

Addis Ababa
University

(Since 1950)



ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES
School OF LAW

The Legal and Institutional Framework for the *Regulation of Tax Avoidance and Evasion in Ethiopia*

By:

Ketema Tesso

Advisor: Tilahun Teshome (Prof.)

A Thesis Submitted In Partial Fulfillment for the Requirements of Masters of Degree of Laws /L.L.M/

March 2013

ADDIS ABABA, ETHIOPIA

Approved by:

Advisor

Examiner

Examiner

Signature

Signature

Signature

Statement of Certification

This is to certify that Ketema Tesso has carried out his research work on the topic entitled "*The Legal and Institutional Framework for the Regulation of Tax Avoidance and Evasion in Ethiopia*" under my supervision. In my opinion this work is suitable for submission in partial fulfillment of the requirements for the award of the LLM.

Advisor: Tilahun Teshome (Prof.)

Signature: _____

ACKNOWLEDGEMENT

First of all, I would like to express my praise to the almighty Lord, the most merciful and the most compassionate, who has granted me the potential to start and complete this study.

A heartfelt gratitude deserves to my advisor, Prof. Tilahun Teshome, for his constructive advising and comments, and diligent cooperation without which the task would have been hardly easy.

My gratitude is also extended to the following that have helped me in finalizing this study: Ethiopian Revenue and Custom Authority (ERCA)-Particularly My thanks goes to Miss Tihtina Belete for her willingness and cooperation in giving full information about the work done by ERCA in securing voluntary compliance of taxpayers and African Union for allowing me to use their library and internet service.

Table of contents

Content	page
Chapter One: Introduction.....	1
1. Background	1
2. Statement of the problem.	5
3. Objectives of the study.....	7
a. General objective.	7
b. Specific Objectives	7
4. Significance of the study.....	7
5. Methodology	8
6. Scope of the Study	8
7. Organization of the research.....	9
Chapter Two: General Concept of Tax Avoidance and Evasion	10
2.1. Definitions of Tax Avoidance and Evasion	10
2.1.1. Definition of Tax Avoidance	10
2.1.2. Definition of Tax Evasion	16
2.2. Causes of Tax Avoidance and Evasion.....	17
2.2.1. Causes of tax avoidance	18
2.2.1.1. Low Tax Moral	18
i. Low taxpaying culture and Norms	18
ii. Low quality of the service in return for taxes	20
iii. High tax rate	21
iv. Lack of Fairness and Trust	21
v. Lack of awareness/knowledge about the importance of paying tax.....	22
2.2.1.2. High compliance costs.....	23
i. Time compliance cost.....	23
ii. Financial compliance costs.....	24
2.2.1.3. Deficiency/loopholes within the tax legislation	25
i. Taxing similar activities at different rates	25
ii. Exempting some activities from tax liability.....	26
iii. Tax holyday/tax incentives.....	26
2.2.1.4. Weak enforcement of tax laws.....	28
2.2.2. Causes of tax evasion	30
2.2.2.1. Low tax morale	30

i. Low quality of the service in return for taxes	31
ii. Low transparency and accountability of public institutions	31
iii. High level corruption.....	31
iv. High tax rate.....	32
2.2.2.2. High Compliance cost	33
2.2.2.3. Low level of Penalty.....	33
2.2.2.4. Weak enforcement of tax laws.....	35
i. Weak detecting and prosecuting capacity of the tax authority.....	36
ii. Insufficiencies in tax collection capacity.....	36
iii. Inability of controlling underground/informal activities.....	38
Chapter Three: Measures for tackling Tax Avoidance and Evasion	39
3.1. Measures for improving voluntary tax compliance.....	39
3.1.1. Building high tax moral.....	40
i. Taxpayers education and service.....	40
ii. Public Relations and cooperation.....	40
iii. Giving Tax Counseling Service	41
iv. Reducing tax rate.....	42
3.1.2. Addressing tax compliance costs	42
i. Less frequent filing requirements	43
ii. Offering electronic filing and payments.....	44
3.2. Measures that improve legal and administrative framework	46
3.2.1. Legislative measures against tax avoidance and evasion	46
3.2.1.1. Legislative measures against tax avoidance.....	46
1. System rule change	48
2. Legislation that introduces anti-avoidance provisions	48
i. Disclosure legislation/rule	48
ii. Specific Anti-avoidance Rules (SAARs) and General Anti-avoidance Rules (GAARs).....	50
iii. Penalties for abusive tax avoidance.....	53
iv. Promoter penalties.....	53
3.2.1.2. Legislative measures against tax evasion	54
3.2.2. Measures improving the administrative ability of tax authorities	56
i. Establishing autonomous tax authority	57
ii. Improved audit capacity and high probability of detection.....	58
Chapter Four: Tax Avoidance and Evasion in Ethiopia	60
4.1. Causes of tax avoidance and evasion under the Ethiopian context	60

4.1.1. Causes of Tax Avoidance and Evasion that Affect the Voluntary Compliance of Taxpayers ...	60
4.1.1.1. Low Taxpaying Moral	60
i. Level of Taxpaying Culture and Norms	61
ii. Level of Quality of Service in Return for Tax	61
iii. Level of knowledge and awareness about the importance of paying tax	62
iv. Corruption.....	63
v. Level of Tax Rate.....	63
4.1.1.2. Compliance cost	64
i. Time compliance cost.....	64
ii. Financial compliance cost.....	65
4.1.2. Causes of tax avoidance and evasion that relates to the legal framework in Ethiopia	66
4.1.2.1. Loopholes within the tax legislations of Ethiopia	66
4.1.2.2. Extent of Penalty	73
4.1.3. Administrative Framework.....	74
4.2. Measures Taken to Tackle Tax Avoidance and Evasion in Ethiopia	77
4.2.1. Measures taken to improve voluntary compliance of taxpayers	77
i. Educating Taxpayers	77
ii. Combating corruption.....	78
iii. Tax rate cut/reducing the tax rate.....	80
iv. Introduction of e-filing and payment.....	80
v. Free tax counseling service.....	81
4.2.2. Legislative and Administrative Measures.....	81
4.2.2.1. Legislative measures.....	81
4.2.2.2. Reforms taken to build the capacity of tax authority	84
4.2.2.2.1. Measures against underground/informal sectors.....	86
Conclusion.....	88
Recommendation.....	92
Bibliography	

Chapter One: Introduction

1. Background

Taxation is the way through which supply is made to public treasury by citizens and operates as a forced charge independent of the will or contractual consent of the taxpayer.¹ It is a fundamental aspect for any economy, and government of a country can do nothing without collecting revenue (in the form of tax) from taxpayers. In the words of Oliver Wendell Holmes, U.S. Supreme Court Justice:

Taxes are what we pay for a civilized society. Governments need sustainable funding for social programs and public investments to promote economic growth and development. Programs providing health, education, infrastructure and other amenities are important to achieve a common goal of a prosperous, functional and orderly society. Those programs require governments to raise revenue.²

The payment of tax is a civic duty and an imposed contribution by government on its citizens and companies to enable it to finance and run public utilities and perform other social responsibilities. Especially, at the time of recession and fears of global meltdown countries have to find mechanisms to shift away from foreign to domestic financing to meet their annual budgets. In such circumstances government expenditure on infrastructure, healthcare, education and investment is expected to be financed by domestic revenue.

Moreover, in the case of developing countries, tax revenues would be a more sustainable source of financing for they are currently reliant on debt or aid. To this effect, tax is important for any country for its existence as an independent country and constitutes the principal source of government revenue.

¹ Bariyima D. Kiabel and N. Gladson Nwokah, Curbing Tax Evasion and Avoidance in Personal Income Tax Administration: A Study of the South-South States of Nigeria, European Journal of Economics, Finance and Administrative Sciences ISSN 1450-2275 Issue 15, 2009, P. 52

²Oliver Wendell Holmes(1904), U.S. Supreme Court Justice, in John Preston, Andrew Packman et al (eds), Paying taxes; the Global picture, 2012, P. 8

As in all other countries, one of the purposes of taxation in Ethiopia is the raising of as much revenue as possible to meet the ever-expanding public expenditure for the supply of public goods and services which otherwise would not be available to the general public by the market.³ The central aim of the tax system in Ethiopia is to collect sufficient money to finance the administrative machinery of the government as well as to finance the fulfillment of public facilities like roads, telecommunication, electricity and other social services such as education, health and water supply facilities.⁴

It is not, however, an easy task to fully and exhaustively collect taxes. In the field of taxation there are two contradicting aspects; the first aspect is that government always, through its tax authority, strive to collect enough revenue from taxpayers; while the second aspect is that taxpayers always attempt to reduce their tax liability through different methods. “Wherever and whenever authorities decide to levy taxes, individuals and firms try to avoid paying them.”⁵

There are two methods that are always employed by taxpayers to do away with or reduce their tax liability. These are tax avoidance and evasion. Tax avoidance is legal, though against the spirit of tax law, and it often involves manipulation of profits and revenues through diverting to tax shelter activities/transactions where little or no money is required to be paid in form of tax while tax evasion is completely illegal and is the direct violation of the tax law.⁶

Tax avoidance refers to an attempt to reduce tax payments by legal means, for instance by exploiting tax-loopholes, whereas tax evasion refers to an illegal reduction of tax payments, for instance by underreporting income or by stating higher deduction.⁷

In another words, while tax evasion is the willful and deliberate violation of the law in order to escape payment of tax which is unquestionably imposed by law of the tax jurisdiction, tax

³ Jira Jebessa, Fantahun Melles, Dieter Gagel and Gerhard Quincke, Taxation in Ethiopia: Direct and Indirect Taxes - Categories of Tax Payers, Declaration of Income, Assessment of Taxes and Tax Incentives (Ethiopian Chamber of Commerce (ECC), Addis Ababa), 2005, P. 42

⁴ Ibid

⁵ Gudrun Barenbrock, “Addressing Tax evasion and avoidance in developing countries,” (Deutsche Gesellschaft fur, Berlin), 2010, P. 8

⁶ Erich Kirchler, Boris Maciejovsky, and Friedrich Schneider, Everyday Representations of Tax Avoidance, Tax Evasion, and Tax Flight: Do Legal Differences Matter?, 2001, P.2

⁷ Ibid

avoidance is the active means by which the taxpayer seeks to reduce or remove his liability to tax without actually breaking the law.⁸

Tax avoidance and evasion represent a universal phenomenon that takes place in all societies and economic systems. They are probably as old as taxation itself. No country is free from this problem though the gravity of its prevalence is different from country to country. They are mainly the ways by which corporations and individuals get around paying taxes.

Tax avoidance and evasion are common problems of all countries of the world whether developed or undeveloped though the extent of the loss caused by them may differ. Even in the United States, with its sophisticated tax enforcement mechanisms, the IRS (2006) estimated the federal tax gap to reach US\$ 345 billion or 16.3% of total revenues in 2001.⁹ It is unrealistic to expect any tax system to exist without tax avoidance and evasion. In every country a greater or lesser proportion of taxes that are legally due are evaded or otherwise avoided.¹⁰

However, many indicators show evasion and avoidance to be substantially greater in former centrally planned economies and in Africa than in established market economies.¹¹

These “Twin devils” create a great gulf between actual and potential revenue. According to the data by Organization for Economic Cooperation and Development (OECD) Revenue Statistics, in 2005, the average tax revenue to GDP ratio in the developed world was approximately 35%. In the developing countries, it was equal to 15%, and in the poorest of these countries, the group of low income countries, tax revenue was just 12% of GDP.¹²

These activities of taxpayers to reduce/avoid their tax liability put a heavy toll on governments in fully implementing the tax law and create a difficulty in collecting the revenue that is necessary for the effective running of government activities.

⁸ Supra note 1, P. 2

⁹ Tamas K. Papp and Elod Takats, Tax Rate Cuts and Tax Compliance, International Monetary Fund Working Paper: Policy Development and Review Department, 2008, P. 5

¹⁰ Clive Gray, United States Practices in Estimating and Publicizing Tax Evasion: African Economic Policy Discussion Paper Number 15, (Harvard Institute for International Development), 1999, P. 4

¹¹ Ibid, P. 5

¹² OECD (2005), Measuring the revenue loss caused by tax avoidance and evasion, in Clemens Fuest and Nadine Riedel (eds), Tax evasion, tax avoidance and tax expenditures in developing countries: Report prepared for the UK Department for International Development (DFID) (Oxford University Centre for Business Taxation), 2009, P. 8

Consequently, governments throughout the world have complained for the umpteenth time of the widespread incidence of tax avoidance and evasion in their countries as companies and other taxable persons employ various tax avoidance devices to escape or minimize their taxes or deliberately employ fraudulent ways and means of evading tax sometimes with the active connivance of the tax officials.

Considering this revenue loss that will be caused by tax avoidance and evasion, their regulation become the contemporary concern of the world. There are different mechanisms employed by different countries to counter this problem. Legislative, administrative, judicial and other informal methods are employed by the countries. However, none of these measures can meet the purpose of tackling tax avoidance and evasion standing solely from each other. Rather the collective application of them to the extent of their importance is highly advisable. All the measures are equally important in reducing the gravity of tax avoidance and evasion if employed in the order of their necessity and efficiency taking into consideration all surrounding circumstances.

As mentioned above, more tax abuses are experienced in developing countries than in developed countries. As demonstrated by most researches and surveys, many of these abuses can be explained partly by the structure of the economy and partly by the institutional framework of a tax system.¹³ The lack of sufficient expertise and resources to develop an efficient tax administration also perpetuates such problems.¹⁴ This Problem of the administrative weakness and loose legal base in developing counties has aggravated the gravity of tax avoidance and evasion and necessitated the need for taking different policy, legal, and administrative measure to reduce their incidence.

Ethiopia, being one of the least developed countries, the problem of tax avoidance and evasion is undeniably the most prevalent phenomena. In fact, different reform measures have been taken by the government with respect to the legal basis of taxation such as creating different tax basis. To this effect, different reforms in the case of indirect taxes such as replacing the sales tax with VAT have been made. Reforms and amendments have also been made on tax proclamations in order to improve the legal base of the taxation system of the country. Some measures have also

¹³Supra note 1

¹⁴ Supra note 9

been taken regarding tax administration such as establishing autonomous tax authority and strengthening its capacity through different measures.

Regardless of all these measures, Ethiopia is still far away from generating enough revenue that would be raised had all taxpayers been properly and fully taxed. There are different factors that are the main causes of tax avoidance and evasion in Ethiopia. Some of these factors are treating similar activities with different tax rates, exempting some activities from tax liability for the sake of attracting investment and export trade, inability of taking strict measures against informal/underground economies, unawareness by taxpayers and the general public about the usefulness of paying tax for the economic growth of the country, and absence of sophisticated auditing system by the tax authority.

2. Statement of the problem.

In many developing countries, including Ethiopia, a lack of public service provision slows down economic growth and undermines efforts to improve the living standard of their people. The dominant reason for this problem is the inability of generating the necessary tax revenue that would have to be raised had all persons and businesses been properly taxed.

Although some reform measures are taken by the government of Ethiopia to improve the revenue that should be raised from taxation, revenue is still far away from that should be raised in the proper and full implementation of the tax law. The country is not generating full revenue that should be raised had all citizens have complied with their tax liability. Millions (may be billions) of Birr are lost in expected tax revenue annually leading to a shortfall in expected revenue collections due to non-compliance of taxpayers to their tax duty. This shortfall led to public expenditure exceeding public revenue resulting into a deficit. This is then reflected by government's failure to provide basic social services and put in place viable infrastructures from domestic revenue.

Tax avoidance and tax evasion are problems not only in the sense of revenue loss caused by them but also they create inequity between the taxpayers which in turn result in unfair competition and economic inefficiency. As stated by James Alm and Jorge Martinez-vazquez, aside from the collection of additional tax revenues from taxing those activities that escaped

from tax due to tax avoidance and tax evasion, there are other tangible effects such as an improvement of horizontal and vertical equity, increase economic efficiency and higher overall tax moral-citizens' intrinsic motivation to pay taxes.¹⁵

Under the Ethiopian taxation system though there is, to some extent, strong legal base for countering tax evasion, no such significant legislative measure is taken in tackling tax avoidance. As to the institutional capacity of the tax authority though there is significant modification in relation to the prior status, the authority is still weak in tackling these two technical and sophisticated problems.

Ethiopia is still far away from employing the excellent tools used by other countries to tackle these problems, especially in the case of tax avoidance. Thus, the main issue that motivated the researcher to frame this research topic is this problem of the revenue gap created by tax avoidance and evasion, and the existence of many gaps in legislating and administering these problems.

Specifically, this research is designed to answer the following questions:

- What are the causes of tax evasion and avoidance in Ethiopia?
- What are the extents of the legal loopholes within the tax proclamation that attract tax avoidance schemes to be designed along them in Ethiopia?
- What attempts have been made to curb tax avoidance and evasion in Ethiopia?
- What reforms have been made to strengthen the capacity of the Ethiopian tax authority, i.e. Ethiopian Revenues and Customs Authority (ERCA)?
- What types of measures are taken by the Ethiopian tax authority to increase the awareness of the taxpayers and the general public on the importance of paying tax?
- What approaches should be put in place to curb and regulate tax evasion and avoidance in Ethiopia?

Other minor questions in relation to the legal and institutional framework of the Ethiopian taxation system in curbing the problem of tax avoidance and evasion will also be dealt with.

¹⁵James Alm And Jorge Martinez-Vazquez, Tax Moral And Tax Evasion In Latin America, International Studies Program Working Paper, (Georgia University Andrew Young School Of Policy Study, Georgia Atlanta), 2007, P. 5

3. Objectives of the study

The researcher has designed this study to meet some important objectives that are necessary in improving the taxation system of the country. The study has both general objective and specific objectives.

a. General objective.

The general purpose of this study is to assess the extent of legal loopholes in the tax legislations that attract tax avoidances to be schemed along them and the institutional capacity of the tax authority in implementing the tax legislations, especially those tax provisions meant for the protection of tax evasion.

Thus, the main purpose of designing this research is to assess the strength of the legal base and administrative capacity of the country and find out the problems involved and forward some recommendations and suggestions necessary for dealing with these problems in Ethiopia.

b. Specific Objectives

In particular, the researcher seeks to:

- i. Assess provisions of tax legislations of Ethiopia that are designed to fight tax evasion and their ability to tackle them.
- ii. Sort out the main causes of tax avoidance and tax evasion.
- iii. Assess the role played by legislature in enhancing and regulating tax avoidance schemes.
- iv. Assess the administrative measures taken by the Ethiopian Revenues and Customs Authority (ERCA) in tackling the problem of tax avoidance and evasion.
- v. Put the alternative mechanism that helps to reduce tax avoidance and tax evasion in Ethiopia; such as legislative and administrative measures.

4. Significance of the study.

Measures to tackle tax avoidance and evasion are matters of major concern for tax authorities of all countries of the world. This concern is particularly serious for developing countries like Ethiopia given the rapid growth of investment in their economy and their lack of adequate experience in dealing with the problem. Available knowledge on the causes and means for

tackling tax evasion and avoidance is limited in Ethiopia. This non-availability of information on sorting out the causes for tax avoidance and evasion, examining the measures taken to tackle them and forwarding the possible ways of dealing with them is partly due to lack of data and partly due to the absence of well organized research on these issues.

Thus, the outcome of this research will have the following general significance:

- It will provide useful information in the area of tax avoidance and evasion for tax consultants, legal practitioners, audit firms, tax administrative authorities and institutions of specialized studies.
- It will help the reader to easily identify hitches and loopholes in Ethiopia's tax legislations and the measures taken to curb tax evasion and avoidance.
- It will help as a guideline for taking different policy measures in tackling tax avoidance and evasion in Ethiopia.

5. Methodology

The researcher will utilize qualitative exploratory research design methodology by reviewing available international and local literatures, analyzing tax proclamations, looking at the institutional framework of the tax authority of Ethiopia, expert surveys which involves having interviews with experts and officials of the authority who have substantial knowledge and experience on tax avoidance and evasion.

6. Scope of the Study

In Ethiopia, tax avoidance and evasion can take place at federal level or states level since the jurisdiction of tax collection is divided between the federal government and regional governments. However, this paper is limited to the study of tax avoidance and evasion at federal level. Moreover, tax avoidance and evasion may have national/domestic or international Phenomena. But the scope of this paper only covers the national/domestic phenomena of tax avoidance and evasion.

7. Organization of the research

This thesis is divided into four chapters. The first chapter is introductory chapter, and outlines the background, significance, and the research problems/questions of the research. Under this chapter, the general introduction to the paper is overviewed and the research questions are outlined.

Chapter two is about the general concept of tax avoidance and evasion. Under this chapter, literatures will be reviewed on tax avoidance and evasion and the controversy surrounding their definition, especially in the case of tax avoidance will be considered. Chapter two will also deals with the main causes of tax avoidance and evasion in the general context.

Chapter three is about the measures taken, throughout the world, to tackle tax avoidance and evasion. Under this chapter, common measures taken by countries in countering tax avoidance and evasion will be discussed. This chapter is meant to overview the experience of other countries in countering tax avoidance and evasion in order to have adequate concept that helps in analyzing the status of the Ethiopian taxation system in tackling tax avoidance and evasion and recommending important reform measures.

Chapter four, completely, deals with tax avoidance and evasion under the Ethiopian context. Under this chapter, the causes of tax avoidance and evasion, and the measures taken to counter them will be discussed. Emphases will be given to the legislative status of the tax law and the institutional capacity of the tax authority of Ethiopia (ERCA) in tackling/reducing these problems.

Chapter Two: General Concept of Tax Avoidance and Evasion

2.1. Definitions of Tax Avoidance and Evasion

2.1.1. Definition of Tax Avoidance

The term tax avoidance has different names under tax systems of different countries. In Australia it is often referred to, particularly by the Australian Tax Office (ATO), as “aggressive tax planning”; in South Africa as “impermissible or abusive tax avoidance”; in New Zealand and the United Kingdom as “unacceptable tax avoidance”; and in the US the term “tax abusive shelters” is often used.¹⁶

These different names of tax avoidance are the result of an attempt to distinguish it from the acceptable and allowable tax planning/mitigation. An attempt to distinguish tax avoidance from tax planning on the one hand and tax evasion on the other hand has made the concept of tax avoidance more complex and difficult for definition.

In addition to this, the concept of tax avoidance itself and the way in which it occurs has created difficulty in defining tax avoidance in a clear language. “Tax avoidance is a highly subjective and political term and covers an enormous range of actions.”¹⁷ When we literally look at the concept of tax avoidance, it is a legal action and no crime is involved in light of the specific provisions of the tax law.

Even, at the former time, there is an argument that tax avoidance is not a prohibited act and that taxpayers can freely scheme their transaction/affairs in a way that can minimize their tax liability as far as no specific tax legislation is violated. As Lord Clyde so vividly put it in United Kingdom, “No man in this country is under the least obligation, moral or otherwise, so as to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his store.”¹⁸ Even the great American tax avoidance judge,

¹⁶Chris Evans, *Containing Tax Avoidance: Anti-Avoidance Strategies* (The University of New South Wales, Australian School of Taxation), 2008, P. 4

¹⁷Tracey Bowler, *Countering Tax Avoidance in the UK: Which Way Forward?* “TLRC Discussion Paper” (The Institute for Fiscal Studies, London), 2009, No. 7, P. 14

¹⁸Lord Clyde (1929), *Ayrshire Pullman Motor Services & Ritchie v CIR*, in Steve Bond, Malcolm Gammie and John Whiting (eds), *Tax avoidance*, P. 175

Judge Learned Hand, said that there was no morality to the payment of taxes and to say otherwise was ‘mere cant’.¹⁹

Lord Tomlin in *IRC v Duke of Westminster* said that “every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be.”²⁰ “If he succeeds in ordering them so as to secure this result, then he cannot be compelled to pay an increased tax.”²¹

The idea in this argument is that no tax can be imposed unless the government has exercised the legal power to impose the tax, and hence, once the government has stated through a law a tax consequence of certain transaction or event, it is not free to vary the consequences or to amplify them with the benefit of hindsight.²²

Furthermore, the existence of various forms of avoidance schemes has aggravated and complicated the issue of defining tax avoidance in a simple and universally acceptable way. It is generally difficult to predetermine the number of forms tax avoidance schemes may take and is difficult to objectively determine what constitute tax avoidance scheme before its occurrence.

“No two commentators may agree on the categorization of certain behavior as tax avoidance or mere tax planning.”²³ “Commentators spend much time debating what tax avoidance is, and that debate changes over time as governments seek to maximize their exchequer receipts in particular areas of the tax system.”²⁴

Regardless of these difficulties in having clear and single definition on tax avoidance, different persons (writers, judges, tax authorities, etc) have defined it differently at different time with

¹⁹Learned Hand (1947) ,Commissioner vs. Newman, in Steve Bond, Malcolm Gammie and John Whiting (eds), Tax avoidance, P. 175

²⁰ Lidia Xynas, “Tax Planning, Avoidance and Evasion in Australia 1970-2010: The Regulatory Responses and Taxpayer Compliance,” Review Law Journal: 2010, Vol. 20, P. 6

²¹Lord Tomlin (1936), *IRC v Duke of Westminster*, in Lidia Xynas (ed), “Tax Planning, Avoidance and Evasion in Australia 1970-2010: The Regulatory Responses and Taxpayer Compliance,” Review Law Journal: 2010, Vol. 20, P. 175

²²Tracey Bowler, “Countering Tax Avoidance in the UK: Which Way Forward?” TLRC Discussion Paper, (The Institute for Fiscal Studies, London), 2009, P. 16

²³ Tax Law Review Committee of UK, Tax Avoidance, (Institute of Fiscal Studies, London), 1997, P. 13

²⁴ Rebecca Murray, Tax Avoidance, (Sweet and Maxwell, London), P. 3

almost similar meaning. In 1955, the Royal Commission on Taxation of Profits and Income (Radcliffe Commission) of UK defined tax avoidance as:

Some act by which a person so arranges his affairs that he is liable to pay less tax than he would have paid but for the arrangement. Thus the situation which he brings about is one in which he is legally in the right....²⁵

In 1966, the Royal Commission on Taxation (Carter Commission) of Canada described tax avoidance as:

... every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred by taking advantage of some provision or lack of provision in the law. It presupposes the existence of alternatives, one which will result in less tax than the other.²⁶

Rebecca Murray has defined tax avoidance broadly by dividing it into different elements. According to her tax avoidance is;

first, not evasion but lawful, because it is carried out in the genuine belief that the tax advantage in question can be obtained within the rules, for example by exploiting the loophole or other defect in the legislation. Second, tax avoidance is a type of tax planning where the taxpayer seeks to obtain tax advantage in question in a way that is contrary to the intention of the legislature.²⁷

According to Brendan Barber, TUC (Trade Union Congress) General Secretary of UK, tax avoidance in straightforward terms is trying to get round the law without breaking it. He broadly elaborated the term that tax avoidance is said to occur when one of the following happens:²⁸

- a. Less tax is paid than might be required by a reasonable interpretation of the law of a country;
- b. Tax is paid on profits declared in a country which does not appear to be that in which they were earned;
- c. Tax is paid later than the profits to which it relates were earned; or
- d. Tax is paid by a person who did not really generate the income that he declares.

²⁵Royal Commission on Taxation of Profits and Income (Radcliffe Commission) of UK (1955), in Rachel Anne Tooma (ed), *Legislating Against Tax Avoidance*, (H.J.E. Weckebachweg, Amsterdam), 2008, P. 13

²⁶Royal Commission on Taxation (Carter Commission) of Canada (1966), in Chris Evans (ed), *Containing Tax Avoidance: Anti-Avoidance Strategies* (The University of New South Wales, Australian School of Taxation), 2008, P.

4

²⁷Supra note 24, P. 3

²⁸Brendan Barber, "The UK Tax Gap: The Missing Billions," Touch Stone Pamphlets, (Trade Union Congress, London), P. 14

For example, income is quite often switched between members of a family to ensure it is declared by the person with the lowest tax rate even though the family member in question did not really earn the income in question.

Clemens Fuest and Nadine Riedel have defined tax avoidance as “an activity that a person or a business may undertake to reduce tax in a way that runs counter to the spirit and the purpose of the law, without being strictly illegal.” They have identified a set of signposts for tax avoidance activities which include e.g. “transactions or arrangements which have little or no ‘economic’ substance or which have tax consequences not commensurate with the change in a taxpayer’s (or a group of related taxpayers’) economic position”.²⁹

The OECD (Organization for Economic Cooperation and Development) suggests that tax avoidance is “the arrangement of a taxpayer’s affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow.”³⁰

In a recent article on the Canadian General Anti-Avoidance Rule (GAAR), Tim Edgar defines tax avoidance “in its broadest (and perhaps most simplistic sense)” as “any change in behaviour that occurs as a response to the change in price of particular activities, assets or transactions occasioned by the imposition of taxation”.³¹

In the context of income tax, Lord Templeman offered the following definition in the *Challenge Corporation* case:³²

Income tax is avoided and a tax advantage is derived from an arrangement when the taxpayer reduces his liability to tax without involving him in the loss or expenditure which entitles him to

²⁹Clemens Fuest and Nadine Riedel, *Tax Evasion, Tax Avoidance and Tax Expenditures in Developing Countries: A Review of the Literature* (Oxford University Centre for Business Taxation, Oxford), 2009, P.11

³⁰OECD, Centre for Tax Policy and Administration, in Tracey Bowler (ed), “Countering Tax Avoidance in the UK: Which Way Forward?” TLRC Discussion Paper, (The Institute for Fiscal Studies, London), 2009, P. 18

³¹Tim Edgar(2007), “Designing and Implementing a Target-Effective General Anti-Avoidance Rule”, in David G Duff(ed), *Tax Avoidance in the 21st Century*, (Taxation Law and Policy Research Institute, British Columbia), 2008, P. 478

³²Lord Templeman (1987), *Challenge Corporation Ltd v. Commissioner of Inland Revenue*, in Tracey Bowler (ed), “Countering Tax Avoidance in the UK: Which Way Forward?” TLRC Discussion Paper, (The Institute for Fiscal Studies, London), 2009 P. 19

that reduction. The taxpayer engaged in tax avoidance does not reduce his income or suffer a loss or incur expenditure but nevertheless obtains a reduction in his liability to tax as if he had.

A prominent English judge Lord Walker has Attempted to define tax avoidance by exhaustively listing the ways in which it occurs and suggested the following categories of case:³³

1. Using a relief;³⁴
2. Finding a gap;³⁵
3. Exploiting or abusing a relief;³⁶
4. Anti-avoidance karate (turning anti-avoidance measures to a taxpayer's advantage and using them to produce a tax saving);³⁷
5. Unnatural assets or transactions (developing assets or transactions such as dividend stripping, purely to manipulate the tax rules);³⁸
6. Pre-ordained transactions;³⁹
7. Dodgy offshore schemes.⁴⁰

However, even this has its own limitations, which Lord Walker himself has recognized. First, Lord Walker did not clarify/elaborate the time when the use of a relief become abuse or

³³Ramsay 25 years on: some reflections on tax avoidance', an address to the Chancery Bar Association (2004), in Tracey Bowler (ed), "Countering Tax Avoidance in the UK: Which Way Forward?" TLRC Discussion Paper, (The Institute for Fiscal Studies, London), 2009, P. 19

³⁴'Using a relief' is simply relying on the tax benefit provided by the tax law in the form of tax incentives or exemptions for the purpose of reducing tax liability. Lord Walker did not elucidate the time when using of tax relief become tax avoidance.

³⁵'Finding a gap' is a broad term that includes all the categories of case listed by Lord Walker. Strictly speaking, every form of tax planning involves finding a gap in one sense.

³⁶'Exploiting or abusing a relief' is the process of taking advantage of tax incentives or exemptions given for certain group of investors or taxpayers for policy objectives, in a way that is not intended by the parliament.

³⁷'Anti-avoidance karate' is a practice of exploiting the tax law complication caused by the proliferation of Specific Anti-Avoidance Rules. The more detailed the rules, the more opportunity there may be for those wishing to do so to find and exploit loopholes.

³⁸'Unnatural asset or transaction' is said to be occurred when transaction is entered into by exploiting the loophole in the tax legislation with a full or dominant purpose of tax benefit without having such a significant commercial/economic end.

³⁹'Pre-ordained transaction' is the method of avoiding tax by arranging a serious of transactions in which one or more of such transactions are inserted with the only purpose of tax benefit that cannot be obtained in the absence of them.

⁴⁰Dodgy offshore schemes include broad activities that are employed by business/companies to get tax benefit through their foreign subsidiaries/affiliates. One of such scheme is the method of relocating the business to the less/zero tax rate jurisdictions/countries with no/less business/economic substance apart from avoidance of tax liability. For instance, intangible assets such as patents, trademarks and copyrights that generate substantial profits out of license payments are assigned to subsidiaries located in low tax countries whereas cost intensive units are located in high tax countries to reduce taxable profits.

exploitation? Some lay people may argue that even using reliefs in an entirely legitimate and legislatively sanctioned way is, in a sense, a form of tax avoidance. Second, every structure with an offshore element is not automatically ‘dodgy’: Lord Walker seemed to be contemplating the more evasive type of structures where the offshore element is there to hide activity. This may, however, verge on evasion rather than avoidance.

From these definitions, one can understand the difficulty involved in defining tax avoidance in a clear and single statement. Tax avoidance is a term that is difficult to define, but all discussions above relate to situations in which a taxpayer’s liability can be reduced.

When the discussion turns to a distinction between acceptable and unacceptable tax avoidance, the definitions become even less clear. The very word ‘acceptable’ raises the question: ‘To whom?’ Depending upon the perspective of the person asked – taxpayer or tax collector – the answer may vary considerably. To the government, every activity, transaction or scheme that reduces the tax burden of individuals, businesses and other entities below the level envisaged by the government is tax avoidance.⁴¹ For the taxpayer on the other hand, the term acceptable and unacceptable gives different perception and taxpayers always think those activities, transactions or scheme that do not violate a specific provision of the tax law does not amount to tax avoidance.⁴²

From the point of view of providing a clear workable tax system within which taxpayers can confidently operate, identifying the boundaries between acceptable and unacceptable tax avoidance is important. However, from the perspective of taxing authorities, “it may be thought better to keep such boundaries wide and fuzzy, thereby deterring taxpayers from participating in activities that potentially reduce the receipt of revenue.”⁴³ “The problem with such an approach is that some taxpayers will not tolerate insufficient clarity and in today’s globalised economy, they will relocate to a less risky location.”⁴⁴

It is generally advisable to abstain from objectively defining the term tax avoidance due to the above mentioned drawbacks involved with an attempt to define the term. Rather in dealing with

⁴¹Supra note 24, 2012, P. 28

⁴² Supra note 22, P. 29

⁴³ Ibid, P. 20

⁴⁴ Ibid

tax avoidance different and flexible methods should be employed subjectively by balancing between the interest of the government/tax authority on one hand and that of the taxpayer on the other.

2.1.2. Definition of Tax Evasion

The definition of tax evasion is not as difficult as that of tax avoidance. Tax evasion, in general, refers to illegal practices to escape from tax liability. In case of tax evasion, taxable income; profits liable to tax or other taxable activities, i.e. the amount and/or the source of income, are misrepresented, or tax reducing factors such as deductions, exemptions or credits are deliberately overstated. Tax evasion can occur in two major ways: i, in legally registered activities when businesses or individuals completely fail to report their income, understate their income, overstate their deductions/expenses or delay in paying their tax returns; and ii, in the informal/underground economy where the whole activity takes place in an informal manner in which businesses are not only evading tax payments but also not fulfill the legal requirement necessary for their operation.⁴⁵

Tax evasion is defined by Lidia Xynas as:

The criminal falsification or non-disclosure as a means of reducing tax and have always been regarded as unacceptable at law. Tax evasion can occur where taxpayers employ fraudulent methods to evade the payment of taxes. Tax evasion activities are in: contravention of the law whereby a person who derives a taxable income either pays no tax or pays less tax than he would otherwise be bound to pay. Tax evasion includes the failure to make a return of taxable income or a failure to disclose in a return the true amount of income derived.⁴⁶

Brendan Barber has defined tax evasion by listing those activities that are evasive. According to him tax evasion is an illegal activity undertaken to reduce a person or company's tax bill and includes those activities whereby taxpayers⁴⁷ i, fails to declare all or part of their income; ii, make a claim to deduct an expense from their taxable income that they did not incur or which

⁴⁵Supra note 5, P. 10

⁴⁶Supra note 20, P. 7

⁴⁷Supra note 28, P. 13

they were not entitled to deduct; and iii, submit a tax return that appears to be legal but only because relevant facts are not disclosed to the tax authorities.

In short tax evasion is an act of violating the specific provision of the tax law. As included under the definitions given above tax evasion emanates from one of the following acts:

- ✓ The failure to report one's business income;
- ✓ Understating income of a business;
- ✓ Overstating the deduction/expenses of a business; or
- ✓ Delay in delivering the tax return to the tax authority.

2.2. Causes of Tax Avoidance and Evasion

In order to develop methods and instruments for fighting tax avoidance and evasion, it is important to establish a broad understanding of the different causes underlying these problems. To understand what might be done to tackle the issues of tax avoidance and evasion, the mechanisms used to undertake such activities need to be understood first of all. Differentiating between what encourage compliance, on one hand, and what attracts avoidance and evasion, on the other hand, should be the first step in a struggle of curbing tax avoidance and evasion.

There are various causes for tax evasion and avoidance. These causes can be divided in to two main categories.⁴⁸The first category comprises factors that negatively affect taxpayers' compliance with tax legislation. This cause is related with factors that affect the willful compliance of the taxpayers and that discourage taxpayers from complying with their tax liability. These factors can be stated as "low willingness to pay taxes (low tax morale), high costs to comply with tax laws, high tax rate and other similar factors."⁴⁹

The second category contains reasons for the low ability of tax administration and courts to enforce tax liabilities and the defect within the tax law itself. This category is related to those factors that arise from the taxation system itself and low tax performance capacity of the tax authority. These factors can be summarized as defect within the tax legislation resulting from loopholes/gaps, low penalty for violators, insufficiencies or weakness in the administration and

⁴⁸ Gudrun Barenbrock, "Addressing Tax evasion and avoidance in developing countries," (Deutsche Gesellschaft für, Berlin), 2010, P. 14

⁴⁹Ibid

collection of taxes as well as weak capacity in auditing and monitoring tax payments which limit the possibility to detect and prosecute violators.⁵⁰ This second category is the main concern of this paper.

2.2.1. Causes of tax avoidance

There are many and varied reasons why taxpayers avoid their tax liability. These causes might, generally, be categorized under two categories, i.e. causes of tax avoidance that affect the voluntary compliance of taxpayers and causes of tax avoidance that are related to the defect within the tax legislations and the weakness of tax authority in enforcing tax legislations.

Under the category factors that affect the voluntary compliance of taxpayers, the following reasons can be raised:

2.2.1.1. Low Tax Morale

Tax compliance as defined by James and Allay is “the willingness of individuals and other taxable entities to act within the spirit as well as the letter of tax law and administration without enforcement activity.”⁵¹

Tax morale is, however, not easy to establish and most of the time taxpayer are not compliant to the tax law of their countries. Especially, countries without a deep-rooted culture and habit of paying taxes find it difficult to establish tax morale. One cause of tax avoidance is thus, the absence of the complying mental sentiment of taxpayer to comply with the spirit of tax law.

This low tax moral of the taxpayers may arise from the following factors:

i. Low taxpaying culture and Norms

Having a developed culture and norms of paying tax is very essential in encouraging and raising the level of tax compliance. The level of the development of taxpaying culture differs from country to country. In developing countries taxpaying culture has not been well developed as

⁵⁰John McLaren, “The Distinction between Tax Avoidance and Tax Evasion has Become Blurred in Australia: Why has it Happened?” *Journal of the Australasian Tax Teachers Association*, 2008, Vol.3, No.2, P. 4

⁵¹James and Allay (1999), in Valerie Braithwaite(ed), *Taxing democracy: Understanding Tax avoidance and Evasion*, (Ashgate Publishing Ltd, London), 2003, P. 24

compared to that of developed countries.⁵² In developing countries, “a legal concept of taxation has yet to be formed, and taxpayers do not have the habit of paying taxes.”⁵³ This low level of taxpaying culture in developing countries in turn encourages taxpayers to engage in tax avoidance activities.

Research shows that opinions and behaviours of others, or the ideas one has about others’ opinion and behaviour, are of great importance for taxpayer compliance behaviour.⁵⁴ With respect to these social norms and cultures, a distinction can be made between descriptive social norms (what others do or what we think others do) and prescriptive social norms (what others think about certain behaviour or what we believe others think).⁵⁵ Descriptive and prescriptive social norms with respect to certain behaviour are usually strongly related. These social norms have strong impact on willful compliance of the taxpayer.

A study by Scholz and Lubell shows that “people are more inclined to meet their tax obligations when they trust that others will also pay their fair share.”⁵⁶ Furthermore, “perceptions of how others will judge tax avoidance, affects one’s own tax compliance, particularly, when the others are a relevant group that one belongs to or identifies with.”⁵⁷

People who object to paying taxes also believe that others do not comply with tax rules. “This relationship is stronger when it concerns close others, such as friends and family.”⁵⁸

Generally, the taxpaying culture and norms of the society in which taxpayers live highly affluence the willful compliance of the taxpayer and in turn affect the level of tax avoidance. The

⁵²Phyllis Lai Lan Mo, *Tax Avoidance and Anti-Avoidance Measurers in Major Developing Economies*, (Greenwood Publishing Group, Westport), 2003, P. 12

⁵³ Ibid

⁵⁴Wenzel, M. (2004), *An analysis of norm process in tax compliance*, in OECD Forum on Tax Administration (ed): *Understanding and Influencing Taxpayers’ Compliance Behaviour*, (Centre For Tax Policy and Administration), 2010, P. 20

⁵⁵ OECD Forum on Tax Administration: *Understanding and Influencing Taxpayers’ Compliance Behaviour*, (Centre For Tax Policy and Administration), 2010, P. 20

⁵⁶Scholz, J.T. and Lubell, M. (1998), *Trust and taxpaying: testing the heuristic approach to collective action*, in OECD Forum on Tax Administration (ed): *Understanding and Influencing Taxpayers’ Compliance Behaviour*, (Centre For Tax Policy and Administration), 2010, P. 20

⁵⁷Supra note 54

⁵⁸Brooks, N. & Doob, A.N. (1990), *Tax evasion: searching for a theory of compliant behavior*, in OECD Forum on Tax Administration (ed): *Understanding and Influencing Taxpayers’ Compliance Behaviour*, (Centre For Tax Policy and Administration), 2010, P. 20

low the taxpaying culture and norms of the taxpaying society, the high the level and incentive of tax avoidance.

ii. Low quality of the service in return for taxes

Citizens/taxpayers expect some kind of service or benefit in return for the taxes paid. “If the government fails to provide basic public goods and services or provides them insufficiently, citizens may not be willing to pay taxes and tax avoidance will be the consequence.”⁵⁹ For example, “in a survey of taxpayers accused by the Australian Tax Authority (ATO) of engaging in aggressive tax planning/avoidance, it was found that scheme investors were more likely than the public to think that the tax they paid was unfair given the goods and services they received.”⁶⁰

Businesses always care about what they get for their taxes. Extensive and efficient infrastructure is critical for the sound functioning of an economy because it plays an important part in determining the location of economic activity and the kinds of activities or sectors that can develop. But how effectively tax revenue is converted into public goods and services vary around the world. In the case of developing countries the problem is grave that the quality of the service in return of tax collected is too poor in relation to that of developed countries.

Recent data from the World Economic Forum show that “in economies such as France, high tax rates fund high levels of public goods and services such as infrastructure, health, primary education, higher education and training.”⁶¹ The data show the opposite for economies of the developing countries such as Bolivia and Chad “in which case the quality of public service is far below the collected tax revenue and the tax rate.”⁶²

⁵⁹ Pashev, K. (2005), *Tax Compliance of Small Business in Transition Economies*; Everest-Phillips (2008), *Business tax as state-building in developing countries*; Lieberman (2002), *Taxation Data as Indicators of State-Society Relations* and Brautigam et al, (2008), *Taxation and state-building in developing countries*, in Gudrun Barenbrock (ed), “Addressing Tax evasion and avoidance in developing countries,” (Deutsche Gesellschaft für, Berlin), 2010, p.15

⁶⁰Supra note 22, P. 16

⁶¹Bird and Richard, “Smart Tax Administration,” World Economic Forum, *Global Competitiveness Report 2010–2011*. (World Bank Group, Geneva), 2010, P. 1–5

⁶²Ibid

“In economies such as Canada and Denmark, on the other hand, total tax rates are moderate, but the public services provided rank high in a global comparison.”⁶³ This difference between developed countries and developing countries in the quality of services rendered by the government in return of the tax paid has resulted in low tax moral in developing countries which in turn resulted in low collection of revenue in the form of tax.

iii. High tax rate

Some studies suggest that high tax rates foster avoidance. The intuition is that high tax rates increase the tax burden and, hence, lower the disposable income of the taxpayer.⁶⁴ However, the level of the tax rate may not be the only factor influencing people’s decision about paying taxes. In fact, the structure of the overall tax system has an impact as well. If, for example, the tax rate on corporate profits is relatively low, “but individuals are facing a high tax rate on their personal income, they may perceive their personal tax burden as unfair and choose to avoid tax on their income by employing different methods.”⁶⁵ Similarly, large companies can often more easily take advantage of tax loopholes, thereby contributing to the perceived unfairness of the system. Tax rates and the overall structure of the tax system, therefore, have a significant effect on the disposition to avoid taxes.

iv. Lack of Fairness and Trust

Fairness and trust are perceived by many researchers to be important drivers for compliance. Valerie Braithwaite points out “the importance of mutual trust and cooperation between the taxpayers and their tax authority in order to achieve voluntary compliance.”⁶⁶ Kirchler and Hoelzl argue that “fair treatment of taxpayers and trustworthiness of tax authorities will enhance voluntary compliance.”⁶⁷

⁶³Supra note 5

⁶⁴Allingham and Agnar Sandmo (1972), Income tax evasion; and Chipeta (2002), The Second Economy and Tax Yield in Malawi, in Gudrun Barenbrock (ed), “Addressing Tax evasion and avoidance in developing countries,” (Deutsche Gesellschaft fur, Berlin), 2010, P. 15

⁶⁵Supra note 5, P. 15

⁶⁶ Braithwaite, V. (2008), Tax evasion, in OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers’ Compliance Behaviour, (Centre For Tax Policy And Administration), 2010, P. 19

⁶⁷Kirchler, E. and Hoelzl, E. (2006), Modeling taxpayers behavior as a function of interaction between tax authority and taxpayers, in OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers’ Compliance Behaviour, (Centre For Tax Policy And Administration), 2010, P. 19

In a study of accused tax avoiders, Murphy shows that “there is a correlation between fair and correct treatment of the taxpayer and trust in the revenue body.”⁶⁸ Trust is in turn correlated to the willingness to comply. If regulators are seen to be acting fairly, people will trust the motives of that authority. Fairness and trust are thus interlinked and the one cannot exist without the other. Fairness and trust also provide an explanation about why most people comply with tax laws and why some are motivated to evade/avoid taxes. Therefore, the absence/lack of fairness and trust is one of the causes for tax avoidance. As far as the tax authority is not fair and trustworthy to the taxpayers, there is a high probability for taxpayers to become non-compliant.

v. Lack of awareness/knowledge about the importance of paying tax

Most taxpayers perceive taxation as a compulsory extraction of their property by the tax authority. Knowledge is related to the taxpayers’ ability to understand taxation laws, and their willingness to comply. Attitude towards tax compliance can be improved through the enhancement of taxation knowledge. “When a taxpayer has a positive attitude towards tax, this will reduce his or her inclination to avoid tax payment.”⁶⁹ “Taxation knowledge is necessary to increase public awareness especially in areas concerning taxation laws, the role of tax in national development.”⁷⁰

Regardless of this fact, taxpayers, especially in developing countries, do not have enough knowledge about the importance of paying tax for the development of their county in general and the fulfillment of public infrastructures and basic facilities that are necessary for the peaceful running of their business and life in particular. Such a wrong perception of taxation encourages taxpayers to avoid their tax liability by employing different methods.

⁶⁸Murphy, K. (2004), The role of trust in nurturing compliance, in OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers’ Compliance Behaviour, (Centre For Tax Policy And Administration), 2010, P. 19

⁶⁹Eriksen, K and Fallan, L. (1996), tax knowledge and attitude towards taxation, in Zelalem Berhane (ed), The Influence of Tax Education on Tax Compliance Attitude, (Unpublished, Addis Ababa University), 2011, P. 31

⁷⁰Mohd, R. (2010), Tax knowledge and tax compliance determinants in self assessment system, in Zelalem Berhane (ed), The Influence of Tax Education on Tax Compliance Attitude, (Unpublished, Addis Ababa University), 2011, P.

2.2.1.2. High compliance costs

High compliance cost is another factor that influences/affects the voluntary compliance of taxpayers. Compliance costs are those costs incurred directly by taxpayers in complying with their tax-related obligations, and by third parties involved in the tax remittance process, such as employers who are required to remit tax on behalf of their employees; traders and service givers in the case of indirect taxes.⁷¹ High compliance costs are costs a taxpayer has to bear to gather the necessary information, to fill out tax forms, and to effect tax return. Compliance cost is an additional expense that taxpayer covers in addition to the principal tax return owed to the tax authority.

In such a situation it can be assumed that as compliance costs get very high, the probability of the taxpayer complying with taxes becomes low and causes taxpayers to avoid their tax liability.

Compliance cost can be measured on the basis of the following factors:

i. Time compliance cost

Time compliance cost is also called ‘Temporal and opportunity costs’.⁷² “Temporal costs are the amount of time that business owners spend personally, or by using unpaid helpers, to undertake compliance activities.”⁷³ “Opportunity costs are the costs of being unable to undertake an activity because of a requirement to complete another task.”⁷⁴

“In most cases temporal and opportunity or the compliance time costs would be linked, as time spent on tax compliance activities represents time that cannot be spent on the core activities of the business.”⁷⁵ “A loss of core business time was perceived by small business operators as impacting on business performance, business growth and their general wellbeing, thus affecting their ability to remain in business over the longer term.”⁷⁶

⁷¹Jonathan Shaw, Joel Slemrod, and John Whiting, Administration and Compliance, (University of Michigan, Michigan) 2010, P. 1106

⁷²Commonwealth of Australia, Scoping study of small business tax compliance costs, 2007, P. 42

⁷³ Ibid

⁷⁴ Ibid

⁷⁵ Ibid

⁷⁶ Ibid

The time needed for businesses/individuals for complying with their tax liability is the essential factor for determining compliance cost. “The time indicator captures the number of hours it takes to prepare, file and pay taxes.”⁷⁷ Time is the necessary resource for businesses and individual taxpayers to run their business activities and leading individual life respectively. This time framework of compliance cost might be measured in terms of the total number of payment made in a year by the taxpayer and the time taken to carry out each single payment.

If businesses and individuals are going to spend much time for complying with their tax liability and make many payments in a year, they will lose the money they might earn during the spent time. This lost income by businesses and individuals is considered as the compliance cost incurred by taxpayer in addition to the tax return delivered to the tax authority. The more time is spent to discharge tax liability, the more taxpayers manage to avoid their tax liability and hence, compliance time has a great impact on the extent of tax avoidance. The World Bank’s 2008 World Development Indicator for “time to prepare and pay taxes” shows huge differences between countries on the compliance cost incurred by countries.

According to this report “while preparing and paying taxes requires 210 hours on average in high income OECD countries, the required time extends to 1080 hours in developing countries like Bolivia and Vietnam and even 2600 hours in Brazil.”⁷⁸ This situation led businesses to worry more about the compliance burden than about the actual tax burden and induces them to avoid their tax liability.

ii. Financial compliance costs

Financial compliance costs are probably the most easily measured. “Financial compliance costs are payments made to external advisers or internal staff to comply with regulatory obligations on behalf of the business, or spent on the purchase of materials or software to be used for the purpose of fulfilling regulatory requirements (aside from normal accounting requirements).”⁷⁹

⁷⁷John Preston, Andrew Packman, et al, Paying taxes; the Global picture, 2012, P. 14

⁷⁸The World Bank, World Development Indicator, “Time to prepare and pay tax in hours”, 2008

⁷⁹Supra note 72, P. 41

Businesses may incur significant financial tax compliance costs. These could include the costs of “implementing specific systems to comply with the tax law, such as specialized computer software systems, tax agents’ fees, and costs of records storage for a statutory period.”⁸⁰

2.2.1.3. Deficiency/loopholes within the tax legislation

One of the causes for tax avoidance is a defect within the tax legislation that attracts different tax avoidance schemes. As mentioned under the introductory part of this paper, tax avoidance is an activity that does not violate specific provision of the law. Rather it is an activity that exploits the loophole or the gap within the law. If there is no legal loophole there is no tax avoidance activity. But what is difficult is closing all loopholes within the tax legislation. When we say the deficiency/loopholes within the tax legislation, it may relate to taxing similar activities at different rates, exempting some activities from tax liability, or creating tax holiday for investors.

i. Taxing similar activities at different rates

If close substitutes are taxed differently, the system is encouraging taxpayers to choose the one that gives them less tax cost. Where such a chance is there in the tax legislation taxpayers will arrange transactions that may take the form that has less tax cost but different in substance. This has been particularly apparent where the same economic transaction can take numerous forms which may have significantly different tax treatments.

As stated under the UK’s review of the Finance Acts, “tax avoidance is usually generated from unsustainable boundaries in the system.”⁸¹ “If an economic activity can take more than one form and the tax treatment depends upon the form and not the substance, then taxpayers will often use the form that minimizes their tax bill.”⁸²

Thus, it is a matter of tax policy as to where the boundaries should be, but it is clear that to the extent boundaries are put into the rules with differing tax results for the same economic activity, those boundaries will give rise to tax avoidance activities to be designed along with them. For instance, “the progressive rates of taxation encourage income-splitting techniques; tax

⁸⁰Ibid

⁸¹Supra note 22, P. 22

⁸²Ibid

expenditures in favour of activities deemed worthy of encouragement lead to the creation of tax-inspired shelters; administrative necessities such as limiting the taxing exercise to a particular period encourage manipulations of the timing of deductions and receipts of income streams.”⁸³

So there will always be an element of ‘tax avoidance’ if there are unsustainable boundaries in the tax system and similar activities are taxed at different rates.

ii. Exempting some activities from tax liability

Under the tax law of every country, it is common that some activities are exempted from tax liability for policy objective. Some goods and services are exempted from tax liability for policy objectives such as encouraging export trade, attracting investment through exempting investment inputs, encouraging consumption of some necessary goods and services. Though exemption may have these objectives and benefits, it is the main cause of tax avoidance unless properly and strictly regulated. As the number of activities which are exempted from taxation increases, the extent of tax avoidance will increase. This is because taxpayers that want to avoid their tax liability will use the loophole created by the increased exemption.

iii. Tax holyday/tax incentives

The use of tax incentives in developing countries has been very popular and very controversial for decades. Arguments in favor of investment tax incentives are widely known. According to proponents, tax incentives clearly enhance returns on investment; they may be justified by positive externalities stemming from investments; they are relatively easy to target and fine tune; they signal openness to private investment; they are useful in a world of capital mobility; they are necessary for responding to tax competition from other jurisdictions; and they compensate for other deficiencies in the investment climate.⁸⁴ Furthermore, tax incentive is a tool that can actually enhance revenue by stimulating investments that generate other taxable income via employment and linkage effects.

⁸³Ibid

⁸⁴Dr. Bruce Bolnick, Effectiveness and Economic Impact of Tax Incentives in the SADC Region, (Nathan Associates Inc., Arlington), 2004, P. 15

Generally, two fundamental premises underpin the case for tax incentive programs in developing countries: first, that additional investment is needed to foster more rapid economic growth; and second, that tax breaks can be effective in stimulating investment.⁸⁵

However, “although such incentives undoubtedly affect investment decisions in some circumstances, it is not at all clear that the overall benefits outweigh the costs.”⁸⁶ This issue of the advantage and disadvantage of tax incentive is always at controversy.

One of the arguments against tax incentive is based on the fact that it opens the door for those who want to engage in tax avoidance activities. Tax incentives often create opportunities for businesses and individuals to engage in “aggressive tax planning”—a polite term for tax avoidance.⁸⁷ It is instructive to cite a few examples of how tax planning can convert well-intended incentives into a revenue drain.

- *Company “churning.”*⁸⁸ An existing company can close down all or part of its operations and establish a “new” company that qualifies for a full tax holiday. A common variation on this theme occurs when the tax holiday for one comes to an end. The owners may then shut down that company and open a “new” company which continues the operations under a new name with an additional tax holiday.
- *“Income shifting.”*⁸⁹ A corporate group has a strong incentive to manipulate transactions within the group to reduce revenue and increase expenses in a tax-laden unit, to augment the reported income of a related tax-favored unit. There are several ways that this can occur, including transfer pricing on purchases and sales, loans at above-market interest rates, management fees and royalty charges, or sale and leaseback of depreciated equipment.
- *“False export declarations.”*⁹⁰ In many parts of the world, tax incentives or subsidy schemes that target export performance have triggered false declarations that can be extremely costly. The best known example in recent years is the “Goldenberg affair” in

⁸⁵Ibid

⁸⁶Ibid

⁸⁷Ibid

⁸⁸Supra note 5

⁸⁹Ibid

⁹⁰ The scheme widely reported in the local and international press when it became a central issue in the loss of IMF and World Bank funding for Kenya in the late 1990s.

Kenya, in which false export declarations were used to extract hundreds of millions of dollars in export subsidies.

- *Tailor-made loopholes.* The situation in which small tax incentive turned into a giant loophole because of special features in its technical design. That this happens even in a country with enormous resources for tax administration, such as the United States, means that problems can be far worse in countries with weaker tax administration and less transparent processes.

Generally, tax advisors everywhere steer clients toward tax-saving techniques using the loophole created by tax incentives/holiday wherever the tax code creates opportunities to do so. Large taxpayers, who have the best tax advice and the most to gain from minimizing tax obligations, use these techniques the most. Abuse/tax avoidance is especially likely where companies with tax holidays are not audited, by virtue of having no tax obligation.⁹¹

Incentive, even, complicates the tax system and more facilitate for tax avoidance in a way that it require applying different rules to different taxpayers, which inherently complicates the system. Thus, Tax incentive/holiday is the main and forefront cause for tax avoidance.

2.2.1.4. Weak enforcement of tax laws

Weak enforcement of tax law is another big cause for tax avoidance and is a factor that relates to the administrative insufficiency of the tax authority. As mentioned above, tax incentives and exemptions are some of the main causes of tax avoidance. This problem, even, will be aggravated in the absence of strong and well equipped tax authority. Weak enforcement of tax law plus wide exemptions and tax incentives/tax holidays will result in free ride for those taxpayers who wish and have the capacity to avoid their tax liability.

On one hand, “incentive programs encumber tax administration in several ways.”⁹² First, selective incentives require applying different rules to different taxpayers, which inherently complicates the system. Second, preventing and controlling the abuse of loopholes absorbs highly skilled administrative resources. Third, senior tax administrators should be and generally

⁹¹ Supra note 68, P. 53

⁹²Supra note 84, P. 54

do participate in designing tax incentives, screening applicants, and monitoring performance. Highly trained officers are thus diverted from raising revenue to managing programs designed for other social and economic purposes. As emphasized by Zee, et al: “The more scarce resources are devoted to administering tax incentives, the more other important administrative tasks would be impaired: - thus jeopardizing tax collection as a whole.”⁹³

On the other hand, weak administration creates a great chance for those taxpayers who want to exploit the loophole of tax incentive and in turn increase avoidance activities. In the absence of strong and well organized tax authority, this problem will even become worse and tax avoidance activity will reach the stage that highly affects the revenue of a country. This is the way in which weak tax administration will aggravate tax avoidance activities.

The other factor that encourages tax avoidance in relation to the administrative capacity of tax authority is weak capacity in detecting and prosecuting inappropriate tax practices. A well-functioning body of tax investigation is essential for the detection and prosecution of cases of tax avoidance, the lack of sufficient capacities in tax administrations reduce the probability of detection that again influences the decision of a taxpayer as to whether to avoid or not.

In addition, tax laws in many countries, especially in developing countries, change rapidly, thus producing instability and low transparency of the tax code. As a result, complicated tax “legislation and ongoing changes of the tax code confuse tax administrators and taxpayers alike. This produces ample opportunity for tax avoidance.”⁹⁴

The reasons listed above as the main causes of tax avoidance do not occur in isolation and some are mutually enforcing. Often, tax avoidance is a by-product of deficient political, economic and social governance in a country.

⁹³Zee, et al (2002), “Tax Incentives for Business Investment, in Dr. Bruce Bolnick, Effectiveness and Economic Impact of Tax Incentives in the SADC Region, (Nathan Associates Inc., Arlington), 2004, P. 55

⁹⁴Mo, Phyllis Lai Lan (2003), Tax avoidance and anti-avoidance measures in major developing economies, in Gudrun Barenbrock (ed), “Addressing Tax evasion and avoidance in developing countries,” (Deutsche Gesellschaft fur, Berlin), 2010, P. 15

2.2.2. Causes of tax evasion

There are many and varied causes why taxpayers evade from paying their tax liability. Like in the case of tax avoidance, these causes of tax evasions might, generally, be categorized under two main groups, i.e. causes of tax evasion that affect voluntary compliance of taxpayers, and causes of tax evasion that relate to the defect within the tax legislations and the weakness of tax authority in enforcing tax law.

Regarding the causes that affect the voluntary compliance of taxpayers, there is a similarity between tax evasion and tax avoidance. In another words, the factors that discourage willful compliance of taxpayers in the case of tax avoidance are also, almost, the same in the case of tax evasion though the degree of influence of each factor may differ.

Some factors are more grave in causing tax avoidance than tax evasion while most of these factors are more likely to encourage tax evasion than tax avoidance.

2.2.2.1. Low tax morale

Low tax morale is one of the causes for tax evasion. Tax morale as mentioned above should not be viewed as simply depending on the tax burden. Rather, as revealed by different empirical researches, “taxpayers throughout the world pay more taxes than can be explained by even the highest feasible levels of auditing, penalties and risk aversion.”⁹⁵ These high levels of tax compliance result from the tax morale of society that fosters self-enforcement of tax compliance.

“The necessity for considering tax morale in relation to tax evasion is that tax morale can indeed help to explain the puzzle why people pay taxes, despite the existence of low audit probabilities and penalty rates.”⁹⁶

Tax morale is, however, not easy to establish. Especially countries without a deep-rooted culture and habit of paying taxes find it difficult to establish tax morale. This willingness to pay of the taxpayer is influenced by the following factors:

⁹⁵Supra note 15

⁹⁶Martin Halla, Tax Morale and Compliance Behavior: First Evidence on a Causal Link, *The B.E. Journals of Economic Analysis & Policy*, (University of Linz & IZA), 2012, P. 21

i. Low quality of the service in return for taxes

In general, citizens expect some kind of service or benefit in return for the taxes paid. “If citizens perceive that they receive an adequate supply of public goods, their identification with the state and their willingness to pay tax increases.”⁹⁷ “If the government fails to provide basic public goods and services or provides them insufficiently, citizens may not be willing to pay taxes and tax evasion will be the consequence.”⁹⁸ To this effect, Lewis contends that “it could be that tax evasion is the only channel through which taxpayers can express their antipathy and asserted that if tax attitudes become worse, tax evasion will increase.”⁹⁹

ii. Low transparency and accountability of public institutions

Lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the services rendered by the government in return for the tax paid. This, in turn, increases the willingness to evade taxes.¹⁰⁰

iii. High level corruption

“Tax evasion and fiscal corruption have been universal and persistent problems throughout history with many-sided economic consequences.”¹⁰¹ Today, corruption and tax evasion seem to take place practically in every country, and should be considered a potential problem everywhere although evasion and fraud in tax administration are phenomena which hit developing countries hardest.¹⁰² “Many individual tax officials in such countries are alleged to unofficially “negotiate” with taxpayers to reduce their tax payments in return for a bribe which may reduce overall costs (tax payments plus bribes) to the taxpayer at the expense of the Treasury.”¹⁰³

⁹⁷ Benno Torgler, Markus Schaffner And Alison Macintyre, Tax Compliance, Tax Morale And Governance Quality, (Queensland University Of Technology), P. 35

⁹⁸Supra note 59

⁹⁹Lewis, A. (1982), The psychology of taxation, in Benno Torgler, Markus Schaffner and Alison Macintyre, Tax Compliance, Tax Morale and Governance Quality, (Queensland University Of Technology), P. 4

¹⁰⁰Kirchler et al (2007), Why Pay Taxes?, in Gudrun Barenbrock (ed), “Addressing Tax evasion and avoidance in developing countries,” (Deutsche Gesellschaft fur, Berlin), 2010, P. 15

¹⁰¹Odd-Helge Fjeldstad, Tax evasion and corruption in local governments in Tanzania: Alternative economic approaches, Working Paper No 14, 1996, P. 5

¹⁰² Ibid

¹⁰³Supra note 97, P. 264

High level corruption is another cause that discourages taxpayers' non-compliance and encourages tax evasion. If due to high levels corruption, citizens cannot be certain whether their paid taxes are used to finance public goods and services their willingness to pay their tax liability decreases and it becomes more likely that they evade.

Where corruption is rampant the citizens will have little trust in authority and thus will experience a low incentive to cooperate. "Citizens will feel cheated if they believe that corruption is widespread, their tax burden is not spent well, their government lacks accountability, and that they are not protected by the rules of law."¹⁰⁴ This reduces the incentive to pay taxes. "A taxpayer might consider evading taxes if the cost of bribing a tax auditor and other officials is lower than the potential benefit from tax evasion."¹⁰⁵

iv. High tax rate

Businesses always worry about the size of the tax cost. "Where taxes are high, businesses are more inclined to opt out of the formal sector."¹⁰⁶ The tax burden is one of the most commonly cited determinants of tax evasion and, in general, of the underground economy.¹⁰⁷ "The overall tax burden is a key feature for working and producing in the hidden sector and for concealing income and wealth."¹⁰⁸ Tax rate is highly related with the total size of the tax return and hence, high tax rate indicates high size of the tax cost owed to the taxpayers.

As revealed by different studies, "higher tax rates are associated with fewer formal businesses and lower private investment."¹⁰⁹ One widely accepted explanation for the size and growth of unreported income is high marginal income tax rates. According to Gutmann, "higher and higher taxes drive more and more of the economy underground, beyond the reach of the tax collector."¹¹⁰

¹⁰⁴Supra note 84, P. 37

¹⁰⁵Supra note 22, P. 14

¹⁰⁶Supra note 77, P. 15

¹⁰⁷ Bruno Chiarini, Bruno Chiarini and Friedrich Schneider, *Tax Rates and Tax Evasion: An Empirical Analysis of the Structural Aspects and Long-Run Characteristics in Italy*, (The Institute for the Study of Labor) 2008, P. 7

¹⁰⁸ Supra note 77

¹⁰⁹Djankov, Simeon, et al, "The Effect of Corporate Taxes on Investment and Entrepreneurship." *American Economic Journal*, 2010, PP. 31–64.

¹¹⁰Gutmann (1977), *The subterranean economy*, in Charles T. Clotfelter (ed), *Tax Evasion and Tax Rates: An Analysis of Individual Returns*, The Review of Economics and Statistics, 1983, Vol. 65, No. 3, P. 363

As the rate of tax increases/rises, businesses become disinterested to formalize their activities and choose to follow underground economy. In this way high tax rate discourages tax compliance and encourages informal/underground sectors which are the main means of tax evasion.

2.2.2.2. High Compliance cost

High compliance cost is the other factor that convinces taxpayers to evade from paying tax and it is more severe in causing tax evasion than tax avoidance. “Tax ‘compliance costs’ represent the additional costs, in terms of time, effort and financial expense, that taxpayers must bear as a part of meeting their tax obligations, over and above the cost of keeping records and accounts as a normal incident of carrying on a business.”¹¹¹ “High compliance costs are associated with larger informal sectors and more corruption that are main ways through which tax evasion may occur.”¹¹² “While the burden of tax payments themselves are obviously a deterrent to formalization, there is strong evidence that the burden of tax compliance – the time and cost associated with preparing tax returns, filing, effecting payment and interacting with the tax authorities – can often be heavier than the tax payments themselves forcing taxpayers to evade.”¹¹³

Thus, a tax system that offer high compliance cost is more likely to be highly tempted by tax evasion than the system that is excellent in keeping compliance cost at the lower level.¹¹⁴

2.2.2.3. Low level of Penalty

The legal framework is an important prerequisite for any enforcement activity. Penalty is one of the tools that deter taxpayers from engaging in tax evasion activities and is the method that should be applied to secure taxpayers compliance in the absence of voluntary compliance.

The problem that should typically be addressed is how the government should set the parameters of the tax and penalty system if it has to collect a fixed amount of revenue from taxpayers who

¹¹¹Jacqueline Coolidge, Findings of tax compliance cost surveys in developing countries, *ejournal of tax research*, (The University of New South Wales: School of Taxation and Business Law, Australia), 2012, Vol. 10, No. 2, P. 39

¹¹²Supra note 84, P. 17

¹¹³Supra note 111, P. 250

¹¹⁴ Supra note 94, P. 17

are prone to evade. Penalty is based on the concept that the risk of detection and punishment will improve compliance behaviour. The size and nature of penalties that are incurred after evasion has been detected is directly connected to the level of tax compliance.¹¹⁵

The aim of penalty is, therefore, mainly to prevent tax evasion but the concept also includes the idea that the punishment of an evader will discourage future evasion.

Valerie Braithwaite has described penalty as “a double edged sword stating that penalty can strengthen the moral obligation to pay tax because it points out what is the right thing to do.”¹¹⁶

The relationship between penalty and compliance has also been examined in numerous surveys in the past few decades. Some of these studies show that penalty and tax compliance are indeed associated. “People who assess the probability of detection and the level of penalty as being low are more inclined to evade tax than people who assess this penalty as being relatively greater.”¹¹⁷

Though penalty can be raised as one of the tools used for securing compliance and discouraging tax evasion, the effect or importance of penalty cannot be understood without considering the context in which it is applied. First, before applying the principle of the deterrent effect of penalty, those factors that shall encourage the voluntary compliance of the taxpayer should be applied. Of particular policy significance is the finding that personal norms (moral obligation) can be the main driver for tax compliance but with penalty playing a role when moral obligation and social pressure fails.¹¹⁸

When personal norms in favour of compliance are strong, penalty will have weak effect on compliance. Taxpayers will comply with their tax liability when personal norm in favour of compliance is strong because they think it is the right thing to do, not because they are afraid of

¹¹⁵ Fishlow, A. and Friedman, J. (1994), Tax evasion, inflation and stabilization, in Erich Kirchler et al (eds), *Why pay taxes? a review of tax compliance decisions*, (international Study Program Working Paper 07-30), 2007, P. 13

¹¹⁶ Valerie Braithwaite (2009), *Tax Evasion*, in Centre for Tax Policy and Administration, *Understanding and Influencing Taxpayers' Compliance Behaviour*, 2010

¹¹⁷ Grasmick, H. & Scott, W. (1982), *Tax Evasion and Mechanism of Social Control*, In Kristina Murphy (ed), *An Examination of Taxpayers' Attitudes Towards the Australian Tax System: Findings From a Survey of Tax Scheme Investors*, Working Paper No. 46, 2004

¹¹⁸ Wenzel, M. (2004), *The Social Side of Sanction: Personal and Social Norms as Moderators Deterrence*, in Kristina Murphy (ed), *Procedural Justice the Regulation of Tax Compliance Behaviour: The Moderating Role of Personal Norms*, (Andrew Young School Of Policy Study), P. 3

punishment. Thus, the deterrent effect of penalty will be moderated by the strength of prevailing personal and social norms.

But when personal norms are weak, punishment becomes more important.¹¹⁹ If the taxpayer is not affected by a moral obligation to pay tax then the threat of punishment can have a positive impact on behaviour.

Lederman argues that sanctioning people who do not comply can reassure others that they are doing the right thing.¹²⁰ People become more willing to comply if they perceive others are complying as well.¹²¹

It is clear that penalty is an important driver for behaviour. But the effect of penalty differs between individuals and contexts and thus needs to be used in the right way in order to work effectively. Penalty could in this respect be most effective as a tool for supporting existing social norms in favour of compliance and discouraging the behaviour of tax evasion.

Thus, generally speaking, low statutory penalty can be raised as one cause for tax evasion for taxpayers who are habitual evaders and might not be corrected after all measures that can ensure voluntary compliance are applied.

2.2.2.4. Weak enforcement of tax laws

The current section turns to challenges in the enforcement of tax laws. There exist several circumstances that restrain tax administrators from performing their functions properly thereby increasing the possibility of tax evasion. As revealed by different researches, shortfalls in tax collection procedures as well as weak capacities of tax administrations to detect and prosecute tax violators are both factors that contribute to a low enforcement of tax legislation.¹²²

A well functioning tax administration is a key to mobilizing domestic resources and the design of the tax system should be influenced by the ability of tax administrations to administer it. “Yet

¹¹⁹ Ibid

¹²⁰ Lederman, L. (2003), The Interplay Between Norms and Enforcement in Tax Compliance, in Oh Teik Hai & Lim Meng See (eds), Intention of Tax Non-Compliance, International Journal of Business And Social Science, Vol. 2, No. 7, 2011

¹²¹ Ibid

¹²² Supra note 5, P. 18

many administrations continue to be staffed by poorly trained and low paid officials, have structures which do not encourage an integrated approach to different taxes, and are marked by imbalanced service and enforcement functions, especially in developing countries.”¹²³

The following discussion elaborates these sources of tax evasion that are related to the administrative frame work of tax authority:

i. Weak detecting and prosecuting capacity of the tax authority.

A well-functioning body of tax investigation is essential for the detection and prosecution of cases of evasion. The lack of sufficient capacities in tax administrations reduces the probability of detection that again influences the decision of a taxpayer as to whether to evade or not.

A research conducted in UK on the preventive effects of audits using data from random enquiries undertaken in 2000 and 2001 shows that “audits appear to generate positive preventive effects for noncompliant taxpayers but negative preventive effects for compliant ones.”¹²⁴

In a study conducted by the World Bank Group in 2012, a majority of respondent countries rate audits and risk of detection as important drivers of compliance. Especially risk of detection is perceived as very important.¹²⁵ The research carried out by the New Zealand Inland Revenue department (NZ IRD), also suggests that “audits may improve compliance among businesses.”¹²⁶

Thus, since audit and detection are the central measure in ensuring compliance of taxpayers in the absence of voluntary compliance, weak audit and detection capacity of the tax authority is the principal cause for an augmentation of non-compliance behaviours and aggravated tax evasion.

ii. Insufficiencies in tax collection capacity

Regarding tax collection, many developing countries face difficulties with respect to important premises for a well functioning tax administration, especially with respect to identifying and

¹²³ IMF, OECD, UN and World Bank, Supporting The Development of More Effective Tax Systems, a Report to the G-20 Development Working Group, 2011, P. 11

¹²⁴Supra note 55, P. 19

¹²⁵Supra note 77, P. 15

¹²⁶Supra note 5, P. 17

administering those citizens and firms that are liable to tax payments.¹²⁷ Although there has been progress in improving the capacity of the tax authority, tax administrations' capacity to introduce and sustain the service such as well-functioning tax registers still pose severe difficulties in many developing countries.¹²⁸

Problems of insufficient capacity may also occur due to the organizational set up of the tax administration and its relationship to the ministry of finance. In general, "there are two approaches for the organizational set up of tax administration."¹²⁹ The first option is where the ministry of finance itself assumes the tax administration function. The second option is a semi-autonomous revenue authority where tax administration is moved out of the ministry of finance into a separate entity.

Often, "tax administration and collection by ministries of finance were considered inefficient and suffering from corruption and high compliance costs."¹³⁰ Therefore, "the creation of semi autonomous revenue authorities is necessary in strengthening the capacity of the revenue authority and fight against tax evasion."¹³¹

Additionally, unclear responsibilities regarding the collection and administration of specific types of taxes by different institutions can lead to inefficiencies and tax losses and requires a reorganization of the tax administration. "Typically, an organizational approach according to the functions of tax administrations is considered more efficient than one following different tax and revenue types."¹³²

Moreover, one has to bear in mind that "tax administration and tax policy are intertwined spheres and hence, tax policy directly affects the costs and the organization of the tax administration."¹³³ Additionally, the capacities of tax administration influence the way tax policy is implemented. Thus, both areas, i.e. tax policy as well as tax administration have to be taken into consideration

¹²⁷Ibid, P. 17

¹²⁸Ibid

¹²⁹ Supra note 116

¹³⁰Fjeldstad, Odd-Helge and Mick Moore (2009), Revenue authorities and public authority in sub-Saharan Africa, in Gudrun Barenbrock (ed), "Addressing Tax evasion and avoidance in developing countries," (Deutsche Gesellschaft fur, Berlin), 2010, P. 17

¹³¹Supra note 116

¹³²Ibid

¹³³Ibid

when designing successful tax reforms. Otherwise, the proper functioning of the overall system will be affected. For this reason, loose policy action and weak tax collection capacity are the main causes for tax evasion.

Furthermore, insufficiencies in tax collection capacity may arise from less qualified, untrained and under-motivated tax officials/officers.

i. Inability of controlling underground/informal activities

Informal economies are the principal cause of tax evasion in every country. The size of underground economy represents the lion's share of the size of tax evasion though tax evasion is not always limited to underground economy. In fact, all of the above mentioned causes of tax evasion have their own contribution in attracting/encouraging underground economy. Nevertheless, the increased severity of informal economy is highly related with the administrative capacity of the country concerned and the weakness in taking strong policy measure.

Insufficiencies in tax collection in developing countries result from the fact that their economies are characterized by a large informal sector. Firms and individuals active in the informal sector usually do not pay direct taxes on personal or business income, and they do not charge consumption taxes or excises on their sales. The state loses these potential tax revenues and, as a consequence, lacks necessary funds to provide goods and services.

Often, the reasons to be active in the informal economy are not directly related to attempts to avoid taxation but rather to limited options or excessive administrative requirements to enter the formal economy or excessive costs of labour regulations.

Chapter Three: Measures for tackling Tax Avoidance and Evasion

Under this chapter, the main concern is over-viewing the measures taken by different countries in tackling the problem of tax avoidance and evasion. This cross-reference of the measures taken by other countries to fight against tax avoidance and evasion is necessary in establishing the level of development of the Ethiopian taxation system in taking amicable measures against the problem, and thereafter for putting the policy recommendation that is necessary for Ethiopia to reach the level attained by other countries.

Generally, no single measure solely solves the problem of tax avoidance and evasion. As there are variety of causes for them, measures that should be taken to tackle them depend on the nature of the cause.

Hence, in the same way as there is not only one type of tax evasion and avoidance, there is no one size fits all solution to counter tax evasion and avoidance. “The practicability and the size of the window of opportunity depend on the specific situation and the predominant type of tax evasion and avoidance in a country.”¹³⁴ An effective strategy needs to address the underlying causes and needs to be tailored to the specific country environment.

3.1. Measures for improving voluntary tax compliance

Low tax compliance contributes to a large extent to insufficient revenue mobilization resulting from evasion and avoidance of tax payments. Ensuring voluntary compliance, if possible, is the first measure that should be taken and implemented to prevent the problem. “The feasible policy of the tax administration is the one that ensure appropriate tax filing and payment with the taxpayers’ willful cooperation.”¹³⁵

Voluntary compliance of taxpayers to their tax liability might be affected by different factors as stated under chapter two of this paper. The disease that affects the voluntary compliance of the taxpayer can be cured by taking actions or measures that prevent these factors from being occurred.

¹³⁴Supra note 99, P. 26

¹³⁵Tapan K. Sarker, “Improving Tax Compliance in Developing Countries via Self-Assessment Systems - What Could Bangladesh Learn from Japan?” Asia-Pacific Tax Bulletin, 2003, Vol. 9, No. 6, P. 19

The only measure that should be taken to bring about the voluntary compliance of the taxpayers is addressing these factors from their very base. In another word, the measures that should be taken in this context should be the one that improve the taxpaying moral of the taxpayers.

“The improvement of citizens’ tax morale requires measures ensuring and visualizing that the state is acting in a transparent, accountable and efficient manner with the ultimate aim of providing services for its citizens.”¹³⁶

The following discussion presents the main reforms and measures that have been taken by different countries to improve voluntary tax compliance of taxpayers.

3.1.1. Building high tax moral

Building high tax moral is the solution to avoid low tax moral and bring about voluntary compliance of taxpayers. The following are measures implemented by different countries to build high tax moral:

i. Taxpayers education and service

The importance of taxes for the functioning of the state is not always apparent to the taxpayers. Similarly, individual tax liabilities as well as requirements to comply with the tax system such as filling out different tax forms might be unknown or difficult to understand.¹³⁷

By means of taxpayers education and service, citizens can be informed and educated about the tax system and be assisted in their attempts to comply with tax laws. Taxpayers education and service is the first and principal measure employed by different countries to improve the voluntary compliance of taxpayers and thereby reduce/tackle tax avoidance and evasion.

ii. Public Relations and cooperation

Public relation is a term that is similar to taxpayer education and is the broadest way through which the public become aware of the tax system and details of paying tax. The purpose of

¹³⁶Supra Note 99, P. 27

¹³⁷Supra note 116

public relations is to build a tax conscious environment not only among taxpayers but also among the public including potential taxpayers, and can be categorized as the need to:¹³⁸

- enhance tax compliance;
- enhance public knowledge of taxation;
- improve mutual understanding and trust between taxpayers and tax authorities and
- obtain the understanding and cooperation from mass-media for tax administration.

“Many of these activities are carried out through the media including regular television and radio programmes that provide current tax information, answering questions called-in by viewers, and reminding the public of tax deadlines, etc.”¹³⁹ The print media and internet are also widely used. Other than the media, “the authorities also conduct an annual ‘Know-Your-Taxes Week’, during which, tax authorities set-up booths, in public areas in order to meet people and provide tax information or answer any questions that they may have.”¹⁴⁰ “This method is employed by the Japanese National Tax Administration (NTA) whose tax compliance level is very high with the corporate tax compliance more than 90%.”¹⁴¹

iii. Giving Tax Counseling Service

Giving tax counseling service by the tax authority has twofold benefits in securing voluntary compliance of the taxpayers. On the one hand, it educates taxpayers to know how to comply with their tax liability such as how to fill and file the tax return, keep books of account, etc. On the other hand, it reduces compliance cost of taxpayers by reducing the cost they may pay to independent tax advisors for receiving tax advice. “The objective of tax counseling is to assist taxpayers in matters related to tax and encourage the voluntary submission of accurate tax returns and payment of taxes.”¹⁴²

For instance, the Japanese tax administration subscribes to the principle that every tax official is a tax counselor and plays its role in improving the country’s voluntary compliance.¹⁴³

¹³⁸Supra note 135, P. 21

¹³⁹Ibid, P. 21

¹⁴⁰Ibid

¹⁴¹Ibid

¹⁴²Supra note 5, P. 23

¹⁴³Ibid

Generally, a tax counseling office provides advice on the interpretation and application of tax laws, procedures for filing returns and applications, etc and hence, is an important tool through which voluntary compliance of taxpayers can be ensured and tax avoidance and evasion can be reduced.

iv. Reducing tax rate

The Total Tax Rate measures the burden of all the taxes that a company/other businesses must pay in relation to its commercial profit. Thus, all kinds of taxes that impose a cost on the firm and individual taxpayers are profit taxes, property taxes, labour taxes and mandatory contributions paid by the employer, certain sales taxes, and other payments that do not require filing, such as property transfer taxes, stamp duties, dividend tax, capital gains tax, financial transactions tax, environmental tax, and vehicle and road tax.¹⁴⁴

Lowering the tax rate decreases the tax burden of taxpayers and encourages those persons who are non-compliant, especially those that operate underground economy, to comply with their tax liability and formalize their activities. To this effect, the Russian flat tax experiment is particularly interesting.¹⁴⁵ In Russia, research shows that “after the introduction of flat taxes, and effective personal income tax rate cuts, tax revenues increased substantially and almost immediately.”¹⁴⁶

3.1.2. Addressing tax compliance costs

Tax compliance cost is another principal cause for the lack of voluntary compliance of taxpayers to their tax liability. By reducing tax compliance costs and thereby lowering the overall tax burden on businesses, simplification provisions help achieve more neutral tax treatment of firms of varying sizes, implying efficiency gains, and encourage compliance with adherence to the tax laws of a country, including operating in the formal rather than informal (underground) economy, and full reporting of all amounts required to determine the true tax base.¹⁴⁷

¹⁴⁴Supra note 77, P. 17

¹⁴⁵ Tamas K. Papp and Elod Takats, Tax Rate Cuts and Tax Compliance, IMF Working Paper, 2008, P. 3

¹⁴⁶ Ibid

¹⁴⁷SME Tax Compliance and Simplification Background note prepared by the OECD Centre for Tax Policy and Administration for a Roundtable Discussion“ at the 1st Meeting of the Working Group on Taxation of the SEE Investment Committee, P. 6

Thus, reducing tax compliance cost encourages voluntary compliance and can serve as the principal measure for tackling or otherwise reducing tax avoidance and evasion. Tax compliance cost can be reduced through employing different methods. Among these methods the following are the determinant ones.

i. Less frequent filing requirements

Many countries require taxpayers to pay VAT, as well as corporate income tax and personal income tax withholdings, on a monthly basis. Sometimes it is even more frequent. For instance, in Sarajevo (Bosnia and Herzegovina), “until 2005 taxpayers had to pay three different taxes weekly (on sales, beverages, and catering), in three separate payments.”¹⁴⁸

In some countries, withholding taxes on salaries are to be paid twice monthly. “Lowering the frequency for paying such taxes from monthly or more often to quarterly/yearly could result in considerable savings for both business and the tax administration.”¹⁴⁹

It might make sense to have small taxpayers pay quarterly, while keeping larger taxpayers on more frequent schedules. For VAT payments, enterprises which regularly claim refunds could retain a monthly filing period, but small enterprises could be given two or three months, or even longer.¹⁵⁰

In the United Kingdom, for example, “small enterprises file only one VAT declaration per year, although they pay one-twelfth of their estimated tax bill every month, with a reconciliation made at the end of the fiscal year.”¹⁵¹

One approach that reduces tax compliance costs, while at the same time provides firms with a cash flow advantage (i.e. savings in present value terms, owing to the time value of money), is allowing taxpayers to file their income tax returns on a less frequent basis, typically with a small business test based on taxable turnover in the prior year.¹⁵² Most countries require large firms to

¹⁴⁸Mark Gallagher and Arturo Jacobs, “Lowering Tax Payer Compliance Costs: grounds for growth enhancing the competitive impacts business environment reform,” 2009, Vol. 13, P. 6

¹⁴⁹Ibid

¹⁵⁰Ibid

¹⁵¹Ibid

¹⁵²Supra note 147, P. 15

submit business income tax returns on a monthly basis.¹⁵³ “Where small firms are allowed to report less frequently, for example quarterly, semi-annually or annually, compliance costs may be significantly reduced.”¹⁵⁴

Thus, less frequent payment of tax return, especially for small firms, is one measure for reducing tax compliance cost and in turn attracts voluntary compliance of taxpayers which brings about the reduction of the problem of tax avoidance and evasion.

ii. Offering electronic filing and payments

An electronic system for filing and paying taxes, if implemented well and used by most taxpayers, benefits both tax authorities and firms.¹⁵⁵ For tax authorities, electronic filing lightens the workload and reduces operational costs such as the costs of processing, storing and handling tax returns. At the same time, it increases tax compliance and saves time. For taxpayers, “electronic filing saves time by reducing calculation errors on tax returns and making it easier to prepare, file and pay taxes.”¹⁵⁶ “And both sides benefit from a reduction in potential incidents of corruption, which are more likely to occur with more frequent contact with tax administration staff.”¹⁵⁷

“Tax administrations benefit from electronic filing and paying in two ways:”¹⁵⁸ i, by avoiding the traditional paper filing and paying in which tax administrations must re-enter much of the data the taxpayer has included in the tax declaration or payment documents and ii, in saving the resources required and errors creep into the database which often create considerable extra work for both the tax administration and the taxpayer.

Despite these advantages of e-filing and payment, rolling out an electronic filing and payment system and educating taxpayers in its use are not easy tasks for a government. The necessary infrastructure must be put into place, especially where not all citizens have broadband

¹⁵³Ibid, P. 17

¹⁵⁴Ibid

¹⁵⁵Supra note 77, 2012, P. 20

¹⁵⁶Che Azmi and Kamarulzaman, “Adoption of Tax E-filing: A Conceptual Paper.” African Journal of Business Management, 2010, Vol. 4, P. 599–603

¹⁵⁷James, Sebastian, a Handbook for Tax Simplification, Washington, DC: International Finance Corporation, 2009, P. 234

¹⁵⁸Mark Gallagher And Arturo Jacobs, Lowering Taxpayer Compliance Costs, Development Alternatives, 2009, Vol. 13, P. 6

access.¹⁵⁹This fulfillment of the necessary infrastructure and education of the taxpayers on the use of e-filing and payment asks a high cost and technology on the part of the government.

For instance when we consider the case of India, “the Central Board of Direct Taxes took a series of steps to ensure a smooth process of e-filing and payment such as:”¹⁶⁰

- Publishing detailed help manuals on the forms and how to complete them on its website.
- Providing free, downloadable software for preparing tax returns on its website.
- Organizing, in collaboration with the Institute of Chartered Accountants of India, live phone-in question-and-answer sessions with accountants.
- Distributing CDs with software and help content to accountants, trade bodies, and professional and business associations through tax offices throughout India.
- Setting up help centers at all field office headquarters.
- Organizing meetings and seminars with taxpayers and tax practitioners.
- Answering taxpayers’ queries by phone and e-mail at the call centre.

Whatever the difficulty may be to first introduce the process of e-filing and payment, it is an important measure to reduce compliance cost for taxpayers and encourage voluntary compliance. Many countries are on the way of introducing the e-filing and payment as a measure to reduce tax compliance cost and ensure voluntary compliance of taxpayers. Several countries have enabled taxpayers to file their declarations electronically. “These e-declaration systems reduce requirements for taxpayers to print and store documents, and do away with the need to snail-mail or hand-deliver these documents.”¹⁶¹

“By 2010, 66 economies had fully implemented electronic filing and payment of taxes.”¹⁶² “Ten OECD high income economies have made electronic filing and payment mandatory.”¹⁶³ “In the next few years many other OECD high income economies, having introduced requirements for electronic filing and payment for larger businesses, plan to extend them to smaller ones.”¹⁶⁴

¹⁵⁹Supra note 77, P. 21

¹⁶⁰Ibid

¹⁶¹Supra note 158, P. 6

¹⁶²World Bank Group, Investment Climate Advisory Services, Global Tax Team, 2010

¹⁶³Ibid

¹⁶⁴Ibid

3.2. Measures that improve legal and administrative framework

Loose legal base and weak administrative capacity are the main causes for tax avoidance and evasion. Thus, modifying the legal base and improving the administrative capacity of the tax authority are other important measures that are essential in tackling/reducing the problem of tax avoidance and evasion in addition to improving voluntary compliance. In this regard, different measures are taken by countries. These measures are presented as follows:

3.2.1. Legislative measures against tax avoidance and evasion

Countries are on the continuous process of improving their tax legislation in order to tackle the problem of tax avoidance and evasion. Different measures are taken in the field of legislation in order to tackle the problem.

Since the legislative measures for tackling tax avoidance are different from that of the measures for tax evasion, it is good to approach them differently.

3.2.1.1. Legislative measures against tax avoidance

As tax avoidance activity has increased over the past few decades, governments have adopted various legislative measures to discourage this phenomenon.

However, the legislative way of tackling tax avoidance has an inherently difficult problem as the core term 'tax avoidance' is subject to much debate. The grey areas of any definition are precisely the areas giving rise to problems in tackling the tax avoidance. Legislative attempts to enact a sufficiently reliable and predictable rule to combat tax avoidance have not had an entirely satisfactory outcome.¹⁶⁵ Each measure has its own merits and drawbacks and hence, there need a strong precaution before applying each of the legislative measure meant to tackle tax avoidance.

Unless properly selected and employed, legislative measures will result in inefficient way of tackling tax avoidance and cause the tax system to reach a point of complexity that has real costs

¹⁶⁵ G.T. Pagone, Aspects of Tax Avoidance: Trans-Tasman Observations, International Fiscal Association Conference, (Wellington, New Zealand), 2011, P. 13

for taxpayers and the government.¹⁶⁶ Most of the legislative measures that are taken by countries in countering tax avoidance are proactive and are meant to stop the problem of tax avoidance after it occurred.

However, this way of countering tax avoidance cannot bring a long term solution to the problem and cannot be the robust way of solving the problem. The best way to protect tax revenue from being avoided, and that provide certainty for taxpayers and simplify the tax system is to eliminate avoidance opportunities at the outset such as reducing the number of exemptions and incentives, and avoiding the approach of taxing similar activities at different rate, rather than tackling risks once they have materialized.¹⁶⁷ Wherever possible, countries should prioritize robust design of policy and legislation, underpinned by clearly stated policy objectives.¹⁶⁸ The aim is to maximize prevention of avoidance, reducing the need for immediate changes to legislation once an avoidance risk has arisen.¹⁶⁹ “Whatever legislative approach is taken to tackle tax avoidance, there should be full engagement with a consultation process, allowing adequate time for all interested parties to participate properly.”¹⁷⁰

Regardless of the drawbacks involved in legislative measures in solving the problem of tax avoidance, countries have taken and on the way of taking different legislative measures against the problem.

Legislation used to counteract tax avoidance can be seen as falling into two groups:¹⁷¹ the first is the legislation that changes the way the tax system deals with a particular transaction or arrangement, for instance, changing the progressive tax rate system to flat tax rate system to do away with the avoidance of tax that might be occurred through income shifting/splitting. The second is legislation that introduces anti-avoidance provisions, without changing the way the tax system deals with a particular transaction or arrangement, for instance, enacting Specific Anti-Avoidance Rule that prohibits income splitting/shifting without changing progressive tax rate system to flat tax rate system.

¹⁶⁶Ibid

¹⁶⁷HM Treasury, Tackling tax avoidance, 2011, P. 13

¹⁶⁸Ibid

¹⁶⁹Ibid

¹⁷⁰Supra note 22, P. 56

¹⁷¹Ibid, P. 30

1. System rule change

This is a legislative measure that closes the gap/loophole in the legislation in which apparent tax avoidance activity is occurred. It is the process of modifying the legislation through amendments rather than introducing independent tax avoidance rules. “When legislation is introduced to change the way in which the tax system treats a particular transaction, it has often been the case that the rules are changed incrementally, tackling one hole or problem after another.”¹⁷²

2. Legislation that introduces anti-avoidance provisions

In addition to changing the way in which certain legislation is dealing with certain transaction, countries have introduced other anti-avoidance legislations. In this aspect, governments have taken and endeavoured to take serious anti-avoidance legislations such as enacting legislation providing for the disclosure of various tax avoidance arrangements, legislation introducing or enhancing specific and general anti-avoidance rules (SAARs and GAARs), and legislation imposing penalties for abusive tax avoidance.¹⁷³

i. Disclosure legislation/rule

As Braithwaite explains, “disclosure is the first line of defence against aggressive tax planning”- allowing revenue authorities to concentrate scarce resources on tax arrangements that are most likely to involve abusive tax avoidance.¹⁷⁴ In the UK, for example, Evans notes that the new disclosure rules have “provided the revenue authority with unparalleled access to real-time intelligence that has enabled it to move swiftly to legislate against avoidance activity deemed to be a threat to the revenue base”.¹⁷⁵

“In 1984, the United States became the first major country to introduce a registration system for tax avoidance schemes, requiring promoters of potentially abusive tax shelters to register these

¹⁷²Supra note 22, P. 56

¹⁷³G. David Duff, *Tax Avoidance in the 21st Century*, (Thomson Reuters), 2009, P. 12

¹⁷⁴J. Braithwaite, *South African Revenue Service (SARS), Discussion Paper on Tax Avoidance*, 2005, P. 131

¹⁷⁵C. Evans, “Containing Tax Avoidance: Anti-Avoidance Strategies” *University of New South Wales Faculty of Law Research Series No. 40*, 2008, P. 27

shelters and maintain a list of persons investing in these shelters.”¹⁷⁶ “Canada introduced similar tax shelter registration rules in 1987,¹⁷⁷ and the UK followed their lead in 2004.”¹⁷⁸

According to the current US rules, which have been broadened considerably in recent years, taxpayers who participate in reportable transactions as well as material advisors who assist in the organization, management, promotion, sale or implementation of reportable transactions must disclose these transactions in information returns submitted to the Internal Revenue Service (IRS).¹⁷⁹

For the purpose of these rules, reportable transactions include: “listed transactions” identified by the Internal Revenue Service (IRS); confidential transactions offered by an advisor under conditions of confidentiality for a fee; transactions with contractual protection, for which fees are contingent on the realization of tax benefits from the transaction; loss transactions resulting in losses above stipulated dollar amounts; and “transactions of interest” which are the same or substantially similar to transactions identified by the IRS.¹⁸⁰

“Taxpayers and material advisors who fail to file these information returns may be subject to substantial penalties ranging from \$10,000 to \$200,000 plus in the case of taxpayers a percentage of the understated amount of tax.”¹⁸¹

According to the current UK rules, which have also been expanded since their introduction, promoters (and in certain circumstances users) of “hallmarked” schemes are required to disclose information about “tax arrangements” that enable or could enable a person to obtain a tax benefit, where the tax benefit is the main benefit or one of the main benefits arising from the arrangement.¹⁸²

¹⁷⁶D. Weisbach, “Comments on Recent Developments on Tax Shelters in the US,” (2008), pp 57-60

¹⁷⁷R. Wertschek and J Wilson, “Shelter from the Storm: The Current State of the Tax Shelter Rules in Section 237.1,” Canadian Tax Journal, 2008, P. 285

¹⁷⁸Supra note 175, P. 26

¹⁷⁹US Treasury, The Problem of Corporate Tax Shelters–Discussion, Analysis and Legislative Proposals, 1999, PP. 60-63

¹⁸⁰Finance Quebec, Aggressive Tax Planning, 2009, PP. 60-63

¹⁸¹Ibid, PP. 60-63

¹⁸²Ibid, PP. 63-67

For the purpose of these rules, “hallmarked” schemes include: (1) arrangements which the promoter might reasonably be expected to require the user to keep confidential in order to facilitate repeated use; (2) arrangements from which the tax advantages are expected to be obtained from the inclusion of a financial product in which the promoter or a person connected with the promoter becomes a party where the price of the financial product differs significantly from similar financial products in the open market; (3) arrangements that are standardized tax products; (4) arrangements implemented by a promoter for more than one individual, the main purpose of which can reasonably be regarded as the provision of deductible losses; (5) arrangements for which it might reasonably be expected that the promoter or a person connected with the promoter could obtain a premium fee attributable to the tax advantage or contingent on the user obtaining the tax advantage; (6) arrangements related to certain high value plant or machinery leases involving a tax-exempt party, the removal of risk, or a sale-leaseback or lease and finance leaseback; and (7) in-house schemes, where there is no promoter, that are intended for use by large enterprises which seek confidentiality from the tax administration in order to facilitate repeated or continued use.¹⁸³

“Where the promoter or taxpayer does not file the required disclosure within time periods stipulated in the legislation, he/it may be subject to penalties starting at £5,000 and increasing by £600 for each day the return is not filed after the initial penalty is applied.”¹⁸⁴

ii. Specific Anti-avoidance Rules (SAARs) and General Anti-avoidance Rules (GAARs)

In addition to disclosure rules, governments have also endeavoured to combat abusive tax avoidance “through specific anti-avoidance rules (SAARs) and general anti-avoidance rules (GAARs).”¹⁸⁵

According to Chris Evans, the former constitute “smart bombs” in the war against abusive tax avoidance, while the latter represent “weapons of mass destruction”.¹⁸⁶ “The advantages and disadvantages of SAARs are summarized by the Quebec Finance Department.”¹⁸⁷ On the one

¹⁸³Supra note 177, P. 46

¹⁸⁴Ibid

¹⁸⁵Supra note 173, P. 16

¹⁸⁶Supra note 175, P. 32

¹⁸⁷Supra note 180, P. 28

hand, SAARs tend to have a clearly defined field of application, contributing “an element of certainty” to tax legislation and “fostering a better understanding of the object, spirit and purpose of the legislation”.¹⁸⁸ On the other hand, because they apply only to “stipulated or suspected” transactions and are almost never retroactive in application, they “cannot prevent avoidance transactions not previously detected”.¹⁸⁹

In addition, as Evans observes, they can also “contribute enormously to the length and complexity of tax legislation” and “can lead to legislative layering, which can itself facilitate more avoidance possibilities (what Lord Walker has referred to as ‘avoidance karate’)”.¹⁹⁰

Notwithstanding their deficiencies, however, and presumably because of their advantages, countries continue to rely on SAARs to counteract abusive tax avoidance schemes, and may have actually increased their use of these measures as a result of the “boost to real time intelligence” created by the enactment of disclosure regimes.¹⁹¹

In rare circumstances, moreover some jurisdictions have bypassed one of the main deficiencies of most SAARs, by enacting retroactive amendments to invalidate tax benefits from abusive tax avoidance arrangements.¹⁹² Although retroactive legislation is generally denounced as unfair and contrary to the rule of law, the Quebec Finance Department contends that this approach may be justified in exceptional circumstances, “for example, where taxpayers try to take advantage of a weakness or ambiguity in the legislation to develop schemes considered abusive because they are clearly contrary to the objectives of fiscal policy”.¹⁹³

Similarly at the federal level in Canada, the Department of Finance is prepared to implement retroactive clarifying legislation in “exceptional situations” where:¹⁹⁴

- The amendments reflect a long-standing well-known interpretation of the law by the Department of National Revenue (now the Canada Revenue Agency);

¹⁸⁸Ibid

¹⁸⁹Ibid

¹⁹⁰Supra note 175, P. 43

¹⁹¹Ibid, P. 15

¹⁹²Supra note 173, P. 17

¹⁹³Supra note 180, P. 51

¹⁹⁴Canada, *Comprehensive response of the government to the seventh Report of the Standing Committee on Public Accounts*, parliamentary document no 8512-351-79, 1995

- The amendments reflect a policy that is clear from the relevant provisions that is well-known and understood by taxpayers;
- the amendments are intended to prevent a windfall benefit to certain taxpayers;
- The amendments are necessary to preserve the stability of the Government’s revenue base; [or]
- The amendments are corrections of ambiguous or deficient provisions that were not in accordance with the object of the Act.

As a supplement to specific statutory rules and SAARs, many countries have also found it useful to introduce statutory GAARs to discourage abusive tax avoidance. As Stanley Surrey argued 40 years ago, the enactment of general anti-abuse provisions along these lines saves the tax system from “the far greater proliferation of detail that would be necessary if the tax avoider could succeed merely by bringing his scheme within the literal language of substantive provisions written to govern the everyday world”.¹⁹⁵

“To the extent that inconsistencies and discontinuities inherent in detailed tax rules create unforeseen and often unforeseeable opportunities to avoid tax consequences compatible with the purposes of the statute and legislative intent, a general standard like a GAAR can be a more effective and economical way to prevent abusive tax avoidance than specific rules and statutory SAARs.”¹⁹⁶

In assessing the effectiveness of these GAARs, it is useful to recognize their limited role as provisions of last resort that are designed to prevent abusive tax avoidance only when ordinary tax rules and SAARs fail to prevent a tax benefit that is incompatible with the object and purpose of the relevant provision or statutory scheme. For this reason, one can sympathize with the view of at least one commentator that the Australian GAAR (which does not include language limiting its application to abusive transactions) “is drafted so widely as to be capable of enabling the Commissioner to annihilate any transaction which provides a tax advantage”.¹⁹⁷

¹⁹⁵S. Surrey, “Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail” *Law & Contemporary Problems*, 1969, Vol. 34, No. 32, P. 707

¹⁹⁶Supra note 176, PP. 879-880

¹⁹⁷M. Cashmere, “Towards an Appropriate Interpretive Approach to Australia’s General Tax Avoidance Rule – Part IVA” *Australian Tax Review* 2006, Vol. 35, No. 231

iii. Penalties for abusive tax avoidance

Alongside other measures to discourage tax avoidance, some countries impose penalties where the GAAR is successfully applied to disallow a tax benefit. In Australia, for example, taxpayers may be subject to a penalty of 50% of the amount of the income tax attributable to this tax benefit or 25% of the amount of tax if it is reasonably arguable that the GAAR might not have applied.¹⁹⁸

Similarly, in New Zealand, “taxpayers who engage in abusive transactions that are subject to the GAAR are liable for a penalty up to 100% of the resulting tax shortfall, though this percentage is reduced for taxpayers who make voluntary disclosures and taxpayers who have not been subject to a penalty within the last four years.”¹⁹⁹ “A penalty on abusive tax avoidance is also imposed under the Irish GAAR.”²⁰⁰ In Quebec, however, “the Department of Finance has indicated that introduction of a penalty contingent on the application of the provincial GAAR is under consideration”.²⁰¹

iv. Promoter penalties

To the extent that the market for aggressive tax planning is driven as much or more by the supply of tax avoidance schemes as it is by the demand for these schemes, it is often argued that penalties should be imposed on the promoters of these schemes as well as their users.²⁰² For this reason, Australia introduced a new system of penalties, which became effective on 6 April 2006, imposed on promoters of “tax exploitation” schemes.²⁰³

According to these rules, promoter penalties may be imposed where an entity or natural person either engages in conduct resulting in it or another entity or natural person being a promoter of a tax exploitation scheme or engages in conduct that results in a scheme that has been promoted on

¹⁹⁸Supra note 180, P. 69

¹⁹⁹Ibid, 2009, PP. 72-73

²⁰⁰Ibid, P. 74

²⁰¹Ibid, P. 96

²⁰²Supra note 174, P. 182

²⁰³Supra note 175, PP. 43-44

the basis of conformity with a product ruling being implemented in a manner that is materially different from that described in the product ruling.²⁰⁴

Although some commentators have expressed serious reservations about the potential impact of these rules on tax advisors providing tax planning advice, “the Explanatory Memorandum accompanying the new rules explains that the civil penalty regime is not intended to inhibit the provision of independent and objective advice, including advice regarding tax planning.”²⁰⁵

“Recognizing the extent to which the growing market for aggressive tax planning has been driven by the supply of these schemes, it is not surprising that other jurisdictions have either followed or are considering following the Australian example.”²⁰⁶

In New Zealand, for example, promoters of tax avoidance arrangements are subject to penalties where they offer, sell or promote an arrangement to 10 or more people in a taxation year and this arrangement constitutes an abusive tax position,²⁰⁷ and “the Quebec Finance Department is actively considering the introduction of promoter penalty rules in the Province of Quebec which would be contingent on the application of the provincial GAAR.”²⁰⁸

These all mentioned measures are the legislative measures that are taken by different countries to counter the problem of tax avoidance.

3.2.1.2. Legislative measures against tax evasion

Tax evasion by itself is an illegal act that goes against the specifically provided provision of tax law. Thus, there is no need for enacting the base rule for countering tax evasion. The only legislative measure in the case of tax evasion is making the penalty stricter to have a deterrent effect on potential evaders. “Most analysis of the instrumental function of tax penalties begins with the reasonable supposition that, because penalties promote tax compliance, penalty reform requires an understanding of what motivates taxpayers to comply with their tax obligations.”²⁰⁹

²⁰⁴Supra note 173, P. 19

²⁰⁵Paragraph 3.50 of the Explanatory Memorandum to Tax Laws Amendment, Measures No. 1, Act 2006, P. 44

²⁰⁶Supra note 173, P. 20

²⁰⁷Supra note 180, P. 73

²⁰⁸Ibid, PP. 96-102

²⁰⁹Michael Doran, Tax Penalties and Tax Compliance, Harvard Journal on Legislation, 2009, Vol. 46, P. 123

According to Becker the extent of tax evasion highly determined by both the severity of the punishment potentially imposed on the wrongdoer and the probability of punishment.²¹⁰

Allingham and Sandmo analyze evasion by considering the taxpayer's decision of how much income to report on her tax return while treating both the taxpayer's income and the government's enforcement strategy as exogenous.²¹¹ "They argue that the taxpayer will evade tax to the extent that the benefit of evasion (the amount of tax not paid) exceeds the product of the total amount she would have to pay if her evasion were detected (the tax plus any penalty) and the probability of detection."²¹²

The idea is that fear of penalties prohibits tax noncompliance behavior. Establishing an effective system to penalize tax evaders is an important measure to encourage tax compliance. Taxpayers will be more likely to comply if noncompliance may result in severe penalties.

According to the theoretical work conducted by Allingham and Sandmo, "tax compliance can be increased by increasing the penalties associated with it."²¹³ To be effective, penalties must be applied speedily and forcefully."²¹⁴ Witte and Woodbury had demonstrated "a significant relationship between the severity of criminal sanctions and tax compliance."²¹⁵ Other studies by Grasmick and Scott also indicate that respondents acknowledging some form of tax noncompliance are less likely if such acts would result in severe penalties.²¹⁶ The experimental studies conducted by Hasseldine et al, also show that "severity of sanctions has significant effects on tax compliance behavior."²¹⁷

²¹⁰Ibid

²¹¹Ibid, PP. 323-324

²¹²Ibid, P. 326

²¹³Ibid

²¹⁴Gerald Chau and Patrick Leung, A critical review of Fischer tax compliance model: A research synthesis, *Journal of accounting and taxation*, 2009, Vol. 1, No. 2, P. 37

²¹⁵Witte, A. and Woodbury, D. (1985), The effect of tax laws and tax administration on tax compliance, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, *Journal of accounting and taxation*, 2009, Vol. 1, No. 2, P. 37

²¹⁶Grasmick, H. and Scott, W. (1982), Tax Evasion and mechanisms of social control, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, *Journal of accounting and taxation*, 2009, Vol. 1, No. 2, P. 37

²¹⁷Hasseldine, J. et al. (2007), Tax compliance enforcement strategies for sole proprietors, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, *Journal of accounting and taxation*, 2009, Vol. 1, No. 2

Tax penalties obviously are central to the deterrence of non-compliant taxpayers, i.e. they provide the mechanism for imposing higher costs on non-compliant taxpayers. The deterrence model, therefore, implies that accurately penalties should be high and that, at least on certain interpretations of the model, taxpayers should have strict liability for those penalties.²¹⁸

Logue argues that “the optimal level of compliance will be achieved by setting the penalty on noncompliance to equal the quotient of the harm from non-compliance (the understated tax liability) over the ex ante probability of detection, and by imposing strict liability for that penalty.”²¹⁹ “Strict liability forces the taxpayer, when considering a transaction for which the tax treatment is uncertain, to internalize the full cost of the harm from non-compliance.”²²⁰ That, in turn, causes the taxpayer to proceed with the transaction only where the post-tax return, discounted for the possibility of the taxpayer losing on the tax issue, remains positive.²²¹

3.2.2. Measures improving the administrative ability of tax authorities

Similar to legislative measures, broad measures have been taken by countries to improve the administrative capacity of their respective tax authority. Government measures to counteract tax avoidance and evasion include improving the administrative initiatives that are designed to improve the detection and prosecution capacity of the tax authority.

Tax administration reforms are a crucial part of any effective strategy to strengthen enforcement of the tax law. Improving the administrative capacity of the tax authority has a twofold purpose; “first, it helps to enable the tax authority to take extensive measures that ensure the voluntary compliance of the taxpayers as mentioned above; and second, it build the capacity of the tax authority that enable it to detect and punish those taxpayer who are not compliant even after all the measures that bring about the voluntary compliance are taken.”²²²

To this effect, countries are on the continuous process of improving their tax administration capacities. Measures in this area include different approaches of organizational reform such as

²¹⁸Supra note 209, P. 125

²¹⁹ Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, (2007), PP. 266-68

²²⁰Ibid, PP. 278-79

²²¹Ibid

²²²Her Majesty's Revenue and Customs, HMRC Approach to Compliance Risk Management for Large Business, 2007, para 1.4

the creation of autonomous revenue authorities and capacity development such as trainings and courses on selected topics, e.g. specialized courses in the area of detecting illegitimate profit shifting activities or tax fraud, but also restructuring of the wage schedule to offer sufficient incentives in order to attract and recruit capable staff and to minimize the risk of corruptive behaviour.²²³

i. Establishing autonomous tax authority

Reforms referring to the organization of the administration are a sensible step to enhance law enforcement. “Often, the organizational setup of the tax administration is a reason for the extent and prevalence of inefficiencies.”²²⁴ Therefore, public administration reforms should aim at simplifying the organizational body of tax administrations and its working structure.

Consequently, different countries have reduced the number of authorities dealing with tax issues and centralize the collection of tax revenues to one single authority.²²⁵

Strategies to strengthen tax administration should also focus on reducing administrative costs inside the tax administration. “For this purpose introducing unique taxpayer identification numbers are considered a useful instrument as they facilitate cross-checking of information between different types of taxes such as VAT and income tax.”²²⁶ In addition, monitoring and auditing of tax payments and tax arrears are easier if a unique taxpayer identification number exist.

Furthermore, qualified, well trained and motivated tax officials are crucial for the collection of taxes and the performance of tax administration bodies as a whole.

In addition to ensuring the organizational autonomy of the tax authority, strengthening its capacity such as audit and tax collection capacity is the necessary tax administration reform to tackle the problem of tax avoidance and evasion.

²²³Supra note 5, P. 18

²²⁴Ibid, P. 18

²²⁵Ibid, P. 18

²²⁶ Supra note 219, P. 20

ii. Improved audit capacity and high probability of detection

Higher audit probabilities and severe penalties encourage tax compliance. Probability of detection refers to the likelihood that the tax authorities will discover an individual's noncompliance and seek to remedy the evasion. "Individuals normally would like to evade their tax liabilities entirely and the only reason they might not do so is that there is some non-zero probability of being caught."²²⁷ "Raising the probability of detection will increase tax compliance and tax audit represents one of the effective detective measures used by tax authorities."²²⁸ In fact, tax audits are considered to have direct deterrent effect on the taxpayers actually audited and indirect deterrent effect on taxpayers not audited.²²⁹ Witte and Woodbury have also found a significant positive relationship between the risk of tax audit and the rate of voluntary tax compliance.²³⁰

Generally, sophisticated tax audit and high probability of detection is an excellent weapon in fighting tax evasion. Thus, improving the audit capacity of the tax authority is one of the administrative measures necessary in tackling the problem of tax evasion and employed by most countries of the world.

Furthermore, the possibility to detect and prosecute tax violators depends crucially on data availability and data quality. Hence, actions taken against tax evasion and avoidance relate to an improvement of the data quality available to tax officers. The inter-institutional exchange of high quality information requires different steps. On the one hand, it is important to ensure the collection of adequate data. Therefore, one needs to ensure a sufficient endowment with technical equipment and the establishment of good performing statistic divisions with competent staff members to collect data and keep records. On the other hand, good technical equipment and technically educated staff are also a prerequisite for a well functioning information exchange.

²²⁷Bordignon and Massimo, (1993), A fairness approach to income tax evasion, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, Journal of accounting and taxation, 2009, Vol. 1, No. 2, P. 37

²²⁸Alm, J. Bahl, R. and Murray, M. (1991), Tax base erosion in developing countries, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, Journal of accounting and taxation, 2009, Vol. 1, No. 2

²²⁹Gerald Chau and Patrick Leung, A critical review of Fischer tax compliance model: A research synthesis, Journal of accounting and taxation, 2009, Vol. 1, No. 2, P. 3

²³⁰Supra note 215

Along these lines, automation of tax collection procedures e.g. through online tax assessment, payment and monitoring opportunities may serve as an efficient way to reduce the scope for tax evasion and avoidance.

Chapter Four: Tax Avoidance and Evasion in Ethiopia

This chapter is intended to analyze the concept of tax avoidance and evasion in the Ethiopian context and measures taken by the government of Ethiopia in countering them. It also examines the adequacy of tax legislations and the administrative capacity of the tax authority in countering tax avoidance and evasion.

4.1. Causes of tax avoidance and evasion under the Ethiopian context

Though different in the gravity of their severity, causes of tax avoidance and evasion are similar for all countries. Ethiopia cannot be an exception to this practice. Thus, when we think about causes of tax avoidance and evasion in Ethiopia, we have to remember the general causes stated under chapter two of this paper.

4.1.1. Causes of Tax Avoidance and Evasion that Affect the Voluntary Compliance of Taxpayers

Voluntary compliance of taxpayers is important in bringing about cost-effective and efficient way of collecting tax. However, voluntary compliance of taxpayers might be influenced by different factors. Low taxpaying moral and high compliance cost are the foremost factors under this category.

4.1.1.1. Low Taxpaying Moral

Low taxpaying moral is the main factor that affects the voluntary compliance of taxpayers and in turn increases the extent of tax avoidance and evasion. When there is low taxpaying moral, taxpayers look for ways of evading or otherwise avoiding their tax liability. The level of taxpaying moral under Ethiopian situation is, thus, to be determined on basis of the following factors.

i. Level of Taxpaying Culture and Norms

Compared to developed countries, taxpaying culture and norm is very low in developing countries.

Concerning the level of taxpaying culture in Ethiopia, there are limited researches. One of these researches is the survey by Zelalem Birhane in 2011. According to him, “among the respondents asked whether they think it is ethically wrong if they exclude small amount of income when they are filing their tax return, 47.2%, of respondents didn’t agree that it is ethically wrong to exclude small amount when completing the tax return while only 16.2% respondents agreed that it is wrong.”²³¹

The other is the report by World Customs Organization (WCO) in 2011 concerning the problem encountered in assisting the Ethiopian Customs Authority in the modernization of the country’s custom system. According to WCO, “low level of positive and compliant attitude of the public on taxation is the main problem in Ethiopian.”²³²

On the basis of these finding and the result of researches made in developing countries, one can say, though not conclusive, that taxpaying culture is low in Ethiopia.

ii. Level of Quality of Service in Return for Tax

Quality of service in return of the tax collected and fairness of the tax system is important in determining the tax moral of taxpayers.

When we come to the case of Ethiopia, again the perception of taxpayers on the level of quality of service in return for the tax is not clearly known. On the part of government, it is always claimed that revenue collected from the taxpayers in the form of tax are properly utilized for the public good. On the part of taxpayers, though there is no extensive research on it, the survey by Wubshet Aborat demonstrates that the majority of the surveyed and interviewed business profit taxpayers have expressed their disappointment and discomfort concerning the issue of fairness. These participants firmly believe that tax revenues were not properly spent in desired areas, such as health and education and instead wasted on government bureaucracy which has in turn led to

²³¹ Zelalem Berhane, *The Influence of Tax Education on Tax Compliance Attitude*, 2011, P. 106

²³² World Customs Organization (WCO), *Custom reform and Trade Facilitation in Ethiopia*, 2011, P. 6

the loss of trust on the government.²³³ “Some participants further commented on the transparency issue where they claimed that the taxpayers were not well- informed of the details of how the tax revenue is spent.”²³⁴ They expected a full disclosure of government expenditure allowing them to examine the accounts and demonstrating greater government accountability. Specifically, there are comments that there are a lot of hidden tax revenues spending, which have not been made public or told to the public.²³⁵

The research by Zelalem Berhane also shows that “only 16.2% of the total respondents surveyed and interviewed feel that the tax collected by the government is utilized properly while 56.1% feel that the tax collected is improperly utilized.”²³⁶

iii. Level of knowledge and awareness about the importance of paying tax

In Ethiopia, though very limited in number, researches reveal that taxpayers’ awareness of the reason why they pay tax is very low. For instance, according to Wubshet Aborat, “99% of taxpayers surveyed and interviewed have given their response on the reason why they pay taxes.”²³⁷ “59.3% of these respondents replayed that they pay taxes because it is a compulsory act while only 28 percent of the respondent said that it is a duty of participation in public services.”²³⁸

From this survey, though not conclusive, one can understand that taxpayers do not know the exact reason why they pay tax since the majority of them consider tax as a compulsory debt they owed to the government. Only few of them knows the fact that paying tax is the way through which citizen participates in building basic infrastructures and the capacity of their country is manifested.

²³³Wubshet Aborat , Taxpayers’ Perception towards Fairness: Personal Business Profit Taxpayers in Addis Ababa, 2011, P. 104

²³⁴Ibid

²³⁵Ibid

²³⁶Supra note 231, P. 108

²³⁷Ibid, P. 82

²³⁸ Ibid

iv. Corruption

In Ethiopia, it is difficult to know the extent of corruption in relation to tax. However, some reports are made by international bodies regarding the general extent of corruption in Ethiopia which also includes tax related corruption. “Transparency International’s 2011 Corruption Perceptions Index, which measures perceived levels of public sector corruption, ranked Ethiopia as 2.7 out of 10 (with 0 indicating —highly corrupt and 10 indicating —very clean).²³⁹ According to this report, Ethiopia's rank on the corruption perception index was 120 out of 182 rated countries in 2011 and 116th out of 178 rated countries in 2010.”²⁴⁰

According to the outcome of the corruption survey conducted in 2001 by Ethiopian Anti-corruption commission, “the areas where corruption is believed to be rampant are those where financial resources are transferred from the private to the public sector and taxes collection, customs and excise offices.”²⁴¹

According to the paper presented by Eyasu Yimer (Executive Director Transparency Ethiopia) on seminar organized by the Ethiopian International Institute for Peace and Development (EIIPD), “tax and financial sector are the forefront areas that are prone to corruption in Ethiopia.”²⁴²

From this, it is clear that though the specific figure of corruption in relation to tax is not available in Ethiopia, corruption is high in the country and may be one of the causes for low tax moral and high tax evasion.

v. Level of Tax Rate

To assess the level of tax rate in Ethiopia, we have to compare the total tax rate of Ethiopia with the total tax rate of other countries. To this effect, the report of World Bank on the tax rate of almost all countries of the world is very essential.

²³⁹ US Department of State, *Doing Business in Ethiopia: Country Commercial Guide for U.S. Companies*, 2012

²⁴⁰ *Ibid*

²⁴¹ Tesfaye Shamebo, *Anti Corruption Efforts in Ethiopia*, (Federal Ethics & Anti-Corruption Commission of Corruption Prevention & Research Department), 2003, P. 4

²⁴² Eyasu Yimer, *Main Areas of Corruption in Ethiopia*, Report on the seminar “Corruption in light of development and democratization,” 2012, P. 7

According to the report made by the World Bank recently in 2013 on tax rate, “the total tax rate of Ethiopia is 33%.²⁴³ The same report, demonstrates that the total tax rate for sub-Sahara Africa and OECD is 57.8% and 42.7% respectively.”²⁴⁴ In addition, “the 2012 World Bank report shows that the global average total tax rate is 44.8%.”²⁴⁵ Furthermore, “as per the report of the World Bank 2012 Ethiopia is ranked 45th out of 183 countries with the total tax rate of 31.1% before mandatory contribution for pension of private organization employees (social security contribution) is being introduced.”²⁴⁶

From this, it is evident that the total tax rate of Ethiopia is not high in relation to other countries. Regardless of this fact, however, Ethiopia made no tax rate reform during the past decade which the majority of countries have undertaken. During the years covered by the report of World Bank, i.e. 2006-2013, “no reform measure is taken by the government of Ethiopia regarding the tax rate cut other than introducing mandatory contribution for pension of private organization employees in 2011 which is an additional burden.”²⁴⁷

4.1.1.2. Compliance cost

Compliance cost is determined on the basis of different indicators. Among these indicators, the time required for discharging the tax liability and the financial compliance cost, i.e. the finance required to hire those professionals who help taxpayers in filling and filing the tax return are very important. Regarding the general compliance cost in Ethiopia, the survey by Amin Abdella and John Clifford shows that “almost 90 percent of the surveyed taxpayers believe that the total compliance cost is high or very high.”²⁴⁸

i. Time compliance cost

The time indicator captures the number of hours it takes to prepare, file and pay taxes. The time required to comply with tax liability is very high in Ethiopia as indicated by the report of World

²⁴³The International Bank for Reconstruction and Development / The World Bank, Comparing Business Regulations for Domestic Firms in 185 Economies: Doing Business 2013, P. 67

²⁴⁴Ibid

²⁴⁵Supra note 77, P. 15

²⁴⁶Ibid, P. 125

²⁴⁷Supra note 239, P. 66

²⁴⁸Amin Abdella and John Clifford, The Impact of Tax Reform on Private Sector Development (Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations), 2010, P. 40

Bank. According to this report in 2013, “on average, firms make 31 tax payments a year and spend 306 hours a year filing, preparing and paying taxes while the regional average (Sub-Sahara Africa) and the OECD is 39 & 12 tax payments a year and 319 & 176 hours a year for filing, preparing and paying taxes respectively.”²⁴⁹ “Globally, Ethiopia stands at 103 in the ranking of 185 economies on the ease of paying taxes in this regard while regional average (Sub-Sahara Africa) is ranked at 123.”²⁵⁰

Thus, though the time required for discharging tax liability in Ethiopia is good in relation to the African countries, it is high in relation to the world average and developed countries.

ii. Financial compliance cost

As to the financial compliance cost, there are so many costs that are to be covered by the taxpayer in addition to the time that might be lost. Unlike time compliance cost, financial compliance cost is a cost that is a real cost incurred by the taxpayer in cash. Record keeping and furnishing the same to the tax authority when required, remuneration that is to be paid to the tax advisors and other experts who help taxpayer in filling and filing tax return, and the transportation and other cost incurred by the taxpayer in going to and returning back from the office of the tax authority are examples of these costs. It is the total money spent on filling out forms, keeping records, learning tax rules, and other tax related tasks.

Under the Ethiopian income tax proclamation, Schedule B and Schedule C taxpayers are required to declare their income to the tax authority and make payment of the same by themselves. Accordingly, every taxpayer who has Schedule B or Schedule C income shall prepare a declaration of his income in a form prescribed by the Tax Authority and submit the tax declaration to the tax authority at the time of submitting the balance sheet, and the profit and loss account for that tax year.²⁵¹

In the same fashion, withholding agents, i.e. employer of the Schedule A and others under Schedule D taxpayers, are required to withhold the tax they are obliged to do so under the proclamation and submit the same to the tax authority. An employer shall withhold tax from

²⁴⁹Supra note 239, P. 66

²⁵⁰Ibid

²⁵¹ Art. 66 (1) of Income Tax Proclamation of 2002

every "payment to an employee, unless the payment is expressly made tax-exempt by this Proclamation and pay the withheld tax to the tax authority within thirty (30) days of the end of each calendar month."²⁵² The payer of any payment subject to tax under Schedule "D" shall also withhold from the payment the amount of tax required by Schedule 'D' and pay the withheld tax to the Tax Authority within fifteen (15) days of the end of each calendar month.²⁵³

Furthermore, under article 26 of Value Added Tax (VAT) proclamation of the 2002 and article 6 of turnover tax proclamation of the 2002, traders are under an obligation of withholding the consumption tax on their sale and submit the same to tax authority within the deadline (accounting period), i.e. the calendar month for VAT registrants and category 'A' turnover taxpayers, three month period commencing from the first day of the Ethiopian fiscal year for category "B" taxpayers and the fiscal year for Category "C" taxpayers.

In such a process taxpayers and tax withholding agents will incur different costs that make financial compliance cost high.

4.1.2. Causes of tax avoidance and evasion that relates to the legal framework in Ethiopia

4.1.2.1. Loopholes within the tax legislations of Ethiopia

When there is a loophole within the tax legislation there is always tax avoidance. It is impossible to close all the loopholes within the tax legislations. One of the causes of loophole is exemptions and exception in the tax legislation. In fact, exempting some activities from taxation is a policy objective and has its own advantage. Under the Ethiopian tax legislations, there are so many exemptions and exceptions as well as tax incentives that are motivated by different policy objectives. Under all tax proclamations and regulations, there are exemptions.

Though it is impossible to avoid exemption from being granted due to its necessity in some cases, strong regulation is necessary in order to prevent unexpected consequences. If not properly regulated exempting some activities from taxation and giving some investors tax incentives may create problem by encouraging tax avoidance.

²⁵²Ibid, Art. 51 (1 & 3)

²⁵³Ibid Art. 54 (1 & 3)

When we see the extent of exemption and incentive under the Ethiopian tax legislation, many activities are exempted from taxation. For instance, under the income tax proclamation activities that are listed under articles 13, 30 and 37(2) of the proclamation and 3 of the regulation thereto are exempted. Under turnover tax proclamation, goods and services listed under article 7 of the proclamation are exempted and furthermore, the Minister of Finance and Economic Development is given the power to exempt other goods and services by directives. The same exemption is given under article 7(2) and article 8(2) of the VAT proclamation.

As to the tax incentives under the Ethiopian taxation regime, profit tax holiday is granted in accordance with the Council of Ministers Regulation No. 84/2003. According to the regulation, (now repealed), investors engaged in a new manufacturing or agro-industry activities are the beneficiary of the incentive.²⁵⁴

- a) If at least 50% of its production is to be exported, profit tax exemption is for 5 years. In addition, if the investment is made in relatively under-developed regions the profit tax exemption is for 6 years;
- b) If at least 75% of its production will be input for the production of export items there is also a profit tax exemption for 5 years. If the investment is made in relatively underdeveloped region the exemption would be for 6 years;
- c) If the project is evaluated under a special circumstance by the investment board the profit tax exemption would be given up to 7 years. If the investment is made in relatively underdeveloped regions the profit tax exemption would be given up to 8 years. However, the granting of income tax exemption for a period longer than 7 years requires the decision of the Council of Ministers;
- d) If less than 50% of the production is to be exported the profit tax exemption would be given for 2 years. If the investment is made in relatively under-developed regions the exemption would be given for 3 years;
- e) If the production is for the local market there is a profit tax exemption for 2 years; and if the investment is made in relatively under-developed regions the exemption would be given for 3 years;

²⁵⁴Art. 4 of the Council of Ministers Regulations on Investment incentives and Investment Areas Reserved for Domestic Investors, Regulation No. 84/2003

f) If the production mentioned above under (d) and (e) is considered by the investment board to be a special one the profit tax exemption would be given up to 5 years. If the investment is made in relatively under-developed regions the exemption would be given up to 6 years.

It is to be noted that for expansion or upgrading of the above projects which would increase the existing production by 25% in value and if 50% of the production is to be exported, a profit tax exemption would be given for 2 years.

In addition to this, most of the investment goods are exempted from custom duty at the time of their importation. For instance, investors are granted 100% exemption from the payment of import customs duties, and other taxes levied on imports of all investment capital goods, such as plant machinery and equipment, construction materials, and as well as spare parts worth up to 15% of the value of the imported investment capital goods, provided that the goods are not produced locally in comparative quantity, quality and price.²⁵⁵ Exemptions from customs duties or other taxes levied on imports are also granted for raw materials that are necessary for the production of export goods. Furthermore, duty free privilege are given to some persons to import some personal goods like automobile, personal effects and household goods without paying duties and taxes.

This, exemption of investment goods and privileged persons from customs tariffs and other related taxes might result in the abuse of tax free privileges (notably the diversion of goods intended for investment into other markets), and the fact that the available incentives disfavour existing businesses/investors.²⁵⁶

From this, it is clear that the Ethiopian tax law is full of exemptions and incentives. This high number of exemptions and incentives, on the other hand, will be the main cause of tax avoidance unless properly and strictly regulated.

When we see the practical cases in relation to this, much attempts have been made to exploit these exemptions and incentives though not as complicated as that confronted by developed economies. Majority of these cases are related to improper using of investment and personal

²⁵⁵Ibid, article 8

²⁵⁶Supra note 248, P. 53

goods imported free of custom duty, like selling or transferring them in a way that contradict with the intention of the law that gave such exemptions and privileges. Among these, let me raise some cases that got their final ruling by the Federal Supreme Court Cassation Division.

In *W/ro Almaz Dese vs. Ethiopian Customs Authority*,²⁵⁷ the appellant, i.e. W/ro Almaz has imported Suzuki vehicle with code no. 2.76388 AA free of the custom duty under declaration no. 31701 using the duty free privilege accorded by law to persons returned back to Ethiopia after living abroad to import personal goods. Later on, she transferred the vehicle to another person and at the same time, gave it for Wegagen Bank as collateral for the money she borrowed.

The respondent, i.e. the Ethiopian Customs Authority, prosecuted the appellant claiming that the later has committed a crime under article 73 of proclamation no. 60/1997, a proclamation for the re-establishment and modernization of customs authority, by transferring a vehicle imported free of the custom duty to another person and giving the same as collateral for the borrowed money claiming that such act is against the purpose of the law that gave such a duty free privilege. The court before which this case is first instituted, the Federal First Instance Court, has convicted the appellant under the claimed legal provision and sentenced her with fine of 100,489.37 Birr & 6 months imprisonment, and ordered the forfeiture of the vehicle. Though she appealed against the decision of the First Instance Court to the Federal High Court, the later confirmed the decision of lower court.

It is after this that the case was brought before the Federal Supreme Court Cassation division by the appellant for the claim of fundamental error of law. The cassation bench, on its part, analyzed the issue in line with relevant legal provisions and the general spirit of the law that gave such duty free privilege and finally confirmed the decision of lower courts principally reasoning that the vehicle under question had been used for the purpose that is not intended by the law though the appellant argued that her act does not constitute transfer of property as defined under 1186 (1) of the civil code.

²⁵⁷W/ro Almaz Dese vs. Ethiopian Customs Authority, Federal Supreme Court Cassation Decisions, File No. 58266, in Amharic, Vol. 11, PP. 354-56

In *Ethiopian 7th day Adventist Church vs. Akaki-Kaliti Sub-City Administration Revenue Office*,²⁵⁸ a dispute arose over whether the Akaki's Adventist missionary school, which is owned and administered by the Ethiopian 7th day Adventist Church, pays a land and building tax. The respondent, i.e. Akaki-Kaliti Sub-City Administration Revenue Office, claimed that the school should pay land and building tax for it generates a profit like other private schools. The school, on its part, argued that it is not liable for paying land and building tax for it is a charitable organization/religious institution that legally exempted from paying the land building tax and not a legal entity independent of the Ethiopian 7th day Adventist Church. The Addis Ababa City First Instance Court ruled the case in favour of the respondent reasoning that the school is not giving charitable service for it charge high service fee from student which is not different from other private schools established for profit making.

Though the school has appealed against the decision of the lower court, both Addis Ababa City High Court and the Addis Ababa City Cassation Bench confirmed the decision of the lower court. Dissatisfied with this decision, the appellant brought its case before the Federal Supreme Court Cassation division claiming that the lower courts have committed a fundamental error of law by ordering the school which is free from paying tax under proclamation no. 80/1976 article 14 by being charitable organization/religious institution. The Federal Supreme Court cassation bench analyzed the issue with the provision of law, article 14 of the law claimed by the appellant. The claimed law provides that religious institutions and their compound is free from land and building tax.

The cassation bench, finally, confirmed decisions of the lower courts saying that the appellant shall not be free from paying land and building tax under the claimed law reasoning that the school is not found in the compound of the church and at the same time, is generating high income from the service by charging service fee from students which is not different from other profit making private schools and hence, what is claimed by the appellant is not the purpose and sprit of article 14 (b) of proclamation no. 80/1976.

²⁵⁸Ethiopian 7th day Adventist Church vs. Akaki-Kaliti Sub-City Administration Revenue Office Federal Supreme Court Cassation Decisions, File No. 66474, in Amharic, Vol. 13, PP. 506-510

In *Ato Akale Alemu vs. Ethiopian Revenues and Customs Authority*,²⁵⁹ the appellant, i.e. Ato Akale has imported Toyota vehicle with code no. 2-544552 AA and motor no. LM7-5892294 free of the custom duty after living in America from 1990 to 2004 using the duty free privilege accorded by law to persons returned back to Ethiopia after living abroad to import personal goods. Later on, he transferred the vehicle to a person called Ato Tesfaye Tsegaye to use it, and at the same time, gave it for Ethiopian Development Bank as collateral for the money he borrowed.

The respondent, i.e. the Ethiopian Revenues and Customs Authority, prosecuted the appellant claiming that the later has committed a crime under article 73 of proclamation no. 60/1997, a proclamation for the re-establishment and modernization of customs authority, by transferring a vehicle imported free of the custom duty to another person and giving the same as collateral for the borrowed money claiming that such act is against the purpose of the law that gave such a duty free privilege. The court before which this case is first instituted, the Federal First Instance Court, has convicted the appellant under the claimed legal provision and sentenced him with fine of 170,603.21 Birr & 9 months imprisonment, and ordered the forfeiture of the vehicle. Though he appealed against the decision of the First Instance Court to the Federal High Court, the later confirmed the decision of the lower court.

It is after this that the case was brought before the Federal Supreme Court Cassation division by the appellant for the claim of fundamental error of law. The cassation bench, on its part, analyzed the issue in line with relevant legal provisions and the general spirit of the law that gave such duty free privilege and finally, confirmed the decision of lower courts principally reasoning that the vehicle under question had been used for the purpose that is not intended by the law.

All these cases show that attempts are made to exploit exemptions given by the law to some activities and persons though the court finally ruled the case in favour of the tax authority.

The other problem in relation to deficiency in the tax law is that some activities are not completely regulated. In fact, it is impossible to regulate each and every activity at once. In

²⁵⁹ Ato Akale Alemu vs. Ethiopian Revenues and Customs Authority, Federal Supreme Court Cassation Decisions, File No. 69602, in Amharic, Vol. 13, PP. 539-42

practice some gaps might be occurred. Such a problem is not left from being occurred in Ethiopia too. The following two cases are an indication of this fact:

In *FDRE Ministry of justice vs. Ato Tekle Garedow et al*,²⁶⁰ a dispute arose over whether employment tax is payable on compensation paid for the employees retired from their job due to age before their eligibility for pension. The relevant provision of law, i.e. article 10 (1) of the 2002 income tax proclamation, provides that every person deriving income from employment is liable to pay tax on that income at the rate specified. Article 13 of the proclamation, on the other hand, lists those employment incomes free from tax that include pension contribution, provident fund and all forms of retirement benefits contributed by employers in an amount that does not exceed 15% of the monthly salary of the employee. While mentioning these exemptions the proclamation does not clearly provided about the compensation made to employees that stopped working due to their age before they are eligible for pension.

The civil service administrative court before whom the case is first instituted and the Federal Supreme Court that entertained the case as an appeal had adjudicated the case in favour of the respondents saying that employment tax should not be paid on the said compensation for it is very similar with pension.

The appellant, FDRE Ministry of justice, had brought the case before the Federal Supreme court cassation division claiming that the lower courts have committed a fundamental error of law by making the mentioned payment free from tax. The cassation bench, after looking the issue in line with relevant legal provisions, confirmed the decision of lower courts saying that though there is no clear legal provision exempting the said payment from tax, it is not the intention of the law to tax such payment while pension that is very similar with it is exempted.

In *Abyssinia Bank S.C. vs. Federal Inland Revenue Authority (FIRA)*,²⁶¹ a dispute arose over whether the sale of collaterals in a foreclosure by the Bank constituted a taxable transaction for

²⁶⁰FDRE Ministry of justice vs. Ato Tekle Garedow et al, Federal Supreme Court Cassation Decisions, File No. 65330, in Amharic, Vol. 11, PP. 369-70

²⁶¹*Abyssinia Bank S.C. vs. Federal Inland Revenue Authority*, Federal High Court, File No. 31952, in Amharic, unpublished, as analyzed by Taddese Lencho under an article "VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia",

VAT purposes. Abyssinia Bank S.C. (lender) took tires from Tana International Trading PLC (the borrower – hereinafter simply Tana International) as security for the payment of loans it extended to the latter. Tana International defaulted on its payment, and Abyssinia Bank sold the tires (collaterals) in a foreclosure sale for a total price of 4 million ETB. The Tax Authority assessed that VAT was due on the sales, to which the Bank objected.

Abyssinia Bank argued that the sale was exempted from VAT as Abyssinia Bank is a financial institution. Federal Inland Revenue Authority (FIRA – the predecessor of ERCA) argued that the sale was not an exempt transaction although the Bank was a financial institution.

Abyssinia Bank appealed against the decision of the Tax Authority to the Tax Appeal Commission. The Commission decided by a majority opinion that the sales of tires by Abyssinia Bank S. C. constituted taxable transactions. The case went to the High Court on appeal, which reversed the decision of the Tax Appeal Commission. The High Court ruled that the sale did not constitute a taxable transaction as the sale by the Bank was not a continuous or regular activity of the Bank.

4.1.2.2. Extent of Penalty

Under the Ethiopian taxation law high penalty is provided. Under all tax proclamations of Ethiopian, two types of penalties are provided. These are administrative penalty and penalty by court of law (punishment for offenses which include both fine and imprisonment).

All tax proclamations of Ethiopia proclaim that taxpayers that fail to fulfill the requirements of tax liability are chargeable with penalties ranging from financial penalties to imprisonment which is high. Thus, the extent of statutory penalty is not low in the case of Ethiopia and cannot be raised as the cause of tax evasion.

Rather statutorily provided penalties are severe and even, more than necessary in some cases. In some incidents, the financial penalty exceeds the total value of the assets of the business, leading

to its closure.²⁶² According to the survey undertaken by Amin Abdella and John Clifford, “more than 80% of the respondents consider the financial penalties to be severe or very severe.”²⁶³

On the other hand, provision of high level of penalty has not barred habitual evaders from their conduct for the probability of detection is very low. This weakness in ensuring high probability of detection has laid a shadow on the effectiveness of the penalty, and as a result, habitual noncompliant taxpayers remained indifferent. This matter is highly reflected in a survey of taxpayers by Zelalem Berhane. According to him, “94.3% of the surveyed taxpayers responded that they wish not to comply with tax laws because of the non-serious enforcement of penalty by the tax authority that may result if they do not comply.”²⁶⁴ That is, these respondents do not agree with the existence of serious enforcement of penalty by the tax authority. “Only 5.7% respondents agree that there may result serious enforcement of penalty by the authority if they do not comply.”²⁶⁵

Therefore, even though there is strict statutory penalty for the non-compliant taxpayers under the Ethiopian tax legislation, the enforcement and the probability of detection is weak rendering the penalty ineffective.

4.1.3. Administrative Framework

The weakness of administrative capacity of the tax authority takes the upper position in contributing for the increase in tax avoidance and evasion. Like other developing countries, administrative capacity of the tax authority of Ethiopia is limited in many aspects though on the process of gradual improvement.

As per survey outcomes by Wollela Abehodie, “34.2% of taxpayers that responded to the questionnaire replied that tax administrators are not qualified enough and also not capable of

²⁶²Supra note 248, P. 39

²⁶³Ibid

²⁶⁴Supra note 231, p. 82

²⁶⁵Ibid

handling cases quickly, particularly at the time of audit.”²⁶⁶ “These respondents further indicated that tax administrators lack confidence to make decisions and willingness to help taxpayers.”²⁶⁷

Similarly, “55.2% of tax practitioner survey respondents emphasized the lack of well trained personnel and noted the necessity of staffing the tax authorities with qualified personnel.”²⁶⁸

In addition to this, the survey by Zelalem reveals that “the majority of the respondents wish not to comply with the tax laws because they believe that the tax authority has weak capacity to investigate the correct amount of income that must be reported.”²⁶⁹

In general, the quality of auditors that appears to be poor coupled with their relatively small number is affecting the effectiveness of the audit program. This is, in turn, likely to impact on the revenue that could be generated through effective audit programs and on the use of effective audits as tools of deterring noncompliance. Thus, the weakness of the tax authority in properly auditing the tax liability and detecting tax evaders can be raised as one of the causes of tax evasion in Ethiopia.

The other thing that should be considered under this topic is the extent of underground/informal economy in Ethiopia. Underground/informal economy is one of the prevalent problems in Ethiopia. Though it is the problem of all countries, underground economy is high in Ethiopia. Everyone knows that in, Ethiopia, informal trade is almost equals with the formal one. Every day, we witness when the street is filled with those traders who are not formally registered and do not pay tax on the income they receive from their activities.

Though it is difficult to correctly know the estimate of underground economy, the econometric estimation reveals that “the underground economy in Ethiopia amounted to about 35.9% of the official economy over the estimated period reaching the highest level of 51.8% and 51.4% in 1979 and 1985.”²⁷⁰ “It is estimated that the amount of the hidden economy is about 28.2% over

²⁶⁶Wollela Abehodie , “Value Added Tax Administration in Ethiopia: A Reflection of Problems,” eJournal of Tax Research, 2008, Vol. 6, No. 2, p. 155

²⁶⁷Ibid

²⁶⁸Ibid

²⁶⁹Supra note 231, P. 113

²⁷⁰Central Statistical Agency (CSA), Report on Urban Informal Sector Sample Survey, Statistical Bulletin , 2004

the years since 2000 while the ratio of evaded tax to official GDP due to underground economy is as high as 10% over the entire period.”²⁷¹

The estimation result shows that “the informal economy was significant during the late 1970’s, the 1980’s, and early 1990’s partly owing to the widespread conflict, civil war and instability that prevailed in the country demanding the government extra tax burdens on economic agents.”²⁷²

According to the study, “the lowest level (in percent of GDP) of the informal economy is observed in 2004 (23.4 percent).”²⁷³ “Succeeding years are also characterized by one of the lowest prevalence of the underground economy in the country.”²⁷⁴ “For the years 2007 and 2008, the informal economy again started to swell.”²⁷⁵ “This new development seems to be in response to the government’s huge engagement in the tax market by introducing various types of tax burdens.”²⁷⁶

Another important observation is that “the underground economy has been growing on average by 1.4 percentage points more than the formal economy over the entire data.”²⁷⁷

“The difference in growth rate of the two economies was a little bit higher after 1991(reaching 2.0 percentage points) and since 2007 (growing more by 2.9 percentage points) implying that the informal economy is again becoming a dominant sector in the country.”²⁷⁸

In terms of employment, “the informal sector accounts for the majority of employment in Ethiopia. According to the CSA’s 2005 labour force survey report, the informal sector represents 71 percent of urban employment and 81 percent of youth employment.”²⁷⁹ “Several sectors are almost exclusively informal (at least as measured by the number of employees in the sector).”²⁸⁰

²⁷¹Ibid

²⁷²Emerta Asaminew, *The Underground Economy and Tax Evasion in Ethiopia: Implications for Tax Policy* (Ethiopian Economic Policy Research Institute (EEPRI)), 2010 , P. 16

²⁷³Ibid

²⁷⁴Ibid

²⁷⁵Ibid, P. 17

²⁷⁶Ibid

²⁷⁷Ibid

²⁷⁸Ibid

²⁷⁹Central Statistical Agency, *the 2005 Labor Force Survey Report*, 2006

²⁸⁰Ibid

From these empirical data, it is easy to understand that underground economy is very high in Ethiopia. This high level of underground economy boosted the level of tax evasion in the country.

4.2. Measures Taken to Tackle Tax Avoidance and Evasion in Ethiopia

Different reform measures are taken by the government of Ethiopia to improve the amount of revenue to be raised from taxation and in turn to reduce the prevalence of tax evasion and avoidance. This section is, thus, meant to discuss the measures taken by the government in tackling tax avoidance and evasion. In relation to this, the writer of this paper has also made an interview with Miss Tihtina Belete, Team coordinator of tax compliance and risk management at the Ethiopian Revenues and Customs Authority.

4.2.1. Measures taken to improve voluntary compliance of taxpayers

Securing voluntary compliance of taxpayers is the first measure that should be taken in tackling tax avoidance and evasion. Government cannot “control” every individual taxpayer. Above all, government needs to provide taxpayers with everything necessary to secure their voluntary compliance.²⁸¹ Taxpayers should be treated as customers of the tax authority rather than enemies and thus, an attempt should first be made to do away with causes of tax avoidance and evasion that affect voluntary compliance. Enforcement action and appropriate penalties should only be taken if taxpayer chooses not to comply after all the necessary actions to enable voluntary compliance are fulfilled.

In this respect, some measures are taken by the government of Ethiopia though not satisfactory. These measures are:

i. Educating Taxpayers

Educating taxpayers about the importance of paying tax is one of the measures employed by ERCA starting from the last few years. Tax officials arrange meetings with taxpayers to provide clarifications on different tax issues. Especially, in Addis Ababa, the tax authority organizes

²⁸¹Andrew Okello, Tax Administration reforms - recent trends and developments, (Compliance Management in Tax Administration Workshop, Nairobi, Kenya, November 3-7, 2008)

different discussion forums for taxpayers in an attempt to give the necessary awareness on the tax and taxation system of the country.

The tax authority has also developed a website to provide information related to tax matters and make available all tax proclamations with their amendments, all regulations with their amendments and all directives.

As stated by Miss Tihtina, ERCA is using different Medias such as Radio programs, i.e. National Radio and FMs, 11 times a week; TV-program through ETV-1 weekly on Sunday morning; Monthly News Paper which is called ‘Gebii Lelimat’; and different panels through ETV-2 & 3 on different tax related topics for the purpose of increasing the awareness of taxpayers on importance of paying tax. She further said that there were different panels in the head office and other public areas held by the Director General Ato Melaku Fenta with an intention of creating awareness on the importance of paying tax.

These measures can be raised as an attempt made by ERCA to create awareness about the importance of paying tax and in turn to build the taxpaying culture of the society.

However, regardless of this effort the availability of tax information to the public remains unsatisfactory.²⁸² Most taxpayers do not have the required level of knowledge about the tax and tax system of the country. In respect of the business profit tax knowledge, the survey by Wubshet Aborat shows that “37.3 and 38.0 percent of survey respondents replied that there are no explicit mechanisms that enhance the awareness of tax system and tax knowledge in general, and 15.3, 3.3 and 6 percent of the survey respondents indicated that there are no any tax training /follow up, technical and legal knowledge provided by the tax authority to them.”²⁸³ As a result it is not easy for the average taxpayer to understand and comply with the tax laws.

ii. Combating corruption

In reducing the incidence of tax corruption, some reform measures are taken by the government. The significant reform of recent times in this respect is the decision to create special personnel administration rules and procedures for employees of the tax authority in 2008 following the

²⁸²Supra note 248, P. 66

²⁸³Supra note 233, P. 90

reorganization of the tax authority under the Ethiopian Revenues and Customs Authority (ERCA). Though bound to become controversial for they depart from and at times conflict with the general rules of civil service regulations in Federal Civil Service laws, the special rules and procedures of the “Special Personnel” Regulations have come up with novel requirements and procedures, which are not contemplated in the Federal Civil Service Laws in requiring prospective and existing employees of ERCA to submit property held in their names or in the name of their spouses or minor children for registration.²⁸⁴ This rule is no doubt meant to combat corruption.²⁸⁵ The Regulations have also contained a long list of offenses which entail rigorous penalties.²⁸⁶

Furthermore, leaving the issue of due process of law and the rights of employees for another research, the new Regulations confer sweeping powers upon the Director of ERCA to pass a final decision on the dismissal of any employee of the authority upon mere suspicion of corruption. To this effect, a department called ‘Ethics Liaison Directorate’ which follow up and controls the behavior of the employees of the authority is established at the head office and branch offices.

In addition to this, strict and rigorous penalties up to Birr 50,000 and imprisonment for a term of not less than 10 years and not more than 20 years is provided under all tax proclamations for tax officer who in connection with any of his duties, directly or indirectly asks for or receives a payment or reward, whether pecuniary or otherwise, or promise or security for that payment or reward, not being a payment or reward to which he is lawfully entitled to receive; or enters into or acquiesces in an agreement to do or to abstain from doing anything, or to permit, conceal or connive at any act where by the tax revenue defrauded or which is contrary to the provisions of the tax law or to the proper execution of his duty; or exceeds the power conferred upon the Tax Authority or misuses such authority.

As per the interview with Miss Tihtina, the other measure that is raised as anti-corruption measure is the use of cash register machine to counteract corruption that may arise in manual

²⁸⁴Taddese Lencho, The Ethiopian Tax System: Excesses and Gaps, Michigan State International Law Review, Vol. 20:2, P. 350

²⁸⁵Ibid

²⁸⁶Ibid

determination of business profit and VAT. Cash register machine reduce the probability of corruption in a way that the direct contact between the taxpayer and the tax officer in assessing tax obligation of the taxpayer will become less since all information will be retrieved from the machine.

iii. Tax rate cut/reducing the tax rate

Regarding tax rate reduction, some reforms are taken by the government in relation to the situation before 1991. “After 1991, income tax rates were reduced both to encourage individuals to work more and to address issues of vertical equity.”²⁸⁷ For example, until 1992, “the maximum employment tax rate was 85% at a graduating level above the threshold of Birr 50 monthly.”²⁸⁸ “In 1992 the highest tax rate was reduced to 50% while the threshold was raised to Birr 105 monthly.”²⁸⁹ “The highest rate was subsequently further reduced to 35% and the threshold level raised to Birr 120 monthly.”²⁹⁰ “The business income tax rate was reduced from 59 to 40% in 1995.”²⁹¹ “In 1996 the rate was further reduced to 35% so as to encourage business development.”²⁹²

“Dividend tax rate was reduced from 25% to 10% in 1992. Royalties was reduced from 40 percent to the current rate of 5%.”²⁹³

iv. Introduction of e-filing and payment

Electronic filing and payment is the main tool employed by other countries in reducing the compliance cost of taxpayers. In Ethiopia, e-filing and payment has got the legal base under the 2008 Proclamation to Amend the Income Tax Proclamation No. 608/2008 and the Proclamation to Amend the Value Added Tax Proclamation No. 609/2008 for the first time. ‘Electronic filing and payment system’ is defined under Proclamation to Amend the Income Tax Proclamation No. 608/2008 as a method of e-filing and e-payment made by using a computerized network.

²⁸⁷Supra note 248, P. 39

²⁸⁸Ibid

²⁸⁹Ibid

²⁹⁰Ibid

²⁹¹Ibid

²⁹²Ibid

²⁹³Ibid

A Proclamation to Amend the Income Tax Proclamation No. 608/2008 has also provided that the tax to be paid to the tax Authority by the taxpayer can be made through electronic filing and payment system pending the time for the commencement of such mode of payment to be announced by the Ethiopian Revenue and Customs Authority by a public notice to be issued later on. Accordingly, as per the information obtained from Miss Tihtina, ERCA has started e-filing of tax return by large taxpayers who file their tax return through their own infrastructure, i.e. using their own email. However, e-payment of tax is not yet started in Ethiopia for it requires proper infrastructure to be put in place by ERCA.

v. Free tax counseling service

Giving free tax counseling service to the taxpayer on the matters relating to filling out forms, keeping book of account, filing the tax return and other tax related issues is one important measure in reducing tax compliance cost. In this regard question is raised to Miss Tihtina about the measure taken by ERCA in an attempt to give free tax counseling service to taxpayers. She responded that different mechanism is devised by ERCA in an effort to give free tax counseling service to taxpayers. Among these, the following can be raised as a good example:

- ✓ Customer service-: a program through which taxpayers can freely get the counseling of tax officers on tax related issue at the head office and the branch offices of ERCA.
- ✓ Call center that is managed under the customer service office-: a system through which taxpayers can freely call the phone and ask questions on tax related matters.
- ✓ The web forum-: a forum through which taxpayers ask questions and get answer on the official website of the authority.

4.2.2. Legislative and Administrative Measures

4.2.2.1. Legislative measures

The government of Ethiopia has enacted a number of proclamations aimed at reforming the income tax, taxes on goods and services, and tax on international trade.²⁹⁴ “In line with the

²⁹⁴ Alemayehu Geda and Abebe Shimeles, Taxes and Tax Reform in Ethiopia, 1990-2003, Research Paper No. 2005/65, 2005, P. 12

liberalization drive, the government not only reduced the average level of tax and tariffs but also made the move to focus more on the value-added tax.”²⁹⁵

The new income tax law also allowed deductions for business expenditures such as tax payments, land lease payments, interest payments on loans, insurance premiums and other expenditures, which previously were not deductible from taxable income. It also provided provisions for loss carry-forward and capital gains.

In addition to these reforms, an attempt is also made to close some gaps/loopholes that are discovered to be the main causes of tax avoidance though the term tax avoidance is not used and defined under the tax legislations of Ethiopia. In this regard, some legislative measures that seem to be Specific Anti-Avoidance Rules (SAARs) are included under the current tax legislations of Ethiopia. The following are some of them:

- Article 7 (2) of the income tax proclamation which prohibits the reduction of the amount of foreign tax payable on income derived from foreign source from the income tax payable by that resident in respect of that income in excess of the tax payable in Ethiopia that would otherwise be payable on the foreign source income.
- Article 7 (3) of the income tax proclamation which limits the reduction of the amount of foreign tax payable, in the case of a taxpayer subject to income tax on Schedule C income, to the tax that would otherwise be payable in Ethiopia computed as if Article 28 (loss carry forward) of the Proclamation applied separately to each foreign country in respect of profit and losses derived from sources therein.
- Article 7 (4) of the income tax proclamation, which provides for a separate calculation of the reduction of the amount of foreign tax payable in respect of each foreign country from which income or profit is derived.
- Article 21 of the income tax proclamation which excludes some business expenses which are known in causing tax avoidance, such as an increase of the share of capital of a company or the basic capital of a registered partnership; voluntary pension or provident fund contribution over and above 15% of the monthly salary of the employee; declared dividends and paid-out profit shares; interest in excess of the rate used between the

²⁹⁵ Ibid

National Bank of Ethiopia and the Commercial Banks increased by two (2) percentage points; representation expenses over and above 10% of the salary of the employee; personal consumption expenses; entertainment expenses; donation or gift; and damages covered by insurance policy from being considered as deductible business expenses.

- Article 24 (2) of the income tax proclamation which excludes transfers of business assets among companies which are parties to a reorganization from being treated as a disposal of the property as far as transfer of loss is concerned and sub-article 6 of the same provisions which excludes loss on the transfer of a business asset to related person from being recognized as a deductible loss.
- Article 29 (1) of the income tax proclamation which prohibit the tax benefit that arise from transfer pricing providing that where conditions are made or imposed between persons carrying on business in their commercial or financial relations which differ from those which would be made between independent persons, the tax authority may direct that the income of one or more of those related persons is to include profits which he or they would have made but for those conditions.
- Article 8 (6) of Council of Ministers Income Tax Regulations No. 78/2002 that prohibit the deduction of commissions paid for services rendered to a business located and operating in Ethiopia as the branch, subsidiary or associated company of a business located and operating abroad by holding or associated company of the business in Ethiopia from gross income in calculating the taxable income unless the payment in question was made for services actually rendered and the said service was necessary for the business and could not be performed by other persons or bodies or by the business itself at a lower cost.
- Article 8 (7) of Council of Ministers Income Tax Regulations No. 78/2002 that gives the tax authority to intervene and consider the total amount of salaries and other personal emoluments payable to the manager or managers of a private limited company and reduce the same if there is a reason that it is exaggerated.
- Sub-article 8 of the same provision that exclude from deduction sums paid as salary, wages or other emoluments to the children of the proprietor or member of the partnership if such employees cannot fulfill the qualifications required by the post.

- Article 13 (3 & 4) of Council of Ministers Income Tax Regulations No. 78/2002 that disregard gain obtained as a result of re-evaluation of assets from being considered as the basis for depreciation and that disallow depreciation for assets in respect of which all capitalized costs have been fully recovered if the transfer of such assets is made between related persons.
- Article 14 (2) of Council of Ministers Income Tax Regulations No. 78/2002 that consider the amount deducted from taxable income in case when a resident company or partnership reinvests the profit it earned to raise the capital of another company or partnership pursuant to article 27 of the income tax proclamation as part of the taxable income of the accounting year in which the transfer was effected if the taxpayer transfers the share or capital contribution in respect of which deduction was allowed.
- Sub-article 3 of the same provision that disallows deduction under Article 27 of the Proclamation if purchase of shares and capital contributions made between related persons.
- Article 98 of Customs Proclamation No. 622/2009 which provides for serious punishment for a person who uses duty free goods or goods imported on the basis of reduced duty and tax rates for purposes other than which the duty relief is granted or transfers them to another person or places them, in any manner, under the service or possession of other persons outside of his family.
- Council of Ministers Regulations No. 84/2003 which provides that capital goods imported free of customs duty shall not be transferred to third parties not entitled to similar duty free privileges unless prior payment of the customs duty is effected thereon. Strict penalty is provided for the investor who violates this rule under article 12 of the same regulation.

4.2.2.2. Reforms taken to build the capacity of tax authority

With respect to the strengthening of the capacity of the tax authority of Ethiopia, different reform measures are taken. “The major reform is started in 1995 with the establishment of the Federal Government Revenue Board that enabled the Ethiopian tax administration to be organized as a separate and autonomous government body for the first time.”²⁹⁶ “The Board was established to

²⁹⁶Supra note 284, P. 348

oversee and coordinate the operations of three federal revenue agencies at the time: the Inland Revenue Authority, the Ethiopian Customs Authority, and the National Lottery Administration.”²⁹⁷ “This reform was further continued and resulted in the scaling up the board to ministerial level to become the Ministry of Revenue in 2001.”²⁹⁸ “Like the board this ministry controls the three revenue collection institutions: Federal Inland Revenue Authority (FIRA), Ethiopian Custom Authority (ECA) and the National Lottery Administration (NLA).”²⁹⁹

Still, bestowing the tax administration for the ministry of revenue by itself is not enough for it scatters the tax administration under the three organs. To this effect, latter on in 2008 the autonomous tax authority called Ethiopian Revenue and Custom Authority (ERCA) was established by taking over the powers of the ministry, FIRA and ECA to ensure the administrative autonomy of the tax authority. “This reorganization of Federal Tax Administration has relegated the task of tax administration from ministerial level to an authority but in substance, the reorganization has in fact strengthened the powers of the Tax Authority.”³⁰⁰

“By this reorganization, the tax authority (ERCA) has assumed the powers to investigate and prosecute tax and a customs offense directly without having to rely upon the goodwill of the regular police and prosecution offices as was previously the case.”³⁰¹ Currently, most of the power to investigate and prosecute the tax crimes is handled within the tax authority and the technical matters of tax and customs crime investigation and prosecution are now the exclusive preserve of tax administration.³⁰²

The other reform measures include the establishment of additional branch offices, training and recruitment of qualified personnel, introduction of performance and accountability measures and similar initiatives aimed at implementing the new income tax, VAT, turnover tax and excise tax proclamations.³⁰³

²⁹⁷Ibid, P. 349

²⁹⁸T. Ghirmai Kefela, Reforming tax policies and revenue mobilization promotes a fiscal responsibility: A study of East and West African states, *Journal of Law and Conflict Resolution* Vol. 1, No. 5, 2009, P. 101

²⁹⁹Supra note 294, P. 12

³⁰⁰supra note 284, P. 349

³⁰¹Ibid

³⁰²Ibid

³⁰³Supra note 294, P. 12

With respect to hiring qualified personnel and building the capacity of the employees of the authority the interview with Miss Tihtina shows that ERCA is hiring new graduates from Universities with high CGPA and gives them 2-3 months training before their assignment to job with a purpose of equipping them with basic technical knowledge of the post on which they are going to be assigned. ERCA is also giving continuous on job training on different topics for its employees including international training and workshop in collaboration with IMF and other international organizations. She added that different trainings have been given for tax auditors to build their auditing capacity and many new auditors are hired to increase their number.

“The government is currently in the process of upgrading its computer system, implementing the use of a tax identification number for the enforcement, verification and processing of sales tax and VAT refund claims.”³⁰⁴ The other important reform taken to strengthen the capacity of the tax authority and increase its efficiency in collecting tax was “the introduction of information technology.”³⁰⁵

Generally, Ethiopia, like most countries in Africa, has been making considerable efforts in recent years to restructure its tax system with a view to increase tax revenue and reduce tax avoidance and evasion though it is too early to evaluate the effect of these reforms.³⁰⁶

4.2.2.2.1. Measures against underground/informal sectors

Generally speaking, taking measures against other causes of tax avoidance and evasion will indirectly reduce the escalation of informal sectors causes of tax avoidance and evasion since all these causes may contribute their part in increasing informal sectors and hence, all the above mentioned measures taken by the government of Ethiopia will partly be considered as the measures taken against informal sectors.

Regarding the direct administrative measures, question was posed to Miss Tihtina as to what ERCA is doing in combating informal sectors in Ethiopia. She responded that ERCA is taking different measures such as punishing those persons participating in such sectors. ERCA has also

³⁰⁴ Ibid

³⁰⁵ Ibid

³⁰⁶ Ibid

currently established especial organ around Merkato, where informal sector is much amplified, for the purpose of following up and bring informal traders before the law.

However, informal sector is still very high in Ethiopia and the main cause of tax evasion. The country is very far from taking proper measure that combats this sector.

Conclusion

Though scholars are always at controversy regarding the definition and distinction of tax avoidance and evasion, tax avoidance can be defined as an act by which individuals and firms reduce their tax liability in a way that may be unintended by legislators while tax evasion is unlawful act which directly violate the tax legislation. Avoidance is typically accomplished by structuring transactions so as to minimize tax liability and is mainly encouraged by legislation granting favorable tax treatment to specific activities in contrast to general taxation principles while evasion involves illegal arrangements through or by means of which liability to tax is hidden or ignored as a consequence of which the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities.

However, as far as economic function is concerned evasion and avoidance obviously have very strong similarities; sometimes, indeed, they can hardly be distinguished in which case their distinction becomes notoriously fuzzy.

Whatever the controversy regarding the definition and distinction of tax avoidance and evasion may be, they are the two ways through which taxpayers get around paying tax or otherwise reduce their tax liability. They are the two phenomena that are as old as taxation itself and common problems of all countries whether developed or undeveloped.

Tax avoidance and evasion is more pressing in developing countries taking the loose legal base and weak institutional framework arising from lack of sufficient expertise and resources to develop an efficient tax administration. Being one of the developing countries, Ethiopia has suffered much from these two problems and lost substantial tax revenue.

As perceived from the experience of other countries, tax avoidance and evasion mainly arise from two main categories of causes. These causes are:

- i. Causes that affect the voluntary compliance of taxpayers; and
- ii. Causes that relate to the defects/loopholes in tax legislations and the weakness of the tax authority in properly implementing tax legislations.

Voluntary compliance of taxpayers is dominantly affected by the following two factors:

- Low tax moral; and
- high compliance cost

Low tax moral arises from factors such as:

- ✓ Low taxpaying culture and norms;
- ✓ Low quality of service in return for taxes;
- ✓ High tax rate;
- ✓ Lack of fairness and trust;
- ✓ Lack of awareness/knowledge about the importance of paying tax;
- ✓ High level corruption;
- ✓ Low transparency and accountability of public institutions

While high compliance cost arises from:

- Frequent filing requirements;
- much number of payments per year; and
- non-assisting of taxpayers in keeping book of account, filling and filing tax return such as absence of free tax consultancy service for taxpayers by the tax authority.

The second cause of tax avoidance and evasion, i.e. the cause that relates to the defect of tax legislations and weakness of tax authority arises from:

- Taxing similar activities at different rates;
- high exemptions of activities from tax liability;
- high tax incentives/holiday;
- Low level of penalty for violators;
- weak detecting and prosecuting capacity
- Insufficiency in tax collection;
- Inability of controlling underground/informal economies

Since the fight against tax avoidance and evasion presupposes the control of these causes, different measures are taken by different countries in countering these causes. Some of these measures are:

- Taxpayer education and service;
- Public relation and cooperation;
- Giving free tax counseling service;
- reducing tax rate or tax rate cuts;
- less frequent filing requirements;
- Offering electronic filing and payments;
- Introducing anti-avoidance provision such as Specific Anti-Avoidance Rules (SAARS), General Anti-Avoidance Rules (GAARS), mandatory disclosure rules, and avoiders and promoters penalty;
- Proper penalty for evaders;
- Establishing autonomous tax authority;
- Improving audit capacity and increasing the probability of detection of the violators.

As grasped from different surveys and in-depth looking of tax legislations, those above mentioned causes of tax avoidance and evasion are also prevalent in Ethiopia. To this effect, an attempt is made to scrutinize measures taken by the government of Ethiopian in countering these causes of tax avoidance and evasion. The measures taken are:

- Educating taxpayers about the importance of paying tax;
- Reducing corruption
- Tax rate cut/reducing tax rate
- Introduction of e-filing
- Free tax counseling service
- An attempt to close some loopholes within tax legislation through inserting Specific Anti-Avoidance Provisions/Rules;
- Establishing autonomous tax authority called 'Ethiopian Revenue And Custom Authority (ERCA)';

- Improving the performing capacity of the tax authority through hiring new graduates from Universities with high CGPA and giving them short training before their assignment to job with a purpose of equipping them with the basic knowledge of the post on which they are going to be assigned and giving continues on job training on different topics for its employees including international training and workshop in collaboration with IMF and other international organizations.

Though these measures are taken by the government of Ethiopia in countering tax avoidance and evasion, they are not satisfactory when seen in light of the experience of other countries. Especially, as can be comprehended from surveys made by other researchers, the tax reforms taken by the government are not satisfactory in many aspects: The following are some of the problems that require further measures:

- Tax educations given by ERCA are not equally available to all taxpayers and sufficient;
- The tax system does not minimize noncompliance; rather it increases compliance costs;
- Detecting and prosecuting capacity of the tax authority is still low;
- Tax related corruption is still prevalent;
- Legislative measures taken to counter tax avoidance are insignificant;
- Tax administration is inefficient;
- The tax administrators are not effective in collecting taxes;
- Service and support to taxpayers is inadequate;
- Measures taken to bar underground/informal trade is not satisfactory;
- The number of payment per year and the time required for discharging tax liability is high;
- Though e-filing by large taxpayers by using their own email is started, the infrastructure needed for this purpose is not fulfilled and e-payment is not yet implemented.

Recommendation

Taking the above mentioned problems with the tax system and tax authority of Ethiopia, the writer recommends the following reform measures:

- Taxpayers' education should be extensively continued in a way that is adequate and available to all taxpayers equally.
- Continuous reform should be there in reducing the tax rate cut to the extent necessary. Reduced tax rate, especially, helps to attract investors without giving tax incentive which is another way of fighting tax avoidance.
- Sophisticated strategy should be employed to reduce/combat tax related corruption. The reform that should be taken in this regard must be the one that reduce the contact between the tax officer and taxpayer by using electronic system of filing and payment than targeting on the punishment of corruptive officers.
- The tax system and the service rendered in return for the tax paid should be transparent to the public and unnecessary and inefficient allocation of the tax revenue should be kept away from.
- A significant easing of the compliance burden should be achieved through a reduction in the reporting frequency to quarterly rather than monthly.
- Increased use of electronic filing and payment schemes would be implemented and infrastructures necessary for this purpose should also be put in place.
- Strong emphases should be given for securing the voluntary compliance of taxpayers before applying punitive measures.
- Tax exemptions and incentives should be reduced, and regulated properly in case when it is mandatory to have them. The extent of exemptions for individuals, employees and businesses needs to be revisited in order to close the loopholes that might be used by businesses to avoid their tax liability contrary to what is intended by the parliament and if possible tax incentive should be replaced by reduced tax rate that treat all taxpayers equally without discouraging investment at the same time.
- Legislative measures taken in the field of tax avoidance are almost nil when seen in relation to the measure taken by other countries. Currently, tax avoidance might not be serious problem in Ethiopia for there are no such sophisticated companies and

independent Professional firms that can develop massive tax avoidance schemes. But, Ethiopia is now negotiating to accede to WTO. Up on accession, foreign sophisticated and complicated firms might come with their tax avoidance experience. Thus, broad legislative measures such as disclosure rules, general anti-avoidance rules and avoiders and promoters penalty should be introduced after proper consideration and discussion with all stakeholders.

- Though there have been substantial improvements in the organizational structure and procedural laws, there are still gaps between the tax laws and implementation; these gaps must be closed and the capacity of the tax authority should be continuously and vigorously improved, especially, in the area of auditing, prosecuting and tax collecting.
- Strict measure should be taken to reduce/combat the increasing trend of informal trade.
- Taxpayer information and support systems should be continued and strengthened, including a comprehensive support web site and information publications made available at all tax offices.

Bibliography

Abebe Shimeles and Alemayehu Geda, Taxes and Tax Reform in Ethiopia, 1990-2003, Research Paper No. 2005/65, 2005

Abyssinia Bank S.C. vs. Federal Inland Revenue Authority, Federal High Court, File No. 31952, in Amharic, unpublished, as analyzed by Taddese Lencho under an article “VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia”

Akale Alemu vs. Ethiopian Revenues and Customs Authority, Federal Supreme Court Cassation Decisions, File No. 69602, in Amharic, Vol. 13

Allingham and Agnar Sandmo (1972), Income tax evasion; and Chipeta (2002), The Second Economy and Tax Yield in Malawi, in Gudrun Barenbrock (ed), “Addressing Tax evasion and avoidance in developing countries,” (Deutsche Gesellschaft fur, Berlin), 2010

Allay and James (1999), in Valerie Braithwaite(ed), Taxing democracy: Understanding Tax avoidance and Evasion, (Ashgate Publishing Ltd, London), 2003

Almaz Dese vs. Ethiopian Customs Authority, Federal Supreme Court Cassation Decisions, File No. 58266, in Amharic, Vol. 11, PP. 354-56

Alm, J., Bahl, R. and Murray, M. (1991), Tax base erosion in developing counties, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, Journal of accounting and taxation, 2009, Vol. 1, No. 2

Alm, J. and Jorge Martinez-Vazquez, Tax Moral And Tax Evasion In Latin America, International Studies Program Working Paper, (Georgia University Andrew Young School Of Policy Study, Georgia Atlanta), 2007

Amin Abdella and John Clifford, The Impact of Tax Reform on Private Sector Development (Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations), 2010

Andrew Okello, Tax Administration reforms - recent trends and developments, (Compliance Management in Tax Administration Workshop, Nairobi, Kenya, November 3-7, 2008)

Bariyima D. Kiabel and N. Gladson Nwokah, Curbing Tax Evasion and Avoidance in Personal Income Tax Administration: A Study of the South-South States of Nigeria, *European Journal of Economics, Finance and Administrative Sciences* ISSN 1450-2275 Issue 15, 2009

Benno Torgler, Markus Schaffner And Alison Macintyre (eds), *Tax Compliance, Tax Morale And Governance Quality*, (Queensland University Of Technology)

Bird and Richard, "Smart Tax Administration," *World Economic Forum, Global Competitiveness Report 2010–2011*. (World Bank Group, Geneva), 2010

Bordignon and Massimo, (1993), A fairness approach to income tax evasion, in Gerald Chau and Patrick Leung (eds), *A critical review of Fischer tax compliance model: A research synthesis*, *Journal of accounting and taxation*, 2009, Vol. 1, No. 2

Braithwaite, V. (2008), *Tax evasion*, in *OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers' Compliance Behaviour*, (Centre For Tax Policy And Administration), 2010

Braithwaite, J., *South African Revenue Service (SARS), Discussion Paper on Tax Avoidance*, 2005

Brendan Barber, "The UK Tax Gap: The Missing Billions," *Touch Stone Pamphlets*, (Trade Union Congress, London)

Brooks, N. & Doob, A.N. (1990), *Tax evasion: searching for a theory of compliant behavior*, in *OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers' Compliance Behaviour*, (Centre For Tax Policy and Administration), 2010

Bruce Bolnick, *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*, (Nathan Associates Inc., Arlington), 2004

Bruno Chiarini, Bruno Chiarini and Friedrich Schneider, *Tax Rates and Tax Evasion: An Empirical Analysis of the Structural Aspects and Long-Run Characteristics in Italy*, (the Institute for the Study of Labor) 2008

Canada, Comprehensive response of the government to the seventh Report of the Standing Committee on Public Accounts, parliamentary document no 8512-351-79, 1995

Cashmere, M., "Towards an Appropriate Interpretive Approach to Australia's General Tax Avoidance Rule – Part IVA" Australian Tax Review 2006, Vol. 35, No. 231

Central Statistical Agency (CSA), Report on Urban Informal Sector Sample Survey, Statistical Bulletin, 2004

Central Statistical Agency, the 2005 Labor Force Survey Report, 2006

Che Azmi and Kamarulzaman, "Adoption of Tax E-filing: A Conceptual Paper." African Journal of Business Management, 2010, Vol. 4

Chris Evans, Containing Tax Avoidance: Anti-Avoidance Strategies (The University of New South Wales, Australian School of Taxation), 2008

Clemens Fuest and Nadine Riedel, Tax Evasion, Tax Avoidance and Tax Expenditures in Developing Countries: A Review of the Literature (Oxford University Centre for Business Taxation, Oxford), 2009

Clive Gray, United States Practices in Estimating and Publicizing Tax Evasion: African Economic Policy Discussion Paper Number 15, (Harvard Institute for International Development), 1999

Commonwealth of Australia, Scoping study of small business tax compliance costs, 2007

David, G. Duff, Tax Avoidance in the 21st Century, (Thomson Reuters), 2009

Djankov, Simeon, et al, "The Effect of Corporate Taxes on Investment and Entrepreneurship." American Economic Journal, 2010

Emerta Asaminew, The Underground Economy and Tax Evasion in Ethiopia: Implications for Tax Policy (Ethiopian Economic Policy Research Institute (EEPRI)), 2010

Erich Kirchler, and Friedrich Schneider, *Everyday Representations of Tax Avoidance, Tax Evasion, and Tax Flight: Do Legal Differences Matter?*, 2001

Eriksen, K and Fallan, L. (1996), tax knowledge and attitude towards taxation, in Zelalem Berhane (ed), *The Influence of Tax Education on Tax Compliance Attitude*, (Unpublished, Addis Ababa University), 2011

Ethiopian 7th day Adventist Church vs. Akaki-Kaliti Sub-City Administration Revenue Office
Federal Supreme Court Cassation Decisions, File No. 66474, in Amharic, Vol. 13

Evans, C., “Containing Tax Avoidance: Anti-Avoidance Strategies” University of New South Wales Faculty of Law Research Series No. 40, 2008

Eyasu Yimer, *Main Areas of Corruption in Ethiopia*, Report on the seminar “Corruption in light of development and democratization,” 2012

FDRE Ministry of justice vs. Ato Tekle Garedow et al, Federal Supreme Court Cassation Decisions, File No. 65330, in Amharic, Vol. 11

Finance Quebec, *Aggressive Tax Planning*, 2009

Fishlow, A. and Friedman, J. (1994), Tax evasion, inflation and stabilization, in Erich Kirchler et al (eds), *Why pay taxes? a review of tax compliance decisions*, (international Study Program Working Paper 07-30), 2007

Fjeldstad, Odd-Helge and Mick Moore (2009), Revenue authorities and public authority in sub-Saharan Africa, in Gudrun Barenbrock (ed), “Addressing Tax evasion and avoidance in developing countries,” (Deutsche Gesellschaft fur, Berlin), 2010

Gerald Chau and Patrick Leung, A critical review of Fischer tax compliance model: A research synthesis, *Journal of accounting and taxation*, 2009, Vol. 1, No. 2

Ghirmai, T. Kefela, Reforming tax policies and revenue mobilization promotes a fiscal responsibility: A study of East and West African states, *Journal of Law and Conflict Resolution* Vol. 1, No. 5, 2009

Grasmick, H. and Scott, W. (1982), Tax Evasion and mechanisms of social control, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, Journal of accounting and taxation, 2009, Vol. 1, No. 2

Gudrun Barenbrock, “Addressing Tax evasion and avoidance in developing countries,” (Deutsche Gesellschaft fur, Berlin), 2010

Gutmann (1977), The subterranean economy, in Charles T. Clotfelter (ed), Tax Evasion and Tax Rates: An Analysis of Individual Returns, The Review of Economics and Statistics, 1983, Vol. 65, No. 3

Hasseldine, J. et al. (2007), Tax compliance enforcement strategies for sole proprietors, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, Journal of accounting and taxation, 2009, Vol. 1, No. 2

Her Majesty’s Revenue and Customs, HMRC Approach to Compliance Risk Management for Large Business, 2007, para 1.4

HM Treasury, Tackling tax avoidance, 2011

IMF, OECD, UN and World Bank, Supporting the Development of More Effective Tax Systems, a Report to the G-20 Development Working Group, 2011

Jacqueline Coolidge, Findings of tax compliance cost surveys in developing countries, ejournal of tax research, (The University of New South Wales: School of Taxation and Business Law, Australia), 2012, Vol. 10, No. 2

James, Sebastian, a Handbook for Tax Simplification, Washington, DC: International Finance Corporation, 2009

Jira Jebessa, Fantahun Melles, Dieter Gagel and Gerhard Quincke, Taxation in Ethiopia: Direct and Indirect Taxes - Categories of Tax Payers, Declaration of Income, Assessment of Taxes and Tax Incentives (Ethiopian Chamber of Commerce (ECC), Addis Ababa), 2005

Jonathan Shaw, Joel Slemrod, and John Whiting, Administration and Compliance, (University of Michigan, Michigan) 2010

Kirchler, E. and Hoelzl, E. (2006), Modeling taxpayers behavior as a function of interaction between tax authority and taxpayers, in OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers' Compliance Behaviour, (Centre For Tax Policy And Administration), 2010

Kirchler et al (2007), Why Pay Taxes?, in Gudrun Barenbrock (ed), "Addressing Tax evasion and avoidance in developing countries," (Deutsche Gesellschaft fur, Berlin), 2010

Kyle D. Logue, Optimal Tax Compliance and Penalties When the Law is Uncertain, (2007)

Learned Hand (1947) ,Commissioner vs. Newman, in Steve Bond, Malcolm Gammie and John Whiting (eds), Tax avoidance

Lederman, L. (2003), The Interplay Between Norms and Enforcement in Tax Compliance, in Oh Teik Hai & Lim Meng See (eds), Intention of Tax Non-Compliance, International Journal of Business And Social Science, 2011, Vol. 2, No. 7

Lewis, A. (1982), The psychology of taxation, in Benno Torgler, Markus Schaffner and Alison Macintyre, Tax Compliance, Tax Morale and Governance Quality, (Queensland University Of Technology)

Lidia Xynas, "Tax Planning, Avoidance and Evasion in Australia 1970-2010: The Regulatory Responses and Taxpayer Compliance," Review Law Journal: 2010, Vol. 20

Lord Clyde (1929), Ayrshire Pullman Motor Services & Ritchie v CIR, in Steve Bond, Malcolm Gammie and John Whiting (eds), Tax avoidance

Lord Templeman (1987), *Challenge Corporation Ltd v. Commissioner of Inland Revenue*, in Tracey Bowler (ed), "Countering Tax Avoidance in the UK: Which Way Forward?" TLRC Discussion Paper, (The Institute for Fiscal Studies, London), 2009

Lord Tomlin (1936), IRC v Duke of Westminster, in Lidia Xynas (ed), "Tax Planning, Avoidance and Evasion in Australia 1970-2010: The Regulatory Responses and Taxpayer Compliance," Review Law Journal: 2010, Vol. 20

Mark Gallagher and Arturo Jacobs, "Lowering Tax Payer Compliance Costs: grounds for growth enhancing the competitive impacts business environment reform," 2009, Vol. 13

Martin Halla, Tax Morale and Compliance Behavior: First Evidence on a Causal Link, The B.E. Journals of Economic Analysis & Policy, (University of Linz & IZA), 2012

Mclaren, J., "The Distinction between Tax Avoidance and Tax Evasion has Become Blurred in Australia: Why has it Happened?" Journal of the Australasian Tax Teachers Association, 2008, Vol. 3, No.2

Michael Doran, Tax Penalties and Tax Compliance, Harvard Journal on Legislation, 2009

Mohd, R. (2010), Tax knowledge and tax compliance determinants in self assessment system, in Zelalem Berhane (ed), The Influence of Tax Education on Tax Compliance Attitude, (Unpublished, Addis Ababa University), 2011

Mo, Phyllis Lai Lan (2003), Tax avoidance and anti-avoidance measures in major developing economies, in Gudrun Barenbrock (ed), "Addressing Tax evasion and avoidance in developing countries," (Deutsche Gesellschaft fur, Berlin), 2010

Murphy, K. (2004), The role of trust in nurturing compliance, in OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers' Compliance Behaviour, (Centre For Tax Policy And Administration), 2010

Odd-Helge Fjeldstad, Tax evasion and corruption in local governments in Tanzania: Alternative economic approaches, Working Paper No 14, 1996

OECD (2005), Measuring the revenue loss caused by tax avoidance and evasion, in Clemens Fuest and Nadine Riedel (eds), Tax evasion, tax avoidance and tax expenditures in developing countries: Report prepared for the UK Department for International Development (DFID) (Oxford University Centre for Business Taxation), 2009

OECD, Centre for Tax Policy and Administration, in Tracey Bowler (ed), "Countering Tax Avoidance in the UK: Which Way Forward?" TLRC Discussion Paper, (The Institute for Fiscal Studies, London), 2009

OECD Forum on Tax Administration: Understanding and Influencing Taxpayers' Compliance Behaviour, (Centre For Tax Policy and Administration), 2010

Oliver Wendell Holmes(1904), U.S. Supreme Court Justice, in John Preston et al (eds), Paying taxes; the Global picture, 2012

Phyllis Lai Lan Mo, Tax Avoidance and Anti-Avoidance Measurers in Major Developing Economies, (Greenwood Publishing Group, Westport), 2003

Pashev, K. (2005), Tax Compliance of Small Business in Transition Economies, in Gudrun Barenbrock (ed), "Addressing Tax evasion and avoidance in developing countries," (Deutsche Gesellschaft fur, Berlin), 2010

Preston, J., Andrew Packman, et al, Paying taxes; the Global picture, 2012

Pagone, G.T., Aspects of Tax Avoidance: Trans-Tasman Observations, International Fiscal Association Conference, (Wellington, New Zealand), 2011

Ramsay 25 years on: some reflections on tax avoidance', an address to the Chancery Bar Association (2004), in Tracey Bowler (ed), "Countering Tax Avoidance in the UK: Which Way Forward?" TLRC Discussion Paper, (The Institute for Fiscal Studies, London), 2009

Royal Commission on Taxation (Carter Commission) of Canada (1966), in Chris Evans (ed), Containing Tax Avoidance: Anti-Avoidance Strategies (The University of New South Wales, Australian School of Taxation), 2008

Royal Commission on Taxation of Profits and Income (Radcliffe Commission) of UK (1955), in Rachel Anne Tooma (ed), Legislating Against Tax Avoidance, (H.J.E.Weckebachweg, Amsterdam), 2008

Scholz, J.T. and Lubell, M. (1998), Trust and taxpaying: testing the heuristic approach to collective action, in OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers' Compliance Behaviour, (Centre For Tax Policy and Administration), 2010

SME Tax Compliance and Simplification Background note prepared by the OECD Centre for Tax Policy and Administration for a Roundtable Discussion" at the 1st Meeting of the Working Group on Taxation of the SEE Investment Committee

Surrey, S., "Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail" Law & Contemporary Problems, 1969, Vol. 34, No. 3

Taddese Lencho, the Ethiopian Tax System: Excesses and Gaps, Michigan State International Law Review, Vol. 20:2

Tamas K. Papp and Elod Takats, Tax Rate Cuts and Tax Compliance, International Monetary Fund Working Paper: Policy Development and Review Department, 2008

Tapan K. Sarker, "Improving Tax Compliance in Developing Countries via Self-Assessment Systems - What Could Bangladesh Learn from Japan?" Asia-Pacific Tax Bulletin, 2003, Vol. 9, No. 6

Tax Law Review Committee of UK, Tax Avoidance, (Institute of Fiscal Studies, London), 1997

Tesfaye Shamebo, Anti Corruption Efforts in Ethiopia, (Federal Ethics & Anti-Corruption Commission of Corruption Prevention & Research Department), 2003

The International Bank for Reconstruction and Development / The World Bank, Comparing Business Regulations for Domestic Firms in 185 Economies: Doing Business 2013

The World Bank, World Development Indicator, "Time to prepare and pay tax in hours", 2008

Tim Edgar(2007), "Designing and Implementing a Target-Effective General Anti-Avoidance Rule", in David G Duff(ed), Tax Avoidance in the 21st Century, (Taxation Law and Policy Research Institute, British Columbia), 2008

Tracey Bowler, “Countering Tax Avoidance in the UK: Which Way Forward?” TLRC Discussion Paper, (The Institute for Fiscal Studies, London), 2009

US Department of State, Doing Business in Ethiopia: Country Commercial Guide for U.S. Companies, 2012

US Treasury, the Problem of Corporate Tax Shelters—Discussion, Analysis and Legislative Proposals, 1999

Valerie Braithwaite (2009), Tax Evasion, in Centre for Tax Policy and Administration, Understanding and Influencing Taxpayers’ Compliance Behaviour, 2010

Wenzel, M. (2004), an analysis of norm process in tax compliance, in OECD Forum on Tax Administration (ed): Understanding and Influencing Taxpayers’ Compliance Behaviour, (Centre For Tax Policy and Administration), 2010

Wenzel, M. (2004), the Social Side of Sanction: Personal and Social Norms as Moderators Deterrence, in Kristina Murphy (ed), Procedural Justice the Regulation of Tax Compliance Behaviour: The Moderating Role of Personal Norms, (Andrew Young School Of Policy Study)

Weisbach, D., Comments on Recent Developments on Tax Shelters in the US, 2008

Wertschek, R. and J Wilson, “Shelter from the Storm: The Current State of the Tax Shelter Rules in Section 237.1,” Canadian Tax Journal, 2008

Witte, A. and Woodbury, D. (1985), The effect of tax laws and tax administration on tax compliance, in Gerald Chau and Patrick Leung (eds), A critical review of Fischer tax compliance model: A research synthesis, Journal of accounting and taxation, 2009, Vol. 1, No. 2

Wollela Abehodie , “Value Added Tax Administration in Ethiopia: A Reflection of Problems,” ejournal of Tax Research, 2008, Vol. 6, No. 2

World Bank Group, Investment Climate Advisory Services, Global Tax Team, 2010

World Customs Organization (WCO), Custom reform and Trade Facilitation in Ethiopia, 2011

Wubshet Aborat , Taxpayers' Perception towards Fairness: Personal Business Profit Taxpayers in Addis Ababa, 2011

Zee, et al (2002), "Tax Incentives for Business Investment, in Bruce Bolnick, Effectiveness and Economic Impact of Tax Incentives in the SADC Region, (Nathan Associates Inc., Arlington), 2004

Zelalem Berhane, the Influence of Tax Education on Tax Compliance Attitude, 2011