ST. MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

MBA IN ACCOUNTING AND FINANCE

THE EFFECT OF INCOME TAX ON SMALL BUSINESSES: THE CASE OF ADDIS KETEMA

BY

HANAN ABDULHAMID

JUNE 2023

ADDIS ABABA, ETHIOPIA

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APPROVED BY BOARD OF EXAMINERS

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DECLARATION

I, the undersigned, declare that this study entitled "The effect of income tax on small businesses: The case of Addis Ketema" is my original work, prepared under the guidance of Andinet Asmelash (Asst. Prof). All sources of materials used for this thesis have been duly acknowledged. I further confirm that the thesis has not been submitted either in part or in full to any other higher learning institution for the purpose of earning any degree.

Name	Signature
St. Mary's University, Addis Ababa	**June, 2023**

ENDORSEMENT

This thesis has been submitted to St. Mary's University, School of Graduate Studies for examination with my approval as a university advisor.

_Andinet Asmelash (Asst. Prof)_____ ________________________

Advisor Signature

St. Mary's University, Addis Ababa June, 2023

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LIST OF ACRONYMS

AACRA: Addis Ababa City Government Revenue Authority

ETB: Ethiopian Birr

MoR: Ministry of Revenue

MSE: Micro and Small Enterprise

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ABSTRACT

This thesis examines the effect of income tax on small businesses based in mainly in Addis Ketema sub city, Addis Ababa, Ethiopia. The research is based on a comprehensive review of literature on income tax and small businesses in Ethiopia, including academic articles, government reports, and policy documents. The findings suggest that income tax has a significant effect on the profitability and growth of small businesses in Addis Ababa. Specifically, the study shows that high tax rates and complex tax regulations can discourage entrepreneurship and reduce the willingness of small business owners to invest in their ventures. The research also finds that tax compliance costs can be a significant burden for small businesses, particularly for those with limited resources and inadequate access to information and support. The study also highlights the need for policymakers in Ethiopia to design tax policies that promote entrepreneurship and support the growth of small businesses. This includes simplifying tax regulations and procedures, providing more accessible and affordable tax services, and offering targeted tax incentives to encourage investment and innovation. The research contributes to the understanding of the effect of income tax on small businesses in Addis Ababa and provides recommendations for improving the tax system for these critical engines of economic growth.

CHAPTER ONE: INTRODUCTION

Small businesses play a crucial role in the economy by creating jobs, driving innovation, and contributing to economic growth. However, these businesses often face significant challenges when it comes to managing their finances and navigating the complex tax system. Income tax, in particular, can have a significant effect on the success and growth of small businesses.

The findings of this study are expected to provide valuable insights into the challenges faced by small businesses regarding income tax compliance, as well as the effect of tax policies on their growth and success. This research will contribute to the existing body of knowledge on income tax and business, and inform policymakers and business owners on the most effective ways to support these important drivers of economic growth and innovation.

1.1 Background of the Study

If nurtured carefully and supported via a conducive business environment, MSEs can be a seedbed of future large companies and a hub for indigenous entrepreneurship (Aryeetey & Ahene, 2004). Through social inclusion and women's empowerment, they can also contribute to laying the groundwork for strong communities. A small business is easier to start and run since it takes less capital, human, and physical; making it more appealing to underprivileged and historically marginalized groups like women and young people. Additionally, effective small businesses may be used to significantly reduce poverty.

It is impossible to overstate the significance of small enterprises in Ethiopia. Present-day Ethiopia is more characterized by a small private sector, a high unemployment rate, and low-paying jobs, particularly in the manufacturing sector. 98% of Ethiopian enterprises, of which 65% were MSEs, according to Aregash (2005). Only around 9.2% and 4.4% of these businesses were in the manufacturing and construction sectors, respectively, while 86.4% of these businesses were in the service sector (including the trading sub-sector) (Bekele & Muchie, 2009). For the vast majority of impoverished women in Ethiopia, owning and operating a small or microbusiness is their only option for a living (Rahmato, 2004). MSEs made up around 31.8% of Ethiopia's total output (value added), 18.5% of its total labor force, and 13.3% of its total capital, excluding the agricultural sector, according to a research by Engida et al. (2017). This demonstrates that MSEs require less capital to start up and run and are more labor-intensive. More labor-intensive MSEs could be a realistic policy option to promote private sector development and lower the unemployment rate in the urban regions, especially in big cities like Addis Ababa, in countries like Ethiopia where labor is abundant and the capital deficit is acute.

The Ethiopian government emphasizes in its national development plans, GTP-I, GTP-II, and the new ten-year economic plan, that MSEs are a critical tool in reducing urban poverty and unemployment. However, providing a supportive business environment for the emergence and expansion of thriving small businesses continues to be a challenge in Ethiopia. Poor public services, such as those related to taxes, insufficient dispute resolution procedures, a lack of markets for their goods, and restricted access to formal financial institutions are consistently cited as important roadblocks (ILO, 2015; Nega & Hussein, 2016).

It is significant to emphasize that small enterprises, by their very nature, are extremely susceptible to unfavorable business situations. Therefore, when it comes to small firms, government acts, rules, processes, and regulations may result in varied reactions. For instance, governments in developing nations confront the most difficult issues when it comes to collecting taxes (Aryeetey & Ahene, 2005), which are compounded by the limited administrative capacity of the tax authorities and low levels of tax awareness in their society. Small enterprises are typically thought of as the economy's "hard to tax" sector.

The question that follows is whether a government in a developing country should tax MSEs. If so, which tax system: special or regular will apply? The second concern is the appropriate amount of tax and administrative expenditures associated with MSE compliance for the government.

Governments must collect money from a variety of enterprises and citizens in order to raise enough revenue to pay for public spending. In other words, because they have few other sources of money, governments in low-income nations like Ethiopia might feel compelled to tax MSEs as well. The convenience of taxing MSEs is brought to light in the context of this requirement to cast a wide net when it comes to taxes.

However, generating money should not always be the primary or even the primary goal of taxing MSEs. Economic efficiency is prioritized by many nations as one of their main taxation objectives. Governments would be more than ready to accept a trade-off in their revenue in favor of these goals, to the extent that tax rates and systems of collection and administration encourage efficiency and innovation in MSEs.

In any case, a fair and equitable tax system that lessens the burden of taxpayer compliance with the law is prudent for the long-term viability of the tax system. The tax code's simplicity would lower compliance costs for small taxpayers, according to tax policy specialists (Shome, 2004).

Given the crucial role that taxes play in economic growth, nations must set up a tax structure that is appropriate for their unique economic conditions. Tax policy, tax regulations, and tax administration are primarily referred to as the "tax system" (Kariuki, 2003). The fundamental components of the tax system, including the tax base and the procedures for tax assessment and collection, are outlined in tax policy and tax laws. Contrarily, tax administration establishes the framework for the actual tax collection by specified governmental entities, typically a tax authority.

Different strategies for taxing small firms have been explored by policymakers (Shome, 2004). Presumptive taxation is a special regime of taxation that is primarily used in developing nations and is designed specifically to benefit small enterprises. In general, certain taxation criteria, sometimes known as principles that have been widely recognized have a significant impact on attitudes toward the selection of taxes and tax systems. A good tax system is created based on an acceptable set of criteria, such as equity or fairness, convenience, and predictability, according to Hines (Hines, 2000). Presumptive taxation is designed to positively handle this set of concepts.

The above-mentioned appropriate taxation principles are the cornerstones of any ideal taxation, yet they are in no way adequate to create a perfect tax system. According to Lemessa (2005), tax regimes that rely on ad hoc administrative procedures quickly lose credibility and jeopardize voluntary compliance. A competent tax system must take into consideration the mindset of taxpayers, the effectiveness of the system, and the organizational capacity of tax authorities, according to Bhatia (2001).

The Ethiopian government implemented a presumptive tax scheme on category "C" taxpayers in addition to category "A" and "B" tax payers. The amount of taxes to be imposed on an MSE in Ethiopia are determined based on the company's daily revenue since the presumptive tax system was implemented more than ten years ago. In other words, firms pay their taxes annually in accordance with their taxable income. Small business status, location, client convenience, and brand reputation are just a few of the broad indicators that are utilized to estimate daily revenue for small enterprises. As will be seen later in this study, the legislation also makes reference to daily expenses.

However, MSEs in Ethiopia confront a variety of tax-related issues, including deficiencies in the tax code, weak administrative capabilities of the tax authorities, and a lack of awareness of their tax obligations. Research demonstrates that there are special difficulties and gaps in the tax code that make it challenging for MSEs to comply. Taxpayers frequently complain that multiple tax procedures and laws frequently conflict with one another, that MSE participation in daily income assessments is insufficient, and that tax laws do not adequately take into account the seasonality of some firms. Additionally, taxpayers state that they pay more taxes than they can afford to (Workeneh et al., 2019) and that they have no faith in either the tax authority' personnel or the process for estimating, assessing, and collecting their taxes as a whole. All of them have the implication that tax procedures need to be more impartial, open, and clear to both taxpayers and collectors. In actuality, tax laws are so complex that even tax assessors struggle to fully implement them.

1.2 Statement of the Problem

Despite the importance of income tax on small businesses, there is a lack of research on the specific effect of income tax on these types of businesses. The existing literature on income tax and business often focuses on larger corporations, with little attention given to the unique challenges faced by small businesses.

Moreover, there is a lack of understanding about the factors that influence the tax compliance behavior of small businesses. While some businesses may comply with tax regulations out of a sense of obligation or fear of penalties, others may be more motivated by the potential benefits of tax compliance, such as access to government funding or improved reputation.

Therefore, the aim of this study is to address these gaps in the literature by investigating the effect of income tax on small businesses. Specifically, the study seeks to answer the following research questions:

- What factors influence the tax compliance behavior of small businesses?
- How does income tax affect the financial performance and growth of small businesses?

By answering these research questions, this study will provide valuable insights into the challenges faced by small businesses regarding income tax compliance, as well as the effect of tax policies on their growth and success. These findings will be of interest to policymakers, tax professionals, and business owners who seek to support these important drivers of economic growth and innovation.

1.3 Objectives of the Study

Startups and small businesses have the ability to innovate, embrace new technology and know-how, create jobs, contribute to the state budget through taxation, and diversify risk. Working in the informal sector is strongly encouraged by complex tax laws and administrative procedures, a lack of a culture of voluntary tax compliance, and other factors (Engels chalk, 2005).

1.3.1 General Objective

The main objective of this study is to investigate the effect of income tax on small businesses.

1.3.2. Specific Objectives

- To assess how income tax affects the profitability of small businesses.
- To evaluate the tax compliance behavior of the small business owners.
- To analyze the effect of tax deductions and credits on small business growth and investments.
- To provide recommendations for policymakers and small business owners to improve the effectiveness of income tax policies and reduce the burden on small businesses.

By addressing these objectives, the study aims to provide insights into the effect of income tax policies on small businesses and inform policy decisions that promote sustainable growth and development of small businesses.

1.4 Research Questions:

1. What is the relationship between income tax rates and small business profitability?
2. What factors influence the tax compliance behavior of small businesses?
3. How do tax deductions and credits affect small business growth and investment?
4. What are the recommendations for policymakers and small business owners to improve the effectiveness of income tax policies and reduce the burden on small businesses?

1.5 Research Hypotheses:

1. Hypothesis 1: The higher the income tax rates, the lower the profitability of small businesses.

2. Hypothesis 2: Small businesses that take advantage of tax deductions and credits experience higher levels of business growth and investment compared to those that do not.
3. Hypothesis 3: Compliance costs and administrative burden associated with income tax regulations negatively affect the financial performance of small businesses.
4. Hypothesis 4: Streamlining income tax policies and providing additional resources for small business owners can help reduce the tax burden and improve compliance, leading to increased profitability and business growth.

1.6 Significance of the Study

This study is significant for several reasons. First, it addresses a gap in the literature on income tax and business by focusing specifically on small businesses. While there is a significant body of research on income tax and its impact on larger corporations, there is little research on the unique challenges faced by small businesses in managing their income tax obligations. This study aims to fill this gap by investigating the impact of income tax on small businesses and identifying the factors that influence their tax compliance behavior.

Second, this study has practical implications for policymakers and business owners. By identifying the advantages and disadvantages of income tax on small businesses and the factors that influence their tax compliance behavior. This study will provide valuable information to policymakers who seek to support these important drivers of economic growth and innovation. Likewise, business owners will benefit from a better understanding of the effect of income tax on their financial performance and growth, and the most effective ways to manage their income tax obligations.

Third, this study contributes to the broader debate on the role of taxation in promoting economic growth and development. By investigating the impact of income tax on small businesses, this study will shed light on the relationship between tax policies and economic outcomes, and contribute to the ongoing discussion on the most effective ways to design tax policies that support economic growth and development.

1.7 Scope of the Study

The scope of this study is focused on the effect of income tax on small businesses. Specifically, the study will investigate the advantages and disadvantages of income tax on these types of businesses, as well as the factors that influence their tax compliance behavior. The study will also analyze the effect of income tax on the financial performance and growth of startups and small businesses.

The study is going to be conducted through a review of the existing literature on income tax and business, as well as primary data collection through surveys and interviews with business owners and tax professionals. The study focuses on businesses operating in a specific geographic area or country, and may not be applicable to businesses operating in different contexts.

1.8 Limitations of the Study

Despite the focus on small businesses, the study may not be able to capture the full range of experiences and perspectives of all businesses in these categories. The study may also be limited by issues related to data availability and sample size, which may affect the generalizability of the findings.

Moreover, the study is limited to the effect of income tax on small businesses, and does not investigate other forms of taxation or other factors that may influence the financial performance and growth of these businesses.

Overall, while this study aims to provide valuable insights into the effect of income tax on small businesses, its findings should be interpreted with caution, taking into account the limitations of the study and the specific context in which the research was conducted.

1.9 Operational Definition of Terms

Authors and organizations have made numerous attempts to define MSEs. Depending on the various fundamentals, traits, variables, or attributes they try to represent, the definition exercise differs. Nevertheless, the majority of these definitions place a strong emphasis on size, as measured by annual sales income, total assets, and an average number of permanent employees (Maseko, 2014).

Depending on the goal of the law, the word "small businesses" is frequently used to indicate different things. According to Ethiopia's Federal Urban Job Creation and Food Security Agency Establishment Council of Ministers Regulation No. 374/2014, a small enterprise is an organization that employs between five and thirty people, including workers, and has a total capital of up to 500,000 ETB in the service sector and up to 1,500,000 ETB in the urban agriculture, artisanal mining, and construction sectors.

Table 1: Definition of Small Business (Enterprise)

Classification of Business	Sector	Number of Employees	Total Asset
Small Business	Industry	6-30	<1.5 Million Birr
	Services	6-30	<500,000 Birr

There is no explicit definition of a small business or small business taxpayers in the Ethiopian Income Tax Proclamation 2. Instead, the law divides corporate taxpayers into three categories: category "A," category "B," and category "C." From this, it is possible to define Category "C" taxpayers as small business taxpayers. Small business taxpayers in Ethiopia are defined as sole proprietors with yearly revenue of less than 500,000 ETB and small and micro-enterprises with annual revenue of less than 500,000 ETB.

Table 2: Characteristics of a Small Business

Characteristics	Small Business
Number of taxpayers	Many
Types of taxpayers	Family-owned business with some employees; highly specialized self-employers
Ownership Structure	The owner(s) are generally the manager
Type of transactions	Cash/bank; some informality
Place of business	Fixed (but maybe volatile)
Business administration	Some professional assistance
Accounting Standards	Some records limited to partial compliance; limited understanding
Market reach	Local or Regional
Life-span of business	Dynamic; may disappear or change business approach,
Growth potential	Limited, many stay small, but growth is not infrequent

More Terms used

Income Tax: A tax levied by the government on the income earned by individuals and businesses. In this study, income tax specifically refers to the tax obligations of small businesses.

Tax Compliance Behavior: The actions taken by businesses to meet their tax obligations, including timely and accurate preparation and submission of tax returns, payment of taxes owed, and adherence to tax laws and regulations.

Financial Performance: The ability of a business to generate profits and achieve financial goals, including revenue growth, profitability, and return on investment.

Growth: The increase in size, scope, or revenue of a business over time.

1.10 Organization of the Paper

This study is organized into 5 chapters, each of which contributes to the overall objective of investigating the impact of income tax on small businesses. The following provides an overview of the chapters:

Chapter 1: Introduction

This chapter deals with background of the study, statement of the research problem, research questions, hypotheses, objective of the study, significance of the study, scope and limitations of the study, definition of terms and organization of the study.

Chapter 2: Literature Review

This chapter reviews existing related literature which describes the detailed theoretical and empirical aspects that support and clarify the practical aspects of the study.

Chapter 3: Research Methodology

This chapter describes the research design, data collection methods, sampling strategy, and data analysis techniques used in the study. The chapter will detail the survey and interview questions used to collect primary data from business owners and tax professionals, and provide an overview of the data analysis process.

Chapter 4: Results and Discussions

This chapter presents the results of the data analysis, organized according to the research questions and hypotheses. This chapter also discusses the findings of the study and compares the results to the existing literature. The chapter will also identify the practical implications of the study for policymakers, tax professionals, and business owners.

Chapter 5: Conclusion and Recommendation

This chapter summarizes the main findings of the study, discusses the implications for future research, and provides recommendations for policymakers and business owners.

References

Appendices

The appendices will include the questionnaire and interview questions, as well as any additional data tables or figures that supplement the findings presented in the main text.

CHAPTER TWO: LITERATURE REVIEW

2.1 Definition and Classification of Taxes

Even so, there have been numerous attempts to define the word "tax." It is challenging to assert that decision-makers have produced a unique and comprehensive definition. A tax is generally defined as:

"A contribution from individuals or legal entities out of their revenue, property or gain in whatever form, unless exempted, to be tailored for the provision of services by the government entrusted by them."

A brief description of "tax" provided by the OECD is "a compulsory unrequited payment to the government." The well-known 'investopedia', a web-based dictionary of financial and business words, defines 'Tax' as a term referring to "all types of involuntary levies, from income to capital gains to estate taxes." It breaks down the word "tax" into four parts.

- Tax occurs when a government or other authority requires that a fee be paid by citizens and corporations, to that authority.
- The fee is involuntary, and as opposed to other payments, not linked to any specific services that have been or will be provided.
- Tax occurs on physical assets, including property and transactions, such as a sale of stock, or a home.
- Types of taxes include income, corporate, capital gains, property, inheritance, and sales.

Taxes can be commonly classified as direct and indirect taxes. A 'Direct tax' is one for which the formal and economic incidence is essentially the same, i.e. the taxpayer is not able to pass the burden to someone else. Direct Taxes are therefore fully paid by the individuals upon whom they are imposed. On the other hand, an 'Indirect tax' is a tax whereby the tax payer's burden to pay the tax can easily be passed on to another person. The end consumer is typically the target of an indirect tax; however, occasionally, sellers may absorb such indirect taxes to remain competitive in the market in which they are operating.

Personal income tax, rental tax, business profit tax, withholding tax, and other taxes like royalties, games of chance, dividends, or property taxes are the main direct tax kinds in Ethiopia. Value Added Tax, Customs Duties, Stamp Duties, Excise Tax, and Turnover Tax are the principal categories of Indirect Taxes in Ethiopia. 2009 (Mesfine).

2.2. Principles of Taxation

There is a lengthy list of taxation concepts in the literature. Efficiency, Fairness, Certainty, and Simplicity are the only four fundamental tax concepts that are discussed for the purposes of this article.

According to the **Efficiency Principle**, administrative and compliance costs for businesses and governments should be kept to a minimum. An efficient tax system is one that raises money for the government by using the least amount of money and other resources possible. Various criteria, including administrative and compliance expenses among others, can be used to determine efficiency. These two have an impact on the tax system's operating expenses, which in turn affect its adaptability and certainty. The expenses incurred by the government in obtaining tax income are eventually borne by the taxpayer. The government must employ tax collectors, data entry clerks to process tax returns, auditors to examine disputed returns, attorneys to resolve disputes, and accountants to monitor the movement of money in order to collect taxes. The government must pay all of these expenses to run the tax system.

Contrarily, compliance costs are expenses related to paying taxes to the government that are separate from the actual taxes. Citizens are obligated to pay specific charges in order to fulfill their tax payment requirement. In addition to the money consumers spend on accountants, tax preparers, and/or tax lawyers, these compliance expenses also include the time spent submitting tax forms and maintaining records.

As for the **Fairness Principle,** it states that the tax burden is allocated evenly. Two sub-principles, the benefits sub-principle and the ability-to-pay sub-principle, further emphasize equity or fairness. Simply expressed, the capacity-to-pay sub-principle promotes the idea that the amount of taxes that individuals pay should be based on their ability to pay, in contrast to the benefit sub-principle, which advocates for taxing people in proportion to the amount of benefit they receive from government services. This idea has the following two implications:

- Horizontal Equity: People in equal positions should be made to pay the same relative amount of taxes.
- Vertical Equity: A tax system should distribute the burden of paying taxes fairly across people with different abilities to pay. Thus, people who earn more should pay more than those people who make less.

Another extremely important principle is the **certainty principle**. Adam Smith, a British economist and philosopher who lived in the 18th century, wrote a great deal on taxes in his well-known work "The Wealth of Nations." He selects many notions related to the certainty principle. In light of this, he writes the following about this idea:

“The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.”

According to the **Simplicity Principle**, tax laws should be transparent and easy to comprehend so that taxpayers are aware of their obligations. Understanding one's obligations and entitlements is made simpler for both individuals and businesses by a straightforward tax system. Additionally, it makes it simple for them to cooperate. Businesses are therefore more likely to decide wisely and implement planned policy decisions. Aggressive tax planning is also encouraged by complexity, which may result in economic deadweight costs.

2.3. Overview of Ethiopian tax system as applied to MSEs

This section provides an overview of Addis Ababa's small business taxation laws, focusing on the types of taxes levied against them and the procedures used to determine their value. A few tax system traps caused by tax rules and procedures will be explored later in the chapter. The ability of tax assessors, how MSEs are handled after business termination, aggregation, the computation of small business taxation, etc. are all crucial in this regard to illustrate the tax compliance burden faced by small firms. Despite the fact that the legislation contains provisions regarding each type of tax that MSEs are responsible for, this work only addresses Business Income Tax because it is the most common tax type that MSEs are accountable for.

In addition to definition and classification, taxation of small enterprises is a crucial and complex problem. Due to their very nature, small businesses raise a number of challenges, including whether or not to tax, which tax system to use (special or ordinary), issues with compliance and administration costs, how taxes are designed, etc. What matters most is whether a nation is developing or developed. However, it is undeniable that the "hard to tax" sector in any economy is small enterprises.

Revenue collection to support public spending is a key goal of taxation. However, generating income is not always the primary or even the main goal of taxation. Economic efficiency is prioritized by many nations as the main objective of their taxation systems. In other words, as a tool in the policy toolbox of enforcing incentives and sanctions, countries utilize taxation as a policy lever to enhance the performance of their economies. In fact, despite their best efforts, the majority of governments will not be able to collect nearly as much money from MSEs as they could from larger businesses (Ketema, 2016).

Therefore, each nation that designs its taxation of small enterprises policy must first delve into the following empirical questions.

- What tax structure would have the greatest impact on the tax system's ability to motivate MSEs to participate in the formal economy?
- Is the price of small business tax compliance reasonable?
- What socioeconomic advantages do thriving MSEs have in terms of creating jobs for women and young people?

Before choosing the specific tax system and its administration, it is necessary to provide answers to these concerns through consideration based on policy study. Therefore, it is crucial to be crystal clear on the goals to be focused on when considering taxing MSEs.

Despite the urgent need to solve the aforementioned challenges, nations all over the world have implemented tax systems that take into account their unique socioeconomic situations. Different methods of taxing small enterprises have been devised by policymakers based on the policy goals that nations wish to address and their unique situations (Shome, 2004). However, there is now a noticeable trend toward using specialized taxing systems for small businesses in the majority of emerging countries. 'Presumptive Taxation' is currently the prevailing strategy. Some industrialized countries also employ this strategy.

Proclamation No. 979/2016 and a supporting regulation known as "Council of Ministers Regulation No. 410/2017" (issued in 2016 and 2017 respectively) set the rules for all types of direct taxation in Ethiopia.

The five schedules listed below are how income is taxed under this law:

- Schedule A: Income from employment;
- Schedule B: Income from the rental of buildings;
- Schedule C: Income from business activities;
- Schedule D: Other income;
- Schedule E: Exempt income.

The Ethiopian tax system divides enterprises into three categories—A, B, and C—based on their size as determined by their turnover as well as whether or not they are incorporated. No matter how big or little, corporations are considered to be Category "A" taxpayers and are subject to the same administrative requirements and uniform 30% tax rate. According to the group an unincorporated taxpayer falls into, Table3's information requirements for reporting to the revenue authority and whether the company must use cash or an accruals basis for accounting are both affected. Those who fall under the unique presumptive tax regime, or Category "C" taxpayers, are an exception (see Table 3 below).

Table 3: Categories of Firms in Ethiopia, Thresholds and Reporting Requirements

Categories	**Threshold for Unincorporated Businesses**	**Reporting Requirements**
Category “A”	Over 1 Million ETB	Businesses are required to submit a balance sheet (a financial statement) and a profit and loss statement showing their gross profit/loss, and how it is computed, general and administrative expenses, depreciation, and Provisions and reserves. Businesses must keep their accounts on an accruals basis and must file their returns within four months of the end of the financial year. Businesses liable for rental income tax are required to keep records of rental income received, fees paid to a state or city administration about the rented building, and expenditure incurred by the taxpayer about the rented building, and keep a register of rental buildings showing the acquisition date, the cost of acquisition, any cost of improvement about the building and the current Net book value of the building.
Category “B”	500,000ETB to 1,000,000 ETB	Businesses are required to submit a profit and loss statement that summarizes the revenues and expenses of

		the business over the reporting period, but no balance Sheet (financial statement) information is required. They can keep simplified books of accounts using cash basis accounting and must file their returns within two months of the end of the financial year, reflecting the Simplified requirements. Similar to Category "A" taxpayers, if these businesses are liable for rental income tax, they are expected to keep records about the rented building (see above under Category "A" for details).
Category "C"	Below 500,000 ETB	Businesses are not required to keep books of accounts, as firms pay their taxes based on an assessment made by the MoR. However, they can pay according to the information from their books of accounts if the MoR finds that acceptable and permits them to do so. Category "C" taxpayers must pay their tax liability within one month of the end of the financial year (i.e. between 7 July and 6 August).

Table 4: Business income tax rates for unincorporated businesses

Taxable Business Income (per year, ETB)	Tax Rates
0 - 7200	0%
7,201 - 19,800	10%
19,801 - 38,400	15%
38,401 - 63,000	20%
63,001 - 93,600	25%
93,601 - 130,800	30%
Over 130,800	35%

A. Calculation of Taxable Income

For Category "C" taxpayers, the AACRA employs a presumptive tax system that is determined based on the daily turnover of a certain business. Taxes for small enterprises are paid annually based on their taxable income. The AACRA established committees for each woreda to estimate daily turnover, which is then transformed into an annual equivalent and placed into the appropriate band (which is divided into 19 bands) and an assumed profit margin, which varies between industries, is applied. The legal status of a firm, location, customer convenience, goodwill, expenditures, records of daily income, etc. are taken into consideration as broad indicators for daily income estimation when taxation a small business.

B. Business Income Tax (Schedule 'C')

Small businesses in Ethiopia must pay a variety of taxes, including the business income tax, the windfall income tax, the other income tax, the turnover tax, and the excise tax. Since it predominates, business income tax is the main topic of this article. Three distinct methods of determining the income tax burden of small businesses are provided by the most recent Income Tax Proclamation. These include indicator-based presumptive tax assessment, conventional presumptive company tax assessment, and optional accounting record keeping. The next section discusses the unique characteristics of the various techniques of assessment.

C. Voluntary Records of Books of Account

MSEs or taxpayers in the Category 'C' are often exempt from the requirement to maintain a book of accounts. However, the legislation permits MSEs to maintain a book of records if they choose (Income Tax Proclamation Art. 82(4)). According to the decree, the Council of Ministries will decide how and what kinds of data small firms must preserve in order to establish their tax liability. The Federal Income Tax Regulation, 2017, Art. 49(1) & (2), states that small enterprises must maintain the accounting records required for Category "B" taxpayers. As a result, Category 'C' taxpayers are required to keep track of their daily earnings and expenses, as well as all purchases and sells of trading stock, payroll, and other important data that can be used to calculate their tax due. According to Federal Income Tax Proclamation No. 979/2016, Art. 82(4) (b) & 82(5) (b), the MSEs who offered their services in this case are not subject to tax assessment.

D. Presumptive Income Tax Assessment

When there is no requirement to retain an accounting book of records, presumed taxation is used. The Federal Income Tax Proclamation No. 979/2016, Art. 49, acknowledges Ethiopia's presumptive determination of income tax. Therefore, Category "C" taxpayers are not required to maintain a logbook. As was already mentioned, Presumptive Tax determines their tax and applies it automatically. The task of establishing regulations regarding the specifics of presumptive tax assessment methodology fell to the Council of Ministries. As a result, the Council issued a directive that recognizes two presumptive tax assessment methodology: the traditional presumptive business tax assessment and the indicator-based presumptive business tax assessment methodologies. Federal Income Tax Regulation, Reg. 410/2017, Art. 49(1) & (2) states that MSEs' yearly taxable income is determined using the maximum annual turnover for the income category in which the taxpayer's annual gross income falls. The details of what Standard Assessment comprises are covered in more depth below.

A standard tax was specified in the Income Tax Regulation for 99 different MSE business types. The ultimate tax obligation for small taxpayers is calculated by the Council of Ministries using the tax rates for Categories "B" and "C." Taxpayers Daily Revenue Estimation Information Collection Implementation, ERCA Directive, 2017 No. 123, was a directive issued by the former "Ethiopian Revenue and Customs Authority." Only small businesses with yearly turnovers under 500,000 Birr are subject to the Directive.

The committee that performs the estimation first calculates the daily turnover using the aforementioned indicators, multiplied by the number of annual working days. The committee then determines the small firm in question's taxable income for the year. For three years, the company will pay the same amount of tax.

The annual taxable income and the annual tax liabilities of specific sectors are also determined by the Council of Ministries in addition to the indicators for taxation of such sectors. These comprise the use of public transportation, the movement of dry freight, tanker trucks, single-hopper flour mills, and agricultural vehicles. The Authority's only responsibility in this situation is to collect the tax that the Council of Ministries has established and imposed.

2.4 Rationale for Tax Simplification

The entire cost to business in a particular tax system is typically split into two categories: the cost of statutory taxes and the cost of tax compliance. The sum of money that taxpayers must give to the government in cash is known as the statutory burden. Although compliance expenses are incurred to complete the procedure and satisfy one's tax responsibility, they are not paid directly to the government. Examples of compliance costs include document production, tax amount determination, and tax payment execution. The cost of compliance includes the time actually spent on record keeping, calculating tax returns, and filing them.

Measures that have an impact on both types of costs have broad ramifications for government revenue, public opinion of a government, business productivity, business investment and entrepreneurship appetite, cost accumulation to the final consumer, and the overall economy of a given nation.

In this regard, it's crucial to list the elements that drive up taxpayers' costs for tax compliance. The primary ones include the quantity of taxes that an entrepreneur must pay, the complexity of the tax laws, how frequently tax returns must be filed, and how many levels of government are involved in tax levying and collection.

By reducing the time and resources businesses need to spend complying with the tax system (aside from their tax liability), simplifying the requirements for MSE compliance (e.g., allowing simplified accounts, simplified tax calculations, and less frequent filing) will increase the growth of existing MSEs as well as the creation of new businesses. Depending on design elements, simplification methods may offer small firms extra cost savings through lower tax payments to the government in addition to lowering tax compliance costs. Reduced tax compliance costs stimulate greater MSE formation and greater adherence to a tax system, with or without these additional cost reductions.

Therefore, maintaining effective and straightforward tax systems for MSEs requires ongoing revision of tax legislation, tax procedures, tax collection and estimating practices, and most crucially, expanding administrative capacity.

Despite various efforts, it has been challenging to precisely quantify the costs of tax compliance on business (Smulders et al., 2012). It is also difficult to compare the total tax burden across different economies. This is due in part to the fact that MSEs typically bear a case-by-case tax compliance burden.

A general finding from empirical literature is that MSEs have a higher tax compliance burden than large businesses and payroll employees. If the statutory (actual payment) tax burden on a given amount of labor and capital income for an employee and a self-employed person (small business) is roughly equal, it follows that the higher compliance burden for the latter would mean that the tax system is non-neutral, tending to discourage MSE creation.

What the impact of a non-neutral tax system is is the question that arises from the foregoing. Entrepreneurs who must pay a significant tax burden to the government in terms of both the amount of tax paid and the associated compliance costs may decide to work in the informal sector.

Another, even more bleak possibility is that a prospective entrepreneur decides against starting a business and opts to continue working for someone else. This is due to the fact that business owners also take into account the after-tax earnings from employment, the drawbacks of engaging in unofficial trade, the likelihood of being discovered, including reputational harm and tax fraud fines, as well as the negative effects of doing so. However, many might be persuaded to start firms in the event that compliance expenses are decreased.

In other words, taxation simplification may increase the competitiveness of small firms, boost business growth, and encourage business development by lowering the tax burden on MSEs. In order to achieve more equitable tax treatment of businesses of various sizes, implying efficiency improvements, and encouraging adherence to a nation's tax rules, it is necessary to minimize the cost of tax compliance and, as a result, lessen the overall tax burden on small businesses. Therefore, the benefits of choosing the formal sector will outweigh those of the informal sector, not to mention the growing demand for accurate reporting of all the data needed to ascertain the exact tax base.

From a different angle, a small business would be at a competitive disadvantage for a different reason if compliance expenses were the same for big and small companies: doing so would necessitate a greater pre-tax rate of return on capital. This implies an inefficient allocation of capital, with underinvestment in small enterprises, which would be addressed by enacting simplification measures. Therefore, by providing a fair playing field, lower compliance costs for smaller enterprises lead to increased efficiency. However, there is a strong governmental urge to go beyond that by intentionally discriminating in favor of small businesses.

Generally speaking, small businesses would gain more from tax simplification initiatives than would large ones. Even if that were the case, these policies are anticipated to have a wide range of effects on small businesses due to the diversity of the small business community. There is a need to evaluate a variety of approaches because some may directly boost company formation and tax compliance more for particular types of small enterprises.

CHAPTER THREE: RESEARCH DESIGN AND METHODOLOGY

This chapter describes the research design for the study, including research approach, research design, data type and data source, population of the study, sampling strategy, data gathering instruments, data analysis techniques, validity and reliability and ethical considerations.

3.1. Research Approach

This study will employ a mixed-methods research approach to investigate the effect of income tax policies on small businesses. The quantitative component will involve the collection and analysis of financial data from a sample of small businesses mainly in Addis Ketema sub city. Specifically, regression analysis will be conducted to examine the relationship between income tax rates and small business profitability, as well as the effect of tax deductions and credits on business growth and investment. The qualitative component will involve in-depth interviews with small business owners and tax professionals to explore the compliance costs and administrative burden of income tax regulations on small businesses, as well as to identify potential policy solutions to improve the effectiveness of income tax policies and reduce the burden on small businesses. Overall, the research approach aims to provide a comprehensive understanding of the effect of income tax policies on small businesses and inform policy decisions that promote the sustainable growth and development of small businesses.

3.2. Research Design

The research design for this study is explanatory research, which seeks to identify the cause-and-effect relationships between income tax policies and the financial performance of small businesses. By combining quantitative and qualitative data sources, the study aims to provide a comprehensive understanding of the effect of income tax policies on small businesses and to explain the mechanisms through which income tax policies affect small business profitability. The research design aims to provide a comprehensive and explanatory understanding of the effect of income tax policies on small businesses, which can inform policy decisions that promote the sustainable growth and development of small businesses.

3.3. Data Types and Data Sources

A desk analysis of government tax legislation, procedures, and current literature, along with primary research, comprise our approach to the subject at hand. As a result, information from primary and secondary sources is incorporated. The latter will come after the former in chronological order. When it comes to primary sources, information is gathered through interviews with important participants and pertinent key informants, such as employees of tax authorities, proprietors of small businesses, members of trade groups, and representatives of non-governmental organizations dedicated to the growth of the private sector.

To complement the findings from the literature and the interviews, a tax perception survey was undertaken among taxpayers (mostly category "C" taxpayers operating in Addis Ketema sub city) as part of this study. As a result, this poll aimed to learn how small business owners generally perceived the tax system. In addition, details regarding how a target firm views tax laws, methods, and practices as well as information on the objectivity of tax estimation, the fairness and equity of the taxes, dispute resolution procedures, and the ease of the Addis Ababa taxation system were sought.

The government faces difficulties in collecting taxes from MSEs, and works of literature that may have an impact on MSE operations were consulted. Additionally, the current study materials on tax simplification for MSEs were examined. In addition, pertinent literature is reviewed on the major difficulties MSEs encounter, including the complexity of the tax system, the need for bribes from tax assessors, the subjectivity level involved in estimating annual turnover, the fairness of the tax rate, and the AACRA compliance management system. The tax rules and processes as they relate to MSEs operating in Addis Ababa were critically examined. This investigation assisted in identifying the areas where Addis Ababa's MSEs struggle to comply with tax rules and regulations.

A general interview with tax practitioners is also done as part of the data gathering. The tax professionals that were interviewed came from various AACRA administrative levels. The initial set of 5 experts, who worked on several topics like tax estimation, tax law, planning, ethics, and customer service, were selected from the Head Office. The purpose of the interviews was to clarify the difficulties and complexity of the tax rules and procedures.

Tax rules, procedures and their dangers, the authority's human capacity, service provision, and complaint handling methods are just a few of the topics brought up with the staff of the Authority. The group is thought to be better able to understand these problems because the professionals have worked with tax rules and procedures for a number of years. In-depth, enlightening insights into these difficulties were achieved, especially insights that helped identify tax law hazards, procedural loopholes, and compatibility with processes and practices. The other source of tax professionals and specialists came from the tax offices in the woredas (administrative districts). A series of in-depth interviews with woreda tax specialists were undertaken in order to compare them to the experts selected from the head office. The focus of the interview was on comprehending the tax practices at the common level, for instance, the extent to which the experts are complying with tax rules and procedures while enforcing them, given that woreda tax offices directly engage with small taxpayers (MSEs). In a similar vein, a thorough interview with tax professionals at the sub-city level: a higher level in the hierarchy was also conducted. The Sub-city AACRA is directly in charge of the Woreda tax offices.

Table 5: List of Participants in a consultation Workshop

Head Office	**Sub-City Tax Office**	**Woreda (District) Office**
Tax Assessment and Collection Team Lead	Tax Assessment and Collection Officer	Tax Assessment and Collection Officer
Legal Officer	Customer Services and Support Officer	Customer Services and Complaint Officer
Ethics Officer		
Customer Services and Support Work Team Lead		
Planning Team lead		

3.4. Target Population

As previously noted, the tax professionals who participated in the interview came from the head office, the sub-city, and the woredas. Because there are disproportionately many category "C" taxpayers in those, Addis Ketema Sub-City Tax Office was purposely chosen after speaking with head office practitioners, followed by Woreda 10 Tax Office. The target population for this study was 130 including small business owners and tax professionals at the woreda, with a total of 96 responses. Three tax professionals who work for the Addis Ketema Sub-City Tax Office's departments of tax estimation, customer service, and complaint management were given the identical detailed interview questionnaire.

This method of choosing tax professionals is meant to accomplish two key goals. First, each hierarchy's input should be in accordance with the varied dimensions of its mandate and related obligations. Second, it was anticipated that interactions with practitioners at various levels of hierarchy would reveal differences in how well employees in the same office and across several offices understood and applied tax rules, processes, and practices.

3.5. Sample Selection

Three sub-cities were chosen for the taxpayer perception study based on a number of factors. The Gulele and Kality Sub-Cities are also included, in addition to the Addis Ketema Sub-City where small taxpayers and, for that matter, big corporations are disproportionately located.

The last two were picked based on how small businesses impacted their economic operations and how much poverty there was relative to other sub-cities. Additionally, an effort has been made to include individuals from the three primary industries: manufacturing and construction, general trade, and services. The majority of small businesses in the manufacturing industry are centered in the two sub-cities that were chosen. In this manner, 130 MSEs were really contacted, with a response of 96 taxpayers and individual MSEs.

3.6. Data Collection Instruments

To gather data on the research questions, the study used a mixed-methods approach that included both quantitative and qualitative data collection methods. For the quantitative component, a survey questionnaire was used to collect data from small business owners in Ethiopia. The questionnaire included closed-ended inquiries, such as multiple-choice questions, to gather information on tax compliance practices, the effect of income tax on financial performance and growth, and the benefits and drawbacks of income tax. The questionnaire also contained open-ended questions to allow participants to offer more in-depth comments and insights.

For the qualitative component, a semi-structured interview guide was developed to collect data from business owners and tax professionals. The interview guide included open-ended questions that allowed participants to provide detailed responses about their experiences with income tax and tax compliance. The interview also included probes and follow-up questions to encourage participants to elaborate on their responses and provide more in-depth insights. In addition to primary data collection, secondary data sources, such as government reports, academic articles, and industry reports, were collected and analyzed to provide contextual information about the tax regime in Ethiopia and the challenges facing small businesses. This data was used to supplement the primary data collected through the survey and interviews. The mixed-methods approach allowed for a comprehensive understanding of the effect of income tax on small businesses in Ethiopia and provided insights into the challenges and opportunities for tax compliance among small business owners and tax professionals.

3.7. Data Analysis Techniques

The statistical package for social sciences (SPSS) program, version 23, was used to enter the data gathered from the questionnaires. SPSS is a program used to transform raw data into tabulated reports, charts, descriptive statistics, and complex statistical analysis like correlation and regression analysis. The analysis of the data's means and standard deviations was done using descriptive statistics. Measurement of the intensity or degree of relationship between variables was done using correlation analysis. In order to quantify or forecast the impact of income tax on startups and small businesses, regression analysis was also performed.

3.8. Reliability and Validity

3.8.1. Reliability

On the basis of appropriate research and expert comments, a systematic questionnaire and interview guide were established in order to assure the reliability of the data gathered through the survey and interviews. The survey was pilot-tested with a small sample of participants to discover any problems or discrepancies in the questions or responses, and the same questions or items were consistently used across all respondents. In order to preserve consistency in the data collection process, the survey and interview questions were also created to be simple, uncomplicated, and clear.

3.8.2. Validity

To ensure the validity of the data collected in this study, the survey and interview questions were designed to measure the effect of income tax on small businesses accurately and meaningfully, and were based on relevant literature and expert opinions. The sampling strategy was designed to ensure that the sample was representative of the population of interest, with a targeted sample size of 130 small businesses operating in Addis Ababa, Ethiopia. A stratified random sampling strategy was used to select businesses from different industry sectors.

3.9. Ethical Considerations

In conducting research, ethical considerations are essential to ensure that research participants are treated with respect and dignity. Informed consent is crucial, as participants must understand the purpose, procedures, risks, and benefits of the study, and be free to withdraw at any time. Confidentiality is also paramount, as participants' identities and responses must be kept confidential to protect personal information. Researchers must respect participants' privacy by avoiding public observation and unauthorized disclosure of personal information. To minimize harm, researchers should avoid intrusive questions and ensure participants are informed of potential risks. Fairness is also essential, and researchers must treat participants without discrimination based on race, ethnicity, gender, age, religion, or other characteristics. Institutional review boards can approve studies to ensure ethical conduct and integrity by following institutional guidelines. Finally, researchers must ensure study validity and reliability through appropriate sampling methods, reliable measures, and statistical techniques. By following ethical considerations, researchers can ensure that their studies are conducted with integrity and respect for all participants involved.

CHAPTER FOUR: RESULT AND DISCUSSION

This chapter presents the results of the study on the effect of income tax on small businesses, providing a summary of the data collected, followed by a presentation and analysis of the results.

4.1. Demographics of the Respondents

Gender

Only 21% of the sample as a whole are women. Furthermore, owner/managers run 87 percent of small businesses. Only 3% of those respondents said they hired a manager. The remaining replies are run by co-owners or members of their families. Males hold the majority of ownership positions in the companies in our sample.

Age of Respondents

The respondents' ages are shown in the Table below. 16.4% of the sample is made up of young people under the age of 29. Only 12.8% of the sampled small business owners are above 45 years old. The small business firms in our sample were dominated by people between the ages of 30 and 45. One can see that the majority (70.8%) of business owners belong to age groups that are economically active.

Age of Business

The maturity of the firm as well as the experiences of the owners are reflected by noting the small businesses' ages. Accordingly, 10% of all respondents are new enterprises that have been around for less than a year. Mature enterprises, those that have been operating for over ten years, make up almost 13 percent of all businesses. Nearly 42% of the sampled companies are between 6 and 10 years old, which is a fairly high percentage. This is extremely favorable for the validity of our findings because a sizable portion of the businesses we questioned might be considered to be well-versed in the business world and thus able to talk authentically about the business climate and taxation system. In other words, the data collected comes from individuals who have solid knowledge of the business environment in general and the taxing process in particular.

Business Composition

The service and retail trade industries dominate economic activity both nationally and locally. However, a non-random selection of the business sector was made for the survey. It was deliberate to take a disproportionate sample of the industrial industry. Despite the low statistics, it should be emphasized that the manufacturing sector has a higher capacity than the retail and service sectors to create jobs per enterprise (World Bank, 2015).

Ownership of the Sampled Businesses

Most of small businesses are comprised of 70%, are sole proprietorships, 27% are some kind of legally recognized partnership, and the other 15% are private limited companies (plc).

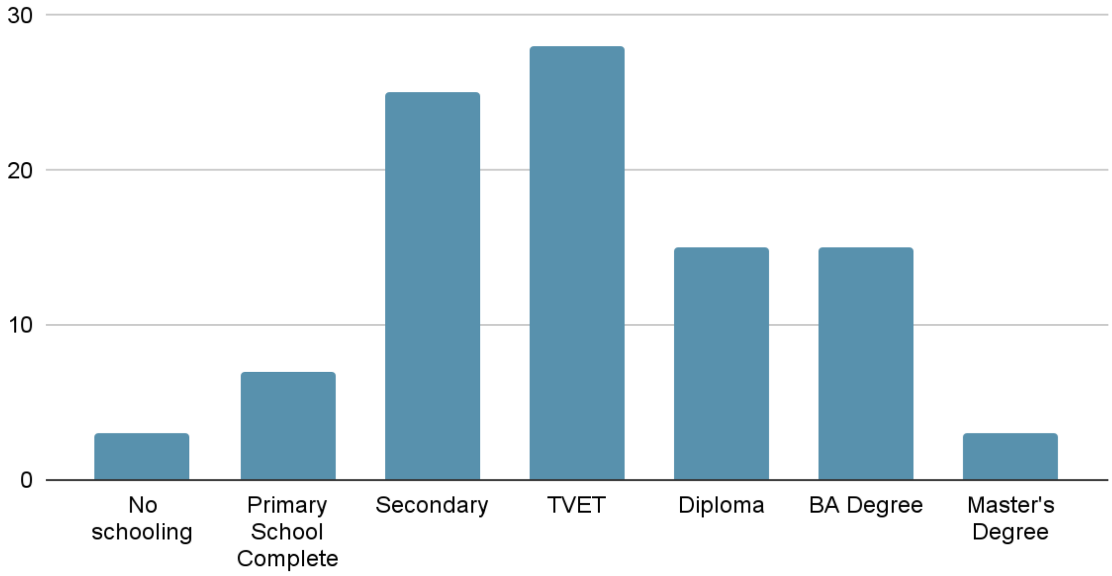
Table 6: Demographics of the respondents

Gender	Male: 78.6%	Female: 21.4%
Age of Respondents	15-29: 16.4% 20-45: 70.8%	Above 45: 12.8%
Age of Business	Less than one year: 9.7% 2-5 years: 35.5%	6-10 years: 41.9% More than 10 years: 12.9%
Business Composition	Manufacturing: 34.7% Merchandise: 32.7%	Services: 32.7%
Legal Form	PLC: 3% Partnership: 27%	Sole Proprietorship: 70%

Education Level

The majority of the surveyed small businesses are both TVET qualified individuals and high school graduates in terms of educational background. Together, they are responsible for 55% of the total, or 29% and 26%, respectively. The small businesses survey conducted for this research shows that people with diplomas and BA degrees are the next most significant participants. With 16 percent each, the two make up 32 percent. The least important participants are those who never attended school and those with master's degrees. The figure below shows the diagrammatic presentation.

Figure 1: Educational Status



4.2. Pitfalls in the Legislation and Practices

Aggregation of Tax

Equity or fairness is important in taxation because it prevents a tax system from being progressive by ensuring that taxpayers with various revenue sources are treated equally. According to the Income Proclamation, subject to Article 64(2), taxpayers from various sources who are subject to the same tax schedule are taxable under the annual total income.

According to the Directive, taxpayers must aggregate their income from two or more firms, various income sources falling into the same category, and the same tax year. However, due to distinct taxation in Addis Ababa, aggregation does not actually apply to small businesses. The law forbids aggregation from separate schedules, prohibiting small enterprises to aggregate different incomes. Aggregation from several businesses would minimize tax liability.

Since TIN uniquely identifies taxpayers, the Authority should combine income from many firms. Small businesses fall under Categories "C", hence the rule against aggregation from various schedules needs to be changed. It is necessary to amend and correct both the law and the behaviors.

Applying Upper Limit

The maximum annual turnover for the income group in which the taxpayer's gross income falls determines the small businesses' taxable income each year. This tax calculation procedure contains two steps: first determining annual turnover and then establishing higher limits in accordance with applicable laws. For instance, if a company's yearly sales are 380,000 ETB, the tax office determines the 400,000 ETB upper limit, resulting in a tax of 20,000 ETB on unearned income.

Due to the failure to combine income from several sources and apply top restrictions individually, taxpayers who own many enterprises suffer even harsher repercussions. Due to the high tax burden, this deters small businesses and lowers their competitiveness.

Disharmony in Tax Declaration

According to Article 83 of Income Tax Proclamation Number 979/2008, Category "C" taxpayers are required to declare their income and spending to the tax office annually. A taxpayer will also receive a fine if they fail to declare their tax after a process to apply the Income Tax proclamation.

For small taxpayers, there is a discrepancy between tax law and tax determination procedures. While a Directive specifies that the Authority determines the tax liability for Category "C" taxpayers, the Proclamation mandates that MSEs disclose their revenue. Given that the tax obligation is fixed for five years according to the Directive, it is unclear why MSEs are required to report their revenue and expenses every other year.

According to Penalty Administration Code 9/2012, Category "C" taxpayers are not subject to penalties for informing the tax office of their income and expenses. These clauses are not, however, compatible. The Proclamation, Directive, and Penalty Administration Code should be amended in order to simplify the law.

Lack of Representation

The committee for evaluating daily revenue is not required by law to include representatives of the taxpayers. The expertise of the Amhara National State Tax Authority and the participation of the local chamber of commerce in the estimation committee improve fairness and strengthen the voices of taxpayers on crucial issues. Asking taxpayers about their income, expenses, and business information is one method suggested by tax professionals for assuring their involvement in the tax system. The final estimation, however, frequently differs from what people disclose to the committee, according to the results of the taxpayer survey, suggesting that taxpayers are not completely participating in the tax estimation processes.

Generally speaking, fair representation of the taxpayer's community in the estimation process will increase the tax system's openness and provide taxpayers' voices a chance to be heard. In the end, this will also ease the strain of tax compliance.

The inclusion of people with advanced developmental ideas and corporate representatives in the makeup of the Committee of Tax Estimation and Complaints Resolution raises questions. The selection procedure for the committee may be biased and partial as a result of the tax system's lack of objectivity and openness.

Tax assessors encounter difficulties when determining taxpayers' taxes and are sometimes accused of lacking developmental mindsets. This has a detrimental effect on the highly politicized atmosphere since assessors frequently try to raise too much money by levying high taxes on specific companies, which raises the tax burden on MSEs. Tax loads on MSEs may be substantial due to tax assessors' high revenue generation. To ensure that an additional burden doesn't hinder the creation of jobs or economic activity, the government should strike a balance between revenue generation and equitable taxation of MSEs.

Seasonality and Limited Frequency

A team of professionals will visit a taxpayer's place of business to assess taxes using estimation indications. The ultimate tax amount, which is subsequently established for the next three years, is calculated using the average estimate. During this phase, it is essential to address any practical difficulties.

The committee makes a single visit to taxpayers' locations in Addis Ababa to ascertain their tax burden, which is influenced by things like seasonality. Businesses that operate during peak season, such as restaurants, vegetable stands, and bridal gown rentals, may be subject to high tax rates. A skewed impression of these firms' performance and status may result from data that has only been obtained once.

The experience of the Tigray Regional State emphasizes the value of periodic inspections to evaluate enterprises for seasonality. The same company is inspected by tax assessors four times a year, with different committees performing each inspection. As opposed to Addis Ababa, where tax assessors are made up of representatives from various sector institutions, this method increases estimation accuracy and equity.

Specialization and Knowledge of Tax Assessors

The Tax Assessment Committee in Addis Ababa set out to increase tax collection significantly in 2017 by aggressively assessing taxpayers. The assignment was finished within a month by the group, which included representatives from trade, health, and other governmental agencies. Employees discovered, however, that the process of tax estimation had limitations.

Tax professionals frequently lack the specialized knowledge necessary for understanding certain enterprises, which may have increased compliance and decreased complaints. Specialization in tax offices enables them to concentrate on more significant concerns as opposed to handling numerous complaints resulting from inaccurate estimation. Due to their competence in a variety of business sectors, the tax assessors of the Tigray Regional States Tax Authority reduce irregularities in tax estimation.

Complexity of Matrix of Tax Estimation

85 enterprises with accompanying profit margins and 19 tax rates make up the presumptive tax schedule matrix. Most tax office staff find it difficult to comprehend the matrix and correctly apply it due to hectic schedules and a lack of necessary skills. Numerous factors further compound the difficulty of tax estimation, resulting in a high number of complaints and unhappiness among taxpayers. To make the complex matrix easier to understand for staff and taxpayers, the Authority should look into automating and streamlining it.

MSEs are not expected to Post Losses

When estimating tax on profit during the interview, AACRA assessors take company expenses into account. MSEs, on the other hand, are thought to be profitable and only represent a loss if issues of a natural or artificial nature arise. The Authority may change tax rates if a loss arises, but MSEs are typically thought to be profitable. Business closures could result from losses. Even after ceasing operations, MSEs are legally obligated to pay taxes for the time they were in operation. They also pay taxes for the time they were operating due to high tax burdens. Tax regulations and procedures should be adaptable enough to take prospective losses into account without outlawing them. The use of indicators for income business estimation is pointless if they do not take future losses into account.

The Tax Law Punishes the Less Efficient Business

Tax law mandates that corporations take expenses into account when estimating their tax liabilities, but this is not how it actually works. The Authority calculates sales tax and collects it. According to the interview and tax experts, if two similar enterprises have comparable turnover, they should each pay the same amount of tax. This implies that two businesses with comparable sales but drastically differing cost expenditures will pay the same amount of tax, placing a heavier tax burden on the less efficient business. The equity and fairness premise of taxation is broken by this.

4.3. Profile of Addis Ababa City Government Revenue Authority (AACRA)

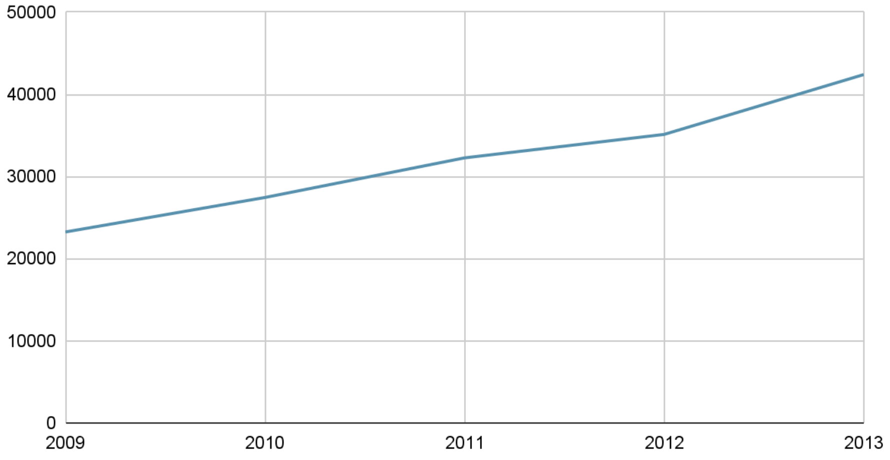
Taxpayers have a significant incentive to reduce their tax obligations through evasion (illegal) or avoidance (legal). A variety of registration, assessment, and collection procedures must be used by the tax administration to ensure conformity with the substantive legislation. The nature of the economy's actual tax base and the effectiveness of administration will determine how a government can halt (or limit) tax evasion and avoidance by preventing taxpayers from engaging in inappropriate activities. Therefore, the primary goal of tax administration should be to enhance the rules governing the registration, assessment, and collection of revenue as well as to fully utilize a nation's taxing capacity (Barbone, 1999).

Some inferences about tax administration and the effectiveness of the Authority in terms of total revenue collection, human resource development, customer services, and taxpayers' tax compliant management have been made after studying the self-published Annual Report of AACRA. In addition to using insights from in-depth interviews with Authority officials, this section also uses secondary data to support its arguments.

Revenue Collection

The AACRA collected 42.4 billion ETB in total in 2020 across all tax forms. The Bureau's capacity for revenue collection has grown over time. From 23.2 billion ETB in 2016 to 42.4 billion ETB in 2020, it has practically doubled in just five years.

Figure 2: Revenue Collection in Millions of ETB



Source: Annual Report of AACRA various years

Figure 2 shows that the increase rate of revenue collection during the 2012 Ethiopian Fiscal Year was less than in previous years. This can be an indication of how the Covid-19 pandemic has affected society.

The Bureau's approved yearly budget for 2020 was 1.2 billion ETB. Over the past five years, the Authority's budget has consistently been split between operations and human capital development. More than 70% of the budget was spent on salaries and the development of human capital, with the remaining 30% going toward operations.

Taxpayers' Complaints

Any tax system should be extremely concerned about the tax complaint process. Accordingly, Addis Ababa receives reports of two main categories of tax complaints. The first one is closely related to judgments regarding tax rate (liability). This area includes issues such as tax audit, investigative audit, tax assessment, and tax estimation conclusions. The Authority's ability to provide services is the subject of the second type of complaints.

The Authority received 7,518 complaints in total about tax-related problems in 2020. These complaints included 3.1 Billion ETB in financial matters. The majority of complaints (34%), followed by tax audit results (25%), others (21%), and tax assessment (21%), concern concerns with estimating daily income.

With Category "C" taxpayers without an accounting system and not being subject to tax audits and investigations, complaints about tax audit findings predominate (83%). While large taxpayers frequently complain about tax audits, they frequently complain about daily income estimation. However, there were only a tiny number of complaints from Category "C" taxpayers, which suggests that administrative costs were higher than the amount of money collected.

Although specific information on how quickly and effectively AACRA had responded to complaints was not available, nearly all concerns were resolved throughout the fiscal year. Therefore, a taxpayer's complaint can be addressed in the same year that it is filed.

Table 7: Tax Complaints in 2020

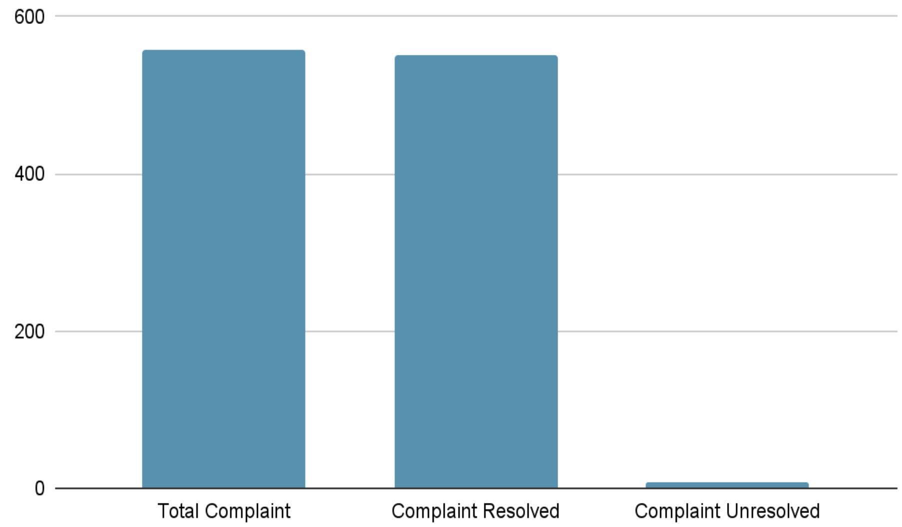
Type of Complaints	No.	Value	Percent Share	
Tax Audit	1851	22,618,592,525	24.6	83.2
Investigation Audit	7	35,981,708	0.1	1.1
Daily Income Estimation	2534	125,467,365	33.7	4.0
Other	1585	60,865,000	21.1	1.9
Tax Assessment	1541	306,068,037.70	20.5	9.7
Total	7518	3,146,974,637	100	100

Source: AACRA

Service Delivery

The Authority has received 557 complaints in total regarding the performance of services in 2020. Even while the number of complaints is minimal in comparison to the total number of taxpayers, it is difficult to assume that everyone who was unhappy with the Authority's services in some way did so formally.

Figure 3: Complaint on Service Delivery



Based on the AACRA assessment, we may conclude that the Authority has delivered services admirably despite the previously indicated severe staff deficit. The Authority provided service to 2,051,343 clients in 2020. The same report emphasizes that there were only 36,574 instances (less than 2%) where service delivery took longer than the allotted amount of time for decision-making and action by the Authority.

Human Capital

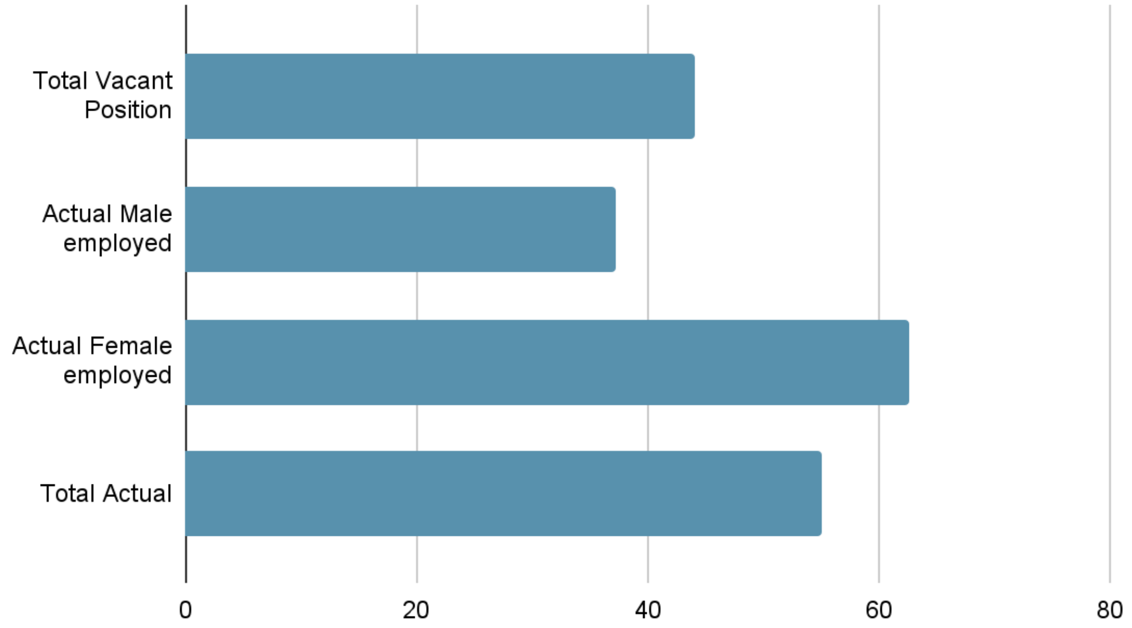
There are 11,442 total approved roles for AACRA. However, AACRA only employed 6,368 people in 2020. Only 55.7 percent of the necessary human resource total is met by this. With the reasonable expectation that the situation persists beyond 2021, AACRA is providing inadequate service to taxpayers.

The number of employees at AACRA, which was reformed under the control of the City Government of Addis Ababa in 2018, is impacted by structural concerns and budgetary constraints. Despite assuming control of taxation, AACRA continues to perform poorly in terms of service delivery, tax assessment, and other responsibilities.

Increased staffing is the greatest requirement for enhancing tax estimation and assessment, particularly for MSE taxpayers. For Category "C" taxpayers, whose numbers are great despite having a small workforce, this problem is more severe.

Regarding the ratio of male to female employees, there is an interesting fact. In contrast to the trends in other industries, there are much more female employees than male employees: 62.7% against 37.3%.

Figure 4: Share of Staffs Composition and Vacant positions



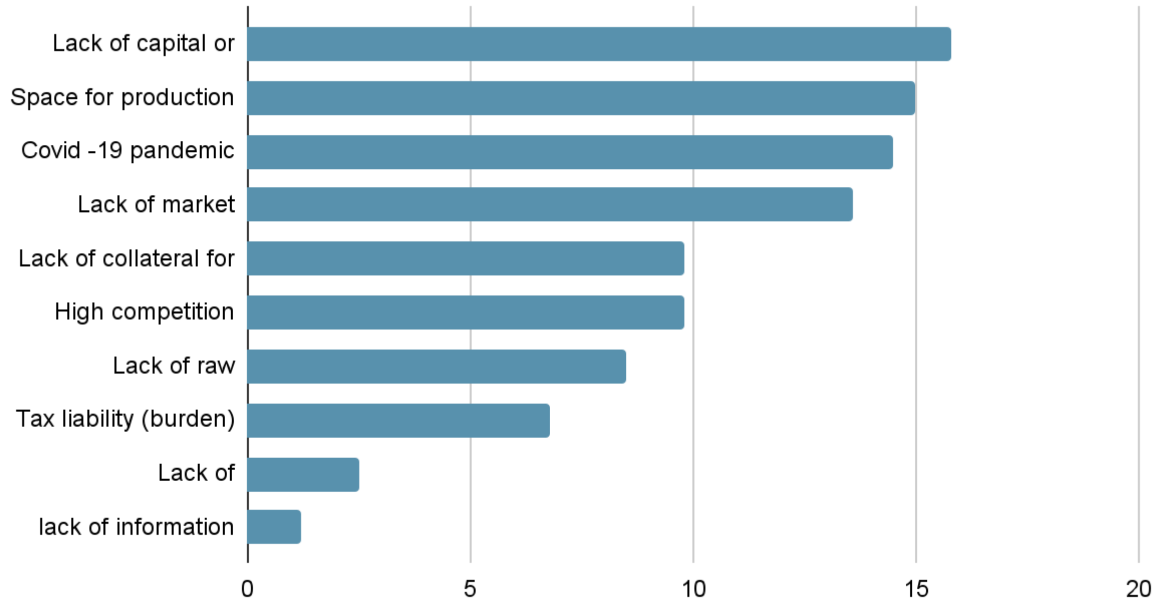
Training and Capital Building

Both internally and in partnership with partners like ERCA, training has been conducted. According to AACRA's assessment, its staff has access to considerable training. However, there are concerns raised about the trainings' sufficiency and relevance in both the report itself and the interview with AACRA staff.

According to 'value for money' standards, the research shows that main office and sub-city workers receive the majority of training and capacity-building resources. This emphasizes employees working with Category "A" and "B" taxpayers but also leaves gaps in lower-level employees' tax understanding and procedural processes, making skills scarce. Because Category C taxpayers are larger than those in Categories A and B, there are vacancies at the woreda level and a lack of personnel expertise. Micro-enterprises' (MSEs') growth is hampered by the burden placed on small taxpayers and a lack of strategic thinking. MSEs can only make a small difference in terms of employment, economic expansion, and social stability. Instead of concentrating simply on return on investment, AACRA should take into account non-revenue-related benefits and the potential of MSEs in its strategy.

The issues faced by MSEs as identified in the conducted interviews may be summed up in the graphic below.

Figure 5: Challenges for small Businesses to grow



4.4. Small Business Taxpayers Perception Survey Analysis

The examination of the tax laws and procedures in the preceding sections was supported by information from key sources, including tax professionals. The painting won't be finished, though, until taxpayer feedback is taken into account. Therefore, it is essential to look at how startups and small businesses view the tax system and practice before drawing any conclusions or suggesting measures for simplification and streamlining.

This section analyzes a survey finding from 96 small business respondents regarding Addis Ababa's tax law and general practice. The survey questionnaires contain a variety of questions that elicit data on small businesses' tax compliances, the demographics of small businesses, their understanding of tax laws and procedures, corruption, service delivery, their tax burden, and the procedure for resolving complaints.

Constraints for Establishing and running a Small Business

MSEs are generally limited by a variety of variables. 16 percent of MSEs worldwide see access to capital as their main barrier, ranking it at the top of the list of challenges they must overcome. 14.8 percent of taxes are made up of tax rates and administrative problems. The formation and expansion of MSEs are being hampered globally by taxation and its management (ILO, 2015).

A few studies on the issues preventing the formal private sector from creating jobs have been done in Ethiopia. According to the World Bank's 2009 "Assessment of the Investment Climate," more than 70% of business owners express dissatisfaction with high tax rates, as was mentioned in Brixiova. In addition to expensive rates, one of the main reasons for dissatisfaction is unreliable and ineffective government. In a different study (Nega & Hussein, 2016), which used Addis Ababa as its sample region, tax rates and tax administration problems were also highlighted as significant obstacles for startups and small businesses in Ethiopia.

The goal of this study was to determine whether or not the tax system is one of the primary obstacles that company owners would face while starting new small businesses or growing current ones. The key obstacles that restrict the growth and establishment of startups and small businesses in Addis Ababa are discovered to be the tax burden, space for production and marketing, access to credit, access and supply of power, and the availability of credit.

Taxpayer's Views

Tax knowledge is the comprehension of tax laws and regulations by taxpayers, which affects their compliance. For the purpose of accurately calculating income and liabilities, applying the proper rates, and meeting filing requirements, tax education is essential. According to research, the majority of small businesses find it difficult to comply with tax regulations since they don't fully understand them.

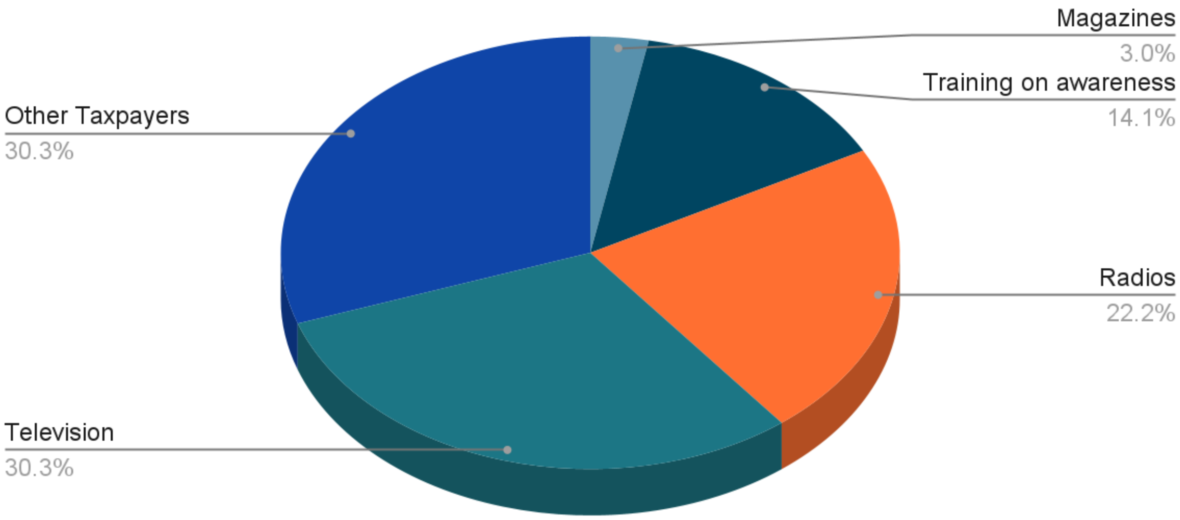
In order to appropriately calculate their income and tax obligations, respondents were asked to apply the proper tax rates, deductible and nondeductible expenses, and filing requirements. On a five-point Likert scale, the respondents were questioned. Due to their backgrounds and the inadequate training provided by the tax authority, the poll indicated that small businesses lack awareness of tax rules and procedures.

The study demonstrates that MSEs have little tax awareness, according to Palil's (2011) study. Respondents were instructed to determine their tax deductions and apply Category "C" tax brackets to determine their tax burden. The majority of survey participants were unsure of tax brackets and were unfamiliar with pertinent tax rules and procedures.

Many of the responders are aware of certain significant tax-related difficulties. For instance, they convey confidence and a favorable impression that they are well-versed on their company's revenue and expenses. Surprisingly, the majority of MSEs also understand exactly when to pay taxes each year. For the purpose of raising awareness and educating taxpayers on taxation, the

Authority may employ a variety of communication avenues. Respondents were asked to identify their primary sources of information on topics such as legislation, procedures, and modifications to tax laws and practices. Most of the time, small businesses learn information from other startups and small businesses. This suggests that taxpayers have close relationships with one another that allow them to communicate information about their firms, including information about taxes. To effectively communicate information and raise business community knowledge, a tax authority should take into account several methods of communication. Additionally important channels are radio, television, and the Authority's awareness-raising events. Diagram below uses a pie chart to illustrate the many information sources available to startups and small businesses.

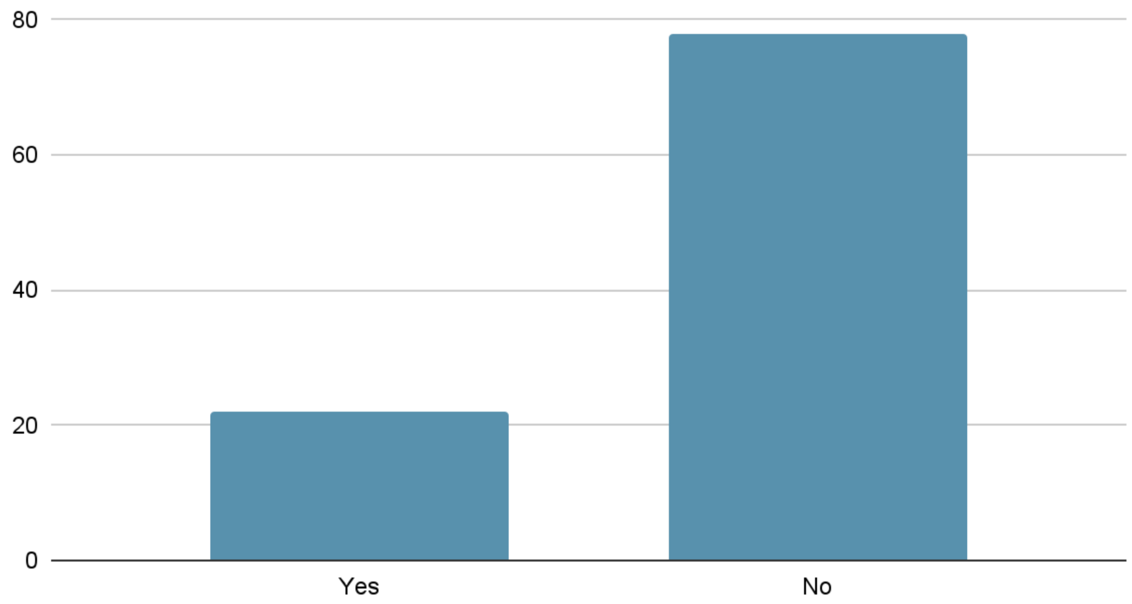
Figure 6: Sources of Information for Small Businesses



Training and Awareness Creation

It is crucial that the AACRA continues to assist MSEs. The Authority is tasked with preparing programs to raise awareness of new laws, processes, and altered practices. Our respondents (77%) had not received any training or assistance from the Authority in this area. Despite several attempts to educate taxpayers, experts concurred at the interview with the Authority that the quantity and relevancy of the trainings provided were insufficient. The same experts also said that taxpayers are not eager to take part in organized campaigns to raise awareness.

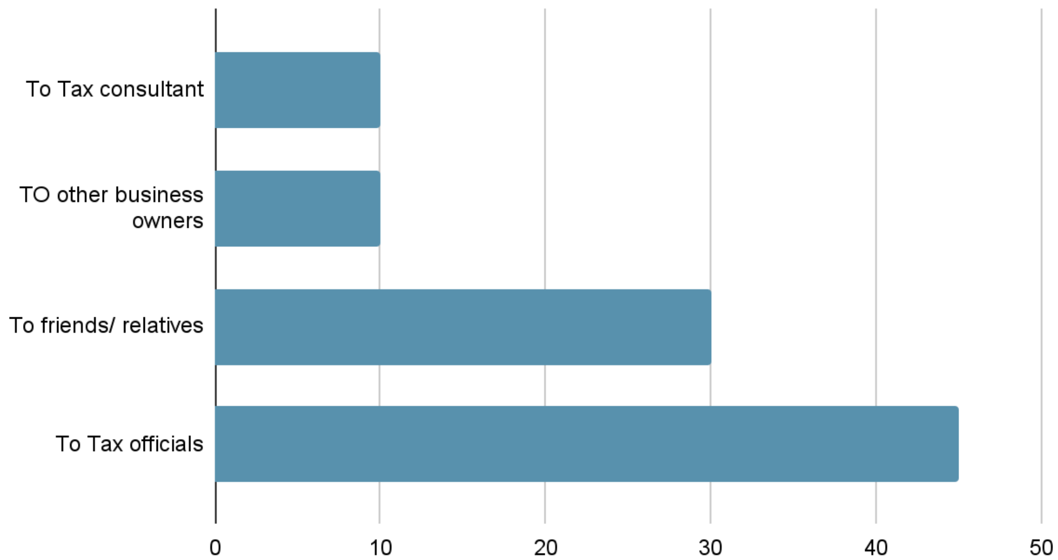
Figure 7: Small Businesses Response on Receipt of Training



Since most Small Businesses are owned and operated by a single person, taking part in campaigns to raise awareness is challenging. The impact of closing the business on revenue makes careful planning of the relevance, timing, and length of training programs essential for success.

Due to expensive market consultancy costs and a lack of financial records, MSEs have restricted access to tax consultants. As a result, they frequently seek advice from friends, relatives, and tax office employees. For interested parties dealing with private sector enterprises, such as NGOs and chambers of commerce, this scenario is significant.

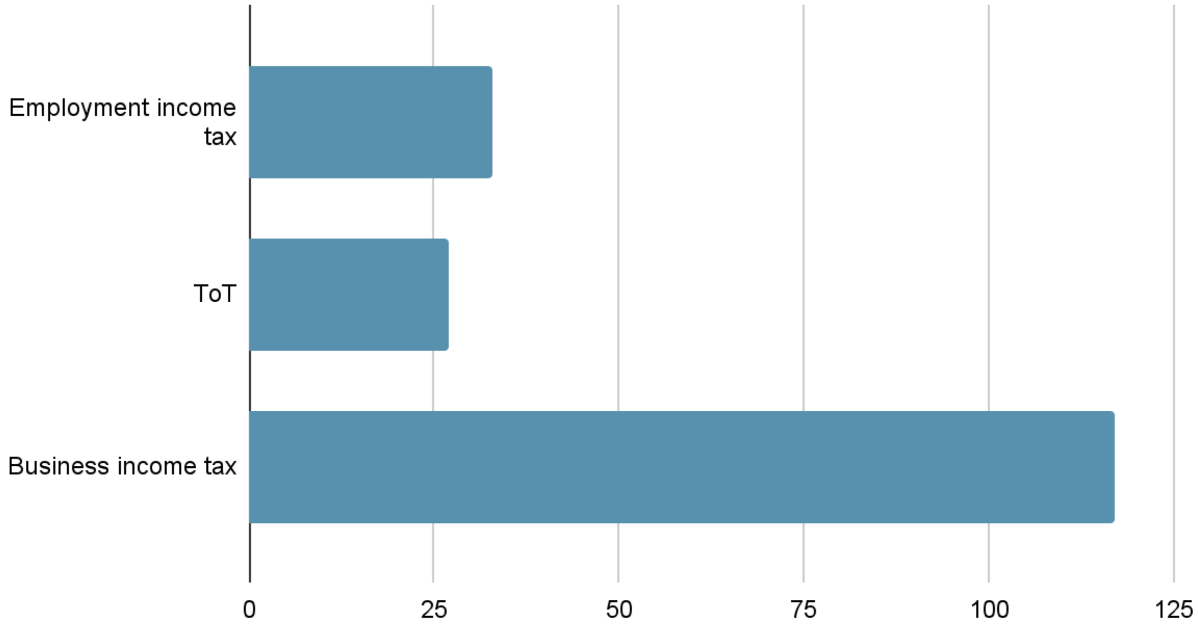
Figure 8: Sources of Small Businesses Advice on Tax Issues



The Complexity of the Tax System and Small Businesses' Trust

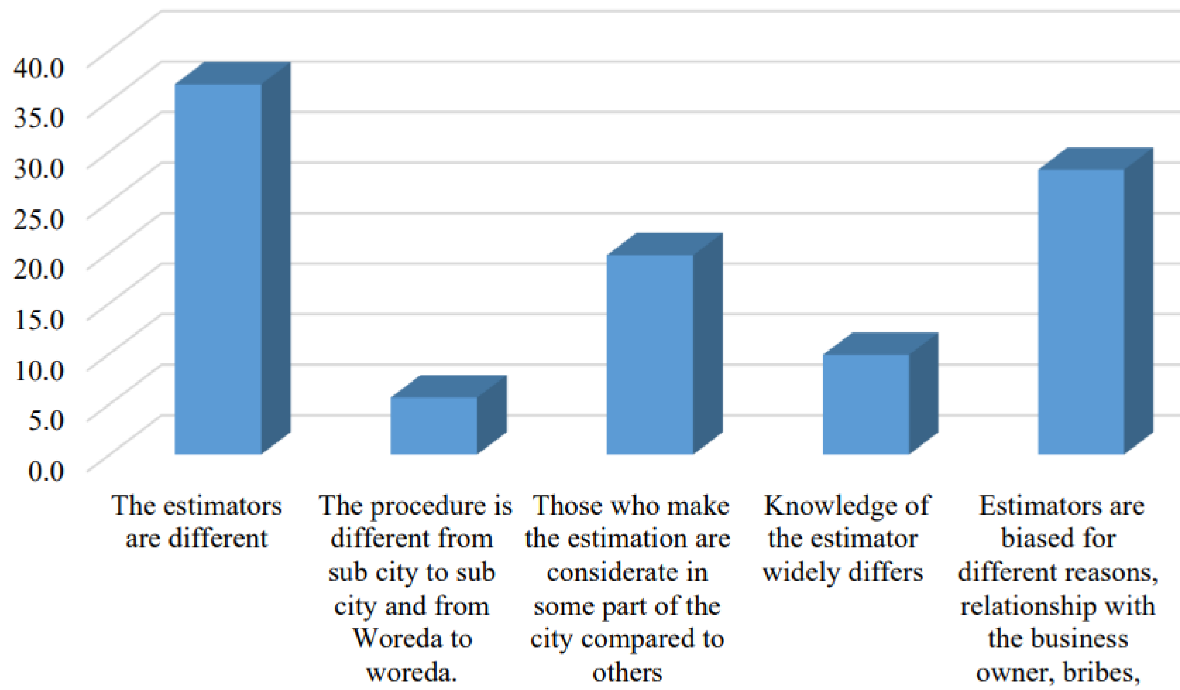
The number of taxes small businesses are required to pay is one way to gauge how simple taxes are. Small firms are liable to a variety of taxes under the tax laws. Without a doubt, the complexity of the tax system grows as more taxes are imposed. The same is true for Addis Ababa, where small businesses must pay various taxes. There is a sizable portion of small businesses that pay more than one or two taxes, such as Employment Tax and Turnover Tax (ToT), even though the majority of them only pay company income tax. Paying several taxes increases the compliance expenses for small businesses even further and may deplete the few resources they have available for tax compliance.

Figure 9: Type of Taxes Applicable to small businesses in Addis Ababa In % terms



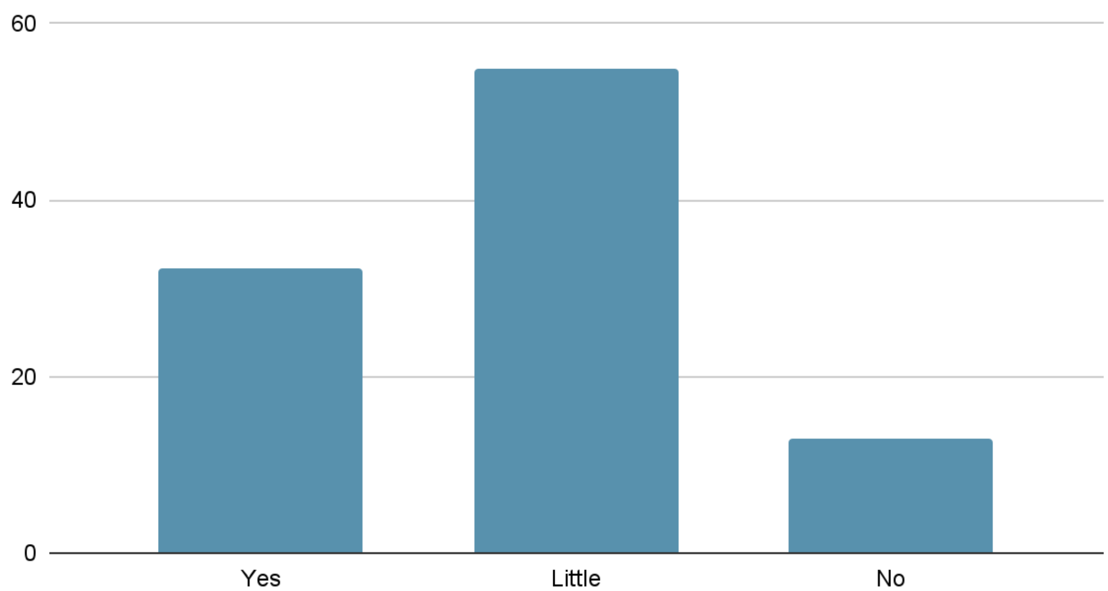
Only 6 MSEs—out of the 98 participants in the study—believe that tax estimating is consistently used from woreda to woreda. The skeptical respondents were questioned about their explanations for the extreme variation in applicability from one location to another. Subjectivity is at the top of the list of the main causes cited by the respondents, followed by the Authority staff's improper relationships with specific taxpayers and bribery to obtain reduced tax estimations.

Figure 10: Perceived Reasons for Disparities of Tax Assessment



A key component of taxation is the taxpayers' trust. More than half of our survey participants had little faith in the evaluation process. The absence of trust perpetuates itself and has an ongoing impact on the actions of both taxpayers and assessors. The correct information will not be provided by the taxpayers, and the assessors will likely conclude that the taxpayers omit the correct information. Due to this, the latter chooses to use a greater estimate than would seem appropriate in the given situation. This emphasizes how important it is for AACRA to work hard to earn the trust of taxpayers and to boost voluntary compliance.

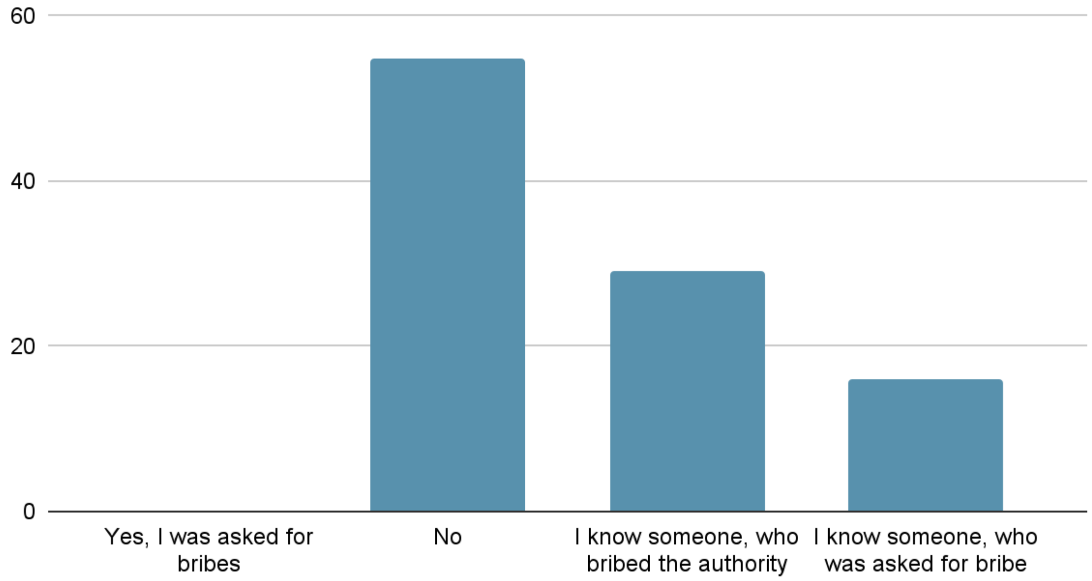
Figure 11: Taxpayer's Trust on Tax Assessment Procedures



Due to the perception that assessors blindly follow authority orders in an effort to collect the most money possible without considering justice, taxpayers frequently harbor mistrust for the tax assessment system. Private companies' fraud serves to further this bias by making assessors reject financial records and ultimately determine tax rates without consulting taxpayers. In the business community, tax assessors and AACRA workers who work with small business taxation have a bad reputation for trying to extort additional tax money.

More than half of respondents said they had never accepted bribes, while 29% said they knew someone who had. Furthermore, 16% claim to know someone who was approached by assessors for bribes. If tax-related misconceptions are not addressed and staff misconduct is not corrected, the problem could get worse, which would hurt business competition and tax income.

Figure 12: Experience of Request for Bribes

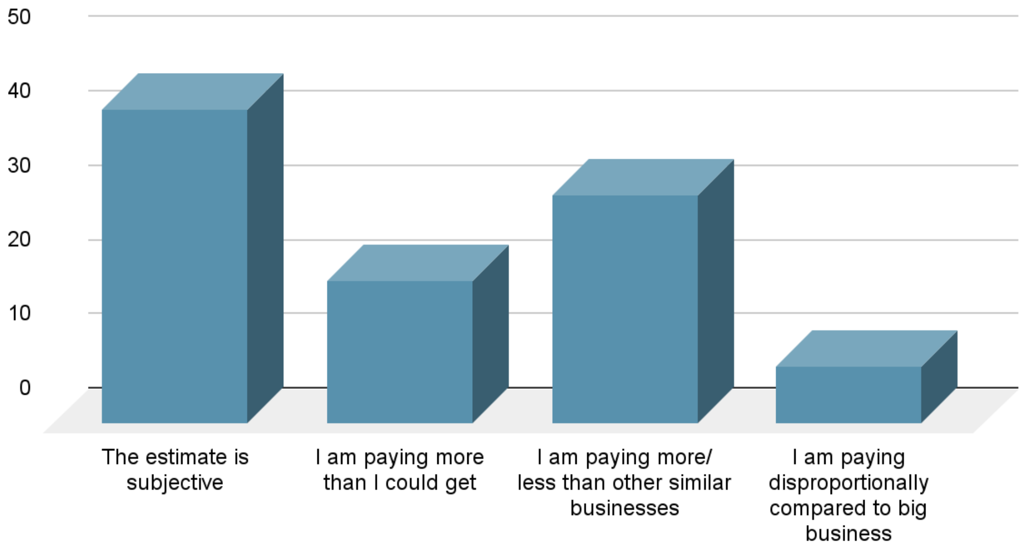


Perceived Unfairness of Average Daily Revenue Estimates

Equity is among the most important taxation tenets. The most reliable indicator of one's ability to pay taxes is typically income. To guarantee horizontal equity (equal treatment of equals), taxpayers assumed to have similar income should also be taxed similarly. To achieve vertical equity (unfair treatment of unfair), taxpayers with various income levels should be taxed at various rates. Only 4 out of 98 respondents in the study claimed the tax amount imposed on them is within their capacity to pay.

Additionally, the respondents were questioned about the apparent justifications for why the tax they are paying is unfair. It is all summarized in the figure below.

Figure 13: Reasons for Perceived Unfairness of Tax System

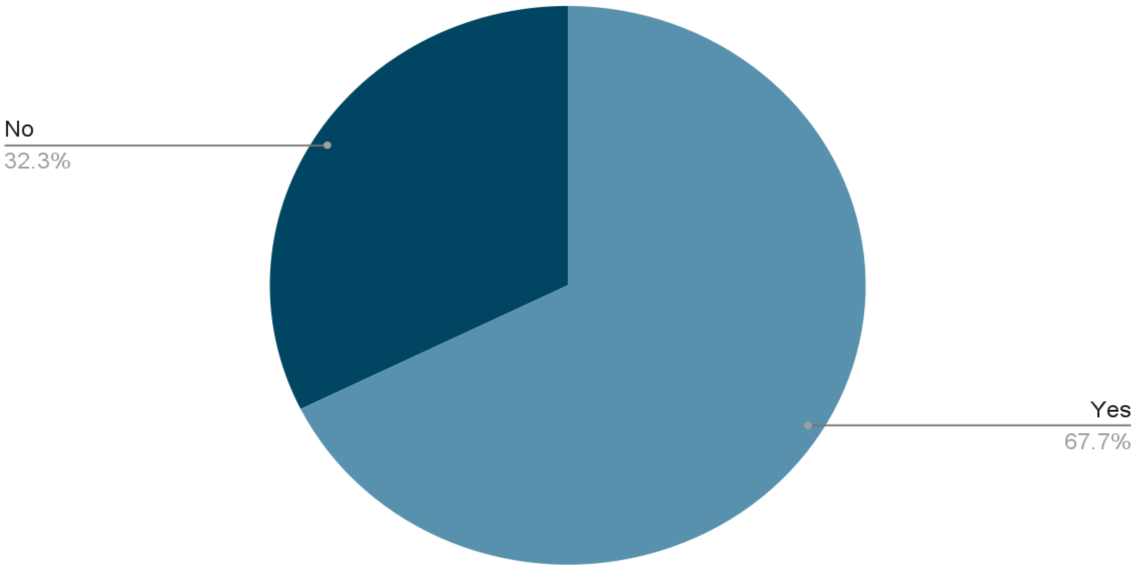


Ethiopia's complicated tax estimation procedure results in regressive taxes. With over 31% of respondents feeling that similar businesses are treated differently, subjectivity is the main perceived cause. According to 19% of respondents, this goes against the ideals of horizontal equity, and 8% of respondents think they pay taxes that are too high relative to major enterprises. Additionally, taxpayers complain that the government still expects them to pay at least a similar amount to what they have been paying in previous good years, despite the severe effects of COVID-19 for almost 2 years and the national political instability that has coincided with COVID-19.

The Complaint Resolution Process

Complaint Resolution Committees are established at the woreda level by Tax Directive and are chosen based on criteria. A taxpayer will pay the same amount for three to five years after their income has been projected. A major reassessment of taxpayers' income in Addis Ababa in November 2017 resulted in a 52% increase in the number of taxpayers filing complaints. According to research, 67% of MSEs have filed at least one tax reduction appeal. This emphasizes how crucial it is for taxpayers to have the freedom to protest and guarantee fair tax treatment.

Figure 14: Incidence of Appeal on Tax



Dissatisfaction resulted from the fact that many taxpayers' concerns to tax branch offices went unanswered. Only 48% of complaints were answered promptly by the complaint resolution committee. 14% of people expressed dissatisfaction with the overall reaction as well. The Complaint Resolution Committee reduced taxes for the vast majority of taxpayers, but many weren't happy with the amount. 87.7% of people who got a reduction said they weren't happy with the new amount.

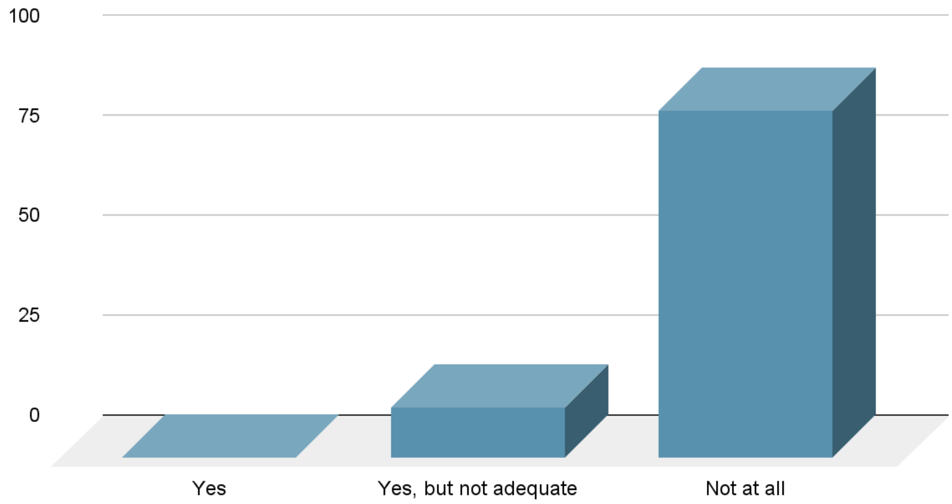
Table 8: Summary of Result on Tax Complaints

Questions	Yes in %	No in %
Did you receive a timely response from the relevant complaint resolution committee?	47.6	52.4
Did you receive a satisfactory response from the relevant complaint resolution committee?	14.3	85.7
Did you receive a deduction from the initial assessment after filing a complaint?	66.7	33.3
If you received a deduction from the initial, was it satisfactory?	13.3	86.7

Participation of MSEs in Tax Estimation and Complaint Resolution Process

Transparency in the tax estimation process is essential to fostering a relationship of confidence between taxpayers and the AACRA. It is crucial to encourage representatives of the business community to participate in the process. This is demonstrated by the experience of the Amhara Regional State, which encourages a more inclusive and transparent tax estimating process by involving taxpayers through chambers of business**.** The study demonstrates the absence of such a practice, which MSE respondents concur with. The business community is not included in the Authority's processes for estimating taxes or resolving complaints. It is essential to include members of the business community in these processes in order to achieve transparency and compliance.

Figure 15: Participation of MSEs in the Tax Estimation Process



Taxpayers' Recommendations for Changes in the Tax System

In Addis Ababa, uncontrolled online enterprises and street selling are booming, and small businesses are whining about these problems. Social media networks like Facebook and Telegram are used to stage online enterprises, which have many advantages over traditional physical businesses. Due to the fact that these companies do not need to pay rent or taxes, they may sell their goods for less money. However, these enterprises are becoming more competitive than conventional businesses. People who responded recommend that the government regulate online enterprises and include unregistered businesses in the tax system.

Respondents strongly support streamlining the tax system and lowering tax rates since the existing amount is excessive and beyond their means. They also demand unbiased tax estimation based on the nature of the firm, the location, and the amount of sales. They demand that the estimation procedure be transparent, accept corporate financial facts, be automated, and be made simpler for taxpayers and assessors to comprehend and use. Additionally, they favor involving the corporate sector in the process. The ability of tax assessors is a worry since many find it difficult to explain to taxpayers how they determine the tax amount.

4.5 Discussion

The findings of this study provide valuable insights into the challenges facing startups and small businesses in complying with tax regulations and the impact of income tax on their financial performance. The study found that tax compliance is a significant burden for startups and small businesses, with complex regulations and administrative requirements making it difficult for them to understand their obligations and avoid penalties for non-compliance. This finding is consistent with previous research that has highlighted the challenges of tax compliance for small businesses (Alm and McKee, 2019; Cullis and Jones, 2020).

Moreover, the study found that income tax has a significant impact on the financial performance of startups and small businesses, with high tax rates and compliance costs reducing profitability and hindering growth. This finding is consistent with previous research that has shown the negative impact of income tax on small business growth and investment (Bartelsman et al., 2017; Devereux et al., 2019). The study also found that tax incentives, such as tax holidays and exemptions, can have a positive impact on small business growth and investment, providing support for policy recommendations to reduce tax rates and provide tax incentives for compliance.

The study's policy recommendations, including simplifying the tax system, providing more education and outreach, reducing compliance costs, and improving fairness, can help address the challenges facing startups and small businesses in complying with tax regulations and promoting their growth and development. These recommendations are consistent with previous research and policy proposals that have highlighted the need for a more supportive tax environment for small businesses (Baldwin et al., 2018; OECD, 2019).

However, the study has several limitations that should be considered when interpreting the findings. Firstly, the study was conducted in a specific region, and the findings may not be generalizable to other contexts. Secondly, the study relied on self-reported data, which may be subject to response bias and measurement error. Finally, the study did not examine the impact of other taxes, such as value-added tax and excise tax, on small businesses, which may have significant implications for their financial performance.

In conclusion, this study provides important insights into the challenges facing startups and small businesses in complying with tax regulations and the impact of income tax on their financial performance. The study's policy recommendations can help policymakers create a more supportive tax environment for small businesses, promote compliance, and facilitate their growth and development. However, further research is needed to explore the impact of other taxes on small businesses and to test the effectiveness of the policy recommendations in different contexts.

CHAPTER FIVE: CONCLUSIONS AND RECOMMENDATIONS

This chapter provides a summary of the study's findings and conclusions, followed by recommendations for policymakers and future research.

5.1 Summary of Findings

The study examined the effect of income tax on small businesses in Addis Ketema sub city, Addis Ababa, Ethiopia. The study found that income tax has a significant negative effect on business performance, including reduced revenue growth and profit growth of small businesses. Additionally, income tax compliance costs were a significant burden on small businesses. Factors that influenced income tax compliance included the complexity of the tax system, the lack of understanding of tax regulations, and the perception of unfairness in the tax system, and the fear of punishment for non-compliance.

5.2 Conclusion

The study's findings highlight the need for policymakers to take steps to simplify the tax system, provide more education and outreach on tax regulations, and explore ways to reduce compliance costs for startups and small businesses. Specifically, policymakers should consider the following recommendations:

To address the challenges facing small businesses in complying with tax regulations, policymakers should consider implementing several policy recommendations. Firstly, the tax system should be simplified to reduce the burden on small businesses. This could involve reducing the number of tax categories, simplifying tax forms, and providing more guidance on tax regulations. Secondly, policymakers should provide more education and outreach on tax regulations to help small businesses better understand their tax obligations. This could include providing workshops, seminars, and online resources. Thirdly, policymakers should explore ways to reduce compliance costs for small businesses, such as reducing the tax rate for small businesses, providing tax incentives for compliance, and reducing the penalties for non-compliance. Finally, policymakers should address the perception of unfairness in the tax system by ensuring that the tax burden is distributed fairly among different income groups and by improving transparency in the tax system. By implementing these policy recommendations, policymakers can create a more supportive environment for small businesses, promote compliance with tax regulations, and facilitate the growth and development of these vital sectors of the economy.

5.3 Recommendations

The study's ultimate goal is to produce high-minded and practical recommendations for leveraging policy and the law to allow the MSE sector to play its proper role in the socioeconomic development of the nation, including job creation, increased entrepreneurship and innovation, expanding the tax base, fostering social cohesion and stability, and increasing the opportunity for sustainable livelihood.

Despite the complexity of the subject and the variety of variables at play, it is nevertheless possible to identify a few key difficulties and offer recommendations based on our research, which is explained in the paper's main body. Eight different subject categories are used to group the recommendations.

a. Simplifying Taxation Requirements on MSEs

b. Redressing the Incongruity between the Law and Practice

c. Removing the Rough Edges of the Law

d. Sensitive or Considerate Application of the Law

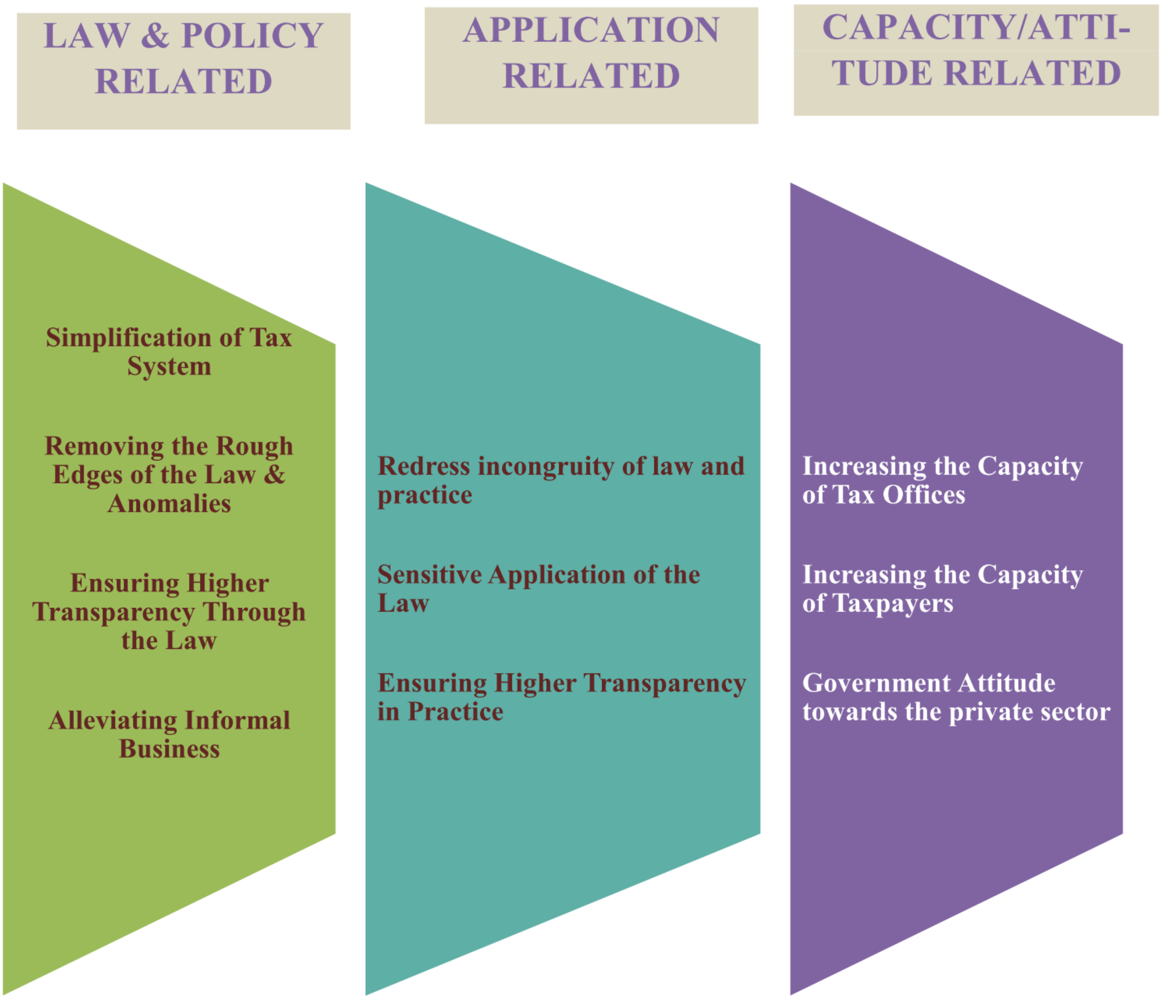
e. Ensuring Higher Transparency in the Tax System

f. Building the Capacity and Participation of Taxpayers

g. Building the Capacity of the Tax Authority

h. Addressing the Unfair Competition from Informal Businesses

The recommendation can be summarized as follows using a diagram



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APPENDICES

Appendix A: Questionnaire

1. What is the legal form of your business?
2. How many years has your business been operating?
3. What is the total annual revenue of your business?
4. Do you pay income tax?
5. How do you perceive income tax in Ethiopia?
6. What is your level of understanding of income tax regulations?
7. How much time and money do you spend on income tax compliance?
8. How has income tax affected your business performance?
9. What factors influence your compliance with income tax regulations?
10. What suggestions do you have for improving the tax system for startups and small businesses?

Appendix B: In-Depth Interview Guide

1. Can you describe your experience with income tax compliance?
2. What factors influence your compliance behavior?
3. How has income tax affected your business performance?
4. Do you believe that the tax system is fair? Why or why not?
5. What suggestions do you have for improving the tax system for startups and small businesses?

Questionnaire

Introduction: Thank you for participating in this survey. The purpose of this survey is to examine the impact of income tax on startups and small businesses in Addis Ababa, Ethiopia. Your participation in this study is voluntary, and your responses will be kept confidential.

Section 1: Business Information

1. Address of the tax payer

A. Sub-city----------------------------

B. Woreda ---------------------------

C. Mobile------------------------------

2. What is the legal form of your business?

a. Sole proprietorship

b. Partnership

c. Limited liability company

d. Other (please specify)

3. How many years has your business been operating?

a. Less than 1 year

b. 1-3 years

c. 4-6 years

d. More than 6 years

4. What is your main business sector?

A. Manufacturing and construction

B. General merchandising & trade

C. Services (secretarial, café, maintenance, food & beverage, etc.)

If other, please specify ……………….

5. What is your position (role) in the business?

A. Owner

B. Manager

C. Accountant

If other, please specify (Cashier, Salesman …)

6. Gender A. Male B. Female

7. Age ranges

A. from 18-30 C. From 31-40

B. From 41-50 D. Above 51

8. What is the total annual revenue of your business?

a. Less than ETB 100,000

b. ETB 100,000 - ETB 500,000

c. ETB 500,000 - ETB 1 million

d. More than ETB 1 million

Section 2: Income Tax Compliance

9. Do you pay income tax?

a. Yes

b. No

10. How do you perceive income tax in Ethiopia?

a. Necessary for the development of the country

b. Unnecessary and burdensome for businesses

c. Other (please specify)

11. What is your level of understanding of income tax regulations?

a. Very high

b. High

c. Moderate

d. Low

e. Very low

12. How much time and money do you spend on income tax compliance?
a. Less than 1 hour and ETB 500 or less
b. 1-3 hours and ETB 500 - ETB 1,000
c. 4-6 hours and ETB 1,000 - ETB 2,000
d. More than 6 hours and more than ETB 2,000

Section 3: Impact of Income Tax on Business Performance

13. How has income tax affected your business performance?
a. Increased revenue growth
b. Decreased revenue growth
c. No effect on revenue growth
d. Increased profit growth
e. Decreased profit growth
f. No effect on profit growth

Section 4: Factors Influencing Income Tax Compliance

14. What factors influence your compliance behavior?
a. Complexity of the tax system
b. Lack of understanding of tax regulations
c. Perception of unfairness in the tax system
d. Fear of punishment for non-compliance
e. Other (please specify)

15. What suggestions do you have for improving the tax system for small businesses?
a. Simplify the tax system
b. Provide more education and outreach on tax regulations
c. Reduce compliance costs
d. Improve fairness in the tax system
e. Other (please specify)

16. Have you ever sought professional assistance to help you with income tax compliance?
a. Yes

b. No

17. If you answered "yes" to question 11, what type of professional assistance have you sought?

a. Tax consultancy firms

b. Lawyers

c. Accountants

d. Other (please specify)

18. Have you ever been penalized for non-compliance with income tax regulations?

a. Yes

b. No

19. If you answered "yes" to question 13, what was the reason for the penalty?

a. Late filing of tax returns

b. Late payment of taxes

c. Under-reporting of income

d. Other (please specify)

20. In your opinion, what is the ideal income tax rate for small businesses in Ethiopia?

a. 0%

b. 5%

c. 10%

d. 15%

e. 20%

f. Other (please specify)

21. How would you rate the overall tax environment for small businesses in Ethiopia?

a. Very favorable

b. Somewhat favorable

c. Neutral

d. Somewhat unfavorable

e. Very unfavorable

22. What other challenges do small businesses face in Ethiopia besides income tax?

a. Access to finance

b. Bureaucracy and red tape

c. Competition from larger businesses

d. Lack of skilled labor

e. Other (please specify)

23. Do you believe that the current income tax system in Ethiopia supports the growth and development of small businesses?

a. Yes

b. No

c. Unsure

24. What type of support do you think the government could provide to help small businesses comply with income tax regulations?

a. Free tax education and training

b. Simplification of tax regulations

c. Tax incentives for small businesses

d. Other (please specify)

25. Have you ever considered operating your business informally to avoid income tax obligations?

a. Yes

b. No

c. Unsure

Thank you for taking the time to complete this survey. Your feedback is greatly appreciated.