
UNIT 1: AN OVERVIEW OF TAXATION

Contents

- 1.0 Aims and Objectives
- 1.1. Introduction
- 1.2. Definition
- 1.3. Historical Development of Taxation
- 1.4. Objectives and Principles of Taxation
 - 1.4.1. Objectives of Taxation
 - 1.4.2. Principles of Taxation
- 1.5. Characteristics of a Good Tax System
- 1.6. Classification and Choices of Taxes
 - 1.6.1. Single Vs Multiple Tax
 - 1.6.2. Proportional Vs Progressive Taxes
 - 1.6.3. Direct Vs Indirect Taxes
- 1.7. Taxation of Capital Gains
- 1.8. Expenditure Tax
- 1.9. Government Revenue
- 1.10. Theories of Taxation
- 1.11. Summary
- 1.12. Answer to Check Your Progress Exercise

1.0 AIMS AND OBJECTIVE

When you have studied this chapter you should be able to

- Define what tax mean
- Explain the principles of taxation
- Describe the characteristic that make a tax system good
- Identify the pros and cons of the different classes of taxation
- Differentiate the different theories of taxation

1.1 INTRODUCTION

Government is inconceivable without taxation. Tax is the major source of revenue needed to run a range of tax rates. Excessive tax rate, however, leads to undesirable economic effects as it induces taxpayers to change their behavior to avoid or lessen tax liabilities. In this concoction, any tax tends to discourage saving, investment and work.

Apart from raising the necessary revenue, taxes have multiple objectives. Thus, tax policies have to be designed properly in order to promote incentives to work, save invest and support economic growth and equity. Tax reform, therefore has to balance multiple objectives of taxation including, raising adequate revenue, ensuring economic efficiency and equity. It must limit unproductive taxes and tax incentives, keep differential rates to a minimum and reduce economic distortions.

In the past the government attempted to reduce the excessively high tax rates, in order to reduce distortion and encourage compliance. Continuous measures also put into practice to broaden the base remove unessential taxes and rationalize domestic indirect and foreign trade taxes. To enhance competitiveness in the global market and challenge the current globalization issue there is a need to undertake further policy measures. The attention given to reforming the tax administration, which is an integral part of revenue collection mechanism, has been minimal so far. Currently, however, the government took initiative to embark on reforming the various aspects of tax administration including taxpayer's registration tax assessment and collection.

1.2 DEFINITION

A "tax" is a compulsory levy and those who are taxed have to pay the sums irrespective of any corresponding return of services or goods by the

government. The tax, pays do get many benefits form the government but no tax-payer has a right to any benefit form 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.

A tax is a liability imposed upon the tax assessed who may be individuals, groups of individuals, or other legal entities. It is a liability to pay an amount on account of the fact that the tax assesses have income of the minimize amount and form certain specified resources, or that they own certain tangible or intangible properly or that they easily on certain economic securities which have been chosen for taxation. Thus a tax is generalized exaction it may be noted that a public receipt containing an element of compulsion does not automatically become a tax.

Public authorities charge prices for specific service or goods supplied by them. Here the individuals and firms etc pay voluntarily, for the purchase of these goods and services but the element of compulsion is not always missing. If the authorities have a monopoly of the good or service in question (such as the city bus service) and if they choose to charge a price in excess of the competitive one (that is the cost of production inclusive of a normal, profit), then the 'excess' price paid becomes a tax for the buyers. We must however remember that it is not easy to separate the elements of pure price and taxation is such situations and the problem becomes more complicated when the public undertaking have a high costs of production on grounds of inefficiency. Again, there may be some goods or services regarding which the 'consumers' have no choice the authorities may thrust the supplies on them compulsorily and collectively even when all the members of the society do not want them.

This does not excuse the list of public receipts, which contain an element of compulsion. We can also mention the special assessment', the fee and fines. A special assessment (or a better way levy) is a kind of special

charge levied on certain member of the community who are believed to be the beneficiaries of certain government activities or public projects for example, due to provision of parks or other facilities, the land values in the neighborhood may go up. On account of the provision of irrigation facilities the productivity of the irrigated lands increases and the land prices move up such benefits are not due to the efforts of the property owners. They got an 'un-earned increment' which the authorities would like to take away for various reasons. Being a compulsory payment a betterment levy is like a tax.

Fines (such as court fines) are also compulsory payments but they are different from taxes because fines are imposed to curb certain offences and not to get revenue for the state. In this sense fines are not taxes similarly, import and export duties may be imposed with different intentions in mind. If the intention is to get the revenue for the public treasury, they are taxes, but if the intention is to regulate the flow of imports and exports, then they change their character.

The authorities also charge fees for certain services such as registration of marriage, births and deaths. However, quite often the fees charged are far in excess of the cost of these services (except, probably, in the case of health services). To the extent that the fees charged represent the cost of services, they are like prices. But the excess charges are in the nature of a tax.

There are certain other sources of public income also which, to some extent, are like compulsory levies upon the public. One such important source of public income is deficit financing. Ordinarily, deficit financing but the excess charges are in the nature of a tax.

There are certain other sources of public income also which, to some extent, are like compulsory levies upon the public. One such important

source of public income is deficit financing. Ordinarily deficit financing means an excess of public expenditure over public revenue. This excess may be met by borrowing, from the market, borrowing from abroad, as the use of printing press. In the case of borrowing from abroad, as the case of printing press. In the case of borrowing from abroad, those cannot be any compulsion for the lender, but in the case of internal borrowings there can be. The government may force various individuals. Firms, corporations and other institutions to lend to it by the virtue of this compulsion, it may be able to get loans at rates lower than what the lenders would be able to get by investing their funds otherwise this amounts to a kind of taxation in the sense that the government does not pay to the lender which they could get otherwise. On the other hand, instead of borrowing, the government may choose to use the printing press. When the government spends the additional funds so created, the aggregate demand increases and prices are pushed up. The government purchases away a part of resources and the market is left with smaller supplies in other words the government through the use of the printing press, takes away some resources of the markets just as it could tax them directly.

If voluntary gifts are made to the authorities, such as during a war, then such an income is neither in the nature of a tax nor a price.

1.3 HISTORICAL DEVELOPMENT OF TAXATION

- In ancient Greece the cost of public activities was directly financed by the rich members of the community
- Then, later, financed by donation and these in time become regular obligations
- The increased power of the state and the extension of its activities required regular and increasing revenue. This was obtained by compulsory levies from which a system of taxation developed.

- One of the early forms of taxation on which the Greek City-states and the Roman public relied was harbors taxes. These were a lucrative source of revenue because of the volume of foreign trade.
- By the time of the Roman Empire was established (191B.C) the bulk of the tax revenue came from land.
- Later taxation based on property was introduced.
- The vast revenue was required to wage wars, build magnificent churches and palaces and to provide for the administration of a great empire.
- Thus state treasuries were forced to seek an ever wider basis for taxation until a time comes when virtually nobody and nothing was exempted.
- This was the stage that Britain reached in the nineteenth century.
- Until well into the twentieth century, the main purpose of taxation was to raise revenue. But now it is being used more as instrument of growth, stabilization of economy and of determination of the direction of the economy

1.4 OBJECTIVES AND PRINCIPLES OF TAXATION

The major objectives of taxation is to mobilize sufficient revenue to meet the ever grow in needs of government expenditure. In addition to raising revenue, taxes have other objectives, including redistribution of income and wealth, discourage or encouraging of specific activities. A good tax system is also anticipated to following the principles of efficiency, fairness and administrative ease.

1.4.1 Objectives of Taxation

The major objectives of taxes include mobilizing the necessary revenue to finance government expenditure, distribution of income and encouraging

or discouraging of specific activities and production. Obviously, in developing countries, where government intervention in providing countries, where government intervention in providing social goods and service as well as infrastructure is huge raising more revenue is critical. Similarly in these countries uneven distribution of income and a high percentage of the population affected by severe poverty is a serious problem. Thus the role of taxation in redistributing income and wealth in these countries is very demanding. The level of saving and investment, which is an important ingredient of development, is also weak in developing countries. A tax policy geared towards promoting investment from domestic and abroad is also inevitable.

Raise Revenue

The principal objectives of taxation rest the need to raise sufficient revenue to cover the cost of government expenditure. It is clear that there is no other reason to raise tax rates or adoption of new taxes except the need to raise additional government revenue. For those countries with significant sources of revenue other than taxes, government can fund operations with less reliance on tax revenue. Countries with abundant resources such as oil and minerals could be cited as a case in point. These countries more relying on non - tax revenue sources.

It is apparent that government services are provided to society without concurrent payments, but there are some services, which some prices are attached to them. The price could be a sort of cost sharing or full cost recovery. In most cases the former is the common practice. In other words, there are instances where users of the service could pay the cost of services rendered by government wholly or partially. Nevertheless, since most services of government are indivisible and basic, it is not simple to put prices and collect the cost of those services. Hence, such costs are financed through taxes and the burden is up to the whole taxpayers.

Redistribution of income or wealth

Taxes redistribute resources through both reducing the wealth and income of the rich and transferring funds directly to the poor through government expenditure allocation. It is true that redistribution via taxation comes with economic costs. There often exists a trade off between distribution of income and other aspect of economic activities. For example, high marginal income tax rates may be desirable for equity reasons, but may create incentive to reduce work effort or may cause income and capital to be shifted outside the country to avoid taxation. The high tax rate would also put deterrent effects to attract foreign investment. The quality of government expenditure policy also matters realize the redistribution objectives.

Encourage or Discourage Activities

Any tax system can encourage or discourage certain activities. In this regard, taxes can be used to correct market failures, such as positive or negative externalities the tax system can serve as a tool to correct externalities. A tax on pollution may correct market failure by imposing additional cost on polluting agents. In addition excise taxes on goods that have bad effects on health, moral and social setting of the community, would discourage the consumption and production of such goods. The levy could be by imposing relatively higher or special taxes like excise on the goods.

On the other hand, taxes can apply to encourage some activities or the production and consumption of some goods. Tax provisions related to encouraging the production and consumption of basic goods as well as healthier and basic services are treated positively. In this context high tariff on import duty serves to protect domestic infant industries from foreign completion. Further more, tax policies are designed to support industrial development, export promotion, rural development and development of back ward regions of a country.

1.4.2 Principles of Taxation

There are three basic principles of taxation, namely efficiency fairness and administrative feasibility. In fact these are easier to say than to apply in specific circumstances.

Efficiency

Traditionally efficiency in the tax system focused on neutrality. Since any tax system incorporates distortions minimizing its interference is very essential. A change in the selection of products, a choice between work and leisure, or a choice between present and future consumption are major aspects of economic distortions arise from taxes. Distortion originated from any tax system can be summarized in to the income effect, the substitution effect, and the financial effect.

Under the income effect taxes reduce the amount of resources available to the taxpayer. The incidence of income effect can be demonstrated by taxes on wages. As, taxes reduce net wages; one makes choice different from those he would make if wage were not subject to tax. The substitution effect attests when individual change behavior by choosing non-taxed activities or goods over taxed activities or goods, or lightly taxed over highly taxed ones. The financial effect arises as taxpayers change the organization or structure of their activities because of taxes.

Naturally, although the magnitude varies from tax to tax, all taxes distort against some thing, Income taxes reduce incentives to work, save and consumption. It is worthwhile to mention here that taxes can damage or encourage economic efficiency. In this connection, it can reduce incentive to work, or invest. Highly progressive taxes with very high tax rates are cases in point. Carefully designed taxes, however , can improve efficiency by encouraging desirable activities.

Fairness

The tax system is expected to be fair in the sense that each taxpayer should contribute his/her "fair share" to the revenue basket. The issue of fair share is viewed from two angles, namely, the benefit and the ability to pay principle. The benefit principle, argued that those who benefited from the services of government should pay taxes. It is justified by taxing a group or citizen who are directly benefited by the service under consideration.

Contrary to the benefit principle, the ability to pay approach considers the tax liability as its direct concept- a compulsory payment to the government, with out any claim. Accordingly a citizen is paying tax, as he can, and his relative paying capacity determines his relative share in the total tax burden.

The ability to pay principle further defined as horizontal and vertical equity. Horizontal equity refers equal taxation of persons with equal abilities to pay. It holds the notion of ability or capacity to pay, those who have the same ability to pay should bear the same tax liability.

In the case of vertical equality to pay principle calls reasonable differences in taxation of individuals with unequal ability to pay. In this regard, the tax liability increases at a more rapid rate than income or wealth.

Fairness, however considers several possible conceptions. Form its ordinary view fairness could require that all individual pay the same amount of tax. This requires designing a tax system that imposes an equal amount irrespective of several considerations including the level of income .A head tax on each individual could be cited as an example. Fairness advocates all tax payers to pay the same rate on their income. The flat tax or single rate tax are popular in this aspect.

On the other hand, however, fairness could be also explained by higher taxes on higher income. This consideration is argued on the bases of ability to pay with the result that the rich are better able to contribute to finance government operations. In this connection progressive taxes are advocated on the basis of the following principles.

- A) A certain minimum standard of living should be protected in the interest of health, welfare efficiency,
- B) The marginal utility of income declines as income increase so that the sacrifice of any given fraction of income is less painful for a higher income person than for a low income person, and
- C) Reduction in economic inequality is politically and ethically desirable.

On the other hand, others argue the question of consumption taxes versus income taxes. Consumption tax supporters questions whether any income tax system can be fair. In this context, income is what individuals contribute to society; consumption is what they take away from the purse. Therefore, the economy could be benefited when it taxed consumption rather than income. Income taxes impose higher taxes on households with higher saving. As such, the income tax system penalizes savers over those who consume currently. Further more, consumption is a better measure of an individual's ability to pay.

Indeed, there is counter argument that income tax claimed as a net increase in economic wealth is better measurement of ability to pay than the use of income. Under a consumption tax, every consumer is equally treated by the tax rate irrespective of the level of income.

Administrative Feasibility

As any activity, tax collection has significant cost. The cost could be direct or indirect. The cost attached with tax administration of government is considered as direct costs, while the cost born by

taxpayers is indirect costs. The nature of tax could influence both direct costs. If the tax system is simple and clear its cost could be low, while very complicated and complex tax laws and systems entails substantial administrative costs both from the taxpayers and tax collectors point of view. thus to minimize the cost of tax admonition, the tax system should not be complicated , difficult to administer and understand and in interpretation and legal disputes

If the tax system is complex and complicated ,it requires the tax office to assign significant financial and human resource as well as equipment and the taxpayer to employ -qualified accountants. Tax simplicity is therefore an important administrative advantage and necessary to minimize waste of resources. Indirect taxes on production and sales are relatively simple than direct taxes on income wealth. Moreover, foreign taxes that are collected at point of entry or exit are very simple to apply than taxes on domestic production and sales taxes. Withholding and presumptive taxes are important mechanisms to minimize economic cost of taxation.

1.5 CHARACTERISTICS OF A GOOD TAX SYSTEM

Tax revenue has occupied the most important place in the revenue system of almost all the governments. On account of this and other reasons theory of taxation has always occupied an important and leading position in the discussions of public finance, various aspects of the problems have been brought into focus, and the discussion has not always been about one or the other aspect only. Thus, in some cases, the problem has been viewed from administrative angle; in other cases, the debate has been about the objectives which the tax system should aim at under different circumstances. Various kinds, forms, rates and timings of taxation have been analyzed and discussed. There are also analyses of the incidence and effects of various tax measures, and so on.

It would be helpful in this connection, the following points are kept in mind.

Firstly, it should be noted that taxation is only a part (though an important one) of the total budget of the government. On the revenue side, there are items other than taxation. To consider a tax system in isolation from other items of public revenue, or public expenditure, would be an incomplete and unrealistic attempt. The effects of any tax system are always intermixed with those of non-tax expenditure parts of the public budget. Of course, in cash taxation happens to be a major part of the public revenue, its share in the total of effects would be correspondingly greater within the overall framework of the total revenue, the effects of taxation will depend upon the structure of the tax system, the tax rates and so on. Equally important is the consideration as to what is being done on the expenditure side of the budget, since that will influence the attitudes and reactions of the taxpayers. This reactions will be conditioned by whether they believe public expenditure to be wasteful or productive, and so on.

When we consider the effects of taxation and thereby try to figure out the characteristics of a good tax system, it is not implied thereby that the non-tax items or the public expenditures should be ignored. It only implies that for the sake of clarity of analysis and understanding, a step-by-step approach is being adopted. It must also be remembered that though non-tax items by public revenue are there, tax forms a major portion of the public revenue in most countries. Quite a substantial portion of the national income fronts through the hands of the public to those of the authorities by way of taxation. Therefore, only for the sake of convenience of analysis the characteristics of a good tax system may be formulated in isolation. It is assumed here, implicitly, that the public expenditure side of the budget is being administered in an optimum

manner or at least it is not working against the objectives of the tax system.

Secondly, a tax system has many dimensions. We should look into its volume, composition, rates, coverage, timings of collection, mode of collection and so on in order to grasp its effects in their totality. Alternative sets of those tax features would form alternative tax systems. Each system will have effects different from those of the other. Each system will have its merits and demerits in terms of these social and economic effects, and therefore, quite a number of these sets will claim our attention as the possible first choice. Thus in general, it is rather difficult to evolve a tax system which is the best or ideal in every respect. The choice will have to be between different conflicting objectives and effects; a larger gain in terms of some objectives will normally entail a larger loss in terms of the others. To put it in conventional terminology, no tax system will be the 'best' in an absolute sense, and a 'trade-off' will have to be there as between different objectives. Depending upon our preference (or value judgments) we may opt to a particular tax system.

Thirdly, we must keep in mind that a tax system which is theoretically the best need not be the one which can be put into practice also. In abstract theory we may talk of the marginal utility and disutility of various tax measures. But in reality, there are various difficulties both conceptual and practical. It is not easy to translate these concepts into concrete terms. Furthermore, though in theory various tax proposals may appear very sound and coming, quite a few of them cannot be implemented due to administrative, political or other difficulties. In theory, it is assumed that a government has an absolute right over the property of all its subjects, in practice it is not a right which can be exercised fully and without limits. Apart from this it is generally assumed that the administrative machinery is efficient and honest. In real life these ideal conditions are seldom satisfied. In a number of cases the members of the tax-enforcing

machinery may not be suitable trained to handle differing situations arising in connection with the performance of their official duties. They may even be indifferent to, or ignorant of the exact legal procedures. They may go too literally by the word of the law and thereby harass taxpayers. Also, it is possible that they may even join hands with the tax dodgers. Again, some taxes, though theoretically sound, may involve a heavy cost of collection. In some countries, there may be long drawn legal procedures (such as passing of the tax measures by legislative bodies) preventing the government from changing its tax policy quickly and easily. In actual practice, therefore, the government has to think of these various problems while working out the best possible tax system in the country. It will generally settle for a compromise between these conflicting considerations and therefore end up with a tax system, which is not a perfect or ideal one. Furthermore, it is conceivable that even the government may fail to make correct estimates as to the effects of different tax-measures, and their appropriate rates. This limitation further supports the earlier statements that an ideal tax system is unlikely to be adopted in practice.

Fourthly, the attitude of the taxpayers is an important variable determining the contents of a good tax system. It may be assumed that such a taxpayer would like to be exempted from tax paying while he would not mind if others bear that burden. In any case, he would want his share to be within the general level of tax burden being borne by others. If this is not so, he will feel exploited. To put it differently, it is essential that a good tax system should appear equitable to the taxpayers. Similarly, overall burden of the tax system is of equal importance. The attitudes of the taxpayers 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.

Fifthly. It is well known that changes in a tax system can be brought about only slowly and in stages. Even if it is decided to have an entirely new tax system the authorities cannot suddenly disrupt the whole old system. They have to gear their tax-machinery to the new system. On account of the above-mentioned limitations, the authorities cannot hope to satisfy all the objective or considerations, and have to be satisfied with a compromise between them.

In general, 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 attitudes and problems of the taxpayers and should not lose sight of the administrative practicability or the goals of social and economic justice. It should also yield adequate revenue for the treasury and should be flexible enough to move the changing requirements of the state and the economy./ the dynamism of the tax system is all the more relevant for a developing economy where the structure and rates of taxes have to be constantly reviewed.

We may say that the interests of the administrative machinery, the economy, the state and the individual tax-payers can be conflicting and a good tax system will try to accommodate them all in the best possible manner.

A good tax system recognizes the basic rights of the taxpayer. The taxpayer is expected to pay his taxes but not undergo harassment. With this in view, tax laws should be simple in language and the tax liability should be determinable with certainty. The mode and timings of payment should suit the convenience of the taxpayer to the extent possible. At the same time, a tax system should be equitable as between different taxpayers. It should be progressive so as to levy an equitably burden on all.

Developed free market economics are subject to cyclical fluctuations in their incomes and employment. A good tax system should be flexible enough to countries, on the other hand, the main problem is not that of cyclical foundations, but of the need to unleash the forces of the economic growth and productivity. For this all the possible source of savings and capital accumulation should be exploited. Paucity of private savings and investment necessitates a greater reliance upon the budgetary savings as a main source of capital accumulations. In the private sector, the tax system should encourage the consumers to go in for durable consumption goods. This will reduce this expenditure on consumption items over time and release larger amounts for savings. Heavy import duties should be used to curb import of and cut the demonstration effect. Within the economy, the demand for luxuries should be reduced while the consumption and production of health-giving and efficiency -producing goods should be encouraged.

Another problem that a developing country like Ethiopia faces that of regional disparities. Tax measures should be so devised as to counteract this tendency and bringing about a more equitable economic growth. In the process of economic growth, a developing country is likely to face the problem of inflation. A good tax system should help in counteracting the inflationary forces. It should be designed to discourage unnecessary consumption and to help in boosting up production along desired lines.

It can be argued that all 'direct' taxes related to income and wealth should be replaced by a single tax on expenditure. The case for expenditure tax is supposed to be stronger in a country like Ethiopia since it rewards savings and taxes consumption. However, this tax has practical limitations. It poses difficult problems of data collection, and is administratively very cumbersome. Moreover, if applied universally, it is not equitable between different income levels.

1.6 CLASSIFICATION AND CHOICES OF TAXES

In the earlier part of this book, we had the occasion to look into various characteristics of a good tax system as judged from various objectives of the society. However, even after these general considerations as to the objectives of the society and the principles involved in the distribution of tax burden etc, the crucial question of choosing between different possible taxes and their rate schedules remains. In this chapter, we shall therefore look at different kinds of taxes and their merits and demerits in terms of the objectives of equity, efficiency, simplicity, resource allocation and so on. It would have been ideal if each tax happened to contribute to some or all these generally accepted objectives. In that case, there would have been no conflict between different taxes and the job of the authorities would have been only to select that combination of taxes, which yielded the “maximum” possible collective attainment of the goals of the society. Such, unfortunately, is not the case. Quite often a tax helps the economy along some of its objectives and militates against the others. In other words, a tax is usually a mixture of both advantages and disadvantages.

When we discuss the question of choice of taxes, we do not imply the State has the full authority to recast its whole tax structure. Every existing tax structure, it must be remembered, evolves over history and leads to a particular mould of the economy. Accordingly, politically and economically, the choice of changing the tax structure is only within limits. The discussion regarding the merits and demerits of different forms of taxes is only meant to be a general guide indicating the variables, which the authorities should keep in mind in their efforts at tax reforms. Also, it must be remembered that though we assume that state may choose any tax and any rate schedule, in practice it need not do so.

Generally, every tax variation has to have a political approval of the society (such as the approval of the legislature) before it can be adopted. Even then some tax modifications or variations can be unacceptable to the powerful sections of the people and the State may think it better not to levy them-even though on economic grounds it is desirable to do so. Furthermore, in theory, we generally assume that the government has adequate and honest administrative machinery through which the tax system can be enforced. In practice, a government may find that its administrative machinery is not adequate for particular types of taxes and because of that fact these taxes cannot be adopted. Again, the cost of collection of some taxes may be so high as to make them impracticable.

Thus, we find that theory and practice of tax structure and policy can be at variance from each other, and quite often tax proposal, which theoretically are quite sound and desirable, may have to be left out from practical point of view. However, to the extent possible, the authorities must see to it that the taxes are designed in such a way as to reduce their ill effects to the minimum and strengthen their good effects to the maximum. It is in the light of these observations that we find it necessary to study some general classifications of the possible taxes and their relative merits and demerits.

1.6.1 Single Vs Multiple Tax System

Notwithstanding the above comment, a tax system comprising of only one tax has been advocated at times in the past. Partly this was due to the inadequate understanding of the working of a complex modern economy, and partly it was the result of the belief in the concentration theory of incidence'. Conceptual and analytical inadequacies also contributed to this type of reasoning. DeMarco claimed that taxpayers are more certain of their liabilities' in a single tax and this can help in a more equitable distribution of the tax burden and in reducing cost of collection. As against these claims, however, we should note the difficult problems,

which are faced here including, for example, the identification and choice of an appropriate single tax, the determination of rate schedule, the adequacy and growth of revenue, and its role in promoting national objectives.

One simple form of a single tax is the poll tax, or the head tax which is imposed on a person simply because he is there in the society and not because he has an income, or wealth, or is following any particular trade or profession etc. According to this scheme, a poll tax is expected to be levied on each adult member of the society with the possible exemptions for the blind, deaf, insane, very old, and so on. It is claimed that a poll tax is almost neutral in terms of allocation effects. That is to say, the imposition of this tax does not distort the pattern of economic activity in the country. Since the disposable income of every tax- payer is reduced by a given amount, therefore, a direct effect on market demand and supply takes place. It is also claimed that the rate of poll tax can be adjusted to the needs of the government another point quoted in its favor is that in this system every member of the society contributes to the upkeep of the government. This makes this tax not only widespread; it also instills a sense of awareness and responsibility in the minds of the tax- payers regarding the activities of the government.

These arguments, however, are misplaced and lead us to wrong conclusions. It is highly unlikely that a poll tax would really be neutral in its market repercussions.

First, we must know that in general there are inequalities in the distribution of income and wealth in the country. Such inequalities may be too large or just moderate, but they are seldom absent.

Secondly, the requirements (and therefore the marginal utility of income) of different members of the society are not equal and as a result, an equal

absolute reduction (by way of a poll tax) in the disposable income of every tax- payer would hurt the poorer sections more than the richer ones

While the richer sections may not change their consumption pattern and absolute demand for various goods, the poorer are most likely to do so. The richer sections however, are likely to reduce their savings and investment in order to pay the poll tax and maintain their consumption standards. By itself, a poll tax is inequitable because it is more burdensome for the poor than the rich. It has no relation with the ability – to pay of the taxpayer. A millionaire would be paying the same tax as a poor peon or even a beggar. For this reason, this tax is also likely to militate against the principle of least aggregate sacrifice.

A poll tax is not likely to yield sufficient tax revenue for the public treasury because its rate would have to be fixed with reference to the poorest in the country. In other words, the rate of a poll tax cannot be very high; if it is, it will push many poor people to starvation.

In crude economies where national income mainly originated from agriculture, and where the majority of the people were more or less equally poor, a poll tax could be administratively feasible and economically acceptable. But even then, historically poll tax has existed only in conjunction with other taxes especially those on land. The use of poll tax was there in ancient Greece, Rome, and medieval Britain and even in some of the American colonies. In modern economy, however, such a tax has no place.

Another form of a single tax was advocated by the physiocrats of France in the 18th century. They created a theoretical justification for a single tax on agricultural rent. They believed that a tax could finally be paid only out of an economic surplus. Its incidence could not lie anywhere else. Furthermore, to them such an economic surplus or a net product' as they called it could and did exist only in agricultural produce. Accordingly, all

taxes would finally be borne by this agricultural surplus. To use modern terminology, they were believing in the concentration theory of incidence: they therefore advocated that the state ought to levy a tax only on agriculture and nowhere else.

As noted above, to the extent an economy's income originates from agriculture, such a tax is the only genuine one which may be chosen. In olden times, and taxes on handicrafts and trade were either not levied or were levied only to a limited extent.

The 19th century had an ardent advocate of a single tax in Henry George who wrote his famous book *progress and poverty* in 1879. Henry George provided a more sophisticated argument in favor of a single tax. He distinguished between economic rent of land from other returns on labor and capital returns on labor and capital necessitate an effort on the part of the workers and investors and tax on these returns would therefore discourage savings, investment, and other productive activities. However, with the progress of the society, land values acquired unearned increments in the nature of economic rent and the society could therefore tax this benefit away of course ask for a rate of 100% on the economic rent on an annual basis. Though in practice George's proposal remains unaccepted there have also been other advocates of this single tax. Even as late as 1932, Harry Gunnison wrote a book *The Economic Basis of Tax Reform* justifying a single tax system.

A single tax on economic rent of land has many limitations. Firstly, there are conceptual difficulties. It is not easy to distinguish between economic rent and business rent, that is a return that is attributable to investment of labor and capital in improving land.

Secondly, it is obvious that excepting in the case of improved lands; capital value appreciation (or unearned increment) may equally be associated with buildings, investments and other forms of wealth. In a

modern economy, these other forms of wealth are assuming ever increasing importance.

Thirdly, even if these conceptual and estimation problems were not there, and a single tax on economic rent of land could be imposed and collected, revenue yield from such a tax would be least likely to be adequate for the needs of modern government.

Fourthly, this tax cannot be expected to help the economy in achieving its other objectives such as those of growth. We may conclude by saying that a tax on not only economic rent of land but on all kinds of unearned increments stands justified. However, to use a single tax in the place of large number of judiciously chosen taxes is not desirable.

This leads us to assert that any worthwhile tax system in a modern economy will be a multiple tax system. It can be easily seen why this must be so. Firstly, as noted above, a modern economy is not one objective economy. It tries to forge ahead simultaneously along the paths of growth, equitable distribution of income and wealth, economic stabilization, and so on. And since no single tax can be expected to help the economy on all fronts, a choice of a multiple tax system becomes inevitable. Different taxes contribute to the attainment of different objectives. Thus some taxes would help in the redistribution of income and wealth more equitably. Some other taxes would help the economy in the direction of regional balanced growth. Still others may be needed so as to provide adequate revenue for the government treasury, and so on. A tax system comprising of a number of taxes, therefore, becomes essential in a modern economy where the objectives of the state happen to be many.

Secondly, income of a modern economy originates from many sources. It would be highly unjust to tax income originating from any one source and leave out others. Justice and equity would demand that the state should tax all the important sources of income in an equitable manner.

Thirdly, It is very likely that any single tax, while helping the economy in some objectives, would work against others. For example, a tax which tries to reduce income inequalities might discourage saving and investment and thereby retard capital accumulation and economic growth. It is necessary, therefore, that a judicious mixture of taxes be chosen so as to minimize their possible ill effects and strengthen their beneficial effects for the economy.

1.6.2 Proportional Vs Progressive Taxes

A common classification adopted is that on the basis of degree of progression of a tax. A tax is called progressive when, with increasing income, the tax liability not only increases in absolute terms, but also as a proportion of the income. If, on the other hand, the tax liability increases in the same proportion as the increase in income, and then it is proportional taxation. It would be called a regressive tax if the tax liability, as a proportion of income, falls with the increase in income. The absolute tax liability, even in the last case of course, may increase. We can say the same thing by using the term 'tax bases'. The base of tax is the legal description of the object to which the tax applies such as 'net income of an individual,' 'the value of a property', and so on. The term 'tax rate' is used to denote the amount of a tax per unit of the tax base, it would be called proportional. If on the other hand, the rate rises as the tax base increases, we have progressive tax and the tax is regressive if the tax rate diminishes as the base increases.

It will be noted that the essence of proportionality or progressiveness gives rise to a corresponding relationship between average and marginal tax rates. Average tax rate is computed by dividing the total tax liability by the total tax base. The marginal tax rate, on the other hand is estimated by dividing the change in the total tax liability by the change in

the total tax base. For example, if for an income of Birr 11,000 the tax liability is Birr 1,320, and then the average tax rate for the two incomes would be 10% and 12% respectively. The marginal tax rate would be the additional tax liability (viz . Birr 320) divided by additional tax base (namely Birr 1,000) i.e. 32%. In the case of proportional taxation, since by definition the average tax rate remains unchanged, the marginal rate always remains equal to the average rate. If the tax rate structure is progressive. Then the marginal rate would be rising as the tax base increases and would lie above the average rate of tax. In the case of regressive tax schedules, both the average and the marginal tax rates fall as the tax base increases and accordingly the marginal tax rate lies below the average tax rate.

Another term “digressive taxation” is used to distinguish between certain forms of progressive rates. Digressive progression occurs when there is a declining degree of progression as the tax base increases. Two forms of digression is generally found. In the first case a certain amount of the tax base is exempted, and a single tax rate is applied to the rest. This exemption may be a flat one or a changing amount in relation to total income. Another form of digression is where the rate schedule does not rise fast enough as the tax base increases, more precisely where the degree of progression is not constant throughout so that the addition to tax rate becomes slower as the tax base increases. This sort of digression is often found in practice in the case of income tax.

It must be remembered that the concept of progressiveness as stated above is with reference to only the money /or money-equivalent/ burden of a tax. It is not being translated into real burden or the sacrifice, which the taxpayers undergo. In terms of sacrifice, for example, a proportional income tax will be regressive because it would be involving a proportionately greater sacrifice, for example, a proportional income-taxpayers. Actually, depending upon the rate at which marginal utility of

income to taxpayers falls, even some degree of progressiveness in money terms might turn out to be regressive in its real burden.

Coming to the arguments for and against progressive, proportional and regressive taxes, it must be remembered that ideally the whole argument should run in two terms.

Firstly, as far as the burden of a tax on any individual taxpayer is concerned, it is better if we can measure it in terms of the sacrifice, which a tax imposes upon the taxpayer.

Secondly, we have to look at a tax structure in terms of its various economic and social effects such as its effects in terms of economic growth, saving investment, regional imbalances, and so on.

When we argue in subjective terms, that are in terms of the sacrifice, which individual taxpayers undergo in paying the taxes, we come in contact with the ability-to pay and benefits-received approaches. These approaches are intimately connected with the subjective formulation of the degree of progressiveness of a tax.

Economists have often viewed progressiveness of taxation in terms of relationship between the average and marginal rates of taxation. Some advocate that the rates used here should not be just nominal (as in law) but the effective ones, since actual collections differ from nominal rates on account of various exemptions, rebates and even evasion. Empirically, these rates should be estimated on the basis of actual tax collections from various income classes of taxpayers. It is also possible to devise a measure of tax progressiveness by making use of measures of inequality of income distribution.

Arguments For and Against Proportional Taxation

Proportional taxation has been advocated mainly on grounds of our inability to decide upon a precise and appropriate degree of progression.

It is argued that the case for progressive rates is based only upon the hypothesis that marginal utility of income is lower for the richer sections. It is claimed that this cannot be proved because utility, being a subjective thing, cannot be measured and inter-personal comparisons of utility are not possible. It follows that we cannot impose a large money burden upon the richer sections on ground of sacrifice. This argument, it is obvious, is quite misplaced. It is true that we cannot prove on any objective basis that the marginal utility of income, like the marginal utility of any particular good, falls as income increases. But it can safely be assumed that the marginal utility of income to a poor person will be higher subject to the condition that his capacity to enjoy income is as much as that of the richer man. Even if it is not, over a time, the poor person also learns the use of additional income as well as the rich person does, provided he is allowed an increase in income on a long-term basis. If still the capacity to enjoy income differs from person to person, it can happen both between the poor and the rich.

To put it differently, capacity to enjoy income depends upon one's inherent faculty and one's knowledge and awareness of the use of income. The knowledge of the possible uses of extra income can be imparted to every one. The inherent faculty to enjoy income however is not dependent upon the level of income one is having.

Another argument in favor of proportional tax schedule is its administrative simplicity. It is claimed that proportional taxation is easily decided and enforced, especially because complicated rate schedules and a degree of progression in each tax is not easy to work out. As we have seen above this argument is untenable when its sacrificial dimension is looked at. From that point of view, a proportional tax is really regressive and oppressive and this fact should not be forgotten. In terms of fixing the rate schedules, of course proportional taxes are quite convenient and simple. But to say that they would be simple enough administratively also

is not true. Actually in the case of proportional income tax would involve taxing every individual and family in the society irrespective of the income level. This would involve a task of estimating the net income of too many tax- payers in the country and collecting the tax also. Such a tax no longer remains 'simple' in the true sense of the term .It no longer remains 'economical' also. The cost of collection can be very high compared with the tax proceeds.

It is claimed that a proportional tax does not change the relative position of different taxpayers. They all lose the same proportion of their purchasing power and therefore a proportional tax is 'neutral' in terms of the allocation of resources of the economy to different uses. To put it differently, a proportional tax does not affect the relative demand /supply positions and therefore the developmental course of the economy. This type of reasoning is quite misleading. Firstly, it must be remembered that when the income of a taxpayer is reduced he adjusts his demand pattern for various goods and services. A richer person would tend to maintain his consumption standard by reducing his saving and therefore the consequent supply of investment funds and the demand for capital goods would fall. This in itself would retard the rate of economic growth though the state action may more than compensate the deficiency here. The poorer sections, on the other hand, will have to reduce their consumption itself and this may not be desirable from the point of view of their health and efficiency. Actually a progressive tax would appear to be far more acceptable on these grounds. It would divert potential savings of the rich into state hands and the state can use them for accelerating economic growth. It would at the same time permit the poorer sections to maintain their consumption standards.

Arguments For and Against Progressive Taxation

A very strong case progressive tax rates exist in terms of ability to pay and the corresponding sacrifice which taxation involves. This argument,

of course, is based upon the assumption that marginal utility of income is subject to a reduction as income rises. For believing in this possibility and corresponding policy prescription of progressive rates we do not have to believe in the measurability of utility or the possibility of interpersonal comparisons. Such a possibility, if it existed, would additionally enable us to construct precise schedule of tax rates conforming to the dictum that marginal disutility of tax to each citizen should be the same and that the aggregate sacrifice involved should be the least. However the degree of inequalities of income and wealth are so large that we are not likely to go wrong with a high degree of progression and a scope for reducing the aggregate sacrifice would still remain.

Lerner, in his book *Economics of Control*, demonstrates that even in the absence of known marginal utilities would be different; a movement towards equality of income would increase the total utility of income to the society. He further argues that in case the individual members of the society do not have equal capacity to enjoy income, we should still move towards equality though at a slow rate. Therefore the arguments of those who reject progressive tax rates is that in the short run progression may be within limits and only over time the degree of progression should be increased at a gradual rate. Seligman, however, persists in his belief that different individuals have unequal capacity to enjoy income and therefore rejects a degree of progression that would bring about complete income equality. He says: " Legal justice means legal equality and a legal quit which attempts to force an equality of fortune in the face of inevitable inequalities of native ability would be a travesty of justice". But the problem is that market forces create inequalities that are clearly far in excess of the possible differences in the capacity to enjoy income and as Adolph Wagner puts it, a tax system is a powerful instrument for correcting the distribution of income and wealth as determined by the market forces and the institution of inheritance.

It is found, further, that progression can be advocated on the basis of social justice also, which manifests itself in the form of taxing the people according to their ability to pay. Since progressive tax schedules try to bring about equal marginal sacrifice on the part of the payers and since through that approach the whole tax system moves towards the least aggregate sacrifice, such a tax system is just as between individual taxpayers and for the society as a whole also.

It is, however, to be noted that the case for progressive tax has been disputed on the grounds of not only non-measurability of utility and the impossibility of interpersonal comparisons of utility, but also on the grounds that a progressive tax should be adopted only when marginal utility of income falls faster than the rise in income. Actually, the very objective of imposing equal sacrifice through taxes is contested. It is asserted accordingly that the case for progressive taxation is quite weak.

Benefits received principle does not necessarily imply a progressive tax rate especially when we consider the welfare activities of the government. This approach would direct the government to tax the poor people more on account of the benefits received from its welfare activities. Even if we ignore the welfare activities of the state, it is debatable whether its arguments in detail while discussing the benefits received approach and found that depending upon our opinion we could end up advocating progressive or regressive taxation.

The degree of progression of the tax rates has an important bearing upon the process of saving and capital accumulation in an economy. Here the opponents of progression will claim that it is poor, the saving potential will be lost or reduced. However, the argument in favor of progressive taxation would be that it is only the rich from whose incomes savings can

come. Accordingly, why should not those potential savings be taxed more heavily?

Secondly, in the absence of progressive taxation the richer will be come still richer and inequalities would increase. This tendency will accentuate the process of mal-allocation of the resources of the economy in favor of luxuries at the cost of necessities. It will also lead to a concentration of economic power in the hands of the richer sections, which would be tempted to misuse them.

Thirdly, proportional taxation would endanger the health and productivity of the masses. It may also cause various forms of social and political unrest.

It is, therefore, asserted by the supporters of progression that the state should tax the richer sections more heavily to ward off the possible ill effects in terms of social and political unrest, weak health and low productivity of the masses and misuse of the nation's productive resources. Further, the state should take an active part in the economic growth of the society through its budgetary savings promotion of the public sector, provision of social overheads, and so on.

In a modern free enterprise exchange economy, progressive taxation has an additional advantage of acting as a built-in stabilizer. That is, the tax system acts as a cushion against an excessive upward or downward movement in income and prices. Since the poor are taxed less heavily, and since the poor have a high marginal propensity to consume, it provides a firm base for a minimum effective demand in the country. As income increase, it is higher incomes, which are taxed more, and during a depression, the higher income earners get larger tax relief. Thus, the economy gets a firm demand base even in a depression and its extra purchasing power is taxed away during a boom period. The tax bill varies in line with the upward or downward movement of the economy.

The degree of progression in taxation is also intimately connected with the will to work and save. The opponents of progressive taxation argue that economic progress cannot be ensured unless people work for it: and for hard work they must have adequate economic incentives. In other words, the argument maintains that unless people are able to enjoy the fruits of their labor, they would not work more and productivity in general would decline. The richer people will save less and there will be retardation in the process of capital accumulation.

One further point in favor of progressiveness is its administrative convenience. In case of proportional taxation, or regressive taxation, tax-collecting machinery has to cast its net very wide. This not only causes undue harassment to small taxpayers, it also leads to a high cost of tax collection. In the case of progressive rates (and steeper the progression, the better for it, the cost of tax administration and collection would be proportionately much lower:

1.6.3 Direct Vs Indirect Taxes

The distinction between direct and indirect taxes is not always a satisfactory or a consistent one. There has been a long tradition in economic literature to classify taxes into these two categories. One way of distinguishing between these has been in terms of the incidence of taxation. It is asserted that if the incidence of a tax rests upon the person who bears its impact also, and then it is a direct tax. If on the other hand, the incidence is passed on to others, and then it is an indirect tax. J.S. Mill, the physiocrats and others believed in this kind of distinction. However, it is obvious that such a distinction is not easy to maintain, especially because in some cases the incidence of the tax may shift partly and in some cases fully or even more than fully. Again, the shifting of incidence may differ even in the case of the same tax overtime and so on. Because of these complications, some authors tend to discard this distinction. For example Taylor says, "The terms " direct " and "indirect"

tax.... are finally distinguishable in meaning only in terms of shiftability. Direct taxes are not shifted, while indirect tax are the decline in the use of these terms can be accounted for by inability to make such broad generalization with respect to many tax measures”.

However, the distinction between direct and indirect taxes on the basis of the coincidence of impact and incidence is not the only one available. In economic literature we also come across many other bases of this distinction. For example, it has been maintained that while taxes on production are direct, those on consumption are indirect. Similarly, it has also been claimed that taxes on income are direct but those on expenditure are indirect. It would be noted that these types of distinctions do not have a sound economic basis. For example, why should we term taxes on production direct while those on consumption indirect? Both are two important activities in the economy and one cannot be sustained without the other. Similarly, to distinguish between taxes on income and taxes on expenditure would be equally faulty and more so when we notice that in terms of flow of funds in the economy, receipts and expenses are two dimensions of the same activities. If we want to have an economic basis for distinction between direct and indirect taxes, then the plausible approach would be to maintain that in the case of direct taxes the liability is determined with direct reference to the tax paying ability of the tax payer while in the case indirect taxes such an ability is assessed indirectly. For example, income tax is a direct tax. Here the tax paying ability is assessed directly in relation to the income of the assesses assuming that such an income is a true indicator of his tax paying ability also.

Indirect taxes may be specific or ad valorem. When they are imposed on 'per item' or 'per unit' basis, they are called specific. On the other hand, when the tax amount is scheduled according to the value of the item being taxed, it is ad valorem. Sales taxes are mostly ad valorem. Excise

duties, on the other hand, are sometimes specific sometimes ad valorem and some times a combination of both. Taxes on rail and bus passenger fares are usually ad valorem, but they can be specific basis, each passenger fare would be taxed equally. Since most rail passengers travel only a short distance, the tax per passenger will have to be very low. A very long distance passenger would also pay the same low tax. On the other hand, an ad valorem tax, say 10 per cent, would ensure that a passenger paying Br 2 as rail fare pays only 20 cents as tax, while the passenger paying Br 200 either due to a long distance or due to a higher-class travel pays Br 20 as tax. The yield from ad Valorem tax is more flexible and its incidence is more just.

This brings us to the question of merits and demerits of direct and indirect taxes a knowledge of which helps the government in choosing a judicious combination of both types. We are not likely to come across an economy where only one form of taxation is being used to the exclusion of the other. What would differ from one economy to the other is the exact proportion in which these are mixed.

Merits and Demerits of Direct Taxes

It is claimed that direct taxes are intimately related to the ability to pay in their case ability to pay is judged directly and not indirectly as in the case of indirect taxes. Accordingly, there are lesser chances of making an error of judgment. Direct taxes can be chosen and their rate schedules determined in such a way as to secure the maximum possible closeness to the ability to pay and the least aggregate sacrifice. In these taxes, we can determine the degree of progression that we want and thus bring about adequate social and economic justice. These taxes can be used for reducing income and wealth inequalities and thereby various social evils can be mitigated. We must, however, remember that these arguments are quite sound provided in practice a proper degree of progression of tax schedules could be chosen. Usually what happens is that authorities are

either too hesitant to adopt a fair degree of progression and therefore direct taxes fail to contribute appreciably to the reduction in income and wealth inequalities or they become extra enthusiastic in their zeal to bring about equalities. In the latter case, their policy tends to reduce the generation of national income and therefore leads to an all round reduction in economic welfare. These two are real dangers of using direct taxes for achieving a degree of income and wealth equality, but this demerit is not an inherent feature of direct taxes. It is a possibility that exists and that can be avoided.

The opponents of direct taxes would claim that since a precise degree of needed progress cannot be estimated (on account of the difficulties of measuring the ability to pay and the subjective nature of the marginal utility of income), the state would always end up with either too much or too little progression. This argument, however, cannot be used to banish the use of the direct taxes as such. Firstly, the need for direct taxes is to be recognized in terms of their ability to have progression. Secondly indirect taxes are generally regressive and discarding the direct taxes would entail a far greater movement away from the principle of ability to pay.

It should be noted that no single direct tax might be taken as a measure of ability to pay. A combination of different indices like income, wealth, expenditure, gifts, inheritance capital, gains windfalls, etc would be needed and that is why not one but a number of direct taxes should be used in a harmonious way so as to reach closest to the appropriate and true measure of ability to-pay.

It is claimed that direct taxes do not cause at all (or cause very little) distortion in the resource allocation of the economy and that they leave the tax-payers better off than do the indirect taxes is sought to be established. We shall elaborate this point under the heading "are direct

Taxes Less Burdensome?" of this chapter and we shall see that this assertion is based upon two highly unrealistic assumptions. Here, however, mention may be made of the Clowyn committee Report of 1927 in which it was argued that income taxes do not affect relative prices or production of goods and services. The committee argued that a general income tax would leave the relative profitability of different industries unaltered and would not have any effect on resources allocation. Moreover, in every firm, the marginal cost would equal price which implies that the marginal unit of output does not yield any profit and is not subject to any tax. Hence, taxation of income would not affect output also. The irrelevance of this reasoning can be easily seen. We do not have perfect markets: and the contention that market price and marginal cost of production are equated stands sufficiently discredited in favor of other hypotheses.

Revenue elasticity is another point out fourth in favor of direct taxes. In other words, as income of the community goes up, so does the tax yield from direct taxes. This is a claim, which can be made for indirect taxes as well, and such a claim, which can be made for indirect taxes as well, and such a claim need not be true for all direct taxes. When the general level of activity and income goes up in the economy, there is likely to be a corresponding increase in sales/purchase and activities it is not that income and employment can increase in vacuum. Accordingly, it is not only direct, but indirect taxes also which should be expected to increase. Also it should be noted that the authorities would not be interested only in the tax revenue as such, but also in the social and economic justice through the tax instrument. From that point of view, of course, direct taxes are often preferable.

The advocates of direct taxes assert that these inculcate a spirit of civic responsibility amongst the taxpayers. They then try to be more vigilant about how much tax revenue is being raised and to what uses it is being

put. This argument, it appears, is quite misleading. Firstly, this argument contradicts another one according to which direct taxes leave the taxpayers better off than do the indirect taxes. If this is the case, then obviously people will be less conscious of the taxes when they are being paid directly. Secondly, with this awareness of their tax liability, they would try to evade the taxes. And the practice and possibility of tax evasion and avoidance is more here than in the case of indirect taxes where the tax payers often get the impression that they will be able to pass on their incidence.

Amongst the demerits of direct taxes we may add the fact that they generally violate the canon of convenience. Indirect taxes are usually paid in installments for each transaction and so on. They can also be avoided to some extent by shifting one's expenditure pattern or reducing the total expenditure. Direct taxes, on the other hand, are generally payable in lump sum or even in advance and become quite inconvenient.

Another demerit of direct taxes is their supposed effect on the will to work and save. It is asserted that work (giving income) and leisure are two alternatives before any taxpayer. If, therefore, a tax is imposed say on income, the taxpayer will find that the return from work has decreased as compared with return from leisure. He therefore, tries to substitute leisure for work. Harberger, however, comes to the conclusion that no a priori case in favor of direct taxation can be established since both direct and indirect taxes affect the choice between work and leisure. There is, therefore, a reduction in the will to work on the part of the tax payers and this tendency is bad for the economy since it leads to an all round slowing down of economy growth. Similarly, if the authorities tax property and inheritance etc., it will cause a reduction in the will to save. Capital accumulation in the economy will suffer and there will be again a retardation of economic growth. This happens because the tax payer then starts comparing the utility from current consumption with the utility

from future income (which he shall earn through income from savings)
The tax payer may even compare the utility from current consumption with the satisfaction to the beneficiaries, the tax-payer tends to consume more himself and save less for heirs.

Two other forces, however, may counteract this possible disadvantage:
Firstly, a tax - payer may be seriously interested in leaving at least a certain amount of net inheritance or a net gift to the beneficiary in which case he would try to save more to compensate for the tax payment.

Secondly, it is also possible that the expected income from investing the saving may be so much that even such direct taxes do not have a significant effect upon saving and investment activities. These counteracting forces, however, are not likely to be general and strong. It may be stated quite strongly that direct taxes are very likely to discourage saving and investment activities (though these tendencies may be counterbalanced by other fiscal policies or other socio economic forces)

Merits and Demerits of Indirect Taxes

An important merit of indirect taxes is that they are less inconvenient, and from that point of view less burdensome (their being less burdensome from other points of view is not agreed in general). The taxpayers pay these taxes in bits and generally when they enter in to some transactions of sales and purchase. Furthermore, indirect taxes are usually hidden in the prices of goods and services being transacted and, therefore, their presence is not felt so much.

Another merit of indirect taxes is that with proper administration, the chances of tax evasion in their case are less. Excise duties, for example are quite difficult to evade if the government machinery is vigilant and there is a proper check at the points of production. Sales tax, however, is more difficult to administer especially if we allow various exemptions either to goods and services or to sellers having turnover of less than a certain amount. Furthermore, the points of sales tax are larger in number and spread over wider areas. It is for this reason that in some cases, additional excise duties are imposed in lieu of sales tax are larger in number and spread over wider areas. It is for this reason that in some cases, additional excise duties are imposed in lieu of sales taxes. But there are other indirect taxes, which are not that difficult to collect, for example, taxes on railway and bus fares. Here the points of collection are manageable in number and accounts of the transactions are usually well maintained. All told, indirect taxes are subject to far evasion than direct ones.

In an underdeveloped country, indirect taxes have a special role to play in meeting its need of additional saving and capital accumulation. Total national income being low, the scope of squeezing adequate tax revenue both for running the administration and for bringing about capital accumulation is very limited. Furthermore, in such an economy, there is usually an urgent need for providing certain basic amenities and welfare

activities such as drinking water, health services, protection against malnutrition, and soon. Given this enormous need for tax revenue, and given the limited scope of direct taxes have to play a crucial role in such economics. The only exceptions to this rule can be those economies which have would enable the authorities to finance their welfare and growth activities.

Another merit of indirect taxes is that they are a powerful tool in molding the production and investment activities of the economy i.e. they can guide the economy in its resource allocation .It is generally recognized that market mechanism by itself is not a perfect institution for the economy. It has many defects that manifest themselves in the form of not only inequalities of income and wealth, but also in the distorted patterns of consumption, production and employment. Direct taxes can be used as corrective tools in this connection. A proper structuring of indirect taxes can enable the authorities to twist the demand and supply forces in a way so as to yield desirable results encouraging higher priority industries and discouraging lower priority ones. For example an imposition of a high rate of excise duty or sales tax will raise the price of the good and discourage its demand. Reduced profitable of this item will, there fore, lead to drying up of investment in this line and diverting it to those lines where profitability is comparatively higher. Similarly, indirect taxes can also be oriented towards increasing employment or encouraging the adoption of a particular technology. For example an extra duty upon mill-made cloth, while exempting the handloom cloth from the same will act as a booster for handloom cloth and will encourage capital intensive techniques labor intensive outputs can be taxed more heavily. Similar logic applies to various situations and polices with regard to customs duties The main point to be emphasized is that indirect taxes can be highly selective both commodity wise and rate wise and thus can be designed as a powerful tool for guiding the economy.

Another advantage of indirect taxes, which makes them a versatile and selective policy tool is their flexibility. Direct taxes cannot be very selective and therefore are not so flexible, while indirect taxes are. The rates of indirect taxes and their coverage can be quite selective and can be modified more readily to suit the occasion. This is often practiced also in the case of customs duties.

Arguments against indirect taxes are only a few but powerful ones firstly it is claimed and very rightly that these taxes negate the principle of ability to pay and are therefore unjust to the poor. By their very nature (since one of the objectives is to collect enough of revenue), they are spread over to cover the items, which are purchased generally by the poor this makes them regressive in effect. For this reason, indirect taxes also militate against the objective of least aggregate sacrifice. This ill effect of indirect taxes is sought to be corrected by heavily taxing the luxury items. However, such a correction can only be partial and no more than that taxing the luxuries alone will not yield adequate revenue for the state.

Another defect of indirect taxes is that they feed inflationary forces. Direct taxes take away a part of the purchasing power of the taxpayer and that has the effect of reducing demand and prices. On the other hand, indirect taxes begin with adding to the sale prices of the taxed goods without touching the purchasing power in the first place. The result is that in their case inflationary forces are fed through higher prices, higher costs, and washes and again higher prices.

Are Direct Taxes Less Burdensome?

In economic literature, there has been a good deal of discussion as to which form of taxation is more burdensome for the taxpayer. This discussion is obviously based on the assumption that we are able to

compare alternative ways of raising the same tax revenue. It is further assumed that the public expenditure policy remains unaffected by the form of taxation, so that the superiority or otherwise of a tax does not lie in the amount of resources transferred from the private to public sector, but only in the effects which different methods of such resources transfer entail. We have already discussed the merits and demerits of both direct and indirect taxes. Here, therefore, the question of burden of the alternative forms of taxation may be viewed from the point of view of (a) a possible shift in resources allocation, and (b) a sacrifice on the part of the taxpayers. It is usual to provide this comparison by representing indirect taxation by a proportionate tax on commodities.

An indirect tax is expected to cause a shift in the relative prices of goods and therefore bring about a resource allocation, which would be different from the allocation achieved by free market mechanism. An income tax on the other hand, is expected to let relative prices remain unchanged and therefore be neutral regarding resources allocation. If we assume that the resource allocation in the absence of any tax is already optimum, then an indirect tax would, cause a distortion in it and would be burdensome to the economy to that extent. On the other hand, if the initial resource allocation is not optimum, then indirect taxation becomes an effective instrument in bringing it nearer optimum.

Miss Joseph, Hicks and others have maintained the superiority of direct taxes over indirect ones by showing that the taxpayers have to undergo lesser amount of sacrifice in satisfaction in the case of direct taxes. On welfare grounds, therefore, direct taxes are supposed to be superior.

This treatment showing the superiority of direct tax over indirect taxes however, not free from defects. Firstly, this analysis assumes that the taxpayer's are most sensitive to both the form and rates of taxes. For example, their dislike for direct taxes may be more than their dislike for indirect taxes because direct taxes are more open. Accordingly, even if

theoretically, the consumers are able to reach a higher indifference curve through direct taxes, they may not want to be taxed directly. In such a situation it is not necessary that the higher indifference curve is a preferable situation. In the same manner, the tax rates and the division of taxes between direct and indirect ones is bound to affect the relative preferences of the consumers as between one good and the other and as between money income and goods. To assume in the traditional way that no change in indifference curves would take place on account of different tax rates would amount to saying that the elasticity of demand for goods is zero in each case. This is certainly not true.

Still another defect of this approach is that it starts from a position of no tax and tries to analyze the best way in which a given amount of tax revenue could be raised. In practice, however, every economy has some taxes, both direct and indirect and what is to be decided is a change in their composition and rates. The net effects will differ according to the position from where we are starting. Given these defects, therefore, D Walker asserts, " Broadly speaking, then the Joseph-Hicks theoretical demonstration of the superiority on welfare grounds of direct or indirect taxation is only a satisfactory proof on the twin assumption of a completely inelastic supply of labor with respect to income and outlay taxes and ideal initial conditions. The term ideal conditions, we should note, refer to a position of no taxes in existence.

The Comparison between direct and indirect taxes as outlined above implicitly assumes that the resource allocation as brought about by the market demand and supply forces is an ideal one. This assumption can be challenged. Actually, as we shall have occasion to see time and again, an important reason for an effective government intervention in the market is the defective working of the later. Briefly speaking, we may put forth two arguments here. The first one relates to the popular assumption of a perfectly competitive market. It is now realized that such a market is

merely a myth. In reality a large number of market imperfections are in operation, which bring about a defective allocation and utilization of productive resources. Left to the market forces an economy may not be able to correct regional imbalances, emergence of monopolistic elements and the like. As a result, very often, the economy may not be able to generate the requisite rate of savings and capital accumulation. The second argument relates to income distribution. In a pure market economy, income distribution as between different members of the society is not based upon their relative needs, but is determined by the pricing and ownership of the factors of production. This system creates and perpetuates income inequalities. The institutions of private property and inheritance widen the income and wealth inequalities with the passage of time. Thus we build up the sequence of reasoning like the following: income and wealth distribution in the society are not in harmony with the relative needs of the members of the society. The demand pattern, which emanates from such an income and wealth distribution, fails to reflect the true needs of the society and hence the production pattern and resource allocation of the economy cannot be considered the optimum ones. There would be a divergence between private costs and benefits from social costs and benefits. There may, therefore, be a need to bring about a shift in such an allocation through tax measures. If so, indirect taxes of specific type may be preferable to direct taxes.

It may also be noted that we should not confine ourselves to a comparison between proportional direct income tax with proportional indirect taxation of all goods. A good deal of possibilities exist regarding the exact coverage and rates of both direct and indirect taxes and it is not logical to compartmentalize the comparison between two specific varieties of direct and indirect tax systems only.

Milton Friedman challenged this Joseph Hicks approach by pointing out that this treatment related to a single tax payer. It did not apply to the whole community of taxpayers because this approach was ignoring the expenditure side of the budget and the production possibilities in the economy.

One particular argument in favor of direct taxes however would be that in order to make sure that each tax-payer was paying according to his ability to-pay (in whatever way it is defined), it will be administratively and otherwise easier to collect the taxes directly, imposing indirect taxes cannot ensure the desired relative distribution of tax burden as between different tax- payers.

1.7 TAXATION OF CAPITAL GAINS

Capital gains are just one among several different forms of income from capital. Therefore, the issue of taxing capital gains must be reviewed with in a broader context of taxing the other sources of income from capital, such as interest and dividends, and this chapter should be read in conjunction with succeeding sections that deal with the taxation of other financial instruments. While exempting capital income in its different forms from taxation will help promote the development of capital markets, there is a danger that large-scale, open-ended, tax exemption for incomes from capital can seriously undermine the income tax base, particularly in the business sector.

Why tax capital gains?

Several plausible arguments can be made against the taxation of capital gains. First, it could be argued that subjecting capital gains to taxation would amount to a double taxation of income from capital. After all, the present value of a present asset is nothing else but the (discount) value of the stream of **taxable** incomes that the asset generates. An asset

appreciates in value when these incomes rise. However, these incomes are **after-tax** incomes and there is no rationale for taxing them again, and only when they raise the value of the asset. Second, it is usually impossible to tax accrued but unrealized capital gains, with the consequence that the capital gains tax is payable only upon the sale of the asset. This may cause taxpayers to **artificially** lock-in to their appreciated assets. Third, in practice it is difficult to confine the capital gains tax to only **real** rather than **inflationary** gains, and it is inefficient as well as horizontally inequitable to tax inflationary gains. Fourth, capital gains do not generally yield much revenue.

As against the preceding reasons, the principal overriding reason for their taxation and the justification for the recommendation made below is that if capital gains are not taxed, they could constitute a convenient shelter for other forms of taxation. It is interesting to note the response in OECD countries, where “there has undoubtedly been in recent years a one-way move in OECD countries to both adapting capital gains taxes if they previously did not exist or extending their scope if they did.” ^{1/} Some countries levy a separate tax on capital gains (e.g. Italy, the U.K), while some others tax them within the income tax (e.g. France, Japan, the U.S.). Another reason for taxing capital gains is that they increase one’s ability to pay. It is, therefore, argued that they should be taxed on both vertical and horizontal equity grounds. Some have argued in favor of capital gains taxation on the grounds that these gains are often windfall, unearned manna. In certain countries (e.g. Canada, Spain), capital gains are deemed realized at death and taxed accordingly in an attempt to impede the intergenerational transmission of income inequalities.

But these appear to be relatively weak arguments. In the mission’s view, the most compelling argument for taxing capital gains is that “it reinforces and protects income tax yields. While it is probable that capital gains taxes raise very little revenue (and most countries are unable to

estimate how much revenue they do raise because they generally form part of the personal income tax), it is probable that taxing them helps to protect the yield of the much more important income tax, since there are many tax avoidance devices for transforming taxable income in to less highly taxed to untaxed capital gains.”^{1/}

Although the arguments reviewed above have been generated in the context of the OECD countries, they are quite general and apply with perhaps even greater force to developing countries to the extent they rely relatively more on the business profits tax.

Present Ethiopian Practice and its Reform

Current law in Ethiopia does not explicitly refer to capital gains, but by interpretation of the business profit (income) tax law, capital gains are viewed as ordinary profits and taxed accordingly. The mission was informed that in practice, this interpretation is applied only to corporations, who are required to submit detailed audited books of account as a consequence of which capital assets would be listed. However, other businesses are not required to maintain detailed books of account and are thereby effectively exempted from the capital gains tax, even though there is absolutely no legal distinction in the definition of taxable income between the incorporated and unincorporated sectors. The mission also found that in practice, the capital gains tax levied only on physical assets, mostly because there were practically no other assets (for instance, corporations do not hold shares in subsidiaries).

How should capital gains realized by businesses be treated? As was already mentioned, the mission does not believe that exempting such gains would be advisable. Such an exemption carries the danger that a firm could shelter any profits obtained from its ordinary operations by, say, borrowing funds up to the point where the deductible interest costs equal its profits so that the profits are removed from taxable income, and

investing the proceeds of the borrowing in assets that appreciate. Such a transaction would convert taxable profits into nontaxable gains and is likely to be widely utilized.

Capital gains enjoyed by businesses should, therefore, be taxed as is implicitly done at present, but should it only be restricted to physical assets? The danger here is that in the future, with better developed company structures and financial instruments, it would become possible for firms to avoid the capital gains tax on physical assets by holding financial claims on such assets, rather than the

Steps should be taken to reduce the present discrimination against incorporated businesses, by requiring that unincorporated firms also submit proper books of account. With capital gains of businesses taxable, **realized** capital losses should, in principle, be deductible from taxable income, which they are not at present. However, this raises a practical issue of whether to allow deduction of capital losses against any kind of income or only against capital gains and other forms of capital income. In the mission's view, the authorities would be well advised to limit the capital losses offset to capital gains and other capital income so as to contain recourse to various tax-avoidance schemes. Businesses should also, in principle, be allowed to carry forward losses (current or capital), but, again for practical revenue considerations, the carry-forward should be limited to a certain number of years, say, five.

As regards individuals, the mission believes that under current conditions in Ethiopia, requiring individuals to file detailed tax returns listing their assets is administratively impossible. Further more, taxing capital gains for individuals would undoubtedly require allowing interest deductibility when the loan proceeds are used for investment—another hurdle to burden tax administration. It would, thus, seem inevitable that individuals should in general, and up to a high threshold of, say, Br 10,000 per

transaction, be exempted from the payment of capital gains taxes except in selective cases. One such case would be where the individual owns a major share hold in exceeding a predetermined threshold level, in a corporation. (Whenever dividends are paid on the shares, they would be subject to the present final 10 percent withholding tax). Should such an individual choose to sell his holdings, a capital gains tax would be administratively easy to impose. Another prominent case concerns the gains from the disposal of properties such as dwelling and office buildings. Given that mortgage interest expenses are not deductible, a condition that should be retained so as not to unduly divert scarce capital from productive uses, it would not be appropriate to tax capital gains on owner-occupied houses. This practice of exempting capital gain on owner-occupied dwellings is followed in many countries. (Rather than an outright exemption, some countries, the gains are exempted up to some limit, while in others, the exemption is conditional to using the proceeds of the sale to purchase another house). However, gains realized on the sale of second or more buildings held should be subject to the capital gains tax. The practice of confining the capital gains tax only to businesses (whether or not incorporated), but exempting individuals is shared by many other countries.

An important issue, with substantial implications for the taxation of income from capital and business profits, in general, and capital gains, in particular, concerns inflation. The latter distorts the true, real income of businesses in many ways. Interest earned, which in nominal terms will usually be higher by the extent of inflation, overstates the real income of a business; interest paid understates it; capital gain overstates it; credits by suppliers understates it; credits to customers overstates it; and so on. Partial adjustments to taxable incomes (for instance, excluding inflation at capital gains or inflationary interest received from taxable income) have proved in other countries be largely a failure, both from an

economic efficiency and administrative points of view. Full indexation, item by item, of the financial statements is inappropriate and generally infeasible, even for corporations, let alone unincorporated businesses. Besides, given the current rate of inflation in Ethiopia, there does not seem a compelling need for drastic measures.

The mission, therefore, recommends as the first-best relief for business from inflation in Ethiopia is for tax rates on profits to lower for both incorporated and unincorporated business. Another, but less preferred solution, is to accelerate depreciation, so as to mitigate the historic cost effect on depreciation allowances of inflation lowering them in real terms. Given the relatively low recent rate of inflation in Ethiopia (about 10 percent per year), the acceleration needed is not drastic. For instance, shortening the life of an asset for depreciation purposes by an average of 25 percent to 50 percent may suffice. The acceleration of depreciation could be either stated in the law on a permanent basis or provided on an ad hoc basis when inflation is higher than usual. In the latter case, the acceleration should apply to the remaining life (for depreciation) of all assets purchased before the acceleration was announced. This solution of accelerated depreciation is second best in the mission's view, because it has the possible disadvantage of artificially promoting investments. Another, not mutually exclusive, solution is to readjust on a one-shot basis the historical cost of depreciable assets in the event of a substantial price shock (e.g., devaluation of the birr), so that the depreciation allowances would be automatically increased in nominal terms.

A method that is employed in some countries to lessen the scope of taxing inflationary capital gains is to distinguish between long-term capital gains and short-term capital gains. The rationale is that a greater portion of the long-term gains is likely to be of an inflationary nature. Hence, a lower tax rate or exemption should apply to long-term gains. Even though it may be argued real capital gains should not be taxed, but only nominal

gains because interest earned is taxed (or, more importantly, interest paid is deductible) on a nominal basis, the authorities would still be advised to draw some distinction between long-term and short-term capital gains. However, the spread between the two applicable tax rates should not be excessive, otherwise the scope and incentive for tax-avoidance increases.

Another aspect of inflation is its effect on tax brackets, exemption levels, etc. it is recommended that the authorities examine periodically all the income and profit tax brackets, exemption levels, the newly recommended agricultural tax levels, and the **specific** (as opposed to ad valorem) taxes and excises, adjusting them in accordance to the change in the purchasing power of the birr.

Urban Land Leases

At present, urban land is owned by the government, which assesses and collects annual land use fees (essentially equivalent to property taxes). ^{1/} The authorities believe that the revenues so collected seriously lag behind the increased needs for (a) building infrastructure; (b) providing social services to urban dwellers; and (c) building dwelling houses for low income groups. Maintaining that “the present system of landholding and utilization” makes it “difficult to control discriminatory treatment of applicants and corruption,” a new Urban Lands Lease Holding Proclamation (No. 80.1993) was enacted on December 23, 1993. The Proclamation recognizes that “for the economy of urban centers to grow,” it is essential that real estate developers “have land tenure terms long enough to enable them to plan their activities in advance, to recover their capital expenditure, and to enjoy secure land holdings.” But at the same time, the Proclamation asserts that “the need to promote the economic development of urban centers necessitates the control of appropriation of unjustified gains realized during the transfer of the right to use urban land whose value has appreciated.”

The Proclamation provides that leases will be granted for a period of up to: 99 years for urban land allotted for dwelling houses for private use; from 60 to 99 years (depending on certain characteristics of the urban center) for rental dwellings; from 60 to 95 years for industrial use; from 90 to 99 years for education, science, technology, culture, health and sports uses; and from 50 to 90 years for other use. To avoid speculative leasing, the Proclamation requires anyone who has been granted a land lease to start utilizing the land within a fixed time limit.

Rents are to be determined by public tendering but not below minimum levels determined by town officials. These minima should take in to accounts certain characteristics of the urban center (e.g. zoning), and the purpose for which the particular piece of land is to be used. Some percentage, yet to be decided, of the rents for the whole duration of the lease are payable up front. The Proclamation specifies that “each town administration shall use at least 90 percent of the revenue collected from land lease... for building urban infrastructure and for the construction and expansion of low cost houses”. The Proclamation also specifies that when the lease expires, the lessee has the right to renew the lease at a rent which will be determined by the town administration in accordance with the then going rates. If he does agree to pay this rent and renew the lease, the land goes back to the Government and he is entitled to appropriate compensation for the property on the land.

Another provision of the Proclamation regulates the conditions under which a holder of a land lease can transfer his rights to another person. The Proclamation forbids the holder from collecting for the transfer “income which is higher than the rent of land he paid”; and, if he does he is obliged to pay the difference to the town administration. In effect, this amounts to a 100 percent capital gains tax.

In the mission's view, this Proclamation is an important step towards a market-oriented urban development. Nevertheless, in its present version, the new land lease system suffers from some serious flaws that need to be corrected for the following reasons: (a) some difficulty arises with respect to the duration of the land lease, which even though quite long is nonetheless still limited. A dollar to be received one hundred years from now is worth less today than six cents at an annual real rate of interest of 3 percent and less than one-tenth of one cent at a 5 percent real interest rate. Therefore, for a person contemplating leasing a piece of land for urban development, the 99-year lease duration does not really constitute a meaningful obstacle. However, future improvements of the land and the property on it will be seriously hampered; (b) the determination of the new rent at the time of expiration of the existing lease and the appropriate compensation for any existing property on the land in case the lease is not renewed are both extremely unpleasant bureaucratic hurdles that should be avoided; and (c) in the mission's view, a system that taxes capital gains up on the transfer of land at a rate of 100 percent is economically unsound and administratively unenforceable. Furthermore, in the most likely event of a transfer of a plot of land with a structure built on it, a meaningful distinction between the price paid for the land and the price paid for the property would not be possible.

The mission, therefore, recommends that leases be granted in perpetuity to not erode incentives for land development and improvement, and to avoid the unnecessary process of administering renewal rental rates, or assessing appropriate compensation for property if the land lease is not renewed. The mission also recommends **free** transfers of land leases, together with any property established on the land, with the laws of supply and demand determining the prices (either for the land or for the land together with the property on it, as the case may be). The major objectives of the Proclamation regarding revenue can be achieved in an

economically and administratively superior way by (a) taxing capital gains from such lease transfers with the revenue accruing to the town administration (however, capital gains on owner-occupied houses should be exempted from tax as noted earlier); and (b) encouraging the town administration to revise the present property taxes so that increases in property values are reflected in property tax assessments on an annual basis, which is the proper vehicle for capturing on a recurrent basis, accrued increase in property values.

Rental Income

Proclamation No. 62/1993, dated July 30, 1993, calls for a preferential tax treatment of rental income. It allows for rental income to be taxed separately from other incomes, and at generally lower rates, both for incorporated and unincorporated businesses. Rental incomes of corporations are taxed at a reduced rate of 35 percent, compared to an ordinary rate of 50 percent. Unincorporated businesses and individuals can earn up to Br 1,200 a year in rental income tax-free and then pay at a graduated rate, starting at 10 percent and reaching 45 percent for rental income in excess of Br 50,000 per annum, irrespective of how much other incomes they earn. In addition, individuals and unincorporated businesses who do not maintain books of account may claim generous, non itemized allowances (20 percent of gross income) for depreciation, repairs, and maintenance.

The need to promote a rental market for residential, commercial, industrial or other structures, notwithstanding, the mission cannot endorse such a preferential tax treatment of rental incomes. This is because it distorts the allocation of new investments. Capital is not directed to its most efficient uses, but would be attracted to buildings

from other, presumably, more efficient channels. Such differential tax treatment of rental income also opens a wide door for tax avoidance by rearranging incomes and expenses. For instance, it will always pay corporations to shift their debt from rental activity to other activities in order to benefit from a higher tax rate (50 percent instead of 35 percent) on the deductibility of the interest on debt.

The principal recommendation of the mission is to combine rental income with ordinary income and subject the combined taxable income to either the corporate tax rate or the unincorporated business profit tax schedule, as the case may be.

1.9 EXPENDITURE TAX

Forms

Conceptually, expenditure tax may be formulated in three alternative forms, namely, those of (i) commodity taxation (ii) personal consumption expenditure taxation, and (iii) as a base for corporate taxation.

Of these three forms, the most widely used form is the commodity taxation and covers excise duties, sales tax, turnover tax, value add tax, etc. These taxes are expected to be finally paid by the consumers. But this conventional form of commodity taxation is not likely to become a full-fledged expenditure tax because of two reasons. Firstly, in this case all expenditure is not taxed and the tax liability is not linked to the amount of expenditure but to the types of expenditure. Moreover, the rates of taxation for different types of expenditure here can differ from each other, such as there being different rates of excise duty or sales tax on different items. It may be additionally recalled that commodity taxes may be specific for some items but ad valorem in the case of others which further curtails their collective quality of being an expenditure tax. It would always be fully on the consumers. It may not be so.

In any case, commodity taxation has the demerit of feeding inequalities. Though it is not an inherent feature of commodity taxes to be regressive, they tend to be so all the time. The authorities often choose to tax necessities because, being highly inelastic in demand, they are likely to yield more revenue.

Taxing companies on the basis of their expenditure whether total or only selected component is like taxing their output. Therefore like commodity taxation. It also is an incomplete and indirect substitute of taxation of personal consumption expenditure. Apart from its other merits and demerits, this tax is inflationary in its impact. And for that reason it is regressive and inequitable.

Personal expenditure tax however, has been a more favorite subject for discussion with the theoreticians and other thinkers. It has often been viewed as an alternative to taxation of income .It was considered superior to income tax in a number of ways. J.S Mill considered it a perfect and equitable tax, especially because savings are exempted under it. It was put forth as an ideal tax by Alfred Marshall. Personal expenditure is considered as one of the indices of ability to pay and therefore a suitable base for determining the tax liability. In underdeveloped countries, it claims its worthwhileness by providing an encouragement to savings and investments Meade report maintains that income tax adversely affects incentives to work earn and save. It works against growth and spells a poverty trap. Other advocates of expenditure taxation include N.kaldor, Richard Goode, and Raja J.Chelliah, etc

Case for personal Consumption Expenditure Tax

The case for personal consumption expenditure tax rests primarily on its superiority over income tax. Accordingly arguments in its favor are

derived from the drawbacks of income tax, the false arguments in favor of income tax and merits of consumption expenditure tax itself.

The first set of arguments in favor of expenditure tax is derived from the deficiencies of income tax itself. Essentially, income tax penalizes an earning effort. It is a kind of double taxation. It first taxes the total income including the saved portion and then reduces the compensation for postponing current consumption by taxing the earnings on savings. Additionally, income tax extends to capital gains and wealth, thereby further penalizing those who save and invest. In other words, income tax works against thrift and capital accumulation. Over time, those people who have a higher propensity to save are able to add to their income (as compared with those who spend) get taxed for that. It, therefore, spells a 'poverty trap' for an underdeveloped country like Ethiopia Kaldor argued that a progressive income tax is a greater disincentive to work than a proportional one, because the tax liability increase more than proportionately with an increase in income.

Expenditure tax, on the other hand, is growth oriented. It taxes an activity which drains resources from the common national pool (by way of consumption expenditure) moreover instead it relies upon an individual's decision to spend as an indicator of his capacity to spend. It helps in controlling inflation without curbing growth, because it works on consumption demand and dampens prices. Saving and investment activities however, are not discouraged by this tax. Rather, they are stimulated on account of a reduction in tax liability in the event of saving and non-taxation of profit

A case for expenditure tax can also be argued by refuting some of the advantages attributed to income tax. Thus it is claimed that income tax is usually progressive and based upon ability to pay. We can add that ability to pay is not always equal to the amount of income of the taxpayer. The

needs of different individuals and families vary. Their spending power also varies with the source of income and its regularity, the chances of earning a similar income in future and so on.

Another argument in favor of income tax is that it cannot be shifted. This is not necessarily so. In the case of very incomes, a tax is likely to curtail the relevant supply of labor and cause an upward revision in the wage rates. Similarly, in case of higher incomes, work effort may be substituted by leisure.

Expenditure tax can also be argued for on the basis of its own merits, independent of the drawbacks of income tax. It avoids the difficult problems of bunching of capital gains and double taxation of savings. It is considered a superior index of ability to pay than income. Its rates can be made sufficiently progressive to meet the criterion of equity. While income tax falls more heavily on those with irregular incomes (on account of slab rate system) expenditure tax can avoid problem.

Hurdles

However, the case for taxation of personal consumption expenditure gets weakened on account of several conceptual and administrative problems.

The foremost conceptual problem is the concept of taxable expenditure itself. Irving Fisher suggested a simple method of estimating it, namely, income earned during the year adjusted for net variation in the wealth of the taxpayer. In other words, it is equal to income minus net savings. The net savings are equivalent to the addition to net worth so that borrowings (which reduce the net worth) reflect on addition to personal consumption expenditure while lending means a corresponding reduction in it.

Equally troublesome is the bunching of expenditure on some social and religious occasions and ceremonies. Should such expenditure be allocated to the year in which it is incurred or distributed over some longer period?

Still another conceptual problem relates to increasing prices. Just as income tax liability goes up with our increase in only nominal incomes, so in the case with taxation of expenditure while the taxpayer loses on account of reduced value of money, he is subjected to a higher tax, more so if it is progressive.

Expenditure tax also generates some difficult administrative problems. The tax authorities have to collect and collate information on both earnings and savings.

Business community fears that expenditure taxation causes a recession by discouraging consumption and encouraging savings. In specific circumstances this argument can be quite valid.

In a country like ours, we can mention the paucity and inaccuracy of accounts. We have a very large number of people who are petty shopkeepers, hawkers, farmers etc. These people either do not maintain any accounts, or would combine accounts of their business and households. If we leave out this vast majority, the tax revenue collection would be quite inadequate. An effort to cover everybody would be administratively non-feasible.

A definition of expenditure has to be provided enabling us to distinguish consumption expenditure from gifts, charities, donations, transfer etc. A number of personal consumption expenditures may be recorded as business expenses in order to avoid the tax liability

Similarly, there is the intricate problem of durable consumer goods. Such goods are purchased in lumpy units (value wise) but may be consumed over a number of tax periods. The complication increases when we think of the possibilities of capital gains, destruction of some durable goods, or their final junk value.

An important conceptual problem can arise in demarcating between consumption and investment expenditure. Apart from investment in physical and financial assets, it may be for augmenting 'human capital' (that is, for enhancing the productivity of the persons involved) For example, individuals do spend on their own education and training as also on the education and training of their children. Is this expenditure to be counted in consumption or investment? AS noted above, a similar situation arises in classifying many expenses between business and personal consumption expenses. If the expenditure tax were progressive, there would be an inherent tendency on the part of taxpayers to divide the family into smaller units to escape its incidence. Further, unless the tax machinery of the government is efficient enough to trace out all the incomes receipts the taxpayers may be able to spend a part of their incomes without attracting tax liability.

1.9 GOVERNMENT REVENUE

Public expenditure arises out of the functions of the state that have evolved to reflect the prevailing political, economic and social views of a society. However, simple or complex the form of government, there are some basic functions that are common to all. What has changed over time is the range of the functions and the scale of operations by the state.

The basic needs of any society have been:

- defense from external aggression;
- internal administration of law & order; and
- Improving the welfare of the society.

All entailed expenditure that had to be financed by all which led to the emergence of public finance. According to Adam Smith government should not provide for the people what they can obtain for themselves. However, some of the needs could not be met by an individual that is which justified public expenditure. Why to focus on public expenditure at this point is because the fulfillment of state functions requires public expenditure. Public expenditure intern justifies the importance of public (government) revenue.

Characteristics of functions:

Compatible functions: the performance of one function leads to the automatic performance of another function.

Conflicting functions: the fulfillment of one function operates against the fulfillment of another function.

Identification of such functions is important to avoid duplication of work in the case of compatible functions and to bring optimization in the case of conflicting functions.

Learners Activities:

- **Explain the link between society's needs, public finance and government revenue.**
- **Discuss compatible and conflicting functions.**

Government receipts are divided between two main categories – revenue receipts and capital receipts

Revenue Receipts:

Revenue receipts are divided into tax-revenue and non-tax revenue. Tax revenue itself is divided into three

- a) Taxes on income and expenditure: This section covers corporation tax, income tax, expenditure tax etc.

Taxes on property and capital transactions: This section includes estate duty, wealth tax, gift tax, land revenue etc.

Taxes on commodities and services: this section includes customs (namely import duties, export duties, cesses on export and other receipts.

The non-tax revenue is similarly divided into three sections:

- a) Currency, coinage and mint
- b) Interest receipts, dividends, and profits:
 - Interest receipts on loans by the central governments
 - Dividends and profits from public sector undertakings
 - Surplus profits of the Reserve Bank.
- c) Other non- tax revenue: This section covers revenue from administrative services, public service commission, water and power development services, transport and communications, supplies and disposal, public works, education, housing, information and publicity, broadcasting, grant-in-aid and contributions, etc.

Capital Receipts:

Capital Receipts category includes,

- a) Domestic market borrowings
 - Long term loans
 - Treasury bills which have a maturity of 91 days, 182 days or 364 days at the time of issue
 - Special bonds if any
- b) External loans: central Government may only be authorized to raise loans from abroad.
- c) Recoveries of loans and advances made by the central Government to state Governments, Union Territories and non-Government parties and foreign governments.
- d) Provident funds: represent collections under various schemes introduced by the government.
- e) The net effect of transactions occurring under a variety of funds, reserves, accounts and deposits.

1.10 THEORIES OF TAXATION

1) The Economic Surplus Theory of Taxation

This Theory suggested to tax the excess over what was “physically and morally necessary” to secure continued use of the factors of production. Ex, suppose an owner of land is prepared to lease it for \$ 500 per year. If he is offered \$600 then he receives \$100 surplus that can be taxed away. But the problem with this theory is to establish the minimum amount that is morally and physically acceptable by different individuals or businesses.

2) The Benefit Theory of Taxation

This Theory is based on the assumption that all should contribute to the cost of the state in relation to the benefits they derive from the

state. Ex. If one person owns property worth twice as much as somebody else, then his contribution to the state for protection should be twice as big. Taxes are therefore, regarded on the basis of this theory, as payment for value received and as a reflection of the demand for public services. But critics of this theory have argued that, firstly, it requires measurement of what is immeasurable the value, for example, to an individual of defense of the country from foreign aggression in and secondly, it is incompatible with social justices (fairness) since those most in need of state benefits, such as the aged, the sick or unemployed would be required to pay more taxes.

3) Ability to pay Theory of Taxation

This theory is based on equity reasons. People should contribute to the finance of the state according to their means. Whereas income is indicative of a person's ability to pay taxes, ownership of property may not be, unless the asset yields a return or can be realized.

EX. A house that is let produces rent, which can be taxed, but an owner-occupied house yields no income on which income tax can be assessed and there is no ability to pay a capital tax on it until the property can be sold.

Tax threshold,

A person is deemed to have no ability to pay tax unless his income is above the subsistence level. Thus there must be a certain minimum of income that is not taxed that served as tax threshold i.e., from which income level that taxation should start.

Differentiated Rates of Tax

Rates of tax may vary not only according to the level of income, size of a wealth holding, or the price of an article purchased, but they may also be differentiated according to the nature or origin of what is taxed.

The following are examples of differentiated rates!

a) Tax on consumption

- On luxuries higher rate of purchase tax
- On necessities lower rate of purchase tax

b) Tax on income

- Lower rate on earned income
- Higher rate on unearned income

c) Tax on profits

- A lower rate of tax was imposed on profits that were to go back into the business
- A higher rate on profit that were distributed to shareholders.

d) Tax on capital

- A lower rate on transfer of capital in life time
- A higher rate on transfer of capital on death.

e) Taxes on inheritance.

The bequest of capital to a spouse is not taxed, but all other transfers are taxed. According to the relationship of the beneficiary to the donor the tax is differentiated i.e., direct descendants pay a lower rate than distant relatives.

A differentiation is usually introduced to achieve a specific policy objective such as:

- To make taxes or consumption less regressive;
- To achieve more equal distribution of income or wealth;
- To encourage business savings and investments; or
- To preserve family business.

Approach to Tax Equity

There are two distinct concepts of fairness: horizontal equity and vertical equity.

Horizontal Equity

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

What does it mean for these individuals to be identical in all relevant respects? And what does it mean for two individuals to be treated the same? Consider twins- who are identical in every respect except that one likes chocolate ice cream and only Chocolate ice cream, while the other likes vanilla ice cream, and only vanilla. For simplicity, we assume that chocolate and vanilla ice cream cost exactly the same amount. Is the tax system treating the two individuals in a horizontally equitable manner if it taxes vanilla and chocolate ice cream at different rates? One ends up paying more in taxes than the other and in this sense the tax system appears to be unfair.

Vertical Equity

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: (1) determining who, in principle, should pay at the higher rate; (2) implementing this principle - that is, writing tax rules corresponding to this principle; and (3) deciding, if someone is in a position to pay the higher rate, how much more he should pay than others.

Moreover, implementation requires a quantitative measure of ability to pay. Individuals of same ability to pay should be taxed at the same rate, and individuals of different abilities to pay should be taxed at different rates. The indicator of ability to pay (which is measured by the entire welfare) is income, consumption or wealth. But if an individual has more income or wealth, does this mean he has more welfare? He could be sick or un happy.

Check Your Progress Exercise

1) What is taxation?

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2) What are the historical accounts on the development of taxation?

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3) What makes a tax system good? Explain?

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4) What is the difference between single and multiple tax system?

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5) List the Limitations of single tax on economic rent of land.

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6) Explain the advantages and disadvantages of proportional taxation.

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7) Distinguish direct and indirect taxes.

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8) What are the pros and cons of direct and indirect taxes?
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9) Describe the three alternative forms of expenditure tax.
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10) Explain the two types of government revenue.
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11) What are the major theories of taxation? Describe.
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.....

1.11 SUMMARY

- A tax is a compulsory levy and those who are taxed have to pay the sums irrespective of any corresponding return of services or goods by the government.
- The base of a tax is the legal description of the object with reference to which the tax applies.
- A tax is buoyant if a tax revenue increases with the growth of its base, but, but without an extension of the tax coverage or an upward revision of the tax rates.

- The yield of a tax may 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.
- A good tax system is one which is designed on the basis of an appropriate set of principles, such as equality and certainty.
- There are four major principles of taxation: equality, certainty, convenience, and economy; others include productivity, buoyancy, flexibility, simplicity and diversity.
- A tax system is good when the following points are kept
 - Taxation is an important part of the total budget of the government
 - A tax system has many dimensions
 - A tax system which is theoretically the best need not be the one which can be put into practice also.
 - The attitude of a tax payer is an important variable determining the variables of a good tax system
 - Changes in a tax-system can be brought about only slowly and in changes.
- One simple form of a single tax is the poll tax which is imposed on a person simply because he is there in the society and not because he has an income, or wealth, or following any particular trade or profession, etc.
- A tax on not only economic rent of land but on all kinds of unearned increments stands justified. However, to use a single tax in the place of a large number of various taxes is not desirable.
- A tax is progressive when, with increasing income, the tax liability not only increases in absolute terms, but also as a proportion of the income. If, on the other hand, the tax liability increases in the same proportion as the increase in income, then it is a proportional taxation.

- A tax is direct if the incidence of a tax rests upon a person who bears its impact. If on the other hand the incidence is passed on to the others, then it is an indirect tax.
- Sales tax is a tax on sales transactions but it is applied at only one stage of a business activity right from the manufacture to the retailer.
- Expenditure tax may be formulated in three alternative forms, namely those of
 - i) commodity taxation
 - ii) personal consumption expenditure taxation, and
 - iii) as a base for corporate taxation

1.12 ANSWER TO CHECK YOUR PROGRESS EXERCISE

1. Refer Section 1.2
2. Refer Section 1.3
3. Refer Section 1.5
4. Refer Section 1.6.1
5. Refer Section 1.6.1
6. Refer Section 1.6.2
7. Refer Section 1.6.3
8. Refer Section 1.6.3
9. Refer Section 1.8
10. Refer Section 1.9
11. Refer Section 1.10

Unit 2: Taxation in Ethiopia

Contents

- 2.0 Aims and Objectives
- 2.1 Introduction
- 2.2 Historical Background of Taxation in Ethiopia
- 2.3 Tax Organization System
- 2.4 The Need for Tax Reform in Ethiopia
- 2.5 Tax Reform in Ethiopia
- 2.6 Classification of Taxes
 - 2.6.1 Income and Property Based Taxes
 - 2.6.2 Taxes on Consumption/ Expenditure
- 2.7 Summary
- 2.8 Answer to Check Your Progress Exercise

2.0 AIMS AND OBJECTIVES

When you have studied this chapter you should be able to do the following:

- Explain the tax organization system in Ethiopia
- Discuss the need for tax reform in Ethiopia

- Discuss the Historical Development of Taxation In Ethiopia
- Identify the different classes of taxation in Ethiopia

2.1 INTRODUCTION

Income tax of Ethiopia is based on the new *Income Tax Proclamation No. 286/2002* and *Income Tax Regulation No.78/2002*.

Income is defined as every sort of economic benefit including non recurring gains in cash or in kind, from whatever source directed and in whatever form paid credited or received. The proclamation governing income uses scheduler system of taxation. As per this proclamation, income is classified for income tax purposes according to its nature and source. The classifications into which the income falls are known as *Schedules*.

The income tax proclamation classified income in accordance with its nature in to four schedules as follows:

Schedule	Nature of income
A	Income from employment
B	Income from rental of buildings
C	Income from business
D	Income from royalties; income from rendering of technical service, income from game of chance; dividend income, from casual rental of property; interest income on deposit and gain on transfer of certain investment property

The legal provisions for each of these schedules are applicable on both residents of Ethiopia with respects to their world wide income and non-residents with respect to the Ethiopian source of income. Any person having income of any of the above nature is legally bound to pay tax

accordingly. The law, besides making any resident obtaining income of any form bound to pay tax, it allows tax credits for those residents who generates income from foreign sources.

👉 ***However, the tax credit is available so long as the tax payable in Ethiopia would not exceed the amount of foreign tax payable.***

Hence, the income tax payable by the resident with respect to income generated from foreign source will reduce by the amount of foreign tax paid on the income. To this effect, the resident must present an appropriate evidence (documents) that substantiate the amount of foreign tax paid. In addition, any gains and losses arising from any foreign transactions need to be reported for tax purposes. Such gains and losses should be indicated as taxable income (if gain) or deductible losses (if loss) in the year in which they are realized.

2.2 HISTORICAL BACKGROUND OF TAXATION IN ETHIOPIA

Emperor Tewodros (reigned 1855-1868), a leading protagonist of modernization in Ethiopia, found it difficult to acquire even a fraction of the Maria Theresa thalers, or dollars, then entering the country. He was therefore almost always chronically short of cash.

Explaining his difficulties to Queen Victoria's envoy Hormuzd Rassam, in June 1866, he remarked:

"The people of my country... would sooner bury their money in the ground than trade with it or pay me a percentage out of it."

When the envoy told him about the existence in Britain of taxes on horses and male servants, Tewodros commented,

"Mr. Rassam, you don't know the Abyssinians. Were I to tax their mules, horses and domestic (servant), not one of them would ride, every man would become his own servant."

The above exchange of words illustrates the difficulty which Tewodros and indeed most if not all Ethiopian rulers of the past faced in tax collection.

Despite such difficulties Tewodros was able to levy taxes in the parts of the country he controlled, and his officials, not less remarkably, kept detailed tax records. These seem to have been housed at his capital, and were at Maqdala, when the British Expedition of 1867-8 looted that fortress. They were subsequently taken to the British Museum (later British Library) with many other manuscripts, and were published by the present writer and Germa-Selassie Asfaw, in a monograph entitled *The Tax Records and Inventories of Emperor Tewodros of Ethiopia* (1978). They reveal that the Emperor received around 190,000 Maria Theresa thalers, or a little more, from Tegray, then the country's commercially most advanced region, as well as 47,000 thalers from Bagemder, which constituted his "home province".

Taxes in Ethiopia until the early twentieth century, were, however mainly paid in kind-or labor service, rather than in cash. Some idea of the old system may be gleaned from the glimpses of taxation, which follow.

Taxation in the past varied greatly moreover from region to region, and was often arbitrary, in that it tended to depend on the whim of the chief or tax collector. At the middle of the nineteenth century Tewodros's friend, the British consul Walter Plowden, wrote:

"The imposts (i.e. taxes) are numerous but vary according to the traditional customs of each village. They pay a certain portion in kind to the Ras, or other great chief; and sometimes a regular tax in money; besides this they must furnish oxen to plough the king's lands. Their immediate governor then takes his share of every kind of grain (say a fifth), and feeds besides a certain number of soldiers on each

householder: he has rights to oxen, sheep, goats, mules, butter honey and every other requisite for subsistence; he must be received with joy and fasting by his subjects whenever he visits them, and can demand a contribution from them on fifty pretexts- he is going on campaign, or has just returned from one; he has lost a horse, or married a wife; his property has been consumed by fire, or he has lost his all in battle, or the sacred duty of a funeral banquet cannot be fulfilled without their aid”.

Another foreign visitor, the early nineteenth century Englishman Nathaniel Pearce, also noted the arbitrary element in such taxes, and detrimental burden on the peasantry. He observed; “the peasants.... Never know when their persons or property are safe, on which account they are obliged to repair the habitations of their chief on holydays, some presenting bread, butter, honey and corn, and others a goat, sheep, or fowls, to keep in favors, and to prevent him from sending his soldiers to live upon their premises”.

Another type of taxation was embodied in the traditional Ethiopian system of compulsory hospitality, in which the peasantry was legally obliged to feed and house officials and other traveling through the countryside.

Plwden claims to have seen “many a ruined hamlet” deserted by its inhabitants are result of this system, while a later foreign observer, the British traveler Augustus B.Wylde, declared that to live near the roadside was “like keeping a public house... where the majority of the customers would be those who had free drinks and free food”.

Taxes on trade like wise varied considerably from place to place, and were far from standardized. They took the form of both market dues and taxes in good passing through internal as well as external customs posts.

Market dues were traditionally paid on goods brought for sale, or actually changing hands, at the principal commercial centers. At Gondar, for example, Pearce reported that the owner of every slave, horse or mule taken to market had to pay two drams of gold or the equivalent of two thalers; every large elephant-tusk was charged one dram, while every mule-or donkey-load of imported good was liable to a tax of one waquet, or ounce of gold, and every porter-load six drams. At Adwa on the other hand a mule-or donkey-load of imports paid half annonce of gold, or goods to that value; and a porter-load two and a half drams; a large elephant tusk paid two and a half drams, and a slave or matchlock rifle half annonce. Each porter-load of cotton was charged tow pieces of cotton cloth, equal to two dollars a piece, was as a pound of cloth.

Trade was also taxed at a series of internal customs posts, called kellas, which were much disliked by the commercial community. "Customs-houses, or rather passes, have been established", Plowden reports," on every sport where Nature...has confined the road to some narrow defiled, not to be avoided without an immense detour, if at all, and near some commanding elevation where a good look-out can be stationed or perhaps at a brook fordable only at one stop".

The existence of such customs posts led to much inconvenience and often greatly delayed caravans. The French Scientific Mission of the 1840s noted for example that there were numerous quarrels between the traders and the tax collectors, as a result of the real or alleged smuggling of gold and civet musk. Disputes some times lasted several months, particularly when the customs authorities were not short of money or the merchants too reluctant to accept a protracted stay.

Ethiopia tax collection over the last century or so has been transformed out of all recognition.

The first important reforms, carried out by Emperor Menilek toward the end of the nineteenth century, resulted in the establishment of a fixed tithe rather than the undefined, and essentially arbitrary, system of agricultural taxes described above.

The second major reform, which dates back to the early twentieth century, and resulted largely from the increasing prevalence of money and the growth of trade, was the steady miniaturization of agricultural and other taxation.

Later, more recent, reforms were the fruit of Ethiopia's emergence as a modern state. They involved all the mechanisms of modern tax collection; tax schedules, paper work, and the development of trained and regularly paid civil service, as well as the abolition of the vexatious system of internal customs posts.

2.3 THE TAX ORGANIZATION SYSTEM

Ethiopia has a federal system of government that is the federal government and the constituent regional and city administration the source of revenue for both the federal. Region and city government is the source of revenue for both the federal. The constitution and other relevant legal provisions share region and city gov't. There are two-tax offices responsible for administering the internal tax revenues. These are federal tax office and regional city gov't tax offices.

The Federal Inland Revenue Authority /FIRA/

FIRA was established by proclamation no 367/2003. The authority is a semi-autonomous agent of the government responsible for the administration of the federal as well as joint tax revenues (to be shared between federal and constituted below.

The authority which administers a number of taxes is under the general supervision of ministry of revenues /MOR/. The list of tax laws administered by FIRA is mentioned below.

- Income tax rrocl, no 286/1002
- Mining income tax procl no 53/1993

- Value Added tax /VAT/ procl no 285/2002
- Excise tax procl. No 307/2002
- Turnover tax /TOT/ procl. No 307/2002
- Stamp duty procl. No 110/1998

Functions of FIRA

The major functions of the authority are to:

- Assess, collect enforce and account for federal and joint revenue lists.
- Administer efficiently and effectively all tax laws of the government.
- Promote voluntary compliance.
- Advise the ministry on the tax issues.
- Safeguard taxes from strand and evasion.
- Improve quality of service to the taxpayers.
- Undertake studies to improve the implementation of tax law's. regulations and directives.

The organization structure

FIRA is accountable to the MOR> general manager and one deputy general manager head it.

The general manager is the chief executive of the authority. He is responsible for the day to day-to-day operations subject to general supervision of the MOR. One DGM and several heads of departments, services and branches assist the GM

Tax operation departments /Branches /

- (i) There are three organs, which are involved directly in mobilizing tax revenue through the administration of various tax laws. These are .
 - Large taxpayer office /LTO/
 - Value Added tax Dep't
 - Addis Ababa main Branch

- Six other outlying Branches.
- (ii) A department head manages the functions of the first three while branch managers head that of the outlying branches.
- (iii) The tax investigations and intelligence dep't supports directly the tax operation depts. Enforcing the various tax laws through regular investigations of tax cases with substantial amounts of revenue at risk.
- (iv) The legal services dept suppose mainly the tax operation depts. In execution at curl of law and by seizure of tax payees' property for defaulted taxes.

Support depts.

At present FIRA has eight support depts.. and services.

- Investigation and intelligence dep't/ legal services
- Management information system
- Administration and finance
- Civil service reform program office
- Internal audit services
- Planning and research
- Public relations

The aforementioned are all located in head quarters of the authority except proposed legal services divisions (units) in out lying branches. (The current setup of the authority is separately shown)

Taxing jurisdiction and power

Ethiopia follows residential principle of taxing jurisdiction. Individuals and corporate taxpayers are taxed on all their annual worldwide income while a non-resident is taxed on income, which accrued in or was derived from Ethiopia.

As tax enforcement is concerned the authority is granted the power of seizure of defaulted taxpayers properly without appeal to court of law.

Internal tax structure

The internal tax structure is basically made up of direct and indirect taxes. The direct taxes are taxes on income, and property while the indirect taxes are on consumption /expenditure/. Direct taxes and indirect taxes except Addis Ababa VAT registered, are all administered by the LTO and branches while VAT is separately administered by the VAT dept.

2.4 THE NEED FOR TAX REFORM IN ETHIOPIA

Although taxation has multiple objectives in the management of the economy, its principal objective is mobilizing the necessary revenue to finance government expenditure obligations. More over in developing countries the need to have adequate financial resources is of crucial important, as government intervention in promoting social services and basic infrastructure is immense. The effort made to raise sufficient revenue of a country is traditionally measured in terms of its Gross Domestic Product (GDP) . In this connection, Ethiopia's tax revenue against its GDP remained low as empirical evidences proved.

Such low level of tax revenue is certainly the outcome of the prevailing poor tax revenue mobilization, mechanism be it in policy or administration. The low tax-GDP ration, however, indicates the existence of modest tax burden and the room to raise more revenue. There is an opportunity to increase revenue without affecting the saving investment and production incentive of the private sector.

It has to be noted that excessively high rates apart from encouraging tax evasion, it creates distortions and disincentive to work, and invest. In this regard the previous government tax policy was designed merely to mobilize more revenue and to minimize income inequality. Thus income tax rate was as high as 89 percent. One can imagine easily that no body is foolish to work to generate 11 cents out of a gross income of a Birr over a certain level of income. Like wise the maximum import tariff rate used to

reach to 230 percent, creating more incentive for tax avoidance and evasion.

Due to the existence of difference of different economic structures, diverse economic, social and political standards, the structure of tax revenue differs from government to government. Certainly, in developing countries tax structure, indirect taxes are dominant, as their administration is less difficult than direct taxes . Among indirect taxes, trade taxes contribute significant share in these countries. Ethiopia is not an exception and on the average, more than 60 percent of the total tax revenue, has been mobilized from indirect taxes for the last decade. Moreover, foreign trade taxes accounted 40 percent of the tax revenue in recent years. Its importance in undertaken in the revenue basket continued to move up though, successive tariff reforms has been undertaken. In this regard foreign trade taxes accounted for 41.5 percent of the total tax revenue in fiscal year 1999/00 compared to its 22.6 percent of fiscal year 1990/91.

Table 1
Composition of Tax Revenue (Percentage Share)
(1990/91 -1999/2000)

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
1997/98 1998/99 1999/00							
Direct Taxes	40.5	41.0	33.4	30.7	33.8	37.1	35.6
35.5 35.9 36.1							
Indirect Taxes	59.5	59.0	66.6	69.3	66.2	62.9	64.4
64.5 64.1 63.9							
Domestic Ind. Taxes	36.9	33.0	33.8	27.1	24.4	24.5	24.1
22.4 21.5 22.4							
Foreign Trade Taxes	22.6	26.0	32.7	42.2	41.8	38.4	40.4
42.1 42.5 41.5							

According to the above table, direct taxes contribution depicts declining trends, while the role of indirect taxes continued to rise. Within indirect taxes foreign trade taxes performance registered substantial improvement and its share almost doubled from its level in the beginning of the decade. In contrast, domestic indirect taxes steadily declined although attempts have been made to introduce several tax policy measures including broadening the base. in the current tax structure domestic indirect taxes consists of sales taxes on good and service, excise taxes and stump duties. Their performance mainly depends on the supply and demand of domestic goods and services. The poor performance of these taxes therefore is explained by slower production and consumption and narrow base. More over its share from the total revenue remained low when compared to other countries as shown in the following table.

Table 2

The Share of Domestic Indirect Taxes from Total Revenue

For selected Countries

(Percentage Share from Total Revenue)

No	Country	Direct tax	Indirect Taxes			Non-tax Revenue
			Total indirect Tax	Domestic Ind. Taxes	Foreign Trade tax	
1	Greece	37.83	53.51	53.43	08	8.66
2	Turkey	32.09	45.69	42.69	3.01	19.48
3	Colombia	37.23	50.00	41.16	8.41	12.43
4	Kenya	30.59	56.73	41.53	15.2	11.80
5	Morocco	28.85	55.32	39.31	16.01	13.46
6	South Africa	55.20	37.18	35.92	1.27	5.95
7	Ghana	16.77	30.65	33.89	26.76	22.57
8	Chad	26.69	49.02	33.73	15.29	21.81

9	Israel	52.70	33.64	33.20	0.44	13.49
10	Korea	44.62	38.79	32.57	6.22	12.11
11	Gambia	14.74	74.45	32.41	42.04	5.93
12	Uruguay	44.94	35.67	31.89	3.78	7.02
13	Pakistan	16.14	55.14	31.86	23.28	28.73
14	Sweden	56.58	29.88	29.29	0.59	12.03
15	India	21.47	51.60	28.09	23.51	23.01
16	Mauritius	25.02	60.40	26.98	33.42	14.49
17	Zimbabwe	46.91	41.73	22.91	18.82	10.34
18	Cameron	19.65	46.07	22.51	23.56	28.78
19	Spain	69.51	22.46	22.43	0.03	8.34
20	Tunisia	31.74	48.57	21.66	26.92	16.65
21	Ethiopia	25.27	44.28	20.22	24.07	27.72
22	Zaire	34.29	51.32	18.68	32.64	7.78
23	Egypt	27.54	22.11	12.50	9.61	35.85

Source:- International Financial Statistics year Book (1996-98)
International Monetary Fund

From the above table one can conclude that developed countries indirect taxes holds significant place. Within the indirect taxes the share of foreign trade tax remained very minimal. On the contrary, for several developing countries foreign trade taxes played significant role in their revenue basket.

As part of the developing countries, Ethiopia's tax revenue is dominated by indirect taxes. More over, with in this category foreign trade taxes, derived from import duties and taxes contribution is significantly high. In contrast domestic indirect taxes perform is inferior. Again if we compare to developing countries represented in the table, the revenue from domestic indirect taxes merely holds 20 percent of the total revenue against to 41, 5, 33, and 7,33,9,22,9 percent of Kenya, Chad, Ghana and Zimbabwe respectively. In the case of foreign trade taxes. Ethiopia's share stood 24 percent of the total revenue compared to Kenya's 15, 2

Chad's 15, 3 Ghana's 26, 8 and Zimbabwe's 18.8 percent. It is worth mentioning that being the member of CMESA (Common Market for Eastern and Southern Africa) Ethiopia is prepared for to implement zero tariffs to the imports of member countries. Further more in view of the current globalization treat it is not plausible to depend on this source of revenue. The tax system is there fore assumed to depend on stable sources. It is advised that stability to be ensure by avoiding reliance on such vulnerable tax bases and, exploit domestic taxes including broadening bases on income and Consumption taxes, and exploit domestic taxes including broadening bases on income and Consumption taxes, and ensuring compatibility with tax administration capabilities. Thus revising domestic indirect tax policy aspects and improving its administrations imperative.

To achieve the aforementioned objectives, the need to design an appropriate tax policy is imperative. Any tax system is expected to consider critically its economic efficiency, administration simplicity, flexibility and fairness. To mobilize sufficient revenue it is essential to design a tax system, which enables the government to raise more revenue as the economy grows. This could be made possible if the tax policy focused on the taxation of growing economic sector, taxation of income and profit applies progressive tax rates, taxation of consumption goods with high-income elasticity of demand.

To ward these end global studies recommended to direct the over all tax policy reform to consider the following:- (Tax policy in Sub - Saharan Africa, Zamora Shalizi and Lyn Squire)

- A) A shift from the taxation of international trade to the taxation of domestic transaction
- B) A Shift from the taxation of production to the taxation of consumption,

- C) A restructuring of investment incentives, and in the long run,
- D) A shift in the burden of taxation from the poor to the rich,
- E) A shift from reliance on high tax rates to reliance on broader tax base.

On the hand, the attention improve given to improve tax administration is minimal as compared to tax policy measures. First have all the governing income tax law and regulation lasts for half a century with out substantial changes. Hence it fails to accommodate current business and technology developments. Tax offices at federal and regional level are not properly organized to identify and register potential taxpayers, which is prelude for tax collection.

On top of identifying taxpayers, tax assessment, which requires the recognition of taxable income, is the other difficult are of tax admonition. In Ethiopia the practice to determine taxable income is a mixture of self - declaration and tax office investigation. According to the income tax proclamation No173/61 (as amended) and the regulation (legal Notice No 258of162) category "A" taxpayers whose annual turnover of Birr 250,000 or above is obliged to keep books of account. These taxpayers are required to maintain records and accounts and accounts and present balance sheet and profit and loss statement to the tax office. The record is expected to follow the generally accepted accounting principles and those indicated in the tax law and regulations. The financial statement is expected to certify by external auditors.

The tax law also stipulated that category "B" Taxpayers whose annual turnover is Birr 48,000 and or more and professional or vocational person with gross income Birr 12,000 and any body whose annual taxable income is more than Birr 6000 are required to maintain record or book of daily revenue and expenditure.

More over the tax law requires the tax administration to assess on basis of taxpayers real income. It is hard, however, to implement the law in the case of taxpayers who are not obliged to maintain records and those with low volume of business including self-employed and informal sector activities.

To assess the income of such taxpayers tax office levies the tax using estimated assessment method. To that end, tax assessors visit taxpayers business regular and the income tax is determined on the basis of their observation. Such practices indeed open to corruption and costly.

Tax collection is the ultimate goal of tax administration. To attain efficient and effective tax collection various options are available. Among these options withholding systems are popular. In our tax system withholding system is applied only few sources. Expanding such important means of mobilizing income taxes should be included.

More over the prevailing tax accounting, auditing and receivable management of the system both at Federal and Regional level is very weak and inadequate to perform the required performance. The tax administrations are unable to develop the operational manuals necessary to support the implementation of the intended reforms. It is also recognized that a well-designed computer system is an important toll of tax administration. However, the tax administration lacks such crucial aspects of technology.

A common element of the various tax administration operations is the need for taxpayer's education, information and assistance programs that are necessary to promote and foster voluntary compliance by taxpayers. Nevertheless its importance has never appreciated in the tax offices.

By and large, tax is an exclusive power of government, which enables it draw money from an individual or organization without compensating in return. Thus, it is not surprising if taxpayers attempt to avoid paying

taxes or changed their behavior to reduce tax liabilities. Thus to have an effective and efficient tax administration frequent revision of existing systems and introducing modern and simple systems is mandatory.

2.5 TAX REFORM IN ETHIOPIA

Tax reform must involve the balancing of multiple objectives principles of raising revenue, ensuring economic fervency, equity and administrative efficiency. Thus the tax reform of the country has two major parts, namely policy and administrative reforms.

Tax policy Reform

As it has been mentioned earlier the principal objective of taxation is to raise necessary revenue to finance government expenditure. On top of mobilizing the necessary revenue any tax system plays important role to implement government fiscal policy. In this regard tax policy has multiple objectives of managing the economy. The tax policy of the previous regime aimed at mobilizing more revenue to meet the ever growing demand to finance the over blown public sector.

Furthermore, in agreement with its socialist oriented economic policy the tax policy was designed merely to reduce income inequality. To that end the income tax rates on narrow bases, such high level of tax rates coupled with relatively small tax base and a heavy reliance on few tax instruments resulted in severe distortions in the economy and failed to mobilize sufficient revenue ultimately.

To correct such crucial policy failures, the government adopted a series of tax reform measures focusing on reducing the extreme high rates, removing undesired taxes, broadening the tax base and improving and modernizing the revenue collecting institutions.

In this context among the tax reform measures, priority was given to reduce the very high tradesmen played in payroll, business and agricultural income taxes, In the case of payroll taxes; the highest rate was reduced from 85% to 40%. In addition the minimum tax-free monthly salary rose to Birr 120 from Birr 50. Like wise the maximum rate for business profit tax rate on individuals reduced from 59 percent to 40 percent and minimum excepted income raised to Birr 1200 annual taxable income. Favoring corporate bodies, tax rates on this sector are a flat rate of 35 percent, the reforms also trimmed down income brackets to simplify its administration.

Tariff reduction was the other important trade and tax reform area that materialized in the last decade, it is known that import taxes are levied to raise revenue and protect domestic producers, according; any tax policy with regard to import tariff is expected to expect to balance such important objective. The pre-reform tariff consisted of twenty *advalorem* rates ranging from zero to 230 percent. But due to the existence of wide exemptions on imported items the effective rate was very low.

To avert such distortions, through successive tariff revision since 1994, the maximum rates have reduced to 40 percent. Exemption categories were reduced from 327 pre-reform periods to 167, weighted average tariff rate was reduced from 41.6 percent to 19.5 percent and the number of tariff bands were reduced from 23 to 6.

Table 3

Customs Tariff Reform

No	Description	Pre reform Period	1 st amendm ent (August 1993)	2 nd amendm ent (January 1996)	3 rd amendm ent (Dec 1996)	4 th amend ment (January 1998)	Existing Rate (Dec.19 98)
1	Maximum rate	230	80	60	50	50	40

2	Num. of tax exemption	327	138	169	170	168	185
3	Simple average tariff rate	79.1	35	28.8	24.3	24.3	20
4	Weighted tariff rate	41.6	29.6	24.6	23.6	21.5	19.5
5	Number of tariff bands	23225	9	8	7	7	6
6	Tariff dispersion		75	55	45	45	35

Source: Ministry of Finance

In order to liberalize the economy and open the economy for foreign competitiveness the above successive tariff revisions aimed at reducing the weighted average tariff rate, lowering the maximum tariff rate and narrowing the number of tariff bands. These measures also narrowed tariff dispersion existed between the maximum and minimum tariff rates. The reform reduced number of tax exemptions by way of levying minimal tariff rates on a number of exempted items.

With regard to broadening the tax base, new income, wealth and consumption taxes were introduced. The rental, capital gain and interest income tax, as well as services sales taxes can be cited as additional levies embarked on the tax policy reform. In order to promote nontraditional exports, export taxes were removed from exports except on coffee. Further more, to mitigate the recent coffee price fall at the international market minimum price threshold has been introduced to relieve low proceeds from tax. In this regard unwashed coffee export with a price of less than 50US cents per pound while washed coffee price fetched below 70 US cents per pound is exempted.

To promote domestic and foreign investment, the government provided wide range of tax incentives. The tax incentive scheme granted three-year income tax holiday, allows certified investors to benefit from importation of goods duty free and also exempts goods from sales and excise tax.

2.6 CLASSIFICATION OF TAXES

2.6.1 Income and Property Based Taxes

Corporate taxes

The current corporate tax rate of 30% is applicable to all companies carrying on business in Ethiopia. The taxable income is calculated in a manner closely related to the commercial accounting practice but excludes expenditure specifically not allowed under the income tax law, corporate bodies are all required by law to maintain books of accounts written up on the bases of generally accepted accounting principles.

A corporate body is required to file its self-assessed income returns simultaneously with the payment of tax due within four months from the closure of the accounts.

Individual income tax

Non- corporate taxpayers who include sole traders (proprietors) and salaried employees are taxed at a progressive individual income tax rates which vary from minimum of 10% to the highest marginal tax rate of 35%

Withholding taxes

Withholding tax scheme is operated on a number of payments made by a person in the course of business. In some transactions the amount of tax withheld is treated as a final tax liability. For certain payments that attract a withholding tax the amount of tax withheld is treated as a tax prepayment of the payee to be offset later against his final tax liability. The main withholding tax, bases the prevailing rates and payment status are shown below:

• Royalties	5% Final
• Income from rendering of	
• Income from games of chance	15% Final
• Dividends	10% Final
• Income from rental of property	15% Final
• Interest income on deposits	5% Final
• Salary	10%-35% Final
• Collection of tax on imports	3% Final/ on account
• Withholding of income on payments	2% Final /on account

Capital gains tax

Capital gains tax is charged on income accrued from sell or transfer of building held for business, factory, office at 15% and charged at 30% on transfer of company shares.

Gains obtained from the transfer of building held for residence is exempted from the tax. The basis for residence is exempted from the tax. The basis for computation is separately determined by regulation (the basis is the value of consideration for the asset sold and the adjusted cost of the asset.)

Business losses

When computing the profits of a business during any year of income and a loss is incurred for income tax purposes such a loss is allowed to be carried forward and be offset against future income in the subsequent years for period not exceeding six consecutive years.

2.6.2. Taxes on Consumption /Expenditure

FIRA administers taxes on consumption, which are

- Value Added Tax /VAT
- Excise Tax
- Turnover Tax /TOT/

Value Added Tax

VAT is a consumption of tax charged by VAT registered traders on all taxable goods and services at a standard rate of 15%. The VAT is a multistage tax levied at each stage of production and distribution up to the retail stage. The tax is also levied on taxable imports made by persons whether or not registered for VAT. Some goods and services are taxed at Zero-rate while some are exempted from the tax.

All traders or businesses whose taxable turnover exceed Birr 500,000 per year are obliged to make an application for registration. However person may voluntarily apply for registration. If he regularly is supplying or rendering at least 75% of his goods and services to registered persons.

Excise tax

The excise tax is charged on *advalorem* rate on certain consumer goods on importation and on similar products locally produced. The rate is from minimum of 10% to higher margin of 100% / the list of goods subject to excise tax is separately annexed to the proclamation/.

Turnover tax /TOT/

Turnover tax is payable on goods supplied and services rendered by persons not registered for VAT. It's an equalization tax that came into force to tax persons below the VAT registration threshold of Birr 500,000 TOT is charged at 2% on goods locally sold and 10% on services, except contractors, grinding mills, tractors and combine harvesters which are taxed at 2% the basis of the tax is the gross receipts of goods and services sold.

Stamp duty

Stamp duty is payable on certain (13 items) legal and financial instruments. The charge is made at specific or *advalorem* rate. The basis of the duty is the cost, which the instrument contains (bears)

Check Your Progress Exercise

1. What are the major functions of FIRA?

-
-
2. Discuss briefly the historical development of taxation in Ethiopia.
-
-
3. What the objective of the tax reform in Ethiopia?
-
-
4. What are the items that should be considered in tax policy reform as per the recommendations of global studies?
-
-
5. Taxes in Ethiopia are classified into two. List the components categorized in the two groups.
-
-

2.7 SUMMARY

Ethiopia has a federal system of government, which are the Federal Government and the constituent Regional and City Administrations.

Ethiopia follows residential principle of taxing jurisdiction. Individuals and corporate taxpayers are taxed on all their annual world wide income while a non-resident is tax on income, which accrued in or was derived from Ethiopia.

There are three organs, which are involved directly in mobilizing tax revenue through the administration of various tax laws. These are:

- Large tax payers office
- Value Added Tax department
- Addis Ababa Main Branch

Taxes are generally classified into two:

1. Income and Property based Taxes
2. Taxes on consumption/ Expenditure

Income and property based taxes

- Corporate taxes
- Individual income tax
- Withholding taxes
- Capital Gains Tax
- Business losses

Taxes on consumption/ Expenditure

- Value Added Tax
- Excise Tax
- Turnover Tax
- Stamp Duty

2.8 ANSWER TO CHECK YOUR PROGRESS EXERCISE

1. Refer Sections 2.3
2. Refer Sections 2.2
3. Refer Sections 2.4 & 2.5
4. Refer Sections 2.4
5. Refer Sections 2.6

UNIT 3: EMPLOYMENT INCOME TAX

Contents

- 3.0 Aims and Objectives
- 3.1. Introduction
- 3.2. Determination of Employment Income
 - 3.2.1. Exemptions
 - 3.2.2. Compensation Payments

3.2.3. Tax Rate

3.3. Summary

3.4. Answer to Check Your Progress Exercise

3.0 AIMS AND OBJECTIVES

After the completion of this section you should be able to understand the following:

- Determination of employment taxable income-benefit in cash and in kind
- Compensation payment
- Employment tax rate
- Allowable deductions and Non-allowable deduction for employment
- Exempted income
- Withholding and payment of employment tax

3.1 INTRODUCTION

This section covers Income earned by employees as a result of their employment position. Relevant Labor law proclamations are used to properly account for tax liabilities arising from employment earnings including compensation and severance pay. Except those exempted, any income arising from employment is taxable under this schedule. While every one generating income of such kind is obligated to pay income tax accordingly, employers, on the other hand, are obligated to withhold tax from each payment made to the employee and pay to the tax authority. Hence, employers act as withholding agents; i.e. a party who collects tax on behalf of the government.

3.2 DETERMINATION OF EMPLOYMENT INCOME

3.2.1. Exemptions

Employment income shall include any form of payment or gain, either in the form of cash or in kind, received from current, former or prospecting employment by an individual. - If the tax on employment is paid by the employer in whole or in part, the amount so paid shall be added to the taxable income and considered as part thereof too. Nonetheless, income received in the form of wages does not include representation and other similar expenditures (social functions, guest accommodation etc).

The determination of employment income involves a series of steps and requires such inputs as taxable income and the use of relevant and appropriate tax rates. The determination of taxable income, on the other hand, requires identifying categories of income that are exempted from the payment of tax from those taxable under the law. The following are categories of income that are exempted from the payment of tax.

- ☞ Income from employment by casual employees who do not work for more than one month for the same employee in any twelve months period.
- ☞ Pension contribution, provident fund and all forms of retirement benefit contributed by employers in an amount that does not exceed 15% of the monthly salary of the employee.
- ☞ Subject to reciprocity, income from employment, received for services rendered in the exercise of their duties by:
 - Diplomatic and consular representatives, and
 - Other persons employed in any Embassy, Legation, consulate or mission of a foreign state performing state of affairs, national of the state and bearers of diplomatic passports.
- ☞ Income specifically exempted from income tax by any law in Ethiopia, unless specifically amended or deleted by the Proclamation; International treaty; or an agreement made or approved by the Minister

- ☞ Payments made to a person as compensation or gratitude in relation to personal injuries suffered by that person or the death of another person.
- ☞ Amounts paid by employers to cover the actual cost of medical treatment of employees;
- ☞ Allowance in lieu of means of transportation granted to employees under contract of employment to the extent of the amount to be determined by the Tax Authority.
- ☞ Hardship allowance
- ☞ Reimbursement of traveling expenses incurred on duty to the extent of the amount to be determined by the Tax Authority.
- ☞ Traveling expenses paid to employees recruited from elsewhere than the place of employment or
- ☞ In case of foreigners traveling expenses from or to their country provided that such payments are specifically provided for in the contract. The amount of such payment shall be determined by the Tax Authority.
- ☞ Allowances paid to members and secretaries of boards of public enterprises and public bodies as well as to members and secretaries of study groups set up by the Federal or Regional Government.
- ☞ Income of persons employed for domestic duties;

3.2.2. Compensation Payments

An employee who has completed his probation period but whose contract is terminated is entitled to receive compensations payments from the employer. This form of income falls under *schedule A* income which represents income from employment. For such an employee whose contract is terminated, the employer is bound to pay compensation, an

amount equal to the employee's one month salary for one year of service plus $1/3^{\text{rd}}$ of his monthly salary for every additional year of service over one year. Income tax is, therefore, payable on the earnings from compensation payments.

Note the following;

- 👉 *One month's salary is computed by the average daily wages/salary paid on the last week services multiplied by thirty (30).*
- 👉 *The maximum amount payable in compensation shall not exceed twelve month's wage/salary.*

3.2.3. Tax Rate

The following tax rates are applied for determination of tax payable on income from employment. The rates range from 10% to 35% and making the first Birr 150 exempted from tax payments.

Persons working in different organizations should aggregate and declare their employment income (any tax paid by the withholding agent should be considered deducted).

Employment Income per month		Income Tax payable
Over Birr	To Birr	
0.00	150.00	Exempt threshold
151.00	650.00	10
651.00	1,400.00	15
1,401.00	2,350.00	20
2,351.00	3,550.00	25
3,551.00	5,000.00	30

Over 5000		35
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The following table provides a short cut method of calculating tax payable for income from employment.

Income		Rate	Deduction
From	To		
0.00	150.00	0	
151.00	650.00	10%	15.00
651.00	1,400.00	15%	47.50
1,401.00	2,350.00	20%	117.50
2,351.00	3,550.00	25%	235.00
3,551.00	5,000.00	30%	412.50
5000 & above		35%	662.50

Activity

Mr. x is an international staff for PQR s.c. Is he taxable under the following situations?

- He stayed in Ethiopia for about a year and earn a salary of Ethiopian Birr 15,000./month
- He stayed in Ethiopia for about 179 days at different time and earn a salary of Ethiopian Birr 6,000.00

Example

Mr. Albert gross taxable income from his employers in December 20X3 was Br. 3800.
Calculate the income tax deductible from the salary of Mr. Albert.

Solution

From	To	Total	Income Tax rate
Amount			
0	150	150	Exempted
151	650	500	10%
651	1400	750	15%
1401	2350	950	20%
2351	3550	1200	25%
3551	3800	<u>250</u>	30%
Total		<u>3800</u>	<u>727.50</u>

Shortcut

$$(3800 \times 30\%) - 412.50 = \underline{727.50}$$

Check Your Progress Exercise

1. What type of income is included in Schedule "A"?

.....

2. What income is exempted from employment income tax?

.....

3.3 SUMMARY

Employment income includes any form of payment or gain, either in the form of cash or in kind, received from current former or prospecting employment by an individual. The tax rates of income from employment are progressive that ranges from 10% to 35% and making the first Br. 150 exempted from tax payments.

3.4 ANSWER TO CHECK YOUR PROGRESS EXERCISE

1. Refer Section 3.2
2. Refer Section 3.2.1

UNIT 4: BUSINESS INCOME TAX

Contents

- 4.0 Aims and Objectives
- 4.1. Introduction
- 4.2. General
- 4.3. Determination of Taxable Business Income
 - 4.3.1. Allowable Deductions
 - 4.3.2. Non-Allowable Expenses
 - 4.3.3. Computing Taxable Income
 - 4.3.4. Tax Rate
 - 4.3.5. Less Carry Forward
 - 4.3.6. Transfer of Business Assets Introduction
- 4.4. Summary
- 4.5 Answer to Check Your Progress Exercise

4.0 AIMS AND OBJECTIVES

When you have studied this section you should be able to:

- Determine taxable business income
- Identify allowable deductions and non-allowable expenditures
- Apply the Generally Accepted Accounting Principles applicable for the purpose of tax accounting with regard to depreciation, stock, receivables and others.
- Assess business income tax
- Recognize treatment of loss carry forward

4.1 INTRODUCTION

This section covers tax payables on business undertakings. Business is an industrial or commercial undertaking made by a person or a body in the pursuit of profit. Income arising from such undertakings will be taxed under *Schedule C*. The section, therefore, covers such issues as the determination of taxable business income, tax allowable expenses and the obligations of the taxpayer with respect to maintaining proper accounts.

4.2 GENERAL

The current income tax proclamation and related regulations defined *business* as 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. As compared to the previous income tax rate, the current proclamation provides a reduced tax rate on business income as a measure of the tax reform program in progress. The reduced tax rate is believed to serve as an investment incentive.

For the purpose of payments of business income tax, tax payers are categorized into three, namely category A, Category B, Category C. based on the volume of their sales for a tax year and form of business. Subsequently, the Tax Authority will determine whether the tax payer

shall continue in the same category or his/her category be changed for the following tax year.

Category A includes any company incorporated under the laws of Ethiopia or in a foreign country and other entities having annual turnover of Birr 500,000 and more. This group of tax payers 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" unless already classified in category "A", includes businesses having an annual turnover of over Br 100,000. This category of taxpayers must submit profit and loss statement at the end of the year. The law requires all entries in the records and accounts to be supported by appropriate vouchers.

Category "C" unless already classified in categories "A" and "B" include those tax payers whose annual turnover is estimated by the Tax Authority at Birr 100,000 or less.

Every businessman or body, with the exception of category C, is required to keep proper books of accounts and other records and documents.

The books of accounts must contain;

- a record of business assets and liabilities including a detailed register of fixed assets;
- a record of all daily income and expenses,
- a record of all purchases and sales of goods and services showing the following:-
 - the particular goods and services sold

- the name of the buyers and sellers/providers in such a manner that they can be identified by the Tax authorities
- Using pre-numbered invoices containing vendor's tax identification number.
- a record of trading stock on hand at the end of the accounting period with the method of valuation
- any other document relevant for the determination of the tax liability

If books and records are prepared in a foreign language, the Tax Authority may require translation to the official languages of Ethiopia at the taxpayer's expense. Moreover, the books and records must be kept by the taxpayer for ten years after the end of the tax period to which they relate.

4.3 DETERMINATION OF TAXABLE BUSINESS INCOME

Taxable business income is determined for each tax period on the basis of profit and loss account otherwise known as income statement which should be prepared in accordance with *Generally Accepted Accounting Principles*, and subject to provisions of *Income Tax Proclamation No.286/2002* and related *directives* issued by the Tax Authority.

At the end of each fiscal year, each taxpayer submits a tax return to the Income Tax Authority. The tax return is a statement containing statistical information filled in a pre-printed form (provided by the Tax Authority), given to the Income tax Office. The return should contain full and true information about the income earned by the tax payer. The law requires the tax payer 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

the accountants may not be the same as admissible for tax assessment. There may be certain items of expenditure reasonably chargeable to the income statement but not allowable for tax purposes. Likewise, certain revenue items permissible to be included in the income statement may not be permissible to include in the tax return. It becomes thus necessary to adjust those items to determine taxable income.

4.3.1 Allowable Deductions (Deductible Expenses)

The general principle regarding deductibility is that deductions will be allowed for expenses incurred for the purpose of *earning, securing and maintaining* the business income to the extent that the expenses can be proven by the tax payer and subject to the *limitations* specified by the proclamation. On the basis of this, the law permits the following lists of expenses as deductible from business income.

1. The direct costs of producing the income, such as the direct cost of manufacturing, purchasing, importations, selling and such other similar costs;
2. General administrative expenses connected with the business activity;
3. Premiums payable on insurance directly connected with the business activity;
4. Expenses incurred in connection with the promotion of the business inside and outside the country, subject to the limits set by the directive issued by the Minister of Revenue.
5. Commissions paid for services rendered to the business, provided that:
 - (a). said services were in fact rendered.
 - (b). the amount paid corresponds to normal rates paid for similar services. By other persons or bodies similarly situated.

6. In the case of a business located and operating in Ethiopia as the branch, subsidiary or associated company of a business located and operating abroad, no payment of any kind made to the holding or associated company of the business in Ethiopia shall be accepted as deduction unless:
 - a. The payment in question was made for service actually rendered: and
 - b. said service was necessary for the business and could not be performed by the persons or bodies or by the business itself at a lower cost.
7. If the income tax authority has reason to consider that the total amount of salaries and other personal emoluments payable to the manager of a private limited company is exaggerated it may reduce paid amount for taxation purpose to the limit which, in view of operation of the company, appears justifiable, either by disallowing the payments made to more than one manager or in any other way which may be just and appropriate.
8. Sums paid as salary, wages or other emoluments to the children of the proprietor or member of the partnership shall only be allowed as deduction if such employees have the qualifications required by the post.

In computing taxable income, the above listed expenses could be deducted from gross income. If some conditions are met, the proclamation also allows such expenses as depreciation, bad debts, interest expense and donation and gifts, which is covered separately in this section as deductible expenses. (Refer the proclamations articles 23 to 27 and the regulation 78/2002 articles 10 to 14.) Some of them are discussed in 2.3 below

4.3.2 Non-allowable Expenses

All those expenses, which are not wholly or exclusively incurred for the business activity, are not allowable deductions from gross income. Therefore, in computing taxable income the following expenses should be added back.

- a. Capital Expenditure- the cost of acquisition, improvement, renewal and reconstruction of depreciable assets
- b. Additional Investment- an increase of the share capital of a company or the basic capital of a registered partnership
- c. Declared dividends and paid out project shares.
- d. Voluntary pension or provident fund contributions over and above 15% of the monthly salary of the employee.
- e. Damages covered by insurance policy
- f. Interest in excess of the rate used between the National Bank of Ethiopia and the commercial Banks increased by two percentage points.
- g. Punitive damages and penalties
- h. The creation or increase of reserves, provisions and other special purpose funds unless otherwise allowed by the proclamation.
- i. Income tax paid on schedule "C" income and recoverable Value Added Tax (VAT)
- j. Representation expenses over and above 10% of the salary of the employee.
- k. Personal consumption expenses
- l. Expenditures exceeding the limits set forth by the proclamation or regulations
- m. Entertainment expenses "Entertainment" means the provision of food, beverages, tobacco, accommodation, amusement, recreation or hospitality of any kind to any person whether directly or indirectly.
- n. Donation and gift other than those permitted by regulation.

- o. Sum paid as salary, wages or other personal emoluments to the proprietor or partner of the enterprises. Expenditure for maintenance or other private purpose of the proprietor or partner of the enterprise.
- p. Losses that are not connected with or not arising out of the activity of enterprise.
- q. Grants and donations that exceed 10% of the taxable income of the tax payer.

Allowable deductions that need certain conditions to be met

The following expenses need certain conditions to be met before all are allowed to be deducted from gross income:-

- ***Interest expense***

A) Interest which is not in excess of the rate used between National Bank of Ethiopia and Commercial banks increased by 2 %) is allowable deduction if the lending institution is recognized by NBE or a foreign institution permitted to lend to enterprises in the country. Moreover, for the interest paid to foreign banks to be deductible, the lending bank shall, prior to the granting of any loan to any such person, file a declaration in writing with the Tax Authority wherein it informs said authority concerning all loans granted to any person liable to pay income tax in Ethiopia. In addition, the borrower shall withhold 10% from the gross interest payable and transfer same to the Tax authority within two months of the end of the fiscal year.

B) Interest paid to share holders on loans and advance can be deducted to the extent that the interest paid is less than the average of four times the amount of share capital in a tax period. This provision doesn't apply to banks and insurance companies.

- ***Representation allowances***

Representation allowance is hospitality expense incurred in receiving guests coming from outside the enterprise in connection with the promotion and enhancement of the business. Such expenses are deductible to the extent of 10% of the salary of the employee.

- ***Gifts and donations***

Gifts and donations are allowable deductions under the following conditions

- a. If they are given to a registered welfare organization and where it is certified by the registering authority that the organization has a record of outstanding achievement and its utilization of resources and accounting system operates transparency, accountability.
- b. If the payment is made in response to emergency call issued by the government to defend the sovereignty and integrity of the country, to prevent man made or natural catastrophe, epidemic or for any other similar cause.
- c. Donation made to non commercial education or health facilities.

Nonetheless, grants and donations made for purpose listed above may only be allowed as deduction where the amount of the donation or grant does not exceed 10% of the taxable income of the taxpayer.

- ***Trading stock***



Trading stock is a business asset that is either used in the production process or become part of the product, or that is held for resale purpose.

The cost of *trading stock* disposed of during a tax period is allowable deduction for the purposes of ascertaining income.

📄 The *cost of trading stock* disposed of during a tax period is determined on the basis of the average cost method, i.e. the generally accepted accounting principle under which trading stock valuation is based on an *average cost of units* on hand.

Depreciation

Any business may acquire assets that have non-current nature to generate profit. In determining periodic income, the cost of these fixed assets should be transferred to expense account in a systematic and rational approach called Depreciation. Generally Accepted Accounting Principles (GAAP) allows different methods of computing annual depreciation charges for preparing general purpose financial statements.

Among these methods, the Ethiopian government adopts the straight line – pooling system method. Generally, except the cost of building, intangible assets and Information Technology Equipments purchased by a business, all other assets become part of a pool of expenditures on which capital allowances may be claimed. Under the pooling system, when addition is made, the pool increases; on disposal the pool is reduced by the sale proceeds.

In accordance with the newly enacted income tax proclamation and regulation, depreciation may be deducted in the determination of taxable business income. Nonetheless, fine arts, antiques, jewelry, trading stock and other similar business assets not subject to wear and tear and obsolescence shall not be depreciated.

Depreciation rate

- a. In determining the amount of depreciation the acquisition or construction cost, and the cost of improvement, renewal and reconstruction of buildings and constructions shall be depreciated individually on a straight-line basis at five percent (5%).
- b. The acquisition or construction cost, and the cost of improvement, renewal and reconstruction, of intangible assets shall be depreciated individually on a straight line basis at ten percent (10%).

The above two categories of business assets are depreciated at the given rates based on their cost (gross value).

The following two categories of business assets shall be depreciated according to a pooling system at the following rates;

- a. Computers, Information systems, software products and data storage equipment as a rate of 25%
- d. All other business assets at the rate of 20%. This category includes motor vehicles, plant and machinery, furniture and equipment, etc.

For assets for which the pooling methods are used, the rate is applied to the depreciation base for the determination of depreciation. The depreciation base is the book value of the asset as recorded on the opening day of the balance sheet of the tax period increased by the cost of asset acquired or created and the cost of improvement, renewal and reconstruction of the asset during the tax period. The amount can also be decreased by the sales price of assets disposed of during the period. Losses incurred during the period due to natural calamity and other involuntary conversion will also be considered in the computation of

depreciation base. Any compensation received for these purposes will be deducted from the book value.

While determining the depreciation base, if the depreciation base becomes negative amount, that amount will be added to taxable income and the depreciation shall become zero. On the other hand, if the depreciation base does not exceed Birr 1,000 the entire depreciation base will be a deductible business expense.

If a revaluation of business assets takes place, no depreciation will be allowed for the amount of the revaluation. In determination of taxable business income a deduction is permitted in respect of each category of business assets for the maintenance and improvement expenses up to a maximum of 20% of the depreciation base of the end of the year. Any actual expense exceeding this 20% will increase the depreciation base of that category (or it is capitalized). Nonetheless, depreciation is not allowed for assets in respect of which all *capitalized costs* have been fully recovered if the transfer of such assets is made between related persons.



The regulation issued by the Council Of Ministers indicates that depreciation will be allowed as deduction only if the taxpayer claiming deductions for depreciation keeps proper records showing the cost of acquisition of the asset and the total amount deducted since the date of acquisition. Moreover, the tax payer must furnish the Tax Authority with satisfactory evidence that the data mentioned in the records are true and correct.

Bad debts

In the determination of taxable income, a deduction for a bad debt is allowed if the following conditions are met:

- *An amount corresponding to this debt was previously included in the income;*

- *The debt is written off in the books of tax payer; and*
- *Any legal action to collect the debt has been taken but the debt is not recoverable.*

Activity 1

Identify the following in to “Allowed”, “Disallowed” or “Partially Allowed” business expenses.

- a) 20% provident fund contribution by the company name
- b) 10% provident fund contribution by the employee
- c) 15% provident fund contribution by the company name
- d) Basic salary of the General Manager of NMS p.l.c is br4,500 and his representation allowance is birr 900.
- e) General provision on doubtful debtors
- f) Company motor vehicle with net book value of Birr 250,000.00 was completely destroyed with car accident. The motor vehicle was insured and Birr 200,000.00 was recovered from the insurance company
- g) Br 100,000 donation to indigenous NGO to be utilized for anti-HIV campaign.
- h) Br 25,000. spending on public relations relating to the promotion of company’s business activity
- i) Br 25,000 spending as entertainment

4.3.3 Computing Taxable Income

Using the income statement, taxable income may be determined as follows;

1. Take the net profit as shown in the income statement which is prepared in accordance with Generally Accepted Accounting Principles (GAAP) or International Accounting Standards (IAS).
2. Add back any item deducted as expense, which is not allowed for tax purposes.
3. Deduct any item included in the income on which income tax has already been withheld by the payer. Examples of such items are income received from royalties, income from games of chance, dividends and interest received, etc. refer schedule 'D' other income in the proclamation.
4. Multiply the figure so arrived (from step 1 through step III) by the income tax rate. For bodies use the progressive tax table for persons (other tax payers) to get the tax payable for the fiscal year.

4.3.4 Tax Rate

- Taxable business income of bodies is taxable at the rate of 30%
- Taxable business income of other taxpayers shall be taxed in accordance with the following schedule C.

<i>Taxable Business Income (Per Year)</i>		Income Tax Payable
<i>Over Birr</i>	<i>To Birr</i>	
0	1,800	Exempt Threshold
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

The short cut method of computing business income tax is provided below.

<i>Taxable Income</i>			<i>Deduction</i>
<i>From</i>	<i>To</i>	<i>Rate</i>	
0	1,800	0	Nil
1,801	7,800	10%	180
7,801	16,800	15%	570
16,801	28,200	20%	1,410
28,201	42,600	25%	4,950
42,601	60,000	30%	7,950
60,001 and above		35%	

Activity 2

1. Compute income tax for A p. l. c assuming that its taxable income is Birr 135,000.00 for the current year
2. Compute income tax for Ato Thomas who is engaged in private clinic business and whose annual taxable income is Birr 54,600 based on the books of account maintained by him.

4.3.5 Loss Carry Forward

A business is said to have made loss when the total expenses incurred by the business during a fiscal year are greater than the total income

generated by the business in the same year. Loss carry forward is a procedure whereby a loss incurred in one tax period is carried forward to the next tax period to be deducted from the available profit, if any. Loss carry forward is one of the several changes introduced by new tax law. The importance of the loss carry forward provision to a company is that it preserves valuable cash which otherwise would have to be paid out in taxes. Such funds are retained in the business and can be used for working capital and/or expansion of the business. A business, which has alternate profit and loss years of about the same dimension, would pay no tax at all.

The subsequent paragraphs explain loss relieves available for companies and related eligibility conditions. If the determination of taxable business income results in a loss in a tax period, that loss may be set off against taxable income in 3 years tax periods; earlier losses set being set off before later losses. A continuous set off will be permitted only for a maximum period of 6 years (two periods of three years). However, if during a tax period the direct or indirect ownership of the share capital or the voting rights of a body changes more than 25% by value or by number the provision for set off will not apply to losses by that body in that tax period.

 *Loss carry forward will only be permitted where the books of accounts showing the loss are acceptable to the tax authority.*

Activity 3

Bezawit p. l. c started trading on April 2000 and results for the first three years are as follows

	<u>31-03-00</u>	<u>31-03-01</u>	<u>31-03-02</u>
Trading Profit (Loss)	(20,000)	30,000	21,000

Required: compute Income Tax Payable or Repaid to the Unbelievable n l c

4.3.6 Transfer of Business Assets

When assets used in a business are sold, exchanged or otherwise transferred, gain or loss is recognized on the transfer. Nonetheless, transfer of business assets among companies which are parties to a reorganization is not treated as disposal of the property. On the other hand, the value of assets held by a company or companies which are parties to a reorganization is the same as the value of such assets immediately before the organization. Similarly, the balance of any depreciation categories shall be carried over.

Activity 4

- Is there any relief available for the loss recognized on the transfer of Business Assets?
- How gain/loss does from transfer of business assets is determined?

Check Your Progress Exercise

1. What interest rate is applicable for loan and advance given by the shareholders to the company? Is rate above commercial banks lending rate acceptable?
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2. Explain how annual depreciation is computed under the pooling system method.
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.....
3. Explain the following terms as defined by the Income Tax law

- Business
- Income
- Body

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4. Explain factors that should be considered in planning relief for trading loss?

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5. If a taxpayer has claimed loss relief against total income of the same year, is there any restriction on his claiming relief against total income of the pervious year?

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4.4 SUMMARY

Income tax proclamation defined business as 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.

Tax payers are categorized into three for payments of business income tax based on the volume of their sales for a tax year and form of business: Category A, Category B and Category C.

Taxable business income is determined for each tax period on the basis of profit and loss statement, which should be prepared in accordance with GAAP and relevant proclamations and directions issued by the Tax Authority.

Taxable business income of bodies (organizations) is taxable at the rate of 30%.

4.5 ANSWER TO CHECK YOUR PROGRESS EXERCISE

1. Refer Section 4.3.4
2. Refer Section 4.3.1
3. Refer Section 4.2
4. Refer Section 4.3.5

UNIT 5:RENTAL INCOME TAX

Contents

- 5.0 Aims and Objectives
- 5.1. Introduction
- 5.2. Determination of Rental Income
 - 5.2.1. General
 - 5.2.2. Taxable Income
 - 5.2.3. Tax Rate
- 5.3. Summary
- 5.4. Answer to Check Your Progress Exercise

5.0 AIMS AND OBJECTIVES

After the completion of this section you will be able to:

- assess tax on schedule B income
- describe the declaration of rental income
- identify tax allowable and non-allowable deductions
- recognize the obligation of the tax payer to maintain proper accounts

5.1. INTRODUCTION

This section covers tax payables on income from rental of buildings. Any income arising from rental of buildings is taxable under *schedule B*. The section covers such issues as the determination of rental income, tax allowable expenses and the obligations of the tax payer with respect to maintaining proper accounts. The tax is collected on an annual basis and the tax year is the Ethiopian fiscal year.

5.2 DETERMINATION OF RENTAL INCOME

5.2.1 General

Rental income includes all form of income from rent of a *building* and rent of *furniture and equipment* if the building is fully furnished. Carefully note that income from the lease of business, including goods, equipments and building which are part of the normal operation of a business, (*called business lease*) are taxable under another schedule – *schedule C*.

Gross rental income also includes any cost incurred by the lessee for improvement to the land or building and all payments made by the lessee on behalf of the lessor in accordance with the contract of lease. There are two parties involved in renting a building – the *lessee* and the *lessor*. The party who grants rent of the building is the lessor while the one who leases the property for use is the lessee. In some occasions the lessor may allow the lessee to sub lease the building to another party in such circumstances the first lessee will be called *sub - lessor*. The sub - lessor must pay tax on the difference between income from the sub leasing and the rent paid to the lessor, provided that the amount received by the sub lessor is greater than the amount payable to the lessor. The owner of the building who allows a lessee to sub-lease is liable for payment of the tax for which the sub-lessor is liable, in the event the sub-lessor fails to pay.

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 communicate to tax office in case where the parties fail to do so.

5.2.2 Taxable Income

Gross income includes all payments, either in cash or benefits in kind, received by the lessor and all payments made by the lessee on the behalf of the lessor. The value of any renovation or improvement to the land or the building is also part of taxable income under this schedule if such cost is borne by the lessee in addition to rent payable.

Taxable income from schedule B income is determined by subtracting the allowable deductions from the gross income. Allowable deductions include the following;

- If the lessor does not maintain books of accounts his allowable deductions include taxes paid on land and buildings being leased and 20% of the gross income received as an allowance for repairs, maintenance and depreciation of such buildings, furniture equipment.
- If the lessor maintains books of accounts the allowable deductions (deductible expenses) include (but not limited to):-
 - a. Tax on land and buildings being leased
 - b. Cost of lease (rent) of land
 - c. Repairs, maintenance and depreciation of building (and furniture and equipment if furnished) per income tax proclamations article 23.
 - d. Interest on bank loan if any
 - e. Premium paid on insurance of building.

It is important to keep proper accounts for period of times when the building was not leased (kept idle).

5.2.3 Tax Rate

The income tax payable on rented houses shall be charged, levied and collected at the following rates:

- On income of bodies 30% of taxable income
- On income of persons according to *schedule B* below.

Schedule 'B' Tax Rate

Taxable Income from Rental (per year)		Income Tax Payable
Over Birr	To Birr	
0.00	1,800. 00	Exempt threshold
1,801	7,801. 00	10
7,801	16,800. 00	15
16,801	28,200. 00	20
28,201	42,600. 00	25
42,601	60,000. 00	30
Over 60,000		35

The short cut method of computing the income tax is:

Annual Taxable Income		Rate	Deduction
0.00	1,800	0	Nil
1,801	7,800	10%	180
7,801	16,800	15%	570
16,801	28,200	20%	1,410
28,201	42,600	25%	2,820
42,601	60,000	30%	4,950
60,001	& above	35%	7,950

Example 1

Total Rental Income of MTZ is Br. 40000 for year 1 costs and expense related to the rental include.

Repair and Maintenance Br. 2000

Premium paid on insurance Br. 1000

Calculate the income tax payable by Mr. X

Solution

Total Taxable rental income is Br. 37, 000 i.e. 40000 minus Allowable deductions Br. 3000.

From Payable	To	Total	Rate	Income Tax
0	1800	1800	Exempt	0
1801	7800	6000	10%	600
7801	16800	9000	15%	1350
16801	28200	11400	20%	2280
28201	37000	<u>8800</u>	25%	<u>2200</u>
Total		<u>37000</u>		<u>6430</u>

Short Cut

(Total taxable rental Income x Rate) – Deduction

(Br. 37000 x 25%) – Br. 2820

$$= \text{Br. } 9250 - 2820$$

$$= \text{Br. } \underline{6430}$$

Example 2

XYZ Co's total rental income from building for the year ending 20x2 is Br. 250000 and expenses incurred that are related to the rental of building include:

Tax on building	Br. 3000
Repair and Maintenance	4000
Depreciation	6000
Premium paid on Insurance	2500

Calculate the rental income tax payable by XYZ Co for the year 20x2

Solution

Allowable Deductions:

Tax on building	Br. 3000
Repair and Maintenance	4000
Depreciation	6000
Premium paid on Insurance	<u>2500</u>
Total	<u>Br.15500</u>

$$\begin{aligned} \text{Taxable Rental Income} &= \text{Total Rental Income} - \text{Allowable Deductions} \\ &= \text{Br. } 250000 - 15500 \\ &= \text{Br. } \underline{234500} \end{aligned}$$

$$\begin{aligned} \text{Rental Income Tax} &= \text{Taxable Rental Income} \times \text{Rate} \\ &= \text{Br. } 234500 \times 30\% \\ &= \text{Br. } \underline{70350} \end{aligned}$$

Check Your Progress Exercise

1. What is the basis of assessment for income assessed under Schedule B?

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2. What deductions are allowable from income assessed under
Schedule B?

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5.3 SUMMARY

Income from rental of building is taxable under schedule B, which covers such issues as determination of rental income, tax allowable expenses and obligations of the taxpayer.

The tax is collected on an annual basis and the tax year is the Ethiopian fiscal year, i.e. Hamle 1 to Sene 30.

Taxable income from schedule B income is determined by subtracting allowable deduction from gross income.

The income tax rate under schedule B is progressive that ranges from 10% to 35% and making the first Birr 1,800 exempted from tax payments on income of persons. Where as the rate is 30% person on income of bodies.

5.4 ANSWER TO CHECK YOUR PROGRESS EXERCISE

1. Refer Section 5.2
2. Refer Section 5.2

UNIT 6: SCHEDULE D INCOME TAX

Contents

- 6.0 Aims and Objectives
- 6.1. Introduction
- 6.2. Royalties
- 6.3. Income From Rendering of Technical Services
- 6.4. Income Form Games of Chance
- 6.5. Dividends
- 6.6. Income From Rental of Property
- 6.7. Interest Income on Deposits
- 6.8. Gains on Transfer of Certain Investment Property
- 6.9. Declaration and Assessment
- 6.10. Summary
- 6.11. Answer to Check Your Progress Exercise

6.0 AIMS AND OBJECTIVES

After completion of this chapter you should be able to

- Identify schedule D Income Taxes
- Determine the different other income taxes
- Describe the steps of computing capital gain tax
- Know the rates applicable to each type of schedule D income taxes

6.1 INTRODUCTION

Incomes which are not specifically included under Schedule A, Schedule B and Schedule C is categorized under this schedule. Schedule D income includes;

- Royalties
- Income from rendering of technical services
- Income from games of chance

- Dividends
- Income from rental of property
- Interest Income
- Gain on transfer of certain investment property.

This section covers the determination of taxable income, tax rate and payment of tax with respect to the above listed types of incomes.

6.2 ROYALTIES

Royalty refers to a payment of any kind received as a consideration for the use of or the right to use any copyright of literary, artistic or scientific work, including cinematography film, and films or tapes for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula, or process, or for the use or for the right to use of any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

Royalties is subject to a tax at a flat rate of 5%. The withholding agent who effects royalties payments, withholds the foregoing tax and accounts to the Tax Authority. However, if the payer resides abroad and the recipient is a resident, the recipient must pay the tax on royalty income.



This tax is final in lieu of income tax

6.3 INCOME FROM RENDERING OF TECHNICAL SERVICES

Income from technical service refers to income from any kind of expert *advice* or *technological* service rendered. All payments made in consideration of any kind of technical services rendered outside Ethiopia

to resident persons in this form are subject to a tax rate of 10% which will be withheld and paid to the tax authority by the payer.

6.5. INCOME FROM GAMES OF CHANCE

This form of income is derived from winning at games of chance (lotteries, Tom bolas, and other similar activities). This income is subject to tax at the rate of 15%, except for winnings of less than Br. 100 similar to income from rendering technical activities the payer must withhold or collect the tax and account to the Tax Authority.

 *This tax is final in lieu of income tax.*

6.5 DIVIDENDS

The taxable Income is income received in the form of dividend from a share company or withdrawals of profits from a private limited company. Dividend Income is subject to tax at the rate of 10%. The withholding agent (payer) shall withhold or collect the tax and account to the tax Authority.

 *This tax is final in lieu of income tax.*

6.6 INCOME FROM RENTAL OF PROPERTY

The taxable income under this category is income derived from casual rental of property (land, building, or moveable asset) not related to a

business activity. This type of income is subject to tax at a flat rate 15% of the annual gross income.

👉 *This tax is a final tax in lieu of a net income tax.*

6.7 INTEREST INCOME ON DEPOSITS

This includes income derived from interest on deposits. Interest Income will be taxed at the rate of 5% and the payer must withhold the tax and account to the Tax Authority.

👉 *This tax is a final tax in lieu of income tax.*

6.8 GAINS ON TRANSFER OF CERTAIN INVESTMENT PROPERTY

Gains obtained from the transfer (sale or gift) of building held for business, factory, and office and a share of companies is taxable under this category. Such income is taxable at the following rates:-

- Building held for business, factory, and office at the rate of 15%, and
- Shares of companies at the rate of 30%

Nonetheless, Gains obtained from the transfer of building held for residence is exempted from tax provided that such building is fully used for dwelling for two years prior to the date of transfer.

Computation of Capital Gain Tax

In computing capital gain tax, you should follow the following procedures;

STEP 1. Determine the historical cost of the building or the par-value of the Share, as appropriate.

- When calculating the capital gain realized from the alienation of building, the cost registered with the appropriate government body at the time of issuance of construction permit shall be taken to be the cost of constructing the building. Tax payable on gain realized from alienation of buildings shall be applicable only to buildings in municipal areas.

STEP 2 Determine allowable deductions which includes

- inflation adjustment at a rate to be determined by the appropriate authority
- taxes paid for the land and the buildings

STEP 3 Determine proceeds from the transfer of capital assets

STEP 4 Capital gain tax equals tax rate mentioned above times the amount obtained after deducting the sum of step1 and step 2 from step 3.

Example

ABC Co. sold a building, which is held for business for Br. 1,000,000, which is acquired at a cost of Br. 1, 200,000. Depreciation until time of sale amounts Br. 500,000 and property tax paid for the building Birr 50, 000.

Calculate the capital gain tax payable by ABC Co.

Solution

$$\begin{aligned} \blacksquare \text{ Book value of the Building} &= \text{Cost} - \text{Accumulated Depreciation} \\ &= 1,200,000 - 500,000 \\ &= \underline{700,000} \end{aligned}$$

$$\blacksquare \text{ Property tax on the building is allowable deduction. Br. 50, 000}$$

$$\begin{aligned} \text{Capital gain tax} &= (\text{Br. } 1,000,000 - (\text{Br. } 700,000 + \text{Br. } 50,000)) \times 15\% \end{aligned}$$

$$= \text{Br. } 250,000 \times 15\%$$

$$= \underline{\text{Br. } 37,500}$$

6.9 DECLARATION AND ASSESSMENT

As already indicated in earlier discussions each tax payer submits a tax return (financial statements) to the income tax authority at the end of each fiscal year. The tax return will, then, be subject to a review by a tax officials. This review by a tax official of the tax declaration and information provided by the tax payer and a verification of the

arithmetical and technical accuracy of the declaration tax liability shortly after the **submission** of the declaration is called Tax Assessment.

The tax year of a person is the fiscal year for an individual or association whereas it is the accounting year of the body in the case of a body. The Procedures for the assessment of business income tax takes two forms, assessment by books of account and assessment by estimation.

A) Assessment by books of account.

Assessment by books will be done for those who maintain books of accounts (Category A&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 table within the time required.

B) 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.

Assessment Notification

Notification regarding the assessment of tax, in writing, is served to taxpayers in the following ways.

1. **To non-residents:** By a registered letter to the agent or by affixing the notice on the residence or place of business.
2. **To Resident individuals:** By registered post or in person. (Incasing if the taxpayer is absent, to any adult member of the family). In the absence of any person to receive the notice, it will be affixed to the door of residence or place of business.
3. **To bodies:** By a registered letter to the body or to any director or employee.

Change of accounting year

A body can not change its accounting year unless it obtains prior approval in writing from the Tax Authority and complies with any condition that may be attached to the approval. However, the Tax Authority may remove the approval granted by notice in writing if the body fails to comply with any conditions set by the tax authority. When the tax year of a person changes, as a result of failure to comply with the tax authority's conditions, the period between the last full year and the date on which the new tax year commences will be treated as a separate tax year to be known as the "*transitional year*".

Declaration and assessment of Schedule B and C income

For the purpose of declaration and payment of income tax, schedule "B" and schedule "C" income tax payers are classified into three categories, known as category "A" category "B" and category "C"

The difference of and the requirements from each category are summarized in the table below:-

Category	Basis of classification	Requirements basis for assessment	Period of payment/ declaration
A	Any company incorporated under the law of Ethiopia or in a	- Balance sheet - Profits and loss	Within four months from the end of the tax

	foreign country Any other business having an annual turnover of Birr 500,000 or more	statement Details of gross profit and the manner in which it is computed, general and administrative expense, depreciation, provisions and reserves	payers tax year
B	Unless already classified in category "A", any business having an annual turnover of over Birr 100,000.	- Profit and loss statement - Vouchers supporting the above	Within two months from the tax payers tax year
C	Unless already classified in categories "A" and "B" whose annual turnover is estimated by the tax authority as being up to Birr 100,000	- A standard assessment method shall be used to determine the income tax liability. (fixed amount) and - The tax will be paid in accordance with schedule 1 and 2 attached with the regulation or - If the tax payer maintains accountable books of accounts, the tax will be paid based on such books	Hamele 1 to Hamele 30 of each year

The tax calculated in accordance with the tax declaration less tax withheld and foreign tax credit must be transferred to the Tax Authority. The tax authority will refund any excess payments resulting from the above within 90 days of becoming satisfied on the tax declaration. The amount of tax due for the year stated in the declaration is the amount assessed by the tax authority although the authority may issue an amended assessment if it discovers an error or omission.

Declaration and assessment of schedule “D” income

Income tax withheld by a payer from Schedule “D” income at source constituting a final tax payable to the tax Authority within 15 days of the end of each calendar month. If, however, a taxpayer who has schedule ‘D’ income, not subjected to withholding at source consulting a final tax, shall prepare a declaration of that income in a form prescribed by tax authority. Taxpayers shall submit this declaration to the tax authority within two months from the end of the Ethiopian fiscal year.

Check Your Progress Exercises

3.

What are the main examples of Schedule D Income?

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4.

Who is the tax agent for any tax collected from royalty income?

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5.

What is the maximum tax payment a person or a body makes from dividend income?

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6. On what date does a disposal occur for capital gain tax?

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7. What formula is used to calculate the indexation factor (Inflation Adjustment)?

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8. Explain the two forms of procedures for the assessment of business income tax.

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6.10 SUMMARY

All incomes which are not categorized under schedule A, schedule B and schedule C, are grouped under schedule D, other income. This schedule includes

- Royalties
- Income from rendering of technical services
- Income from games of chance
- Dividends
- Income from rental of buildings
- Interest income
- Gain from transfer of certain investment property

The procedures for the assessment of business income tax takes two forms:

- Assessment by book of account

■ Assessment by estimation

6.11 ANSWER TO CHECK YOUR PROGRESS EXERCISE

1. Refer Section 6.1
2. Refer Section 6.2
3. Refer Section 6.5
4. Refer Section 6.8
5. Refer Section 6.8
6. Refer Section 6.9

UNIT 7: VALUE ADDED TAX (VAT)

Contents

- 7.0 Aims and Objectives
- 7.1 Introduction
- 7.2 Registration
 - 7.2.1 Forms of Registration
 - 7.2.2 Registration Formalities
 - 7.2.3 Cancellation of Registration
- 7.3 Scope and Application of VAT
- 7.4 Calculation of Tax Payable
- 7.5 Preparing Tax Returns and Payment
- 7.6 Assessment of Tax and Administration
- 7.7 Transitional Rules
- 7.8 Exemptions and Zero Rated Tax
 - 7.8.1 Exemptions
 - 7.8.2 Zero rate tax
- 7.9 Summary
- 7.10 Answer to Check Your Progress Exercise

7.0 AIMS AND OBJECTIVES

After the completion of this section you should have learned the following:

- Forms of registration and their particulars
- Registration formalities
- Grounds for cancellation of registration
- Taxable and non-taxable transactions
- Place and timing of taxable transactions
- Determination of the values of taxable transactions and necessary adjustments

- Determination of tax payable for different taxable activities
- Tax credits rules
- Issuance of VAT invoices and requirements
- Transactions by agents

7.1 INTRODUCTION

The introduction of value Added Tax (VAT) is probably the most important tax development in the world. VAT has been introduced for the first time almost 50 years ago, and its applications remained confined to a handful of countries until the late 1960's. Today, VAT is applied in over 120 countries. This makes about 4 billion people or 70% of the world's populations live in countries with a VAT. In these countries VAT raises about \$18 trillion in tax revenue, roughly a quarter of all governments revenue. The Federal Democratic Republic of Ethiopia recently has joined the over 120 countries of the world that have already adopted VAT into their tax system. VAT is introduced in Ethiopia with the following main objectives.

- to minimize the damage caused by attempts to avoid and trade the tax and ascertain the profit obtained by tax payables.
- to enhance economic growth and import the ratio relationship between from Domestic Production and Government Revenue.

- to enhance saving and investment as it is essentially a consumption tax and does not tax capital.

The key feature of this form of tax is that it is charged and collected through out the production and value adding processes with provisions for tax payable to be reduced by the tax point in respect of purchases. It allows collection of tax on the *added value* wherever a sales transaction is conducted. The law governing VAT requires the following persons to pay value added tax.

- A registered person – a person who is registered or required to be registered
- a person carrying out taxable import of goods, with respect to such import.
- A non-resident person who performs services without registration, with respect to such services.

A person who is registered is taxable as soon as registration for VAT takes place. But a person who fails to adhere to the registration requirement is considered to be taxable beginning from the start of the accounting period following the period the obligation for registration arose.

Taxable persons pay VAT on any activity carried on continuously or regularly in Ethiopia, wholly or partly, whether or not for a profit, that involves or intends to involve in whole or in part the supply of goods and services to another person for consideration.

Anything done in connection with the commencement or termination of a taxable activity is treated as carried out in the course or furtherance of that taxable activity. Nonetheless, taxable activity does not include any activity carried on by a natural person essentially as a private recreational pursuit, hobby or an activity by a legal person having the same essence. Moreover, an activity is not a taxable activity if it involves the making of exempt supplies.

Check Your Progress Exercise 1

1. What is VAT?

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2. What is taxable activity?

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3. Who pays Value Added Tax?

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4. What are the main differences between VAT and Sales Tax?

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7.2 REGISTRATION

This section covers some essential points related to getting registered for VAT. Registration may take different forms - *voluntary or obligatory*. Hence, each form of registration shall be discussed. Moreover, registration procedures and matters related to cancellation of registration are also addressed in this section.

Registration takes two forms. In compulsory (obligatory) registration taxable persons are required to get registered when they meet some criteria. Others can still register on voluntary basis depending on the nature of their activities.

7.2.1 Forms of Registration

a. Obligatory Registration

A person who carries on a taxable activity is required to get registered if at the end of any period of the 12 calendar months the person made taxable transactions whose value exceeds Br. 500,000. In addition to this, a person must get registered for VAT if there is a reasonable ground to expect that the persons taxable activity shall exceed Br. 500,000 at the beginning of any period of 12 calendar months. However, carefully note that the Birr 500,000 threshold may be increased or decreased by a directive issued by the minister of Finance and Economic Development.

A person required to register has to file an application for registration no later than the last day of the month after the end of the period in which its activities exceed the thresh out

or the last day of the month of the period the expectation to exceed the threshold is made.

b. Voluntary Registration

A person not required to be registered for VAT may voluntarily apply to the authority for such registration, if he is regularly supplying or rendering at least 75% of his goods and services to registered persons.

c. Divisional Registration

A registered person may conduct taxable activities in different branches or divisions. In such cases, the registered person must be registered only in the name of the registered person at its main address.

Notwithstanding the above, the authority may, upon application in writing by a registered person operating in corporate form, allows the registered person to register one or more of its branches or divisions as separate registered persons if it is satisfied that the branch or division maintains an independent accounting system and can be separately identified by the nature of its activities or location subject conditions and restriction the minister of revenue may seem fit. A registered person and its separately registered division and separately registered divisions of a head office registered person, are “related persons”. In determining whether a person has an obligation to register, the authority may aggregate the value of taxable transaction made by one person with that of other person where both are related persons.

If a division is registered separately it must file a VAT return for each accounting period. Besides, each separately registered part of the entity is subject to all of the obligations imposed on a registered person, but it remains a part of the entity.

It is also possible for a registered person to apply for divisional registration if a single registration requiring a single VAT return imposes an onerous compliance burden on it. In this case, the authority, in its sole discretion, decides if the applicant will experience real difficulties in submitting a single VAT return. Moreover, a registered person may request that some, but not all divisions be registered separately and those not registered separately continues to be treated as part of the entity's registration.

The authority may withhold a refund to a separately registered division in order to satisfy the tax levy, interest, or penalty payable by the entity or another division. Moreover, transactions between the head office and separately registered division or between separately registered divisions are closely scrutinized by the authority to prevent the use of divisional registration to obtain unintended tax benefits.

In line with the above, supplies made by a separately registered division to the head office or between separately registered divisions are treated as supplied between related persons for tax purposes, but the supplier must issue tax invoices for those transactions and the recipient can claim tax

credits on the purchases. Expenses allocated by the head office to a separately registered division may also be treated as taxable supplies by the head office. For purposes of the registration threshold, the supplies of each separately registered division are included as supplies of the entity.

 Is divisional registration compulsory?

Separate divisional registration is discretionary with the authority and to be eligible the head office applicant must satisfy all of the following conditions:

- a. The applicant must be an incorporated company and a registered person, but not a person who voluntarily registered;
- b. The application must be made in writing and include the applicant's taxpayer identification number and VAT certificate number; and the likely problems to be encountered to file a single return, the persons for this difficult of meeting due dates.
- c. The applicant must have proper records of its receipts and payments and produce financial statements using the same accounting period and bear end date.
- d. The division for which separate registration is requested must be separately identified by reference to the nature of its activities or its location, and must maintain sound accounting system.

In addition to these conditions for separate registration, the authority may impose additional conditions before approving an application for divisional registration, or may impose different conditions on a newly registering entity.

The registered person must file a separate application for each division seeking separate registration on the form and containing the information required by the authority, or a newly registering person must submit an application for registration and an application for divisional registration at the same time.

Each separately registered division will be issued a taxpayer identification number and VAT certificate number that identify it as a division of the entity. The registered division, following separate registration, must issue tax invoices listing its unique taxpayer identification number and VAT certificate number.

During allocations of tax credits, the authority may require the allocations to be made on an entity basis, rather than on a division-by-division basis.

Cancellation of separate registration

It is the sole discretion of the authority to determine if divisional registration shall be allowed to continue. Nonetheless, the home office registered person may apply in writing for the cancellation of the separate registration of a division. This is particularly necessary when an entity or a division ceases to satisfy any of the conditions imposed on divisional registration. In such circumstances, the entity must

notify the authority in writing of the change within 30 days of the date any condition to be met. Moreover, unless the authority approves a rather shorter period, the separate registration of a division will remain in effect for not less than two years.

The authority may also initiate a cancellation of divisional registration on certain grounds. The authority may cancel divisional registration if the conditions are no longer in existence. Such cancellation would be necessary for the protection of the revenue;

The cancellation of divisional registration will be effective from the date specified by the authority.

7.2.2 Registration Formalities

A person applying to register for VAT is required to do so in a form established by the authority. When a registration application is filed by a person carrying out taxable transaction, the authority will include the person in the VAT register, containing details of all persons registered, and issue out a *certificate of registration* within 30 days of registration.. The VAT registration certificate issued by the authority contains such details as:

- a. the full name and other relevant details of the registered person;
- b. the date of issuance of the certificate;
- c. the date from which the registration takes effect;

- d. the registered person's taxpayer identification number.

Registration takes place on one of the following dates, whichever comes first:

- a. in case of obligatory registration, on the first day of the accounting period following the month in which the obligation to apply for registration arose;
- b. in the case of voluntary registration, on the first day of the accounting period following the month in which the person applied for registration
- c. on the date selected by the registered person on his application subject to acceptance of this by the Authority who may at its sole discretion change the accounting period.

If a person required to register for VAT has not applied to be registered, the authority may register the person on its own initiative and send the certificate of registration to the registered person. On the other hand, when a person applies for a voluntary registration, the authority may deny the application the person has no fixed place of business. Application for registration may also be denied if there is adequate ground for the authority to believe that the person will not keep proper records or will not submit regular and reliable tax returns.

In addition, the authority may waive the requirement for registration where it is satisfied that the value of a person's taxable transaction exceeds or will exceed Br. 500,000. This may be due to a cessation, or substantial and permanent reduction in the size or scale of a taxable activity carried on by the person. The supply of capital goods that are being replaced with other capital goods to be used in the taxable activity carried by that person may be another reason for the waiver.

7.2.3 Cancellation of Registration

A registered person can apply to have his registration cancelled he ceases to make taxable transactions. The person must apply in writing for cancellation of registration within 30 days of the date he ceases to make taxable transactions . he must also indicate if he intends to make taxable transactions within twelve months from the date of application.

Cancellation of registration can also be initiated by a registered person if at any time after a period of three years of his most recent registration, his total transaction for the period of 12 months then beginning are expected to be not more than Br. 500,000.

The authority is expected to approve an application for the cancellation unless it has reasonable grounds to believe that the person will make taxable transactions at any time within 12 months from the date of cessation.

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. While the cancellation of registration generally takes effect on the date of cessation, the authority can cancel the registration retroactively if it's satisfied that the person did not make taxable transactions since the registration took effect.

When registration is cancelled the registered person be deemed to have sold the goods on hand in a taxable transaction.

Any obligation or liability including the furnishing of returns, in respect of anything done by that person while the person was a registered person, is not affected by cancellation of registration.

Following cancellation, the authority will 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 back to the authority.

Check Your Progress Exercise 2

1. What are the consequences of Deregistration?

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2. Explain the condition that makes registration for VAT Voluntary?

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3. Who is legally obliged to register for VAT?

7.3 SCOPE AND APPLICATION OF VAT

This section covers the scope of application for VAT. The section primarily discusses the nature of taxable transactions, the determination of values for taxable supplies and services, and the place and timing of taxable transactions. It also covers other related issues.

1. Introduction

VAT is imposed on taxable transactions. A transaction will be taxable under VAT if it involves *supplying of goods* or *rendering of services* in Ethiopia with the exception of exempted supplies. VAT is payable on taxable transactions and accounted for and paid by a registered person making the supply, or by the importer in the case of an import of goods, and by the recipient of the services in the case of an import of services.

2. Imposition of Tax on Imports of Goods

In case of imports of goods the importer must furnish the customs authority an import declaration in the form prescribed and furnished in the manner specified by the Customs

Authority and pay the tax due. The import declaration must include the information necessary to calculate the tax payable in respect of the import.

The Customs Authority will collect any tax due on imported goods on the behalf of the Authority. To this end the customs Authority need to obtain the name, the tax identification number of the importer and the invoice value of the goods imported. in addition, the customs authority will make necessary arrangements with the Ethiopian Postal Services to perform functions on its behalf in respect of tax on imports that arrive through the Postal Services.

3. Imposition of tax on supply of Goods and Rendition of Services

3.1. Meaning

Supply of goods refers to any of the following.

- A sale of goods
- A grant of the use or right to use goods with or without a driver, pilot, agreement, credit agreement, freight contract, agreement for charter, or any other agreement under which such use or right to use is granted; or
- A transfer or provision of thermal or electrical energy, gas, or water.

on the other hand, a rendition of services means anything done which is not a supply of goods or money, including:

- The granting, assignment, cessation, or surrender of any right; or

- Making available a facility or advantage.

Purchase of goods by a registered person with payment of VAT for which appropriate credit is received or can rightfully be received is considered to be used in the taxable business.

a. Supply by employers

The supplies of goods or services by an employer to his employees, including those made gratuitously represent supply of goods or services and therefore are taxable even if the employee doesn't pay or pays less than market value, unless the transaction is specifically exempted. On the other hand, if an employer provides an employee a cash advance, pays a supplier on his behalf or the employee reimburses an employer for the cost of goods or services provided as a fringe benefit, the employee is not entitled to claim any portion of the cost as a tax credit because the goods or services provided are not used in connection with the employers taxable activity.

Similarly, if an employer was denied a tax credit on the purchase of goods or services (such as a passenger vehicles), the supply of those items to an employee is not a supply in connection with a taxable activity and, therefore, not subject to tax.

A supply of goods with VAT for which the acquirer is not entitled to VAT credit is not considered a taxable transaction or the amount is proportionality reduced if credit is partially allows.

The value of returnable packaging is not included in the taxable amount but retailers may reduce their taxable transaction by refundable amounts paid for containers.

Provisions of proclamation apply to the supply of goods and rendering of services carried out by a non-resident in Ethiopia through a permanent establishment in Ethiopia or through the Internet.

b. Supply upon cancellation of registration

When a VAT registration is cancelled, goods (including capital goods) on hand are considered to be supplied at cost in a taxable transaction taking place at the time the registered person claimed or had a right to claim a tax credit on to the acquisition of the goods.

Upon cancellation of registration the cost of capital goods (determined asset by asset) treated as supplied at the time is equal to the cost of such goods multiplied by the fraction, number of years of actual use of the asset over the total useful life. For this purpose, the useful lives of assets shall be determined under the directives to be issued by MOR.

c. Disposal of taxable activities

The disposal of a taxable activity as a going concern, or a part of taxable activity that is capable of separate operation, represents a supply of goods made in the course or furtherance of such taxable activity and the transferee succeed to the rights and obligation of the supplier with respect to the asset transferred.

A taxable activity or a part of it capable of separate operation is said to be disposed of as a going concern and considered as a supply of goods where all the goods and services necessary for the continued operation of that activity or its part are supplied to the transferee and the transferor carries on that taxable activity or its part up to the time of transfer.

The supply is charged with tax at the rate of zero percent if the recipient acquires the goods and services wholly or partly for a purpose other than consumption use or revalue.

Acquisition of less than 10% of a taxable activity is not considered a supply of goods. The council of ministers may, however, provide in regulation for the treatment of other transaction as supplies of goods or rendition of services.

d. Repossession of a supply

Where goods supplied under an installment sale or finance lease (collectively referred to as a credit agreement) are repossessed, the repossession is a supply of the goods by the debtor, and where such debtor is a registered person, the supply is made in the course or furtherance of the debtor's taxable activity unless the goods did not form part of the assets held or used by the debtor in connection with that taxable activity.

e. Others

- The sale of a lottery ticket by the National Lottery Administration is a supply of services.

- The rendition of services by an employee to an employer by reason of employment is not a supply.
- The provision of goods on consignment and the transfer of goods to a person in a representative's capacity is not a supply.
- The removal of goods from a bonded manufacturing warehouse or any supply of goods subject to export duty incentive scheme is treated as a supply of goods and;
 - If the goods are sold in the domestic market, the supply is taxable at the standard rate.
 - If the goods are exported, the supply is taxable at the zero rate.
- A supply of goods or rendition of services to an agent is treated as a supply to the principal.

f. Mixed Supplies

A supply of goods or rendering of services, which is incidental to a main supply of goods or rendering of services is treated as part of the latter. Accordingly, the rendering of services incidental to import of goods is part of the import of goods.

A taxable transaction involving independent elements of separate supply of goods or rendering of services exempt from tax, is treated as separate transactions.

Similarly, if an exempt transaction involves independent elements with separate supply of taxable goods or services, is treated as separate transactions. Moreover, where a supply consists of supplies chargeable at zero rate and at a positive

rate, each part of the supply is treated a separate supply, unless one part is incidental to a main supply as in above.

Check Your Progress Exercise 3

2. What are taxable supplies?

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3.2. Exempt Transactions

The following types of supplies of goods (other than by way of export) and rendering of services, as well as imports of goods, are exempt from payment of VAT to the extent provided by regulation:

- a. The sale or transfer of a used dwelling, or the lease of dwelling;
- b. The rendering of financial services;
- c. The supply or import of national or foreign currency (except for that used for numismatic purposes), and of securities;
- d. The import of good to be transferred to the National Bank of Ethiopia.
- e. The rendering by religions organizations of religious or church related services;
- f. The import or supply of prescription drugs specified in directive issues by the Minister of Health, and the rendering of medical services.

- g. The rendering of educational services provided by educational institutions, as well as child car services for children at per-school institutions;
- h. The supply of goods and rendering of service in the form of humanitarian aid, as well as import of goods transferred to state agencies of Ethiopia and public organizations for the purpose of rehabilitation after natural disasters, industrial accidents, and catastrophes;
- i. The supply, kerosene, and water;
- j. Goods imported by the government, organizations, institutions or projects exempted from duties and other import taxes to the extent provided by law or agreement.
- k. Supplies by the post office authorized under the Ethiopian Postal Services Proclamation, other than services rendered for a fee or commission.
- l. The provision of transport;
- m. Permits and license fees;
- n. The import of goods to the extent provided under schedule 2 of the customs Tariffs Regulations;
- o. The supply of goods or services by a workshop employing disabled individuals if more than 60% of the employees are disabled;
- p. The import or supply of books and their printed materials to the extent provided in regulations.

Moreover, the ministry of finance and economic development may exempt goods and services other than these by directive.

Carefully note that a supply of goods or services is not an exempt supply if it is charged at the rate of *zero percent*.

Check Your Progress Exercise 4

1. Identify the main categories of exempt supplies?

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2. Is there any consequence of making exempt supplies?

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3.2. Place, Time and Value of Supplies

3.2.1 Place of Supply

a. Place of supply of goods

If a supply involves goods being transported, the supply takes place at the source. In other cases, the supply of goods shall be deemed to take place at the location where the goods are transferred. In the case of a supply of electric or thermal energy, gas or water supply takes place where the goods are received, except in the case of export where the supply is considered to take place in Ethiopia.

b. Place of rendering of services

In most cases the place of rendering of services is the location of the taxable activity of the person who renders services. Accordingly, the place of rendering of services is:

- a. The place where immovable property is located, if the services are directly connected with the property and the place where the services are carried out, if they are connected with movable property;
- b. The place where services are actually carried out, if they are rendered in the field of culture, art, education, physical fitness, sports, or in another similar activity;
- c. The place where transportation actually takes place. Transportation service rendered by a person outside Ethiopia is considered as carried out in Ethiopia.
- d. The location of the permanent establishment of the purchaser of the services to which the services most closely relate for;
 - The transfer of ownership or concession of patents, licenses, trademarks, copyrights, or other similar rights;
 - Consulting, legal, accounting, engineering, and advertising services, as well as data processing services, and other similar services.
 - The leasing of movable property (except for vehicles of transportation enterprises);
 - Services of an agent that engages a person (enterprise or physical person) on behalf of the main participant in a contract to perform the services described above.

3.2.2. Time of Supply

A supply occurs when a VAT invoice is issued for that transaction. Besides, invoices should be issued within 5 days after the time the goods are made available to the recipient, sold or transferred, or the services are rendered. In a similar manner, invoices should be issued within 5 days after the shipment starts in case of delivery of goods that involves shipment of the goods. If a VAT invoice is not issued within 5 days after the moment described above, the supply will be considered as having taken place.

With all these provisions, if payment is made in advance of the time described and VAT invoice of the time described but a VAT invoice is not issued within 5 days, the supply will be considered as having taken place at the time of payment.

Sometimes two or more payments may be made for a supply. in such cases each payment is treated as made for a separate supply to the extent of the payment.

If services are rendered on a regular or continuing basis, the supply is treated as taking place on each occasion when a VAT invoice is issued or, if payment is made earlier, at the time of payment for any part of such services.

In case of an employee providing service to its employee, the time of supply is when the use or consumption of goods or services begins.

If a registered person's VAT registration is cancelled, the time of supply is immediately before the cancellation takes effect.

A supply for a consideration in money received by the supplier by means of machine, meter or other device operated by coin, note, or coupon occurs when the money is taken from the device by or on behalf of the supplier.

As it has already been indicated above, the repossession of goods under a credit agreement is treated as a supply of the goods. The supply occurs on the day the goods are repossessed. However, when the debtor is reinstated in his rights and obligations under the credit agreement, supply shall be deemed to take place on the day after the last day of any period during which the debtor is instated so.

In case of transfer of a taxable activity or its portion as a going concern, the supply occurs when the transfer occurs.

In case of removal of goods subject to export trade duty incentive scheme (including a sale in the domestic market), the supply occurs when the goods are supplied in the domestic market or exported.

In addition to all these, the time when other supplies occur may be provided by directives issued by the minister of revenue.

3.2.3. Value of a Supply

The value of a supply is determined according to the amount the person receives or is entitled to receive in return for the supply excluding VAT. Hence, if a person receives or is entitled to receive goods or services in exchange for a supply of goods

or services, the value of the supply includes the market price of the goods or services excluding VAT.

In case where a person receives or is entitled to receive nothing of value in exchange for a supply of goods or a rendition of services (including that of goods remaining on hand in the case of a cancellation of registration, but not including a supply of business samples), the value of the supply is market price of the goods or services excluding VAT.

In the case of consumption or use of goods and services, other than in connection with taxable activity as well as in the case of supply or rendering to an employee, the value of the supply is the cost price of the goods or services supplied without including VAT.

However, the value of a supply may be reduced by any price discounts or rebates allowed and accounted for at the time of the supply. Post supply price adjustments must be accounted for as provided below.

☞ Where a portion of the price of a supply represents tax imposed not separately accounted for, the value of the supply is the price reduced by an amount equal to the product of the tax.

☞ A registered person may convert a portion of or an entire good or service for which a tax credit was allowed from use in a taxable activity to a different use. Such a change in use is treated as a supply of the goods or services in

the course of a taxable activity. The Minister of Revenue may issue directives on the value of such supplies.

An import of goods takes place when the goods are entered into the customs declaration. The value of a taxable import is the customs value of the goods plus the sum of duties and taxes payable upon the import, excluding VAT and income tax withholding. In the case of services considered part of import, their value, without VAT, is added to the value defined above.

The value of supply of goods under an installment sale or finance lease (a credit agreement) is the cash value of the supply. The “cash value” in relation to supply of goods under a credit agreement is determined as follows.

- a. where the seller or lessor is a bank or other financial institution, the cash value is an amount equal to the sum of:
 - i. The consideration paid by the bank or other financial institution for the goods or the market value of the goods, whichever is the greater, and
 - ii. Any consideration for erection, construction, assembly, or installation of the goods borne by the seller or lessor.
- b. Where the seller or lessor is a supplier, the cash value is an amount equal to the sum of:

- i. The consideration for which the goods are normally sold by the supplier for cash.
- ii. Any consideration for erection, construction, assembly, or installation of the goods borne by the supplier.

Where the debtor is deemed to make a supply of goods as a result of repossession of goods under a credit agreement the value of the supply is an amount equal to the balance of the cash value of the supply that has not been recovered at the time of the supply.

The balance of the cash value of the supply is the amount remaining after deducting the sum of the payments made by the debtor under the agreement on the basis of an apportion regarded as having been made in respect of the cash value of the supply.

The values of the goods subject to an export trade duty incentive scheme that are removed for export or that are supplied but not exported, is the market value of the goods.

Where a recipient of a zero rated transfer of a going concern acquired some of the goods in the transfer for a purpose other than to make taxable transactions, the acquisition of those goods is treated as a supply of good by the recipient in the course or furtherance of a taxable activity. In such cases, the value of the supply will be the consideration for the acquisition of the taxable activity, proportionately reduced to the amount of the intended use or application of the taxable activity.

The Minister of Revenue may issue a directive to provide for the calculation of the value of a supply of goods or rendition of services for supplies not covered above.

Adjustment of the Value of a Taxable Transaction

Adjustment of the value of a taxable transaction in relation to a taxable transaction made by a registered person is necessary when

- a. the transaction is cancelled;
- b. the nature of the transaction is changed;
- c. the previously agreed consideration for the transaction is altered, whether due to a reduction of prices or for any other reason; or
- d. the goods or services are returned in full or in part to the registered person.

If a registered person has, as a result of occurrence of one or more of the events described above must provide a VAT invoice, and the amount of VAT shown on the invoice is incorrect, or shown an incorrect amount of VAT on a VAT return, then appropriate adjustment should be made.

Where a tax invoice is issued as indicated above and the amount of tax charged exceeds the tax properly chargeable, the registered person making the supply should provide the recipient with a tax credit note. A person should not provide a tax credit note in any circumstances other than those specified above.

Where a registered person claims to have lost the original tax credit note or the debit note, the registered person who made the supply may provide a copy clearly marked “copy”. The tax credit note, except as the Authority may otherwise allow, must contain the following particulars.

- a. The words “tax credit note” in a prominent place;
- b. The name, address and taxable identification number of the registered person making the supply; and that of the recipient of the supply,
- c. The date of issuance of the tax credit note
- d. The value of the supply shown on the tax invoice, the correct amount of the value of the supply, the difference between the two amounts, and the tax relating to the difference.
- e. A brief explanation of the circumstances that gives rise to issuance of the tax credit note; and
- f. Information sufficient to identify the taxable supply to which the tax credit note relates.

7.4 CALCULATION OF TAX PAYABLE

This section is concerned with the determination of tax payables on taxable transactions. Hence, the major emphasis will be illustrating the applications of different provisions with regard to the calculation of tax payable, issues related to tax credits and related matters.

1. Tax rate

Value added tax shall be levied and paid at the rate of 15% of the value of every taxable transaction by a registered person, on every import of goods other than an exempt import, and on import of services. However, the following taxable transactions will be charged with tax at a zero percent:

- a. the export of goods to the extent provided in regulations;
- b. the rendering 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;
- c. the supply of gold to the National Bank of Ethiopia.
- d. A supply by a registered person to another registered person in a single transaction substantially all of the assets of a taxable activity or its independently functioning part as a going concern, provided a notice in writing, including details of the supply, signed by the transferor and transferee is furnished to the Authority within 21 days after the supply takes place.

2. Tax payable for tax period

The amount of tax payable for any accounting period by a person who is registered or is required to register is the difference between the amount of tax charged on taxable transactions and the amount of the tax creditable.

3. Tax Credit

The amount of VAT that is creditable is the amount of VAT payable (paid) by a registered person in respect of tax invoices for a taxable transaction involving the supply of goods or rendering of services that takes place during the current or preceding accounting period, where the goods or services are used or to be used for the purpose of the registered person's taxable transactions. For import of goods that take place during the current accounting period the tax credited is the amount with respect to customs declarations issued to the person for:

However, if only parts of the supplies made by a registered person during a tax period are taxable transactions, the amount of tax creditable is determined as follows:

- a. in respect of a supply or import received which is directly allocable to the making of taxable transactions, the full amount of tax payable/paid in respect of the supply or import is allowed as a credit;
- b. in respect of a supply or import received which is directly allocable to the making of exempt transactions, any amount of tax paid in respect of the supply or import is not allowed as a credit
- c. in respect of a supply or import received which is used both for the making of taxable and exempt transactions, the rules of apportionment of the credit will be determined by a directive to be issued by the Minister of Revenue.

Moreover, no credit is allowed for VAT on a taxable transaction to or import of a passenger vehicle by a person unless the person is in the business of dealing in, or hiring of, such vehicles, and the vehicle was acquired for the purposes of such business. Tax credit is allowed, however, if the person is engaged in the business of transporting passengers for hire and the vehicle was acquired and is licensed for that purpose.

☞ *“passenger vehicle” means a road vehicle designed or adapted for the transport of eight or fewer seated persons, including a double cab which, and*

Credit is not allowed on a taxable transaction to, or import by, a person of goods or services acquired for the purposes of entertainment or providing entertainment, unless the person is in the business of providing entertainment and the supply or import relates to the provision of taxable transactions involving entertainment in the ordinary course of that business. For a tax credit to be allowed the person must be engaged in the business of providing taxable transactions involving transportation services and the entertainment is provided to passengers as part of the transportation services.

☞ *“Entertainment” means the provision of food, beverages, tobacco, accommodation, amusement, recreation, or hospitality of any kind by a registered person whether directly or indirectly to any person in connection with a taxable activity carried on by the registered person.*

Where the amount of VAT indicated in the VAT invoice or customs declaration for a transaction exceeds the VAT payable on this transaction, the registered person is allowed a credit for the amount of the excess in the accounting periods in which the event occurred, except that if the supply was made to a person who is not a registered person. No credit allowed unless the excess tax has been repaid to the recipient of the supply.

A person who registers after introduction of VAT shall be entitled for credit in the first accounting period in which the person registered for VAT paid or payable on goods (including capital goods) that are on hand on the date of registration, but only for purchase or import of goods occurred not more than six month prior to the date of registration.

A beneficiary of the duty Draw-Back Scheme is into entitled to a refund for VAT paid on imports under that scheme to the extent that the beneficiary claims a credit of VAT on imports.

4. Tax Credit Rules

A tax credit is allowable only if a tax invoice, or debit or tax credit note, in relation to the supply, has been provided and the registered person claiming the tax credit is holding that supporting document/unless an invoice is not required/ at the time any return in respect of the supply is furnished. Moreover, for imported goods a customs declaration or a document issued by the customs authority must be presented evidencing payment of tax in relation to the import and is held by the

registered person claiming the credit at the time any return in respect of the import is furnished.

The costs incurred to begin or terminate a taxable or exempt activity are taken into account in calculating the allowable tax credits.

The provision concerning a tax credit on the acquisition of a passenger vehicle, indicated above does not apply to a commercial truck or other vehicle designed and used primarily for the carriage of goods.

A tax credit is not allowed for VAT on the purchase by a registered person of restaurant meals for executives, employees or customers or for VAT on the rental of a lodge and the charge for food at a rate for employees. However, the disallowance rules does not apply to purchases of “entertainment” by a registered person engaged in the business of selling “entertainment” (such as a restaurant) if the purchases are used directly in the provision of taxable entertainment.

A person who registers after VAT becomes effective can claim credit for tax on goods on hand when the registration takes effect if the goods were acquired within the six months period before the effective date and the goods are to be used in taxable activity after registration.

5. Tax Invoices

Any person registered for VAT that carries out a taxable transaction is required to issue a VAT invoice to a person who

receives the goods or services. A person who is not registered for VAT does not have the right to issue a tax invoice. A VAT invoice is a document executed in the form stipulated by the Minister of Revenue and containing the following information:

- a. full name of the registered person and the purchaser, and the registered person's trade name, if different from the legal name,
- b. taxpayer identification number of the registered person and the purchases,
- c. member and date of the VAT registration certificate;
- d. name of the goods shipped or services rendered,
- e. amount of the taxable transaction;
- f. amount of the excise on excisable goods;
- g. sum of the VAT due on the give taxable transaction;
- h. the issue date of the VAT invoice, and
- i. Serial number of the VAT invoice.

The registered person is required to issue the VAT invoice to the purchases of goods or services upon the supply or rendering, but not later than 5 days after the transaction. On the other hand, a registered recipient who has not received a tax invoice may request in writing within 60 days after the date of the supply, the registered supplier to provide a tax invoice and the supplier must comply within 14 days after receiving the request. This does not, however, apply for transactions where tax invoice is not required.

Where a registered recipient claims to have lost the original tax invoice for a taxable transaction, the registered supplier may provide a copy clearly marked “copy”.

In case a registered person supply goods or render services at retail to purchasers who are not VAT registered, the Minister of Revenue may issue a directive that provide the use of receipt or simplified form of VAT invoice instead of a VAT invoice.

The Minister of Revenue may also waive a registered person’s obligation to issue a receipt or tax invoice for each sales if the total consideration for the entire supply does not exceed 10 Birr through a directive.

6. Reverse Taxation

If a non resident person who has not registered for VAT in Ethiopia renders service in Ethiopia to any person registered for VAT in Ethiopia or any resident legal person (customer), the customer must withhold the tax from the amount payable to the non-resident.

If the customer is registered for VAT, the withhold tax is payable at the time for filing of the VAT return for the accounting period in which the transaction took place. The payment document for payment of the withhold tax is considered to be a VAT invoice, and, hence, gives the customer the right to a VAT credit. However, if the customer is not registered for VAT, he is required to pay the withheld tax in the manner prescribed by the implementation directives issued

by the Minister of Revenue within 30 days of the date of payment to the non-resident.

In the case of import of property owned by a non resident for lease, where the lease payments are subject to VAT, the lessee may claim a VAT credit for the tax paid on the import upon the agreement of the non-resident owner. Here, the lesser is treated as the taxpayer and is responsible for VAT payable upon the subsequent supply of the property. However, this provision does not apply to an import of services to the extent that the non-resident supplier of the services pays the tax imposed on the import services under.

The value of an import of services taxable generally is the amount of the consideration that the recipient is obliged to pay for the services, except that if the supplier and the recipient are related persons, the value of the import is its market value. Where a portion of the consideration represents tax that is not accounted for separately, the value of the import is the consideration, reduced by an amount equal to the tax fraction multiplied by that consideration. The tax fraction is $(100+r)$, where “r” is the rate of tax applicable.

7. Transaction by Agent

A supply of goods or rendering of services by a person as agent (“*proxy*”) for another person (“*principal*”) on behalf and instruction of the other person is considered as a transaction made by the principal. In such cases both the agent and the principal will be held liable to pay the tax. This provision,

however, does not apply to services rendered by an agent to the principal.

The provision also does not apply to the supply of goods in Ethiopia by a resident agent of a non-resident person who is not registered person for VAT in Ethiopia. In this case for purpose of VAT the supply is considered as carried out by the agent.

Where a taxable transaction has been made by an agent on the behalf of his principal, and the recipient of the taxable transaction is a registered person, the agent, not the principal, may issue a tax invoice in relation to the transaction.

Where a taxable transition has been made to an agent on behalf of the agents principal and the principal is a registered person, at the request of the agent, a tax invoice in relation to the taxable transaction may be issued to the agent; and a tax invoice will not be issued to the principal in relation to the same transaction.

8. Special Rules

When the rules in the proclamation are difficult to apply, such as calculating the tax liability of suppliers of gambling, lottery, and travel agent services, sales on commission, sales of second-hands, and supplies of other industries, the Minister of Revenue may issue directives governing these suppliers or supplies.

Check Your Progress Exercise 5

1. Identify the major particulars a tax invoice must contain?

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3. What are tax rates for VAT?

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7.5 PREPARING TAX RETURNS AND PAYMENT

This section covers the filing of VAT returns by a registered person, and the payment of tax by registered persons and importers.

1. Filing tax return

Every registered person is required to file a VAT return with the Authority for each accounting period, whether or not tax is payable in respect of that period and pay the tax for every accounting period by the deadline for filing the VAT return. The VAT return for every accounting period must be filed with no later than the last day of the calendar month following the accounting period.

In cases where a registration takes place with retroactive effect, the registered person is required to pay VAT for taxable transactions taking place since the coming into effect of the registration and is entitled to a VAT credit according to credit procedures for registered persons. In addition, the

corresponding transactions are to be reflected on the first return filed by the registration person and are considered as taking place during the month to which the return relates. In this event, the registered person is entitled to issue VAT invoices for the transactions shown on the return.

2. Form and Manner of Filing Returns

A return must be made in the form and furnished in manner prescribed by the Authority, and must include the information necessary to calculate the tax payable for the accounting period and be furnished in the manner prescribed by the Authority.

3. VAT Refund

If at least 25 percent of the value of a registered person's taxable transactions for the accounting period 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 accounting period 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 accounting period is to be carried forward to the next five accounting periods and credited against payments for these periods, 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.

However, in all cases where an amount refunded to a person is established by the Authority to have been made erroneously, the Authority may demand the return of such amount. Moreover, the Minister of Finance and Economic Development determines the manner in which and the amount of the tax collections that will be retained for VAT refunds.

Where the Authority is satisfied that a person who made an application for refund has overpaid tax, the Authority will first apply the amount of the excess in reduction of any tax, levy, interest or penalty payable by the person under this proclamation, the customs proclamation, the income tax proclamation, or the sales and excise tax proclamation. Following this the authority, then, repays any amount remaining to the person if the amount to be refunded is more than 50 birr.

If the Authority does not pay the refund by the date specified in the proclamation, for a registered person who has overpaid tax and hence entitled to a refund, then, 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. In general, if the Authority does not pay the refund in a timely manner it must pay interest calculated from the date on which

the refund was due until the date on which the payment of the refund is made.

The proclamation provides, however, that the Authority is not obliged to refund excess credits if the amount to be refunded is not more than 50 Birr. If the amount eligible for refund is 50 Birr or less, this amount can be carried forward and credited against tax due in the subsequent accounting period.

Where a registered person applying for a tax refund has failed to furnish a required return, the Authority may withhold payment of any amount refundable until the registered person furnishes such return.

Check Your Progress Exercise 6

1. Is a registered person obliged to file a return for an accounting period, regardless of whether or not any tax is payable for that period?

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2. When should a VAT return be filed?

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3. Identify the consequence of failure to furnish tax return on a timely basis from legal point of view.

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4. Explain the two classes of cases where a registered person can claim VAT refund.
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7.6 ASSESSMENT OF TAX AND ADMINISTRATION

This article provides that for the responsibility for calculating and reporting tax liabilities and for the administration of the VAT. The taxpayer or other person specified in the proclamation is responsible for the calculation and timely filing of returns and payment of tax. Where the proclamation requires the tax to be collected by the Ethiopian Custom Authority, the Custom Authority is responsible for the tax collection in accordance with the customs legislation. The Tax Authority and the Customs Authority are responsible for carrying out the provisions of the proclamation within their respective competences. For example, the Customs Authority is responsible the issuance of documents and collection of tax on imports of goods in accordance with the proclamation.

1. Assessment of Tax

Additional assessment is required by the Authority when, after review by the Authority, it appears that a person has understated his tax obligation. Assessment is carried out within 5 years after the end of the accounting period concerned or at any time in the case of fraud or gross or willful negligence, notwithstanding any limitation in any other law.

If the Authority makes an additional assessment within 30 days of the notice and demand, the person assessed does not pay for the additional assessment or appeal the assessment the person is in default.

The Authority may issue an additional assessment in a variety of circumstances, including the case where:

- a. a person fails to furnish a return import declaration
- b. the Authority is not satisfied with a return or import declaration furnished by a person;
- c. the Authority has reason to believe that a person has become liable for the payment of an amount of tax but has not paid such amount;
- d. a person, other than a registered person, supplies goods or services and represents that tax is charged on the supply
- e. a registered person supplies goods or service and the supply is not a taxable transaction or is a taxable transaction charged with tax at the rate of zero per cent and, in either case, the registered person represents that a positive rate of tax is charge on the transaction; or

The person to be assessed is the person making the supply, the person whose liability has been determined or the person required to account for the tax. In making an additional assessment the Authority may estimate the tax payable by a person. Where an additional assessment has been the Authority may serve a notice of the assessment on the person

assessed, which includes the tax payable the date the tax is due. The production of such a notice of assessment or a certified copy of a notice of assessment is receivable in any proceedings as conclusive evidence that the assessment has been duly made.

No assessment or other document purporting to be made, issued, or executed could be quashed or deemed to be void or voidable for want of form or affected by reason of mistake, defect, or omission therein. If it is, in substance and effect, in conformity with the proclamation or this regulation and the person assessed, or intended to be assessed or affected by the document is designed in it according to common understanding.

2. Responsibility for Administration and Reporting

The responsibility for the correct calculation and timely payment of VAT and presentation of a return to the Authority by the prescribed deadline rests on the taxpayer or other pertinent persons and in cases where the collection of VAT is in the competence of the Ethiopian Customs Authority, in accordance with the customs legislation of Ethiopia.

The tax is administrated by the Authority and by the Customs Authority within their respective competencies, in accordance with this proclamation and with the customs legislation of Ethiopia.

3. Collection Enforcement

a. Powers and Duties of Tax Administration

The implementation and enforcement of the proclamation on VAT and of regulations issued is the duty of the Authority. moreover, the Authority is empowered to investigate any statements, records and books of account submitted by any person at any time by sending duly accredited inspectors, requiring the person or any employee who has access to or custody of any information or requiring any person to disclose particulars of any information or transactions.

b. Seizure of Property to Collect Tax

If a person liable to pay any tax imposed by this proclamation is in default the Authority has the power to collect such tax (and such further amount that will be sufficient to cover the expenses of the seizure) by seizing any property belonging to such person.

☞ *“Seizure” includes seizure by any means, as well as collection from a person who owes money or property to the person liable for VAT.*

The seizure of property apply only to property possessed and obligations existing at the time the seizure is made. The Authority may request a police officer to be present during the seizure. Where the Authority seizes any property it will have the right to sell the seized goods at public auction or in any other manner approved by the Authority not less than 10 days after the seizure or within a reasonable period of time when goods seized are perishable.

Whenever any property on which seizure had been made is not sufficient to satisfy the claim for which seizure is made, the Authority may, thereafter and as may be necessary, proceed to seize other property liable to seizure of the person against whom the claim exists until the amount due from such person, together with all expenses, is fully paid.

Seizure can be made on property of any person in default with respect to any unpaid tax only after the Authority has notified such person in writing of the intention to make such seizure. The notice must be delivered not less than thirty (30) days before the day of the seizure.

If the Authority makes a finding that the collection of the tax is in jeopardy, demand for immediate payment of such tax may be made by the Authority and on failure or refusal to pay the tax, collection thereof by seizure will be lawful without regard to the 30 day period provided.

If a seizure has been made or is about to be made on any property, any person having custody or control of any books or records containing evidence or statements relating to the property subject to seizure can, on demand of the Authority, exhibit such books or records to the Authority.

Any person in possession of (or obligated with respect to) property subject to seizure on which a seizure has been made must, on the demand of the Authority, surrender such property (or discharge such obligation) to the Authority, except such part of the property as is, at the time of such demand, subject

to a prior secured claim of creditors and subject to an attachment or execution under any judicial process.

Any person who fails or refuses to seizure, on demand of the Authority, will be personally liable to the government in a sum equal to the value of the property not so surrendered, but not exceeding the amount of tax for the collection of which seizure has been made (together with costs and interest on such sum).

In addition to the personal liability imposed, if the failure or refusal to surrender is without reasonable cause, such person will be liable for an additional charge equal to fifty percent (50%) of the amount recoverable.

Any person in possession of property who surrenders or makes payment in accordance with this article will be discharged from any obligation or liability to the delinquent person or to any other person arising from such surrender or payment.

While the Authority must give 30 days notice before seizing property of a person in default, after making reasonable enquiries, and if the authority does not have sufficient information to identify the person on whom the notice should be served, the notice will be deemed to have been served and then it can proceed to seize the property.

The Authority may authorize the delivery of goods seized to the owner of the goods or the person who had custody or control of the goods immediately before seizure, where that person pays the tax or other amount due that gave rise to the seizure.

4. Record Keeping

Definition

- a. Records means accounting records, accounts, books, computer stored information or any other documents.

Documentation

- b. The law obliges a person liable for VAT to maintain in Ethiopia for 10 years the following records-
 - i. Original tax invoices received by the person. This obligation is relevant for registered persons who are claiming credit for tax on purchases.
 - ii. A copy of all tax invoices issued by the person. This obligation is relevant for registered persons as these documents can only be provided when a taxable transactions is made by a registered person.
 - iii. Customs documentation relating to imports and exports by the person. In the case of imports, this obligation relates to all persons, not just registered persons, as any person who makes an import may be liable for the VAT on the import.

- iv. Accounting records and any other records as may be prescribed by the authority. It is expected that the Minister of Revenue will require registered persons to maintain tax credit notes and debit notes.

Explanation

The records required to be kept include all documents that affect the amount of VAT paid or claimed, and records necessary to verify VAT returns, including records relating to exempt supplies. Records must be kept up to date and in sufficient details to enable correct calculation of VAT to be paid or claimed. Records should be kept in a way that enables easy checking of the figures used to complete the VAT return.

The records specified above must be maintained in Ethiopia. This means, for example, that a non- resident person who is operating a taxable activity in Ethiopia is required to keep the records specified in Ethiopia rather than, say, at its head office outside Ethiopia. While records must be maintained in Ethiopia, persons liable for VAT do not have to maintain them at their business premises. They may keep them, for example, at the business premises of their accountant in Ethiopia. The requirement that the accounts and records be maintained in Ethiopia is intended to ensure that they are readily accessible to the Authority.

The records specified above must be retained for at least 10 years after the end of the tax period to which they relate. The

proper maintenance of records is vital for the effective functioning of VAT. Consequently, substantial penalties are imposed on a person who fails to comply with and a tax officer who permits unauthorized access to records.

Activity 1

1. Identify those taxable persons subject to assessment? 7.6
2. Is there any time limit for additional assessment?
3. What conditions leads Tax Authority to conduct additional assessment?
4. Explain the powers and duties of the Tax Inspectors?
5. Identify the rights and obligation of the registered person with respect to tax payments?
6. What is the minimum number of days that the Authority should provide notice to taxpayer before seizures of property?
7. Is there any limit for the Authority's power to seize taxpayer property?
8. What is amount of additional liability when the taxpayer fails or refuses to comply with a demand by the Authority to surrender property subject to seizure?

7.7 TRANSITIONAL RULES

This article provides for a credit under the VAT for certain sales tax paid on goods on hand when the VAT becomes effective. The credit is available only with respect to goods on hand that were acquired or imported not more than 6 months before the tax becomes effective.

Scope of Application

The repealed legislation, including the rules governing the levy, payment, assessment, reporting, and recovery of those taxes, continues to apply to a supply or import that takes place prior to the date on which the proclamation comes into force. Every appointment made under the repealed legislation and subsisting at the date of commencement of the proclamation is also considered as has been made under the new proclamation. In calculating the amount of tax payable by a registered person in respect of the first accounting period after the tax becomes effective, the registered person may claim to credit an amount equal to the sales tax.

In cases where a registered person held, at the end of the last business day prior to the date the value added tax comes into force, qualifying goods being goods acquired not more than six(6) months before the tax comes into force and if the Authority is satisfied that sales tax has been charged to the person on a sales invoice and paid on the acquisition or import of those goods, and the sales tax has not been rebated the amount of the creditable sales tax will be the amount of such taxes paid on such goods, but with respect to each item qualifying for the tax must not exceed the amount of tax which would have been payable had the goods been subject to tax chargeable under the proclamation.

However, credit is not allowed sales tax paid on qualifying goods on hand on the date on which the proclamation comes

into force if the person gets registered as of such date. Any person claiming a credit after the tax comes into force must submit an inventory of all qualifying goods on hand at the beginning of the first day on which the proclamation comes into force with the first VAT return. These must be supported by documents evidencing the payment of sales tax.

A disallowance of a credit for sales tax imposed before the date on which the tax law comes into force will not be treated as a disallowance.

If a contract is concluded between two or more parties before the proclamation comes into force and no provision relating to tax is made in the contract, the supplier can recover from the recipient, tax due on any taxable transaction made under the contract and made after the date on which the proclamation comes into operation. On the other hand, if a contract that has been concluded after the date on which the proclamation comes into effect does not include a provision relating to tax, the contract price is taken to include tax and the supplier under the contract must account for the tax due.

In connection with a supply of goods or services, if title to goods passes, delivery of goods is made or services are rendered after the date on which the proclamation comes into force the payment is treated as having been made or the invoice is treated as having been issued on the date on which the proclamation came into force. This is also the case when

payment is received or an invoice is issued within nine months before that date.

If services subject to sales tax were rendered before the date on which the proclamation came into force and payment is made within four months after the proclamation came into force, VAT is not imposed on the supply of the services.

If goods are leased under an agreement that provides for periodic payments or if services subject to sales tax were rendered during a period that began before and ended after the proclamation came into force, VAT is imposed on the consideration for the services rendered after the proclamation came into force. However, this does not apply if payment is made more than four months after the proclamation came into force. Hence, the consideration is treated as consideration for the rendition of services on the day after the end of that four months period.

If construction, manufacture or extension of building or civil engineering work is performed under a written agreement executed before the proclamation came into force and the property is made available to the recipient after that date, VAT is imposed only on the value of work performed after that date. This would be the case if the value of the work on the day before the proclamation came in to force is determined in a manner approved by the Authority and is submitted to the Authority by the end of the supplier's first VAT period after VAT comes into force.

If immovable property is provided under a rental agreement, for a period that commences before and ends after the date the proclamation comes into force, the consideration for the rental will not include the amount attributable to the period that ends before the effective date of the proclamation.

Activity 2

1. Explain following as provided in the Transitional rules.

b. Qualifying Goods

c. Sales Tax

2. Explain the conditions that should be fulfilled to be

The law, in addition to transactions discussed in earlier sections, exempts several supplies of goods and services. This section provides a brief coverage on exemptions and zero rated tax.

7.8.1 Exemption**Overview**

An exempt supply is not subject to VAT. A registered person making exempt supplies is not entitled to deduct input tax payable on its acquisitions related to the making of exempt supplies and is not entitled to issue tax invoices covering exempt supplies. A registered person that purchases goods or services exempt from tax is not entitled to claim an input tax credit for any tax embedded in the prices of those purchases, even if acquired for use in a taxable activity, because the item was not purchased in a taxable transaction.

In the following paragraph we will see in detail exempt supply and scope of application as described in the proclamation.

Exempt Supply

The following are exempted from VAT.

a. Dwellings

A “dwelling” includes an area surrounding or appurtenant to the dwelling necessary for its enjoyment. It does not, however, include farm land adjacent to a dwelling. The land surrounding a dwelling complex, including the driveway, paths, gardens and landscaped grounds for the use and enjoyment of residents are also taken as part of the dwelling. Dwellings of such nature are, therefore, exempted from VAT.

However, if a registered person purchases a new or used property for lease as a dwelling, he will be denied tax credits for tax on any costs attributable to the exempt lease of the dwelling.

Moreover, if an employer provides a dwelling to an employee as a fringe benefit, the benefits will not be considered as provided to employees by the employer in the course or furtherance of a taxable activity. The benefit is, therefore, exempt from tax. However, the employer is denied tax credits for any tax on costs attributable to the exempt fringe benefit.

The exemption also applies on a sale of a parking space that is part of the dwelling to the purchaser of a dwelling, or the lease of a parking space as part of a lease of a dwelling.

b. Financial Services

Financial services, whether provided for explicit or implicit fees are exempt from tax. The financial services exempt from tax include the following:

- a. granting, negotiating or dealing with loans, credit, credit guarantees, or any security for money, including management of loans credit, or credit guarantees by the grantor or the arranging such services
- b. transactions concerning money (including the exchange of currency), deposit, savings, and current accounts, payments, transfers, debts, cheques, or negotiable instruments, other than debt collection and factoring or arranging such services.

☞ *“cheque” includes a postal order, a money order, a traveler’s cheque, or any order or authorization (whether in writing, by electronic means, or otherwise) to a financial institution to credit or debit any account;*

☞ *“currency” means any bank note or other currency of any country, other than when used as a collector’s piece, investment article, item of numismatic interest, or otherwise than as a medium of exchange;*

- c. Provision of credit under a hire purchase agreement or sale of goods, but only if the credit is provided for a

separate charge, and the separate charge is disclosed to the recipient of the goods or arranging such services

- d. Provision or transfer of ownership, of an insurance policy, or the provision of reinsurance in respect of any such policy or arranging such services.

 *“insurance policy” means insurance covered under a policy treated as general insurance business or as long term insurance business under proclamation No. 86/1994: Licensing and Supervision of Insurance Business)the “Insurance proclamation”);*

- e. Provision, or transfer of ownership, of an interest, of an interest in a scheme whereby provision is made for the payment or granting of by a benefit fund, provident fund, pension fund, retirement annuity fund, or preservation fund
- f. Provision of intermediation services by a buy-aid society or medical aid fund.

 *“Merchant’s discount” means a charge made to merchants for accepting a credit or debit card as payment for the supply of goods or services, or a similar charge made by a buying organization.*

These financial services are exempt whether rendered by a registered bank or financial institution or by any other person.

In addition to the above definition of financial services the Minister may issue a directive listing financial services and specifying their treatment as taxable, exempt, or zero-rated supplies. The Minister may also modify any such list including changes required by the introduction of new financial services or modification of the nature of the services specified in the list, with any such modification or cancellation having prospective effect only.

Some financial services are not, however, exempt whether or not they are rendered in connection with an exempt financial service. They include, but are not limited to the following:

- a. Legal, accounting and record package services, actuarial, notary, and tax agency services (including advisory services) when rendered to a supplier of financial services or to a customer of that supplier of financial services.
- b. Safe custody for cash, documents or other items;
- c. Data processing and payroll services;
- d. Debt collection or factoring services;
- e. Management services, such as management of a superannuating fund;
- f. Trustee, financial advisory, and estate planning services and
- g. Leases, licenses, and similar arrangements relating to property other than a financial instrument.

It is also noted that accounting and record package services include a financial clearing system that may be part of the

settlement process, the posting of financial transactions to customers' accounts the maintenance of customers accounts, and the rendering of services ancillary to the services just described.

The mere acquisition of a debt is not a taxable transaction, including debt acquired by a factor. The services related to debt recovery, litigation, and the management of the recovery of the amount due from debtors are, nonetheless, taxable, including sales accounting services under a factoring arrangement and other services related to factoring.

The following exports of financial services are taxed at Zero-rate.

- a. financial services rendered in connection with an export of goods;
- b. financial intermediation services rendered in connection with a loan to an unregistered, non-resident person to finance the export of goods; and
- c. Fees imposed by an Ethiopian bank on banking services rendered to a non-resident who is outside Ethiopia when the banking services are rendered, if they do not come within the exceptions in Article 35 of these regulations.

If an exempt or zero-rated financial service is incidental to a main supply, or if such a financial service is the main service, the rules on mixed supplies apply.

Financial institutions and other providers of financial services that make both taxable (including zero-rated exports) and

exempt supplies may claim tax credits only on purchases (including rentals) and imports used in making taxable transactions. Moreover, the provisions on the allocation of tax credits between exempt and taxable transactions do not apply (and full tax credits are allowed) to a registered person who derives more than 90 percent of the person's total supplies in an accounting period from taxable transactions. For this purpose, when calculating the value of the taxable and total supplies, the supplier should use gross figures for supplies other than intermediation services and use net interest amounts (interest income less interest expense) for financial intermediation services.

The value added tax directive to be issued by the minister of revenue may give the authority discretion to determine the allocation of tax credits between taxable and exempt supplies on a base that the authority considers reasonable.

Regardless of method used to allocate tax credits, the registered person must retain records to substantiate the method used. The Authority may require financial service providers to submit statistical data on various product lines.

The exemption for financial services extends to the premiums for insurance cover under an insurance policy.

Premiums attributable to riders attached to an insurance policy that is exempted from tax constitute exempt services if the riders are only incidental to the provision of the insurance cover. Services covered in riders to exempt insurance policies

that are not incidental to the insurance coverage are taxable to the extent that the independent supply of those services would be taxable. It is, however, the sole discretion of the Authority to determine whether a non-insurance rider is incidental to the main insurance policy.

The premium on an insurance policy is exempted only if the premium is charged on a policy issued by a person who is licensed to issue such policies under the Insurance Proclamation. Commissions and other fees earned by brokers/agents who provide insurance coverage for their customers do not come within the exemption for insurance as a financial service.

Nonetheless, an insurance policy does not include insurance cover on a warranty in respect of the quality, or performance of tangible property.

c. Supply or import of securities

The following securities are exempted from tax:

- a. transactions relating to the issuance, transfer, or receipt of, or any dealing with shares, stocks, bonds, treasury bills, or other debt or equity securities, other than custody services;
- b. transactions relating to financial derivatives, forward contracts, options, or similar arrangements, and
- c. transitions relating to the creation, issue, transfer, assignment or receipt of, or dealing with, an option or warrant relating to securities included in (a)

The underwriting of the issuance of securities generally is exempt from tax. However, the exemption for underwriting services does not extend to other services obtained in connection with an underwriting, such as advertising and printing costs, accounting, legal and advisers' fees. The exemption for securities or for financial services does not also include management or administrative services provided to a business whose principal activity is investing funds for shareholders, members, or other persons.

d. Import of gold for National Bank of Ethiopia

The exemption of the import of gold to be transferred to the National Bank of Ethiopia applies to imports by or for the National Bank, regardless of the level of purity of the gold or the form in which it is imported.

e. Religious or Church-related Services

The supply of religious or church-related services by a religious organization is exempted from tax. Generally, services rendered by a religious organization that are integral to the practice of that religion come within the exemption. However, the activities of a religious organization that compete with the private sector or that are not integral to the practice of the religion do not come within the exemption, hence taxable. If the value of these taxable supplies exceeds the threshold specified in the proclamation, the religious organization must register.

Books and other printed materials are also exempt if supplies of books or other printed material is made by a religious organization.

The donation in kind or money (such as church plate donations) or services are not subject to tax if there is no direct link between the payment and any benefit received by the donor.

A receipt by a religious organization from a business is not a supply for consideration if the receipt merely entitles the transferor to be mentioned in a brochure or program, therefore, exempt from tax. However, if a religious organization receives payment when it sells space in a brochure or program, the receipt is a supply for consideration that does not come within the exemption for religious or church-related services.

A religious organization that operates taxable activities through a development commission or similar entity or through a division or branch may apply for or be required to separately-register one or more of the commissions, divisions, or branches.

f. Medical Services and Prescription Drugs

Rendering of medical services, and the import and supply of prescription drugs specified in the directives issued by the Minister of Health are exempt from tax. Medical services are exempt, whether provided with or without charge and whether

paid by the patient or resident or any third party, if the medical services meet two conditions:

- a. they are rendered in a qualified medical facility or by a qualified medical practitioner, or both, and
- b. they qualify as exempt medical services in this article of the regulations.

Nonetheless, to be eligible for exemption, medical services must be rendered at a qualified medical facility that includes the offices of a qualified medical practitioner, a hospital, maternity home, or clinic. In addition a qualified medical service is exempt if it is provided by a qualified medical practitioner who can be a doctor, healer, dresser, health officer, physical therapist, and other health care provider who is required to register and registered with the Ministry of Health.

To qualify for the exemption, medical services must consist of qualified services (including meals and accommodations) in a qualified medical facility, and must involve the rendering of medical services by a qualified medical practitioner. These medical services involve the diagnosis, treatment, prevention, or amelioration of a disease, including the promotion of mental health.

Services that qualify as exempt medical services include the services provided to a resident or patient by a qualified medical practitioner in a qualified facility, as well as meals and

accommodations, nursing and personal care, and assistance with daily living activities to meet the needs of the resident or patient.

Exempt medical services also include the following:

- a. medicines and drugs that are issued in a hospital or clinic for which there is no separate charge;
- b. laboratory, X-ray, or other diagnostic service;
- c. medical devices as defined in sub-article(7) of this article that are provided as part of the supply of qualified medical services;
- d. the use of operating rooms, case rooms, or anesthetic facilities, including necessary equipment or supplies;
- e. the use of radiotherapy, physiotherapy, or occupational therapy facilities in rendering exempt medical service;
- f. accommodation and meals (except in a restaurant or cafeteria available to persons other than residents in the course of receiving exempt medical service;
- g. services rendered by the medical facility staff (including orderlies or technicians) in connection with exempt medical services;
- h. dental, periodontal, and endodontal service rendered in connection with a disease, trauma, or congenital deformity, but not for general dentistry or for cosmetic reasons; and
- i. Psychoanalytic services.

Medical devices refers to devices that are supplied to a resident or patient in a qualified medical facility, supplied to a qualified medical facility, or supplied on prescription in connection with the rendition of qualified medical services, including: -

- a. a respiratory or heart monitor, dialysis machine or feeding utensil for use by an individual with a disability;
- b. a medical or surgical prosthesis or orthopedic aid provided as part of the rendition of qualified medical services; and
- c. Medical or surgical equipment supplied to a qualified medical facility, or the sale or rental of such equipment of a patient or resident.

g. Education Services

The law exempts education services rendered by educational institutions, and child care services at pre-school institutions. Qualified charges for education services are exempt if the services meet two conditions provided that they are specified in the regulation governing VAT and they are provided to students by a qualified educational institution.

Moreover, to qualify for the exemption, the services must be provided to students by an accredited pre-primary, primary, or secondary school, technical college or university or institution established to promote adult education, vocational training, technical education, or education or training of physically or mentally handicapped persons.

An educational institution is qualified for exempt whether it is a private school operating on a for-profit basis, or non-profit organization, church, or charity, or a department of government. An educational institution is also a qualified institution if the institution is accredited or is being evaluated for accreditation by the accrediting agency at the time the services are rendered.

The following categories of services qualify as exempt education services:

- a. course of instruction provided to students at a qualified education institution;
- b. qualified meal plans, and other associated goods or services provided in kind as part of the education program of a qualified provider of education services;
- c. instruction in, or the administration of examinations, if provided by the educational institution; and
- d. Instruction or tutoring related to a qualified course.

Qualified charges for exempt education services include:

- a. charges for tuition, facilities, and curriculum related activities and instruction;
- b. compulsory levies for facilities are part of a supply of exempt education services;
- c. student council fees, athletic fees, and other mandatory fees related to course registration;
- d. charges for reports, library services, identity cards, record keeping and other administrative services

provided by the educational institution and directly related to the supply of education courses;

- e. Charges for course materials, the rental of curriculum-related goods by the supplier of the education (e.g., the rental of musical instruments), field trips directly related to the curriculum if not predominantly recreational; and
- f. Student accommodations (including hostels) supplied by the supplier of the education.

Qualified facility charges include charges for buildings, grounds, libraries, and computer sciences and other laboratories.

School bus transportation to and from pre-primary, primary, or secondary schools is an exempt education service if it is provided by the school authority. However, the exemption is not available if the service is provided by a private company under contract with the school authority.

The exemption for education services does not cover the following education courses:

- a. course in sports, games, video recording or photography or other hobbies or recreational pursuits, unless they are part of a degree or diploma granting program;
- b. course, such as picture framing, cooking, and personal investment, that are designed to improve knowledge for personal purposes; and
- c. Music lessons that are not part of a school curriculum.

Religious workers receiving education are treated as students. In addition to services exempt shown above, exempt education services rendered by a pre-primary, primary, or secondary school include.

- a. basic instruction, including special education courses;
- b. fees or charges for a pre-school or after-school program operated by the school;
- c. charges for the use of school musical instruments or sports equipment;
- d. services rendered by students or their teachers as part of the instructional program; and
- e. Charge for students to attend a school play, dance, field trip, or other school sanctioned activity primary for the students.

Exempt education services rendered by a university or technical college include courses, including correspondence courses, which qualify for credit toward a degree or diploma, whether or not the student is pursuing a degree or diploma program.

On the other hand, the education exemption for adult education, vocational training, technical education, and education or training of physically or mentally handicapped persons includes charges for:

- a. adult education courses leading to a degree or diploma or courses that are likely to enhance employment related skills of the students enrolled in the courses;

- b. courses of study at a vocational school that develop or enhance a student's occupational skills;
- c. courses leading to, or to maintain or upgrade, a professional or trade accreditation or designation recognized by the appropriate government accrediting agency; and
- d. a certificate or examination in a course or program for accreditation or designation.

The exemption for education services does not include;

- a. the rental of facilities by an educational institution to an outside group;
- b. the sale of admission to school athletic events open to the general public;
- c. commissions and other fees received from the placement of coin-operated machines on the institution's property; and
- d. The sale of non-course material, such as items containing the school logo.

h. Supplies of Humanitarian Aid, and Imports of Goods for Rehabilitation

After Natural Disasters, Industrial Accidents, and Catastrophes

Supply of humanitarian aid is exempt from tax. The exemption for supplies of humanitarian aid applies to goods imported or purchased locally by organizations registered as humanitarian

organizations. The exemption covers the import of goods or purchase of goods locally in connection with an announcement or declaration of a natural disaster, industrial accident, or catastrophe by the Disaster Prevention and Rehabilitation Commission.

i. Water

A supply of water is exempt from tax provided that it is not processed in a factory.

j. Imports Exempt by Law or Agreement

Exemption also applies to import of goods by the government, organizations, institutions or projects. This is so only to the extent that they are exempt from duties and other import taxes by law or by agreement. An exemption by law covers an exemption for certain imports granted by a proclamation or, when specifically delegated by a proclamation, granted by a Regulation or directive.

An exemption by agreement covers tax exemptions for certain imports of goods only if the agreement is entered into by the government or the agreement is entered into with permission granted by the government. The exemption by agreement includes an exemption provided under:

- a. a technical assistance or humanitarian assistance agreement entered into between the Government of any country;
- b. the Diplomatic Immunities and Privileges Registration;

- c. an international convention having the force of law in Ethiopia;
- d. any other multilateral agreement to which Ethiopia is a party;

k. Transport

The exemption for transport services is a broad exemption covering the charge imposed for the transport of passengers or freight by any mode of transport. If a transaction involving the international transport of goods or passengers qualified for exemption the transaction is treated at zero-rate.

l. Permits and Licenses

The exemption for permits and license fees is limited to fees charged for permits and licenses issued by a government agency. The exemption, however, does not apply to licenses of intangibles and other licenses or permits, such as the right to use property, granted by private parties.

m. Workshops for Disabled

This exemption applies to goods sold and services rendered by workshops employing physically or mentally disabled individuals. To be eligible for exemption, more than 60 percent of the workshop's employees must be disabled. The 60 percent threshold is measured by the number of disabled and total employees in the previous 12 months, except that if the workshop has been in existence for less than 12 months, then the threshold is measured for the number of months the workshop has been in existence.

n. Books and other Printed Materials

Exemption also applies to a printed book or an update of a book. The exemption applies to a bound or unbound printed version of scripture of any religion. However, the exemption for books generally does not apply to an audio recording that is a spoken reading of a printed book, except for import and supplies of talking books (in cassettes or other forms of recording) specifically designed for the blind or severely handicapped.

7.8.2. Zero Rate Tax

Overview

A zero-rated transaction is a taxable transaction that is taxed at a zero rate of tax. The tax on supply (the output tax) is nil , and the registered supplier is entitled to credits for input tax on acquisitions related to the zero-rated transaction. Thus, the transaction is completely free of tax.

Where a registered person has applied the rate of zero percent to a supply, the registered person must obtain and retain such documentary proof acceptable to the Authority substantiating the person's entitlement to apply the zero rate to the supply.

Zero rate supply

Zero-rate tax applies on the following.

a. Export of Goods or Services

The following supplies are zero-rated exports.

- a. a supply of goods where the supplier has entered the goods for export, pursuant to the Customs Proclamation,

- and the goods have been exported from Ethiopia by the supplier;
- b. a supply of goods where the Authority is satisfied that the goods have been exported from Ethiopia by the supplier;
 - c. a supply of goods where the goods are not situated in Ethiopia at the time of supply and are not to be entered into Ethiopia for home consumption pursuant to the Customs Proclamation by the supplier of the goods;
 - d. a supply of services directly in respect of
 - 1. movable property situated outside Ethiopia at the time the services are rendered;
 - 2. goods temporarily imported into Ethiopia under Chapter 5 of the Customs Proclamation; or
 - 3. a supply of goods referred to in (a) or(b) of the definition of “exported from Ethiopia”
 - e. a supply of services directly in connection with land, or any improvement thereto, situated outside Ethiopia;
 - f. a supply of services to a non-resident person who is not a registered person comprising the arranging for the person of a supply of goods referred to in (a) and (b) of the definition of “exported from Ethiopia”;
 - g. a supply of services physically rendered elsewhere than in Ethiopia;
 - h. a supply of services to a non-resident person who is outside Ethiopia at the time the services are supplied, other than a supply of services;

- i. directly in connection with immovable property situated in Ethiopia
 - ii. directly in connection with movable property situated in Ethiopia at the time the services are supplied unless the movable property is exported from Ethiopia subsequent to the supply of services;
 - iii. comprising the refraining from undertaking any taxable activity in Ethiopia; or
 - iv. Comprising the tolerating of another person undertaking any taxable activity in Ethiopia.
- i. a supply of service comprising
 - 1. the filling, prosecution, granting, maintenance, transfer, assignment, licensing, or enforcement of intellectual property rights for use outside Ethiopia
 - 2. incidental services necessary for the supply of services referred to in (1) above
 - 3. The acceptance by any person of an obligation to refrain from pursuing or exercising in whole or part, intellectual property rights for use outside Ethiopia.

International Transport of Goods or Passengers

Zero rates apply to a wide range of transportation and ancillary services associated with international passenger and freight transport. Zero-rating extends to lubricants and supplies to be consumed international flights.

Supply of Gold to National Bank of Ethiopia

Gold to be provided to the National Bank of Ethiopia is free of VAT as it is categorized under zero-rates supply. The law is also considering import of gold for the National Bank as exempt supply (and therefore free of VAT).

Transfer of Going Concern

If a supply of goods or services by a registered person in connection with a taxable activity conducted by that person qualifies as a supply of a going concern, the supply is taxed at a zero rate. The supply must be made to a registered person in a single transaction, and the supply must consist of substantially all of the assets of a taxable activity or consists of an independent functioning part of a taxable activity that can operate as a going concern. To obtain zero rating, the transferor and transferee must furnish the Authority, within 21 days after the supply takes place, a signed notice of the transaction that includes the essential details of the supply.

👉 Additional requirements for a zero-rated supply of a going business are provided in regulations.

Activity 3

1. Distinguish the difference between exempt supplies and Zero-rated supplies?
2. Identify the main categories of Zero-rated supplies?
3. List down supply of goods and services eligible for zero rates

7.9 SUMMARY

- VAT allows collections of tax on the added value whenever a sales transaction is conducted.
- There are three forms of registration for VAT
 - Obligatory registration
 - Voluntary registration
 - Divisional registration
- A person applying to register for VAT is required to do so in a form established by the authority.
- A registered person can apply to have his registration cancelled when he ceased to make taxable transactions.
- A transaction will be taxable under VAT if it involves supplying of goods or rendering of services in Ethiopia with the exception of exempted supplies.
- A supply occurs when a VAT invoice is issued for the transaction.
- The value of a supply is determined according to the amount the person receives or is entitled to receive in return for the supply excluding VAT.
- VAT shall be levied and paid at the rate of 15% of the value of taxable transaction by a registered person.
- Every registered person is required to file a VAT return with the Authority for each accounting period, whether or not tax for accounting period by the deadline for filing the VAT return.

- Additional assessment is required by the authority when after renew by the authority, it appears that a person has understated his tax obligation.
- A Zero-rated transaction is a taxable transaction that is taxed at zero rate of tax.
- An exempt supply is not subject to VAT.

7.10 ANSWER TO CHECK YOUR PROGRESS EXERCISE

Check Your Progress Exercise 1

1. Refer Section 7.1
2. Refer Section 7.1
3. Refer Section 7.2
4. Refer Sections 7.1 and 7.2

Check Your Progress Exercise 2

1. Refer Section 7.2
2. Refer Section 7.2
3. Refer Section 7.2.1

Check Your Progress Exercise 3

1. Refer Section 7.3

Check Your Progress Exercise 4

1. Refer Section 7.8.1
2. Refer Section 7.8.1

Check Your Progress Exercise 5

1. Refer Section 7.4
2. Refer Section 7.4

Check Your Progress Exercise 6

1. Refer Section 7.5
2. Refer Section 7.5
3. Refer Section 7.5

4. Refer Section 7.5

UNIT 8: EXCISE TAX AND TURN OVER TAX

Contents

- 8.0 Aims and Objectives
- 8.1 Introduction
- 8.2 Excise Tax
- 8.3 Turn over Tax
- 8.4 Summary
- 8.5 Answer to Check Your Progress Exercise

8.0 AIMS AND OBJECTIVES

After you have studied this chapter you should be able to:

- how excise tax is computed and payment effected
- know how turnover tax is computed,
- explain the assessment of turnover tax

8.1 INTRODUCTION

Turnover tax and excise tax are indicate taxes where the incidence of tax is passed on to others, i.e. not or person who bears its impact.

8.2 EXCISE TAX

Definition

- ⇒ “Bonded Warehouse” means the building or place destined for storage of specified goods before the tax is paid, secured in accordance with requirements of the Tax Authority.

- ➡ “Cost of production” means direct labour and raw material cost incurred in the production process, cost of indirect inputs and overhead costs, but does not include depreciation costs of machineries;

Rate of Excise Tax

The excise tax shall be paid on goods

- a. When imported;
- b. When produced locally at the rate prescribed in the Schedule

Base of Computation of Excise Tax

1. in respect of goods produced locally, the cost of production;
2. in respect of goods imported, cost, insurance and freight (C.I.F.);

Payment of Excise Tax

1. The Excise tax shall be paid
 - In respect of goods produced locally, by the producer;
 - In respect of goods imported, by the importer.
2. Time of Payment:
 - a) Unless decide otherwise,
 - 1) When imported at the time of clearing the goods from Customs area:
 - 2) When produced locally, not later than 30 days from the date of production:
 - b) Where the tax payer requests for permission to deposit goods produced in a bonded warehouse without payment of tax and if the request is approved by the Tax Authority the payment of the tax on such goods so deposited shall be effected at the time they are being removed from the Bounded warehouse:

- c) If the Tax Authority believes that the activity of the taxpayer requires a Bonded Warehouse may give him permission to establish such Bonded Warehouse. The conditions under which the Bonded Warehouse operates shall also be laid down by directive to be issued by the Tax Authority. No goods shall therefore be deposited in or removed from a Bonded Warehouse except in the presence and under the control of a representative of the Authority;
- d) Where a producer fails to keep proper accounts and records or fails to submit a monthly declaration or pay the tax within the time limit or submits declaration which upon investigation is found incorrect the Tax Authority shall be empowered to forbid the produce to remove any good from the place of production or Bounded Warehouse.

Assessment of the Excise Tax

- 1. If the Tax Authority accepts that the books and records maintained by the producer are properly kept and that the monthly declaration submitted by him, is correct the tax paid in accordance with the monthly declaration shall be considered accurate.
- 2. If, after review by the Tax Authority, it appears that a person has understated his tax obligation, the Authority shall issue an additional assessment.
- 3. The assessment made shall be prepared in an assessment notification and be delivered to the taxpayer. Delivery of the assessment notification shall be made in accordance with the provisions of Income Tax Proclamation.

Obligations of the Tax Payer

- 1. maintain books of accounts and supporting. Documents in accordance with proper accounting principles and in a manner acceptable to the Tax Authority:

2. submit every 30 days to the Tax Authority, in a form which shall be supplied by said Authority, a declaration containing such information as may be necessary for proper collection of tax.
3. pay in full the tax due with 30 days from the date of termination where such business is termination.

8.3 TURNOVER TAX

Rate of Turnover Tax

The Turnover Tax shall be:

1. 2% (two percent) on Goods sold locally
2. for Services rendered locally;
 - i. 2% (percent) on Contractors, grain mills, tractors and combine-harvesters;
 - ii. 10% (ten percent) on others.

Base of Computation of the Turnover Tax

Base of computation of the Turnover Tax shall be the gross receipts in respect of goods supplied or services rendered.

Obligation to Collect and Transfer the Turnover Tax

A person who sells goods and services has the obligation to collect the Turnover Tax from the buyer and transfer same to the Tax Authority. Hence, the seller is principally accountable for the payment of the tax.

Exemption

1. The following shall be exempted from Turnover Tax:
 - a. the sale or transfer of a dwelling used for a minimum of two years, or the lease of a dwelling;
 - b. the rendering of financial services;
 - c. the supply of national or foreign currency (except for the used for numismatic purposes) and of security;

- d. the rendering by religious organizations of religious or other related services;
- e. the supply of prescription drugs specified in directives issued by the relevant government agency, and the rendering of medical services;
- f. the rendering of educational services provided by educational institutions, as well as child care services of children at pre-school institution;
- g. the supply of goods and rendering of services in the form of humanitarian aid;
- h. the supply of electricity, kerosene, and water;
- i. the provision of transport;
- j. permits and license fees;
- k. the supply of goods or services by a workshop employing disabled individuals if more than 60% of the employees are disabled; and
- l. the supply of books.

Responsibility for Administration and Reporting

- a. The responsibility for the correct calculation and timely payment of Turnover Tax and presentation of a return to the Authority by the prescribed deadline rests on the tax payer in accordance with this proclamation.
- b. The Turnover Tax is administered by the Tax Authority.

Records

Tax payer shall keep the records for use in determining Turnover Tax.

Filing of Turnover Tax Return and Payment

- 1. Tax payers subject to turnover tax shall:
 - a. File a Turnover Tax return with the Tax Authority within one month after the end of every accounting period.

- b. Pay the tax for every accounting period by the deadline for filing the Turnover Tax return.
- 2. For purposes of this Article “Accounting period” shall mean:
 - a. For taxpayers classified as category ‘A’ taxpayers under the Income Tax proclamation No. 286/2002, but are not required to register for VAT, the calendar month;
 - b. For category “B” taxpayers who are required to keep records under the Income Tax Proclamation No. 286/2002 each three month period commencing from the first day of the Ethiopian fiscal year or when approved by the Tax Authority, the first day of the Gregorian calendar year;
 - c. For category “C” taxpayers, who are not required to keep records under Income Tax Proclamation No. 286/2002, the fiscal year.

Assessment of the Tax

- a. If, after review by the Tax Authority, it appears that a person has understand his tax obligation, the Authority shall issue an additional assessment.
- b. If, for any reason, the books of account are unacceptable to the Tax Authority, or if the tax payer fails to submit same when requested by the Tax Authority, or if no books of account and supporting documents are maintained, the Tax Authority shall assess the tax on the basis of information available to it or on the basis of market price of such good or service in the local market or if the market rice is unknown, on the basis of the market price of an equivalent good or service.
- c. A presumptive turnover tax shall be payable by Category “C” taxpayers who are not required to keep records. The base

for the presumptive turnover tax shall be the total turnover used as base for the income tax.

- d. The assessment made shall be prepared in an assessment notification and be delivered to the taxpayer. Delivery of the assessment notification shall be made in accordance with provisions of the income tax proclamation.

Check Your Progress Exercise

1. Define "Bonded ware house" and cost of production.
.....
.....
.....
2. Who and when should excise be paid?
.....
.....
3. How is excise tax assessed?
.....
.....
4. What is the rate of Turnover Tax?
.....
.....
5. What is the base of computing turnover tax?
.....
.....

8.4 SUMMARY

- Excise tax shall be paid on good
 - When imported;
 - When produced locally
- Turnover tax shall be
 - On goods sold locally

- For services rendered locally
- Turnover tax is 2% on goods sold locally

8.5 ANSWER TO CHECK YOUR PROGRESS EXERCISE

1. Refer Section 8.2
2. Refer Section 8.2
3. Refer Section 8.2
4. Refer Section 8.3
5. Refer Section 8.3

UNIT 9: TAX ADMINISTRATION

Contents

- 9.0 Aims and Objectives
- 9.1. Introduction
- 9.2. Laws and Regulations
- 9.3. Tax Payers Registration
- 9.4. Presumptive Taxation
 - 9.4.1. Standard Assessment
 - 9.4.2. Withholding Taxes
 - 9.4.3. Presumptive Minimum Taxes
- 9.5. Tax Collection
- 9.6. Computerization
- 9.7. Tax Payers Education
- 9.8. Penalties
- 9.9. Tax Accounting Principles
- 9.10. Developments in Government Revenue
- 9.11. Summary
- 9.12. Answer to Check Your Progress Exercise

9.0 AIMS AND OBJECTIVES

When you have studied this unit you should be able to

- explain the administration of tax revenue.
- explain the development of government revenue.
- describe the penalties related to tax administration.
- explain the need for taxpayers' education.
- discuss the two methods of accounting for the tax purpose.

9.1 INTRODUCTION

In order to mobilize more domestic revenue and rationalize the tax system, thoughtful attention is given to improve tax policies and laws. In other words, previous reforms undertaken in the tax system were mainly focused on policy reforms or targeted in reviewing the tax rates. Little attention was given to the administration wing of the tax system, however. It is worth mentioning that a change in tax policy and law without an improved tax administration will be a futile exercise. Thus modern tax administration is the key to an effective tax system.

The major objectives of the tax administration reform strategy should be to improve the effectiveness and efficiency of tax operations, to change the behavior of the taxpayer, and to raise the compliance level of the general tax payer population.

It is obvious that the ultimate goal of tax administration is promoting tax collection. The economic efficiency gains obtained from the various reforms undertaken are equally important. Improvement in the tax administration is not a one-time measure, is rather a continuous effort. An effective tax administration reform effort requires strong and dutiful commitment of all stakeholders. In this regard the government's political commitment should be clearly seen and guide the reform. This could be expressed in the form of ensuring the rapid approval of tax legislation and regulation. Thus the active support of the executive body of the government, the civil society and media is significantly important for the effectiveness of the reforms. More importantly public information and public relations campaigns informing taxpayers of the new procedures, as well as involving in the enforcement activities if the taxpayer fails to comply with the tax laws is critically essential.

By and large to be successful and effective in tax administration reforms the following six factors are considered very essential

- An explicit and sustained political commitment,
- A team of capable, hard working officials dedicated full-time to tax administration reform,
- Relevant training for staff,
- Additional resources to the tax administration or at least some reallocation of existing resources,
- Chants in incentives for bathe taxpayers and tax administrators.(Vito Tanzi and Anthony Pellucid)

To enhance government revenue, therefore, strong commitment to reform at policymaking and managerial level together with technical competence and improving tax administration supported with modern technology is vital.

To design an appropriate tax administration reform the identification of bottlenecks that hinder the smooth operation of the system is very crucial. In doing so, the primary task of administration reform should focus on identifying gaps in the existing tax collection capacity. Carlos Silvani and Catherine Bair (1997) summarized these gaps in the following four categories: - The first is the difference between the potential taxpayers and registered taxpayers. In this regard it is essential to identify non- registered taxpayers. The second is the difference between the potential taxpayers and those who file returns. These cornpones to stop filers. If the tax administration can quickly identified.

Can quickly identify stop filers, it can reduce the probability that large tax debts well accumulate. The third gap 9s the difference between the tax reporter as due and the tax actual paid. This gap corresponds to deli pent taxpayers. The fourth gap is the difference between the full tax liability that taxpayers should pay and the tax actually reported by the taxpayer. This gap correspondence to evaders. The following section wills adders

how the ongoing reform on tax administration attempts to minimize such gaps, as they are common to all tax administration.

9.2 LAWS AND REGULATIONS

For the presence of good and efficient tax administration plays significant role. Thus inefficiency in the tax administration can be originated from the prevailing tax laws and regulations. The tax laws are expected to be clear originated from the prevailing tax laws and regulations. The tax laws are expected to be clear and simple. When the tax laws are differently interpreted between the administration and the payers it creates in centime for litigation. Excessively high penalties for delinquent taxpayers could encourage for collusion, while very low penalties fail to enforce properly.

The current income tax law dating back to 1961 and supplemented by numerous amendments, has become complex to administer, and confusing for the taxpaying community to understand. Apart from these shortcomings the tax law fails to give proper power to the collecting institutions repaired for enforcement i.e. the tax administering authorities do not have the necessary enforcement powers to collect tax administering authorities do not have the necessary enforcement powers to collect tax delinquents to tax institution for tax fraud. It fails to give them proper power to enforce tax delinquents top at act institutions. More over it doesn't reflect the current bosons and investment environment since it exists for the lasts 50 years without radical improvements. In this commission it in corporate narrow definition or income and as a result its definition of income limited to in come originated in Ethiopia and sources such as foreign income are.

Excluded the prevailing depreciation allowance also does not consider the new fast changing technologies such as computers and it does not

provide any allowances to cover the costs of extraction of minerals and other geographical resources. The law is also silent with regard to scientific research and environment consideration. Therefore, the legislation requires in mediate revision to reflect the current tax, business and investment environment.

In order to alleviate the problems, codification of the income tax law into a single text and integrating the various legal documents, as well as modernizing and incorporating new concepts and procedures are being exercised at large. In effect it is anticipated the new and comprehensive legal framework, which is compatible with the current national and international development, will be on board by the current fiscal year.

9.3 TAXPAYERS' REGISTRATION

In any tax system identifying and registering actual and potential taxpayers is a primary function unless, the tax office has reliable and easily identifiable taxpayers registration system, tax assessment and collection will be difficult.

Thus, the use of taxpayer's identification number to identify taxpayers is a first step in the management of tax collection. The TIN system provides the foundation for the tax administration to independently identify taxpayers, control evasion, and create a dependable database for efficient and affective tax collection.

Moreover, it is expected that the use of a unique taxpayer registration number will enable the tax collectors to strengthen their capabilities in identifying every person whose income is subject to tax, and those who deliberately understate declarations or fail to disclose income

The Ethiopian tax administration, however, lacks such very important instrument. Accordingly current tax-collecting institutions both at federal and regional level have no proper and clear taxpayers registration they

even are unable to recognize the total number of taxpayers in their office. Thus introducing proper and technologically backed unique taxpayers identification number would facilitate better tax collection.

To that effect the government issued proclamation no 227/2001 which marked the introduction of tax identification number the tax system, the proclamation obliged any taxpayer to have a tax identification number (TIN) according the proclamation any person or organization looking for a license to carry on a business occupation is required to supply the TIN to the licensing authority in this case all public bodies and institutions issuing a business or occupational license is not allowed to issue or renew such license unless the taxpayer has supplied the TIN.

To realize the systems, the Government committed to finance the project and signed an agreement with an international company. The project envisaged the development of the long-term strategy to computerize the operation of the federal, regional, and city administrations and the development of the required financial information systems.

9.4 PRESUMPTIVE TAXATION

Presumptive taxation provides the instruments to broaden the tax base and raise more revenue that fail to declare or understate income. It is an important tool to collect revenue particularly from the hard to tax sector including the large informal sector. This is due to the fact that it involves the use of simplified and cost effective techniques to capture domestic transactions and sources of income that frequently escape taxation under conventional norms. It is recognized that presumptive taxation provides a tool to combat limited record keeping by the business community, considerable tax evasion, limited tax compliance and weak tax administration capacity.

The most common presumptive taxation methods include, standard assessment, estimated assessments, presumptive minimum taxes, presumptive import axes, with holding tax schemes and license fees, (Ethiopia Documents on Tax Administration and Policy Reforms)

To incorporate such systems the undergoing tax administration reform considers the following presumptive schemes.

9.4.1 Standard Assessment

Tax assessment is one of the most difficult aspects of tax administration. It requires clear transparent and comprehensive law, directives and manuals from the tax collectors point of view and knowledge of accounting by the tax payee. It is the process of determining tax liability based on the income obtained within a specific period. The assessment could be based on information declared by the taxpayer and information obtained from different sources.

Self- assessment is when the tax is computer and declared by the taxpayer, and when the tax office through audit and investigation determines the tax it is called official assessment. In order to assess taxable income based on actual income and expenses of business, the taxpayer is required to produce proper records and accounts, which show balance sheet and profit and loss statement in accordance with generally, accepted account in principles.

Taxpayers with small volume of business are not usually obliged to maintain books of account the assessment of their taxable income is based on their self-declaration and the tax office investigation. Tax offices apply presumptive assessment to decide the taxable income such practices are usually discretionary and involve subjective judgment.

To improve tax assessment of taxpayers who don't have books of account standard presumptive assessment is recommended standard presumptive

assessment is assumed to have the advantages of broadening the tax base, limited disincentive effect and to be more equitable than estimated assessment and is less open to corruption in effect presumptive taxation is a proxy for an income tax and doesn't necessarily reflects the actual income of taxpayers. Administratively it reduces collusion and cost. It is also beneficial in countries where accounting illiteracy is widespread. Presumptive taxes generally take the form of a tax on average or nominal income

To abandon the current estimated assessment and pave the way for introducing standard assessment proclamation no 227/2001 put specific articles. It is clearly stated that beginning fiscal year of 2002/03 a standard assessment method will be applied to determine the income tax liability of category "c" taxpayers. The proclamation stipulates that the standard assessment would be fixed amount of tax, which will be determined by a regulation of the council of ministers. More over up to its implementation the law incorporates a transitional tax computation rule. Under the transition rule a category "c" taxpayer will be liable to pay the amount of tax due for the preceding tax due for the preceding tax year, adjusted upward by a coefficient of 6 percent.

Designing an appropriate system of standard assessment requires, considerable cautious and technologically supported mechanisms. It entails to set a fixed lump-sum tax for a taxpayer on the basis of occupation or business activity. Thus, to introduce such practices, the presence of dependable database is highly demanding.

To put in place a well functioning and productive standard assessment scheme, therefore, it is essential to conduct a statistical survey that generates strong database. To that end, the tax administration reform program is envisaged to conduct taxpayers' survey. The survey is

assumed to categorize business activities based on collected data and set sandaled profit margins for each category and within each category.

9.4.2 Withholding Taxes

One of the primary goals of the tax administration reform is to collect more revenue with minimum cost. To ward this end, the use of withholding taxes on income is popular in many countries. It is a means to collect income taxes through withholding at source with minimal use of administration resources. A popular mechanism is wage withholding commonly known as pay-as-you-earn (PAYE), in which employers are withholding agents for personal income tax on the earning of their employees. On top of promoting compliance, the system shifts the responsibility from the person or organization which the incidence is falling to another agent. This has also a direct effect to efficiency and effectiveness. By way of shifting the tax administration's monitoring responsibilities from a large number of individual taxpayers to a much smaller number of employers, thus achieving a more efficient focusing of administrative resources. (vito tanzi and Anthony pellechio 1995)

Under the prevailing tax system in Ethiopia, withholding tax system is in practice in the payroll, interest income, dividend and chance winning. To expand the system recently proclamation No,227/2001 introduced withholding taxes on import and local transactions. According to this proclamation an importer is obliged to pay 5 percent income tax at the time of importing goods for commercial use. The tax is treated as tax withheld that is creditable against the taxpayer's income tax liability for goods results in underpayment of business income tax due for the year, as determine at the time of declaration of income tax, the tax payer is required to pay the difference with the declaration. Conversely, if the amount represents an overpayment of income tax due for the year, the tax authority shall forth with refund the taxpayer the amount overpaid.

Likewise, withholding tax on income tax on payments is also promulgated by the same proclamation. The proclamation obliged the following agents to withheld 5 percent income tax on payments made persons within categories specified in regulations to be issued by the council of ministers. These are

- Category “A” taxpayers,
- Government agencies
- Private nonprofit institutions
- Non governmental organizations

The withholding agents are required to transfer to the government the amount required to be withheld on payments made during the month, on the last day of each month. For the proper implementation of the proclamation, the council of ministers issued a regulation to provide for the application of tax withholding scheme. The regulation primarily identified taxpayers, which the withholding scheme is applied. It listed 10 service categories, which liable for the scheme is applied. With respect to goods, a single transaction involving more than birr 10,000 is subject to the withholding scheme.

9.4.3 Presumptive Minimum Taxes

Presumptive minimum taxes involves the levying of a specified tax burden on individual or business irrespective of the volume of business activity or level of income in a given year. The taxes are levied on the basis of gross receipts (turnover-based presumptive taxation) or the basis of a firm’s assets (assets- based presumptive taxation) or lump-sum form.

To enhance the revenue mobilization effort proclamation no 227/2001 also introduced minimum tax on income of “A” and “B” taxpayers. Accordingly these taxpayers are liable to pay a minimum income tax equal to 2 percent of their turnover. Nevertheless if the regular tax liability exceeds the minimum tax amount, the taxpayer is forced to pay

the regular tax or declare loss, he is obliged to submit books of account certified by an independent auditor.

Virtually, the scheme has the revenue potential and relative ease in administration. However, since its application is restricted to large business, unlike the withholding taxes, it does not address the hard to tax groups or those taxpayers who understate or under declare income, nor maintain adequate books and accounts.

9.5 TAX COLLECTION

Tax collection is the ultimate goal of tax administration. Revenue accounting, enforcement and receivable management are important aspects of tax collection. Unless the assessed tax is properly and timely collected the entire tax administration exercise would be futile.

In a country where a prevalence of huge informal sector, mainly consisting of small and medium size firms, professionals and farmers is significant tax collection mechanism is essential. Introducing withholding tax system is one of the most efficient techniques for improving collection. _

In our tax system both at federal and regional tax accounting and collection is made manually. Accordingly it is not possible for the administration to identify and takes timely action on the taxpayers who are delinquent in paying taxes. At present the tax administration lacks the required accounting and receivable management due to weak technical and personal support. There is no any investigation mechanism to address tax fraud and evasion.

It is advisable to treat separately the small number of taxpayers contributing a large percentage of taxes collected thus in order to monitor, audit and enforce the smallest number of tax payers but

contributing more than 70 percent of the federal tax revenue an independent office has been organized since July 2001

9.6 COMPUTERIZATION

As it has been mentioned repeatedly, tax collection is not functioning properly without an effective and efficient tax administration. To that end, a well-designed computer system is an important tool of tax administration naturally computerization is useful to improve efficiency and reduce cost in the current information technology age, computers and their wide spread application allow tax collectors to provide efficient, timely and accurate services. Computers application is equally important to save taxpayers time and promote tax equity.

However, such benefits of computers are not easily accessible to developing countries. Due to high costs associated with purchasing of hard and soft water and shortage of computer technicians and personal hinders developing countries to enjoy the advantage of computers.

There is also a counter argument in the application of computers in an economy full of unemployment t. but experiences proved that computers relief the problem of boring and repetitive tasks by using educated manpower. In this case the opposite is witnessed in application of computers” since computer technology was adopted in 1957, the number of US internal revenue service employees outside Washington D.C has more or less double (from 48,000 to 90,000) but the cost of collection has remained at 49 cents per \$100 “(Alan A. Tait, “VAT: international practices and problems.”

Generally speaking computers do not support the Ethiopian tax administration. The only computerized tax collection system currently functional is the customs ASYCUDA. The introduction of ASYCUDA, a computerized customs entry processing system helps facilitate the

revenue collection procedures through improve control, faster clearance of imports, and providing reliable data for the purpose of valuation and tax assessment.

No computerized system is operational in the management of income taxation which is the most difficult to administer. All revenue accounting is done manually, on ledger cards and there is no master fill of taxpayers, or lists of delinquent tax filers. As a result taxpayers are not identified in a timely manner and routine management information is not available. At any rate, it is imperative to introduce computerization In taxpayer's identification, tax assessment and collection mechanisms.

To begin with the installation of taxpayers identification number (TIN) will not be practical with out computer net working. Computerization in the TIN system is essential to provide updated lists of registered taxpayers to various tax offices at federal and regional level.

In order to reduce the reliance on foreign trade and build strong domestic indirect taxes the introduction of VAT in the tax system is recommended and appreciated by the government. Its implementation will not be feasible, without automation.

Computerization is essential to change the manual ledger system to ensure better management of the taxpayers' accounts. It helps the ledgers to update instantly with information on assessment, refunds, interest, penalties and other forms of adjustment.

9.7 TAXPAYERS EDUCATION

Taxpayer's education and information is very essential in promoting compliance. Taxpayers must receive clear and concise information on describing what is taxable, how to calculate their tax liabilities, and procedures for calculating and paying taxes and where they pay taxes.

Also forms and procedures for calculating and paying taxes should be as simple as possible.

More over tax offices are expected to develop programs to inform the business community of the requirements to make declaration, they based for the declarations and the penalty provisions for non-compliance. The program could utilize information pamphlets to be made available at key locations and public gatherings such as post offices trade licensing bureaus, chamber of commerce, and media.

Given the importance of taxpayer's education in the tax system the attention given in this regard is very marginal so far. The resource devoted to promote such essential aspects of the tax administration is almost non- existence. Taxpayers awareness hwy where and when they pay taxes is very poor. The ongoing tax reform program, therefore, put emphasis to enhance tax offices capacity in this area.

9.8 PENALTIES

The following penalties are provided in the proclamation against non-compliance.

For Non-declaration: Taxpayers who do not declare taxable income within the period specified in the regulation will be liable to pay Birr 1000 for the first 30 days of non- declaration. The penalty is Birr 2000 for the next 30 days of non-m declaration. Birr 1500 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 understated. If the understatement is substantial, the penalty will be 50%. (The understatement is substantial if it exceeds smaller of 25% of tax or Birr 20000).

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 days 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 not been withheld). In addition, this failure obliges the agent to pay Birr 1000 per case. The following individuals are also liable in this regard.

The manager who knew or should have known of the failure. The chief accountant or a senior officer who was responsible for the supervision of the withholding activities.

For failure to supply TIN: The agent, from a person who doesn't supply TIN, should withhold 30% of the payment. The taxpayer, who has not supplied TIN, is also liable to pay lower of Birr 5000 or the amount of payment

Interest: Taxpayers who do not pay tax within the due date are obliged to pay interest for the amount unpaid for the periods of non-payment. The interest rate for this purpose is 25% more than the highest interest rate in the preceding quarter. The same procedure will be followed for cases where a refund (if any) of tax is not made by the Tax Authority within 90 days of having satisfied with the tax declaration.

9.9 TAX ACCOUNTING PRINCIPLES

Methods of Accounting

Subject to the proclamation for the purposes of ascertaining a person's income accruing or derived during a tax period, the timing, inclusions and deductions shall be made in accordance with the generally accepted accounting principles. Unless the Tax office prescribes otherwise in particular case, a tax payer must account for tax purposes on a cash or accrual basis. A company must account for tax purposes on an accrual basis.

A person may apply in writing for a change of accounting method and the tax office may, by notice in writing, may approve the application if it considers the change necessary to clearly reflect that person's income. If a person's accounting method is changed, proper adjustments to items of income, deduction or credit must be made in the tax period following the change.

A. Cash Basis Accounting

Under this method of accounting amounts are recognized as income when they are received or made available and expenses are recognized when they are paid.

B. Accrual-Basis Accounting

With this method of accounting amounts are recognized as income when they are receivable and expenses are recognized when they are payable. An amount is receivable when a person becomes entitled to receive it, even if payment is postponed or the entitlement is payable by installments. On the other hand, an amount is treated as payable when all the events that determine liabilities have occurred and the amount can be determined with reasonable accuracy, but not before economic performance with respect to that amount occurs economic performance occurs: -

- With respect to the acquisition of services or property, at the time the services or properties are provided;
- With respect to use of property, at the time the property is used; or
- In any other case, at the time that person makes payment in full settlement of the liabilities

A deduction for an expense incurred on a service or other benefit, which extends beyond 12 months including cost of lease of land shall be allowed proportionately over the tax periods to which the service or benefit relates. When a taxpayer using cash basis of accounting, later refunds an amount received or recovers expense paid, an adjustment shall be made to that person's income in the tax period in which the refund or recovery occurs.

A person accounting for tax purpose on accrual basis later cease to claim the right to receive an amount or to claim an obligation to pay the expense, an appropriate adjustment must be made to that person's income of the tax period during which that person ceases to make the claim.

Long Term contracts

Long-term contract refers to a contract for manufacture, installation, construction or the performance of related services not completed within the tax period in which the work under the construct commenced. In the case of accrual basis accounting, income and costs relating to a long-term contract will be accounted for on the basis of the percentage of the contract completed during any tax period.

The percentage of completion is determined by comparing the total costs allocated to the contract and incurred before the end of the tax period with the estimated total contract costs including any variations or fluctuation. Where, during the tax period a long term contract is

completed, a person carrying on the business incurs a loss or has an unrelieved loss available for carrying forward attributable to the long term contract, the Tax Authority may allow the loss to be carried back to preceding tax periods, and deducted from income of a tax period as far as the loss is not in excess of deductible expenses for the period a loss incurred is attributable to a long -term contract to the extent that deductions exceed income.

9.10 DEVELOPMENTS IN GOVERNMENT REVENUE

As it been stated repeatedly the aforementioned tax reform measures were taken to minimize the nature of tax distortion, promote as well as foreign investment, improve equity and efficiency. More importantly all are aimed to enhance revenue collection capacity both at regional and federal level. In this regard, the area of reform in broadening the tax base and improving tax administration are assumed to result in higher revenue than its previous level.

Traditionally the level of tax revenue in a country is judged in terms of the ratio of taxes to some measure of national product. Thus the following table depicts developments in tax over GDP performance exhibited in the past decade.

Table 4

**Government revenue performance
(In percent of GDP)**

	1990/9 1	1991/92	1992/9 3	1993/9 4	1994/9 5	1995/96	1996/ 97	1997/ 98	1998/ 99	1999/ 00
Direct taxes	4.33	3.19	2.76	3.34	3.87	4.62	4.59	4.15	4.15	4.50
Domestic indirect tax	3.95	2.57	2.79	2.94	2.79	3.05	3.11	2.62	2.49	2.78
Foreign trade taxes	2.42	2.02	2.71	4.58	4.79	4.78	5.22	4.93	4.91	5.17

Total tax revenue	10.7	7.78	8.26	10.86	11.45	12.45	12.92	11.70	11.54	12.45
Non tax revenue	3.4	2.84	4.52	3.04	6.00	5.59	6.09	6.88	8.83	7.03
Total go revenue	14.10	10.62	12.79	13.9	17.45	18.04	19.01	18.58	20.38	19.48

Tax revenue in the past decade averaged 11 percent of GDP, which is far below compared to internationally recognized average performance of 20-25 percent. Its performance also varies from year to year, yet it showed significant improvements following the tax reform measures taken since 1995. as a result it peaked to 13 percent in 1996/97 compared to 8 percent of

The healthier feature of the revenue performance however reversed in fiscal year 1997/98 due to the aftermath of the border conflict accordingly tax over GDP ratio dropped to 11.7 percent immediately but showed slight improvements to 12.5 percent in 1999/00

To respond the revenue needs during the war years the government tends to non -tax revenue. Hence non-tax revenue performance increased to 9 percent of total revenue in 1998/99 from 3 percent in 1993/94. by and large, during the past decade on top of exhibiting ups and downs, tax revenue of the government tilted to indirect taxes, particularly to foreign trade taxes. domestic indirect taxes, which emanated from the production and consumption of domestic goods and services decelerated. This could be either from low demand and supply of domestic goods and services or poor domestic tax administration. Further more the role of non-tax revenue significantly increased but unable to sustain.

In view of the current globalization treat depending on foreign trade taxes is not feasible. It is important therefore to mobilize more revenue from domestic consumption taxes. Recent developments in revenue

collection, however, attested that the revenue emanated from domestic indirect taxes depicted declining trend.

Check Your Progress Exercise

- 1. What are the essential factors that should be considered to make tax administration effective?
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- 2. What are the benefits of computerization with regard to tax administration?
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- 3. Explain the need for taxpayer’s education.
.....
.....
- 4. Discuss the major objectives of tax administration reform.
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.....
- 5. Explain the different penalties against non-compliance with the proclamation.
.....
.....
- 6. Describe the two methods of accounting for tax purpose.
.....
.....

9.11 SUMMARY

Tax administration reform includes the proper registration of taxpayers, assessing taxable income and timely collecting of the assessed tax. An

efficient and proper tax administration requires the prevalence of clear and transparent rules and regulations. Tax laws and regulations should minimize discretionary powers of tax collectors but give sufficient enforcement power to them.

This requires periodic inventory and revision of all existing rules and regulations. The presence of an efficient and modern tax revenue collecting institutions equipped with capable employees and new technology is equally important.

Despite considerable achievements in reducing tax and tariff rates, rationalizing domestic sales and excise taxes, the revenue mobilization effort needs further actions both in policy and administrative aspects.

By and large, government's ability to carry out its on going expenditure programs in infrastructure and social sector depends on the level of domestic financial resources, largely expected to flow from its tax system. Nevertheless, Ethiopia's revenue performance over the past decade has been low, when compared to other developing countries. The tax revenue GDP ratio, which had peaked at 13 percent in 1996/97 fell to 11.7 and 11.5 percent in the following two years. Although it showed slight improvements in 1999/2000 and reached to 12.6 percent, it remained low compared to the internationally accepted level of developing countries ratio, which is 20-25 percent.

Compared to other countries in Africa, income tax rates are still high. Various tax studies also advised the elimination of differentials existing between maximum rates across taxpayers. In the tax system, import duties still contribute significant portion of tax revenue nevertheless, the current globalization agenda demands the need to liberalize trade policy. This entails further reduction on duty rates.

In reforming the tax structure shifting the dependence of foreign trade tax to taxation of domestic transaction seems urgent. More specifically taxing consumption than production is highly advisable, since they do not affect the efficiency of domestic production. In this regard, VAT could be one of the envisaged candidates. It is acknowledged to reduce tax distortions, encourage investment by allowing input credits, broaden the tax base and ultimately raised the revenue potential. Nevertheless, VAT requires the existence of developed accounting and documentation systems with in the business community.

It is true that manpower matters are always marginalized as compared to the attention given to improve systems and procedures. For the success of the tax reform effort tax policy and administration staff should be strengthen. It is recognized that the current structure and number of staff both in the tax policy and collection institutions are not fully equipped in terms of competency and equipment. It is therefore very essential to prop up the necessary capacity in order to provide the required services in all aspects. Similarly the capacity of tax offices to conduct taxpayer recruitment and taxpayer's education is neither well organized nor sufficiently equipped. In this connection, the tax offices are expected to strengthen so as to properly publicize the tax administration's efforts and inform the taxpayers to accomplish their duties and responsibilities.

To significantly improve the effectiveness of the various reform measures a collaborative effort of the different stakeholders, including the public and private such as government's top officials, the civil society, the business community and the media, has paramount importance. Hence for the successful implementation of the ongoing reform willingness and full participation of these and other segments of the public should be encouraged. This could be materialized by bringing the whole community in the reform process in terms of organizing consultation forums.

The importance of simplifying the tax system is highly appreciated. In this regard it is recommended that tax law, regulation and procedures, forms and related information to be easily accessible and available.

Improving tax policy and administration is a complex, long-term endeavor. Since it requires significant level of financial and human resource it is beyond the internal capacity in order to yield results. Thus, the ongoing reform particularly the tax administration part demands significant intervention from the international community. Thus looking for technical and financial assistance from the government side and showing to support the effort by the international community is mandatory.

9.12 ANSWER TO CHECK YOUR PROGRESS EXERCISE

1. Refer Section 9.1
2. Refer Section 9.6
3. Refer Section 9.7
4. Refer Section 9.1
5. Refer Section 9.8
6. Refer Section 9.9