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## RESEARCH ARTICLE

### FACTORS AFFECTING FAIRNESS OF TAXATION ON CATEGORY "A" TAX PAYERS: THE CASE OF HAWASSA CITY ADMINISTRATION TABOR SUB CITY REVENUE AUTHORITY OFFICE

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#### ABSTRACT

Currently Ethiopia is in an era of renaissances and struggling to overcome her poverty. For Ethiopia Taxation is a weapon that support this struggle for this to happen a fair tax system is needed. The goal of this study is to investigate fairness of taxation on category "A" tax payers found in Hawassa city administration Tabor sub-city Revenue authority. The researcher distributed questionnaires to selected tax payers and tax officers. In addition the researcher used in- depth interview and Focus group discussion with management bodies and Tax payers respectively. The objective of this study is to investigate the determinants of tax fairness among category "A" tax payers of Hawassa City Administration, Tabor Sub city. To this end the study conducted a cross-sectional study on a sample of 286tax payers using multistage sampling technique. The study also employed a probit model to identify determinants of tax fairness. Accordingly, the probit regression result of tax fairness revealed that four variables namely attitude of tax payers, corruption, tax system and license of trade are significantly rated with tax fairness. The findings show that fairness of taxation is directly and positively determined by attitude of tax payers and trade license. In addition to that tax fairness is also affected but negatively and significantly by corruption and tax system. The study concluded that tax fairness can be created and maintained through developing positive attitude of taxation among tax payers, ensuring that all businesses should operate under proper trade license, strengthening the tax system and combating with corruption on the part of revenue authority and tax administration staff.

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#### INTRODUCTION

The fairness of a tax system may also be perceived in different ways by the taxpayers and tax authorities. What is fair in the eye of the tax authorities may not have the same image in the mind of the taxpayers. According to James (2003), the most obvious requirement of equity or fairness is to treat equal people in equal circumstances in an equal way. To put it differently, it is essential that a good tax system should appear equitable to the taxpayers. In Ethiopia, tax is administered at federal or central and regional levels. The constitution of Federal Democratic Republic of Ethiopia (FRDE) has separated the tax revenue to be collected by federal government, state or regional government and jointly by the federal and state government.

The regional governments of Ethiopia collect taxes and revenue by bureaus of Regional Inland Revenue Authorities from privately owned enterprises and organs of regional governments. Whereas, the central government revenue collection organs are responsible to collect revenues of federal and joint revenues owned by both the central government and regional governments from different organizations including which are owned by federal government (Council of Ministers, 2002). The Ethiopian Revenue and Custom Authority (ERCA) are responsible for the enforcement of the tax laws relating to income tax particularly business profit taxes, and other types of taxes. In addition to this, the ERCA is also responsible for collecting withholding tax on payments made to non-residents relating to interest, royalties, contract payments, special classes of income (such as fees for technical advice) and income in respect of services performed by a public entertainer. According to Anna, Che, and Kamala (2008), taxpayers' perception on the tax system is important because fairness of the tax system will instill compliance among taxpayers. Attitudes about the tax system and perceptions of fairness are naturally influenced by what the public actually know about it.

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A tax system that is complex, that is poorly understood by both tax administrators and taxpayers, that creates numerous opportunities for corrupt behavior, and that involves coercion in the collection of taxes from reluctant citizens provides a poor basis upon which to build trust between citizens and the government. Brooks (2001) states that fairness has always been widely regarded as the most important criteria in judging tax systems. Governments in order to meet the escalating needs of the people require large resources today than ever, while balancing income and expenditure through collecting fair tax. As Tax is major source of income to the governments operation, the government of Ethiopia is working to promote fairness among the taxpayers, so as to maintain equality between the collection plan and capacity of revenue generating. The annual report of Hawassa city administration revenues authority shows that from the total planed level of revenue the city managed to collect only about 58% stating that lack of fairness on taxation has contributed for the mismatch of collection and generating capacity of tax in the city (Hawassa city administration annual report, 2013). Amin and Jhon (2008) further revealed that the impact of over-taxation of big and visible businesses is excessively lowering legally earned. It creates a loophole whereby those small businesses, including the large informal sectors are taxed either to a much lesser extent or not at all.

Under-capacity of collection of revenue is lack of fairness of taxation due to above factors that affect fairness of taxation. Poor or weak administration systems affect fairness of taxation. For instance, tax officers delay to register tax payers' on time, they also delay to give order to use cash register machine and on the other hand give service to those tax payers who are ready to make than happing through corruption practices affect fairness of taxation due to non compliances to tax law and tax payers' overstate their expenses on taxation also affect fairness of taxation due to increase of non receipt expenses. Further, according to GTP (2011/12) forwarded by MoFED, there is a plan of increasing tax to GDP ratio to 17 percent in the five years plan. However, the evidence obtained recently shows that the tax to GDP ratios has decreased. According to MOFED, this is specifically due to the prevalence of a high number of non-complying tax payers (MoFED, 2011/12). Moreover, it is believed that well educated tax payers use their knowledge to overstate their expenses by increases the amount stated on no invoice payments. This leads to affect fairness of taxation because of increasing unnecessary expenses or overstate the expenses to reduce the income tax; they pay unfair tax based on ability to pay compared with other tax payer. Despite, a lot of efforts have been made to ensure the fairness of taxation and to reduce tax evasion in the past several years; lack of fairness is still the major challenge. Therefore, this study tries to investigate those factors that affect fairness of taxation in Ethiopia, specifically in the case of Hawassa city. The overall objectives of this study is to investigate factors that affect fairness of taxation on "A" categories' tax payers and causes of unfair taxation present at Hawassa city administration.

**A brief literature review:** According to Bhatia (1976), a good tax system, in order to achieve various objectives, chooses and adheres to certain principles, which become its characteristics. A good tax system, therefore, is one, which is designed based on an appropriate set of principles, such as equality or fairness and certainty. According to James (2003), the most obvious requirement of equity or fairness is to treat equal people in

equal circumstances in an equal way. To put it differently, it is essential that a good tax system should appear equitable to the taxpayers. The principle of equity asserts that tax payers of the same levels should be taxed similarly that is to say tax payers with equal abilities should pay the same amount of tax. Citizens with great ability should pay more. The principle of equity is also viewed as fairness by most scholars because it stipulates that those with greatest ability to pay should have the highest tax burden (AICPA, 1992). Brooks (2001), states that fairness has always been widely regarded as the most important criteria in judging a tax system. The problem of unfairness is that a tax system allows taxes to be shifted from dishonest to honest taxpayers. The fairness of a tax system may also be perceived in different ways by the taxpayers and tax authorities. What is fair in the eye of the tax authorities may not have the same image in the mind of the taxpayers. In addition, the implementation of the tax systems based on either progressive tax structure or flat tax rate structure however, most of the individual taxes are progressive tax structures. i.e., that is vertical in terms of providing equity does not meet. Lemessa (2005) also adds that a major responsibility is to ensure that all taxpayers dealt with by a given official are accorded similar treatment and that all officials dealing with a given taxpayer would accord the same treatment. The importance of a sound legal structure for effective tax administration and the importance of incorporating principles that will further tax compliance in the design of that legal structure. Since each stage of the administrative process is dependent upon the other, to achieve a significant improvement in the overall effectiveness of the tax administration each element of the legal structure needs to be designed for maximum effectiveness (Asian Development Bank, 2001).

Bhatia (1976) further says, a good tax system, in order to achieve various objectives, chooses and adheres to certain principles which become its characteristics. A good tax system, therefore, is one which is designed on the basis of an appropriate set of principles, such as equality or fairness and certainty. Since fairness of a tax system is its corner stone. Kirchler (2007) and Wenzel (2004) suggested that fairness can be conceptualized as distributive justice, procedural justice and retributive justice. Distributive justice is concerned with fairness in exchange of resources in both the benefit and cost, while procedural justice refers to fairness in the process of resources distribution and retributive justice is concerned with about the fairness in appropriateness of sanctions when rules are broken. However, Kirchler (2007) stated that research relating to fairness and tax compliance only focuses on distributive justice. With regard to distributive justice, comparisons are made on the basis of individuals, groups and societal level and at individual level; taxpayers will be interested in the fairness of his tax burden, if it is perceived to be too high compare to other individuals' tax burden, his rate of compliance is likely to decrease. A passive attitude by the authorities towards these errors and falsifications will soon undermine the entire structure, since the diligent and honest taxpayers will almost in self-defense be forced to the level of the careless and dishonest. Bird and Oldman (1967) further state that the sure sign of ineffective tax administration is the presence of a very large delinquency in tax payments for it indicates the lack of taxpayer respect for the tax system. The taxpayer in effect is acting on his belief that the administrative machinery may bark, but that it has no bite.

According to Anna, Che, and Kamala (2008), taxpayers' perception on the tax system is important because fairness of the tax system will instill compliance among taxpayers. Attitudes about the tax system and perceptions of fairness are naturally influenced by what the public actually knows about it. A tax system that is complex, that is poorly understood by both tax administrators and taxpayers, that creates numerous opportunities for corrupt behavior, and that involves coercion in the collection of taxes from reluctant citizens provides a poor basis upon which to build trust between citizens and the government. Hence, due to complex tax system and weak data compile system are believed to affect the amount of tax to be collected. The aspect of knowledge that relates to compliance is the general understanding about taxation regulations and information pertaining to the opportunity to evade tax. 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 evade tax payment (Eriksen & Fallan, 1996). Previous studies have evidenced that general tax knowledge has a very close relationship with taxpayers' ability to understand the laws and regulations of taxation, and their ability to comply with them (Singh, 2003).

## MATERIAL AND METHODS

**The study area:** Hawassa town is located in southern part of Ethiopia, Southern Nations, Nationalities and Peoples Regional State, in Sidama Zone at a distance of 275 km from Addis Ababa. It is bounded by Lake Hawassa on the west and north-west, Chelelaka swampy area on the east and south-east, Tikur Wuha River on the north and Alamura Mountain on the south. Its astronomical location is 07° 03' north latitude and 30° Hawassa city is bounded by Lake Hawassa in the West, Oromia Region in the North, Wendogenet woreda in the East and Shebedino woreda in the south. The city has total area of 157.2 sq.km Divided in to Eight(8) sub cities and Each sub cities is divided in to 32 Kebeles, These Eight sub cities are Hayek Dare, Menehariya, Tabore, Misrak, Bahile Adarash ,Addis Ketema, Hawela Tula and Mehal sub city. The lake and the land along the edge of the lake have got different names in Sidama Language. The Lake has been called 'Hawassa', which means 'big' in Sidama language; and the land nearby was called 'Ada'are', equivalent in meaning to the phrase " " "the field of cattle". As it is comfortable place for rearing animals. Hence, the town established in the land Adaare has got its name from the lake -Hawassa. The inherent attractiveness of the lake Hawassa was the major inspiring reason for the people to establish the town in this site. So far, the place was not occupied by residents; rather, it was used by pastoralists for raising their livestock. As the access of water and grasses for their cattle caught the attention of high land people, they used to make frequent visit to this area, and settled here.

**Data type and instruments:** In this both primary and secondary data were used. Primary data was collected from respondents using self administered questionnaire and in depth interview from "A" category tax payers of Tabor sub city in Hawassa city administration. The questionnaire was divided into four Parts with the intention of extracting information to address the research questions. The first part comprised questions pertaining to the samples respondents' demographic information.

The second part contained questions related to attitude of tax payers. The third part consisted of questions regarding level of education of tax payer and the last part consisting questions related with level of administration system. According to Ahmad (1997), there are advantages of using questionnaires such as, each sample is given the same questions in the same sequence, and standardized questionnaires expedite data gathering process and ensure the quality of data gathered, Allows easy data processing. This study has also used secondary data collected through the review of Hawassa city administration Tabor sub city annual plan, and reports of in Hawassa city administration Tabor sub city revenue authority plan. From annual reports, published literature, journal, website and internet libraries. This study used structured and self administered questionnaires and interview. The questionnaires were prepared in both English language and Amharic language to non- English speakers of respondents.

**Research design:** This study used a cross sectional survey design and considered both descriptive and analytical aspects. The descriptive survey was used to assess the relationship between fairness of taxation and attitude of tax payers. The analytical aspect was used to assess relationship between fairness of taxation and level of administration system of revenue authority and to assess relationship between tax fairness and level of education and also assessing relationship of fairness of taxation attitude of tax payers.

**Study of population:** This study used population of category "A" tax payers in three sub city in Hawassa city administration. There are around 600 category "A" tax payers in these three sub cities and 21 employees of the authority consists the population of the study.

**Sample size and sampling method:** This study used 248 samples of category "A" tax payers from the total population of 621 in the sub cities. It used systematic sampling technique and the sample size was calculated by the formula of finite population sample formula. (Given by Yemaneh,):

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

Where

n –sample size, N –population, e -permitted error

$$n = \frac{600}{1+600(0.05)^2} = \frac{600}{1+600(0.0025)} = \frac{621}{1+1.5} = \frac{621}{2.5} = 248$$

If consider 17% of contingency the final sample size will be  $(0.17*248) + 248 = 286$ . A multi-stage sampling method is employed in order to select respondents who reside in the study area during the reference period. In stage one Hawassa city is selected purposively, in stage two one sub city, namely Tabor sub city is selected, purposively due to high concentration of tax payers and finally in the third stage Simple random sampling is employed to collect data from the tax payer while paying attention to the size of each kebele. Both primary and secondary data are be used in conducting the study. The main source of the data for this study, however, is primary data of the cross sectional survey conducted on the tax payers of Tabor sub city administration Revenue authority.

Secondary data on various aspects of tax payers is obtained from published and unpublished documents, records, evaluation reports, proceedings, journals, and strategy and policy documents and from department Revenue authority of Tabor sub city. This has been used to triangulate and substantiate the findings from the primary data. The target population of this study is comprised of all tax payers of Hawassa city Tabor sub city and the unit of analysis is the tax payers of Hawassa city Tabor sub city. To this end questionnaire is used as a primary tool for collecting data from the sampled tax payers. The questionnaires have many close ended and some open ended items. Moreover, the questionnaires were prepared, commented and pilot tested to make sure that reliable and authentic data are collected. In order to triangulate and substantiate results the study had also analyzed relevant documents such as policy manuals, plans and programs records, current performance evaluation reports, proceedings, strategy documents and policy notes, and previous research outputs.

**Model specification:** Discrete regression models are models in which the dependent variable assumes discrete values. Econometricians have developed a model that best captures the behavior of a discrete dependent variable. For the simple discrete dependent variable, econometric literatures have the three most commonly used approaches to estimating such models are the linear Probability model, the Logit model and the probit model. The linear probability model has an obvious limitation in that the estimated probability values can lie outside the normal 0 to 1 range and it also assumes that the marginal or incremental effect of explanatory variables remains constant. Thus this model is discarded from the set of alternative models. The Logit and Probit models are the convenient functional forms for models with binary dependent variable. The choice between the two is one of mathematical convenience. The study, however, employed the probit model. (Gujarati, 2007; Wooldridge, 2009).

The probit model is generated by a simple latent model of the form shown below

$$y_i^* = X' \beta + \epsilon \quad (1)$$

$$y_i = \begin{cases} 1 & \text{if } y_i^* > 0 \\ 0 & \text{otherwise} \end{cases} \quad (2)$$

Where

$y_i^*$  is the latent variable or unobserved variable;  $y_i$  is the  $i^{th}$  merchandisers and its value is 1 if she/he regards the tax payment is fair and 0 otherwise;  $X'$  is a vector of explanatory variables;  $\beta$  is a vector of parameters to be estimated and  $\epsilon$  is the error term which is normally distributed with mean 0 and variance  $\delta^2$ . With the assumption of normal distribution function, the model to estimate the probability of observing a merchandiser who considers that tax is fair can be stated as:

$$P(y_i = 1|X) = \Phi(X' \beta) = \int_{-\infty}^{X' \beta} \frac{1}{\sqrt{2\pi}} \exp(-z^2/2) dz \quad (3)$$

Where  $p$  is the probability that the  $i^{th}$  merchandise who is considers that tax is fair and 0 otherwise. The specific probit model for the tax fairness is:

$$y_i = \beta_0 + \beta_1 EDUTP + \beta_2 ATITP + \beta_3 CORRTA + \beta_4 SYTTA + \beta_7 LOTRD + \beta_8 DSJRA + \beta_9 VCOTP + \epsilon_i \quad (4)$$

Where EDUTP represents Education level/tax knowledge of tax payers, ATITP represents Attitude of tax payers, CORRTA is Corruption on Revenue authority, SYTTA is Tax system, LOTRD is License of Trade, DSJRA is Distributive justice and VCOTP is Voluntary compliance.

**Variable specification and hypothesis:** The description of these explanatory variables, their measurement and expected sing of their relationship with the dependent variable is presented in the table below.

## RESULTS AND DISCUSSION

Table II below depicts the regression result of the probit model of tax fairness. Accordingly, therefore, it is revealed that the likelihood ratio chi-square of 81.38 with a p-value of 0.0000 implies that the regression model (i.e. the probit model) as a whole is statistically significant and hence explanatory variables put together do explain the variation in the dependent variable which is tax fairness. In the definition of variable and hypothesis of expected sign, the study in table I, has already identified that several variables are deemed to affect tax fairness. These are :( EDUTP) Education level of the tax payers, (ATITP) Attitude of tax payers, (CORRTA) Corruption of the staff of authority and tax administration, (SYTTA) Tax system, (LOTRD) License of Trade, (DSJRA) Distributive justice and (VCOTP) Voluntary compliance. We used these set of independent variables to fit into the probit model of tax fairness. Accordingly the probit regression of the model results in Table II below depicts from the total of seven variables, four of them were found to be significant at different level of significance. These are (ATITP) Attitude of tax payers, (CORRTA) Corruption of the staff of authority and tax administration, (SYTTA) Tax system, (LOTRD) License of Trade. The rest, though not significant are of the expected sign. The result of table II depicts only the direction of relationship between tax fairness and its determinants. In order to interpret the quantitative implications of the determinants of tax fairness, we need to compute the partial effects, using marginal effects for continuous explanatory variables and average effects for binary explanatory variable. The partial derivatives (marginal effects) of the variables on the probability of tax fairness is displayed in the table III below.

Table III above showed that the coefficient of the partial effect of (ATITP) Attitude of tax payers) is positive and significant at one percent level of significance. This implies tax payers who have positive attitude toward tax do contribute for an increased probability of tax being fair. This can be partly explained by the fact that attitude matters most be it in tax collection or even in insuring the fairness of tax. The table below depicts that, keeping all other factors constant, an average tax payer with positive attitude of tax payment and the entire tax system and tax issues makes the tax fairness better off by 37 percent than their counter part and this relationship is significant at one percent level of significance. The variable (CORRTA) measures whether or not the staff in the sax authority and tax administration is corrupt. It is a tax payer's opinion of the revenue authority and tax administration staff. The stat output of the probit model revels that there is negative and significant relationship between corruption of revenue authority and tax administration staff and tax fairness. Accordingly corrupt individuals in the tax system and revenue authority contribute for more than 50% increase in the

**Table 1. Independent variables and expected sign**

Independent variables	Description of variable s	Type	Measurement	Expected sign
EDUTP	Education level	Continuous	Years	-
ATITP	Attitude of tax payers towards tax payments	Dummy	1=positive 0=negative	+
CORRTA	Corruption	Dummy	1 if the individuals is corrupt, 0 otherwise	-
SYTTA	Tax system	Dummy	1 if system is weak, 0 otherwise	-
LOTRD	License of Trade	Dummy	1 if have license, 0 otherwise	+
DSJRA	Distributive justice	Dummy	1 if it's just , 0 otherwise	+
VCOTP	Voluntary compliance	Dummy	1 if there is compliance, 0 otherwise	-

**Table 2. Estimation result of the probit model of tax fairness**

Dependent variable : Tax fairness				
Independent variables	Coefficients	Stand error	Z-stat	P value
EDUTP	-0.1262968	.1007502	-1.25	0.210
ATITP	1.144739	.2071072	5.53	0.000*
CORRA	-1.62581	.6938825	-2.34	0.019**
SYTTA	-1.426332	.5950379	-2.40	0.017**
LOTRD	0.1952685	.1084848	1.80	0.072 *
DSJRA	0.0880845	0.1001598	0.88	0.379
VCOTP	-.3398478	.4143208	-0.82	0.412
Constant	-4.814209	.9629803	-5.00	0.000
Number of observation = 286				
LR chi2(9)=81.38				
Prob > chi2=0.000				
Log likelihood = -89.40				

Source: own survey and calculation 2019. \*, \*\*, \*\*\* significant at 1%, 5% and 10 % respectively

**Table 3. Partial effect for probit model of tax fairness**

Dependent variable				
Independent variables	Coefficients	Stand error	Z-stat	P value
EDUTP	-0.0409114	.03276	-1.25	0.212
ATITP	0.3708161	.06033	6.15	0.000*
CORRA	-0.5333471	.23246	2.29	0.022 **
SYTTA	0.464426	.17028	2.73	0.006 **
LOTRD	0.2293877	.13151	1.74	.0081 ***
DSJRA	0.0285333	.03229	0.88	0.377
VCOTP	-0.0988043	0.10623	-0.93	0.352

Source: own survey and calculation 2019.

probability of tax being unfair and this empirical result is significant at five percent level of significance. A weak tax system contributes a lot in causing taxation to be unfair and dissatisfy the tax paying citizens. A weak tax system becomes insufficient, inconvenient, and unfair to tax payers. In our study this variable is a dummy variable where the value one is given for a weak tax system and zero otherwise. Table III above revealed that this variable is significantly and positively related at five percent level of significance. Accordingly a weak tax system, keeping all factors constant, increases the probability of tax unfairness by 46%. The intuition behind this empirics is that if a system is weak it paves all the way for tax evasion, tax under or over estimation, tax compliance and the like. Furthermore it lacks its credibility among the tax paying citizens. In the category "A" tax payers there are some merchants or trades operating in the business field with our having proper license when actually there some business people who are strictly abiding by the law. This significantly affects the tax revenue and tax fairness as well. In the probit regression result above there is positive and significant relationship between license and tax fairness. Accordingly the survey result revealed that those who have license do contribute for tax fairness by 23 % than their counter part, keeping all other factors constant. Even business people whose annual turnover is among category "A" tax payers are operating their business without license during initial period of time. This greatly affects the government revenue and fairness of tax.

## Conclusion

The result of the econometric analysis using the probit model has unveiled that there are four variables that are empirically found to be significantly affecting the fairness of tax. These are attitude of tax payers, corruption, and trade license and tax system. Thus, the study underscored that tax fairness can be created and maintained through developing positive attitude of taxation among tax payers, ensuring that all businesses should operate under proper trade license, strengthening the tax system and combating with corruption on the part of revenue authority and tax administration staff.

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