

An Assessment of Business Income Taxpayers' Tax Knowledge, Tax Complexity, and Tax Compliance: A Case of Amhara Regional State of Ethiopia

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Abstract: *The main objective of this study was to assess the business income taxpayers' level of tax knowledge, perceived complexity of the income tax system and tax compliance issues in the metropolitan cities of the Amhara Regional State of Ethiopia. A cross-sectional survey research design and a qualitative research approach were adopted in this study. Purposive sampling technique was employed to select the study participants. The sample size for the purpose of this study was 24. The data were collected using semi-structured interviews. The Data gathered from interviews were analyzed using thematic analysis. Results suggest that taxpayers have inadequate technical knowledge and perceive the income tax system as complex. Tax knowledge and tax complexity were considered as important factors towards non-compliance behavior among business income taxpayers.*

Keywords: Tax knowledge, tax complexity, tax compliance, taxpayers.

1. Introduction

Most tax compliance studies are about the tax systems in the United States and other developed countries. There are relatively few studies analyzing tax compliance in developing countries, mainly because of data availability problems (Alm, 1999)^[1]. Studies of tax compliance are also very limited in Ethiopia with only a few studies on the tax system, tax fairness and tax compliance issues (Taddese, 2014^[2]; Wubshet, 2011^[3]; Asmamaw, 2014^[4]). In his study of the income tax system of Ethiopia Tadesse (2014)^[2] emphasized on the legal aspects of the existing tax system and its practice such as tax equity. A Comparative Study of Compliant and Non- Compliant Individual Taxpayers in Ethiopia evidence from Amhara regional, state conducted by Asmamaw (2014)^[4] revealed that tax morals, tax fairness and to a lesser degree in tax enforcement and tax awareness both directly and indirectly impacted upon taxpayer compliance.

Beginning with the establishment of a separate tax administration body in 1995, successive reforms were undertaken in the organization of tax administration, culminating in the merger of the separate tax authorities and establishment of the Ethiopian Revenues and Customs Authority (ERCA) in 2008. This reorganization did not simply merge the separate authorities at the time, but affected many other areas of Ethiopian tax administration. The upshot of those reforms was to strengthen the arm of ERCA in many areas of tax administration: assessment, collection, investigation and enforcement. ERCA's powers of investigation and prosecution were strengthened quite considerably when the established laws conferred original jurisdiction over the investigation and prosecution of tax and customs offenses. As a result of these reforms in tax administration, ERCA has emerged as one of the most powerful government bodies of both the Federal and regional Governments.

In the last decade alone, the Ethiopian Government introduced major tax administration reforms with a view to improving the performance of Ethiopian tax administration in generating revenues for the Government. Some of these reforms included the introduction of the Tax Identification Numbers (TIN), the obligatory use of the cash-register machines by many taxpayers and the installation of a number of information technologies to improve the performance of the Ethiopian Tax Administration. Despite all the tax reform measures taken, the behavioral aspects of tax compliance decision making issues of income tax payers the performance of the Ethiopian tax system has not improved quite considerably over the last decade. For instance, the tax-to-GDP ratio has been far lower than even the Sub-Saharan average. Ethiopian current tax-to-GDP ratio of 11% is far lower than the average for developed tax systems (25-35%), developing countries (18-25%) and even of the Sub-Saharan average (16%).

There is a paradox in the Ethiopian tax system in general and in the income tax system in particular. One of the fastest growing economies in the world as per IMF (2015)^[5] with a highly authoritative tax authority failed to finance its activities by its own means due to noncompliance even after a series of tax system reforms. Therefore, the intent of this study was trying to solve the puzzle by exploring the factors such as tax knowledge and tax complexity issues which influence business income taxpayer's compliance behavior. The absence of critical studies on the Ethiopian income tax system, especially on the tax knowledge and tax complexity effects of tax compliance decision making issues of business income tax payers also, made this study one of the few sustained studies in Ethiopian in general and in the Amhara Regional State in particular.

2. Objectives of the study

The main objective of this study is to assess the business income taxpayers' perceived level of tax knowledge,

perceived complexity of the income tax system and tax compliance issues in the metropolitan cities of the Amhara Regional State of Ethiopia.. Specifically to:

- 1) Assess taxpayers' perceptions on their knowledge and complexity of the income tax system in the Amhara Regional State of Ethiopia, and
- 2) Examine whether or not such perceptions affect their compliance behavior.

3. Literature Reviews

3.1. Tax Knowledge

Tax knowledge is an essential element in a voluntary compliance, tax system (Kasippilai, 2000)^[6], particularly in determining an accurate tax liability (Palil, 2005^[7]; Saad et al., 2003^[8]). Studies undertaken in Malaysia (Loo, 2006^[9]; Loo et al., 2008^[10]; 2009^[11]) also suggested that tax knowledge to be the most influential factor to determine taxpayers' compliance behavior under the self-assessment system. This is empirically established by several other studies (for example, Kasipillai & Jabbar, 2003^[12]; Kirchler et al., 2006^[13]), which documented that possessing tax knowledge would lead to higher compliance rates. On a similar note, the absence of tax knowledge may lead to noncompliance behavior among taxpayers, either intentionally or unintentionally. This is postulated by McKerchar (1995)^[14] who studied small business taxpayers in Australia. She suggested that small business taxpayers are not even aware of their tax knowledge shortfall and this may lead to unintentional non-compliance behavior. Such evidence was also documented among individual taxpayers in Malaysia who unintentionally committed mistakes in their tax return forms (Loo, et al., 2008)^[10]. In this study, a mixed method design was used by conducting a mail survey, quasi experiment and case study concurrently between November 2005 and July 2005.

The above mentioned studies, which indicate a positive relationship between tax knowledge and compliance behavior, however, were not consistent with an earlier study by Harris (1989)^[15], who claimed that tax knowledge has no direct significant effect on taxpayers' compliance behavior. One possible explanation for such inconsistent results is the difference in tax jurisdictions. The studies mentioned above were either conducted in Malaysia or Australia, while this study was conducted in the US. Another potential reason may be that the different measures were used in the studies.

3.2. Tax Complexity

Tax complexity arises due to the increased sophistication in the tax law (Richardson & Sawyer, 2001)^[16]. Tax complexity can take many forms such as computational complexity, form's complexity (American Institute of Certified Public Accountants, 1992)^[17], compliance complexity, rule complexity (Carnes & Cuccia, 1996)^[18], procedural complexity (Cox & Eger, 2006)^[19] and the low level of readability (Pau et al., 2007^[20]; Richardson & Sawyer, 1998^[21]; Saw & Sawyer, 2010^[22]).

In Malaysia, Mustafa (1996)^[23], who studied taxpayers' perceptions towards the self-assessment system which was to be introduced (at that time), suggested the presence of tax complexity in Malaysia, particularly in terms of record keeping, too much detail in the tax law and ambiguity. The findings were partly consistent with the six potential causes of complexity labeled as: ambiguity, calculations, changes, details, forms and recordkeeping, identified by Long and Swingen (1987)^[24]. Such complexity was also present in Australia, where it forces taxpayers to engage tax agents to deal with their tax matters (McKerchar, 2001^[25]; 2003^[26]). McKerchar (2003)^[26] further identified the most common problem faced by taxpayers is to understand the instructions in the Taxpack 2000. This is followed by the problems of understanding the rules, the tax return forms and other relevant written information provided by the tax authority.

Richardson (2006)^[27], in his research on 45 countries, found that complexity is the most important determinant of non-compliance, apart from education, income source, fairness and tax morale. His findings were consistent with Cox and Eger (2006)^[19] who focused on the State Road Funds in the US State of Kentucky. The authors found that procedural tax complexity contributes to an increase in tax non-compliance. In Australia, McKerchar (2005)^[28], who carried out a survey among tax agents, noted that tax agents were not happy with the increasing complexity of the tax law. She further claimed that the tax agents desired a much simpler tax law, with less regulatory material and adhoc change. Similar findings were documented by Kirchler et al. (2006)^[13]. He found that taxpayers were more likely to comply when the tax law was perceived as less complex..

3.3. Tax Compliance

According to James and Alley (2002, p. 32)^[29], tax compliance refers to the willingness of individuals to act in accordance with both the 'spirit' and the 'letter' of the tax law and administration without the application of enforcement activity. Prior to that, Roth et al. (1989)^[30] defined tax compliance as filing all required tax returns at the proper time and that returns accurately report tax liability in accordance with the tax law applicable at the time the return is filed. The findings from a cross cultural study between Hong Kong and Australia indicated that Australian taxpayers were generally more compliant than the Hong Kong taxpayers (Richardson, 2005)^[31]. Bobek et al. (2007)^[32], on the other hand, used a hypothetical tax scenario in their experimental study to investigate the taxpayers' noncompliance behavior in the US, Australia and Singapore. Results indicated that Singaporean taxpayers had the lowest noncompliance rate of almost 26 percent, while Australian taxpayers had the highest at 45 percent. The findings further suggested that complete compliance was highest in Singapore (54 percent) and lowest in Australia (30 percent). The US was in the middle in terms of both the compliance and noncompliance rates. Belkaoui (2004)^[33], in his study of thirty countries, measured the level of tax compliance using the index that varies from 0 to 6, where higher scores indicated higher compliance. In this study, New Zealand was ranked the second most compliant after Singapore. This was followed by Australia, the United Kingdom (UK) and Hong Kong. Malaysia was ranked eighth, after the US,

while Italy was considered to be the least compliant. A review of the above-mentioned studies provides useful information to the researcher on the level of compliance behavior across countries. However, studies on compliance behavior would be less meaningful without investigating the potential factors leading to such behavior. Jackson and Milliron (1986) ^[34], in their earlier review of 43 tax compliance studies undertaken from 1974 to 1985, identified fourteen key variables of compliance behavior, which include: age; gender; education; income level; income source; occupation; peer influence; ethics; fairness; complexity; tax authority contact; sanctions; probability of detection; and tax rates.

4. Research Methodology

For the study purpose, a cross-sectional research design was adopted. The research employed the qualitative approach in assessing the views of the business income taxpayers in the metropolitan cities of the Amhara Regional State of Ethiopia. The sample size was 24 and for their selection a purposive sampling technique was employed. This study adopts semi-structured interviews to collect qualitative data. The use of interviews is appropriate in obtaining either multifaceted or sensitive information, as well as understanding concepts which require elaboration (Hair et al., 2007^[35]). The interview was conducted from August 2015 to September 2015 and it took approximately thirty to forty five minutes per session to conduct - following the recommendations of previous researchers like (Synodinos, 2003) ^[36]. The interviews were recorded and transcribed. A step-by step thematic analysis was then performed on the transcribed data.

5. Analysis and Results

5.1 Introduction

The interview participants were allowed to communicate either in the Amharic language (Regional as well as Ethiopian national language) or in the English language or a combination of the two. However, for the purpose of analyzing and reporting the results, comments offered in the Amharic language were carefully translated by the researcher with the help of English language Lecturer. To distinguish between the translated versions from the original version (where the English language is used) in the text, the term non-translated" is used for the comments that are originally drawn from participants" own words (rather than being translated), at the end of the comments cited. The demographic description of the participants was presented in Table 1.1 below:

Table 1.1: Demographic Description of the Participants

<i>Gender</i>	<i>Number</i>
Male	15
Female	9
Cities	
Bahirdar	9
Gonder	8
Dessie	7
Level of Education	
Secondary/Technical school	4
Diploma	3
BA/BSC Degree	11
Masters and above	6

5.2 Data Analysis and Results

5.2.1 Tax Knowledge

In this study, the researcher has sought to understand the level of tax knowledge among taxpayers, which encompasses general knowledge, technical knowledge and legal knowledge (concerning taxation). However, during the interviews, participants were generally asked about their knowledge of the income tax system without mentioning a specific type of knowledge as mentioned above. These types of knowledge only emerged while analyzing the participants' responses to the questions. The results indicate that some participants had a general idea of the income tax system, but not much on the details of the system. They admitted that their knowledge was restricted to a broad knowledge of the income tax such as, the objectives of income tax, types of income tax, and tax rates. The following are examples of the comments received:

"It [the income tax system] is a progressive system which essentially assists with redistributing wealth at a certain stage." (Participant 1, male, from Dessie)

"I don't [have a good knowledge of tax]. I know that people are taxed to pay bills in the country, employment, social security, something like that..." (Participant 23, male, from Bahirdar)

"I'm not intimate with the details of some of the taxes. I know what they [government] are getting [through taxes]... where they're going [the government expenditure] and coming from [various sources of tax] but I don't think that I know all about the tax system..." (Participant 10, female, from Gonder)

"Tax knowledge, obviously with my background, I've got better than average, but I certainly wouldn't claim to be a tax expert; I [am] certainly not at the detail level, but much more on a broader policy [level]." (Participant 13, male, from Gonder) (non-translated)

The majority of the participants, when asked about their tax knowledge, instantly revealed their knowledge of the technical parts of the income tax system. This implicitly indicates that technical knowledge is very important to them. This does make sense due to the need to have applied tax knowledge when meeting their income tax obligations. When taxpayers are lacking in technical knowledge of taxation, this is not an issue for salary and wage earners

(even though all of them admitted to having limited knowledge), since they do not have to file tax returns. However, such a deficiency is certainly of concern for the self-employed people or those with other incomes who are required to file tax return forms. This is evidenced from the study, where only two participants claimed to independently prepare their own tax return forms, while the remaining participants (with obligations to file the tax return forms) sought help from accountants:

“Well, I do all my tax returns [but my knowledge] is still limited, I guess.”
(Participant 4, female, from Dessie)

“I would say, [in terms of tax knowledge] I’m better than most. I used to be an accountant years ago, so I’ve got a fairly good knowledge of it.” (Participant 18, male, from Bahirdar)

“[My tax knowledge is] very limited. I’ve tried to do it [tax return], but it’s confusing.”
(Participant 5, male, from Dessie)

“Not that good... I use accountants for my income tax returns. I don’t know too much about it.”
(Participant 1, male, from Dessie)

“Average, really. I have a tax accountant. I don’t personally do my income tax returns. I have got my tax accountant to do that.” (Participant 16, female, from Bahirdar)

“Knowledge among lower income taxpayers, for example, small traders, entrepreneurs, lorry driver[s] with [their] own business, from that aspect [tax knowledge] they know nothing at all. If no one teaches them, they will not do [it]. They will not read [a] tax book, they will not read books related to tax filing... they are totally lost unless they get help from others usually accountants. But most of the time they simply accepted whatever, levied by tax officers through a standard assessment or estimation” (Participant 17, male, from Bahirdar).

“I would say my knowledge is quite good. I actually prepare the tax returns... I have tax accountants that I have to ring for that information because I don’t know it myself...”
(Participant 11, male, from Gonder)

“I have a very good accountant, so I expect my accountant to make sure that I’m informed. I’ve been a self-employed [person] for a lot of years, so yeah; I think I have as much as I need to know.” (Participant 20, female, from Bahirdar)

“I’m not really aware of the penalty in details such as how much is the penalty and so on because every year I always send [the tax return form] on time and so on, in order to avoid the penalty. What I know at least is the penalty is very severe.” (Participant 6, female, from Dessie)

From the interviews, very few participants mentioned their knowledge of the legal aspects of the income tax system. This could be due to the fact that they had little knowledge of it and/or they did not find it to be an important aspect of income tax to discuss.

5.2.2 Tax Complexity

With regard to the complexity of the income tax system, the majority of the interview participants claimed that the system is generally too complex for taxpayers to understand. While one participant puts the blame on the multitude of forms for causing the complexity in the income tax system, another claimed that the income tax itself is inherently complex. With that in mind, it is therefore not surprising that the majority of the participants regarded the income tax system as seriously complicated. The following is a sample of views from participants:

“It is [complex] for somebody like me. I do try to understand like I read about it and I just get lost. [It’s] not for me.” (Participant 15, female, from Gonder)

“It is complex. I think it could be made simpler for everybody, so everybody truly understands because sometimes they make forms and it’s too much. That needs to be taken out.”

(Participant 3, male, from Dessie)

“I think the tax system is really complex. I think it is so in the most countries. I think the main reason for the taxation to be so complex is that government attempts to use [the system to] firstly, redistribute incomes and secondly to achieve other social goals. They are trying to take the tax system and use it for something that the tax system is not really designed for.” (Participant 13, male, from Gonder)

“I think it is [complex] for less educated people, I don’t know about educated people, but unrelated to tax, unless they have a good accountant.” (Participant 12, female, from Gonder)

Parallel with the mainstream opinion among the participants that the income tax system is complex, some participants expressed their concern towards the small traders who need to deal with onerous tax matters. This concern makes sense for smaller businesses have to deal with various tax matters, including provisional income tax, PAYE, VAT and so on, which is expected to result in high compliance costs. For instance, three participants commented:

“...how is, you know what they call Mr. Average on the street, going to understand this. He’s not, and so, I feel very sorry for people who are trying to start up their business, but compliance costs are huge.” (Participant 13, male, from Gonder) (non-translated)

“...when you start getting into self-employed or when you start becoming an employer, [the tax system is] getting quite complex.” (Participant 22, female, from Bahirdar)

“...with regard to the sole trader, the small business, those who employing less than five people or people who are consulted in trying to pay their own tax, I think they get in trouble. I think the provisional tax is the one with that problem...” (Participant 6, female, from Dessie)

Undeniably, there were interviews participants who considered the income tax system not complex. However, according to four such participants, this view was merely true in the case of micro businesses that paid income tax based on standard assessment without the need to have maintenance of books and accounts. It is also important to note that the remaining participants, who had a favorable opinion on the complexity of the income tax system, were a hotel owner, and one clinic owner who had a tax accountant to deal with their tax matters. In other words, their comments on the complexity of the income tax system may be biased since they had little or no experience dealing with tax matters themselves. A selection of comments follows:

"It's not complex and I don't have a problem with it."
(Participant 11, male, from Gonder)

"[The income tax system is] relatively easy. (Participant 18, male, from Bahirdar)

One taxpayer claimed that the complexity of the income tax system had benefited none other than the accountants and lawyers. Such a statement provides support to previous studies by White (1990) ^[37] and Sawyer (1996b) ^[38], who discussed the complexity scenarios preferred by various groups of tax professionals. Specifically, this participant stated:

"I mean, in my own particular case, for the first time ever, I have to use an accountant to do my tax return quite simply because I had some diversified businesses with various transactions and I had to pay tax on them. That, I think, was crazy because the only people who really benefit from that are the accountants because the tax system is too complex... and the second beneficiary is the lawyers." (Participant 20, female, from Bahirdar)

5.2.3 Compliance behavior

Based on the literature discussed, this study assumes that taxpayers were considered to be complying with the income tax system when they filed all their required tax return forms within the stipulated time frame and these return forms correctly report their tax liabilities in accordance with the relevant tax laws (Roth et al., 1989) ^[30]. To capture tax compliance behavior, participants were initially asked about their perceptions of taxpayers' compliance behavior in general. Most participants implicitly claimed that taxpayers' compliance behavior should be observed in terms of their characteristics and opportunities available.

"I know there are a lot of businesses out there that don't pay their fair share of taxes. And I believe someone protected it, particularly I'm gonna use the term, say'' untouchable'' shop owners who sell spare parts, although they work very long hours (seven days a week), I know the cash that they actually declare is the fraction of what they [are] actually earning, all right." (Participant 19, female, from Bahirdar) (non-translated)

Unlike salaried taxpayers, the self-employed have opportunities to decide whether to comply or not comply with their tax obligation. One participant admitted to the fact that many self-employed people evaded tax. This evasion

practice was performed sometimes with assistance from accountants by simply adjusting the income and expenses in the business to end up with a smaller tax liability. Participants commented as follows:

"I think that most people, you know, that has [a] small sole trader business, are you trying to tell me that the local grocery owner or fruit shop owner [is] paying the tax he should be paying? I'm saying you are having a laugh."
(Participant 7, male, from Dessie)

"I would say that the small self-employed businesses, I would have thought, may be trying to have a little bit of tax evasion. Doing cash jobs for friends and that, but otherwise I think the Revenue Authority is pretty hard to have not complied with, I would have thought." (Participant 8, male, from Gonder)

When probed on the reasons for tax non-compliance, various answers were given by the participants. The first is that the taxpayers' attitude of being greedy and no feelings of civic duty to share their incomes with other members of the society, as stated in the following comments:

"They're just greedy. They just want to keep more money themselves." (Participant 4, female, from Dessie)

"...some [people do not comply], I think it's just real greed, really... I think some people just hold that kind of an attitude to life really, and comes into their taxes."
(Participant 23, male, from Bahirdar)

Another potential reason for non-compliance, from the participants' perspective, was the taxpayers' belief that they could avoid paying tax without being caught by Revenue Authority. Such perceived behavioral control among taxpayers motivated them to constantly not comply with their tax obligations. Some attributed that control to the assistance provided by the accountants, while others blamed the loopholes in the tax system itself that provided room for manipulation:

"...because if people can get away with things, they will."
(Participant 5, male, from Dessie)

"I think it is possible that they think that for small occasional, say, source of income, they probably do things for friends, and they might think that they can get away with it enough." (Participant 8, male, from Gonder)

"I think probably most people would have tried to avoid tax if they know they can get away with it." (Participant 13, male, from Gonder)

Interestingly, one participant, claimed that good tax knowledge could also motivate taxpayers to avoid (or evade) paying tax. In this instance, this comment suggests that taxpayers with good tax knowledge were not necessarily expected to comply with their tax obligations since some may have misused this in their attempt to avoid fully complying:

"If you've got good knowledge, you'll probably attempt to, well, I wouldn't say avoid, but yeah, avoid paying as much, paying unnecessary tax."

(Participant 14, male, from Gonder)

Complexity of the income tax system was perceived as another rationale for non-compliance among taxpayers. Participants believed that complexity of the income tax system compelled taxpayers to not comply, either intentionally or unintentionally, for instance:

"...I also think that probably some people don't comply strictly because the tax system is too complex." (Participant 2, male, from Dessie)

"I think, sometimes people try to deliberately avoid doing it [tax compliance] because the aid [assistance from the Revenue Authority] is painful, especially if you're a small business and the provisional tax is coming..." (Participant 16, female, Bahirdar)

"...I think most people try to be compliant and if they aren't, it is because it is too complex." (Participant 3, male, from Dessie)

Another significant explanation for non-compliance was the fairness perceptions of the income tax system as a whole. Participants clearly mentioned that their negative perceptions of the income tax system, particularly on the tax rate structures and government spending, had motivated them to avoid and evade paying taxes:

"I don't think we do comply properly because the system is not fair... I think that with a fairer tax, I think that we would comply, we would be much more happy to comply and we would like; I mean most of my [business expenses], in my business dates you know, I put back most [expenses] to wages so I don't have to pay such a high percentage in tax, but if it was a fair amount, I don't think we would have creative accounting like we do now." (Participant 20, female, from Bahirdar)

"And I think in most cases, people will evade it because they feel that money has been wasted." (Participant 24, male, from Bahirdar)

"I think a lot of [non-compliance behavior] is down to people's perceptions of whether they are being treated fairly or not." (Participant 23, male, from Bahirdar) (non-translated)

6. Conclusion and Recommendation

When discussing about their knowledge of the income tax system, the participants appeared to have inadequate knowledge of the technical aspects of the income tax system. Some are more critical on this issue because in dealing with their tax affairs, they may have to incur more compliance costs (in terms of time and money), which might be the source of their frustrations towards the income tax system. The participants also perceived the current income tax system as complex. They claimed that while the income

tax system itself is inherently complex, the huge amount of paperwork to be completed in complying with their tax obligations further escalated the problem. This is not surprising as the income tax system has been criticized for being overly complex. Even though tax simplicity and education /awareness creation campaign/program has been continuously undertaken, perhaps the benefits of such programs were not yet visible, in the view of the participants. With regard to their impact on taxpayers' compliance behavior, participants generally believed that, inadequate technical knowledge and complexity of the income tax system have partly contributed to taxpayers' noncompliance. Therefore the tax authorities and tax policy makers shall give more attention to enhance business income taxpayers, tax knowledge and making the income tax system simpler if they want to achieve a high level of voluntary tax compliance.

7. Contribution of the Study

The information obtained from this study would be beneficial to both tax literature and practice. From the policy makers' perspectives, the results of this study can help the Ethiopian policy makers in general and the Amhara Regional State policy makers in particular understand the important segment of tax knowledge and complexity of the income tax system so that the appropriate improvements can be made to ensure high compliance in future. In addition, this paper will contribute to the tax literature in two ways: first, the information obtained will add to the limited literature available in the region, second, the information on tax knowledge and tax complexity may provide the basis to develop tax knowledge and tax complexity measures and finally the information on possible determinants of non-compliance could be used for future research.

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