UNIT FIVE

TAX THEORY AND PRACTICE

INTRODUCTION

- Taxation forms a critical element of modern government.
- Taxation is the process by which governments collect funds to finance public expenditures.
- It involves levying taxes on individuals, businesses, and other entities based on various sources of income.

5.1 Taxes: Definition, Principles, Objectives And Classifications

5.1.1 Definition and Terminologies in Taxation

- Tax, as defined by the “compulsory, unrequited payments to general government”.
- The term “compulsory” indicates that taxes are not voluntary purchase payments but mandatory impositions, payable in line with what is legislated.
- To enforce the compulsion, different governments have constitutions, proclamations, regulations and directives to charge tax for different categories of people.
- Indicating the inevitability of taxation, it is said that there are two things that are certain in life: death and taxes.
- It is also said that without tax, there will be no revenue, and hence, no government.

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- In minimalist terms, governments impose taxes for three basic purposes:
  - To cover the cost of administration,
  - To maintain law and order and
  - To defend the public.
- They also impose taxes to raise revenue to fund economic infrastructure, health facilities, transport, education, telecom, electricity, or free facilities for less able members of society.
- The field of taxation is rich in terminology. The following terms are widely used.
  - Tax rate is the per-unit amount of the tax or the percentage rate at which the economic activity is taxed.
  - Tax base is the level or quantity of an economic activity that is taxed.
  - Tax incidence relates to the way the burden of a tax is distributed among economic units.
    - ✓ It points out who is legally responsible for paying the tax.
    - ✓ It is said that taxes are the price we pay for a civilized society.
  - Impact of tax is tax's first point of contact with the taxpayers.
    - It is felt by those who bear the first statutory responsibility of paying it to the government.

- Effect of a tax refers to responses from taxpayers and the economy to the imposition and collection of taxes.

5.1.2 Objectives of Taxation

- Accordingly, the objectives of taxation are to:
  a. Minimize income and wealth inequalities.
  b. Stabilize the economy.
  c. Discourage the consumption of harmful products.
  d. Provide incentives for capital formation in the private sector.
  e. Reduce regional imbalance.
  f. Enhance standards of livings.etc.
- Governments have monetary and fiscal tools to achieve the above and other related goals.
- Taxation plays a significant role in allocation, distribution, and re-distribution of resources.

5.1.3 Principles of Taxation

- In the Wealth of Nations (1776), Adam Smith proposed the principle/canons of taxation as summarized below.
  1. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities.
  2. The tax which everyone 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.
  3. Every tax ought to be levied at the time or in the manner that makes it the most convenient for the contributor to pay it.
  4. Every tax ought to be planned in manner it takes as little as possible out of the pockets of the people, over and above what it brings into the public treasury of the state.
  5. Every tax has a cost of collection. It is important that the cost of collection should be the minimum possible. This is called the "canon/principle of economy".
  6. The tax system should be able to yield enough revenue for the government so that it should not be forced to resort to deficit financing. This is called the "canon of fiscal adequacy".
- These classical maxims can be translated to modern principles of taxation.

5.1.4 Characteristics of a Good Tax System

- Taxation is broadly characterized by the compulsory nature whereby it imposes obligations on taxpayers.
- Tax is levied on all people without discrimination, yet according to their ability to pay.
- A good tax system is characterized by the following features:
  a) Simple, financially adequate and elastic.
  b) Broad based - tax is levied not only on income but also on property and commodities.
  c) Administratively efficient.
  d) Balanced and harmonious.
  e) Ensures the reduction of economic inequalities.
  f) Ensuring economic stability.
  g) Ensures that national income or standard of living is increases.
- In addition, the revenue yield should be adequate; the distribution of the tax burden should be equitable.
- The tax system should permit fair and non-arbitrary administration and should be understandable to the taxpayer.

5.1.5 Classification of Taxes

- There are two major types of taxes based on impact or incidence. They are

I. Direct taxes impose the burden or impact and incidence on the same person who earns the income.
   - They are computed based on the ability of the taxpayer to pay.
   - Examples: employee's income tax, business income tax, and other income taxes, poll tax, land tax, property tax, royalty tax, capital gain tax, property tax, gift tax and inheritance tax.
   - Direct taxes are further divided into:
     a) Income tax: governments impose on income generated by individuals and businesses.
     b) Transfer tax: such a tax levied on real estate. Such a tax is levied on the taxable portion of the property.
     c) Property tax: charged on properties such as land and building and is used for maintaining public service.
     d) Capital gains tax: charged when an individual sells assets such as stocks real estate, or a business.

II. Indirect taxes impose the impact and incidence on different persons.
   - Examples: consumption taxes such as value added tax (VAT), excise tax, turnover tax (TOT), surtax, customs duty, and stamp duty.

5.1.6 Major Categories and Sources of Taxes

- Different countries have different names to classify their tax systems.
- In the case of the UK, the main types of taxes are:
  - Income tax – a tax on one's income. The basic rate of income tax is 20%, paid on income over the income tax threshold of £11,500.
  - National insurance contributions – a tax by taking a certain percentage of income.
  - Consumption tax – VAT – 17.5%.
  - Excise duties on alcohol, tobacco.
  - Corporation tax – tax on company profit.
  - Stamp duty – tax on buying houses/shares.
- The UK also has a minor category known as "sin tax" which is imposed on goods and services that commonly include tobacco, alcohol, sugar-added drinks, and gambling.
- The main purposes of imposing sin taxes are to reduce the consumption of harmful goods and to increase government revenue.

- In the USA, there are five most common types of taxes. They are:
  1. Earnings (payroll tax).
  2. Individual income, (individual income tax, capital gains).
  3. Corporate income (corporate income tax).
  4. Wealth (property taxes, estate taxes).
  5. Consumption (consumption tax, sales taxes, excise tax).
- From this list, items 1-4 are direct taxes and item 5 represents indirect tax.

5.2 Approaches to Tax Equity

5.2.1 The Benefits Approach

- It is a principle for distributing the tax load among individuals and groups indicating that tax obligations should be based on the benefits received.
- The benefits approach has the advantage of linking the discussion of tax equity with the expenditure side of the public budget.
- Some types of government spending can easily be attributed to beneficiary households.

5.2.2 The Ability-to-pay Approach

- Tax is levied on each taxpayer in line with his/her ability pay.
- Taxes should be distributed as per the capacity of taxpayers to pay them.
- People with equal capacity to pay the same and for people with greater ability, to pay more.
- The ability to-pay approach is based on horizontal equity and vertical equity.
  - Horizontal equity is a situation where people in the same circumstances pay the same taxes.
  - Vertical equity is a situation where a degree of proportionality is important whereby unequals should be treated unequally.
- The concepts of progressive, proportional, and regressive taxes help address this issue
  - A progressive tax is one where those with higher incomes pay a higher share of taxes out of their income compared to those with lower incomes.
  - A proportional tax is one where everyone pays the same share of taxes regardless of income level.
    - ✓ Here, the average tax rate is the same at all income levels.
  - A regressive tax is one where those with high income pay a lower share of income in taxes than those with lower incomes.

5.3 Tax System and Structure in Ethiopia

- Ethiopia introduced the concept of income taxation in 1944 when the Emperor issued a decree requiring all peasants to pay one-tenth of their agricultural products to tax officials.
- The legal framework for taxation is provided by Proclamation No. 33/1992 and the Federal Democratic Republic of Ethiopia (FDRE) Constitution (1995) that promulgated the sharing of revenue between the federal and regional governments.
- Currently, the government agency which is responsible for tax collection is the federal Ministry of Revenues (MoR).
- The Federal government shall levy taxes and collect duties on revenue sources which are reserved to the federal government.
- The regional states levy and collect and duties on revenue sources which are reserved to the states.

5.4 Types of Tax and Tax Accounting in Ethiopia

- In Ethiopia, there are four schedules of income in addition to exempt income. They are:

- **Schedule A: income from employment** is taxed at rates ranging from 10 to 35%.
  - Employment income tax is withheld by employers and is a final tax.
  - Employment income includes the following earnings:
    a) Salary, wages, an allowance, bonus, commission, gratuity, or other remuneration
    b) The value of fringe benefits received by an employee
    c) An amount received by an employee on termination of employment,

Fig: Employment Income Tax Rates In Ethiopia VS Employment Income Tax Deduction

Monthly employment income (Birr)	Employment income tax rate
0-600	0%
601-1650	10%
1651-3200	15%
3201-5250	20%
5251-7800	25%
7801-10900	30%
More than 10900	35%

Employment Income per Month (I) (Birr)	Employment income tax rate	Deduction	Tax computation I=Employment income EIT=Employment income tax
0-600	0%	0	
601-1650	10%	60	$EIT = I \times 10\% - 60$
1651-3200	15%	142.5	$EIT = I \times 15\% - 142.5$
3201-5250	20%	302.5	$EIT = I \times 20\% - 302.5$
5251-7800	25%	565	$EIT = I \times 25\% - 565$
7801-10900	30%	955	$EIT = I \times 30\% - 955$
More than 10900	35%	1500	$EIT = I \times 35\% - 1500$

Source: Ethiopian Investment commission (2020)

- **Schedule B: rental income tax** is imposed for each tax year on a person renting out a building or buildings who has taxable income for the year.
  - The taxable income tax of a taxpayer for a tax year is the gross amount of income derived by the taxpayer from the rental of a building.
- **Schedule C: Income from business,** is imposed for each tax year.
  - The taxable income for a tax year is the total business income reduced by the total deductions allowed to the taxpayer for the year.
- **Schedule D:** Includes other income such as income from royalties, income paid for services rendered outside of Ethiopia, income from games, dividends, etc.
- **Schedule E:** refers to exempt income.
  - A list of exempted income items includes the cost of medical treatment of employees, hardship allowance, salary paid to domestic servants, maintenance, or child support payments, pension contribution, and payments made to a person as compensation.

- The following indirect taxes are levied by the government. They are
- Value added tax (VAT): is a tax levied on the value added at different stages. It is an indirect tax.
  - Ethiopia introduced the VAT Act with the standard rate of 15% which is applied on every taxable transaction.
  - VAT is a destination-based or consumption tax, which means that only the consumption of goods and services is taxed.
- Turnover tax (TOT): this is an equalization tax that is imposed on persons not registered for value-added tax to fulfil their obligations, with annual transactions to the total value exceeding 500,000 Bir.
  - For services rendered locally, the rate is 2% on contractors, grain mills, tractors and combine harvesters, 10% on others.
- Excise tax; this is imposed and payable on selected goods such as, luxury items and basic goods which are demand inelastic.
  - Excise tax is applicable on 19 groups of items and 378 goods. The tax rate ranges from 5% to 500%.

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- Surtax: it is an additional 10% tax that is applicable on imported goods except for fertilizers, petroleum and lubricants, motor vehicles for freight, passengers and special purpose motor vehicles, aircraft, etc
- Pension contribution: the contributions payable to the Private Organizations Pension Fund shall, based on the employee's salary, be by the employer (11%) and by the employee (7%).
- Withholding Tax all bodies and specified sole proprietor businesses are required to deduct withholding tax on domestic transactions at a rate of 2% of the value of the transaction and remit to the tax authority monthly.
- Stamp Duty basically imposed on the services given to individuals through affixing seals.
  - Stamp duty is a tax raised by requiring stamps sold by the government to be affixed to designed documents, which form one kind of revenue to the government treasury.
- Customs Duty: is tax imposed on imported or exported goods.
  - This is the best instrument to prevent or reduce importation of goods. It serves as trade barrier.
  - Whenever a state needs to ban or reduce importations to her territory, it can impose high rate in some goods (excise taxation) it might reach a rate of 100% or above.

5.5 Problems Associated with Taxation in Ethiopia

- In developed countries, one of the tools for improving efficiency in tax administration is to modernize customer services.
- In developing countries including Ethiopia, on the other hand, tax systems face diverse problems.
- Some of these include the complexity of the tax system, perception of corruption, the cost of compliance, fairness perception of the tax system as well as tax knowledge.
- The term "tax compliance" refers to the degree to which the taxpayers with the tax laws.
  - On the contrary, tax non-compliance takes the form of tax avoidance and tax evasion.
- Tax avoidance refers to arranging one's affairs so as to minimize the tax burden.
  - It entails taking full advantage of the provisions of the tax code or schedule to reduce one's tax obligations.
- Tax evasion is falsifying information on a tax return in order to reduce one's tax liability or even not filing at all (failing to pay legally due taxes) which is illegal.
- Tax evasion rooted in underground economic activities that exist for, at least, two reasons:
  a) Because certain activities are illegal and individuals do not want records of those activities. And
  b) Because high marginal tax rates give people an incentive to obtain income without reporting it.

Thank you …