

Introduction

The finance sector is an pillar to the economic system of any economy. And public finance comprises of the public revenue and public expenditure issues. Public Finance, therefore, deals with the income and expenditure of public authorities. It deals with the financial operations or finances of the government. Central, state and local government raises revenues from various tax sources and non-tax sources, such as revenue from general, administrative and economic services, borrowings from individuals, corporations and friendly foreign countries. This course provides students with the essential knowledge required to understand the nature and role of the financial system in the economy and the characteristics and operations of the major financial institutions. Generally speaking the course public finance is designed to acquaint students with the basic concepts and principles of public revenue and public expenditure issues by giving a special emphasis to Ethiopian context.

Course Objectives

Up on completing this course, students will be able to,

- 🌿 Explain the role of the financial system in the economy.
- 🌿 Distinguish as well as explain the nature of financial assets and financial transactions.
- 🌿 Identify the depository and non-depository financial institutions.
- 🌿 Explain the role, operations, and services of depository institutions.
- 🌿 Understand the theories, structure, and measures of interest rates.
- 🌿 Explain the relationships between interest rates, security prices, and inflation.
- 🌿 Explain the nature, importance, characteristics, and operations of financial markets.

CHAPTER ONE

NATURE AND SCOPE OF PUBLIC FINANCE

Learning Objectives

After you complete this chapter you should be able to:

- Define public finance
- Understand the meaning and scope of public finance
- Distinguish between private and public finance
- Understand the economic and social significance of public finance

1.1 Overview of Public Finance

Governments, all over the world have started number of public projects, such as social security, protection and other services of public utilities like electricity, water supply, railways, heavy electricity, atomic energy, etc. To provide social amenities in the form of education, health and sanitation facilities and public utilities, the government requires adequate revenue.

Public Finance, therefore, deals with the income and expenditure of public authorities. It deals with the financial operations or finances of the government. Central, state and local government raises revenues from various tax sources and non-tax sources, such as revenue from general, administrative and economic services, borrowings from individuals, corporations and friendly foreign countries. The government raises revenue from internal as well as external sources to incur huge expenditure on various functions the government has to perform. The important ones being maintenance of law and order, defense, socio- economic development, etc...Public finance is thus concerned with the use and accomplishment of essential monetary resources of the government. In fact, public finance deals with how and through what different sources the government

gets income, how it spends it and how it controls and administers its incomes and expenditures. These two activities, i.e. raising of revenue through taxation and other sources, and spending it on various services plus borrowings from internal

as well as external sources, together constitute “Public Finance.” Therefore, the subject matter of public finance deals with public revenue, public expenditure, and public debt.

1.2 Definition and Scope of Public Finance

Public finance is a very old science and different economists have defined it in their own ways. Some of the important definitions of public finance are shown in following box.

1.2.1 Definitions of Public Finance

1. “Public finance is concerned with the income and expenditure of public authorities and with the adjustment of one to the other.” Huge Dalton
2. “Public finance deals with the provision custody and disbursement of resources needed for conduct of public or government functions.” Lutz
3. “Public finance is a science which deals with the activity of the state in obtaining and applying the material means necessary for fulfilling the proper functions of the state.” Carl Plehn
4. “Public finance is the study of the principles underlying the spending and raising of funds of public authorities.” Findley Shirras
5. “The government, considered as a unit, may be defined as the subject of study of public finance. More specifically, public finance studies the economic activity of government as a unit.” Buchanan
6. “Public finance deals with expenditure and income of public authorities of the state and their mutual relations as also with the financial administration and control.” Bastable

All of them say that it is a study of income and expenditure of the central, state, and local governments. Government performs many functions which the individual cannot or do not perform. Therefore, raising of funds for the expenditure and their disbursement constitutes the subject of Public finance.

Source: Gupta(2001)

1.2.2 Scope of Public Finance

The contents of the science of public finance are divided into five categories of financial activities of the government:

1. Public Revenue,
2. Public Expenditure,
3. Public Debt,
4. Financial Administration and Control, and
5. Economic Stability and Growth.

(1) Public Revenue

Revenue includes all incomes irrespective of the source they are obtained from. Thus, in the wider sense, we can include taxes as well as borrowings under public revenue. But in the interest of the clarity, we study such incomes separately. Hence, in public revenue, we include only those incomes which do not carry with them the obligation of repayment for the state.

Thus, public revenue implies raising income by way of taxation.

(2) Public Expenditure

Expenditure is the end and aim of the collection of revenues. In public expenditure, we are concerned with the principles and problems relating to the expenditure of public funds. We study the fundamental doctrine that governs the distribution of the expenditure among various heads. As public expenditure is an important component of public finance, therefore we also study various effects of public expenditure on total employment, total income, aggregate investment, output, distribution and general price level etc.

Through public expenditure, the government contributes to the financial flows of the economy and conditions the demand and supply patterns. Public expenditure is also used as a tool for implementing welfare, growth, stabilization and other policies, by the

government.

(3) Public Debt

A public authority can obtain income through loans and public borrowings. The loans raised in a particular year constitute receipts for that year. It is an income of a capital nature, while the provision for repayment of the capital sum for the year constitutes expenditure of a capital nature.

The study public debt also includes:

- (i) Methods and objectives of public borrowings; (ii) Management of public debt; and
- (iii) Burden of public-internal and external

Methods of public debt are an important instruments of not only raising funds but also for meeting increasing government expenditure, for securing economic stability, increasing public borrowings during the periods of inflation and liquidation of public debt during the period of depression, borrowings from the people during inflation and borrowings from banks during depression and so on.

(4) Financial Administration and Control

The scope of public finance is not confined only to public revenue, public expenditure and public debt. We have to examine the mechanism by which the above processes are carried on. Without a study of relevant dimensions of financial administration the subject of public finance remains incomplete.

Thus financial administration and control include the following: (i) Study of budgets and their procedure.

- (ii) Budget as a instrument of securing certain objectives, such as promotion of employment, economic growth with stability, welfare of the weaker sections, infrastructural development for promoting private investments, etc.
- (iii) Financial and physical controls through different fiscal tools for controlling private expenditure in the economy to avoid the effects inflation deflation, recession etc.

(5) Economic Stability and Growth

The study of public finance includes fiscal policy of the government in dealing with inflationary and deflationary situations, instability of the price level, promotion of full employment, growth of economy, welfare of the people, etc.

Economic stabilization is of recent origin. It has a wide scope to play especially in the less developed countries. The main task of this section is to frame and look after the implementation of various policies required for economic stabilization and growth.

1.3 Difference between Public Finance and Private Finance

Finance in general means public as well as private finance. Public finance relates to the money-raising and income-expenditure functions of the government. Private finance refers to the income-expenditure phenomenon of an individual or private business firm. By private finance we mean the financial problems and policies of an individual economic unit.

It is a convention to look into similarities and dissimilarities between the two so as to provide an analytical foundation for the decision making aspects of public finance

Similarities

(1) Satisfaction of Human Wants

Both the public and private finance have the same objective, i.e., the satisfaction of human wants. Public finance is concerned with the satisfaction of social or collective wants, whereas private finance is concerned with the satisfaction of personal or individual wants.

(2) Maximum Advantage

Both the public finance and private finance try to secure maximum advantage or maximum benefit. An individual or a corporation or a private business firm tries to

obtain maximum advantage from his expenditure. Similarly, the government

also tries to obtain maximum good of the people by incurring expenditure on the society.

(3) Borrowings

Another similarity between the public and private finance is that many times both have to be obtained from the market in the form of borrowings whenever the expenditure of either the government or any individual or firm exceeds their income/revenue.

(4) Engagement in Similar Activities

Both the private and public sectors are engaged in activities that involve lots of purchases, sales and other transactions. Similarly, they are engaged in production, exchange, saving capital accumulation, investment, and so on. In order to finance these operations, the government, creates money, raises loans and makes payments etc. Similarly, a private economic unit lends, borrows, receives payments, makes payments and so on. In these respects, therefore, both the public and private finance are quite similar to each other.

(5) Scarcity of Resources

The scarcity of resources is also an important factor which is common to both. They have unlimited objectives, whereas the resources are limited.

(6) Problem of Adjustment of Income and Expenditure

Another similarity between public and private finance is that both the public as well as private sectors face the problem of adjustment of income and expenditure.

Dissimilarities

(1) Motive

The motive of private finance is personal interest or benefit, whereas the motive of public finance is social benefit or public welfare.

(2) Adjustment Approach of Income and Expenditure

Another dissimilarity between the individual's private finance and the government's public finance is that every individual tries as far as possible to adjust his expenditure to his income because his expenditure depends on his income. Conversely, the government first prepares its budget. In other words, the

government first determines its expenditure and then devises ways and means to raise the requisite revenue to meet its expenses.

(3) Nature of Resources

The resources (private finance) of an individual are more or less limited, whereas the resources of the government (public finance) are enormous. Government can raise resources from tax sources as well as non-tax sources. The government can borrow from internal as well as external sources.

(4) Coercive Methods

An individual (private finance) cannot use coercive methods to raise his income, whereas the government (public finance) can use forceful methods to collect revenue. In other words, to collect revenue, the government imposes taxes at a high rate on the people irrespective of their capacity to pay. Private individuals or bodies have no such powers.

(5) Secrecy of Budget

Public finance is an open affair as the government gives utmost publicity to its budget by publishing it in newspapers and by showing it on television. For example, the Ethiopian government tells to the public the yearly approved budget by parliament, whereas private finance is a secret affair. An individual tries to keep his accounts secret as he does not want his competitors to know his real financial position.

(6) Long/Short-term Consideration

Another point of difference between private and public finance is that the private individuals incur expenditure in those areas of business which give quick returns. They, as individuals keep in view short-term considerations. On the contrary, government incurs expenditure keeping in view the long-term considerations, such as construction of dams, multipurpose hydro-electric projects, etc.

(7) Elasticity of Finance

Public finance is elastic in nature-as compared to private finance. Public finance can be increased by imposing various taxes as public finance is open to drastic changes.

Private finance on the other hand, cannot be increased as there is not much scope for changes in private finance.

(8) Deliberation in Expenditure

The pattern of expenditure of an individual is governed by habits, customs, status, personal needs etc. On the contrary, the pattern of public expenditure is governed and controlled by deliberate economic policy of the Government

(9) Right to Print Currency

The government has a right to print currency which is legal, whereas private individual does not enjoy such a right.

1.4 Economic and Social Significance of Public Finance

1.4.1 Economic Significance

Economic Stability and maintenance of full employment are the two main goals of public finance in advance countries like the U.K. and the U.S.A. In developing countries economists were of the view that the fiscal policies should be formulated for the rapid economic development.

Public Finance occupies great significance in an under developed or developing country. According to R.J. Chelliah, “Public Finance has a positive and significant role in the context of economic development.” The importance of public finance in an under developed/developing country discussed as follows:

(1) Capital Formation

Since the economic development of the country depends on the rate of capital formulation, the first and the foremost aim of public finance is to promote capital formation. In a developing country, the government’s economic policy should concentrate on production and fiscal policy should act as a tool of capital formation. For rapid capital formation, the government should incur expenditure on the establishment of basic and heavy industries,

infrastructural development, such as power projects, transport sector, means of communications etc.

(2) Economic Stabilization

Economic stabilization is yet another economically significant responsibility of the government. The problem arises whenever there is economic instability such as inflation, deflation and recession. Public finance (revenue and expenditure process of the government) may be, therefore, used to secure economic stability or to remove economic fluctuations in the economy.

(3) Full Employment

Public finance also plays an important role in increasing employment. In an underdeveloped/developing country, major problem faced by the people is the problem of unemployment. This problem leads to low standard of living, poverty, backwardness, ignorance and above all starvation. It is the function of public finance to provide employment opportunities. Therefore, expenditure should be incurred by the government for increasing employment and for achieving full employment. To generate employment, public expenditure should be incurred on setting up new industries, encouraging small-scale and cottage industries through financial subsidies, expenditure on training schemes etc.

(4) Balanced Regional Development

For the economic development of a country, balanced regional development is very essential. Balanced regional development is possible by setting up private industries in backward areas instead of in urban areas. To encourage this diversion, the government should provide fiscal or tax concessions in the form of 5 year tax holiday, communication facilities should also be provided. If the private industries fail to divert to backward regions, should be taxed heavily.

(5) Reduction in Economic Inequalities

One of the major problems of underdeveloped countries is the unequal distribution of income and wealth. There is a gap between the rich and the poor. Public finance has an important role to play in this context. To bring about equitable distribution of income and

wealth, the government should follow the system of progressive taxation. In other words, the government should impose heavy taxes on the richer section of society, and the amount realized from the rich should then be spent on the poor by way of providing them social amenities such as free education, medical facilities, public utilities like road, water facility, recreation facilities etc.

(6) Mobilization of Resources

Mobilization of resources is another important role of public finance. The government can mobilize or raise resources by imposing taxes on the people and industries, by encouraging savings through various saving schemes, surplus of public enterprises and borrowings and making them available for investment for the rapid economic development of the underdeveloped country.

(7) Optimum Utilization of Resources

Optimum utilization of scarce resources is very essential for the economic development of the underdeveloped countries. In a developing country it is not uncommon to find non-utilization or destruction of scarce resources. The solution of this problem lies in the optimum utilization of available resources by means of adopting planned monetary and public finance policies. The state can direct the flow of consumption, production and distribution in the right direction by adopting balanced budgetary policy.

1.4.2 Social Significance

Social justice or equitable distribution of income and wealth is another responsibility of the government in its public finance operations. As already been discussed there is unequal distribution of income and wealth in developing countries. There is a wide gap between the rich and the poor. For example according to Fikreyesus (2006), the top 20 percent of the population have control about 50 percent of the Ethiopian economy. This gap can be bridged by adopting a rational fiscal policy, such as taxation and public expenditure. In other words luxury items purchased mainly by the rich should be subjected to higher rates of taxation, and necessary items should be exempted from taxation. Social justice also requires investment expenditure on the establishment of enterprises in the public sector. By doing so, the government would be able to produce goods of mass consumption to make available cheap goods to the people.

1.4.3 Satisfaction of Social Wants and Merit Wants

Another significant point of public finance is the satisfaction of social or collective wants and merit wants.

Wants are divided under three heads: (a) Private Wants:

- (b) Social Wants or Collective Wants and
- (c) Merit Wants

(a) Private Wants

Private wants are those wants which are satisfied by individuals according to their personal incomes. Degree of satisfaction depends upon their respective incomes. Wants for houses, food, clothes, entertainment or recreation etc. are satisfied according to individual preferences.

(b) Social Wants or Collective Wants

Social or collective wants require public goods which are demanded by all members of society equally whether the people have the capacity to pay or not. Wants like defense, education, public health, flood control provisions, weather forecasting bureaus, research centers, police protection, social overhead capital like roads, bridges, etc. are collective wants which must be available to all the people, irrespective of whether they are rich or poor, whether they can afford to have them or not. In other words, consumer is supreme. Public expenditure on these heads is necessary to satisfy social or collective wants. Since nobody is ready to pay for them, therefore, taxes are imposed on the people to meet expenditure for the satisfaction of these wants.

(c) Merit Wants

Merit wants are essential private such as food, clothing, housing etc, which are satisfied by the government at low prices for the poor due to their low level of income. Merit wants are, thus, provided by the government for the benefit of the poor. These wants are satisfied by the government for the upliftment and progress of the poor. Such wants are food, clothing, low cost housing (eg. condominium), free nutritious meals to school children, free education to the children of the poor, low priced milk to the poor, old age pensions and social security measures, maternity benefits etc. Satisfaction of these wants for the poor increases their productivity efficiency and thereby their income.

1.5 Fiscal Policy to Curb or Prevent Undesirable Wants

Another important aspect of public finance is that the government not only satisfies social wants and merit wants, but also discourages and curbs certain undesirable wants of the people from the social point of view. Undesirable wants are cigarette-smoking, liquor drinking, chewing of opium and tobacco etc. Such harmful wants are discouraged and curbed by imposing heavy taxes and spending large amount on publicity, health measures for the affected people, etc.

Self test Questions

1. Define Public finance in your own words
2. Discuss the main objectives of public finance
3. Distinguish between public and private finance
3. Discuss the major portions of the subject matter of public finance
4. Discuss the economic and social significance of public finance
5. One important aspect of public finance is the satisfaction of social or collective wants and merit wants. How public finance could satisfy social or collective wants and merit wants
6. Even though, Ethiopia recently did experience a remarkable economic growth, regional imbalance is still widely visible. What is the role of public finance in promoting regional balance?
7. One important aspect of public finance is that not only satisfies social wants and merit wants, but also discourages and curbs certain undesirable wants of the people from the social point of view. Mention at least three undesirable wants that could be discouraged and how a government could curb such undesirable wants.

CHAPTER TWO

PUBLIC EXPENDITURE

Learning Objectives

After you complete this chapter you should be able to:

- Understand the meaning and nature of public expenditure
- Differentiate between current expenditure and capital expenditure
- Understand the objective of expenditures
- Understand the canons of expenditure

2.1 Meaning and Importance of Public Expenditure

Public expenditure is incurred by public authorities --Central, State and local Governments either for the satisfaction of collective needs of the citizens or for promoting their economic and social welfare.

Public expenditure is not only the most important but also the central part of the study of public finance. It is incurred by the government for the attainment of public good. Every government has to maintain law and order, armed forces for providing protection, public parks, schools, health of the people. Government has to perform certain other welfare measures like maternity protection, arranging for cheap food, cloth and low-cost housing for the poor and so on. All these multifarious activities which are increasing every year require huge funds. Therefore public expenditure, deals with the expenditure which a government incur for its own maintenance, the society and the economy and helping other countries.

2.2 Current and Capital Expenditure

Technically, in the structure of a budget, most governments classify public expenditure into two:

- (i) Current expenditure, and
- (ii) Capital expenditure

All sorts of administrative and defense expenditure and debt services are called current expenditure. They are also referred to as non-developmental expenditure. They are intended for continuing the existing flow of goods and services and maintaining the capital of the country intact. On the other hand, capital expenditures contribute to increased productive capacity of the nation and therefore, are known as development expenditure. Expenditures on construction of dams, public works, state enterprises, agricultural and industrial development etc., are instances of capital expenditure.

Though public expenditure is a means of maintaining the capital of the country intact, it is not merely a financial mechanism, it is rather a means of securing social objectives. Socialism can be realized only through progressive taxation and their distribution afterwards. Therefore, public expenditure is that expenditure incurred by the public authorities i.e. Central, State and Local Governments, to satisfy those common wants which the people in their individual capacity are unable to satisfy efficiency wants.

2.3. Objectives of Public Expenditure

Dr. Dalton divided the aims of public expenditure into two parts:

- (i) Security of life against the external aggression and internal disorder and injustice.
- (ii) Development or up gradation of social life in the community.
 - The public authority works in many ways for the benefit of the people. The government organizes the generalized services like public health and education. The whole society is benefited by these functions of the state.
 - Secondly, through public expenditure, the government influences directly or indirectly, the industrial and commercial system of the nation thereby helps towards the economic and social development of the society.
 - Thirdly, in modern times, the responsibilities of the government are increasing every year. For the economic development of the country, the government has started, on

its own accord, industries and commercial

business. This sector of the economy which is under the direct control of state has come to be known as public sector. Expenditure on this sector is increasing rapidly every year.

- Fourthly, Dalton points out that the public expenditure should be carried on up to that limit where the marginal benefits arising from different branches of expenditure are equal. These marginal benefits must be equal to the marginal sacrifice incurred by the public.
- Public spending should be designed to optimize the level of investment in such a way as to maintain full employment--with growth.
- Public spending may be incurred at an increasing rate in the backward region to uplift their economy.

2.4 Reasons for Growing Expenditure

A multitude of factors have caused the rising trend of public expenditure in modern times. The followings are few of them:

(1) **Welfare State:** The modern state is a welfare state. It aims at promoting the economic, political and social well being of citizens. It has to spend increasing amounts on such items as social insurance, unemployment relief, free medical aid, free education, child welfare, women welfare, labor welfare, concessional rates of water supply, food stuff, electricity etc., to improve the economic and social welfare of the country. As a result, the public expenditure is bound to increase.

(2) **Defense:** Due to the invention of nuclear weapons there is always a danger of foreign aggression. International political situation is uncertain and insecure. As such, every nation has to prepare itself for a strong defense. The defense expenditure in the form of expenditure on war materials, maintenance and growth of armed forces, pension to retired war personnel etc. are, are perpetually rising.

(3) **Population Growth:** It is an admitted fact that the population is increasing rapidly. As a result, the government has to incur greater expenditure to meet the requirements of the increasing population.

(3) **Transport and Communication:** With the expansion of trade and commerce, the state has to provide and maintain a quick and efficient transport system. Transport being a public utility, the state has to provide it cheaply also. The government has to spend a lot on constructing new railway lines, good roads, new roads, highways, bridges and even canals to connect different areas with a smooth transport system as a precondition of growth.

(4) **Urbanization Effect:** The spread of urbanization is an important factor leading to relative growth of public expenditure in modern times. Urbanization is responsible for the increase in expenditure on water supply, electricity, construction and maintenance of hospitals, schools and other public services.

(5) **Growth of Democracy:** Growth of democracy and socialism has been responsible for the increasing tendency of public expenditure to a great extent. In a democracy, to achieve the goodwill of the public, the ruling party has to incur heavy expenditure on providing variety of services and facilities to the public. Expenditure on elections and by elections is increasing every year. Number of ministries and executive offices has also been increased. As a result of this the public expenditure increases rapidly.

(6) **Rising Trend of Prices:** Public expenditure is also increasing in every country due to rising trend of prices. The reason is that the government has to buy goods and services from the market at higher prices. The government has also to increase the salaries, dearness allowance etc., of government employees leading to a rapid increase in government expenditure.

(7) **Increase in the Activities of the State:** In recent years, activities of the state, particularly in the social and economic fields, such as education, public health, public recreation, public works, commerce and industry, five year plans, etc. have increased tremendously.

(8) The planning effects: In a less developed economy, the government adopts economic planning for the development of the country. In a planned economy, thus, when the public sector is expanding its role, the public expenditure shows an increasing trend. Huge sums are also spent by the government on formulating and implementing plans.

(9) The Rural Development Effect: In an underdeveloped country, the government has also to spend more and more for rural development. It has to undertake schemes like community development projects and social measures. The government also incurs expenditure on imparting training to personnel for implementing rural development programmes.

(10) General Expenditure and Internal Security: Internal situation of a country is becoming uncertain and insecure day by day. Government has been constantly facing communal and political riots. Hence, to check and control these troubles, the government has to spend more on the maintenance of law and order. Moreover, the government is bound to spend huge amounts, as in a free country it is essential that the just demands of the public are duly considered.

2.5 Canons of Public Expenditure

The expression “canons of public expenditure” is used for the fundamental rules or principles governing the spending policy of the government. The following canons of public expenditure have been laid down by Prof. Findley Shirras:

- 1) Canon of Benefit: This canon suggests that every public spending must ultimately be used for the cause of social benefit i.e. for the general well-being of the common people. In other words, the state spending should confer benefits on the entire community at large rather than on an individual group or section. It means public funds should be spent in such directions which pursue common interest and promote general welfare.
- 2) Canon of Economy: It implies that public expenditure should be incurred carefully and economically. Economy here means that wasteful and extravagant expenditure should be

avoided at all levels. Public expenditure must be productive and efficient. Hence, it must be incurred only on every

essential items of common benefit- without duplication in a way that involves minimum cost. An efficient system of financial administration is therefore, very essential in any country.

3) Canon of sanction: this canon suggests that no public spending should be made without the approval of proper authority. Only obtaining prior sanction is not sufficient. It must be properly inspected and examined whether the sanctioned amount of money is being spent properly on sanctioned items or not. As a rule, therefore, money must be spent on the purpose for which it is sanctioned by the highest authority and accounts properly audited.

4) Canon of Surplus: this canon suggests that saving is a virtue even for the government, so an ideal budget is one which contains an element of surplus by keeping public expenditure below public revenue. In other words, public authorities should aim at surplus of income over expenditure and they should avoid deficits. Frequent and huge deficits lead to uncontrollable financial situation with dire consequences of inflation. Therefore, every government should attempt to balance its income and expenditure.

5) Canon of Elasticity: this canon requires that the expenditure policy of the state should be such that changes must be possible in the expenses according to the change in requirements and circumstances. In other words, there should be scope for charges in public expenditure according to the requirements of the country.

6) Canon of Productivity: This canon or principle implies that the expenditure policy of the Governments should be such that would encourage production in a country. That means a large part of public expenditure must be allocated for development purpose.

7) Canon of Equity: One of the foremost aims of public expenditure is also to ensure the just and equitable distribution of is more significant for the countries where the gap between the highest income and the lowest income groups is very wide. Underdeveloped countries like India have

given this aim a significant and particular importance in the economic activities of the State and in their fiscal policies.

2.7 Effects of Public expenditure

Public expenditure, in modern government finance, is regarded as a means of securing social ends rather than just being a mere financial mechanism. Public expenditure is significant in a modern economy because it produces many direct and indirect socio-economic effects. A brief account of these effects may be given as under:

(I) Effects of public expenditure on production

(i) Effects upon ability to work, save and invest

Ability to work, save and invest depends upon the health and efficiency possessed by the persons. Health and efficiency depends upon the level of consumption and level of consumption depends upon the public expenditure incurred by the government. Public expenditure on education, medical services, cheap housing facilities, means of transport and communication etc, will increase the efficiency of persons to work. Some of the expenditure, like the expenditure on free education, unemployment benefit and free medical facilities etc., are helpful in increasing the purchasing power of the people especially of the low income groups and hence it helps to protect and promote the efficiency of the people and their ability to work and save. Public expenditure on increasing the salaries and wages of the people and the supply of goods and articles at cheap rates to them will increase their purchasing power, standard of living, health, efficiency and hence their ability to work and save may increase. Likewise, public expenditure on the maintenance of law and order, creates confidence in the minds of the people and hence it encourages them to make investment in productive activities. As production increases, income of the people also increases; hence their ability to work, save and invest also goes up. Thus it is evident that public expenditure can promote ability to work, save and invest and thus promote production and employment.

(ii) Effects upon willingness to work, save and invest

Public expenditure also affects the willingness of the people to work, save and invest. Pension, provident fund, interest loan, free medical and unemployment allowances and other government payments provide security to a person and, therefore, reduce the willingness of persons to work and save, when a person knows that will be looked after by the government when he is not in a position to earn any income. In the absence of any saving, the question of investment does not arise at all.

On the contrary, expectation of larger amenities and higher standard of living would stimulate people to work hard. It is this encouragement which would encourage them to save more and to invest their savings for production purposes. Expenditure on benefits such as sickness benefits would certainly increase the desire of the people to work more, since they are assured of relief if they fall sick due to hard work.

(iii) Effects on diversion of resources

Public expenditure also affects the diversion of resources. Government incurs public expenditure in the form of giving financial assistance to productive sector. In the same way, if the government wishes to attract productive resources to a particular area or region, it will start giving variety of incentives in the form of tax holidays and other allowances or concessions etc. to the industrialists.

II. Effects of public expenditure on distribution

Public expenditure also helps the government in bringing about equitable distribution on income and wealth. Not only taxation policy but public expenditure policy can also remove inequalities in the distribution of income and wealth. To bring about equitable distribution of income and wealth, the government should impose higher taxes on the richer section of society and the amount realized from them should then be spent on the poorer section of society

by way of providing social amenities, and subsidies to them. Public expenditure has, thus, an important role in reducing economic inequalities in the society.

III. Effects of public expenditure on employment

Public expenditure affects employment as well as employment opportunities. It can increase employment in the country. Therefore, the public expenditure policy of the government should be so devised as to create additional jobs both in the public and private sectors. The following expenditures of the government increase employment opportunities.

(i) Heavy expenditure in the public sector

For the economic development of the country, the government should make investment in public sector such as heavy engineering, iron and steel coal etc. Production goods sector provides direct employment to the people by creating millions of jobs. Thus it clearly becomes the responsibility of the state to prevent a situation of unemployment.

(ii) Expenditure on public utilities

Public expenditure incurred by the government on public utilities, such as supply of water, electricity, telephone services, etc., create a large volume of employment.

(iii) Public expenditure to encourage small-scale industries

To promote employment in small-scale industries, the government should provide tax incentives and allowances to such industries. The government should incur public expenditure on small-scale sector in the form of cheap credit, supply of raw materials at concessional rates, free technological assistance, helping these industries in the marketing of goods etc. In this way, large employment is created in the small-scale sector.

(iv) Public expenditure during the period of depression

Public expenditure plays an important role during the periods of depression and recession. Depression is a period of falling prices, falling demand due to falling incomes.

Recession is a period of rising prices,

falling demand and rising cost of production. It is the responsibility of the government to check these situations by incurring public expenditure on public works, programmes and producers by way of providing tax incentives and reducing the rates of sales tax, duties, custom duties etc. Such expenditure creates employment and income in the country and consequently, effective demand starts rising.

(v) Public expenditure to create employment in backward areas

To create employment opportunities in backward regions, the government should promote industries in the public sector and private sector in backward areas. To encourage industries in the public as well as private sectors, the government should grant deductions and concessions to such industries. If public expenditure is directed towards the promotion of industries in the public and private sectors in backward areas, not only will additional jobs be created, but the markets will be also widened and there will be all round economic development of the country.

IV. Effects of public expenditure on economic stability

Economic stability is judged by the behavior of prices. Price stability is related to the manner in which price behaves in an economy. There should be a normal rise in price because normal is considered as a sign of a healthy economy problem arises whenever there are price fluctuations. Price fluctuations may be known as abnormal economic situations.

There may be three state of abnormal price behavior:

- (i) Inflation,
- (ii) Deflation or depression, and
- (iii) Recession.

(i) Effects of public expenditure in Inflation

Inflation is a state of rising money supply, rising demand but stable supply. Public expenditure may be useful in controlling inflation. In this situation the aim of the government should be to spend than its revenue. Inflation may be averted by reducing

public expenditure on civil services,

defense, interest payments etc. The funds acquired by means of a surplus budget may be used to provide capital to those sectors which experience shortage of capital so that the total productive capacity of the economy may increase. Therefore, public expenditure should be incurred on minor irrigation projects, better quality of seeds, manure, etc., in the field of agriculture. In the field of industries, public expenditure may be incurred on providing facilities for the establishment of new industries and for the expansion of the existing ones.

(ii) Effects of public expenditure in deflation/depression

Depression is a state of falling price, falling money supply and falling demand. Falling prices cause losses among business-men and manufactures and this leads them to curtail production and employment. Thus, a large number of workers are thrown out of employment. In such a situation, the government should employ workers on public works projects. The employed workers receive wages from the government and can thus increase the demand for various commodities. The increased demand leads to increase in production. Thus, the objective of public expenditure during depression should be to create effective demand for consumer goods, which would create employment and thus, would help to maintain economic stability.

(iii) Effects of public expenditure on recession

In a state of recession prices continue to rise in spite of continuously falling demand. Recession or in other words, prices could be kept under control through proper public expenditure policy. To sustain demand, it becomes essential to bring down prices. This is only possible if cost of production is kept under control. To keep the cost of production under control, fiscal support may be extended to the producers in the form of reduction in the rates of sales tax, excise duties, custom duties etc. This would create demand for the products which would increase employment. Increased demand would induce the government to incur expenditure in the form of higher wages to the workers.

V. Effects of public expenditure on economic development

Economic development depends on the rate at which the per capital income increase. It also refers to the structural changes in the economy. Economic development also refers to the problems of under developed countries and economic growth of advance countries. In underdeveloped countries, the problems are concerned with unused resources even though their uses are well- known, while those of advanced countries are related to growth, most of the resources, being, already known and developed. However, the problem of underdeveloped countries is to make rapid and accelerated economic development.

Public expenditure --a powerful remedy

(1) Public expenditure, if properly planned can play an important role in the economic development of the country. The biggest problem, which the developed and underdeveloped countries face, is the problem of unemployment and increasing incomes.

Public expenditure programmes may directly help to provide employment to many individuals and increase in peoples demand for goods and services will lead to greater production and, thus, will provide employment to large number people.

(2) Secondly, in order to increase employment and production, the government should make investment in basic and heavy industries such as iron steel, atomic power, hydro-electric multipurpose projects, heavy electrical and engineering, which are needed for making rapid economic development. However, the objective of public expenditure in mixed economy should not be to compete with the private sector, but to act as supplementary and complimentary to it.

(3) Thirdly, the aim of public expenditure to give fillip to private sector by providing loans, grants and subsidies, tax concessions and exemptions, market and other information and research facilities. The government may set up special banking and financial facilities such as an industrial development bank and financial corporation to provide finance for

medium and long term loans at low interest rates to provide adequate finance for private sector industries.

(4) Lastly, for the economic development of the country the government must provide indirect fillip by incurring public expenditure on such heads as education, public health, training and research and development and on creating employment opportunities in backward regions etc. Besides, economic overheads include transport and communication, water and power facilities, etc.

Thus in the development programmes, all sectors of the economy should grow simultaneously so as to keep a proper balance between industry and agriculture, and between production for home consumption and production for export.

2.7 The principle of maximum social advantage

The fiscal or budgetary operations of the state have manifold effects on the economy. The revenue collected by the state through taxation and the disposal of public expenditure can have significant influence on the consumption, production and distribution of the national income of the country.

Public revenue and public expenditure are two important financial operations of a state. Every government has to obtain revenue to incur expenditure. These two financial operations of the state must be governed by some fundamental principle, so that they may result in maximum social benefit.

Both public revenue and public expenditure are known as public finance. Pigou and Prof. were the two prominent economists, who formulated and popularized the fundamental principle of public finance. The principle says that the State should collect revenue and spend money so as to maximize the welfare of the people.

The best system of public finance is that which secures maximum social advantage from the operation which it conducts. Prof. Dalton called this principle

as the principle of maximum social advantage. Maximum social advantage is the maximum for the states. It has already been mentioned above that maximum advantage to the society depends on public revenue.

There are two important sources public revenue: (i) Tax sources

(ii) Non-tax sources

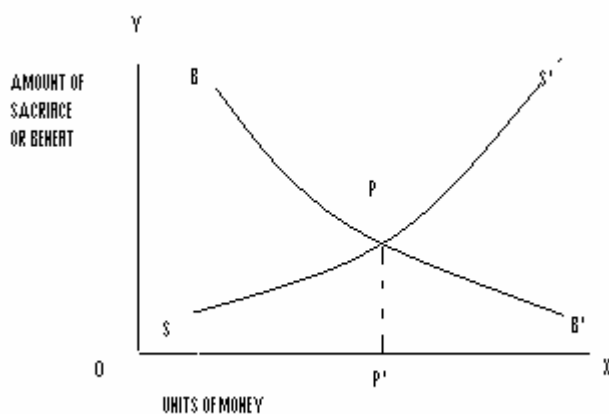
To provide maximum advantage to the society, the government imposes taxes on the people to incur expenditure on social welfare apart from other heads of expenditure, e.g., defense, maintenance of law and order. Only the expenditure incurred on social welfare i.e., social amenities, provides direct benefit to the people.

While explaining how to achieve maximum social advantage, it is necessary to understand two important concepts:

(1) Increasing marginal social sacrifice due to additional taxation

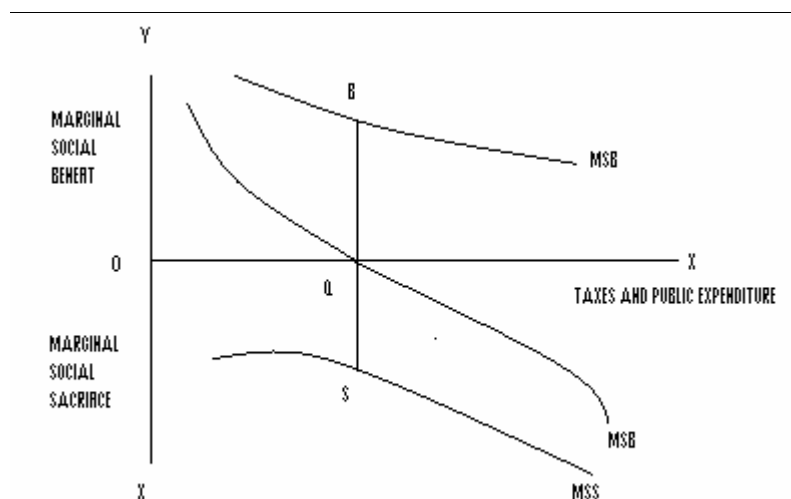
As it has been discussed that to maximize the welfare of the people, the government has to impose taxes. Taxes put a real burden on the people. Whenever tax is imposed, tax-payers have to sacrifice their consumption and other wants to pay taxes. In other words, tax payers are forced to curtail their expenditure which cause inconvenience to them.

According to Dalton, every additional taxation leads to additional sacrifice. But with every increase in taxes, the additional sacrifice goes on increasing with every additional birr collected by way of tax. This involves a greater additional sacrifice on the part of the people. This, on other words, is called “increasing marginal sacrifice (MSS) due to additional taxation. “ In simple words, it means with every additional tax collected, the marginal social sacrifice goes on increasing.



(2) Diminishing marginal social benefits (MSB)

When the government spends money, it confers benefit on the people: Since the tax revenue is to be spent to provide welfare to public at large, the benefit from the expenditure of the government keeps on declining. In other words, as more and more benefits are conferred on the people, its utility to the people goes on diminishing. Hence, Dr. Dalton says as more and more money is spent on the people, the total benefit increases but additional public expenditure leads to diminishing marginal social benefit (MSB). In other words, the main reason for this downward trend is that, when more and more people and more and more areas are brought within the purview of welfare amenities, social benefit from public expenditure declines.



Extent of public revenue and expenditure

To maximize the social welfare, the state should so adjust the revenue and expenditure that the surplus of utility is maximized and disutility is minimized. In other words, to provide maximum advantage to the people, the state should adjust revenue and expenditure up to the point where marginal sacrifice is equal to the marginal benefit. This is the optimum limit of state's public finance activity. Thus public expenditure should be incurred up to the point, where marginal utility, due to public expenditure, is just equal to the marginal disutility due to taxation of public income.

Tests of social Advantage

Prof. Dalton has suggested certain tests of social advantage i.e certain objectives which are to be achieved, which enhance social advantage of the community as a whole. Social advantage may be judged by certain objective tests,

(1) Preservation of the community

The duty of every government should be to preserve the community against internal disorders and external attack. Public expenditure should be so devised by the government as to preserve the interests of the community. More the public expenditure on defense and maintenance of law and order, more the preservation of

society against foreign attack or internal disorder like terrorism, theft etc. Thus, defense expenditure,

expenditure on police, etc., to maintain law and order, security and democracy are justifiable. In fact, preservation, protection and maintenance of the community is the prime requisite of social advantage. It is, therefore, essential to maintain army, police and judiciary etc. to meet external and internal threats of the enemy successfully. If there is political disorder and fear of foreign attack, the welfare or advantage in general will deteriorate. For this reason, the large sum of money spent on armed forces, police and judiciary may be quite justifiable. In any case, it is the duty of the state to increase welfare, both economic and non-economic, of its members. To preserve the community, peaceful and just policy may be followed. Any unsound public policy may cause discontent in the country, and may perhaps necessitate increased expenditure for maintaining law and order.

(2) Improvement in production

The second objective of the operations of public finance should be to increase the level of production, so that the economic welfare of the community may increase. Economic welfare depends on the income generation from agricultural sector and industrial sector. To increase income from these sectors, the government should incur expenditure on the development of these sectors by way of creating infrastructure in the form of canals, electricity generation etc. The expenditure incurred by the government on the infrastructure will increase production. With the increase in production, more and more people will get employment; their purchasing power will also go up. Thus improvement in production implies (i) increase in productive power, so that a larger product per worker shall be obtained with a small effort; (ii) improvements in the organization of production, so as to reduce, to a minimum, the waste of economic resources through unemployment; (iii) improvement in the composition and pattern of production, so as to serve the needs of the community.

(3) Improvement in distribution

Public expenditure and public revenue seeks to reduce economic inequality by distributing whatever is produced equitably among different groups of the community. To bring about improvement in distribution, the government should follow the policy of progressive taxation, Progressive taxation, if followed will reduce the capacity to pay of the richer section of society. The amount so realized from them will then be spent on social welfare which will provide direct advantage to the poorer section of society. As Dalton puts “Improvement in distribution implies (i) reduction in inequality, which is found in the incomes of different individuals and families, and (ii) a reduction in great fluctuation between different periods of time, incomes of particular individuals and families, especially among the poor section of society”

(4) Stability and full employment

Economic instability (booms and depressions) i.e. inflation and deflation is the cause of unemployment and over production. Social advantages to the community can be increased if business conditions in the country are stable and all fluctuations are eliminated. Hence, the aim of taxation should be to bring and maintain economic stability at high level of employment. Fiscal operations designed to maintain economic stability benefit social advantage. Control of economic fluctuations means economic stability. Reduction in tax liability and expenditure on public works etc., can reduce the effects of depression and thus may increase employment and effective demand. Similarly public borrowing and heavy taxation during the period of inflation may help to bring the price level down.

(5) Provision of future

Public expenditure and taxation policy can provide stable future if the principle of maximum social advantage is adhered to by the government. In other words, the government should stop public expenditure at a level where utility of public expenditure is maximum and disutility of public

taxes is minimum. This will prove to be good for the present as well as for the future. If the government allows public expenditure beyond this level, the level of sacrifice will be much higher than the benefit derived by the public at large. The operations of public finance should, therefore, prefer a larger social advantage in the future period to a smaller one of today.

Limitations of principle of maximum social advantage

Although the principle of maximum social advantage is regarded as an ideal and the best guiding principle of the state's financial activities yet there are certain limitations and difficulties in the way of practical application of this principle.

(1) The society gets maximum advantage when the government incurs expenditure on the people. This principle is criticized on the ground that it is very difficult to measure the benefit derived by the people from the expenditure incurred by the government. How much benefit an individual derives from the expenditure incurred by the government on army, police education, cannot exactly be estimated. So also, it is difficult to measure the marginal dissatisfaction caused to each individual separately from each additional tax. In other words, when some public spending is made for the future benefits, measurement of its utility cannot be determined in the present. As such, the government may find it impossible to compare the marginal social benefits and sacrifice related to its fiscal operations.

(2) It is incorrect to say that every tax is burden on society and every state expenditure is a benefit. For example, a tax on excess profit or inheritance tax is not a burden on each and every tax-payer. On the other hand, expenditure incurred by the government on potato chips cannot be called a benefit.

(3) There is no direct relationship between the tax and the expenditure incurred during a period of one financial year. In other words, the tax imposed in one year and expenditure incurred by the government in the same year may not have direct benefit to the people in the same year. The

benefit may spill over subsequent years. For e.g. expenditure incurred by the government on the construction of dam may not provide benefit in the year of incurring expenditure. People may derive benefit in subsequent years.

(4) The principle of maximum social advantage takes into account only tax revenue. But in public finance, it is not only the tax revenue which is important, even non-tax revenue such as loans, borrowing constitute a sizeable portion of revenue. Non-tax revenue, like tax revenue, may also be spent for the public good. Hence, the entire principle of maximum social advantage based on tax revenue and expenditure is incorrect.

(5) The Government is obliged and committed to certain expenses -a liability it cannot free itself from easily. These expenses include maintenance of law and order, defense of the country and certain welfare measures such as old age pension etc. Even if authorities believe that some of these expenses should be reduced, it is not so easy to do, because these heads are vital for the existence of society.

(6) Lastly, the principle of maximum social advantage becomes inoperative when the government seeks to realize revenue objective only. Revenue objective implies optimizing revenues which may be possible more often by taxing some of the necessities of life. The tax imposed on the necessities of life does not bring about any shortfall in demand. Hence, the government earns maximum revenue. This is against the principle of maximum social advantage.

Self Test Questions

1. Distinguish between current expenditure and capital expenditures.
2. Enumerate the reasons why governments are intended to increase public expenditure.
3. Discuss the different canons of public expenditure.
4. Discuss the effects of public expenditure on economic development of a country.

CHAPTER THREE

PUBLIC REVENUE---- GENERAL CONSIDERATIONS

After you have completed this chapter you should be able to

- Understand the meaning and objective of taxation
- Distinguish between tax revenue and non tax revenue
- Understand the characteristics of a good tax system
- Understand the base, buoyancy and elasticity of a tax
- Comprehend the canons of taxation

3. Public Revenue

3.1. Sources of public revenues

Government has played an important role in the socio economic development of society. Social development may be in the form of raising the level of living and social welfare in the form of providing social amenities to the people. Social amenities are in the form of education, health and sanitation, utilities like electric supply, water supply etc, and recreation facilities.

The process of socio-economic development requiring huge expenditure can not be carried unless the government has the perennial source of income. Every government has two important sources of revenue. These are:

- (a) Tax sources, and
- (b) Non-tax sources.

What is a Tax?

Tax is one of the most important sources of revenue to every government. In the earlier days, payment of taxes was optional. A choice was given to the people to pay the tax and to avail the benefit of social amenities in the form of education, health and sanitation,

utilities and recreation facilities. Naturally, everyone interested in availing social amenities used to evaluate the benefit derived by him

in exchange for the tax to be paid by him. But the option in the payment of tax created lot of problems for the government in fulfilling their obligations to society. Hence, in modern times, option was withdrawn and tax became a compulsory contribution by every citizen to the government to enable the government to fulfill its commitments towards society.

Every Government imposes two kinds of taxes: (1) Direct taxes, and
(2) Indirect taxes

A tax, in the modern times, therefore is a compulsory levy and those who are taxed have to pay the sums irrespective of corresponding return of services or goods by the government. It is not a price paid by the tax-payer for any definite service rendered or a commodity supplied by the government. The tax-payers do get many benefits from the government but no tax-payer has a right to any benefit from the public expenditure on the ground that he is paying a tax. The benefits of public expenditure may go to anyone irrespective of the taxes paid. Therefore, we may say that taxes are compulsory payments to government without expectation of direct return or benefit to the tax-payer.

3.2 Objectives of Taxation

Initially, governments impose taxes for three basic purposes: to cover the cost of administration, maintaining law and order in the country and for defense. But now government's expenditure pattern changed and gives service to the public more than these three basic purpose and it restore social justice in the society by providing social services such as public health, employment, pension, housing, sanitation and other public services. Therefore, governments need much amount of revenue than before. To generate more revenue a government imposes taxes on various types. In general objective of taxations are:

1. Raising revenue: to render various economic and social activities, a government needs large amount of revenue and to meet this government imposes various types of taxes.

2. Removal of inequalities in income and wealth: government adopts progressive tax system and stressed on canon of equality to remove inequalities in income and wealth of the people.
3. Ensuring economic stability: taxation affects the general level of consumption and production. Hence, it can be used as effective tool for achieving economic stability. Governments use taxation to control inflation and deflation
4. Reduction in regional imbalances: If there is regional imbalance with in the country, governments can use taxation to remove such imbalance by tax exemptions and tax concessions to investors who made investment in under developed regions.
5. Capital accumulation

Tax concession or tax rebates given for savings or investment in provident funds, life insurance, investment in shares and debentures lead to large amount of capital accumulation, which is essential for the promotion of industrial development.

6. Creation of employment opportunities

Governments might minimize unemployment in the country by giving tax concession or exemptions to small entrepreneurs and labor intensive industries.

7. Preventing harmful consumptions

Government can reduce harmful things on the society by levying heavy excise tax on cigarettes, alcohols and other products, which worsen people's health.

8. Beneficial diversion of resources

Governments impose heavy tax on non- essential and luxury goods to discourage producers of such goods and give tax rate reduction or exemption on most essential goods. This diverts produce's attention and enables the country utilize to utilize the limited resources for production of essential goods only.

9. Encouragement of exports

Governments enhance foreign exchange requirement through export- oriented strategy. These provide a certain tax exemption for those exporters and encourage them with arranging a free trade zones and by making a bilateral and multilateral agreement

10. Enhancement of standard of living

The government also increases the living standard of people by giving tax concessions to certain essential goods.

3.3 Characteristics of a Good Tax System

(1) Tax is a Compulsory Contribution

A tax is a compulsory payment from the person to the Government without expectation of any direct return. Every person has to pay direct as well as indirect taxes. As it is a compulsory contribution, no one can refuse to pay a tax on the ground that he or she does not get any benefit from certain public services the government provides.

(2) The Assessee will be required to pay Tax if is due from him

No one can be forced by any authority to pay tax, if it is not due from him. Suppose, if there is a tax on liquor, the state can force an individual to pay the tax only when he drinks liquor. But, if he does not drink liquor, he cannot be forced to pay the tax on liquor. Similarly, if an individual's income is below the exemption limit, he cannot be forced to pay tax on income. For example individuals earning monthly salary below birr 150 can not be forced to pay tax on income.

(3) Taxes are levied by the Government

No one has the right to impose taxes. Only the government has the right to impose taxes and to collect tax proceeds from the people.

(4) Common Benefits to All

The tax, so collected by the Government, is spent for the common benefit of all the people. In other words, when the government collects a tax, its proceeds are

spent to extend common benefits to all the people. The Government incurs expenditure on the defense of the country, on maintenance of law and order, provision of social services such as education, health etc. Such benefits are given to all the people-whether they are tax-payers or non-taxpayers. These benefits satisfy social wants. But the Government also spends on subsidies to satisfy merit wants of poor people.

(5) No Direct Benefit

In the modern times, there is no direct relationship between the payment of tax and direct benefits. In other words, there is absence of any benefit for taxes paid to the Governmental authorities. The government compulsorily collects all types of taxes and does not give any direct benefit to tax-payers for taxes paid. For example, when taxable income is earned by an individual or a corporation, he or it simply pays the tax amount at the specified rate cannot demand any benefit against such payment.

(6) Certain Taxes Levied for Specific Objectives

Though taxes are imposed for collecting revenue for the government to meet expenditure on social wants and merit wants, certain taxes are imposed to achieve specific objectives. For example, heavy taxes are imposed on luxury goods to reduce their consumption so that resources are directed to the production of essential goods, such as cheaper variety of cloth, less costly goods of mass consumption, etc. Thus, taxes are levied not only to earn revenue but also for diversion of resources or saving foreign exchange. Certain taxes are imposed to reduce inequalities of income and wealth.

(7) Attitude of the Tax-Payers

The attitude of the tax-payers is an important variable determining the contents of a good tax system. It may be assumed that each tax-payer would like to be exempted from tax paying, while he would not mind if other bears that burden. In any case, he would want his share to be within the general level of tax burden being borne by others. In other words, it is essential that a good tax system should appear equitable to the tax-payers. Similarly, overall burden of the tax system is of equal importance. The attitudes of the tax-payers in this regard are influenced

by a host of other factors like the political situation such as war or peace, natural calamities like floods and droughts, economic situations like prosperity or depression and so on.

(8) Good tax system should be in harmony with national objectives

A good tax system should run in harmony with important national objectives and if possible should assist the society in achieving them. It should try to accommodate the attitude and problems of tax-payers and should also take into consideration the goals of social and economic justice. It should also yield adequate revenue for the treasury and should be flexible enough to move with the changing requirements of the State and the economy.

(9) Tax-system recognizes basic rights of tax-payers

A good tax system recognizes the basic rights of the tax-payers. The tax-payer is expected to pay his taxes but not undergo harassment. In other words, the tax law should be simple in language and the tax liability should be determined with certainty. The mode and timings of payment should be convenient to the tax- payer. At the same time, a tax system should be equitable between tax-payers. It should be progressive and burden of taxation should be equitable on all the tax- payers.

3.4 Revenue Receipts

These receipts are divided into tax-revenue and non-tax revenue. Tax-revenue is divided into three sections:

a) Taxes on income and expenditure

This section covers corporation tax, income tax, expenditure tax and similar other taxes, if any

b) Taxes on property and capital transactions

This section covers taxes on specific forms of wealth and its transfers such as estate duty, wealth tax, gift tax, house tax, land revenue and stamps and registration fees, etc.

c) Taxes on commodities and services

This section includes taxes on production, sale, purchase, transport, storage, and consumption of goods and services.

Non-tax revenue of the government is divided into three sections

- (a) Currency, coinage and mint: This category covers the receipts of Currency Note Press and of the Mints. Profit from circulation of small coins is also included here.
- (b) Interest receipts, dividends and profits: This section comprises, apart from interest receipts on loans by the government to other parties, dividends and profits from public sector undertakings run by or as government departments including other income generating departments. Examples are contributions from railways and posts and telecommunications, and surplus profits of the Reserve Bank transferred to the Government.
- (c) Other non-tax revenue: This section covers revenue from various government activities and services such as from administrative services, public service commission, police, jails, agricultural and allied services, industry and minerals, water and power development services, transport and communications, supplies and disposal, public works, education, housing, information and publicity, broadcasting, grants-in-aid and contributions etc.

3.5 Capital Receipts

Capital receipts of the government take money forms. The most important one comprises of fresh borrowings which can be classified in terms of their origin and maturity etc. For example, on the basis of origin, public borrowings may be external (outside the country), or internal (within the country). In terms of maturity, there may be non-terminable (or perpetuities), "long term", "medium term", or "short term" loans with specific demarcation of boundaries for each. They may be marketable or non-marketable, interest-free or interest bearing, etc.

The next category of receipts covers recovery of loans due from debtors to the government. Some capital receipts may be in the form of grants and donations, deposits and appropriations to various funds and so on.

3.6 The base, buoyancy and Elasticity of a tax

3.6.1 The base of tax

The base of a tax is the legal description of the object with reference to which the tax applies. Every tax has a base. For example, the base of income-tax is the money income of assessee; the base of an exercise duty is the volume of production or packing or processing of a specific good-within the enterprise, the base of customs duty is the value of import or export of goods. The base of each tax has to be defined legally for the purpose of determining the tax liability of an individual tax-payer. Each tax payer is considered a legal entity for this purpose. Accordingly, an individual legal entity may be subjected to more than one tax. Every tax base may have a time-dimension also. For instance, income-tax is usually on annual basis.

With the passage of time, a tax base under consideration may grow or may shrink. This will depend on the volume, transaction or the policy of the government. For example as production of excisable goods increases, the base of excise duties would be termed to have grown. If new items are brought within the purview of excise taxation, we shall say that the coverage of excise taxation have extended and the base of excise taxation has been widened, if the production of new items covered under excise duties increases.

3.6.2 Buoyancy of a Tax

Buoyancy of a tax indicates the factors responsible for an increase in the yield of a tax-over time. If a tax revenue increase with the growth of its base, but without an upward revision of the tax rates (without an increase in the rate of tax), then the tax is said to be buoyant. It has an inherent tendency to yield more tax revenue with the growth of the base.

For example, if 10% increase in sales tax collection is

owing to 10% increase if the volume of sales and not due to an increase in tax rates, it is termed as the measure of buoyancy i.e. 10% buoyancy.

Similarly, if yield from income-tax increases as national income increases with given rates of income-tax, it would be termed a buoyant tax. Another example is that of excise duties. Excise duties are imposed on production of specified goods. If new items are not brought under these duties and the rates of existing duties remain unchanged, but the revenue from excise duties increases with an increase in the production of excisable items, we have a case of buoyancy of excise duties.

3.6.2 Elasticity of a Tax

Elasticity tax is related to the rate of tax and yield of a tax. If the yield of a tax increases or decreases owing to reduction or increase in tax rates, we call it elasticity of a tax. The yield of a tax may also go up on account of extension of its coverage or a revision of its rates. Such a characteristic of a tax is referred to as its elasticity. In other words, the elasticity of a tax refers to the steps taken by authorities in increasing its yield through an extension of its coverage or revision of its rates.

3.7 Principles of taxation

A tax system (that is, the set of all taxes) for achieving certain objectives chooses and adheres to certain principles which are termed its characteristics. A good tax system therefore, is one of which designed on the basis of an appropriate set of principles, such as equality and certainty. Mostly, however, objectives of taxation conflict with each other and a compromise is needed. therefore, usually economists select some important objectives and work out the corresponding principles which the tax system should adhere to. The first set of such principles was enunciated by Adam Smith (which he called Cannons of Taxation)

Canons of Taxation

The four canons of taxation as prescribed by Adam Smith are the following:

(1) Canon of Equality

This canon proclaims that a good tax is that which is based on the principle of equality. In other words subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion of their respective abilities, that is, in proportion to the reserve which they respectively enjoy under the protection of the State. It implies what the income which a person enjoys under the protection of the State, should be taxed on the proportional rate of taxation. But modern economists do not agree with Adam Smith. They advocate progressive taxation to observe the canon of equality. In other words, they advocate progression should be the basis for imposing taxes.

(2) Canon of Certainty

This canon is meant to protect the tax payers from unnecessary harassment by the 'tax officials'. It implies that the tax-payer should be well informed about the time, amount and the method of tax payment. According to Adam Smith, "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 was also of the view that the government must also be certain of the amount which it derives from a particular tax. Thus this canon is equally important both for the individual and the state.

(2) Canon of Convenience

The third canon of Adam Smith is that of convenience. According to Adam Smith, "every tax ought to be so levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it." In other words, taxes should be imposed in such a manner and at the time

which is most convenient for the tax-payer, i.e., the best time for the collection of land revenue is the time of harvest. Similarly, taxes on rent of houses should be collected when it is most convenient for the contributor to pay.

(3) Canon of Economy

The fourth canon is the canon of economy. This canon implies that the administrative cost of tax collection should be minimum, i.e., the difference between the money, which comes out of the pockets of people and that which is deposited in the public treasury, should be as small as possible. Administrative cost of tax collection should be minimum because levying of a tax may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose pre-requisites may impose another additional tax upon the people. Hence, the administrative cost should be minimum.

In addition to the above four canons given by Adam Smith, the following other canons have been advanced by Bastable and other economists

(4) Canon of Productivity

The canon of productivity advocated by Bastable implies that taxes should be productive. The productivity of a tax may be observed in two ways. In the first place, a tax should yield a satisfactory amount for the maintenance of a government. In other words, the tax should be such that it procures a considerable amount of revenue for the expenditure of the government. Secondly, the taxes should not obstruct and discourage production in the short as well as in the long run.

(5) Canon of Elasticity

Bastable also laid stress on the principle of elasticity. The canon of elasticity implies that yields of taxes should be increased or decreased according to the needs of the government. The government may need funds to face natural calamities and other unforeseen contingencies. It may

need funds to finance a war or for development purposes. The government resources can be raised quickly only when the system is elastic.

(6) Canon of Diversity

The canon of diversity put forward by Bastable implies that the tax system should be diverse in nature. In other words, in a tax system, there should be all types of taxes so that everyone may be called upon to contribute something towards the revenues of the state. Thus, the governments should adopt multiple tax system.

(7) Canon of Simplicity

The canon of simplicity implies that a tax should easily be understood by the tax-payer, i.e., its nature its aims, time, of payment, method and basis of estimation should be easily followed by each tax-payer. In other words, the tax imposed on the tax-payers should be so simple that they are able to guess easily the aim of its imposition and they are not confronted with accounting, administrative or any other difficulties.

(8) Canon of Expediency

This canon implies that the possibilities of imposing a tax should be taken into account from different angles, i.e. its reaction upon the tax- payers. Sometimes it is seen that tax may be desirable and may be productive and may have most of the characteristics of a good tax, yet the government may not find it expedient to impose it, for example, progressive agricultural income tax, but it has not been imposed. So far in the manner it should have been imposed.

Self test Questions

1. What is a tax?
2. Discuss the objectives of taxation
3. What are the characteristics of good tax system?
3. Discuss the canons of taxation enumerated by Adam smith
4. What is the difference between tax buoyancy and tax elasticity?
5. Distinguish between revenue receipts and capital receipts

CHAPTER FOUR
CHARACTERISTICS OF A GOOD TAX SYSTEM
AND APPROACHES TO TAXATION

Introduction

Public expenditure is continuously increasing with the increase in the functions of modern governments. It is now an important problem of every government to secure adequate amount of public revenue to finance its expenditure. Temporary revenue may be obtained by borrowing, but eventually loans must be repaid. Some revenues are secured from government enterprises, administrative and judicial activities, and from other sources, but the great bulk of revenue comes from taxation.

Of all these sources of earning revenue, it is the tax system that is the most complicated and difficult to understand. For a country to collect more revenue, the tax system administration should be efficient.

In this chapter, we will discuss about the concept of tax structure and administration, the characteristics of a good tax system, and also the different approaches to taxation.

Chapter Objectives

At the end of this chapter, the students will be able to:

- Discuss tax structure
- Analyze tax administration
- Explain the characteristics of a good tax system
- Explain the different approaches to taxation

CHARACTERISTICS OF A GOOD TAX SYSTEM AND APPROACHES TO TAXATION

4.1 Tax Structure and Tax Administration

4.1.1 Tax Structure

A country imposes various types of taxes (such as sales tax, capital gains tax, income tax, etc). The combinations of different types of taxes imposed in a country are referred to as tax structure.

Tax structures differ from country to country. This is mainly due to the fact that the socio-economic developments of countries vary from one another. When we study about the theoretical justification of laying taxes we said that taxes may be imposed depending upon the socio economic conditions of the country. For this reason the tax structure of many countries become different.

Though many countries use different tax base for collecting revenue, they have common tax structure. For example, income tax, value added tax, capital gains tax are among the most common ones found in many countries.

Activity -1
What is tax structure?

4.1.2 Tax Administration

As Canon of economy recommends, for a good tax system of a country, the cost of

collection of taxes should be as minimum as possible. It is useless to impose taxes which are the widespread and difficult to administer. These taxes entail an unnecessary burden upon the society in the form of additional administrative

expense. Realizing that the taxes collected are being wasted, the tax-payers tend to evade them. Therefore, in short, tax administration is the way which shows the process of levying taxes and collecting them.

To make an overall judgment as to whether or not the tax system is functioning satisfactorily requires an analysis of its ability to raise revenue in relation to tax administration.

Activity-2
What is tax administration?

4.2 Characteristics of a Good Tax System

It is commonly believed that there are five properties of a good tax system, these are: Economic efficiency, Administrative simplicity, Fairness, Political responsibility and Flexibility.

4.2.1 Economic Efficiency

A good tax system should not interfere with the efficient allocation of resources. A good tax policy has to question whether the tax system discourages savings and work and whether it has distorted economic behavior in other ways.

There are many historical instances where taxation has produced distortionary effects. An early example of the failure to think through the full consequences of a tax policy was the window tax which was enacted in England in the year 1696. During those days windows were a luxury and wealthy individuals had houses with more windows than those of the poor individuals. Though the intention of those who levied this tax may not be the

windows should not be blocked up, this was in fact one of the major consequences of the tax. In order to avoid the tax

people built houses with few windows. This implies that the window tax led to dark houses.

Modern England also provides other examples. Three-wheel vehicles, though perhaps slightly less safe, and not much less costly, than four-wheel vehicles, were taxed more lightly than the later. Hence many individuals chose them in preference to the more conventional four-wheel vehicle. Vans (station wagons without windows) were taxed more lightly than station wagons with windows, and again many individuals were motivated to purchase these vehicles, but not by a preference for darkness in the rear of their vehicle.

Most of the efficiency effects of taxation are far more subtle and difficult to assess. The effects of taxation are not limited to decisions concerning work, savings, education, and consumption.

While there is some question of the extent to which the tax system affects whether individuals get married or divorced, there is little doubt that it affects the timing of these decisions. For instance, the United States tax code considers a couple married for the entire calendar year even if the wedding is held on December 31. So, two working people who earn similar incomes, choosing between a December and January wedding date are strongly encouraged by the income tax to choose January. The reverse is true for divorce.

Sometimes, taxation affects the form that a transaction takes more than its substance. For instance, in real terms it may make little difference whether an employer gives an employee money to purchase a health insurance policy or whether the employee purchases it for him. In tax terms, it may make a great deal of difference if fringe benefit is not taxed in the particular tax system. In the former case the individual receives “income” upon which he is taxed; in the latter case the “fringe benefit” is not taxed.

A tax system should as far as possible be non distortionary. Any tax system influences behavior. After all, the government is taking money away from an

individual, and we would expect him to respond, in some way, to this lower income. When we say that we want the tax system to be non-distortionary, we clearly do not mean that we want the individual not react at all.

A tax is non distortionary if, and only if, there is nothing an individual can do to alter his tax liability. Economists call taxes that are non distortionary lump-sum taxes. Distortions are associated with the individual's attempt to lower his tax liability. Any tax on commodities is distortionary: an individual can change his tax liability simply by reducing his purchases of the commodity. Any tax on income is also distortionary: an individual can reduce his tax liability simply by working less or by saving less.

Distortionary taxes are inefficient in the sense that if the government could replace them with a lump-sum tax, it could raise more revenue, with the same effect on welfare of individuals, or equivalently, the government could raise the same revenue and increase the welfare of individuals.

So far, our discussion has emphasized the negative aspects of taxation: that we should attempt to design a tax system not to interfere with economic efficiency. Taxation can sometimes be used in a positive way, to correct some market failure. Taxation could sometimes be used to correct for externalities. Corrective taxes (as these taxes are called) both raise revenue and improve the efficiency of resource allocations. If a tax system imposes tax on the chemical industry, to pay for the costs of cleaning up and disposing of toxic wastes, can be thought of as a corrective tax.

4.2.2 Administrative Simplicity

There are significant costs associated with administering a tax system. There are direct costs- the cost of running the authority responsible to collect and administer taxes and indirect costs, which taxpayers must bear. These indirect costs take on a variety of forms: the costs of time spent filling out the tax forms, costs of record keeping, and the costs of accountants, if any.

The administrative costs of running a tax system depend on a number of factors. First, they depend on what records would be kept in the absence of taxation.

A second factor that determines the administrative costs of a tax system is its complexity. For instance, the deductibility of certain categories of expenditures requires that records be kept on these expenditures.

Third, taxing some categories of income may be more expensive than taxing others. There is widespread belief that the administrative costs associated with imposing taxes on capital are much larger than those associated with taxing labor.

4.2.3 Flexibility

Changes in economic circumstances require changes in tax rates. For some tax structures these adjustments are easy; for some they require extensive political debate; for still others they are done automatically.

For instance it is said that there is usually a difficulty in adjusting the rate of income tax. What must be emphasized is that timing is very crucial element of flexibility. The speed with which changes in the tax legislation (one enacted) can be implemented and the lags in the collection of funds may limit the efficiency of the tax. An important aspect of the “flexibility” of a tax system for purposes of stabilizing the economy is timing: the speed with which changes in the tax laws can be implemented and the lags in the collection of funds. If fluctuations in the economy are rapid, the lags may limit the efficacy of, say, the income tax, in stabilizing the economy.

4.2.4 Political Responsibility

The government is the competent authority to administer taxes. A good tax system requires that the government is not to abuse its power of tax administration.

A politically responsible government has to address the feeling of the tax payers. The government should not take advantage of its tax payers. According to this view it is said that taxes where it is clear who pays are better than taxes where the

burden is not so apparent. Thus the individual income tax is a good tax compared to the corporation tax.

A politically responsible tax structure is also one in which changes in taxes come about as a result of legislated changes, and where the government must repeatedly come back to the tax payers for an appraisal of whether the government is spending too much or too little.

A politically responsible government has to go to the people and make sure their opinions are. A good tax system should be designed so that individuals can ascertain what they are paying so that the political system can more accurately reflect the preferences of individuals.

4.2.5 Fairness

Most criticisms of tax systems begin with their unfairness. It is, however, difficult to define precisely what is or is not fair. There are two distinct concepts of fairness: horizontal equity and vertical equity.

I) Horizontal Equity

A tax system is said to be horizontally equitable if individuals who are the same in all relevant respects are treated equally. The principle of horizontal equity is so important. Thus a tax system that discriminates on the basis of race or color would generally be viewed to be horizontally inequitable.

A condition of perfect horizontal equity can be said to exist when a tax or tax structure can be described as achieving an “equal tax treatment of equals.” That is, horizontal equity requires that people who are deemed to be in an equal economic position should pay the same amount in taxes. James Buchanan has given a broader view to the concept of

horizontal equity. For him it is fiscal residuum (the difference between benefits received and taxes paid) that should be equal for people in an equal economic position.

The significance of this rather straightforward criterion of horizontal equity should not be underestimated. Adherence to it provides a basic protection against discriminatory activity of government. By focusing on people's economic characteristics, the chance of grouping them by their geographic region or by their race is reduced. Horizontal equity represents an application of an ethical value judgment that is pleasing to those who accept democratic as opposed to authoritarian principles of government. If the ethical guideline stopped here, however, designing a tax system would be easy. Everyone or perhaps every citizen would pay the same tax.

II) Vertical Equity

Fairness in taxation must also cope with the idea that we do not all fit in one economic group.

Vertical equity, therefore, requires an acceptable pattern of tax payments among people deemed to be unequal. While the principle of horizontal equity says that individuals who are essentially identical should be treated the same, the principle of vertical equity says that some individuals are in a position to pay higher taxes than others, and that these individuals should do so.

There are three problems in relation to vertical equity: determining who, in principle, should pay at the higher rate; implementing this principle—that is, writing tax rules corresponding to this principle; and deciding, if someone is in a position to pay the higher rate, how much more he should pay than others.

Three criteria are commonly proposed for judging whether one individual should pay more than another. Some individuals may be judged to have a greater ability to pay; some may be judged to have a higher level of economic well being; and some may receive more benefits from general government spending. Even if agreement were to be reached on which of these criteria should be employed, there would be controversies concerning

how to measure ability to pay, economic

well being, or benefits received. In some cases the same measures- such as

income or consumption-might be used to judge ability to pay and economic well- being.

Generally the principle of vertical equity says that those who are better off or have a greater ability to pay ought to contribute more to support the government. The principle of horizontal equity says that those who are equally well off (who have equal ability to pay) should all contribute the same amount. In both cases, there is a difficulty of determining whether an individual is better off than another, or of determining whether an individual has a greater ability to pay than another. This implies that the difficult questions namely-how do we tell which of two individuals is better off or which has a greater ability to pay and what do we mean by equality of treatment?- are very difficult to answer. Furthermore the principle of vertical equality does not tell us how much more someone who is better off should contribute to the support of the government; all that it tells us is that he should pay more.

Because of these difficulties economists have looked for other principles on which to base a fair tax. One such principle is the pareto-efficient taxation. The pareto-efficient tax structures are those that maximize the welfare of one (group of) individuals (s), subject to the government attaining given revenue. No one can be made better off without someone else being made worse off.

Activity- 3

What are the basic requirements for a good tax system?

4.3 Approaches to Taxation

How does the government impose tax? There are a number of theories on the basis of which the government distributes tax burdens.

In this regard there are five approaches that have found a wide coverage. These are the expediency approach, cost-of-service approach, socio-political approach, benefit received approach, and ability to pay approach.

Before going to the discussion of the various approaches, it would be better to take the following general considerations.

Firstly, we should remember that tax by definition is a compulsory payment and has no quid pro quo. In other words it is different from the price which the authorities /government charging for some goods or services.

Secondly, a tax has its initial impact. This means that the tax may be paid in the initial stage by those members of the community who do not bear the final money burden of it. They may collect the tax amount partially, fully or more than fully from other members of the society. For example, it will be totally wrong to say that an excise duty or a sales tax on a good is borne by the producer or the seller.

Thirdly, every tax has its own effects which are generally not confined to the losses or benefits to only the direct tax-payers. There are effects in terms of employment, income stabilization and so on which it may not possible even to quantify.

4.3.1 The Expediency Approach

The Expediency Approach tries to assert that in reality every tax proposal must pass the test of practicability. It means that in the choice of various tax proposals, the authorities need not consider various economic and social objectives or the effects of a tax system. This proposition has a truth in it. In practice, every legislations and every authority is pressurized by various economics, social and political groups to orient its taxation policy in certain directions. Every group

would try to resist a change that goes against its interests. The authorities, in many cases, have to adopt certain policies simply because there are pressures to that effect. Also depending upon the changing political strength of different economic groups, the authorities are likely to reshape the tax structure. It is also clear that while choosing and imposing a tax, the authorities would be making a great blunder if they lose sight of the administrative feasibility, the cost of collection, and so on. They would in general want to pluck the goose “where the feathers are thickest” and there is a ‘minimum amount of squawking’.

A taxation system has a role to play in helping the economy. If anything, it should be anti-cyclical, pro-equity and should contribute towards welfare. But when the tax system is worked out without reference to these objectives and policies, its role is nothing and it will be harmful. It will be a destabilizing factor and would be a source of increasing inequalities and socio-economic injustice.

As stated above, practicability is ‘an essential consideration in every tax proposal. If a tax cannot be collected, it is ridiculous to impose it. But of different practicable taxes, a different practicable rate, the choice has to be in terms of their possible effect on the working of the economy. It must be remembered that within the limits of practicability, the authorities have a lot of maneuverability regarding the choice between different taxes. They must not lose sight of the considerations of equity, economic stabilization, growth,

regional imbalances, and so on.

Activity-4

Discuss the expediency approach?

4.3.2 The Cost-of -Service Approach

This is one of the oldest principles, advocated for distribution of the tax burden.

According to this theory, the basis of taxation should be the cost incurred by the

government on different services for the benefit of the individual tax-payers. Each tax-payer has to pay the tax equal to the cost of service to him. It means, the higher the cost, the higher should be the tax rate and vice-versa. In other words, according to this theory, the citizens are not entitled to any benefits from the state and if they do receive any, they must pay the cost of thereof. The government acts like a producer of a commodity who charges the price from his customers equal to the amount of cost of production of the commodity. By adopting this approach, the government gives up its basic protective and welfare functions. It's only job is to recover the cost of service. The state is not concerned with the problems of income distribution. No effort is made by the government to improve income distribution or no notice is taken of the policy of levying taxes according to the cost of service principle. This deteriorates the income distribution further. If this approach is adopted, quite a few sources of public revenue will be ruled out like taxes on capital gains, unearned increments, gifts, expenditure, excise duties and sales tax etc. Welfare activities including all sorts of relief activities will also be ruled out.

Limitations of Cost-of-Service Approach

This principle is also full of many conceptual difficulties.

Firstly, we have the problem of measuring the cost of Government services and assigning them to the proper beneficiaries. Quite a few of the Government activities are in the nature of those goods (or services) to which the principle of exclusion does not apply (no one can be denied a share in their consumption) but the cost of the service cannot be apportioned between different members of the society. No exact proxy is available for such apportionment, such as the income level, size of the family, etc.

Secondly, in many cases it is not possible to have a conceptual clarity of the cost measures. This principle is not in accordance with the character of a tax. A tax is compulsory payment and there is no special benefit in return of the payment of tax. But according to this theory, the payment of tax is return of the cost of service.

Thirdly, the basis of cost service principles is not fair in a welfare state, If cost is taken as the basis of taxation, the government may not perform various functions which may be very much desirable for the welfare of the country as a whole example, relief in times of drought, flood and earthquake, free education and free medical facilities etc. Hence, the cost of service principle cannot be accepted as the basis of taxation.

Activity-5

What are the limitations of the cost-of-service approach?

4.3.3 The Socio-political Approach

In contrast to the Expediency Approach, Adolph Wagner advocated an approach in which social and political objectives are the deciding factors for the distribution of tax burden. Wagner, like most Germans of those days, did not believe in individualist approach to a problem. He wanted that each economic problem should be looked in its social and political context. Accordingly, a tax system should not be designed to serve the needs of the individual members of the society, but should be used to cure the ills of the society in so far as it is possible. Wagner, in other words, was advocating a modern welfare approach to the whole problem of evolving and adopting a tax policy. He was specifically in favour of using taxation for reduction of income inequalities and to achieve this objective, he advocated that all small incomes should be exempted from taxation.

He states that private property and inheritance were there because the Government was permitting them to be there and not because of any God-given right to

the concerned individuals. The Government, therefore, had the right to

control the ownership of property and the right to inheritance as per the interests of the society as a whole. Wagner's ideas, though much criticized at that time, which are now the hall-mark of modern Government fiscal policies. Taxation in a modern Government is generally designed to curb inequalities arising out of the right to property and inheritance. In the modern context we may extend Wagner's stand by including other economic and social objectives of the society in which taxation could be a helpful tool. For example, there is, in these days a need to curb cyclical fluctuations, unemployment, production of undesirable goods and services, monopolistic and restrictive trade practices, hoarding and so on. There is also the need to bring about a more balanced growth as between different regions. That way, the socio-political Approach is far more meritorious than the Expediency Approach.

Though both the expediency Approach and the Socio-Political Approach have their own merits, they can not be advocated as the basic policies in a tax system. Equity, in whatever way it is defined, has to be the hall-mark of any sound tax system. Without it, not only the tax system loses its fairness as between different members of the society, it becomes a source of social, economic and political unrest in the country.

Socio-political Approach, though having the merits of equity, suffers from short-comings also.

This policy has encouraged lot of a tax evasion either on account of loopholes or by adopting such methods that lead to tax evasion. The problem of taxation has led to the operation of a parallel economy which is causing inflation in economy. The concept is more of academic nature than of much practical relevance. This is proved by the fact that in spite of the fact that government follows the policy of progressive taxation, the gap between the rich and the poor has been increasing at a very rate.

4.3.4 The Benefit Received Approach

This approach was accepted by the political theorists of the 17th century. Taxation in those days was considered as a price for the services rendered by the state. The entire philosophy was based on the contract theory of the state. According to this approach the state provides goods and services to the members of the society and they contribute to the cost of these supplies in proportion to the benefit received. It is an exchange relationship.

According to this principle, the burden of taxation should be divided among the people in proportion to the benefits received from the state. The persons receiving equal benefits from the state should pay equal amount as taxes and those who receive greater benefits should pay more as taxes than those getting less benefits.

The benefit theory, therefore, demands that on the ground of equity, the people should be taxed according to benefits (protection, hospitals, education, roads, irrigation etc) they receive from the government and that the division apportionment of taxes be in proportion to the benefits received by each individual or group of individuals. Larger the benefits received, larger should be the amount of tax on the beneficiary concerned.

The benefit approach is in fact, a combination of two principles i.e. the cost of service principles, and the value of service principle. According to the former, the taxes should be divided in proportion to the cost of services rendered by the state. According to the value of services principle, every individual should contribute in proportion to the value of the services he has received from the government. In fact, both the principles come to the same conclusion that the cost of services rendered the government should be recovered from individuals in proportion to the benefits received by each of them.

But this approach/principle is not immune from criticisms. Accordingly, it has the following drawbacks:

It is very difficult to estimate the benefits that an individual receives from the expenditure of the government, e.g., how much benefit an individual receives from the army, police and educational institutions cannot be exactly estimated. And therefore, the burden of taxation may not be equitable. Hence, this theory may be rejected.

If the basis of taxation is benefit, then the poor will have to pay higher taxes than rich because the poor derives greater benefits than rich from the expenditure of government, e.g., the poor may be more benefited by the provision of free medical service and free education. And, therefore, on this ground also, this theory can not be accepted as the basis of taxation.

Rich people have more capacity to pay taxes than poor; but according to this principle the per capital tax burden upon the rich and the poor is the same. This means regressive taxation. It is, therefore; clear that the benefit principle cannot ensure just distribution of burden of taxation among different sections of society.

The principle is also not conducive to general welfare which requires redistribution of income in favour of the poorer sections through public welfare programs and services for their benefit.

A general objection to the whole approach is that this principle is not based on the concept of equity in taxation. Taxes are not progressive in nature.

Activity-6

- 1) What possible problem do you see in the theory of the benefit-received approach in relation to the definition of tax?

4.3.5 The Ability to pay Approach

This approach considers the tax liability in its true form-a compulsory payment to the state without quid pro quo. It doesn't assume any commercial or semi-commercial relationship between the State and the citizens. According to this approach, a citizen has to pay taxes because he can, and his relative share in the total tax burden is to be determined by his relative paying capacity.

The basic tenet of the ability-to-pay doctrine is that the burden of taxation should be shared amongst the members of the society so as to conform to the principles of justice and equity, and that this equity criterion will be satisfied if the tax burden is apportioned according to their relative ability to pay.

Justification to Ability Theory

The supporters of the ability theory have justified it on three grounds:

Firstly, it has been justified on psychological effects of tax payments upon individual taxpayer. Psychologically every tax-payer should feel that he has made equal sacrifice in the payment of tax. Equality of sacrifice means that all the tax-payers should feel the same pinch by paying the last Birr as tax.

Secondly, it has been justified in terms of diminishing marginal utility of income. As income increases, marginal utility of additional unit of income decreases and vice-versa. The tax-burden should be more on rich than on poor.

Thirdly, ability is known as the faculty interpretation. The faculty is represented by the income, property and wealth on an individual.

Index of Ability to Pay

The theory of ability to pay, however, involves the fundamental problem, as to how to measure the ability to pay of a person. There are two approaches which have so far been advanced for this purpose: the objective approach and the subjective approach. In the

objective approach, the faculty theory has been evolved to measure ability to pay. In the subjective approach the sacrifice has

been evolved to measure ability to pay. The two approaches to measure the ability to pay are discussed hereunder.

4.3.5.1 Objective Approach

In the objective approach, the index could be wealth, property, consumption expenditure, or income. In view of the practical difficulties of sacrifice the ability to pay. Prof. Seligman has used the "faculty" to indicate ability in the objective sense. Thus, it is also known as faculty theory of ability to pay. The objective indices of ability to pay are as follows:

The first index of ability to pay is property. Property or Accumulated wealth was considered as the index of ability to pay. It was considered that property which could be in the form of land, building, etc, was a measure of a person's financial ability. Property gives security and insurance against risks. A person with property has a better ability to pay a tax than a person having no or very little property. Thus it was argued that taxation should be imposed on the basis of the extent of property possessed by the person. A person having larger wealth or property should be made to contribute more.

Though property is an important source of income, yet, it can not be considered as the primary test of ability because of the following reasons. Firstly, property is an important source of income, but all property does not yield income. Secondly, the income from property is not continuous. Thirdly, income from property may vary on account of its nature, location, use, etc. A house in a village may not yield anything, but it may be a good source of income in a town. Fourthly, property is taxed on its capital value, but if it does not yield income, the taxation may be unjust. Hence, it can be said that property may not be regarded as a primary test of ability to pay.

This index has a meaning only in an economy which has the institutions of private property and inheritance and in which; therefore, decisions of saving and investment are primarily

in the hands of private individuals and private economic

units. By itself, it is an insufficient index and may be used only to supplement other indices. However, just as property should not be chosen as the exclusive index of ability to pay, it should not be excluded altogether. Accordingly a tax system has take into account the property ownership and the powers which it confers upon the owners and would consider it as an important source of public revenue.

The second index of ability to pay is income. Income is one of the most accepted indices of ability to pay. Under this index, persons with higher incomes share a larger money burden of tax and lower incomes are taxed at lower rates. People with equal incomes are taxed at equal rates.

According to Adam Smith, “The subject of every state ought to contribute towards the support of the government in proportion to their respective abilities.” That is tax payers are to pay taxes in proportion to their respective incomes. Only net income should be taxed. Gross income can not be treated as an index of ability to pay. This is because monetary and non-monetary expenses would be incurred to earn an income. It is said that leisure is also a part of one’s real income. A person’s net income is therefore his gross income plus leisure minus expenditures incurred to earn that income.

Generally income is classified into earned income and unearned income. Income earned from work is treated as earned income and that from capital gains, from sale of shares, security and buildings etc, interest on savings and rent from immovable property, windfall, gains from gambling, races, lottery, etc, is treated as unearned income. It is argued that unearned income should be taxed heavily as compared with earned income. This is based on the assumption that unearned income discourages willingness to work.

Net income is not an ideal index of measuring ability to pay. It also suffers from a number of limitations.

Firstly, the ability to pay of a taxpayer is as much dependent upon his needs as his income. Persons having same income but different needs do not have same ability to pay.

Secondly, ability to pay depends upon marginal utility of money which is a delicate measure. It is subject to quick variations on several grounds and can not be quantified because of its subjectivity.

The income as an index of ability-to-pay appears far less relevant in the case of corporate incomes with which the ownership pattern of the corporate sector is not necessarily positively correlated. An individual or family might own a number of small enterprises and thereby acquire a large amount of income. Alternatively, a large business may be owned by a number of individuals or families, each getting a small amount of income.

The other limitation relates to the difficulty of applying this to indirect taxes. Since indirect taxes are collected as taxes on commodities and services, it is implicitly assumed that the consumers can be classified into homogeneous groups of equal ability-to-pay according to the types and quantities of goods and services purchased by them. This may be an unrealistic assumption. However, in spite of all the above limitations, income as an index of ability is more appealing than other indices.

Size of the Family may be an index of ability to pay. While determining the tax paying ability of a person, the size of the family may have to be taken into account. A larger size of the family with a given income may have smaller tax paying ability than of a smaller size family, e.g. a bachelor possesses the higher tax paying ability than a married couple having four children while other things being the same. Though, the size of the family can be taken into account while determining the tax ability of an individual, it cannot be taken as the primary measure of the tax paying ability.

Another objective index of ability to pay is the consumption expenditure of the members of the society. Sometimes, it is noticed that taxation on the basis of property and income is not equitable and can be manipulated to evade by the taxpayers in many ways. Hence some economists advocated taxation on expenditures. These economists provide a number of reasons to justify their position.

Firstly, consumption implies withdrawal of resources from the economy. Expenditure drains resources of the society and is therefore a fit base for levying a tax. A man's capacity to pay taxes, therefore, depends upon to what extent he withdraws resources to satisfy his consumption needs.

Secondly, a person spending large amounts on consumption has a greater ability to bear the burden of taxation. It is therefore, argued that persons with a higher consumption expenditure should contribute a larger share of total tax amount. They further argued that people with greater consumption expenditure derive smaller marginal utility from their expenditure. Therefore, they can pay more tax and suffer a greater reduction in their expenditure without losing more utility than those who are spending less.

Thirdly, there has been a larger scale evasion of taxes on income because of the concealment of income by the taxpayers. Since consumption of items especially consumption of items of luxury can not be concealed and because levels of income and expenditure of tax payers rise and fall together and as a result tax payers with high expenditure are those with high income, it is stressed that the consumption expenditure should be used as an index of ability to pay taxes.

Fourthly, it is difficult to locate the different sources of income of an individual. Therefore, his ability to pay cannot exactly be measured since the expenditure on consumption can be located without much difficulty, it would truly represent a man's capacity to spend and hence his ability to pay taxes.

In spite of the fact that expenditure on consumption can, in most of the cases, be located to determine a person's ability to pay, yet it suffers from various limitations.

If the consumption expenditure of a person is taken as an index of his ability to pay then those who save and invest will escape the tax burden. This would be against the canon of equity. This system enables higher income people to plough back their earnings into investment and increase the concentration of economic power in their hands without attracting tax liability.

Since different persons have different standards of living, it will not be proper to tax higher consumption expenditure of the people with higher standard of living.

Activity-7

What constitutes the ability to pay of citizens?

4.3.5.2 Subjective Approach

In the subjective approach, the sacrifice of the taxpayers is used to measure ability to pay. The subjective approach is based on the psychological mental reactions of the tax-payers. In this approach we estimate the burden felt by the tax-payer or sacrifice undergone by him. Each tax-payer should make equal sacrifice, if tax burden is to be justly distributed.

According to John Stuart Mill, "The just distribution of tax share prevails when all individuals incur equal sacrifice while contributing to the common good.

Here equal sacrifice refers to the sacrifice in terms of utility of income sacrificed by individuals in contributing to common good".

Conen Stuart and Edgeworth have advanced three concepts of equal sacrifice, viz:

Equal absolute sacrifice

Equal proportional sacrifice

Equal marginal sacrifice

A) Equal Absolute Sacrifice

Under the concept of equal absolute sacrifice, each tax payer should make equal absolute sacrifice, i.e., the total disutility of tax should be equal for all tax-payers. In other words all should be treated equally under law as well as in all affairs of government. According to J.S. Mill, equity in taxation means equality in sacrifice. When the total tax payable by tax-payers is equally divided among them without regard to their money income, it may be stated as the application of the principle of Equal Absolute sacrifice. In this case the total sacrifice in the form of payment of tax is equally divided among the tax-payers without regard to their ability to pay. This may prove to be highly regressive in nature as the quantum of sacrifice on the part of the assesseees with lower money income may be the highest. Hence, most economists have strongly rejected the concept.

B) Equal Proportional Sacrifice

According to this concept also, no one is exempt from sharing the tax burden. In other words, each tax payer should sacrifice the same proportion of total utility or satisfaction derived from his total income.

When the tax burden is distributed among the tax-payers in proportion to their money income, we call it equal proportional sacrifice. In this case, the sacrifice of the poorer section of society is quite higher because marginal utility of money is quite higher to them as compared to the richer section of the society. Thus, according to the principles of proportional sacrifice, the direct real burden on every tax-payer would be proportionate to the economic welfare which he derives from the income. Hence, this concept can not be considered as a system of just tax payment by the government.

C) Equal Marginal Sacrifice

Edgeworth and later Pigou concluded that least aggregate sacrifice is the superior principle of tax distribution, not because it is equitable, but because it is derived directly from the basic utilitarian principle of maximum happiness. According to

this concept, the tax burden is so distributed among different categories of tax- payers that the marginal sacrifice of all the tax-payers is equal. In other words, according to this concept, everyone, whether rich or poor should feel the same pinch by paying the last rupee as tax. This implies that the tax payers should pay tax according to their money income, i.e., the rich should pay the tax at a much higher rate than poor.

According to Edgeworth, marginal sacrifice and not the total sacrifice of the different tax payers should be the same so that aggregate sacrifice for the community as a whole is the least. In other words, the welfare to all would be maximum. To put it in the words of Prof. Pigou, “Thus the distribution of taxation required to conform to the principle of least aggregate sacrifice is that which makes the marginal not the total sacrifice borne by all the members of the community equal”. The object of the state is to maximize the economic welfare. Taxation creates disutility to the tax payers. Hence, taxes should be distributed in accordance with the principle of least aggregate sacrifice, i.e., the marginal sacrifice imposed by way of taxation on each tax payer is equal. In this approach the emphasis is on the welfare of the community. Musgrave and others consider it as the “ultimate principle of taxation”. Thus this approach leads to progressive taxation.

On the basis of the above analysis, we may conclude by saying that with the exception of equal marginal sacrifice, the case of progression and the degree thereof is quite inconclusive. It means, it is not clear whether progressive distribution of taxation is possible or not. For instance, equal absolute sacrifice points out noting more than the fact that, tax liabilities should rise with the rise in income, under proportional sacrifice, it is not clear, what formulation may lead to equal proportional sacrifice, since the precise shape of the marginal utility is not given.

In the equal marginal sacrifice or minimum aggregate sacrifice approach it is suggested that each taxpayer should bear an equal marginal decrease in the utility

of his income after the payment of a tax. Thus, if the marginal tax dollar paid by taxpayer X causes him 10 units of disutility, while that paid by taxpayer Y renders him 30 units disutility, taxpayer X should pay higher taxes and taxpayer Y should pay lower taxes until their marginal disutilities are equal-at, say, 20 units of disutility. If the conventional assumption of identical utility patterns among taxpayers is followed, this approach will equalize post tax incomes for both X and Y, as well as for all taxpayers in the society. At the same time, minimum aggregate disutility or sacrifice for the society as a whole will have been attained.

This concept of equal marginal sacrifice suggests a highly progressive income tax rate structure. In effect, it applies a marginal tax rate of hundred percent to the highest income group for that income differential which separates it from the next highest group, and so on through successively lower income brackets, resulting in an equalization of post tax incomes for all taxpayers if revenue needs are large enough that all income brackets except the lowest are taxed. Thus, it constitutes a polar extreme from the absolute equality theory, since it “equalizes post tax incomes” rather than requiring “equal tax payments,” regardless of income size.

Activity-8

What do you understand by subjective indices of ability to pay?

Summary

The type of taxes imposed in one country may not be the same with that imposed in another country. The type of tax imposed in a certain country is dependent on the tax

structure. Tax structure relates to the type of taxes imposed in a particular country.

Every modern state which imposes taxes would have its own tax administration. Tax administration is the process of imposing and collecting the same.

There are a number of qualities for a good tax system. The characteristics necessary for a good tax system are its fairness, administrative simplicity, economic efficiency, political responsibility, and flexibility.

To impose a tax a government has to consider certain theories. In this respect there are five most important approaches. These are: expediency approach, cost of service approach, socio-political approach, benefit received approach, and ability to pay approach.

The expediency approach to taxation happens when the government bows before the pressures groups and formulates its tax policy accordingly

The cost of service approach is the oldest approach to taxation that basis taxation cost incurred by the government on different services for the benefit of the individual tax payers.

According to benefit received approach the state provides goods and services to the members of the society and they contribute to the cost of these supplies in proportion to the benefits received.

Ability to pay approach is the most widely accepted theory where each person should contribute to the income of the state in proportion to his/her ability to pay. This concept depends upon the bold concept of equity in taxation.

Review Questions

- 1) Discuss tax structure.
- 2) Explain tax administration
- 3) Briefly explain the characteristics of a good tax system.
- 4) List and explain the different approaches to taxation

CHAPTER FIVE

EFFECTS OF TAXATION

Introduction

Taxation these days is not used as means of raising revenues only, but it is an important instrument for achieving socio-economic objectives, such as, regulation of consumption and production, controlling booms and depression, promoting economic growth and removing inequalities of income. The economic effects of taxation may be good as well as bad. Therefore, the government should not keep only the revenue considerations in mind, but the economic effects of taxation should also be considered. To put it in the words of Dalton, “The best system of taxation from the economic point of view is that which has the best, or the least bad economic effects.” Effects of taxation can be analyzed in terms of production, distribution and stabilization.

Thus, in this chapter we will discuss the economic effects under the following three heads:

- Effects of taxation on production
- Effects of taxation on distribution
- Effects of taxation on stabilization

Objectives

At the end of this chapter, the students will be able to:

Analyze the effects of taxation on production, distribution and stabilization

Differentiate the types of taxes

EFFECTS OF TAXATION

5.1 Effects of Taxation on Production

According to Dalton the effects of taxation on production can be discussed in the following three ways:

- i) Effects of taxation on the capacity to work, save and invest
- ii) Effects on the desire to work, save and invest, and
- iii) Effects on the composition, or pattern of production, (i.e., effects on allocation of resources as between different industries and localities).

I) Effects of Taxation on capacity to Work, Save and Invest

a) Capacity to Work

Capacity to work depends on the health and efficiency possessed by the people. Health is related to the level of consumption which is determined by the money income of the assessee. Imposition of higher tax reduces the purchasing power of the tax payer and his ability to obtain the necessities, comforts and luxuries of life. This effect is most strongly felt by the poorer people. When the tax burden falls upon the poor, it curbs the consumption of necessities and comforts which lowers the standard of living and thus efficiency and ability to work of poor people is adversely affected by taxation. For the rich, however, the ability to work is not so much affected by taxation because taxation on rich may only curb his luxurious consumption and this may not affect his efficiency and ability to work. Therefore, heavy taxation on the poorer section of the community has been strongly objected by most of the economists. Therefore, to maintain the health efficiency and ability to work of the people, system of progressive taxation should be duly implemented by the government. In other words, taxes on low incomes and on those articles which are largely consumed by less well to do sections of the community should be avoided in the interest of production. This will keep the health and efficiency intact without additional work load on them.

b) Capacity to Save

Capacity of the people to save depends on the tax policy followed by the government. Ability to save is adversely affected by taxation as taxes fall on income and savings depend on income. When income is reduced by taxation, savings automatically decline. Ability to save is affected adversely in the case of those who have a higher marginal propensity to save. It is the rich who possesses a high marginal propensity to save since their incomes exceed their expenditure. Taxes falling on the poor have no effect on their ability to save as they have no margin to save out of their low incomes. Since the rich are accustomed to a very high level of living, they maintain their expenditure and pay taxes out of their savings. Hence their ability to save is greatly reduced. This affects investment and capital formation in the economy. Therefore, to maintain the capacity of the people to save the government should provide tax incentives to the rich and spend the tax income on the poor to enhance their ability to save.

c) Capacity to Invest

Capacity to invest depends on the resources available for investment that is savings. It is clear from the above discussion that savings are reduced by taxation. When ability to save is adversely affected by high taxes, ability to invest of those who take investment decisions is automatically reduced. These are the people having a high entrepreneurial ability. Such people are generally the people in the higher income group.

The government has to play a major role in exploiting the capacity to invest of the tax payer by adopting an appropriate tax policy. The government should exempt earnings from investment to encourage savings and capital formation.

II) Effects of Taxation on the will to Work, Save, and Invest
a) Effects on the Will to Work

Will of the people to work depends on the nature of taxes. Each individual tax has its

specific effects. However, some taxes by their very nature have the least or no

bad effect on the willingness to work e.g., estate duty excess profit tax etc. Likewise, reasonable rates of income tax, sales tax, etc, have no bad effects on the desire of the people to work hard. Conversely, unduly high rates of income tax, wealth tax and commodity taxes adversely affect the desire of the people to work hard.

b) Effects on the Will to Save

Will of the people to save depends on the volume of income, volume of tax and the tax policy pursued by the government. If a tax payee has limited income and is hardly sufficient to meet his/her day to day requirements it will be difficult for him to save anything. Some people save for their old age and many times they save to improve their social prestige. So in order to enhance the will of the people to save, the government should provide tax incentives to the people.

c) Effects on the Will to Invest

Will of the people to invest depends on savings. If savings are taxed, nothing will be left with the people for investment purposes.

To enhance the will of the people to invest, the government should devise such a tax policy which provides tax incentives to those who divert their savings towards investment. Investment also depends on the treatment of income from investment- under tax laws. If earnings are exempted from tax net, people will divert most of their savings towards investment.

People will also save and invest if they have full knowledge about the avenues available for investment and the tax incentives associated with each of these channels of investment.

III) Effects of Taxation on the Composition and Pattern of Production

The effects of taxation on the consumption and pattern of production depend upon allocation of resources. When higher taxes are imposed on some industries, resources will shift from the high taxed industries to low taxed industries.

Likewise, when a tax rebate is offered, it will encourage allocation of resources in favour of developing industries.

Similarly, there will be reallocation of resources from high taxed regions to the low taxed regions.

High rate of tax on goods of harmful consumption has a beneficial impact as the production of these goods will be diverted to low-taxed essential goods.

Taxes may thus change the pattern of production in an economy. A high tax on the production of luxuries may improve the production of necessities. Some taxes, however, have no effect on diversion of resources; example, taxes on windfall gains, high land values, monopoly profits and non-differential taxes such as income-tax, etc have no effect on consumption or pattern of production.

Activity-1

Briefly explain the effect of tax on the saving and investment.

5.2 Effects of Taxation on Distribution

There are two aspects of an economy:

Income Generation

Income Distribution

Income generated in society if not distributed properly will create inequality in the distribution of income and wealth. It will give rise to the creation of two classes that is the class of the rich and the class of the poor. The gap between rich and poor will lead to class conflict which may prove disastrous to the society. Every government in the world tries to bridge this gap by imposing higher taxes on the richer section of the society and

the proceeds realized from such taxes are distributed among the poorer section of the society by way of providing social amenities to them.

In other words equitable distribution is the main goal of the modern economy. Taxes serve as a means of reducing inequalities by taking away the excessive capacity to pay of the richer section of society. According to Dalton, “Other things being equal, one tax-system is preferable to another if it has a stronger tendency to check inequality”.

The effects of taxation on the distribution of income and wealth among different sections of the society, however, depend upon two factors: nature of taxes and tax rates and kinds of taxes.

1) Nature of Taxes and Tax Rates

By nature, taxation may be proportional, progressive or regressive. The nature of taxation also implies as how the burden of taxation is distributed among different section of the community.

A tax is called as proportional, if all the tax payers pay the same proportion of their income as tax. A tax is said to be progressive, if larger is the tax payers income, the greater is the proportion that he pays as tax. A tax is regressive, if larger is the tax payee's income, the smaller is the proportion, which he pays as tax.

a) Effects of Regressive Taxation on Distribution

If regressive taxation is followed, the inequalities may increase in the distribution of income and wealth, as the burden of taxation will fall more heavily on the poor than on the rich. A toll-tax is regressive as the amount of the tax is the same for the rich and the poor, while the utility of money, which is paid in tax, is greater for the poor than the rich. A regressive tax thus tends to widen the gap of inequality.

b) Effects of Proportional Taxation on Distribution

Under proportional taxation, inequalities would continue as before, if the income remains the same. However, if the income changes in unequal proportions, the

inequalities in income will increase. For instance if A's income is \$500 and B's income is \$1,000 and both are taxed at the rate of 10% the net income of A and B, after tax payment, would be \$450 and \$900 respectively. The burden of taxation falls heavily on A than on B. Hence, the burden of taxation is higher on the poor than on the rich.

c) Effects of Progressive Taxation on Distribution

Under the progressive system of taxation, inequalities would be reduced, because a higher proportion of the income and wealth of the rich would be taken away by taxes than that of poor. Hence, a sharply progressive tax system tends to reduce inequalities in the distribution of income and wealth. Sharper the progression, greater is the tendency to reduce inequalities. Obviously, progressive system is desirable in order to bring about a more equitable distribution wealth.

However, the tax system should be based on the principle of ability to pay. The higher the income of a person, the greater would be his ability to pay taxes and vice-versa. People who get unearned income should be taxed at higher rate than poor because of their greater capacity to pay taxes. The progressive tax system may be designed in such a way that it may not have adverse effects on production.

In other words, tax system should be progressive to the highest income group, the middle income groups should be subjected to lower tax rates and the low income groups should be exempted from taxation.

1) Tax Rates

While fixing the rates of taxes, progression should be kept in mind. Higher taxes should be imposed on the richer section of society and revenue realized from the rich should be utilized for the benefit of the poorer section of the society by way of providing social amenities to them. In other words taxes should be progressive because sharper the progression, greater is the tendency to reduce inequalities.

2) Kinds of Taxes

Whether the effect of taxation is progressive, proportional or regressive in nature depends upon the kinds of taxes.

There are two kinds of taxes: direct tax and indirect taxes.

a) Indirect Taxes and Distribution

The burden of indirect taxes, like taxes on commodities is regressive in nature. The commodities on which indirect taxes are imposed are widely consumed by the poor and they have to spend larger proportion of their income on such goods than rich. That is, propensity to consume is higher for the poor than that of rich. Hence, the burden of indirect taxes, like the tax on foodstuff, raw tobacco, cheap alcohol, etc., falls more heavily upon the poor than upon the rich. However, the indirect taxes may be made progressive if the necessities are exempted from taxation and luxuries are subjected to higher rates of taxation so that the tax rates would be higher for the high priced goods. But it should be noted that purchase of luxury goods is optional. Hence, the rich can avoid the payment of these taxes by not purchasing such goods or by contracting their demand to some extent. Therefore, indirect or commodity taxes in general are of regressive nature. Thus, inequalities of income and wealth cannot be reduced by these taxes.

b) Direct Taxes and Distribution

To bring about equitable distribution of income and wealth, all taxes which fall heavily or exclusively upon the richer section of society can have favorable distribution effects. All direct taxes which are based on the principle of progression and ability to pay may have desired distributional effects.

The most important taxes, which can be made progressive, are income-tax, property-tax, and inheritance tax.

i) Income Tax and Distribution

An income-tax may be made progressive by subjecting larger incomes to high rates of

taxation than smaller incomes. This will not only achieve equity in taxation but will also reduce the inequalities of income. Additional taxes like

super tax along with general progressive tax should also be imposed on very high income. Secondly, the exemption should be granted to the incomes below a certain level, that is, the income below a certain level should not be taxed at all. And finally, unearned income may be taxed at higher rate than the income earned by means of hard work.

ii) Property Tax and Distribution

A property tax or a net annual wealth-tax if progressive in nature will tend to reduce the amount of property in the hands of property owners. The greater the amount of property or net wealth, the higher would be the burden of tax. Hence, a progressive property-tax may have favorable distributional effects. Secondly, income from property should be taxed at higher rate than income earned by means of hard work. Hence, it may be concluded that progressive property-taxation generally helps in bringing about equitable distribution of wealth and income in the society.

iii) Inheritance Tax and Distribution

A progressive inheritance-tax and death-duty may bring about equitable distribution of wealth and income. It may be made progressive by imposing tax on the amounts inherited by different individuals on the occasion of death. Mill's proposal was to fix up a sum, beyond which no individual could be allowed to inherit. It would be desirable, from the point of view of distribution, to graduate an inheritance tax, not also according to the amounts received inheritance, but also according to the amount of wealth possessed by them.

It should, however, be noted that direct taxes may be helpful in reducing inequalities of income and wealth, only when they are progressive in nature. Thus, it can be concluded, that direct taxes are helpful in making the distribution of income and wealth equitable, if they are steeply graduated.

Activity-2

1. What is a progressive tax rate?

2. What is a regressive tax rate?

3. What is a proportional tax rate?

5.3 Effects of Taxation on Stabilization

Economic stability may be judged by the behavior of prices. This does not mean that prices should remain static. Conversely there should be a normal rise in price because a normal rise in price is a sign of healthy economy. Problem, however, arises whenever there are price fluctuations. These price fluctuations may be known as abnormal economic situations prevailing in the country. Economic stability also implies stability in the economic activity, output and employment. It also refers to the avoidance of inflationary and deflationary conditions.

Every government tries to overcome these problems through fiscal measures which is the safest and the durable course adopted by any government to control such situations.

There may be three abnormal economic situations:

Inflation

Deflation

Stagflation

1) Taxation and Inflation

As regards inflation and deflation, taxes can play important role as they can reduce or stimulate consumption.

Inflation may be defined as a situation in which price continue to rise. Inflation may be either: demand pull, or cost push.

Demand pull inflation is caused by rising demand-owing to higher capacity to pay of the people. In comparison to the capacity to pay of the people, supply of goods and services fails to keep pace with it. In other words, prices rise because the money supply far exceeds the availability of goods and services in the market. Since people have more money to offer for goods which are in short supply, prices continue to rise.

Taxation, if applied properly, may take away the excessive capacity to pay of the people. The aim of taxation in times of inflation should be to reduce the purchasing power in the hands of the people. Thus a rise in the rates of existing taxes and the imposition of new taxes would check consumption, decrease the level of effective demand and therefore, help in bringing up stability in prices. To increase the rate of saving and investment and thus, to increase production, certain tax exemptions and tax concessions should be given and savings utilized for the payment of insurance premium may be exempted from the taxation.

Cost-push inflation is caused on account of rising cost of production which erodes the value of money. In this situation capacity of the people to buy continues to go down, with the result that the demand also continues to fall.

Cost-push inflation may be checked by keeping the cost of production in control. To keep the cost of production in control, certain tax exemptions and concessions should be granted to the producers. Savings may also be exempted from taxation to encourage production.

2) Taxation and Deflation

Deflation is a situation of falling prices. In such a situation people's capacity to pay continues to fall with the result that demand for goods also comes down. With the continuous fall in demand, most of the manufacturing enterprises are unable to stand as the prices prevailing in the market may even be lower than the cost production. Most of the enterprises, under this state decides to close down their business. To check this situation, the government should devise a tax policy which will reduce the tax liability of the people so that they have the needed capacity to buy goods and services in the market. Reduction in taxation during depression may have favorable effects on the level economic activity and employment. The demands for goods will be created which will lead to greater production of goods and services. Moreover, the revenues collected through taxation should be incurred on the construction of services of public utilities such as roads, so that effective demand for goods and services may increase. Again a reduction in those taxes, which falls more heavily on the poorer section of society, such as sales-tax and excise duties on commodities, which are generally used by poor people may have desirable effects on the level of economic activity and employment. Hence, total spending will increase considerably, if tax concessions are made. In fact, the objective of taxation in depression should be to increase the purchasing power of the people by reducing the burden of taxation and by transferring the purchasing power from the hands of the richer section of the community to poor people.

3) Taxation and Stagflation

The third situation consists of the two elements: stagflation and inflation. Hence, inflation with stagflation may also be call recession.

Recession is that abnormal economic situation in which the price continues to rise in spite of continuously falling demand. Normally, when demand continues to fall, the manufactures and sellers control the situation by reducing the prices of products. In this abnormal situation of stagflation, the producers/sellers are not able to effect any

reduction in the price owing to the rising cost of production.

The result of the existence of inflationary conditions prevailing in the market, material and wage cost also continues to rise. In such situation, manufacturers are left with only two choices: to close the business; or to continue charging high prices owing to higher cost of production to remain in the market.

This situation may be averted by following a proper tax policy. On individuals, effective progressive taxation ought to be implemented so that excessive capacity to pay is withdrawn from the richer section of the society. To check this situation, the government should provide tax incentives in form of tax holiday to the producers of goods and services and should also reduce the rates of commodity taxes such as sales tax, excise duties, etc, so that manufacturers/producers could sustain themselves in the face of higher cost production.

Activity-3

Describe the effects of taxation on stabilization.

Summary

Effects of taxation can be analyzed in terms of production, distribution and stabilization.

Effects of taxation on production can be analyzed in terms of effects on: the ability to work, save and invest; the will to work, save and invest; and the composition and pattern.

The effects of taxation on the distribution of income and wealth among the different sections of the society depend upon two factors: nature of taxation and tax rates; and kinds of taxes.

By nature, taxation may be proportional, progressive or regressive. Whether the effect of taxation is progressive, proportional, or regressive in nature, depends upon the kinds of tax. There are two kinds of taxes: direct and indirect taxes.

Inflation, deflation and stagflation can be put as three abnormal economic situations. Inflation can be defined in terms of demand pull or cost push. Demand pull inflation is caused by rising demand owing to higher capacity to the people while cost push inflation is caused on account of rising list of production which erodes the value of money.

Deflation is a situation of falling prices. Stagflation along with inflation is called recession. Recession is abnormal economic situation in which the price continues to rise in spite of continuously fall demand.

Review Questions

1. Discuss the effects of taxation on production.
2. With what factors do the effects of taxation relay on the distribution of income and wealth among different sections of the society?
3. Describe the effects of regressive taxation, proportional taxation and progressive taxation on distribution.
4. What is the difference between direct and indirect tax?
5. Discuss the three abnormal economic situations.

CHAPTER SIX

SHIFTING AND INCIDENCE OF TAXES

Introduction

The burden of a tax does not always lie on the person from whom it is collected. In many cases it is borne by other people also. Thus, the person who initially pays the tax may not be actually bearing its money burden as such. Hence, it is necessary to know who bears the immediate burden of a tax and, who bears the ultimate burden of tax. The problem of determining the ultimate burden of a tax is the problem of determining the incidence of the tax.

This chapter deals with shifting and incidence of taxes. In particular, we will discuss about the distinction between impact and incidence, types of shifting, factors of tax shifting, theories of shifting, analysis of shifting and incidence.

Objectives

At the end of this chapter, the students will be able to:

- Analyze incidence of taxes
- Explain shifting of taxes
- Discuss evasion of taxes
- Explain avoidance of taxes
- Distinguish evasion from avoidance of taxes

SHIFTING AND INCIDENCE OF TAXES

6.1 Meaning of Impact, Shifting, and Incidence

1. Meaning of Impact

The impact of a tax is on the person who pays the money in the first instance. In other words, the man who pays the tax to the government in the first instance bears its impact. The impact of a tax is, therefore, the immediate result of the imposition of a tax on the person who pays in the first instance. It corresponds to what is often, but erroneously called the “original incidence” or the “primary incidence” of a tax. The impact of tax as such, denotes the act of imposing. Impact of a tax, therefore, refers to the immediate burden of the tax and not to the ultimate burden of the tax.

2. Meaning of Shifting

Shifting of a tax refers to the process by which the money burden of a tax is transferred from one person to another. Whenever there is shifting of taxation, the tax may be shifted forward or backward.

3. Meaning of Incidence

Incidence of a tax refers to the money burden of a tax on the person who ultimately bears it. In other words, when the money burden of a tax finally settles or comes to rest on the ultimate taxpayer, is called the incidence of a tax. The incidence of tax remains upon that person who cannot shift its burden to any other person, i.e., who ultimately bears it.

Thus, there are three distinct conceptions- the impact, the shifting and the incidence of a tax, which correspond respectively to the imposition, the transfer, and the settling or coming to rest of the tax. The impact is the initial phenomena, the shifting is the intermediate process, and the incidence is the result.

6.2 Distinction between Impact and Incidence

The impact refers to the initial burden of tax while incidence refers to the ultimate burden of the tax. Impact is felt by the tax payer at the point of imposition of the tax, while the incidence is felt by the tax payer at the point of settlement or rest of the tax.

The impact of the tax is felt by the person from whom the tax is collected, while the incidence is felt by the person who actually bears the burden of the tax.

Impact of a tax can be shifted, but the incidence of a tax cannot be shifted.

Thus, impact of the tax is always on the person who is responsible by law to pay the tax amount to the Government treasury, in the first instance. Incidence may fall on somebody from whom the manufacturer ultimately recovers the amount, provided he shifts the tax.

Activity – 1

Identify the distinction between impact and incidence.

6.3 Tax Shifting

Shifting of a tax refers to the process by which the money burden of a tax is transferred from one person to another. Whenever, there is shifting of taxation, the tax may be shifted forward or backward. Thus, a producer upon whom a tax has been imposed may shift it to the consumer, or a seller may shift it to the purchaser. The tax is shifted forward or backward to the consumer or the purchaser, respectively. On the other hand, the tax may be imposed in the first instance on the consumer or purchaser; he may shift it to the producer or the seller respectively. In this case, tax is shifted backward. When the tax is

shifted from the seller to an immediate purchaser, who then sells it to another person,
and so on

until the tax finally settles on the ultimate purchaser or consumer, it may be called forward shifting.

In other words, the person upon whom the tax is imposed not necessarily bears the burden of tax. In this case, the assessee is given the right to pass on the tax burden to the buyer of goods. Thus, the process of passing on the tax burden to the buyer of goods by the seller of goods is known as shifting of tax.

Shifting can occur only in connection with the price transaction. Price is the only vehicle through which a tax can be shifted. As Seligman points out, shifting of a tax is primarily a function of price. Thus, shifting is common in commodity taxation.

If a tax is shifted, the price of the taxed commodity increases. For example, if a tax is imposed on the manufacturers of TV, the manufacturers, if they are successful, collect the tax by adding it to the price, charged to dealers, who in turn, if they are fortunate, add the tax to the retail price.

6.3.1 Types of Tax Shifting

Tax shifting may be of two types: forward shifting and backward shifting.

Forward Shifting

A tax is said to have shifted forward if price of the commodity which constitutes the medium for shifting the money burden of tax is increased. Under complete shifting; the price will be higher by the full amount of tax. In forward shifting of commodity taxation, the money burden of a tax is transferred from the producer or seller to the consumer or buyer when the tax is initially imposed on the producer. Thus, forward shifting is possible with regard to all indirect taxes which are generally passed partly or shortly to the buyer of goods.

Backward Shifting

Backward shifting refers to the process by which the money burden of commodity tax is

shifted from the consumer or buyer to the producer or seller, if the tax is initially imposed on the consumer. In other words, it is a typical situation in which

the tax burden is shifted backward, that is, from the buyer of good to the seller of goods under the following conditions: Backward shifting is applicable in the case of property tax only. Backward shifting is effected when the buyer of property shifts the entire tax burden to the seller of property. The shifting is done by buyer of property by way of capitalizing the value of tax by the life of the property and deducting it out of the total value of the property. Whether tax is shifted forward or backward depends on the relative strength of resistance to transfer the burden. Commodities having inelastic demand will have less resistance to forward shifting, while commodities having relatively elastic demand would have greater resistance to forward than backward shifting.

Activity – 2

Briefly explain shifting of a tax by taking a particular example.

6.3.2 Factors of Tax Shifting

There could be a number of factors that are important determinant of the direction and extent of shifting. There are two sets of factors which influence tax shifting. These are internal factors and external factors.

1) Internal Factors

Internal factors imply the market conditions which are reflected in the form of elasticity of the demand, and elasticity of supply

Elasticity of demand means changes in the level of demand due to price variation. If with the slight rise in price, a considerable fall in demand obtained, we call it highly elastic demand. When with the moderate rise in price, there is moderate

fall in demand; we call it moderately elastic demand. In the case of the rise in price, if there is no shortfall in demand, we call it inelastic demand.

Another component of market condition is elasticity of supply. When supply changes with the change in the price, the supply is said to be highly elastic. The more elastic the supply of the commodity, the more will be the incidence of the tax upon the buyer. And, the less elastic the supply of a commodity, the greater will be the incidence of the tax upon the seller. If the supply of a commodity is perfectly elastic, the entire tax burden is shifted to the buyers. With the imposition of a tax, the cost of production will rise, hence, the price will rise, which may affect the demand of the commodity and bring loss to the seller. Therefore, the seller would curtail the supply of the commodity, increase the price of the commodity by the amount of tax and will shift the entire burden of the tax upon the buyers. If it is perfectly inelastic, the entire tax burden will be on the seller. If the supply of a commodity is more elastic, a greater part of the tax burden will be upon the buyer and vice versa.

2) External Factors

The following external factors also affect shiftability.

a) Public Policy

Public policy of the Government resists shiftability. Such policies may pertain to the price of the product.

If the Government wants that the business enterprise should not raise the price of the product in the event of shifting the tax burden forward, or in other words, if the Government wants that the seller should charge the pre-tax price even after the imposition of tax, then in that situation, the seller /producer/ business enterprise should bear the burden himself or itself. Therefore, we may say that the Government policy to ask the sellers to charge pre-tax price offers maximum resistance to shiftability.

b) Advertised Prices

Advertised prices can have real effect upon the shiftability of a tax. As per the policy of the Government, of the prices of the products should be displayed at the counter so that the customers become used to the advertised price. In other words, advertised price would psychologically prepare customers in the event of shiftability.

The display of prices at the counter will show separately the actual price of the product and the value of tax. The entire goodwill of the seller, resolves around the advertised price. If the seller, after the imposition of tax changes the price, he may lose all the customers. Under this circumstance, the seller instead of shifting the tax burden forward should bear the tax burden himself. In other words, advertised price also resists shiftability.

c) Customary Price

Customary price means one price charged by the seller year after year. The existence of customary prices in the market militates against forward shifting to the consumer. For example, if a certain price is charged by the seller every year, any rise in price owing to the shifting of tax, may put an end to the years of valuable goodwill of the seller within no time. This is particularly true in cases where the price has traditionally been a small, round sum. If the seller increases the price of the product, all customers will withdraw from him. Under such a circumstance, the sellers should take a decision of not shifting the tax burden forward if the tax is imposed on him.

d) Geographical Area of Tax Coverage

Narrow distance between the markets offers maximum resistance to shiftability. The geographical coverage of the tax law can be important determinant of shiftability. If a local area is covered by a tax on goods, it is difficult to shift it, because, if the prices of such goods rise, local people will buy them from neighboring areas which are not covered by such taxes. In other words, if the seller, having a shop in one market, raises the price of a product and if the same

product is available at lower price in the neighboring market, the customers, may, in such a circumstance, purchase the commodity from the neighboring market at lower price. Therefore, we may say that geographical coverage offers maximum resistance to shiftability.

e) Substitutes

It will be difficult to shift the tax burden in the case of a commodity which has an effective substitute. If the price of the main commodity rises owing to the shiftability of a tax burden forward, the customers will withdraw from the consumption of the main commodity to the consumption of the substitute. In such a case, the seller, instead of shifting the tax burden forward, should bear the tax burden himself. Therefore, the substitutes can be an important determinant of shiftability.

f) Market Structure

Shifting of tax also depends upon the market structure. Shifting of a tax is easier in the case of a monopoly market for a product. In the case of perfectly competitive market for goods, taxes can not be shifted. In case of monopolistic competition, shifting will be determined by the extent of elasticity of demand for the goods. Greater the elasticity of demand for the goods taxed, the lesser is the shifting of the tax to the consumer and vice-versa.

g) Size of the Taxed Area

The size of the taxed area will always affect shiftability of a tax on the production or sale of a commodity. When the goods can be brought in near-by untaxed markets, an attempt at forward shifting will meet vigorous resistance caused by the availability of untaxed competing goods.

h) General Business Conditions

Buying and selling prices and costs are affected by general business conditions, along with

tax shifting. In periods of rising prices and prosperity, it is easier for most enterprises to sell at prices equal to or greater than costs than it is during

falling prices and depression. Tax can, therefore, be shifted more easily during prosperity than during depression. New taxes which are imposed at a time of business crises or depression are especially difficult to shift.

Activity – 3

Discuss the factors that affect tax shifting.

6.3.3 Theories of Tax Shifting

There are a few theories and ideas as to who pays the tax in the final analysis that is to say on whom the final incidence of a tax rests. In this connection, there are three prominent approaches which we shall consider one by one. They may be referred to as the Concentration Theory, the Diffusion Theory and the Demand and Supply Theory. All the three theories assume that the incidence of a tax can shift only through the interaction of demand and supply forces in the market. No tax-payer can recover the tax paid by him from someone else unless something is bought from or sold to the latter.

A) The concentration Theory

This approach maintains that there is an inherent tendency for the taxes to be absorbed by certain income classes. It was advocated by the physiocrats and the classical economists. The French economists believed that the tax levied on anything is ultimately shifted to landlords. They reasoned that agriculture was the only occupation which created surplus over and above the cost of production. According to them all other occupations, such as trade and commerce did not yield any surplus. Wages were at the subsistence level and could not be taxed. Industry was not in a position to generate surplus. This left land rents as the sole taxable surplus. Physiocrats, therefore, strongly advocated that the Government

should concentrate on a single tax on economic rent earned by landlords from the

agricultural occupation. They also argued that the existing diversity of taxes should be abolished. This would simplify taxation, reduce the excessive cost of tax collection and lessen the tax charges upon the land owners.

The theory advocated by physiocrats has been condemned by Adam Smith and Modern economists too. This theory is criticized on the ground that agriculture is not the only occupation yielding economic surplus that is rent. Modern economists are of the view that other occupations are also productive and yield surplus over and above their cost of production and a single tax on land is not suitable in modern welfare societies. The burden of taxation should be distributed in equitable manner on the community as a whole and not on a particular section of the community. Hence, it is wrong to assume that any tax is ultimately shifted to and concentrated in agriculture.

B) The Diffusion Theory

This theory is just the opposite of concentration theory. It negates the basic assumptions of the concentration theory which may be stated as follows.

The tax burden instead of concentrating on the land owning class having surplus gets diffused over different sections of the society. In other words, the diffusion theory asserted that all taxes are diffused among the members of a community. According to this theory, the individuals from whom the tax is collected do not ultimately bear the whole burden but shift it on to the other classes, so that it is diffused all over the society.

However, for some time, a tax may stick at a place where it is imposed, but it is shifted again and again till its burden spreads over the entire society.

According to Canard, the buyer of a commodity is also the seller of something else, and as seller, he passes a part of the tax paid by him to the buyer of his goods. This buyer, being the seller of some other goods, passes on a part of the tax again to his buyers, and in this way, a tax imposed on a labor or business gets diffused over the whole community

through such shifting and reshifting.

The supporters of the diffusion theory are of the opinion that it is immaterial as to where a tax is imposed. It is soon partially shifted and reshifted till its entire burden is spread over the various factors in more or less equitable way. Since surplus exists in different classes of the society, the tax imposed gets diffused among different sections of society. It keeps on shifting from one person to another till it gets diffused on the entire social system.

Criticism

The theory is shallow and misleading as there is no diffusion of tax in the real sense. This theory avoids the question of justice in taxation. In other words, this theory is not based on the principle of ability to pay. It is not progressive in nature. More often the tax imposed on one section is passed on to the other section, that is, the poor section which does not have either the ability or the mechanism to shift the tax burden.

This theory violates the principles of equity in taxation. Equity in taxation implies that the sacrifice of the community should be equal. All the tax payers should feel the same pinch by paying the last Birr as tax. But since the poorer section of the society is supposed to pay higher tax, there is the virtual sacrifice of the equity principle.

This theory ignores the fact that this diffusion does not take place automatically. Unless, the price vehicle exists, the tax burden can not be diffused.

C) Demand and Supply Theory

This is the most acceptable approach in explaining the incidence of tax. Tax incidence can be shifted only through sale or purchase transactions and only through, price revision. A price revision is possible and is determined by the relative values of demand and supply elasticities. A tax can, therefore, be shifted only through a shift in the demand and /or supply curves and the sharing of the incidence will be determined by the demand and

supply elasticities. The general

rule is that irrespective of whether the statutory liability of a tax (the impact of tax) rests upon the buyer or the seller, the share of the tax borne by the seller will be the larger if the elasticity of demand is larger; and the share of the tax borne by the buyer will be the larger if the elasticity of supply is larger. Actually, the tax burden will be shared between the buyer and the seller in the ratio of the elasticities of supply and demand.

6.4 Tax Evasion and Tax Avoidance

Tax evasion and tax avoidance is a problem which is prevalent in almost all countries of the world.

1) Tax Evasion

Tax evasion is the general term for efforts by individuals, firms, and other entities to evade the payment of taxes by breaking the law. Tax evasion usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities to reduce their tax liability, and includes, in particular, dishonest tax reporting (such as under declaring income, profit or gains; or overstating deduction).

Tax evasion is associated with illegal, fraud, criminal prosecution, risk, tax-audit, punishable, penalty, and the risk of getting caught. It involves concealment of the facts and is a criminal offence.

2) Tax Avoidance

The term tax avoidance is taken to refer to arrangements by which a person, acting within the letter of law, reduces his true tax liability, infringing in the process, both the spirit and intention of law. In other words, tax avoidance is a method of reducing ones tax liability by making use of loopholes in tax laws. Therefore, tax avoidance is not illegal.

Tax avoidance may be considered as either the normal dodging of one's duties to society or the right of every citizen to find all the legal ways to avoid paying too much tax. Tax evasion, on the other hand, is a crime in almost all countries and

subjects the guilty party to fines or even imprisonment. Simply put, a taxpayer can organize his financial affairs in such a way that he pays the minimum amount of tax while still being in line with the letter of the law.

Tax avoidance reduces the incidence of tax borne by an individual taxpayer contrary to the intentions of the tax law but does not involve concealment and is not unlawful. Both tax evasion and tax avoidance create unfairness between taxpayers and reduce the tax yield.

Activity – 4 What is tax evasion?

Summary

There are a number of concepts that need to be considered in order to understand the nature of taxation. One basic concept is related to impact and incidence of taxation.

Impact of a tax refers to the immediate (initial) burden of the tax. When the money burden to tax finally settles or comes to rest on the ultimate taxpayer, we call it the incidence of tax.

Shifting of tax refers to the process by which the money burden of tax is transferred from one person to another. There are two types of tax shifting: forward shifting and backward shifting.

Tax evasion is the downright defrauding of revenue through illegal acts and deliberate suppression or falsification of the facts relating to one's true tax liability. Accordingly tax evasion is illegal. Tax avoidance, on the other hand, is a method of

reducing ones tax liability by making use of loopholes in tax laws. Hence tax avoidance is not illegal.

Review Questions

1. Discuss the difference between backward shifting and forward shifting.
2. Explain the factors that affect tax shifting.
3. Which theory of shifting is free from critics and why?
4. Discuss the difference between tax evasion and tax avoidance.
5. Ato Alemu entered a contract to sale a building at Br 85,000 gain in the fiscal year ended Sene 30, 1995. The gain is subject to tax. To avoid reporting the gain in the fiscal year ended Sene 30, 1995, he closed the sale and delivered title to the building to the buyers on Meskerem 11, 1996.

Required: State whether the taxpayer's action is tax evasion or tax avoidance.

6. Discuss the similarities and differences between tax evasion and tax avoidance.

CHAPTER SEVEN

TAXATION IN ETHIOPIA

Introduction

This is the last chapter of your study of the course Public Finance and Taxation. Generally, the chapter deals with taxation in Ethiopia.

This Chapter is divided into three sections. The first section deals with history of taxation in Ethiopia. This section will discuss about traditional taxation in Ethiopia, the evolution of modern taxation in Ethiopia and also the different reasons that account for the modernization of taxation in Ethiopia.

The second section deals with income tax. In this section we will study about the legal provisions for income tax under the current tax law, computation of income tax under different schedules and the accounting procedures.

The third section of this chapter deals with value added tax and excise taxes. This section generally deals with the imposition, computation of value added tax and excise tax, and the accounting procedures.

Objectives:

After having completed the study of this chapter, the students will be able to

- Understand the historical development of tax in Ethiopia

- Identify types of taxes in Ethiopia

- Be familiarized with the legal provisions for the determination of tax

- Compute the different taxes using the legal provisions

SECTION 1: HISTORY OF TAXATION IN ETHIOPIA

Overview

The principal objective of tax is to provide revenue to finance government activities. A relative objective is to accomplish certain social goals. It is a general concept for devices used by government to extract money or other valuable things from people and organizations by the use of law. The contribution received from taxpayers may not be used by government for the benefit of these groups only but for the general and common benefit. It is the price, which each citizen pays to the state to cover his share of the cost of the general public service that he will consume. It is that part of the surplus of the society which is used to maintain the state.

The political system of Ethiopia has undergone many changes from ancient history. After many years of ruling by different emperors and 17 years of military ruling, in 1991, Ethiopia paved her way to democracy and federalism. The changes in political structure over these years necessitated changes in policies and other structures. Consequently, tax policies have undergone many changes overtime.

Objectives:

After having completed the study of this section, you will be able to:

- Discuss traditional taxation
- Explain the evolution of modern taxation
- Analyze characteristics of traditional taxation and modern taxation
- Distinguish traditional taxation from the modern one
- Identify both direct and indirect taxes collected in the country

1.1 Traditional Taxation in Ethiopia

Taxation policies depend on the socio-economic and political structure of a country. Earlier days Ethiopian rulers established fiscal measures by force because there was no legal or institutional mechanism to control and administer the fiscal policy. There were no territorial assemblies and no representative bodies at the central level to introduce taxes. The very mechanism of revenue collection and distribution among the ruling class thus became the absolute power of King. Majority of the state revenue was spent for military purposes.

In Ethiopia, though taxation came into being with the emergence of state and government, there exists hardly any reliable documentary evidence as to when exactly taxation was introduced. During the period of Zera Yacob (1434 – 1468) people used to contribute from their cattle and agricultural products to the governors of the state. The kind of traditional tax system that was introduced during this period did worth for several centuries smoothly until it was replaced by the modern tax system in the mid 20th century. Historical evidences show a picture of giving a fixed amount of tax in the form of mules, horses or cloth. Evidences indicate that in the third quarter of 19th century also taxes were paid in kind and in money. Payment in kind included various forms such as salt, honey, better, grain, livestock (cows, oxen, etc), horses and mules, and cloth. The amount and form of tax were based on the needs of rulers. Until the second half of the 19th century different territorial and geographical administrators of the then kingdom were paying tax in gold.

Taxes during the period 1855-1868 consisted of direct and indirect taxes. Direct taxes included land tax (Gibr), Tithe (Asrat), provincial administrative taxes (Ya Negarit), tax for appointees and appointment, tax on livestock, tax for maintenance (Bal), tax on honey, production tax from certain economic activities, and irregular and ad hoc taxes. Land tax was levied for the use of land and tithe (means a tenth part) was levied on the annul product of land. Bal (a subsistence in lieu of salary) took various forms of tax

including agricultural surplus. Taxes on livestock and honey were also collected in this period. Artisans and salt producers

were also taxed. During periods of war peasants were asked to pay even more than two times a year. Indirect taxes during this period included toll taxes, caravan taxes and Ferida (tax on slaughter cattle).

During the reign of king Menelik, taxes of various forms, as mentioned earlier, were collected. The traditional system of taxation put a heavy burden on taxpayers mainly peasants because the contribution expected from them, in kind and in labor, was more than what they could afford. This forced the peasants to leave their landholdings. The effect of such taxes resulted in social disturbances and political instability. These problems necessitated Emperor Menelik to put an end to the payment of tax in form of labor.

Activity-1
What are the characteristics of traditional taxation?

1.2 The Evolution of the Modern Tax System

Taxes are traditionally being paid in kind but monetary payment steadily increased in 19th and 20th century because of the circulation of money and the changing government policy. As the size of government and its commitment to economic growth increased gradually every citizen, above 18 years, was asked to contribute one Birr a year to total governors, landlords, or any other local chief. Moreover, salary and wage earners were obliged to pay a part of their annual income.

Historical evidences reveal that there was no proper assessment of tax during those days. In certain period, a traditional unit was assigned to collect a fixed amount of tax from various sources regardless of the quantity of taxable product or the area of land.

In certain other period, tax was collected based on the

measurement of land, on the quantity of grain produced or on the number of cattle possessed.

Taxes from 1942 to 1974

During this period (the Regime of Emperor Haile Selassie) taxes were imposed on income from employment; from rent of land and building (used for purposes other than agriculture); from businesses, vocational occupation, and interest and from exploitation of wood and forest used for lumbering purposes. Though at the beginning agricultural income was exempted from payment of tax, later it was also subject to tax. Tax rates for various heads of income varied according to the changes in government policies.

Tax rates for employment income ranged from 1.8% to 25% under different proclamation and tax brackets from Br 30 to Br 5,000. In almost all proclamations, the tax-free income was Br 30. The number of tax brackets was also many in most proclamations. Business profit tax was levied according to different category (Like traders, retailers, etc) or different grades (e.g. Grade I, II, III, etc). Specific tax-free brackets were also included in all proclamations and incorporated bodies are taxed at 15 to 16%. Rental income tax rate ranged from

2% to 16% and tax brackets were ranged from Br 360 to Br 15,000. Taxes on agricultural income, though not imposed at the beginning of the regime, were levied at rates ranging from 1.5% to 20%. Incorporated agricultural bodies were taxed at 20%.

Other taxes collected during this period include land tax (levied on each gasha or gabber of land), education tax (levied on land used for promotion of education), health tax (levied on land used for health activities), road tax (collected on the nature and load capacity of vehicles) cattle tax, tobacco tax excise tax on alcoholic, transaction tax (on import and export and on goods manufactured locally), stamp duty, customs duty and export duty.

Taxes from 1975-1991

Taxes imposed during this period (under military rule) were similar to those of Haile Selassie regime except that wider tax bases and increased tax rates. The changes were made for the purpose of meeting situations of war and to provide for public goods and services.

Employment income tax rates, during this period, ranged from 10% to 85% of employment income. Tax brackets were reduced and tax-exempt income raised to Br 50. For business income tax, together with the reduction in the number of tax brackets, the rate for incorporated bodies to 50% and that of unincorporated businesses to 89% (but later on reduced to 59%). Rental income tax rate was also gone up to 89%. Rural land use fee was first introduced during this regime. Agricultural income was also taxed at varying rates (with the highest rate 89%). It was during this period; urban land rent and urban house tax were first come in to being. Rental tax varied from 1% to 4.5%. Public roads, places of worship, and dwelling houses whose annual rent was less than Br 300 were exempted from tax. Excise tax on tobacco leaf and wooden matchboxes were introduced and a very high rate for sugar and soft drinks was imposed during this period.

Tax from 1991 to 1995

The reorganization of Ethiopia in to Federal and Regional self government, base on democratic principles, and the emergence of market oriented economy are imperatives for making structural changes in tax policy during the transitional period. With the establishment of regional government (pursuant to Proclamation No 7/19920), major changes took place in the tax policy of the country. Tax brackets and tax rates were modified and new tax bases such as tax on mining activities and on capital gains were introduced in this period. The major modifications and introductions are given below.

Employment Income Tax

Tax rate decreased to 10% - 40% range (from 10% - 89% range)

Tax brackets reduced to 5

Business Income Tax

Tax rates lowered to 10% - 40%

Tax rate of incorporated bodies reduced to 45%

Mining Income Tax (newly introduced)

Rates for larger scale mining fixed at 45% and small scale operation at 35%

Capital Gains Tax (newly introduced)

Gains on sale of shares, bonds, and urban houses taxed at 30%

Gain of less than Br 10,000 was exempted from tax

Rental Income Tax

Tax brackets and rates lowered

Income up to Br 1,200 was made tax free

Other Income

Food items such as injera and bread; and fertilizers were exempted

Most of the duties were made ad Valorem

Duty range reduced to 5% - 80%

Duty on export (except coffee) cancelled

Taxes from 1995 onwards

The constitution of Ethiopia approved in 1995 gave powers to Federal and Regional Government to levy and collect taxes from the sources assigned to them to meet their expenditure needs. Accordingly, both levels of government collect direct and indirect taxes from the respective sources. A number of changes have been made in the tax policy of the country pursuant to the structural changes. Most of them are in the area of income tax and customs duties. The following are the most relevant changes that are incorporated in tax laws.

Reduction in the rate of business income tax from 40% to 30%

Equalization of tax rate at 35% for both small scale and large scale mining activities

Assignment of collection of revenue from agricultural income tax to regional

government.

Exemption of capital gains from houses used for residential purposes

Introduction of Taxpayer Identification Number

Introduction of tax withholding system (At 3% and 2% respectively for import and certain types of payments, and on interest, dividend, etc)

Replacement of sales tax by VAT and turn over tax

Tax Assignment

The burden of federal government and regional government in providing public goods and services is cumbersome. To meet these requirements government units need financial resources that could be gathered from different revenue sources. Government of Ethiopia mobilizes the required revenue from sources such as direct taxes, indirect taxes, foreign trade taxes, charges and fees, sale of goods and services, revenue from government property and investment, government employees' contribution to pension, foreign technical aid, capital receipts, and other miscellaneous revenue.

In assigning the mobilization of taxes to different levels of government, issues such as the type of taxes to be levied, the principles on which taxes are to be collected, and the criteria of tax assignment etc should be given serious consideration. Generally the following formula (accepted by economists) is used for assignment of revenue collection.

- i) Taxes suitable for economic stabilization, progressive and redistributive taxes, and taxes on mobile factors could be assigned to central government.
- ii) Tax on consumption goods, residence based taxes and taxes on immobile factors could be assigned to regions
- iii) Benefit taxes and user charges could be given to all levels of government

Application of various principles of tax such as fairness, certainty, predictability, and adequacy etc is utmost importance in designing a tax system in all levels of government. Uniformity in tax rate and tax base is another important factor in the tax policy of regional government for instance, if the tax rate in one region is

different from that people shift the taxed activity to the region from where they could benefit most.

In essence, uniformity avoids tax competition; flow of capital, and cross boarder shopping. Non-uniformity can be applied if it does not affect the benefits of uniformity. It can be resorted to foster revenue mobilization and regional development due to the fact that regions differ significantly in their development and resource availability. For example, in most developing countries there exist industrially developed regions and backward (predominantly rural areas) regions. In the former case revenue could be mobilized with the existing tax base. But in the latter case, more and more money should be spent towards infrastructure facilities resulting in failure to meet a majority of public needs. The case is true for Ethiopia also.

In view of the assignment of expenditure, the Government of Ethiopia issued a proclamation (No 33/1992) that shows the allocation of revenue between Federal and Regional government. This allocation is based on the following objectives.

- i) To carry out the duties and responsibilities effectively and efficiency by both levels of government.
- ii) To develop their own region by taking initiatives by themselves.
- iii) To eliminate the gap between regions in various development activities
- iv) To encourage those activities for which the regions have common interest

Fulfillment of the above mentioned objectives should be the prime responsibility of each regional state while collecting revenue from the sources. The allocation has takes various factors into consideration such as ownership and the character of the source; convenience of levying and collecting tax, population, distribution of wealth, and the standard of development of the region. Based on the above factors revenue of the country is collected by Federal and Regional government as given below.

Revenue collected by Federal Government

This category includes foreign trade tax, tax from employees of central government and international organizations; personal income tax and sales tax from the enterprises owned by federal government; taxes on lottery and other chance winning; tax from air, rail and marine transportation; tax on rent of houses and properties owned by central government; and fee for services rendered and licenses issued by Federal government.

Revenue Collected by Regional Government

Employment income tax from employees of region and from private employees; personal income tax and sales tax of enterprises owned by regional government, agricultural income tax from farmers and rural land use fee; profit and sales tax of traders; tax on income from inland water transport; rent of land, royalty, and income tax from small scale mining operations; fee for services rendered and for license issued by regional government.

Revenue Collected Jointly

Personal income tax and sales tax of enterprises owned jointly; profit, sales tax and dividend of organizations; rent of land, royalty, and profit tax of large scale mining operations, petroleum and gas operations; and forest royalty are shared by Federal and Regional government on an appropriate ratio. A committee appointed by the prime minister decides the ratio in which the revenue should be allocated. This committee consists of representatives of both the government and is responsible to the Council of Ministers. The committee is responsible for giving solution to any problem arising there from.

Regions are also entitled to receive subsidy from central government for the fulfillment of certain objectives. If approved, regions get subsidy for promotion of social services and economic development, acceleration of development of neglected areas, reduction of gap in per capita income between regions, encouragement of foreign currency projects, and projects of national interest.

It should be noted that while making reforms in regional tax policy, regions have to abide by the rules and regulations of central government, exemption privileges granted to taxpayers should adhere to such privileges given by central government.

Activity-2

What are the basic objectives of allocation of revenues between Federal and Regional government of Ethiopia?

Classification of Tax

Tax structure of Ethiopia divides tax in the country as direct and indirect. This classification is purely based on the incidence (tax shifting) of tax. Direct taxes are those obligations of payment that cannot be shifted to a third party. On the other hand, the burden of payment is shifted to third parties, in all indirect taxes, by taxpayers. Direct taxes, in Ethiopia, include employment income tax, business income tax; rental income tax, capital gains tax, agricultural income tax and rural land use fee, mining income tax, taxes on lottery and other chance winning, tax on royalty, interest, dividend, and casual rental of property.

Import and export duty, value added tax and excise tax are the indirect taxes collected by the country.

The principles upon which the Ethiopian Tax Law is based are the following:
Lawfulness

The society which is covered by the tax law is obliged to respect all tax laws, regardless of the name and kind of the instrument.

The Application of Tax Provision

In the tax assessment procedure, the tax rules, which were in force at the time of occurrence of the fact, will be applied.

Objectivity

During assessment, the tax authority establishes the facts such as objectivity and conscientious.

Right to Appeal

This principle enables the taxpayers to file complaints against the assessment procedure

Keeping the Books and Records

This binds the taxpayers (except those who are not required per proclamation) to keep books and Evidences: Both the taxpayers and tax authority have to prove the facts on declaration and assessment.

Good faith and Behavior

All the parties concerned are obliged to behave properly with good intention, cooperatively and conscientiously.

Protection of Confidentiality

The duty of the taxpayer is to give records and submit it to the tax authority, truthful data that is essential for the assessment of tax. At the same time, the tax authority preserves the confidential data in this manner the privacy of the data is protected.

Protection of Human Dignity

The tax procedures protect the reputation, dignity, and honor of the taxpayer.

Right to Respond

Taxpayers have the right to speak about all the facts related to their taxable income.

Activity-3

a) List at least three direct taxes in Ethiopia.

b) List at least three indirect taxes in Ethiopia.

Summary

The historical development of tax system in Ethiopia could be categorized into traditional and modern. Traditional taxation was characterized by a number of distinct features.

Traditional taxation was basically a reflection of the then political, social and economic situation. During those days there was feudal decentralization.

Traditional taxation was also characterized for its lack of centralization of the tax administration. Apart from this there was no effective tax administration. Arbitrariness was one of the features of traditional taxation.

The evolution of modern tax system was brought about due to some factors. One such factor was the replacement of in kind exaction by monetary exaction. The other factors could be categorized into fiscal measures taken by governments. This latter factor includes fiscal laws issued by governments.

The modern tax system of Ethiopia is based on some principles like lawfulness, objectivity, right to appeal, good faith and behavior, protection of human dignity and others.

Review Questions

1. What are the factors that distinguish the evolution of modern tax system from that of traditional taxation?
2. The Ethiopian tax system has undergone through various processes, after the fall of Dergue regime, different changes are made on the nation's tax system. Mention at least four among the most relevant changes that are incorporated in the recent tax law.
3. Discuss the principles upon which Ethiopian tax law is based.

SECTION 2: INCOME TAX

Overview

Income tax is one of the taxes that is levied and collected by the Federal Government. This tax is governed by Income Tax Proclamation No. 286/2002.

To impose this tax a number of conditions have to be met. Before income tax is imposed, the various deductions and exemptions have to be identified. Once the taxable income is determined, this income would be subjected to the rate provided in the particular schedule.

In this section we will study all these points which are relevant to impose income tax.

Objectives:

After having completed the study of this section, you will be able to:

- Define income
- Explain categories of taxpayers
- Describe the various deductions and exemptions under each schedule
- Compute income tax payable under each schedule

2.1 Definition of Income

Proclamation No. 286/2002 gives definition of income. In this regard the proclamation provides that “Income” as used in the proclamation means “every sort of economic benefit including nonrecurring gains in cash or in kind, from whatever source derived and in whatever form paid credited or received”.

Currently, Income Tax in Ethiopia is levied and collected per proclamation 286/2002. Per Article 6 of the proclamation, the following are the sources of taxable income.

- 1) Income from employment exercised in the country
- 2) Income from business activities
- 3) Income derived by an entertainer, musician, or sportsman
- 4) Income from an entrepreneurial activity of a non resident through a permanent establishment in the country and from the transfer of movable property of the establishment
- 5) Income from immovable property, livestock, inventory in agriculture and forestry, right received from immovable property in the country
- 6) Income from the transfer of property
- 7) Dividend of resident company and profit shares of registered partnership
- 8) License fee and royalty and income from chance winning
- 9) Interest paid by government units, residents, or non-residents through their permanent establishment
- 10) Income obtained from a foreign country. (Taxpayers will be permitted for foreign tax credit).

Taxable income (under direct taxes) is categorized into four schedules A, B, C and D. Employment income is categorized as Schedule “A” income, rental as Schedule “B” income, Business income as Schedule “C” income, and all other direct taxes together as Schedule “D” income.

2.2 Employment Income Tax

1) Meaning

Employment Income Tax is a direct tax levied on income from employment. It is the largest single source of revenue for the federal government and perhaps the tax that fills the average taxpayer with the greatest sense of fear. According to the Income Tax Proclamation, every person deriving income from employment is liable to pay tax on that income at the rate specified in Schedule “A” set out in Article 11 of the proclamation.

For tax purpose the Proclamation has defined an employee as any individual, other

than a contractor, engaged (whether on a permanent or temporary basis) to perform services under the direction and control of the employer. A contractor, on

the other hand, is defined as an individual who is engaged to perform services under an agreement by which the individual retains substantial authority to direct and control the manner in which the services are to be performed.

2) Exemptions

The tax proclamation also provides some exemptions. Exemption, in this context, refers to income, which is not subject to tax. The following categories of income are exempted from employment income tax:

Casual employees (who do not work under the same employer for more than one month in a year)

Pension, provident fund and all other retirement benefit (up to 15% of the monthly salary of employee)

Income of diplomats or consular representatives

Foreign personnel employed in Embassy, Legation, Consulate or mission who are bearers of diplomatic passport

Income specifically exempted by law or international treaty or an agreement approved by Minister

Consumption paid for personal injury

Gratitude in relation to the death of another person

3) Allowable Deductions

The following payments, made to an employee by an employer, are allowed to be deducted to determine taxable income.

Reimbursed medical expenses

Transportation allowance

Hardship allowance

Reimbursed traveling expense (incurred on duty)

Traveling expenses from the place of recruitment to the place of employment and on

completion of employment from the place of employment to the place of recruitment

Allowances paid to the members and secretaries of the board of public enterprises and of study groups set by federal or regional government.

Income of persons employed for domestic duties

4) Tax Period

Payment of tax to tax authority: within 30 days from the end of each calendar month. Each payment should be accompanied by a statement containing information such as: the name, address, taxable income, tax withhold, and tax exempt income of each employee.

Special Provision

The following category of employees shall declare and pay taxable income themselves.

Those who work for more than one employer

Those who work in International Organization-Embassies, etc (who are not exempted)

Penalties

For non-filing or late filing:

Birr 1,000 for the first 30 days

Birr 2,000 for the next 30 days

Birr 1,500 for each 30 days thereafter

For non-payment:

5% of tax unpaid on the first day after due date

2% additional tax on the first day of each month thereafter

For failure to withhold:

Withholding agent shall personally be liable to pay the amount due plus Br 1,000 and Br 1,000 will be imposed on the chief accountant or officer who is in charge of supervision.

5) Determination of Tax Liability

Tax liability refers to the amount of tax a given taxpayer is required to pay to the tax authorities. A tax rate is applied to the taxable income to determine the tax that must be paid. Article 11 of the Income Tax Proclamation sets out the tax rate schedule that lists the tax rates that must be applied to determine the tax liability of an employee. This schedule called Schedule “A” is shown below.

Employment Income per month (in birr)	Rate (%)
0 – 150	Nil
151 – 650	10%
651 – 1,400	15%
1,401 – 2,350	20%
2,351 – 3,550	25%
3,551 – 5,000	30%
5001 and above	35%

The total tax payable on employment income can be determined using a simplest method.

Tax Liability = (Taxable Income X Tax Rate for the Bracket) – Deduction.

If “I” is taxable income, income tax on different brackets can be calculated as follows:

Income Bracket	Rate	Deduction
< 150	- 0 -	0
651 – 650	I X 10%	15.00
651 – 1,400	I X 15%	47.50
1,401 – 2,350	I X 20%	117.50
2,351 – 3,550	I X 25%	235.00
3,551 – 5,000	I X 30%	412.50
5001 & above	I X 35%	662.50

Illustration

Ato Belete is an employee of Tired Company and his monthly basic salary is Br4,700. In addition he is getting Br 100 monthly house allowance. Required: Determine his taxable income and income tax liability. Solution:

Taxable income = Br 4,700 + Br 100 = Br4,800

Tax liability = (Taxable income X Tax rate for the Bracket) – Deduction

= (4,800 X 30%) – 412.50

= Br 1,027.50

6) Recording**i) Recording personal income tax data**

To record payment of salary to employee:

Salary Expense	xxx	Employment Income Tax Payable
		xxx Cash
.....		xxx

To record the payment of withhold tax to Federal Inland Revenue

Authority:

Employment Income Tax Payable	xxx
Cash	xxx

ii) Recording the collection of tax

At the regional level, the petty cashier records the cash collection in Ge/He 21/1. The daily collections will be summarized in Model 16 and submitted to the main cashier in return for Model 64. Ge/He 21/1 is prepared in three copies: one copy is given to the taxpayer; second is given to the accounts department and the tax collector retains the third copy. At federal level collections are recorded in Me/Hel.

Activity-1

What is taxable employment income?

2.3 Business Income Tax

1) Meaning

Business is an industrial, commercial, banking, transport, mining or any other activity persuaded by a person or a body. Compared to the previous income tax rates, the current proclamation provides for a reduced tax rate on business income (both for incorporated and for other businesses). The reduction of rate is an incentive for investors, including foreign investors, which in other words considered as an added advantage for the free market economy.

At the end of each fiscal year, each taxpayer submits a Tax Return to the Income Tax Authority. Income Tax Return is a statement containing statistical information filled in a preprinted form (provided by the tax authority, in Ethiopia), given to the Income Tax Office. It should contain full and true information about the income earned by the taxpayer. Income tax laws require the taxpayers to furnish such information within a stipulated period. Many businesses use the service of qualified professional accountants to prepare tax returns and determine taxable income. Profits as shown by accountants may not be the same as admissible for tax assessment. There may be certain items of expenditure reasonably charged to the income statement but not allowable for tax purposes. Likewise, certain revenue items permissible to be included in income statement may not be permissible to include in the tax return. It becomes thus necessary to adjust those items to determine taxable income.

Using the income statement, taxable income may be determined as follows (a method of adjusting profit).

Procedures:

1st. Take the net profit as shown in the income statement (submitted together with income tax return).

2nd. Add back any item deducted, which is not allowed for tax purposes.

3rd. Deduct any item included in the income statement, but not permitted per tax law.

4th. Multiply the figure so arrived (from step-1 through step-3) by the income tax rate.

If the income tax statement shows net loss, the above steps will be reversed in order to arrive at the taxable income.

At present, In Ethiopia, tax on schedule C income is levied and collected per Proclamation 286/2002 (together with the Council of Ministers Regulation)

2) Key Definitions used in Tax Law

Business: Any industrial, commercial, professional, or vocational activity or any other activity recognized as trade by the Commercial Code of Ethiopia and carried on by any person for profit.

Allowable Deductions: All sums that are eligible for subtract from gross income. **Body:** Any company, registered partnership, entity formed under foreign law resembling a company or registered partnership, or any public enterprise or public financial agency that carries out business activities including body of persons corporate or unincorporated, whether created or recognized under a law in Ethiopia or elsewhere and any foreign body's business agent doing business in Ethiopia on behalf of the principal.

Related Person: A natural person, and a relative of the natural person, a trust and any person who is a beneficiary of the trust, a partnership, joint venture, unincorporated association or body or private company and any member thereof, an incorporated company and any person having more than 10% voting right or share of capital or profit in the company, a registered person and branch or division of that registered person.

Long-term Contract: A contract for manufacturing, installation, or in relation to each, the performance of related services, which is not completed with in the tax period in which work under the contract commenced, other than a contract estimated to be completed within 12 months of the date on which work under the contract commenced.

Permanent Establishment: A fixed place of business through which the business is carried on. This includes a branch, factory, workshop, a place for the exploitation of natural resource (mine, quarry, etc), and a place where construction or assembly work is carried on.

Resident: A person is a resident of Ethiopia if he has a domicile or habitual abode in the country or he is a citizen of the country. If a person stays for more than 186 days in a year he is also considered a resident. A body is resident in Ethiopia if it has a principal office and place of effective management and is registered with the Ministry of Trade and Industry. It also includes the permanent establishment of a non-resident in the country.

Fiscal Year: Budgetary year of the Ethiopian Government.

Withholding Agent: A person obliged to withhold tax under the proclamation.

Assessment: A review by a tax official of the tax declaration and information provided by a taxpayer and verification of the arithmetical and financial accuracy of the declared tax liability.

Penalty: Fines imposed on a taxpayer either for failing to comply with a requirement (i.e. failing to file a return or a required statement or failing to pay the amount of tax due) or for providing misleading information.

3) Category of Taxpayers

For the purposes of payment of business tax, taxpayers are categorized into three namely: Category “A”, Category “B”, and Category “C”.

Category “A” includes any company incorporated under the laws of Ethiopia or in a foreign country and other entities having annual turnover of more than Br500,000. Those who are categorized under “A” have to maintain all records and accounts which will enable them to submit a balance sheet and profit and loss account disclosing the gross profit, general and administrative expenses, depreciation, and provisions and reserves (together with the supporting vouchers).

Category “B” includes those enterprises having annual income of more than Br 100,000 and less than Br 500,000. Category “B” taxpayers have to submit the profit and loss statement together with the supporting vouchers.

Category “C” includes all taxpayers who are not classified under the other two categories and whose annual turnover is estimated at Br 100,000 or less.

Every businessman (except Category “C”) is required to preserve all books of accounts and other records and documents for a period of not less than 5 years after the year of income to which such books and documents relate.

4) Tax Period (Article 64)

The period of tax assessment is one fiscal year. The fiscal year starts on Hamle 1 and ends on Sene 30. The body can change the accounting year only with the permission of the tax authority. When the tax period of a body is changed (with the permission); the period between the previous tax period and the new period will be treated as a “transitional period”.

5) Allowable Deductions

In order to determine taxable income under Schedule “C” the following items of expenditures are allowable.

- 1) Direct cost of producing the income such as the direct cost of manufacturing, purchasing, importation, selling and such other similar costs.
- 2) General and administrative expenses incurred for earning, securing and maintaining the income.
- 3) Depreciation expense
- 4) Bad debt
- 5) Premium payable on insurance directly connected with the business activity
- 6) Expense incurred for the promotion of business

- 7) Commission paid for services rendered, provided that the amount shall not exceed the normal rates provided by other similar businesses or persons
- 8) Any payment made by a branch, subsidiary or associated company in Ethiopia to the foreign head office for services rendered (actually), provided that such a services can not be rendered by any other person at a lower cost
- 9) Salaries, wages or other emoluments paid to the children of proprietors or member of partnership, provided it should be proved that they possess the required qualification
- 10) Salaries and other personal emoluments paid to manager or managers of a private limited company.
- 11) Interest expense, if the lending institution is recognized by NBE or a foreign bank permitted to lend to enterprises in the country.
- 12) Donations and gifts under the following conditions:
 - a. If they are given to welfare organizations that have a record of outstanding achievement and have a good accounting system showing the utilization of resources.
 - b. If the payments are made under emergency call issued by government to defend sovereignty and integrity and to prevent manmade or natural catastrophe, epidemic or any other similar cause.
 - c. If the payment is made for non-commercial education or health facilities.

Note: Grants and donation will be allowed as deduction only if it does not exceed 10% of the taxable income.

The following are the rates of depreciation permitted per the rule:

- 1) Building: 5% of the original cost. The cost includes the cost of acquisition, construction, improvement, reconstruction and renewal.
- 2) Intangible Assets: 10% (straight-line basis). The cost of acquisition, construction, improvement, renewal and reconstruction.

3) Computers, information systems, software products and data storage equipment: 25% (on a pooling system).

4) All other business assets: 20% (on a pooling system)

For assets for which the pooling method is used, the rate is applied to the depreciation base for the determination of depreciation. Depreciation base is the book value of the asset on the opening day of the tax period, increased by the cost of acquisition, creation, renewal, etc during the period and reduced by the sales price of the asset disposed during the period. Loss incurred during the period due to natural calamity and other involuntary conversion will also be considered for the computation of depreciation base. Any compensation received for these purposes will be deducted from the book value.

While determining the depreciation base, if it becomes negative, it will be added to the taxable income. On the other hand, if the depreciation base is Br 1,000 or less in any tax period, the entire amount shall be treated as depreciation for that period. Likewise, gain obtained as a result of revaluation of assets shall not be a basis for determining depreciation base.

For each category of assets, the actual expense incurred for the maintenance and improvement is allowable provided it does not exceed 20% of the depreciation base at the end of the year. If such an expense exceeds 20% of the depreciation base, the excess will be added to the depreciation base of the category.

According to the Regulation issued by the Council of Ministers, depreciation will be allowed as deduction only if the tax payers keep satisfactory record and submit the same to the tax authority regarding the date and cost of acquisition and a record of the total amount of depreciation deducted on the asset so far.

However, depreciation on assets such as fine art, antiques, jewelry, trading stock, etc (which are not subject to wear and tear) are not allowed.

Financial institutions are permitted to deduct special reserves from taxable income in accordance with the directives issued by NBE. However, the amount drawn from such reserves will be added to the taxable income of such institutions.

Dividend and profit shares, received by a resident body, are exempted from taxable income provided:

- i) The dividend distributed by the body were subject to taxation
- ii) The recipient body has at least 25% shareholdings in the share capital or voting right of the distributor body
- iii) The profit shares distributed by the registered partnership were subject to taxation
- iv) The recipient body holds at least 25% of the capital of the distributor. (the registered partnership)

6) Non-allowable Deductions

All those expenses, which are not wholly or exclusively incurred for the business activity, shall not be allowed as deductions per the provisions of law. Such expenses include:

- 1) Capital expenditure: the cost of acquisition, improvement, renewal, etc that is depreciated
- 2) Additional investment: an increase in the share capital of a company or the original capital of a registered partnership
- 3) Pension or provident fund contribution in excess of 15% of the monthly salary of employees
- 4) Dividend declared by companies and profit shares distributed by registered partnership
- 5) Interest expense in excess of the rate used between the National Bank of Ethiopia and Commercial banks increased by 2%
- 6) Any tax, fine or penalty paid under any proclamation and recoverable value added tax
- 7) Fines or penalty paid under violation of law
- 8) Losses that are not connected with the business activity

- 9) Losses recoverable by insurance
- 10) Donation and gift other than permitted by regulation
- 11) Entertainment expenses
- 12) Any reserve, provision or special purpose fund, if not permitted by any proclamation.
- 13) Personal consumption expenses
- 14) Salary, wages, and other personal emoluments paid to the partner, or proprietor of an enterprise
- 15) Expenses for maintenance or for other private purposes of proprietor or partner of the enterprise
- 16) Representation expenses in excess of 10% of the salary of employees.

7) Declaration and Payment of Tax

The following is the procedures for the declaration of taxable income by taxpayers.

- A) Taxpayers categorized as “A” are required to declare their taxable income within four months from the end of the tax period
- B) Those taxpayers who are categorized as “B” are required to declare their taxable income within two months from the end of the tax period
- C) Category “C” taxpayers shall declare taxable income between July 07 and August each year

The taxable income of Category “C” taxpayers will be determined through a standard assessment. It is a fixed amount of tax determined through the regulation (of Council of Ministers), considering variations such as type of business, business size and location.

Taxpayers are required to pay tax simultaneously with the declaration of taxable income net of tax withheld and foreign tax credit. Subsequently, after the assessment of tax, the tax authority should refund the excess of tax paid over tax per assessment within 60 days of receiving tax declaration.

If the payment of tax is not made within the time limit permitted, the taxpayers will be obliged to pay interest for the period from the due date to the date of payment. The interest for non-payment is set at 25% more than the highest commercial lending rate prevailed during the preceding quarter.

If the taxpayer has paid tax over and above the amount due (either through withholding or through declaration) and the tax authority has not made the refund within the time limit provided, he (the taxpayer) is entitled to have an interest at 25% above the highest commercial lending rate prevailed during the preceding quarter.

8) Tax Exemptions (Article 30)

The following categories of income and entrepreneurs are exempted from the payment of business income tax.

Income: Awards for adopted and suggested innovations and cost saving measures, public awards for outstanding performance, and income specifically exempted by law

Entrepreneurs: Federal, National and Local Governments, and National Bank of Ethiopia.

9) Tax Withholding (Articles 52 and 53)

The following are the provisions for withholding tax by taxpayers.

On Import: Those taxpayers who import goods for commercial use are required to pay 3% of CIF (Cost, Insurance and Freight) of goods as tax withholding to the Customs Authority.

On other specified transactions: 2% of the gross amount of payments. The withholding agent shall transfer the amount withheld to the tax authority, within

10 days from the last day of each month, in aggregate, indicating the TIN of the taxpayers from whom the tax is withheld.

According to the Council of Ministers Regulation the following persons are required to

withhold tax of 2% from the payment that they make to the taxpayers:

- i) Organizations having legal personality
- ii) Private nonprofit organizations, and
- iii) Non governmental organizations

The regulation states that, withholding will be applicable to the payment for the i) Supply of goods for more than Br 10,000 in any one transaction

- ii) Rendering of the following services involving more than Br 500 in any one transaction or service
 - a. Consultancy services
 - b. Designs, written materials, lectures and dissemination of information
 - c. Lawyers, accountants, auditors, and other services of similar nature
 - d. Sales persons, arts and sports professional, and brokers including insurance brokers and other commission agents
 - e. Advertisement and entertainment programs for television and radio broadcast
 - f. Construction services
 - g. Advertisements services
 - h. Patents for scientific and intellectual works
 - i. Rent for lease of machines, building, and other goods including computers
 - j. Maintenance services, k. Tailoring,
 - l. Printing, m. Insurance.

10) Assessment of Tax

Assessment is a tax review by a tax official of the tax declaration and information provided by a taxpayer and a verification of the arithmetical and financial accuracy of the declared tax liability. Pursuant to the proclamation, each taxpayer is required to furnish the tax authority with all information required for the assessment of income tax including information about his operations, and

relationship with other bodies that may be necessary for the declaration of income or for supporting the books of accounts.

The procedure for the assessment of business income tax takes two forms: A) Assessment by books of accounts, and

B) Assessment by estimation.

Assessment by books will be done for those who maintain books of accounts (Category A and B). The revenue authority makes assessment by estimation when the taxpayers do not maintain the books or when the submitted books are not acceptable. This is also done if the taxpayer fails to declare his/her taxable income within the time required.

Tax, of those taxpayers who have different sources of income, will be assessed on the aggregate of all income.

Assessment by Estimation

If the taxpayers keep no records, or if the income tax authority does not accept the submitted books, or if the taxpayer fails to declare tax within the time specified, the income tax authority estimates tax by the use of certain indicators. Category “C” should pay tax at fixed rate on the income estimated by the income tax authority.

Tax assessors will be assigned by the tax office to estimate the daily sales of the taxpayers. The estimates will be done using the best of their judgment and objectivity. The estimated daily sales will be converted to annual income using the number of working days. Tax on annual sales is determined on the basis of presumptive value assigned to each activity.

11) Business Income Tax Rates

According to the income tax proclamation, the following tax rates are used for computation of business income tax under Schedule “C”.

The Range of Taxable Business Income per annum	Tax Rate on every Additional Amount (%)

0 – 1,800	Exempted
1,801 – 7,800	10%
7,801 – 16,800	15%
16,801 – 28,200	20%
28,201 – 42,600	25%
42,601 – 60,000	30%
Over 60,000	35%

Provision for Loss Carry Forward

If a business incurs a loss in a year, that loss may be set off against taxable income in the next three years, earlier losses being set off before later losses. A net operating loss may be carried forward and deducted only for two periods of three years. However, the loss cannot be carried forward: If during a year, the direct or indirect ownership of the share capital or the voting rights of a business changes more than twenty-five percent, by value or by number and if the business cannot provide a books of account showing the loss, which are acceptable by the authority.

12) Penalties

The following penalties are provided in the proclamation regarding business income tax.
For Non-declaration

Taxpayers who do not declare tax income within the period specified in the regulation will be liable to pay Br 1,000 for the first 30 days of non-declaration. The penalty is Br 2,000 for the next 30 days of non-declaration. Br 1,500 will be charged for each 30 days for failure to declare the taxable income thereafter.

For understatement of taxable income

Understatement of taxable income results in a penalty of 10% of the amount understatement. If the understatement is substantial, the penalty will be 30%.

For late payment

When a taxpayer fails to pay tax within the due date, he/she will be required to pay a penalty of 5% of the amount unpaid. An additional 2% penalty on the amount unpaid is imposed on the first day of each month for non-payment.

For failure to keep records

Failure to keep books of accounts, records and other documents by any taxpayer results in a penalty of 20% of the tax assessed. If this failure continues for two consecutive years, the license of the taxpayer will be suspended. One more year's failure leads the tax authority to revoke the license of the taxpayer.

For failure to withhold

A withholding agent, who fails to withhold tax per the proclamation, will be personally liable to pay tax (which has been withheld). In addition, this failure obliges the agent to pay Br 1,000 per case.

The following individuals are also liable in this regard:

- 1) The manager that has known of the failure
- 2) The chief accountant or a senior officer who was responsible for the supervision of the withholding activities.

13) Recording Business Income Tax

Like any business transaction, profit tax payment must be properly accounted for. To record business profit tax, Income Tax Expense will be debited and Income Tax payable will be credited (if the tax is not paid yet) or cash will be credit (if recording is made at the time when the tax is paid).

For example, Abyssinia Company is required to pay a business profit tax of Br 80,000. The recording is as follows:

i) When the income tax expense is recorded:

Income Tax Expense	80,000	
Income Tax Payable		80,000

ii) When the tax is paid:

Income Tax Payable	80,000
Cash	80,000

Activity - 2
What is the maximum business income tax rate?

2.4 Rental Income Tax

Income tax proclamation 286/2002 classifies rental income as Schedule “B” income and the tax is levied and collected on income from rent of building. The tax collected on annual basis and the tax period is the Ethiopian fiscal year.

1) Determination of Income

Income includes rent of building and rent of furniture and equipment if the building is fully furnished. Gross income shall also include any cost incurred by the lessee for improvement to the land or building in accordance with the contract of lease. The lessor who allows the lessee to sublease the building will get an agreement in writing from the lessee for the payment of tax for the additional rent, if any, received on subleasing. Non-payment of tax by the sublessor will result in the payment by lessor.

2) Taxable Income

Taxable income from Schedule “B” income is determined by subtracting the allowable deductions from gross income. Allowable deductions include the following:

A) Those who do not maintain books and records:

Tax on land and building

20% of gross income as allowance for repairs, maintenance and depreciation

B) Those who maintain books and records:

Tax on land and building

Cost of lease of land

Repairs and maintenance expenses actually incurred

Depreciation on building (and furniture and equipment if fully furnished)

per income tax proclamation

Interest on loan if any

Insurance premium paid on insurance of building

When a building is constructed for the purpose of giving on lease, the owner and contractor should inform the kebele Administration about its completion and the intention of giving it on lease. This is also applicable when the building is rented before its completion. The kebele Administration will pass the information to the tax office for the determination of tax. It is also the responsibility of kebele Administration to gather any such information and disseminate to tax office in case where the parties fail to do so.

3) Tax Rate

The following is the tax rate applicable for determining tax from Schedule “B” income.

I) For bodies having legal personality: 30% II) For others, at the following rates:

<u>Annual Taxable Income</u>	<u>TaxRate</u>
Up to 1,800	Exempted
1,801 – 7,800	10%
7,801 – 16,800	15%
16,801 – 28,200	20%
28,201 – 42,600	25%
42,601 – 60,000	30%
60,001 and above	35%

4) Declaration and Payment of Tax

The period within which the taxable income should be declared and paid shall be the same as that for business income tax. That is, Category “A” taxpayers shall declare and pay within four months, Category “B” within two months and Category “C” within thirty days after the end of fiscal year.

Penalties for non-declaration and non-payment, for failure to keep records, failure to meet taxpayer identification number (TIN) requirements, etc applicable for Schedule “C” income tax are also applicable for Schedule “B” income tax.

Illustration

Assume that Sunshine Private Limited Company rented a furnished office building to Desta Company for Br 40,000 per month on Hamle 1, 1996 for 5 years. The following data pertain to the expenses incurred and other allowable deductions. The company keeps books and records properly.

Tax on building	Br 2,400	
Tax on land		2,160
Maintenance on building	12,000	
Depreciation on building (for 12 months)	28,000	
Interest on loan (for 12 months)	12,000	
Insurance premium (for 12 months)	5,720	

Required: Computes rental income tax for the year ended Sense 30, 1997.

Solution:

Annual Rental Income	40,000 X 12 = Br 480,000	
Less: Allowable Deductions:		
Tax on building	Br2,400	
Tax on land	2,160	
Maintenance	12,000	
Depreciation	28,000	
Interest	12,000	
Insurance	5,720	(62,280)
Taxable Income		Br <u>417,720</u>

Rental Income Tax for

The year ended Sene 30, 1997 = Br 417,000 X 30% = Br 125,316

Activity – 3
What is a tax assessment?

2.5 Taxation of Other Income

There are many types of income that need not be taxed for equity, efficiency and revenue purposes. The income tax proclamation provides provisions to catch those sources of income that do not fall under the three schedules discussed earlier: income from employment, income from rental of building, and business income. The incomes that are not included in these three schedules are many in type and nature and thus taxed at different rates depending on their characteristic. Income tax proclamation 286/2002 specifies these types of income as Schedule “D” income and are discussed as follows.

I) Royalty

Income from royalty is the payment received for the use of (or the right to use) copyright, literary, artistic or scientific work; films or tapes for radio and TV broadcasts; patent or trademark, design, model, plan, or secret formula; any industrial, commercial, scientific equipment or experience, etc. The tax rate is 5%. The payer should withhold and transfer to the tax office. If the payer resides abroad, the recipient is responsible to make the payment.

II) Income paid for Technical Services

This includes income received by residents for services rendered outside Ethiopia. Any kind of expert advice and technical service will come under the purview of the said income. The tax rate is 10% and which is withheld and paid to the tax authority by the payer.

III) Income from Game of Chance

This includes income from lottery and other chance winning. The tax rate is 15%. Winning of less than Br 100 are not taxable. The payer withholds tax and pays tax office within the time specified.

IV) Dividends

This includes dividend income received from share companies and private limited companies. The tax rate is 10%. The payer deducts tax at source and remits to the tax office like other Schedule “D” income tax.

V) Income from Casual Rental of Property

This category includes income received from rental of land, building and other movable asset, which are not related to business activities. The tax rate is 15% and tax is determined on the gross annual income and declared and paid within the period specified.

VI) Income from Interest on Deposit

Interest received on deposit is taxed at 5% and the amount of tax is withheld at source by the payer and transferred to the tax office.

VII) Gain on Transfer of Investment Property

Under this category, gain from transfer of building held for business and factory office; and gain from transfer of shares of companies are included.

Both sale and transfer by way of gift are considered to determine gain. Gain on building is taxable at 15% and that of shares is taxable at 30%. According to the proclamation, gain on transfer of dwelling houses is free from tax. The tax proclamation allows a set off loss on transfer of property gains of the same nature of the current period and a carry forward of any remaining loss indefinitely to future years.

Declaration and Payment of Taxes on Schedule “D” Income

Taxes withheld at source from Schedule “D” income are to be declared and paid within 15 days from the end of each month. Other taxes on Schedule “D” income are to be declared and paid within two months from the end of the fiscal year.

Summary

Income tax is one of the taxes in the present tax system. The federal government has issued income tax proclamation and regulation to this effect. To impose this tax a number of conditions have to be met. First the income must be within the scope of the legislations.

Once the income falls within the ambit of the legislations, the income tax statute provides schedules of income based on which tax is imposed. In addition the statutes provide three categories of taxpayers. To impose tax a particular income must fall under any of the schedules.

Imposition of tax would require determining taxable income under each schedule. The taxable income is determined after making the necessary exemptions and deductions from the gross income. After this the taxable income would be taxed at the rate provided in the particular schedule to which the income belongs.

The implementation of the tax would require regulating certain matters. In this respect, the income tax statutes impose obligations on taxpayers and concerned persons. In addition, the Tax Authority is given power to administer the tax and the governing legislations. The income tax statutes also impose administrative penalties in cases of failure to observe one's legal obligations.

Review Questions

1. Discuss the types of income and how they are taxed under Ethiopian law?
2. The total tax liability of an employee is Br 390, what is his taxable income?
3. What is the purpose of tax identification number?
4. Discuss the difference between standard assessment and estimated assessment.
5. What is the basis for classifying taxpayers into different category?
6. What would be the amount of income tax that would be paid by an employee who gets a monthly employment income of Br 5,300 and transportation allowance of Br 100?
7. A certain building is leased for Br 10,000 per year. The lessor received the rent of the coming two years. What would be the tax to be paid?
8. What would happen if a certain person wins tombolla four times each worth Br 50?
9. What are incomes that are covered by schedule “D”?
10. How is the income from rental of buildings to be determined?

Exercises

1. W/ro Fatuma rented her new building to Guna Bank for 6 years on Hamle 1, 1995 E.C for a monthly rent of Br 10,000. The annual tax on land and building are Br 1,160 and Br 1,240 respectively.

Required: How much does W/ro Fatuma pays as income tax for the year ended Sene 30, 1996?

2. Ato Kebede deposited Br 60,000 at the beginning of 1997 E.C. in Commercial Bank of Ethiopia. The deposit carries interest at 3%.

Required: How much does the Bank withhold as tax from him?

3. Assume that Meron won Birr 160,000 from National Lottery in Hidar 1996 E.C.

Required: Determine the amount received by Meron after deducting tax.

SECTION 3: VALUE ADDED TAX AND EXCISE TAX Overview

VAT and Excise Tax are among the taxes that exist in the tax system. The Federal Government has issued VAT Proclamation No. 285/2002 and Excise Tax Proclamation No. 307/2002. This section deals with these taxes.

This section generally will discuss about VAT and Excise Tax. In particular, we will study about the imposition of VAT and Excise Tax. We will also study the subject matters over which VAT and Excise Tax are imposed and the rates applicable over the various subject matters that are taxable. Finally we will discuss the implementation and enforcement of the tax.

Objectives:

After having completed the study of this section, you will be able to:

- Discuss imposition of VAT and Excise Tax
- Identify exempted items
- Explain the subject matters that are taxable
- Describe the tax rates applicable to taxable subject matters
- Explain the implementation of the taxes

3.1 Value Added Tax**1) Introduction**

In order to minimize the complexity of tax administration, to enhance taxpayer compliance and to encourage investment, Government of Ethiopia has launched a tax reform program. One of the most important outcomes of the reform was the introduction of VAT (Value Added Tax) by the replacement of sales tax.

VAT is a transaction tax collected on all goods and services at all stages of production and

distribution. Tax is collected on the value added at each stage. Value Added is the difference between the sales and the value of purchases at that

stage. The collection of VAT begins with importers or producers and ends with the retailers. The amount of VAT collected from a transaction at different stages of distribution will be equal to the total amount of sales tax collected from one stage of the distribution on that taxpayer against tax payable by him on sales.

The VAT Proclamation No. 285/2002 which has rescinded and replaced the sales and excise tax proclamation No.68/1993 and which has come into force as of January 2003 is a consumption tax which is levied and paid as Value Added Tax at a rate of 15% of the value of every import of goods, other than an exempt import and an import service rendered in Ethiopia for a person registered in Ethiopia for VAT or any resident legal person by a non resident person who is not registered for VAT in Ethiopia.

A taxation transaction is a supply of goods or a rendition of services in Ethiopia in the course or furtherance of a taxable activity other than an exempt supply. On the other hand a taxable activity is any activity, which is carried on continuously, or regularly by any person in Ethiopia, or partly in Ethiopia, whether or not for a pecuniary profit that involves, in whole or in part, the supply of goods or services to another person for consideration. For VAT purposes the sale or disposal of goods, or the rendering of services is called supplies.

2) Value Added Tax (VAT) Rates

The Ethiopian VAT system is invoice based and operates on the destination principle, where goods and services are taxed in the country of consumption and not of origin. As indicated in Article 7 and 8 the tax has two main rates with exemptions that ultimately determine liability to tax. These rates are standard rate, which is at 15%, and zero rate, which is 0%.

a) Standard Rate at 15%

Goods and services applicable to the zero rate and exempt are specifically provided

for in the proclamation with the standard rate being applicable to all supplies so excluded.
That means all goods and services other than those specified

as being exempt or liable at the zero rate are liable to VAT at the standard 15% rate. It would not be feasible to compile a definitive of the coverage of the 15% rate. In general the Value Added Tax rate of 15% would be levied on the value of:

Every taxable transaction by a registered person. A taxable transaction is a supply of goods or a rendering of services in Ethiopia in the course or furtherance of a taxable activity, other than an exempt supply.

Every import of goods, other than an exempt import ; and

An import of services

VAT on Imported Goods and Services

Article 14 and 15 are about the time and value of imports. As indicated in the proclamation all goods imported into Ethiopia are liable to VAT at a standard rate of 15% unless the imported goods are zero-rated and exempted. As far as the payment is concerned the importer is liable to the payment of the tax at the point of clearing the goods in the Customs Department of Ethiopian Custom Authority no matter whether the goods are imported for private or business purposes, and whether or not the importer is registered for Value Added Tax.

The value on which an importer will have to pay VAT at importation is determined by adding the CIF (cost, insurance and freight) duty, the custom duty, and all cost of any service- supplied incidental to the delivery of the goods. The Ethiopian Custom Authority will give the basis of value for VAT purposes.

An importer, if he is registered for VAT can claim VAT refund on imported goods if the imported goods are for taxable business purposes and not for private use. To ask for a VAT claim, however, the importer must obtain a copy of the Customs Bill of Entry certified by Ethiopian Custom Authority as to the amount of VAT paid.

VAT is also paid on services imported from abroad. If the supplier of the service conducts

business in Ethiopia and is registered for Value Added Tax then VAT will have to be paid. If the service is supplied by a foreign who is not registered

for VAT in Ethiopia, then the imported, if is registered for VAT in Ethiopia, must account for the VAT at the time the service is completed, or when the invoice is received from the foreign supplier.

Computation of VAT

The computation of the VAT liability from the manufacturer to the final consumer is presented as follows.

Manufacturer	<u>Birr</u>	<u>Tax</u>	
Purchases of raw materials	Br 2,000		
VAT paid on raw material (15% x 2,000)	300		
Cost of the material to the manufacturer	2,300		
Sells to the wholesaler the finished goods	4,000		
VAT (4,000 X 15%)	600		
Total selling price	4,600		
VAT liability of the manufacturer (600-300)			Br 300
 Wholesaler			
Sells to the retailer at a price	5,600		
VAT (5,600 X 15%)		840	
Total selling price		6,440	
VAT liability of the wholesaler (840-600)			240
 Retailer			
Sells to the final customer at a price	8,400		
VAT (8,400 X 15%)		1,260	
Total selling price		9,660	
VAT liability of the retailer (1,260 – 840)			420
Total VAT paid to FIRA			Br <u>960</u>

b) Zero - Rating

As discussed earlier in VAT zero-rated goods or services are business transactions, which VAT is chargeable at 0%. In effect zero-rated means no VAT is charged. However, from tax perspective zero rate supplies are taxable supplies although no tax is charged and the value of these supplies forms part of the taxable turnover for registration purposes. Remember from the explanation given earlier that if a

business makes zero-rated supplies, it does not charge VAT on sells but can reclaim full input tax credit (VAT paid on purchases) related to its

zero rated supplies from VAT Administration Office, hereinafter to as FIRA / VAT.

Goods and services, which attract the zero rate of VAT, include:

i) The exports of goods or services. However,

Goods are treated as exported from Ethiopia if the goods are delivered to or made available at an address outside Ethiopia as evidenced by documentary proof from Ethiopian custom Authority acceptable to the FIRA/ VAT

Services are treated as exported if the services are supplied for use or consumption outside Ethiopia as evidenced by documentary proof from Ethiopian Custom Authority acceptable to the FIRA/VAT.

ii) The rendering / supply of transportation or other services directly connected with international transport of goods or passengers, as well as the supply of lubricants and other consumable technical supplies taken on board for consumption during international flights.

iii) International transport of goods or passengers occurs where the goods or passengers are transported by road, rail, water or air and also transportation must be:

From a place outside Ethiopia or another place outside Ethiopia where the transport or port of the transport is across the territory of Ethiopia, or

From a place outside Ethiopia to a place in Ethiopia

From a place in Ethiopia to a place outside Ethiopia iv) the supply of gold to the National Bank of Ethiopia.

v) A supply by a registered person to another registered person in a single transaction of substantially all of the assets of a taxable activity or an independent functioning part of a taxable activity as a going concern, provided a notice in writing signed by the transferor and transferee is furnished the Authority within

21 days after the supply takes place and such notice includes the details of the supply.

3) VAT Exemptions

The supply of certain goods and services is exempt from VAT. Exemption from VAT means that the persons engaged in the exempt activity are not liable for VAT on their receipts and are not entitled to a credit or deduction for VAT borne on their purchases. In another word the suppliers of exempted goods and services are not permitted to charge VAT and do not get credit for input VAT on purchases for the exempt goods and services. If it makes taxable and exempt supplies it cannot reclaim the VAT paid on purchases of such exempt supplies. However, if a business makes only exempt supplies it cannot be registered for VAT as it is out of the tax system.

The goods and services that are exempted from VAT as indicated in Art 8 of the proclamation are:

The sale, transfer or lease of immovable property, except for the following:

The sale or transfer of hotel or holiday accommodation;

The sale or transfer of newly constructed residential property, unless the property has been occupied as a residence for at least two years.

The rendering of financial services. Financial services means:-

Granting, negotiating and dealing with loans, credit guarantees, and any security for money, including management of loans, credit or credit guarantees by the grantor.

Transactions concerning deposits and current accounts, payments, transfers, debts, cheques and negotiable instruments other than debt collection and factoring;

Transactions relating to share, stocks, bonds, and other securities other than custody services; Management of investment funds.

The supply or import of national or foreign currency (except for that used for numismatic purposes) and of securities.

The import of gold to be transferred to the National Bank of Ethiopia

The rendering by religious organizations of religious or church-related services,

The rendering of medical services,

The rendering of educational services provided by educational institutions, as well as child care services for children at pre-school institutions,

The supply of goods and rendering of services in the form of humanitarian aid, as well as import of goods transferred to state agencies of Ethiopia and public organizations for purpose of rehabilitation after natural disasters, industrial accidents, and catastrophes,

The supply of electricity and water,

The supply of goods for the official use of diplomatic missions,

Post office operations and the provision of public transport permits and license fees.

Difference between Zero-Rated and Exempt Supplies

It is necessary to identify the difference between exemption and zero-rating. These terms appear to have the same meaning, but only to the extent that both exempt and zero-rated supplies do not attract what is referred to as a positive rate of VAT. That is both mean that there is no VAT charged on the supply, so what is the difference? To the final consumer there is very little difference as no VAT will be charged to them, but to a business the difference is very important. Dealing in taxable supplies, including zero rate supplies allows a business to reclaim input tax; dealing in exempt supplies does not.

Because zero-rated supplies are taxable supplies, a VAT registered business dealing in making only zero-rated supplies is still entitled to reclaim input tax on purchases made (supplies received). This means that most suppliers dealing in only zero-rated supplies will have input tax, which exceeds their output tax, and they will claim for refund from FIRA. Because exempt supplies are not taxable

supplies, a business dealing only in making only exempt supplies is not entitled to register for VAT. This means that this business will have no opportunity to reclaim input tax on purchases (supplies received).

Activity-1

What would happen if a sole proprietor operating a clothing store sells her used personal refrigerator?

4) Registration Requirements

The VAT proclamation provides rules relating to registration for VAT purposes. It describes who is obliged to register, who may not register, procedures for registration etc.

a) Taxpayers

As indicated in article 3 the following persons are taxpayers:

A person who is registered or is required to be registered. A person who is registered is a taxpayer from the time the registration takes effect. A person who is not registered, but who is required to be registered, is a taxpayer from the beginning of the accounting period following the period in which the obligation to apply for registration arose.

A person carrying out taxable import of goods to Ethiopia, with respect to such import;

A nonresident person who is not registered for VAT in Ethiopia and renders services in Ethiopia for any person registered in Ethiopia for VAT or any resident legal person.

b) Option to Register

According to section 5 of the proclamation “any person” (to be defined later) conducting a “ commercial enterprise” (to be defined later) or intending to conduct a commercial enterprise may apply to be registered for VAT. However, if

the taxable turnover of the enterprise that is gross income for 12 calendar months exceeds or is likely to exceed Birr 500,000, the person conducting the enterprise must register for VAT with FIRA / VAT

Turnover related to exempt supplies as listed in the law is not to be included in the total for deciding if VAT registration is compulsory. The term any person for purposes of VAT registration includes sole proprietor, company, partnership, estate of the deceased, trust, incorporated body or unincorporated body, and club or association. The term a commercial enterprise refers to any business of whatever nature and it includes examples such as ordinary business (e.g. shop, contractors, manufactures, wholesales, etc), trades and professions (e.g. builders, engineers, accountants, lawyers, etc), and activities of non-profit making bodies (e.g. societies, associations, sporting clubs, etc).

Thus, there are two types of VAT registration: obligatory and voluntary.

Obligatory Registration

A person is obliged by law to register if one is doing any business, which is likely to have taxable turnover in 12 months exceeding Br 500,000. Thus to know whether a person must register for VAT it is sufficient to consider the business turnover for the past 12 months. If during the past 12 months its gross sales exclude tax exceeds Br 500,000 then it has to register for VAT. Besides, if one reasonably expects that during the next 12 months the total value of taxable supplies excluding tax is likely to exceed Br 500,000 then the person needs to register for VAT.

The turnover is calculated on an ongoing basis. Two periods need to be considered-the past 12 calendar months and the next 12 calendar months on a month-by-month basis. There is the need to estimate at the end of each trading calendar month the total value of taxable goods and services supplied by all the business for the past 12 months. Where the total exceeds Br 500,000 then there is the requirement to register for VAT. If a person is required to register for VAT

and has not applied to be registered, the Tax Authority may register the person on its own initiative and send the registered person the certificate.

Voluntary Registration

A person may voluntarily apply for registration even if his turnover is below Br 500,000 of business activity. However, application for voluntary registration can be made only if the person regularly supplies or renders at least 75% of his goods and services to registered persons. Voluntary application for VAT registration can not necessarily result in acceptance by the FIRA/VAT.

FIRA/VAT can also refuse to register any person who has no fixed address or business, who does not keep proper accounting records, who has no bank account, and who has previously been registered for VAT purposes but failed to perform his duties under the VAT law. If voluntary registration is disallowed by FIRA/VAT, it must notify the applicant with explanation on the reasons for the refusal.

Activity – 2

Ato Mirutse who exports locally made leather products and gets a turnover of Br 2,000,000 per year was not registered for VAT. Should this person register for VAT?

5) Record Keeping

The VAT regulation requires that a VAT registered trader must keep full and true records of all business transactions that affect or may affect his or her liability to VAT. The records must be kept up to date and must be sufficiently detailed to enable a trader to accurately calculate liability or repayment and also to enable the Authority to check the calculations, if necessary. In general, the following records are required to be kept.

a) VAT Account

A VAT registered person is required to keep records of all supplies and purchases made and received and a summary of VAT for each period covered by the VAT Returns. This record is called a “VAT Account”. A VAT account contains information that is entered on ones VAT return. It consists of a tax payable portion and a tax allowable portion. The tax payable portion comprises a total of the output tax due for the prescribed accounting period and any correction to the tax payable portion of a previous return which may be corrected on the current return. The tax allowable portion comprises the total of the input tax allowable to the taxable person for that prescribed accounting period. This includes any permitted correction of tax allowable portion of previous returns, and any other adjustments required. The information can be retained in an account book, or on computer.

Where for any return period the output tax exceeds the input tax, a payment must be made to Authority when submitting a return. Where for any return period the allowable input tax is greater than the out put tax, the amount of the excess is normally repayable to the taxable person by Authority.

b) Records of Purchases

The records of purchases should distinguish between purchases of goods intended for resale and goods or services not intended for resale in the ordinary course of business. The record should show the date of the purchase invoice and a consecutive number (in the order in which the invoices are filed), the name of the supplier, the cost exclusive of VAT and amount of VAT shown. Purchases at each rate must be recorded separately. Purchase record should be divided into three separate accounts:

Local purchases and the VAT thereon Imports and the VAT there on All other purchases, including exempt, zero-rated purchases and purchases from suppliers who are not registered for VAT where the person will not have been charged any VAT.

One must also retain and file separately the following in order of date

Original tax invoices including simplified invoices received from local suppliers, including original debit and credit notes received from the suppliers. Certified copies of Customs import entries Purchases invoices received for all other purchases

c) Record of Sales

In general, the record of sales must include the amount charged in respect of every sale to a registered person and a daily entry of the total amount charged in respect of sales to unregistered persons, distinguishing in all cases between taxable transactions liable at each different rate of VAT (including the zero rates) and exempt transactions. All such entries should be cross-referenced to relevant invoices, cash register tally rolls, delivery notes, etc. A balanced cashbook is essential for trouble-free operation of VAT. Sales record should be divided into three separate accounts:

Taxable sales at the standard rate and the VAT thereon, or VAT charged there from,

Taxable sales at the zero rate

Exempt sales

Like purchase records one must also retain and separately file the following in order of sale: Copies of tax invoices, including simplified invoices related to one's taxable sales, and copies of any debit or credit notes issued to one's customers. If one is using cash accounting or a small trader scheme one must keep a daily record of his gross taking at the standard rate. Copies of invoices of goods sold at zero-rate or a daily record of the value of one's sales at zero-rate if using cash accounting or a small trader scheme. Copies of invoices of exempt goods sold or a daily record of the value of all exempt sales of using cash accounting or a small trader schemes.

d) Cash Records

All records of one's cash transaction must be retained including cashbooks, petty cash vouchers, all account books, and records of daily takings records.

e) Other Records

Stock and manufacturing records must be maintained if appropriate to the business. Discounts or reductions made or received, and affecting the amount charged, should be recorded in the same manner as purchases and sales. Besides copies of Debit and Credit Notes issued should be separately filed from Debit and Credit Notes received. They should all be filled in order of date. Since export is zero-rated and VAT refund can be claimed on input tax, the exporter is required to maintain such records as a certified copy of the Customs Export entry, a purchase order from or contract with the foreign customer, a copy of the invoice issued to the foreign customer, evidence of transportation from Ethiopia in the form of copies of transit documents, such as airway bills, shipping bills or road or rail transit documents.

In addition to the records stated above VAT registered persons whose turnover exceeds Br 500,000 per annum must retain the following:

- Orders and delivery notes

- All business correspondence

- Appointment and job books

- Annual accounts-including income statement and balance sheet

- Bank statements and paying in records.

f) Retention of Records by Taxable Persons

A taxable person must retain all books, records and documents relevant to the business, including invoices, credit and debit notes, receipts, accounts, cash register tally rolls, vouchers, stamped copies of customs entries and other import documents and bank statements, and computer-stored information. These business records must be preserved for ten years from the date of the latest transaction to which they refer.

6) Cancellation of VAT Registration

A person who has registered for VAT may cancel his or her registration by arrangement with FIRA/VAT. Reasons for De-registration include:

If the business ceases trading permanently

If the business is sold

When the value of taxable supplies falls consistently below the VAT registration threshold. In this case Art 19 (2) states that a registered person may apply to have his registration for VAT cancelled at any time after a period of three years of the date of his most recent registration for VAT if the registered person's total taxable transactions in the period of 12 months then beginning reasonably are expected to be not more than Br 500,000

If he or she has been registered in error, or he or she has ceased to be a taxable person

A registered person must notify FIRA/VAT in writing in order that the VAT registration number may be cancelled promptly. The cancellation of VAT registration takes effect at the time the registered person ceased to make taxable transactions or, if the registered person has not ceased to do so, at the end of the accounting period during which the person applies to the Authority for cancellation of VAT registration. If a person's registration for VAT is canceled, the Authority is required to remove the person's name and all other details from the VAT register and the person is required to return the issued certificate of registration.

7) Accounting for VAT

a) When VAT becomes payable

Article 26 of the proclamation requires that every VAT registered trader must, by the end of the month following each month, furnish to the Authority on the prescribed form (VAT Return) a true and correct return for the period showing the amount of VAT due by him or her and the amount of VAT deductible by him or her. Every month he/she has to fill in details of the supplies made and received in

that period and pay the total owed to FIRA/VAT, or claims a further credit or repayment of tax as the case may be VAT on taxable imports is collected by the Ethiopian Customs Authority.

b) Amount of VAT Payable

The amount of tax payable (the VAT liability) for any month by a person who is registered or is required to register is the difference between the amount of tax charged on taxable transactions (output tax) and the amount of tax creditable (input tax).

For any return month if output tax exceeds the input tax, a payment must be made to Authority when submitting a return. Likewise for any return period if the allowable input tax is greater than the output tax, the amount of the excess is normally repayable to the taxable person by the Authority. Therefore, to determine the VAT liability of a taxpayer, it is necessary to understand the meaning of input tax and output tax.

Output Tax

Output tax in relation to a taxable person is the tax on taxable supplies, which he makes (i.e. his sales). The supplier will be liable to VAT either at the standard rate (currently 15%), or the zero rate (0%). This is the VAT a person charges his customer. It is only the registered person who will charge VAT in the course of affecting his supplies.

The output tax becomes due at the time of supply but in practice is accounted for and paid by reference to tax returns completed for prescribed accounting periods.

Input Tax

Many of the things a person buys will carry a VAT charge, but if a person is registered for VAT he can normally claim a credit for the VAT charged on business purchases and expenses. This is his input tax. It includes not only the VAT on purchases of raw materials or on goods purchased for resale, but also the VAT on things like:

Office equipment for the business,

Commercial vehicles used in the business for the carriage of goods,

The telephone bill (for the business)

Payments for services in connection with the business (e.g. Accountants' or Lawyers' fees) Input tax is the VAT incurred by a taxable person on goods or services supplied to him provided the goods or services, acquisition or importation are for the purpose of any business carried on, or to be carried on, by him. The effect of the above is that VAT cannot be reclaimed on goods and services, which are not used for business purposes. For instance, it does not include VAT paid on goods or services for someone else's business or VAT on private purchases, such as furnishings for the home of the business owner. VAT charged in these circumstances is not considered as input tax. There are also some purchases that cannot be allowed as credit for input tax. These are:

Passenger automobiles, unless the business is dealing in or hiring such automobiles;

The repair and maintenance of passenger automobiles unless the business is dealing in or hiring such automobiles; Entertainment unless the business is in the business of providing entertainment Where exempt supplies are made, it may not be possible to recover all input tax incurred. Input tax should normally be claimed on the VAT return for the period during which the supplier's tax point occurs or, for imported goods, in the period during which the date of importation takes place. The tax point will be shown on a supplier's invoice. If unable to make a claim for input tax in the proper period (e.g. because the necessary evidence is not received in time) input tax may normally be claimed in a later period. Input tax cannot be reclaimed unless a valid invoice or other document is held. The taxpayer must have an original copy of a Tax Invoice including a simplified Tax Invoice, or Certified Customs Import Declaration or warehousing Entry to substantiate a claim for input tax credit. If

input tax can be reclaimed in full, the amount to be claimed is that shown on the tax invoice received from the supplier.

8) VAT Refund

As said earlier for any return period if the allowable input tax is greater than the output tax, the amount of the excess is normally repayable to the taxable person by the Authority as a tax refund. According to Article 27, if at least 25% of the value of a registered person's taxable transactions for a month is taxed at a zero rate, the Authority will refund the amount of VAT applied as a credit in excess of the amount of VAT charged for the month within a period of two months after the registered person files an application for refund, accompanied by documentary proof of payment of the excess amounts.

In the case of other registered persons, the amount of VAT applied as a credit in excess of the amount of VAT charged for the month is to be carried forward to the next five months and credited against payments for these months, and any unused excess remaining after the end of this five-month period will be refunded by the Authority within a period of two months after the registered person files an application for refund, accompanied by documentary proof of payment of the excess amounts.

If a registered person is entitled to a refund and the Authority is satisfied that the person has overpaid tax, then if the Authority does not pay the refund by the specified date, the Authority will pay the person entitled to the refund, interest set at 25% (twenty five percent) over and above the highest commercial lending interest rate that prevailed during the preceding quarter.

9) Administrative Penalties

It is stated that a registered person should comply with the tax proclamation. However, if he violates the tax rule and engages himself in criminal activities a wide variety of penalties may be exacted for non-compliance with VAT Proclamations. The main

penalties are as follows.

When a person engages in taxable transactions without VAT registration where VAT registration is required he will be required to pay 100 percent of the amount of tax payable for the entire period of operation without VAT registration;

When a person issues incorrect tax invoice resulting in a decrease in the amount of tax or increase in a credit or in the event of the failure to issue a tax invoice he will be required to pay 100 percent of the amount of tax for the invoice or on the transaction.

When a person who is not registered for VAT issues a tax invoice he will be required to pay a penalty of 100 percent of the tax which is indicated in the tax invoice. When a person fails to maintain records required under the proclamation he will be required to pay Br 2,000 for each month or portion thereof that the failure continues.

Normally a person who fails to file a timely return is liable for a penalty equal to 5 percent of the amount of tax underpayment for each month (or portion thereof) during which the failure continues up to 25 percent of such amount. An underpayment of tax is the difference between the tax required to be shown on the return and the amount of tax Paid by the due date. For this violation the penalty is limited to Br 50,000 for the first month (or portion thereof) in which no return is filed. In any event the penalty may not be less than the smaller Br 10,000 and 100 percent of the amount of tax required to be shown on the return.

If any amount of tax is not paid by the due date, the person liable is obliged to pay interest on such amount for the period from the due date to the date the tax is paid. The interest rate is set at 25 percent over and above the highest commercial lending interest rate that prevailed during the preceding quarter.

In connection with VAT, different offences may be committed by individuals. These offences include tax evasion, declaring false and misleading statements, obstruction of

administration, failure to notify a change in name, address, etc,

unauthorized tax collection, aiding, abetting, conspiring with others to commit violation of the Proclamation, etc. In view of this in addition to the above monetary penalties, section 12 of the Proclamation provides that any form of tax offence is a violation of the criminal law of Ethiopia and will be charged, prosecuted, and appealed in accordance with Ethiopia criminal procedural law.

Activity – 3
1. What is output tax?

2. What is input tax?

3.2 Excise Taxes

1) Introduction

Excise taxes are taxes levied on particular products and services, typically with discriminatory intent. Sometimes, they refer to the profits of fiscal monopolies. Excise taxes are also called selective sales taxes. In most countries, a large share of excise revenue comes from tobacco products, alcoholic beverages, and petroleum products, which are the traditional excisable commodities. Excises are also levied on a variety of other items such as motor vehicles, soft drinks, sugar, cement, entertainment, insurance, and consumer luxuries.

2) Imposition of Excise Tax

The excise tax of the country is imposed with three objectives in mind: to improve government revenue, to improve equity by imposing tax on luxury goods and basic goods which are demand inelastic, and to discourage the consumption of goods that are hazardous to health and which causes social problems. The current excise tax is

governed by excise tax Proclamation No 307/2002. This Proclamation is divided into seven sections and thirty-eight articles. The summary of the articles is given below.

3) The Rate, Base and Payment of Excise Tax

The excise tax is paid on imported as well as locally produced goods listed in the table below at the stated rate. For locally produced goods the excise taxes computed based on the production cost (excluding depreciation cost) of the goods, whereas for imported goods the tax base will be cost, insurance and freight (C.I.F.).

As far as payment of excise tax is concerned, excise tax on locally produced goods will be paid by the producer not later than 30 days from the date of production. For imported goods the tax is to be paid by the importer at the time of clearing the goods from Customs area.

The schedule attached to the proclamation provides the following list of goods that shall be liable to excise tax when either produced locally or imported and the rates at which they are taxed.

<u>Type of Product</u>	<u>Excise Tax Rate (%)</u>
1. Any type of sugar (in solid form) excluding molasses	33
2. Drinks	
2.1 All types of soft drinks (except fruit juices)	40
2.2 Powder soft drinks	40
2.3 Water bottled or canned in a factory	30
2.4 Alcoholic Drinks	
2.4.1 All types of beer & stout	50
2.4.2 All types of wine	50
2.4.3 Whisky	50
2.4.4 Others alcoholic drinks	100
3. All types of pure Alcohol	75
4. Tobacco & Tobacco Products	
4.1 Tobacco Leaf	20
4.2 Cigarettes, cigar, cigarillos, pipe tobacco, snuff and	

Other tobacco products	75
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5. Salt	30
6. Fuel-super Benzene, Regular Benzene, Petrol, Gasoline and other Motor Spirits	30
7. Perfumes and Toilet Waters	100
8. Textile and Textile products	
8.1 Textile fabrics, knitted or woven of natural silk, rayon, nylon, wool, or other similar materials	10
8.2 Textile of any type partly or wholly made from cotton, which is gray, white, dyed or printed, in pieces of any length or width (except Mosquito net and of “Abudgedid”) and including blankets, bed sheets, Counterpanes, towels, table clothes and similar articles	10
8.3 Garments.....	10
9. Personal adornments made of gold, silver or other materials	20
10. Dish washing machines of a kind for domestic use	80
11. Washing machines of a kind for domestic purposes	30
12. Video decks	40
13. Television and Video Cameras	40
14. Television broadcast receivers whether or not combined with Gramophone, radio, or sound receivers & reproducers	10
15. Motor passenger cars, Station Wagons, Utility cars and Land Rovers, Jeeps, Pickups, similar vehicles (including motorized caravans), whether assembled together with their appropriate initial equipment:	
15.1 Up to 1,300 C.C.	30
15.2 From 1,301 up to 1,800 C.C.	60
15.3 Above 1,800 C.C.	100
16. Carpets	30
17. Asbestos and Asbestos products	20
18. Clocks and watches	20
19. Dolls and toys	20

Every taxpayer is required to maintain books of accounts and supporting documents in accordance with proper accounting principle and in a manner acceptable to the Tax Authority and submit every 30 days to the Tax Authority, in a form, which is supplied by the Authority, a declaration containing such information that is necessary for proper collection of the tax. Any taxpayer is subject to administrative penalty if he fails to comply with the requirements stated in this proclamation.

A person who fails to file a timely return is liable for a penalty equal to 5% of the amount of tax underpayment (which is the difference between the tax required to be shown on the return and the amount of tax paid by the due date) for each month (or portion thereof) during which the failure continues, up to 25% of such amount. The penalty under for such late filling is limited to Br 50,000 for the first month (or portion thereof) in which not return is filed. However, this penalty can not be smaller than Br 10,000 and 100% of the amount of tax required to be shown on the return, whichever is lower.

In addition to the penalty if any amount of tax is not paid by the due date, the person liable is obliged to pay interest on such amount for the period from the due date to the date the tax is paid at 25% over and above the highest commercial lending interest rate that prevailed during the preceding quarter.

Illustration

Lem Sugar Factory incurs the following costs and expenses for the production of sugar in the month of Sene 1996.

Raw material used	Br 1,200,000
Labor used	80, 000
Repair and maintenance of factory machinery	16,000
Utility expenses (Applicable to production Dept.).....	36,000

Required: Compute excise tax for the month

Solution:

Total cost of production = Br 1,332,000

Excise tax rate	<u>33%</u> Excise Tax	<u>Br439,560</u>
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Summary

VAT and Excise Tax are among the taxes that exist in the federal tax system. The Federal Government has issued VAT and Excise Tax Proclamations.

VAT is imposed on every taxable transaction by a registered person, every import of goods, other than an exempt import and an import of services as provided in Article 23.

VAT is imposed at 15% of the value of every import of goods, other than an exempt import and an import of services as provided in Article 23 unless the transaction is exempt or zero-rated. When the transaction is exempt, no tax is imposed on it. If however the transaction is taxable, the rate could be a standard one .i.e. 15% or it could be zero-rated.

As was mentioned earlier there is excise tax which is imposed on certain goods. This tax is imposed with a view to reduce the consumption of certain goods that are hazardous to health and goods which are causes to social problems. Similarly this tax is also imposed on luxury goods and goods which are demand inelastic. The excise tax proclamation gives a list of the type of taxable goods and the rate at which they are taxed.

Like in the case of other tax legislations, VAT and Excise Tax legislations lay down rules on the administration and enforcement of these taxes. In this respect a number of obligations are imposed on taxpayers and other persons. The Tax Authority is required to administer these taxes.

Review Questions

- 1) Discuss the imposition of VAT and Excise Tax.
- 2) What is zero-rating?
- 3) Discuss the difference between VAT exemption and zero-rating.
- 4) What is the basis for the computation of excise tax?
- 5) Explain the purpose of imposing Excise Tax.
- 6) Which goods are subjected to Excise Tax?

Exercises

- 1) In Megabit 1996 E.C Anbessa Share Company, with head office in Addis, purchased items with a total invoice price before VAT of Br 300,000 from a VAT registered business in Ethiopia. Anbessa exported 60% of the items to a firm in Japan with a selling price of Br 270,000. The remaining 40% of the items were sold in the domestic market with a selling price of Br 220,000.

Required: Determine Anbessa Company's total VAT liability for the month of Megabit 1996 E.C.

- 2) Assume that Medeset Company is not registered for VAT. In the year ended Sene 30, 1998 E.C, the company's outputs total Br 128,000 and it has inputs costing Br 40,000 plus VAT at 15%.

Required: How much profit does the company make for the year, if the company registered for VAT voluntarily?

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