Tax Law



LECTURE ONE: INTRODUCTION TO TAXATION

Introducing the course syllabus

- Topics of Fiscal federalism are not included
  - For next class read the relevant provisions of the FDRE constitution on state Vs federal powers of taxation
  - Articles 96,97, 98 and the following provisions
- Participation, attendance, disturbance (late coming & mobile)
  - I will not brag about this and that (rather I will give assignments)
  - other than this ‘my motto is this is a university’ so there isn’t anything that you cant do.
- Laws and proclamation – I will prepare a brief consolidation of the relevant legal tests
- You really don’t have to take notes – but since we will have to discuss that are in long serious, you might have to keep an outline
- Exam – conventional (50 continuous assessment -50 final)

1. Purpose and Meaning of Taxation

- Every gov’t is expected to fulfill a least three functions: 1, Defense of the country 2, Maintenance of law and order 3, Socio-economic development.
  - All these and other gov’t functions require expenditure so that gov’ts support themselves partly by taking a portion of the wealth of their citizens.
- Broadly speaking there are two principal ways in which governments rise their revenues:-
  - Tax revenue
  - Non tax revenue - fees, prices, special assessment, fines and penalties, gifts, borrowings and printing of paper money
- However, the chief means by which gov’t do this is through tax.

Meaning of Tax

- In the past tax has been defined in a variety of ways. We will see some of these definitions just to get an idea as to what kind of definitions existed back then.
  - Dictionary definition: a contribution imposed by authority up on the people to meet the expenses of gov't or other public services [*encyclopedic] [1879-1888]*
  - Tax is a compulsory contribution to the support of the gov't, levied on persons, income, commodities, transactions, etc, now at a fixed rate, mostly proportional to the amount on which the contribution is levied. *Dr. [sir James] Murray's "New English Dictionary" [1888]*
  - Modern Day definition: Tax may be defined as a compulsory contribution (levy) payable by an economic unit to a government without expectation of direct and equivalent return (quid pro quo) from the gov't for the contribution made.*[HL Bhatia, Public Finance, New Delhi, 2003]*

2. Basic Characteristics of Taxation

- From the above definition we can infer the following characteristics of taxation.
- Tax is a compulsory contribution
  - Tax is a compulsory levy to a person who is eligible for tax payment on the basis of the prescribed criteria. Those persons on whom the tax is imposed has no other option than paying. Refusal to pay tax can lead to punishment by law.
- Tax is levied only by the gov't
  - In modern taxation system, no one has a legal right to impose tax except the gov't.
  - See Art 51 of the FDRE Constitution
  - Of courses, there are withholding agents who are required by law to collect taxes on behalf of the gov't.

- Tax is not based on condition
  - The statement – tax is not conditional – implies that tax does not mean it is paid by the tax payers if they got benefit from the government and what is abandoned if they don't get any return from the gov't. There is no direct give and take relationship b/n the tax paid and the benefit received from the gov't.
- Tax is a legal collection
  - Generally gov'ts collect taxes from legal activities based on tax rules and regulations. A gov't does not collect taxes from illegal activities such as from prostitution, begging, stealing, and contraband.
    - This characteristics also mandates constitutionality of tax laws

- Most taxes have some other specific objectives
  - Even though the primary objective of taxation is to raise revenue, most taxes are imposed to achieve some other specific objectives.
    - i.e. ‘regulatory taxes’
  - **Social Objectives** - By imposing high/heavy taxes on harmful products that affect public health such as tobacco and alcoholic products, government can reduce the consumption of such products.
    - For instance, in Ethiopia, tobacco products are subject to 20-75% excise tax and alcoholic products are also subject to 50-100% excise tax. i.e. imposing heavy taxes on such products increases their prices and the majority of the society may be discouraged to buy those products.
    - Exemptions for health expenses, retirement plans, gifts for charities,

- **Equity objectives -** To minimize income and wealth inequalities. [progressive taxation]
- **Economic objectives**
  - Governments also can use the same method to utilize scarce resources for the production of more essential goods.
  - Moreover, each instance in the tax law may be tuned by economic considerations
    - E.g. depreciation rules are determined based on their economic consequences
    - Retirement plans has better treatment in the income tax law because saving is good for the economy
    - The tax law is used to encourage investment in new industries/regions

3. Principles/Canons of Taxation

- Why need to have principles of taxation?
  - Taxes have broad economic and social impact. It shapes, the way we live, some employment decisions that we make, the form of our compensation when we retire and our saving and investment decisions etc.
  - If a government chooses it can levy taxes on any thing it likes. Nevertheless, gov’ts doesn't want to make such non rational decisions. Tax authorities must follow certain code of conduct in the form of principles of taxation while determining the type and amount of tax.

- Generally, the criteria's should benefit our large, complex and diverse society and economy, Thus, principle of taxation refer to the appropriate criteria to be employed in developing [devising] and evaluating a good tax structure/system of a country.
- Adam Smith, who was perhaps the first writer to attempt a general statement of the principles of taxation and most other economists believe that tax system should be based on the following principles of taxation.

1) Equity/Fairness Principle

- According to Adam Smith, “ the subjects of every state ought to contribute towards the support of the gov’t, as nearly as possible, in proportion to their respective abilities; in proportion to the revenue, which they respectively enjoy under the protection of the state.”
- Once the government has decided to collect some amount of taxes, it has a bewildering array of possible taxes available to it.
  - It can tax income, tax profits, or tax sales. It can tax the rich or tax the poor, tax the old or tax the young. Are there any guidelines that can help construct fair and efficient tax systems? Indeed there are. Economists and political philosophers have proposed two major principles for organizing a tax system:

- The Benefit Received principle
  - Holds that different individuals should be taxed in proportion to the benefit, they receive from government programs.
    - Just as people pay private dollars in proportion to their consumption of private bread, a person's taxes should be related to his or her use of collective goods like public roads or parks.
  - Today, despite being overwhelmed by the Ability to Pay principle, this principle might still have some influence on current policies.
    - For instance see Art 100 (2) of the FDRE Constitution

- The Ability to Pay Principle,
  - States that the amount of taxes people pay should relate to their income or wealth.
  - The higher the wealth or income, the higher the taxes.
  - Tax systems organized along the ability to pay principle are also redistributive, meaning that they raise funds from higher income people to increase the incomes and consumption of poorer groups.

- Other than the above, the principle takes two forms: horizontal equity and vertical equity.
  - Horizontal equity states that tax payers in equal position or with equal ability to pay should pay the same amount of tax.
    - For instance if two persons both of which have an income of say Br. 3000 each, then horizontal equity requires the two persons to pay the same amount of tax regardless of their positions.
- On the other hand vertical equity implies that tax payers with greater ability to pay should pay more amount of tax. This in other words means tax payers in unlike circumstances should be treated differently.
    - i.e. there is no good to levy the same amount of tax on two persons earning different amount of incomes. The progressive tax rate structure is founded on the vertical equity premise.

2. Certainty Principle

- This principle states that taxes should not be arbitrary and based on relationship rather it should be based on statutory bases. Therefore, a tax system to be in accord to this principle should specify;
  - How the amount of tax that is due is determined.
  - How the tax is to be paid [the method of payment], and
  - When the tax is to be paid [the period of payment]

- Adam Smith has unambiguously stated that, “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.”
- Adam Smith has further pointed out that even a very small degree of uncertainty is a mater of great importance than a considerable degree of inequality in taxation.
- Here, one should also note that both the tax payer as well as the gov’t benefits if the tax satisfies this canon.

3. Canon of Convenience

- According to this canon, tax should be levied in such a manner and at such a time that it affords the maximum convenience to the tax payer.
- The reason for prescribing this canon is that the tax payer makes a sacrifice at the time of payment of tax. Consequently the gov't should see to it that the tax payer suffers no or least convenience on account of the payment of the tax.
- It is for this reason that the modern gov't pay special attention to the convenience of the taxpayers while collecting taxes from them..
  - For example, the government of Ethiopia collects income tax from the salaries of tax payers at the time they receive salaries from their employers.

- Adam Smith has said, “… taxes upon such consumable goods as are articles of luxury, are all finally paid by the customers, and generally in a manner that is convenient for him. He pays them little by little, as he has occasion to buy the goods. And he is at liberty too, either to buy, or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconveniency from such taxes.”

4. Canon of Economy/ Efficiency

- This canon implies that the cost of tax collection should be the minimum.
  - The tax should be such as to bring the maximum part of the collected revenue in to government treasury.
- Elucidating this idea Adam Smith stated that, “every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. Thus a tax should not require a large number of tax collecting officers whose salaries may eat up a greater part of the tax revenue …”

- Some economists have expressed this canon in different way.
  - According to them, if a tax produces adverse repercussions on the productive power of the country or on its trade and industry or discourages the power to save of the people, such a tax is not to be said economical.

- Efficiency principle can be seen in three different prospects.
  - **1. Administrative Costs**: tax collection in and of itself costs money. This is because the gov’t needs so pay tax collectors, hire data entry clerks to process tax returns, auditors to inspect questionable returns, lawyers to handle tax dispute, accountants to track money flow etc.
  - **2. Compliance Costs**: when a tax payer pays his due it costs money and time. And this extra money they pay can, sometimes does, go beyond the actual tax amount.
    - These includes, the payment they make to their lawyers, accountants, and people who prepare the taxes etc. Keeping tax records and filling out tax returns every time is also a time consuming effort.

- **3. Excess Burden:** a tax system must take in to consideration that when taxes are levied it distorts the behavior of consumers. The behavioral change due to taxes is called excess burden.
  - The notion is that this interference with choice resulting from taxation is a burden on consumers in addition to the actual money handed over in the payment of a tax; this burden provides no benefit to anyone else in the economy and so represents a straightforward loss.
    - This can be appreciated by considering the case of a taxpayer who succeeds in avoiding the payment of a tax.

Other Canons of Taxation

5. Canon of Productivity

- This canon was developed by a well known classical economist Charles F. Bastable.
- Tax revenue must be enough to enable the government to secure enough facilities by providing free public goods and services for the people. If a tax yields poor income, it cannot be considered as productive tax.
- According to this canon it is better levy a few productive taxes rather than to impose unmanageable large number of unproductive taxes on the people.
- Further more taxation must be dynamic. It must be based on earnings and mobility of money and income in the future.
- All this implies that a detailed study should be undertaken to avoid any kind of evil influences of taxation on the various sections of the community. No tax, ought to discourage the productive capacity of the individuals.

6. Canon of Elasticity

- This canon implies that taxes should be levied so that the amount of revenue to be procured through them can be increased or decreased with the least inconvenience as the necessity of the state expenditure wants it to be decreased or increased.
- For example, if the government needs more income at a time of crisis, the tax should be capable of yielding more income through an increase in its rate.

7) Canon of Diversity or Variety

- This canon also was developed by Bastable. It implies that diversity should exist in the tax system of a country. The reason is that if the gov’t levies a single tax, it will become easier for the taxpayers to evade it.
- But if the gov’t imposes a large variety of taxes, it will be difficult for the people to evade or to avoid them.
- Consequently, every tax payer will pay some amount of tax to the gov’t according to his ability to pay.
- The diversification of taxes should be practiced in such a way that every section and every individual must pay tax.

8. Canon of Simplicity

- This canon implies that every tax should be simple so that the tax payer can understand its implications with out inviting the costly help of tax experts.
- Besides this, a complex tax also increases the chance of corruption in the country. Unfortunately, the Ethiopian tax system does not satisfy this canon because if is beyond the understanding of ordinary taxpayer on account of its complexities and complications. But see this as a comment from some economists.

9. Neutrality Principle

- The tax system should be impartial towards tax payers, a tax system should not significantly affect transaction undertaken by tax payers.
- It should not create any inflationary or deflationary affects in the economy, the gov’t should not collect too much tax just to finance its operations.

Therefore, THE BEST MEANS of raising public revenues will be one that meets these conditions:

- It should bear as lightly as possible on production -- least impeding the growth of the general fund, from which taxes must be paid and the community maintained.
- It should be easily and cheaply collected, and it should fall as directly as possible on the ultimate payers -- taking as little as possible from the people beyond what it yields the government.
- It should be certain -- offering the least opportunity for abuse and corruption, and the least temptation for evasion.
- It should bear equally -- giving no one an advantage, nor putting another at a disadvantage.

4. Classification of Taxes

- Economists have classified taxes from different angles there by providing us a long list of different kinds of taxes. In this section we are going to see these different kinds of taxes and their merits and demerits in terms of the objectives of equity, efficiency, simplicity, resource allocation and so on.
- The following are some of the heads under which various taxes are classified.
    1. Direct and Indirect taxes
    2. Proportional, Progressive, Regressive, and Digressive taxes
    3. Specific and Ad-valorem taxes
    4. Single and Multiple taxes

Direct Vs Indirect Taxes

- According to John Stuart Mill, “ **a direct tax is demanded from the very person who it is intended or desired to pay it**.”
- Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expenses of another.
  - According to this definition, a direct tax is paid by the person on whom it is legally imposed while an indirect tax is imposed on one person but is paid either partly or wholly by another person due to a consequential change in the terms of some bargain b/n them.
- At this juncture lets stop and see the concept of Impact, incidence, and shifting of Taxes.

Impact, Incidence, and Shifting of Taxes

- ***Impact of tax -*** *refers to the immediate/ initial burden of a tax on the person who pays it in the first instance*. In other words, the person who pays the tax to the gov't in the first instance bears its impact. Hence, impact of a tax is always on the person who is responsible by law to pay the tax amount to the gov't in the first instance.
- ***Incidence of a tax -*** *refers to the final or ultimate resting place of the burden of the tax payment*. If the person who pays the tax in the first instance finds that he cannot transfer of shift the burden of the tax to any body else, then the incidence as well as the impact of the tax is on the same person.
- ***Shifting of tax -*** refers to the process by which the money burden of a tax is transferred from one person to another person. In other words, the person up on whom the tax is imposed not necessarily bears the burden of tax. Thus, the process of passing on the tax burden to the buyer of goods by the seller is known as shifting of tax**.**

- Thus, taxes are direct or indirect depending up on the fact whether or not they are actually paid by the person on whom their immediate burden of payment [impact] falls.
- In other words in case of direct taxes both the impact and incidence of tax falls on the same person. And incase of indirect taxes the impact and incidence of tax falls on different persons.

- *For example:* The import duty on motor cars is paid in the first instance by the importer of the cars but ultimately he transfers the burden of this duty to the purchaser of the car in the form of higher prices. i.e. the importer includes the import duty paid by him in the price of the car, which is charged from the customer.
- Similarly the burden of payment of an excise duty on cloth, which is initially paid by the textile mill, is shifted to the consumer by including it in the price of cloth. Thus, all indirect taxes are borne by the buyers although the manufactures pay them in the first instance.

Merits of Direct Taxes

1. **Direct Taxes Create Civic Consciousness**

   A direct tax like the income tax pinches the people on whom the it is imposed. Consequently, the tax payers become conscious about their rights. They also see to it that the tax-income accruing to the gov’t is not wasted on useless projects.

2. **Direct Taxes are Economical**

   Direct taxes are economical in the sense that the cost of collecting these taxes for the gov’t is relatively low as these taxes are usually collected at source.

3. **Direct Taxes are Certain**

   The taxpayers know how much they have to pay and on what basis they are going to pay the tax to the gov’t. Thus, the tax payers can make adequate provision for the payment of tax in advance. The gov't can also estimate the amount of revenue from such taxes, which it will receive from the public, and accordingly, it can prepare its development plans.

On the other hand, direct taxes suffer from the following weakness

1. Direct Taxes Can be Easily Evaded

   There is always a possibility of tax evasion in the case of direct taxes. People do not show their correct incomes to the tax officials.

2. Direct Taxes are Unpopular

   Direct taxes are directly imposed on individuals. People have to bear both the impact and incidence of these taxes. Thus, they experience their pinch directly. Consequently, direct taxes are unpopular.

Merit and Demerits of Indirect Taxes

- The following are the main advantages of indirect taxes:

1. Indirect Taxes are Convenient

An important merit of indirect taxes is that they are less inconvenient and less burden some than are direct taxes. The taxpayers generally pay these taxes in small bits and mostly when they buy goods and services in the market.

The amount of tax is included in the price of the commodity and the consumer pays the tax without experiencing its pinch. Sometimes the consumer is not even aware of the fact that he is paying the tax in the form of higher price of the commodity.

2. Indirect Taxes Cannot be Evaded

   Indirect taxes are paid when the goods are purchased in the market. Consequently, there is no possibility of the evasion of indirect taxes.

3. Indirect Taxes lead to Social Welfare

   Indirect taxes imposed on intoxicants like alcoholic drinks, cigarettes etc. serve a great social purpose by curtailing and limiting the consumption of such harmful commodities.

Proportional, Progressive, Regressive and Digressive Taxes

Taxes can also be classified on the basis of the degree of progression or distribution of their burden on the tax payers. [tax system structures]

- A tax is called ***Progressive*** when, with the increasing income the tax liability not only increases in absolute terms, but it also increases as a proportion of the income.
- If the tax liability increases in the same proportion as the increase in the tax payer's income, it is termed as a ***Proportional*** tax.
- If the tax liability as a proportion of income falls with the increase in the taxpayer's income, it is termed as ***Regressive*** tax.
- In the case of ***Digressive*** taxation, there is a declining degree of progression as the tax base increases.

Now lets see these taxes in detail…

Proportional Tax

- In the proportional tax system, all incomes are taxed at a single uniform rate and it does not matter if the tax payer’s income is higher or low.
  - For example, if the rate of income tax is 10 percent, all persons shall have to pay the income tax at this rate as there is no change in the rate of tax with the increase or decrease in incomes.
  - i.e. Proportional taxes maintain equal tax incidence regardless of the ability-to-pay and do not shift the incidence disproportionately to those with a higher or lower economic well-being.
- The tax doesn't alter the proportion of difference of income after the payment of tax has been made. In other words the relative status of individual taxpayers with respect to income and/or wealth remains unchanged after the payment of proportional tax.

Merits and Demerits of Proportional Tax

- The following are the main arguments advanced in favor of proportional tax.
  - First it is easy for individuals to evaluate the total amount of tax they have to pay.
  - Second, it is neutral with respect to income and wealth distribution and consequently it involves no structural change in the socio-economic set-up of the country.

- But, unlike these advantages proportional tax system suffers from the following disadvantages.
  - In the case of proportional tax, the burden of tax falls more heavily on the poorer section of the society.
    - The reason is that as income of individuals increases, the marginal utility of money for him diminishes. In other words, the marginal utility of money for the rich is lower than the marginal utility for the poor.
    - Thus, if the reach and the poor are taxed at the same rate, obviously, the poorer sections of the society will be making greater sacrifice than the richer section. Consequently, the proportional tax system does not satisfy the important canon of equity and justice in taxation.
  - Also this system of taxation does not reduce the inequalities of income and wealth; rather it enhances

Progressive Tax

- A progressive tax is a tax, which varies with the change in the income of individuals, and the rate of tax becomes gradually higher for the increasing incomes and lower for lower incomes.
  - "Progressive" describes a distribution effect on income or expenditure, referring to the way the rate progresses from low to high.
  - It does not provide for a fixed and uniform percentage for all income levels.
- Progressive taxation has become ***popular*** in all countries in the world today. The reasons for its universal popularity are the benefits, which accrue to the community from it. The following are some of the important ***advantages*** of progressive taxation.

1. Progressive tax is based on the ability to pay principle.
2. Progressive tax promotes equality of incomes and wealth.
3. Progressive tax is productive.
4. Progressive tax is economical.
5. Progressive tax is elastic.

- Unlike these advantages, progressive taxation has the following major disadvantage. **i.e. Progressive tax reduces capital formation.**
  - The critics of progressive taxation states that it is only the rich who can save and, therefore, if they are taxed more heavily than the poor, the saving potential will either be lost completely or reduced substantially. Consequently, the process of capital formation is lost.

- Further more, the term is frequently applied in reference to personal income taxes, where people with more disposable income pay a higher percentage of that income in tax than do those with less income.
- But, it can also apply to adjustment of the tax base by using tax exemptions, tax credits, or selective taxation that would create progressive distributional effects.
  - For example, a sales tax on luxury goods or the exemption of basic necessities may be described as having progressive effects as it increases a tax burden on high end consumption or decreases a tax burden on low end consumption respectively.

Regressive Tax

- A regressive tax is the opposite of progressive tax. According to this system of taxation, the rate of tax diminishes as the income of an individual increases.
- Under this system of taxation, the poorer section of the society are taxed at higher rate than the richer sections.

Digressive Tax

- Digressive tax structure is similar to progressive tax structure, but digressive tax the rate of progression is not in the same proportion as the income.
- In digressive tax system the marginal tax rate declines with each incremental tax base, i.e. the tax rate increases but at a decreasing rate. The result of this tax system is that the higher income groups make less sacrifice than the lower income groups and, thus, it can be used as incentive to work, save and invest.

Specific and Ad valorem Tax

- Specific Tax
  - ***When a tax is imposed on a commodity according to its weight, size, or measurement, it is called a specific tax.***
    - For instance, when a tax is imposed on the basis of its weight or the cloth is taxed according to its length or a tax on a car is imposed on the basis of its brand and type, it is known as a specific tax.
  - The main advantage of specific tax is that it is easy to level and more convenient to collect.
  - The other advantage of this tax is that it does not take in to consideration the value of the commodity. Consequently, a cheap and costly object may be taxed at the same rate.

Ad valorem Tax

- When the tax is imposed on commodity according to its value, it is termed an ad valorem tax.
  - Whatever, be the weight or size of the unit of the commodity, the tax is charged according to its value.
- Several imported commodities are taxed not according to their weight or size but according to their value.
- The main advantage of an Ad valorem tax is that it is more equitable. While its main problem is that it is difficult to know the real value of the commodity as the time of imposing the tax.
  - This is because, generally traders understate the value of the commodities in their invoices in order to escape the burden of the ad valorem tax.
- In fact, it is difficult to choose b/n a specific and ad valorem tax. A good tax system should have a judicious blending of both specific and ad valorem tax, according to the nature of the commodities.

Single and Multiple Taxes

- A single tax is a tax that occurs in a system in which the taxes are levied only on one subject. There is only one tax, which constitutes the source of public revenue.
- ***Whereas multiple tax refers to the tax system in which taxes are levied on various items.***
  - It can be easily seen why this is so. A modern economy is not one or single objective economy. ***It tries to forge ahead simultaneously along the paths of growth, equitable distribution of incomes and wealth and stabilization etc.*** Thus, since no single tax can be expected to help the economy on all fronts, choice for a multiple tax system becomes inevitable.
- However, notwithstanding the superiority of the multiple tax system, too great a multiplicity of taxes is undesirable and should be avoided. Therefore it is best to rely on a few substantial taxes for achieving the major portion of the tax revenue.