹³⁶ On the other hand, non-financial incentives such as ethical considerations, usually aim to influence taxpayers behavior.¹³⁷ Non-financial incentives include recognition programs, certificates or awards, social status, priority treatments etc.¹³⁸ Compliant taxpayers in addition to avoiding a potential penalty may receive a prize and non-monetary incentives may work better at influencing the moral determinants of compliance (for example,

¹³⁰ Marina Bornman and Lilla Stack, 'Rewarding Tax Compliance: Taxpayers' Attitudes and Beliefs', (Journal Of Economic And Financial Sciences Vol.8(3)) October 2015, 793.

¹³¹ *ibid.*

¹³² *ibid.*

¹³³ *ibid.*

¹³⁴ Jonathan Rillstone, "Rewarding Taxpayers: A Possible Method to Improve Tax Compliance in New Zealand?" (Master's thesis, University of Canterbury 2015) 48-53

¹³⁵ Bonner, S. and G.B. Sprinkle, 'The effects of monetary incentives on effort and task performance: theories, evidence, and a framework for research' (Accounting, Organizations and Society, Vol. 27, issue 4-5 2002)303–345 <[https://doi.org/10.1016/s0361-3682\(01\)00052-6](https://doi.org/10.1016/s0361-3682(01)00052-6)> Accessed February 2025

¹³⁶ *ibid*

¹³⁷ *ibid*

¹³⁸ *ibid*; Marina Bornman and Lilla Stack, '(n 130) 796

reciprocity and peer-effects).¹³⁹ For instance instead of providing a reward governments around the world implement tax amnesty more often to get evaders back on the route to honesty.¹⁴⁰ When taxpayers fail to pay their tax on time this tax amnesty provides taxpayers an immunity not to be penalized when they pay their previously unpaid debts, however the former compliant taxpayers considers such amnesty as unfair and feel discouraged to comply, as a result, its' long run effect is disregarded in the political process¹⁴¹

Social recognition (Naming and Promoting) - one type of incentive through which countries encourage voluntary compliance is by publicly acknowledging and rewarding taxpayers who have been loyal to the tax system.¹⁴² This naming and promoting program can create a sense of pride to compliant taxpayers and motivate others to become more compliant due to the desire for similar acknowledgment or social pressure.¹⁴³ To the contrary naming and shaming of taxpayers will be applied on taxpayers that have negative behavioral record.¹⁴⁴ For instance, a research conducted in Bangladesh applied social recognition as an incentive to increase tax compliance by making a promise of disclosing tax payment record of all firms for the public, which brings a positive behavioral response and improve tax compliance.¹⁴⁵ Sharing information about tax payment history of a certain firm to their peer can increase tax compliance.¹⁴⁶ In addition this public recognition may affect consumer behavior, possibly lead customers towards tax compliant businesses.¹⁴⁷ Hence, publicly available information of firms' tax compliance history may affect behavior of consumers which increase the businesses' competitiveness, which induces another

¹³⁹Paul Carrillo, Edgar Castro, et al 'Do Rewards Work to Maintain and Increase Tax Compliance? Evidence from the Randomization of Public Goods' (George Washington University Research Department, Inter-American Development Bank, 2016)7.

¹⁴⁰Marina Bornman and Lilla Stack, (n 130) 793.

¹⁴¹ ibid

¹⁴² Priya Manwaring & Tanner Regan, 'Public Disclosure and Tax Compliance: Evidence from Uganda', (Working paper UGA-20088) August 8, 2023, p 2.

¹⁴³ Raj Chettya, Mushfiq Mobarakb and Monica Singha, Increasing Tax Compliance through Social Recognition, Policy brief 14/0658, (International Growth Centre London School of Economics and Political Science Houghton Street London WC2A 2AE United Kingdom), August 2014, 1. <https://www.theigc.org/sites/default/files/2014/09/Chetty-Et-Al-2014-Policy-Brief.pdf> Accessed May, 2025

¹⁴⁴ Priya Manwaring & Tanner Regan (n 76), 2.

¹⁴⁵ Raj Chettya, Mushfiq Mobarakb and Monica Singha,(177) 1.

¹⁴⁶ ibid 2.

¹⁴⁷ ibid .

incentive to comply.¹⁴⁸ This kind of social recognition programs may be cost effective method of increasing tax collection.¹⁴⁹

As an incentive scheme to encourage taxpayers compliance behavior Pakistan's president gives a Privilege Card to selected top compliant taxpayers which allows them to get access to VIP lounges at airports, fast-track clearance at immigration counters, free passports and enhanced baggage allowance for the recognized top taxpayers every year.¹⁵⁰

Starting from 1997, the government of Malta has been running a well known lottery.¹⁵¹ Taxpayers' submit physical and electronic VAT receipts which serve as their lottery tickets and a public draw will be made every month.¹⁵² The lucky taxpayer will be the winner of a cash prize that is worth 100 times the tax he/she paid and other prizes to the extent of the monthly budget will be given away. This lottery encourages consumers to always request receipts, ensure record and payment of VAT, which results in improvement of VAT compliance and increase of government revenue.¹⁵³ The same is true with the case of Philippines and Poland's National Receipt Lottery.¹⁵⁴ In 2012, The Mauritius Revenue Authority (MRA) also introduced a lottery draw which enabled all taxpayers who filed their returns electronically to automatically participate in the lottery draw and prizes were given away.¹⁵⁵

In Sri Lanka top taxpayers with the history consistent tax compliance will be granted Privilege Cards by the Inland Revenue Department.¹⁵⁶ These privilege cards enable eligible compliant taxpayers to get benefits such as preferential treatment at the airport, special treatment from

¹⁴⁸ Ibid 5.

¹⁴⁹ ibid

¹⁵⁰ Mubarak Zeb Khan, Dawn E-paper, published July 16 2014. <https://www.dawn.com/news/1119502> Accessed on may 8/2025; Privilege cards given to top hundred taxpayers, Business Recorder, July 16 2014. <https://www.brecorder.com/news/4214629/privilege-cards-given-to-top-100-taxpayers-201407161202452> accessed on May 7, 2025.

¹⁵¹Businesses Today. 'This Is How Some Countries Reward Honest Taxpayers' <https://www.businesstoday.in/panorama/photo/this-is-how-some-countries-reward-honest-taxpayers-5747-2018-10-10/6> Accessed on May 7, 2025

¹⁵² Mubarak Zeb Khan,(n 150)5

¹⁵³ Ganny Borg, 'Boosting VAT Compliance: Insights into Poland and Malta's Innovative VAT Lottery System, January 19/2024. <https://www.maltafootball.com/2024/01/19/boosting-vat-compliance-insights-into-poland-and-maltas-innovative-vat-lottery-systems/><https://www.maltafootball.com/2024/01/19/boosting-vat-compliance-insights-into-poland-and-maltas-innovative-vat-lottery-systems/> Accessed on May 7, 2025

¹⁵⁴ibid

¹⁵⁵ Marina Bornman and E M (Lilla) Stack, (n 130)805

¹⁵⁶ Businesses Today(n 151)

government bodies like Customs and Police Service and other various concessions.¹⁵⁷ However, the Inland Revenue Department issues these privileges only to high net worth taxpayers.¹⁵⁸ South Korea provides loyal tax payers certificate of recognition, awards, free parking service in public parking and VIP room in the airport; and Japan also offers the chance to take a picture with the Emperor if they are found compliant.¹⁵⁹

The Kenya Revenue Authority gives recognition and reward certificates to distinguished taxpayers by hosting every annual tax week.¹⁶⁰ With the purpose of supporting the needy ones, various activities such as tax clinic and tax education will take place in annual taxpayers' week.¹⁶¹ Compliant taxpayers will also be awarded in a special taxpayer's luncheon, in the same week. Moreover, In Kenya compliant taxpayers are entitled for a grant of faster tax clearance certificate at any time they apply for.¹⁶²

All of the aforementioned incentives have their own benefits and drawbacks. Therefore, governments must balance the advantages of incentives with potential revenue losses. Scholars suggest that there is a social norm of tax compliance that exists in society that can be shifted by deliberate government policy actions.¹⁶³ The main aim of this study is to help policymakers utilize potential possibilities implementing incentives that can bring about a desired goal of tax compliance and enabling the policymakers choose the suitable types of incentives to achieve maximum revenue from tax in a long run by compromising existing variables.

2.2. Summary

Incentives for compliant taxpayers relates to the privileges accorded to taxpayers for their loyalty to the tax laws, regulations, directives and circulars with the objective of encouraging voluntary compliance.¹⁶⁴ Most tax incentives are originally meant to attract investments and called

¹⁵⁷ *ibid*

¹⁵⁸ *ibid*

¹⁵⁹ Lars P. Feld, Bruno S. Frey and Benno Torgler, 'Rewarding Honest Taxpayers? Evidence On The Impact Of Rewards From Field Experiments', (The Hague Boom Legal Publishers) April 9-11, 2006, 4

¹⁶⁰ Marina Bornman and E M (Lilla) Stack, (n 164)805

¹⁶¹ *Ibid*.

¹⁶² Alan Kasibiwa, 'An Introspective look into Tax Incentives' (Kenya Revenue Authority)

<<https://www.kra.go.ke/news-center/blog/1893-an-introspective-look-into-tax-incentives>> accessed February 2024.

¹⁶³ James Alm, Gari H. McClelland, et al, Changing the Social Norm of Tax Compliance by Voting, (KYKLOS Wiley Blackwell Vol. 52, 1999) 143

¹⁶⁴ Marina Bornman and Lilla Stack, 'Rewarding Tax Compliance: Taxpayers' Attitudes and Beliefs', (Journal of Economic and Financial Sciences | JEF | Vol.8(3), 790-807) October 2006, 796.

investment incentives.¹⁶⁵ Though incentives have the same goal of bringing economic growth, incentives accorded to compliant taxpayers must be clearly identified from other kinds of incentives so that taxpayers will not suffer from a differentiated treatment based on the sector they involve, but for their loyalty to their tax obligations. This in turn will foster tax compliance and contribute its own part for the economic growth of the country. Aiming at encouraging tax compliance and increase national revenue governments of various countries offered prerogatives for compliant taxpayers; it includes special treatment, certificate of recognition, award, and chance of winning lottery. The trend of applying incentives in Ethiopia usually goes to sectors in corporate levels and individual taxpayers have minimal places to benefit from incentives. Whether the Ethiopian tax laws seriously incorporate provisions relating to incentives applicable to compliant taxpayers or not as different from investment related incentives, and kinds of those incentives, if any, will thoroughly be assessed in the subsequent chapter.

¹⁶⁵ Sebastian James, Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications, FIAS, The World Bank Group 2009)54 <<https://ssrn.com/abstract=2401905>> Accessed February 2025

CHAPTER THREE

3. Analyzing Incentives for Compliant Taxpayers under Ethiopian Tax Law: Legal and Practical Analysis

3.1. Introduction

Attracting investors or individuals to engage in particular sector or activities is not a new phenomenon in Ethiopia. However, this particular chapter delves into the legal and practical dimensions of incentives for compliant taxpayers under Ethiopian tax laws. It examines the current legal framework, highlighting the specific incentives provided to encourage tax compliance, if any. Additionally, this chapter will assess the effectiveness of these incentives, identify challenges faced in their implementation, and propose potential improvements. By offering a comprehensive analysis, it aims to provide a deeper understanding of how these incentives influence compliance and the broader tax environment in Ethiopia.

3.2. Overview of Incentives for Compliant Taxpayers under Ethiopia Tax

Laws: Since 1941

Ethiopia's tax system is still in progress, which has been going through continuous reforms to improve revenue generation, increase economic growth, and ensure a fair distribution of the tax burdens. The legal framework is primarily comes from the law making body of the country in the form of proclamations, and other legal documents having the forms of regulations, directives, and guidelines issued by different organs and ministries of the federal government. This particular section discusses the historical development of incentives for taxpayers that took place in the four regimes of the Ethiopian history.

3.2.1. Historical Background

Ethiopia has a long history in exercising taxation however its modern taxation system begins in 1941, after the departure of Italians¹⁶⁶ occupation of Ethiopia. Although the traditional tax system dominated the country until the restoration of Emperor Haile Selassie I to the throne, few modern taxes had already started to be implemented prior to the imperial period. Most tax

¹⁶⁶TadesseLencho, 'Towards Legislative History of Modern Taxes in Ethiopia' (1941-2008) (Journal of Ethiopian law, Vol. 25 No. 2(2012), p 104.

incentives of the country are incorporated in general investment incentive laws of Ethiopia however it is not possible to separate tax incentives from the remaining tax system of Ethiopia by the mere fact that this incentives employ taxes as a tool of a particular policy, promote capital investment. Thus, we can't separate tax incentives from tax laws. Tax incentive may serve as a vital tool to increase tax compliance, promote investment and foster economic growth through issuance and implementation of comprehensive and consistent positive policies.

3.2.1.1. Incentives for Compliant Tax Payers during the Imperial Period (1941-1974)

The imperial period in Ethiopia saw the beginning of modern state and economy, and that included the introduction of tax and non-tax incentives to encourage development. The majority of Ethiopia's tax incentives were introduced in separate tax legislations.¹⁶⁷ Typically, they were issued in the body of investment laws in general.¹⁶⁸ The 1949 income tax law was the first to introduce tax incentive as deliberate policies to encourage foreign investment. This income tax proclamation grants an income tax exemption, which is called a tax holiday, of five years to long term investments in industrial, mining, or transport enterprises.¹⁶⁹ Although the 1949 tax law is the first to introduce tax incentives in Ethiopian legislation history, the government officially announced and formalized its investment policy in 1950.¹⁷⁰ This policy statement grants special facilities, like tax holidays, to encourage newly established foreign investments that are deemed to be beneficial to the country, despite what is beneficial is not clearly defined in the policy.¹⁷¹ Four years later, in 1954, aiming at encouraging agricultural and industrial expansion, a separate law that exempted industrial or agricultural machines and parts from all applicable laws at that time was issued.¹⁷²

Besides, as the desire to attract investment through tax incentive continues, the 1966 investment incentive law came up with various tax and non-tax incentives; for instance, the tax incentive

¹⁶⁷ Timothy P. Bodman, 'Income Tax Exemption as an Incentive to Investment in Ethiopia'(Journal of Ethiopian Law, vol. 6, No.1, 1969) pp. 215-225

¹⁶⁸TadesseLencho, (n 200) 149.

¹⁶⁹ ibid, see 'a Proclamation to Provide for the Payment of Tax by All Individuals and Businesses', 1949, Article 3(iii), Proc. No. 107, NegaritGazeta, 8th year, No., op cit, Article 3(iii).

¹⁷⁰Assefa Ali, Problems of Incentive Regime of Foreign Private Investment in Ethiopia: the Law and Practice, (Master's thesis, Addis Ababa University, 2015), p 27.

¹⁷¹EmebetTafere, The Design And Implementation Of Tax Holiday Policy And Laws In Ethiopia: Critical Issues And Problems,(Master's thesis, Bahirdar University, 2017) P31.

¹⁷²Tadesse (n 200) 20, see a Proclamation to Encourage Agricultural and Industrial Expansion, (Proc. No. 145, NegaritGazeta, 14th year, No. 3.)1954, Article 2.

includes, income tax relief (income tax holiday), import and export duty relief and non-tax incentives such as repatriation guarantee and access to immovable property by foreign investors.¹⁷³ The proclamation granted five years and three years income tax holiday to newly established firms with a capital of not less than 200,000 ETB and for enterprises who had expanded their existing business respectively.¹⁷⁴ Of all types of enterprises only industries engaged in manufacture of alcoholic beverages and liquors were not beneficiaries of the income tax holiday.¹⁷⁵ Regarding the customs duty relief, only agricultural and industrial enterprises are allowed to enjoy the relief. Enterprises that are eligible to this relief were not only exempted from import tariffs, but also municipal taxes, transaction taxes on imports and other taxes levied on imports.¹⁷⁶ When it comes to the export duty incentive, it was granted on discretionary basis to manufactured finished items headed for export. Since the proclamation did not clearly specify the incentive period it was up to the ‘investment committee’ to decide whether to extend the relief or not.¹⁷⁷

Despite the existence the aforementioned legislations that proves the ambition of the imperial regime to promote both domestic and foreign investment by granting various types of tax and non tax incentives, it is hard to get provision that aimed at encouraging compliant taxpayers as a means to improve revenue generation. Its major focus was on increasing export and earning foreign currency by encouraging foreign investment and industrialization through granting incentives that help to reduce initial investment cost for new business.

3.2.1.2. During the Derg Regime

During the 1974 revolution Ethiopia had a socialist oriented economic system which significantly affected its tax system, including tax incentive. Unlike the current market driven economy, under the derg regime taxation was mainly focused on nationalizing the economy and state control over resources and wealth distribution.¹⁷⁸ At that period government shows a great animosity towards private investment and private capital formation in general.¹⁷⁹ With a clear

¹⁷³Tadesse, (n 200) 150.

¹⁷⁴ibid., 150; Assefa(n 204) 150.

¹⁷⁵ Proclamation to Provide for the Encouragement of Capital Investment in Ethiopia, 1966, Proc. No. 242, NegaritGazeta, 26th year, No. 2., Article 5(3).

¹⁷⁶Ibid., Article 6(1).

¹⁷⁷Tadesse (n 200) 151, See ibid, Article 27.

¹⁷⁸Emebet (n 205) 32.

¹⁷⁹Tadesse(n 200) 151.

intention of discouraging private investment and hindering the growth of capitalism the government took a step to impose a heavy tax burden rather than encouraging foreign and domestic investors;¹⁸⁰ For instance, the 1978 income tax law, that impose heavy tax burden up to 89%, was a reflection of the hostile government policy towards private investment and capital formation.¹⁸¹ However, with the aim of introducing capital know how and transfer of technology into the country¹⁸², later on in the early and late 1980s, the government shows little relaxation of this aversion towards private investment.¹⁸³ In order to encourage participation of both domestic and foreign investors in joint venture investment the government issued a joint venture proclamation in 1983, which incorporate a number of tax incentive for investors. The tax incentive includes; income tax holidays for five years in case of new projects and for three years in case of extension of existing projects, exemption from customs duties on import of investment goods and spare parts, possible exemptions from customs duties for imports of raw materials, and from customs and transactions taxes for goods exported.¹⁸⁴ In addition, by issuing the Petroleum Operation Income Tax Law in 1986 and Investment Incentive Law in 1990 the then government provided more incentives to encourage private investors and increase foreign exchange.¹⁸⁵ The incentives include; exemption from import duties for import of machinery, vehicles, fuels, equipments, and chemicals necessary for petroleum explorations and extractions.¹⁸⁶

Hence, the same with the imperial period, in the late years of the derg era, there was an attempt to incorporate incentives as a means to encourage private investments and promote export despite its limited in scope. In general, unlike the current taxation system, taxation during the 1974 revolution was primarily about state revenue collection rather than encouraging investment and promoting tax compliance using different incentives. As a result, tax incentive for compliant tax payers was ignored as the main focus was on state ownership and control rather than promoting private investors through tax and non-tax relief measures.

¹⁸⁰Ibid., 1.

¹⁸¹Emebet (n 205) 31.

¹⁸²ibid 32.

¹⁸³Tadesse(201) 151.

¹⁸⁴ibid 152.

¹⁸⁵Emebet (n 205).

¹⁸⁶Tadesse(200) 151; Petroleum Operations Proclamation No. 295/1986, cited above, Article 21

3.2.1.3. During The Transitional Period (1991-1995)

After change of government in 1991 the future prospect of domestic and foreign investments in Ethiopia changed in a good way.¹⁸⁷ Following the fall of the derg regime the country under went through significant political and economic changes, leading to implementation of various tax incentives. Unlike the military government, the transitional government shifted from socialist to free market economy¹⁸⁸ and enacted economic and investment policies that create enabling conditions for participation of domestic and foreign investors in the economy.¹⁸⁹ It allows private investors to engage in different economic activities by removing capital limitations and bureaucratic procedures imposed by the previous military government.¹⁹⁰ The 1992 proclamation to provide for the Encouragement, Expansion and Coordination of Investment was one of the legislations that are enacted to achieve the liberal policy.¹⁹¹ The proclamation contained various types of tax incentives for both domestic and foreign investors; including; tax exemptions for domestic and foreign investment: exemption from import duties for import up to the 15% of the capital invested of capital goods and spare parts; exemption from export duties; tax deductions for research and development expenses, income tax holidays for three years for commencement and 2 years for expansion; income tax holiday for three years for reinvestment; and loss carry-forward beyond the tax holiday period.¹⁹² In addition, the export sector other than coffee received a huge tax relief with the issuance of the 1993 proclamation which aimed at cancelling taxes and duties levied on export goods.¹⁹³

Most of the tax incentives enacted during the transitional period were equally applicable for both domestic and foreign investors.¹⁹⁴ However there were specific economic sectors blessed with special tax incentives; For instance, the 1992 council of ministers regulation for transport sector granted a duty free privilege to imports of vehicles that have a certain carrying capacity¹⁹⁵, the 1993 mining proclamation offered an income tax exemption to expatriates working for mining

¹⁸⁷Tadeseelencho, (n 200)152.

¹⁸⁸Emebet, (n 205)32.

¹⁸⁹Assefa(n 204) 30.

¹⁹⁰ibid.

¹⁹¹ Proclamation to provide for the Encouragement, Expansion and Coordination of Investment, 1992, Proc. No. 15, NegaritGazeta, 51st year, No. 11., Art.13.

¹⁹²Tadesse (200) 152.

¹⁹³ ibid 51; A Proclamation to Cancel Taxes and Duties Levied on Export Goods, 1993, Proc. No. 38, NegaritGazeta, 52nd year, No. 23

¹⁹⁴ibid, 153.

¹⁹⁵Council of Ministers Regulations, 1992, Regs. No. 3, NegaritGazeta, 51st year, No. 12 , Art.3(1)

companies, abolished export duties for all minerals exported from Ethiopia and relieved import of all equipments, machinery, vehicles and spare parts for mining operation from the payment of customs duties and taxes.¹⁹⁶

In general, despite the transitional era marked a significant shift from the previous regimes by offering various incentives for both domestic and foreign investors it failed to incorporate legislations that aimed at incentivizing compliant tax payers particularly to boost tax compliance.

3.3. The current Legal Framework for Incentives to Compliant Taxpayers in Ethiopia

3.3.1. Overview of Ethiopian Tax Laws Related to Incentives for Compliant Taxpayers

Incentives are significant tools for encouraging tax compliance and promoting economic growth. In Ethiopia, in order to foster the establishment of new business and encourage existing businesses to expand or relocate, the government offers various incentives (tax and non tax incentives) for both domestic and foreign investors provided that they have fulfilled the eligibility requirements set by the law. These incentives are primarily governed by a range of investment and tax proclamations, regulations, and directives. This section provides an overview of the key Ethiopian tax laws related to incentives for compliant tax payers, focusing on their legal framework and provisions.

Key Ethiopian Tax Laws Governing Tax incentives:

➤ Customs Proclamation No. 859/2014

The customs proclamation is enacted on December 2014 to address different problems. As its clearly stated in the preamble its aim is, among others, introducing a law that prevent the increase incidence of contraband and other commercial crimes that negatively impact the public security, government revenue, and traders who perform their transaction legally. It incorporates different principles of customs operations.¹⁹⁷The proclamation took a step for incentivizing compliant taxpayers by including the principle of “prevent illegal practice by promoting self-

¹⁹⁶Tadese(n 200) 153 ; Mining Proclamation, 1993, Proc. No. 52, Negarit Gazeta, 52nd year, No. 42, Art. 38(2).

¹⁹⁷Customs Proclamation (n 6) Article 5.

compliance” as one of the principles of customs operation;¹⁹⁸ meaning that a customs operation shall be able avoid illegal practices(noncompliance) through encouraging and promoting compliant taxpayers, which affirms the need to incentivize compliant taxpayers to bring more compliance.

The proclamation allows release of goods when an importer provides a guaranty to make the payment of taxes or duties within a certain period of time, provided, however, that the differed payment period can’t exceed 12 month; though it leaves the eligibility requirements to be dictated by consequent directives of the Ethiopian Revenue and Customs authority.¹⁹⁹Hence, let’s bounce into the directive enacted for the implementation of this specific provision and look for individuals or companies that are eligible for this privilege.

Directive for Determining the Circumstances for Releasing Goods under Warranty No. 166/2012) -based on its power given by the customs proclamation ministry of revenue exhaustively lists importers that are allowed to enjoy the release of goods up on providing guarantee by this directive. According to Article 3 of the directive this privilege is given only for Authorized Economic Operators (here in after referred to us AEOs), government development agencies, importers thatengage in manufacturing industries and others who get the permission of the Ethiopian customs commission due to different reasons.²⁰⁰Rather than clearly incorporating them in the list, this directive also chose to stay silent when it comes to encouraging compliant taxpayers. In general, neither the directive nor the Ethiopian customs commission grants such privilege to encourage compliant taxpayers.

On the other hand chapter thirteen of the proclamation provides a simplified customs procedures for selected and registered persons upon the fulfilling criteria specified by the authority.²⁰¹ This simplified customs procedure includes: simplified procedure for goods declaration²⁰², simplified procedure for clearance of goods²⁰³, and self-assessment of customs duty and tax liabilities²⁰⁴. Simplified procedure for goods declaration includes allowing the release of goods upon the

¹⁹⁸ibid., Article 5(5).

¹⁹⁹ibid., Article 25(2).

²⁰⁰Directive for Determining the Circumstances for Releasing Goods under Warranty, (Directive NO.166/2012, September 2012, Addis Ababa, Ethiopia) Article 3.

²⁰¹ Customs proclamation, (n 6) Article 84.

²⁰²ibid., Article 85.

²⁰³ibid. Article 86.

²⁰⁴ibid., Article 87

provision of essential information needed to identify the goods and permit the later completion of the final goods declaration, allowing a consolidated declaration of goods for all imports or exports in a given period when the same individual frequently imports or exports goods and permitting lodgment of goods declaration through an entry in the record of authorized person, with a supplementary declaration provided later. And simplified procedure for clearance of goods allows the clearance of goods at the business premise of the declaring or another place authorized by the authority. Lastly, self-assessment of customs duty and self-liability permits the authorized person to self-assess duty and tax liabilities using its own commercial records and to ensure compliance with other customs liability requirements, when appropriate.

The provisions of these special customs procedures facilitate trade through streamlining the movement of goods from place to place, which avoid delay and other administrative costs. It also enhances efficiency and provides flexibility in customs clearance, while ensuring compliance with tax laws. This special procedure helps the government in balancing trade facilitation with regulatory control. However, despite these and other advantages of providing such special privilege, the customs proclamation failed to offer compliant taxpayers those privileges, unlike AEOs. For more understanding on this, let's delve into Customs Regulation No.518/2022.

Customs Regulation No. 518/2022- under article 11 and the following provisions the regulation incorporated the simplified customs procedures stated under the customs proclamation and others; such as release of goods on deferred payment and provision of priority service across all customs offices, for AEOs.²⁰⁵ It also provides the criteria for selection of AEOs²⁰⁶ and responsibilities of other concerned bodies towards the later.²⁰⁷ Government organizations are obliged to design and implement a system which enables them to give priority service to AEOs.²⁰⁸ However, the same with its predecessor customs proclamation this regulation also failed to allow compliant taxpayers to enjoy those special procedures for being loyal to the tax system.

²⁰⁵ Customs Regulation No. 518/2022, Article 13.

²⁰⁶ibid., Article 12.

²⁰⁷ibid., Article 14.

²⁰⁸ibid Art.14(2)

Directive For Determining the Risk Level Of Goods No.132/2010)²⁰⁹-As its clearly indicated in the preamble one of the aims this directive stands to achieve is encouraging compliant taxpayers through creating system that provides a expedite service and appropriately control noncompliant taxpayers who act against the tax legislations and bring them to compliance.²¹⁰As the name indicates this directive is enacted to determine the risk level of goods which establishes whether a shipment can be released directly or whether it requires additional inspection, either physical or documentary.²¹¹ Those categories indicate the level of control that will be applied to the goods before they are allowed to enter or leave Ethiopia.²¹²For instance the green channel allows the immediate release of the goods without the need for further physical or documentary inspection though there is a chance of being inspected after the release of the shipment by Post Clearance Audit (PCA) or other competent organs.²¹³ Unlike the green channel, red channel indicates the need to make the highest level of control during clearance of goods, both documentary and physical inspection is mandatory.²¹⁴Thirdly, the yellow channel represents a medium level of control in the clearance of goods; only documentary inspection of the good is needed.²¹⁵ In addition there are also blue orange and white channels included in the directive.²¹⁶ According to Article 6 of the directive importers or exporters who are allowed to be served by green channel are government organizations, diplomats, international and intercontinental organizations, manufacturing companies benefiting from special customs service or Authorized Economic Operators (AEO). Exceptionally, the directive allows the authority (Ethiopian revenue and customs authority) to decide other individuals or companies to be served by green channel.²¹⁷ However, even though the directive allows the authority to designate others companies or individuals to be served by green channel (low inspection), it has never extended this privilege to compliant taxpayers. This implies that the directive does not give attention to incentivizing compliant taxpayers other than merely stating on its preamble about its aim to encourage and provide them speedy service. Allowing immediate clearance for compliant

²⁰⁹Directive for Determining the Risk Level of Goods (Directive No. 132/2010, February 2017, Addis Ababa Ethiopia)

²¹⁰Ibid., Preamble.

²¹¹ibid .Article 2.

²¹²Ibid.

²¹³ibid Article 2(8).

²¹⁴ibid Article 2(6)

²¹⁵ibid Article 2(7).

²¹⁶ibid Article 2(9, 10, 11).

²¹⁷ibid Article 6 (2).

taxpayers helps them to clear goods quickly without going through physical inspection which reduces delays, storage costs, and potential demurrage fees. Moreover, it reduces uncertainty which enables business owners plan logistics and supply chain management more effectively, improves business efficiency and effectiveness. This type of meaningful incentives encourage compliant tax payers to be more compliant and bring the noncompliant ones to compliance, results in achieving the objective of the directive.

Excise Tax Proclamation No. 1186/2020 – along with various provisions that impose obligation on taxpayers the excise tax proclamation provides several conditions by which taxpayers could be relieved from their excise tax obligations. This includes, offsetting excise tax on inputs, excise tax refunds and exemption from excise tax. For instance, Article 14 of the proclamation allows manufacturers to offset the excise tax they have paid for imported or locally produced raw materials used in production of other excisable goods against the excise tax payable on the finished products except tobacco, alcohol and sugar products. In addition, it provided a tax relief by which an excise tax already paid to the tax authority could be refunded to the taxpayer, provided that certain conditions such as, loss or damage of goods, or their return to the seller by the buyer, excisable goods used by manufacturer to produce unexcisable goods, are fulfilled.²¹⁸ The proclamation also includes a list of goods, services and situations that are exempted from payment of excise tax; such as, excisable goods and services that are supplied to entities with a tax privilege and excisable services exported from Ethiopia.²¹⁹ It also gives the ministry of finance the power to exempt goods and services based on social, economic, and administrative reasons. According to Art 26 of Definition of Powers and Duties of the Executive Organs Proclamation No. 1262/2021, the ministry is empowered to initiate policies, strategies, and that can serve as a base for the tax and customs laws. Thus, the Ministry of Finance is under duty to follow up a proper development of policies that can best serve the economic, social and administrative arena in relation to taxation.

Given such a policy implementation duty in relation to taxation is left to the Ministry of Finance, one cannot find a single provision within the excise tax proclamation that deal with incentivizing compliant taxpayers.

²¹⁸Excise Tax Proclamation No. 1186/2020(26th Year No. 25, Addis Ababa ,17th March, 2020), Art.30(1)

²¹⁹ibid Art. 8.

Federal Income Tax Proclamation No. 979/2016—this proclamation provides detailed guideline for taxpayers’ duties, such as: timely filing of tax returns, accurate reporting of taxable income and on time payment of taxes. Taxpayers’ failure to comply with this proclamation results in penalties and interest charges, stressing the significance of tax compliance. The same with the aforementioned tax laws, the federal income tax proclamation does not explicitly give a space to incentivizing compliant taxpayer. Although it gives a financial relief to taxpayers through deduction of expenditures,²²⁰ loss carry forward, and exemption²²¹ for a certain type of incomes, irrespective of the compliance level of the taxpayers, none of the provisions are dedicated to encouraging tax compliance through giving an incentive.

Therefore, unlike other jurisdiction that provides direct incentives such as reduced tax rates, credits or priority services for taxpayers who are consistently compliant to the tax system, Ethiopian income tax proclamation emphasis on penalty rather than reward, which discourages voluntary compliance. Although the proclamation provides a certain benefits for taxpayers, provided that a certain requirement is fulfilled, there is a huge room for policy development to include direct incentives that encourages consistent compliance.

Federal Tax Administration Proclamation No. 983/2016- The federal tax administration proclamation is promulgated to achieve the objective of making the tax administration system more efficient, effective, and measurable.²²² In addition, it also aimed at introducing a tax administration law that addresses the problem of prolonged pendency of taxpayers cases due to interpretation of various tax laws; and establishing a well-organized and accessible system that review taxpayers’ compliant on tax decisions efficiently.²²³

When we delve into the provisions of this proclamation under Article 135(1) it states that “*The Authority shall reward a tax officer for outstanding performance and a taxpayer for exemplary discharge of his tax obligations.*” This provision implies the recognition of tax incentives for compliant taxpayers under the tax administration proclamation. However, although it indicates the need for rewarding compliant taxpayers; the proclamation gave the discretion to provide

²²⁰Federal Income Tax Proclamation 987/2016(22th Year No. 104, Addis Ababa, 18th August, 2016) Article 22, 23, 24, 25.

²²¹ibid., Art.65.

²²²Federal Tax Administration Proclamation No. 983/2016 (22th Year No. 103, Addis Ababa , August, 2016) Preamble.

²²³ibid.

detail of the reward to the ministry by consequent directive. Despite its power to enact a directive, the ministry of revenue fails to enact a directive for the effective implementation of this particular provision. Therefore, this causes a gap in determining who is eligible for the reward and what type of reward could an exemplary taxpayer get from the government. This proclamation also gives a relief for taxpayers in cases of serious hardship,²²⁴ however it is applicable to all taxpayers irrespective of their level of compliance.

To sum up, most of Ethiopian tax laws highly focus on deterring tax noncompliance through different forms of penalties but not on promoting compliance behavior by different rewarding mechanisms.

3.4. Criteria and Selection Process for Recognizing Compliant Taxpayers

According to the definition given by ministry of revenue, Tax compliance means a voluntary compliance with the tax laws regulations, guidelines, and principles that governments have enacted to collect tax revenue, and fulfilling taxes and duties in a timely and appropriate manner.²²⁵

Starting from 2019G.C. (2011 E.C.) until today the Ministry of Revenue recognizes and award loyal taxpayers who have a record of consistent compliance and made more contribution to the government revenue during a tax year, through an annual award program. The most recent one is the one which was held for the 6th time in 2024(2016 E.C.) and recognized 66 platinum level, 165 Gold level and 319 silver level, totally 550 loyal taxpayers. This recognition program primarily aims at encouraging voluntary tax compliance by acknowledging taxpayers that consistently fulfill their tax obligations so that others could be motivated to pay taxes and get the same honor. The recognition program is being held by classifying selected taxpayers into 3 categories, Platinum, Gold, Silver level and certificate based on their loyalty in paying taxes and contributions they made to the government revenue.

²²⁴ibid, Article 51.

²²⁵Ministry Of Revenue, Criteria for Assessing the Level of Compliance of Taxpayers for Recognition and Awards to Be Given To Taxpayers (June 2016, Addis Ababa) preamble.

3.4.1. Criteria Used by the Ministry of Revenue

The selection criteria used by the ministry of revenue for these awards include various tax compliance related factors classified into four;²²⁶ which are;

1. Registration- Every individual and institution engaged in business activity and required to register as taxpayer must, on its own initiative, come to the tax network and register as a taxpayer. Registration includes registering for all types of taxes, including notifying any changes related to registration within the period specified by law. However, registration for one tax type and failure to register for another when required by law does not constitute tax compliance.

The taxpayer registration procedure in Ethiopia includes submitting biometric information, to have a taxpayer's identification number (TIN), full address including email address and bank account, as well as maintaining accounting records as necessary, and notifying any changes in business activities, address changes, and bank account details to the authorities and the like. Therefore, so as to be selected as a loyal taxpayer in Ethiopia, first and foremost each taxpayer must complete these processes and register as a taxpayer and notify any changes in registration.

2. Filing- Secondly, another obligation expected of a registered taxpayer is to notify the tax authority of the amount of tax due, within the tax period and means of filing set by the tax authority. This means, it's a process by which taxpayers submit the required financial documents and information to the ministry of revenue; including; detailing the income earned, taxes owed and any deductions or credits applicable in accordance with the Ethiopian tax laws. Recently, ministry of revenue has introduced a system for taxpayers to electronically file(e-filing) and pay (e-payments)their taxes directly from their home location. Therefore, taxpayers are required to notify the required information through the electronic filing system.

3. Reporting - Thirdly, ataxpayer who has declared the amount of tax due is required to submit various reports that can support the accuracy of the declared tax amount, including refunds

²²⁶Ibid.

and losses.²²⁷ These reports mainly include income statement, balance sheet, cash flow statement, purchase and sales receipts, and other supporting documents.

4. On Time Payment- Fourth, the obligation expected of a taxpayer is to pay the tax amount that he voluntarily declares to be due and confirmed in various reports, according to the schedule set by the tax authority.²²⁸ This means paying annual taxes annually, monthly taxes monthly, and others on time according to the schedule set for them.

- **Income contribution:** Last but not least criterion to award a taxpayer in Ethiopia in a specific tax year is taxpayer's income contribution to the government revenue.²²⁹ Except for pension contributions and personal income tax, the taxpayer's self-declared income contribution in all types of taxes is one factor to reward taxpayer. And this criterion holds 30% of the total point that a taxpayer could get. Although it will be disclosed at the recognition program, the income contribution identified through audits, assessments or any additional investigations findings which exceed the amount declared by the taxpayer will not be used for competition purposes.²³⁰

Based on the criteria discussed above, taxpayers who can be nominated for the award are taxpayers with high and medium legal compliance, while taxpayers with low legal compliance are not nominated for the award at all. In addition, if the total purchase/purchase of the fiscal year/in connection with fraudulent transaction receipts is 3 percent or more, and the frequency of fraudulent transaction receipts is more than 10, they will be disqualified from the competition as well.²³¹ Moreover, a taxpayer who has not reached the risk level for the following year during the tax year in which the award is granted (a taxpayer who does not fulfill the minimum requirement) will not be included in the recognition and award competition from the outset.

In general, from the above discussions, tax compliance means voluntarily fulfilling these and other tax-related obligations in appropriate manner. For the Ethiopian Ministry of Revenue, tax compliance means voluntarily complying with tax laws, regulations, and guidelines issued by the Ministry and legislative organs to enforce tax obligations. On the other hand tax non compliance

²²⁷ *ibid.*

²²⁸ *ibid.*

²²⁹ *ibid.*

²³⁰ *ibid.*

²³¹ Ministry Of Revenue, (n 259).

means, not fulfilling tax related obligations properly, which is the exact opposite of tax compliance. Therefore, tax non compliance in terms of domestic taxes includes failure to register as a taxpayer, failure to report and pay taxes on time, filing false financial statements (understating income and overstating expenses), claiming refunds that are not due, improperly declaring losses, making tax deductions, and failing to issue receipts during transactions, improper use of cash register machine, failure to comply with the operating systems established by the authority, and so on.

3.4. The Types of Taxes and the Time Limit for Information to Be Assessed in the Selection Process

The types of taxes that will be analyzed through the selection criteria will be value added tax (turnover tax), business profits tax, excise tax, and other types of taxes except pension and employment taxes. The time frame for additional information will be based on the following:

- 1. Business Profit Information:** Information on the final business profit reported for the tax year in which the award is to be presented;²³²
- 2. Information on Value Added Tax (Turnover Tax), Excise Tax and other types of taxes-** the last 3 months (tax periods) of the fiscal year preceding the fiscal year in which the award is made and the first 9 months (tax periods) of the fiscal year in which the award is made, for a total of 12 months (i.e., the tax period from April of the previous fiscal year to March of the fiscal year in which the award is made) will be used.²³³
- 3. Audit Findings difference:** Audit findings obtained from tax audits, investigation audits, internal audits, desk audits, service audits, or other types of audits within the last 2 years, totaling one year prior to the fiscal year in which the recognition and award is made and one year during the fiscal year in which the recognition and award is made, will be used.²³⁴
- 4. Refund request difference:** Information on the variance between the number of refund requests and those approved in the last 2 years, totaling one year prior to the fiscal year in which the award is being made and one year in which the award is being made,²³⁵

²³² Ministry of revenue(n 259)

²³³ibid.

²³⁴ibid.

²³⁵ibid.

5. **Taxpayer's Penalty History:** Any penalty information recorded within the last 2 years, including the one year preceding the fiscal year in which the recognition and award is made and the one year in which the recognition and award is made;²³⁶
6. **Tax Assessment Differences:** - Information on tax assessment differences found in the last 2 years, including the one year preceding the fiscal year in which the recognition and award is being held and the one year in which the recognition and award is being made, as well as information on taxpayers who have not been assessed;²³⁷
7. **Customs Risk Level-** taxpayer information of post-clearance audit and random inspection information history obtained during the fiscal year in which the award is being made will be used;²³⁸
8. **Information on taxpayers who have been convicted of tax fraud and evasion or have been convicted of fraudulent transactions and have been punished for not issuing a receipt;** Taxpayer information obtained during the fiscal year in which the award is being made will be used;²³⁹
9. **Information on Taxpayers with Tax Debts:-** their payment status recorded during the last 2 months prior to the fiscal year in which the award is made and the first 10 months of the fiscal year in which the award is made, for a total of 12 months will be used;²⁴⁰
10. **Filing Status:** Under the selection criteria for filing status of business profits, TOT or VAT and excise taxes, Value Added Tax (VAT) holds 20 percent; Excise Tax is 16% and Business Profit is 8%, totaling 44%. If the taxpayer is not subject to one of the above-mentioned tax types, the points earned by the taxpayer for the tax type he is subjected to will be added together and converted to 44%;
11. **Taxpayer's Income Contribution:** Except for pension contributions and personal income tax, the taxpayer's self-declared income contribution is reflected in all types of taxes and is calculated as follows.²⁴¹

²³⁶ibid.

²³⁷Ministry of Revenue (n 260)

²³⁸ibid.

²³⁹ibid.

²⁴⁰ibid.

²⁴¹ibid.

- 11.1. Business profits are 15%, VAT/TOT is 8%/, excise tax is 5%, and other types of taxes are 2%, for a total of 30%. If the taxpayer is not subject to any of the above-mentioned tax types, the points earned by the taxpayer in the tax type he/she/it is subjected to will be added together and converted to 30%;
- 11.2. Notwithstanding the provisions of 11.1., the total tax compliance of taxpayers shall be determined by taking into account the following factors: contributions from business profits, VAT/TOT, excise tax and other types of taxes, which shall account for 30% of the total tax liability, and the other qualifying factors, shall be added together and converted to 70%.²⁴²

12. Turnover tax registrants will be assessed according to the criteria set for assessing VAT registrants.

3.4.2. Types and Levels of Awards

3.4.2.1. Level of Award

In Ethiopia under the control of ministry of revenue the award of loyal taxpayers is given in two stages, which are:

Institutional Award (National): Is an award that will be granted to taxpayers at the national level. Hence, all taxpayers will be selected among their fellow taxpayers in their branch office based on the criteria set by the ministry, and the final analysis and selection will be conducted by head office of the ministry of revenue. Among all medium and high level compliant taxpayers the number of compliant taxpayers who are eligible for national recognition will be decided by the competent organs in the ministry of revenue head office.

Branch-level awards: here taxpayers will be awarded at the branch level. In this way, the final analysis and selection for national level award will be conducted at the head office based on the quota given to them, and taxpayers who are not included in the national level awards will be selected and awarded at their respective branch based on their compliance level.

²⁴²Interview with W/roMahletAmdeAbebe, Tax Risk and Compliance Strategic Directorate Director, Ministry of Revenue, (Addis Ababa, Ethiopia, Tuesday, February 18, 2025).

3.4.2.2. *Types of Awards for Compliant Taxpayers*

There are four types of awards given by the ministry of revenue to encourage tax compliance, which are:

- ❖ Platinum(at the institutional level)
- ❖ Gold(at the institutional level)
- ❖ Silver(at the institutional level) and
- ❖ Certificate(at the ministerial and branch office level).

The ministry of revenue gives recognition to compliant tax payers every budget year by categorizing taxpayers into four levels as listed above.²⁴³ Taxpayers are awarded for qualifying the compliance related requirements. 30% of this leveling is determined based on the taxpayer's contribution to the government revenue.²⁴⁴ However, there are taxpayers who consider this incentive as a mere recognition that is not worth fighting for. According to a questioner conducted with compliant taxpayer 01 on March 20/2025, it is found that it is just a waste of time for taxpayers to spend the day just to hear their name being called at the recognition program without any meaningful benefit.²⁴⁵ They also claim for the provisions of more incentives that could effectively contribute for the enhancement of their business and ease the complex tax system beyond mere recognition.²⁴⁶

Benefits from the recognition- after the recognition the authority will give those selected compliant taxpayers a **badge** that will serve them as an identification card to get a speedy service and preferential treatment during their time in the authority.²⁴⁷ A contact person will also be assigned in the authority especially to large taxpayers who need any kind of information or assist with regard to their tax life. In addition this recognition will give them a **good will** before any national and international organizations, which will help them to get trust and get things done easily.²⁴⁸ **Training** will be given for compliant tax payers to make them aware about the new

²⁴³ Questioner Conducted on March 20/2025 with Compliant taxpayer 08, Addis Ababa Ethiopia

²⁴⁴ Ibid.

²⁴⁵ Questioner Conducted on March 20/2025 with Compliant taxpayer 01, 02, 05, and 07, Addis Ababa Ethiopia.

²⁴⁶ Ibid, with all selected compliant taxpayers

²⁴⁷ Mahlet (n 276)

²⁴⁸ Ibid.

laws, rights they are entitled, obligations they need to discharge and to answer questions with regard to the problems they are struggling with and bring them to more compliance.²⁴⁹

Naming and promoting-unlike naming and shaming, the ministry publicly recognizes and praises taxpayers for consistently complying with the tax system and distribute list of compliant taxpayers through social media and other means. This type of mechanism encourages voluntary compliance by showing their compliance is valued, not just enforced and increase the trust between the government and taxpayers.

Naming and shaming- the ministry of revenue and customs commission publicly reveals the identity of the taxpayers who are not compliant to the tax system through social media or other means, to pressure them in to correcting their non-compliant behavior and to warn and deter others from doing the same.

Future plans of the ministry of revenue, with regard to incentives to be given for compliant taxpayers:

As foreign currency shortage is a significant challenge for business owners in countries like Ethiopia the ministry of revenue has a plan to grants compliant taxpayers access to foreign currency.²⁵⁰ It also plans to allow compliant taxpayers and their families to enter through the gate assigned for the business class customers at Ethiopian Airlines Group, so taxpayers and their families will be proud by their compliance to the tax system.²⁵¹ There are plans to facilitate the establishment of facilities in all offices across the country to ensure that loyal taxpayers receive priority and expedite services. It also intends to dedicate a particular window in each branch office or open one separate branch office aimed at serving only compliant taxpayers based on Pareto efficiency state. In the near future the ministry has a plan to make the selection process completely automated, free from human intervention.

²⁴⁹Interview with W/roElfness Negash, Tax Risk and Compliance Strategic Directorate Lead Expert, Ministry of Revenue, (Addis Ababa, Ethiopia, Wednesday, February 5, 2025).

²⁵⁰Mahlet (n 276).

²⁵¹ibid.

3.4.3. Practical Challenges or Concerns Regarding Compliant Taxpayers Recognition

According to W/ro Mahlet,²⁵² the ministry is facing various challenges while selecting and rewarding loyal tax payers. Among others, lack of technological support to determine compliant taxpayers without any human intervention is the huge challenge they are facing in the process.²⁵³ The backwardness in technological equipments affects the quality of the data to be collected. Since there are multiple information that need to be gathered from different bodies including the taxpayer and federal police, the ministry of revenue struggles in finding a reliable data to determine compliance of a particular taxpayer.

The other challenge is lack of attention by the top management of the ministry, they said allowing tax incentives costs the government a portion of its revenue and that is why this issue does not get much attention from the top management as it requires.²⁵⁴ Most of them believe that tax is a compulsory levy imposed by the law. So there is no need for the government to incentivize compliant taxpayers for just discharging their obligation. In addition, lack of experienced human resource is the other thing that hinders the process of incentivizing compliant taxpayers.²⁵⁵ In order to give tax incentives to compliant taxpayers government needs experienced and trust worthy taxpayers who participate in drafting the best criteria to determine compliant taxpayers and righteously select compliant taxpayers based on nothing but the stated criteria. In addition, the government needs more human resources than what it currently have so as to provide expedite service and priority treatment for compliant taxpayers across the country, said w/roMahlet.

According to w/roElflesh, no matter how hard the government tried to incorporate incentives there are financial impediments that constrain the government from doing so.²⁵⁶ since there are a lot of facilities that needs to be given priority to be fulfilled than compliant taxpayers who

²⁵² ibid

²⁵³ ibid.

²⁵⁴ Interview with w/ro ZiyadaTahir Mama, Compliance Strategy Leading Expert, Ethiopian Customs Commission (Addis Ababa, Ethiopia, Monday, January 13, 2025).

²⁵⁵ Mahlet (n 276).

²⁵⁶ Elflesh(n 283)

discharge their obligation imposed by law, the government does not have sufficient budget to offer incentives for compliant taxpayers.²⁵⁷

There are also taxpayers who have brought complains in relation to transparency and bias of the tax authority in the process of recognizing compliant taxpayers, which discourages voluntary compliance.²⁵⁸ Taxpayers claims that they are being approached by officers of the ministry and asked to pay a certain amount of money so they, can be selected as one of the most compliant taxpayers.²⁵⁹ This questions the impartiality of the selection process.

Taxpayers' awareness and understanding of tax laws and incentives is one of the challenges. Lack of awareness and understanding of taxpayers in relation to the value of existing incentives granted to compliant tax payers by the ministry of revenue, meaning that although certifying compliant taxpayers is a good beginning for encouraging compliance it not an effective means unless its supported by other positive rewards.²⁶⁰ While it serves as a supporting document for competitions to be held nationally and internationally and gives their company a good will around the world and benefit from the organizations reputation taxpayers consider such recognition something that is not worth fighting for.

The other thing raised by both the tax authority and the taxpayers is that the current criteria are not sufficient enough to determine the compliance level of a taxpayer in a tax year. For instance, taxpayers claim that the 30% value given for 'contribution of taxpayer to the government revenue' is unfair and discouraging for low income taxpayers. And the authority defends this claim by impossibility of rewarding all compliant taxpayers unless we follow the pareto efficiency system that enables the government to earn more revenue.

3.5. Conclusion

The assessment of Ethiopian tax laws reveals that, despite the tax administration proclamation provides a clause that allows a reward for taxpayers that have outstanding performance it failure in clearly specifying the eligibility criteria and the type of incentives that may be offered for being compliant taxpayers highly limits the practicality of this provision.

²⁵⁷ *ibid.*

²⁵⁸ Questioner Conducted on March 20/2025 with compliant taxpayer 01, and 07, Addis Ababa Ethiopia.

²⁵⁹ Mahlet (n 276).

²⁶⁰ Questioner Conducted on March 20/2025 with compliant taxpayer 06, 09 and 10 Addis Ababa Ethiopia.

Moreover, in Ethiopia the implementation of tax incentives face several challenges, including: financial inefficiency, absence of technological infrastructure, short of qualified expertise, lack of attention by the top management, transparency and fairness and the like. Such limitations impede the development of strong incentive system and weaken the effectiveness of the already existing incentive system, the public recognition program.

As a result, the findings of this research shows that in Ethiopia despite the presence of legal basis for incentivizing compliant taxpayers, the absence of specificity in the law and practical enforcement mechanisms erode the potential of this incentives to promote tax compliance. It is important to have a stronger legal system backed by adequate financial and human resources, technological capacity to transform incentive related clauses from abstract principles into effective policy tools.

CHAPTER FOUR

Conclusion and Recommendations

Introduction

This chapter outlines the core findings of the research and offers practical and legal recommendations to foster tax compliance through targeted incentives under Ethiopian tax law.

Conclusion

In this research the legal framework regulating incentives for taxpayers that have consistent compliance record, with an emphasis on identifying whether the existing tax laws effectively encourage tax compliance, has been explored. However, despite the fact that incentives play a crucial role in promoting tax compliance, the analysis demonstrates that Ethiopia does not yet have a comprehensive and legally enforceable system of tax incentive for compliant taxpayers.

The study finds that the only mechanism currently recognized by Ethiopia is a non financial incentive system, which publicly recognizes and awards compliant taxpayers a certificate that entitles them priority treatment for services delivered by the tax authority. Despite its symbolic value, this type of incentive mechanism is very narrow in scope and impact, because it does not give any financial and procedural privilege that would provide a meaningful incentive for consistent compliance.

Furthermore, the study draws attention to the fact that the key tax laws of Ethiopia, such as Federal tax administration and federal income tax proclamation, lacks provisions that would allow tax credits, or rebates, reduced audit frequency, penalty relief, simplified customs procedures and the like for compliant taxpayers.

With regard to the objectives of this research, the analysis confirms the absence of Ethiopian tax law that provides comprehensive incentive framework for compliant taxpayers. It also highlights the shortcomings and challenges the government face in encouraging voluntary tax compliance without providing any financial and procedural benefits. In addition, the study concludes that

short of such incentives may discourage compliant taxpayers, particularly small and medium sized enterprises that face high compliance cost.

Recommendation

Although Ethiopia has improved in its tax administration, there still are no clear and legally binding incentives to promote voluntary compliance. The following recommendations aimed at filling the existing gaps and encouraging a more cooperative tax system.

The researcher recommends the Ethiopian tax system to introduce financial and non- financial incentives for compliant taxpayers such as:

The federal income tax proclamation should be amended to include a provision that allow Ministry of Revenues to offer performance based deductions, tax credit or rate reduction for long term compliant taxpayers. This helps to improve cash flow of compliant taxpayers and motivate others to follow their step. The customs proclamation should be revised to include provisions that allow compliant taxpayers to enjoy the privilege of simplified customs procedure. Further, a clause that allows a duty free exemption on importation of capital goods and vehicles for subsequent investments should be included.

Although tax audit is important to trace tax fraud and evasions, it is capable of creating distrust between government and the taxpayer. Therefore Ethiopia needs to introduce a law that exempts loyal taxpayers from rigorous tax audits unless red flag appeared, this helps to save administrative resources and improve taxpayers' trust. I recommend the law to formally recognize selected compliant tax payers as low risk and eliminate them from unnecessary audit without having substantial cause.

Taxpayers with the history of consistent compliance record should be benefited from administrative simplifications. Therefore, it is important to make the tax registration, filing, reporting, and payment process less complex, easier and speedy for compliant taxpayers through digital systems, which simplify filing, reduce paper works and compliance costs. Giving priority service or fast track processing for businesses with a strong compliance record also play a great role in encouraging voluntary compliance by saving their time. Moreover, in order to avoid the lengthy court procedure taxpayers may face, the tax administration proclamation should include

provision that allow the case to which recognized compliant taxpayers are a party to get the priority to be entertained first.

A law should be introduced to allow compliant taxpayers get priority to government contracts. Because prioritizing the one with tax compliance certificate in case of bidding on public procurement or tenders promote voluntary compliance and encourage other to become more compliant.

The current legal framework does not take into consideration the compliance history of a taxpayer while imposing penalty. Therefore, I recommend a legal exception that offer waiver or reduction of penalty when a compliant taxpayer voluntarily reports error. In addition, the tax administration proclamation should be revised to include a clause that allow compliant taxpayers to take their case before the federal tax appeal commission and other level of courts without the need to deposit the required payment first or reduce the percentage they are required to pay. Moreover, it also need to introduce a provision that grant a grace period for compliant taxpayers that failed to discharge its obligation within the specified time because of emergency or financial hardship, other than what is already given to all taxpayers.

Ethiopia should introduce a directive or regulation that clearly specifies the criteria for recognition of compliant taxpayers and the privilege granted so taxpayer can be able claim their right. Strengthening the current public recognition program by using media and other platforms to promote taxpayers with outstanding tax compliance should be give attention. Although having a tier or level while recognizing compliant taxpayers is a good beginning however; there should be a special service they can access compared to the one on the lower hierarchy. Amending the federal tax administration proclamation to introduce specific privileges that targets on compliant taxpayers and links with the compliance hierarchy of tax payers is important.

In countries like Ethiopia, where access to foreign currency is restricted, allowing access to compliant taxpayers can be one way to encourage tax compliance. Because, compliant taxpayers need foreign currency to import goods, pay for services and or invest in technologies. Therefore, if Ethiopia give priority for compliant taxpayers in foreign currency allocation their cost of doing business will be reduced and increase their competitiveness. In addition, I recommend the Ethiopian government, in collaboration with private and public financial institutions, to introduce

loan programs with reduced interest rates particularly targeted at taxpayers with consistent compliance record and their employees; this lowers the cost of capital for businesses and motivate employees to support tax compliance internally.

Last but not least, it is important to govern the process of selecting eligible taxpayers and granting incentives by clear, transparent and objective criteria. The tax authority should introduce standardize procedure to make sure that every compliant taxpayer have equal opportunity to be selected and to access the available incentives, without any partiality and corruption.

Ultimately, this study marks the need for Ethiopia to reform its policy and amend its laws in a way it introduces an incentive mechanism beyond a mere annual recognition that offers tangible benefit and encourage culture of consistent voluntary compliance in Ethiopia.

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Interview with W/ro Ziyada Tahir Mama, Compliance Strategy Leading Expert, Ethiopian Customs Commission (Addis Ababa, Ethiopia, Monday, January 13, 2025);

Interview with Ato Talema Ayele, Authorized Service Operators (AEO) Lead Expert at Ethiopian Customs Commission (Addis Ababa, Ethiopia, Monday, February 10, 2025);

Interview with w/ro Shewaye Takele, Authorized Service Operators (AEO) Customers Service Support Lead Expert at Ethiopian Customs Commission (Addis Ababa, Ethiopia, Monday, February 10, 2025);

Questioner

A questioner conducted with 10 randomly selected compliant taxpayers recognized in 2021/22 budget year, March 20/2025, Addis Ababa, Ethiopia.