

PUBLIC FINANCE AND TAXATION (AcFn 3171)
DISTANCE LEARNING MODULE



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JANUARY, 2020
ARBA MINCH, ETHIOPIA

Course Introduction

Well come to the course Public finance and taxation. The course focuses on the tax system in Ethiopia and spending activities of a government and their influence on the allocation of resources and distribution of income in general and with special reference to Ethiopia as per the new economic policy. Moreover, the course will provide a reliable foundation in the core areas of public finance and Ethiopian taxation, and enable students understand the operation of the Ethiopian tax system. In addition to the above issues it will provide reliable information on public debt, deficit financing as well as public finance laws and constitutional provisions of the Ethiopian government particularly on public revenue and expenditure laws.

Module Overview

This module consists of four chapters. The first chapter discusses the nature and scope of public finance, Functions of Modern Government, Public versus Private Goods and Comparison of public finance with private finance. In addition to this this chapter discusses public expenditure, classification of public expenditures and basic principles (canons) of public expenditure.

The second chapter is about basics of taxation and that of definition of taxation, general theories and principles of taxation in particular. In this chapter issues like characteristics of tax, direct and indirect taxes, impact, shifting and incidence of a tax and effect of taxation will be also discussed. The third chapter discusses the public finance in Ethiopia. Primarily this chapter focuses on the principles of allocation of resources between Federal and State governments and it covers four aspects of deficit financing- meaning of deficit financing; objectives of deficit financing; Effects of deficit financing and Limits of deficit financing.. All the nine chapters are highly interrelated. The fourth chapter deals with Ethiopian taxation system including direct and indirect tax.

Objectives of this module

Upon the successful completion of this module, the students will be expected to:

- ☞ Discuss the essence of public finance and taxation in theory and in Ethiopian context
- ☞ Apply basic Ethiopian tax concepts to various circumstances relating to VAT, turnover tax, excise taxes, and custom duty
- ☞ Apply basic Ethiopian tax concepts to various circumstances relating to the employment, business and other income taxes

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UNIT ONE: BASICS OF PUBLIC FINANCE

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- Unit Summary
- Model Examination Questions
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Unit/ Learning Objectives

After learning this unit, students will be able to:

- Define public finance
- Identify the scope of public finance
- Know the role of government in the economy
- Explain and differentiate among public expenditure, public revenue, and public debt
- Describe public administration
- Understand the concept of fiscal federalism

Unit Introduction

The participation of the government in the economic activities is essential to accomplish the goals of any welfare state. Classical economists advocated minimum functions for the government. Subsequently, the economists Keynes demonstrated that it was possible through fiscal activities of the state to increase employment and to maintain it at high level. This realization led to emphasis on the active participation of the state in the economic activity.

The governments of advanced countries are committed to stability and full employment. In case of under developed countries the government aims at accelerated economic development. Government sector can play a decisive role in shaping and charting the path of any economy. Depending on the level of development of each country the roles of government sector differ. However, in all cases the aim is to attain full employment and economic development through the development of agriculture, industry and service sector. Today the communication sector has also been included in these vital sectors of the economy.

The Private finance deals with the wants and the satisfaction of households and firms. But the public finance deals with the collective wants and their satisfaction. The objective of both private and public finance is similar. Private finance aims at maximizing social welfare or social benefit by efficient use of public goods. Distinction between private and public goods is important in the study of public finance.

1.1 Definition of Public Finance

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Pretest

Dear students, now, we are going to define the term public finance and its related terminologies. So, try to define public finance before reading the following sections.

The study of state is called “Public Finance”. Public finance is the study of income and the expenditure of the government. Rising of necessary funds for incurring expenditure constitutes the subject matter of public finance. The methods of public finance have certain effects on economic life and can, therefore, be used as an instrument for bringing about desired social and economic changes. Public finance also deals with the problems of adjustments of income and expenditure of the government. It is also known as fiscal operations of the treasury. Thus, fiscal operations and fiscal policies are integral part of public finance.

Public Finance deals with the income and expenditure of the public authorities. Here the term Public means the Government that is Central, state and local authorities. According to Prof. Dalton, public finance is one of those subjects, which lie on the borderline between Economics and Politics. It is concerned with the income and expenditure of public authorities and with the adjustment of one to another.

Hence, it can be defined as the science that deals with the nature and principles of the income and expenditure of the government. Ethiopia has adopted the policy of welfare state for bringing about

social and economic justice. Public finance policy of the country is drawn up in tune with the constitutional commitment Welfare state. Under the welfare state, government performs important functions and takes up certain public or collective welfare measures which private sector cannot provide.

Public finance is also related to the financing of the state activities and a narrow definition of the public finance would try to say that public finance is a subject which discusses the financial operation of the fiscal or of the public treasury.

Taking in to consideration of the concepts of the various definitions given by different writers, Public finance may comprehensively defined as ‘a branch of economics which deals with the nature and principles of the income (receipt) and expenditure of a government and their effects on economic and social systems.’ The salient elements embodied within the above definition and their connotations are as follows;

A branch (Field) of economics; the study of public finance properly belongs in the field of economics.

A government; a government is a political organization/entity which governs or administers a state or a country.

Nature of government income and expenditure; Public finance deals with why a government raises incomes, what the different sources of a government incomes are; what the different heads of a government expenditure are; and how they differ to each other.

Principles of government income and expenditure; Public finance studies the principles which govern incomes and expenditures of government and its administration.

Their effects; Public finance deals with the effect of a government income /revenue and expenditures on socio economic systems

Mrs. Ursula Hicks (1958) also gives a comprehensive definition. She writes, ‘the main content of Public finance consist of the examination and appraisal of the methods by which government bodies provide for the collective satisfaction of wants and secure the necessary funds to carry on their purposes(functions). The political dimension of the subject is noted in her (Ursula’s) definition.

Activity 1.1

1. Define Public finance comprehensively.

1.2 Public finance Vs Private finance

Pretest

Dear students, would you try to list the commonalties and differences between public & private finance before reading the following sections?

There are both similarities and differences between public finance and private finance. Let us discuss the similarities first.

1. Similarities between Public Finance and Private Finance:

- 1. Satisfaction of Human Wants:** Individual is concerned with the personal wants, while the Government is concerned with the social wants. Thus, both the private and public finance have the same objective, viz, the satisfaction of human wants.
- 2. Balancing of Income and Expenditure:** Both individual and government have incomes and expenditures and trying to balance each other.
- 3. Maximum Satisfaction:** Both private and public finance aim at maximum satisfaction.
- 4. Borrowing a Common Feature:** As and when the current incomes become insufficient to meet the current expenditure, the individuals and Governments rely upon borrowings. Both of them are having loan repayment plans.
- 5. Economic Choice a Common Problem:** Both the individual and Government face the problem of economic choice. That is their sources of revenue are limited, comparing with their expenditure. Hence they have to satisfy the unlimited ends with limited means.

2. Dissimilarities between Public Finance and Private Finance

Even though the private and public finances look alike, there are certain fundamental differences between them. They are;

- 1. Adjustment of Income and Expenditure:** In private finance, the individual first considers his income and then decides about his expenditure. But the case of public finance, the government first estimates the volume of expenditure and then tries to find out the methods of raisins the necessary income. That is the private finance tries to adjust its income to expenditure, whereas the public finance tries to meet the expenditure by raising income.
- 2. Nature of Benefit:** The private finance aims at individual benefit ie the benefit of individual household. But the public finance aims at collective benefit, i.e. the benefit of the nation as a whole.

3. Postponement of Expenditure: In private finance, the individual can postpone or even avoid certain expenditure, as he likes. But in the case of public finance, the Government cannot avoid certain commitments like social welfare measures and thus cannot postpone the certain expenses like relief measures, defense, etc.

4. Allocation of Resources: In private finance the individual can allocate or distribute his income to various expenditure in such a way to get the maximum satisfaction. But it is not possible in the case of public finance; Government cannot aim at maximum satisfaction on the expenditures made.

5. Motive of expenditure: In the case of private finance, the individual expects return in benefit from the expenditure made. But the government cannot expect return in benefit from various expenditures made. That is profit or benefit is the motive of private finance whereas the social welfare and economic development is the motive of public finance.

6. Influence on expenditure: The expenditure pattern of private finance is influenced by various factors such as customs, habits culture religion, business conditions etc. But the pattern of expenditure of public finance is influenced and controlled by the economic policy of the Government.

7. Nature of Perspective: In private finance, the individual strives for immediate and quick return. Since his life span is definite and limited he gives importance to the present or current needs and allots only a little portion of income for the future. But, the Government is a permanent organization and is the caretaker of the present and the future as well. Thus, the Government allots a considerable amount for its income for the promotion of future interests. That is private finance has a short-term perspective whereas the public finance has a long term perspective.

8. Nature of Budget:

In private finance individuals prefer surplus budget as virtue and a deficit budget is undesirable to them.

But the Government does not prefer a surplus budget. If the Government brings surplus budget, it will create negative opinion on the Government. This is because surplus budget is the result of high level of taxation or low level of public expenditure both of which may affect the Government adversely.

9. Nature of resources: In private finance the individuals have limited resources. They cannot raise the income, as they like. They do not have the power to issue paper currencies.

But, in the case of public finance the Government has enormous kinds of resources. Besides the administrative and commercial revenues the Government can get grants-in-aid and borrow from other countries. The government can print currency notes to increase its revenue.

10. Coercion: Under private finance the individuals and business units cannot use force to get their income.

But, in public finance the governments can use force in the form of imposing taxes to get income i.e. taxes are compulsory in nature. It is an obligation on the part of the tax payer. No one can refuse to pay taxes if he is liable to pay them. Besides the above the Government can undertake any of the existing private business by way of nationalization, which is not possible in the hands of individuals.

11. Publicity: Individuals do not like to disclose their financial transactions to others. They want to keep them secret. But, the Government gives the greatest publicity to its budget proposals and the allocation of resources to different heads. It is widely discussed. Publicity strengthens the confidence of the people in the Government.

12. Audit: In the case of private finance, auditing of the financial transactions of the individuals is not always necessary. But the accounts of the public authorities are subject to audit and inspection.

Activity 1.2

1. List & briefly explain the similarities between Public finance & private finance.

2. List & briefly explain the differences between Public finance & private finance.

1.3 Provision of public and merit goods for social services

Pretest

Dear students, please distinguish between private and public goods before reading the following sections.

Distinction between private and public goods is important in the study of public finance.

1. Private Goods

Private goods refer to all those goods and services, which are consumed by people to satisfy their personal and private wants or needs. They relate to articles of food, clothing, shelter, recreation, transportation, communication etc. These goods are priced in the market on the basis of their cost of production on the one side and the nature of demand on the other. All those who want them and are willing to pay the market price will buy them. Those who do not want them or who are not in a position to pay for them will be excluded from the consumption of these goods. In other words there is no compulsion that everyone will have to buy them. Thus distribution of these goods is based on

effective demand and market price. As a result, only those who do demand the private goods will pay for their cost of production on a voluntary basis. Thus, private goods are divisible in the sense that price mechanism divides people in to two groups, viz., those who want to consume them and those do not; and private goods are subject to the principle of exclusion; in the sense that price mechanism excludes the group of people who are not willing to consume a particular good.

But price mechanism or market mechanism may fail when ever private goods are associated with the concept of externalities. Now, externalities refer to favorable and unfavorable effects which are associated with the production of those goods. The setting up of a factory in a backward region will help to open up the former and help to develop it; this is an example of an externality in the form of an economic gain. On the other hand, an atmospheric and water pollution of a chemical and fertilizer factory in an area is an example of unfavorable economic effect. The externalities are also referred to as spillover effects, neighborhood effects or third party effects.

The economic gain or economic loss associated with externalities cannot always be priced in the market and cannot be apportioned to particular parties. For example, it is not possible to find out exactly how much is the benefit of a new factory set up in a backward region or the exact extent of economic loss due to ash and smoke nuisance of a thermal power station using coal. These are examples of non- market external effects. In case, external effects, favorable or unfavorable, can precisely be calculated, in terms of money, and can be made part of the cost of production; then they can be passed on to those who get those external efforts – this will be the case of market external efforts.

2. Public Goods

Collective wants are those which are demanded by all members of the community in equal or more or less equal measures. Defense, education, public health, infrastructure facilities like power, transportation and communication, etc., are examples of collective wants. Goods and services produced to satisfy collective wants are known as public goods. These goods are produced and supplied by the society to meet its collective wants for increasing social welfare. These goods are supplied by the country to all its citizens. But the degree of benefit a person derives will depend upon the use he can put it to. For example medical and educational facilities are made available for all the people of Ethiopia.

It is important to recognize two features of public goods. First, they cannot be divided and their benefits cannot be shared between the people on the basis of each man's requirements. In other

words, unlike private goods, public goods are not divisible but have to be collectively consumed. If public goods are made available to meet collective wants, the question is: who will pay for them or in what proportion they will bear the cost of production of these goods and services.

Secondly, the principle of exclusion easily associated with private goods is not applicable in the case of public goods since they are not consumed distributively. Hence, these goods will not be produced by the private sector. On the other hand, they will have to be produced and supplied by the public authorities to meet collective wants. The price mechanism does not apply and these goods cannot carry a price tag. As everyone is a beneficiary - directly or indirectly of the public goods, everyone is asked by the public sector authorities to pay towards the cost of production of the public goods. No one can refuse to pay for the supply of public goods on the ground that they are direct beneficiaries. For example, an abiding citizen cannot refuse to pay towards the maintenance of police or a childless cannot refuse to pay towards the expenditure on education on the plea they do not benefit by them.

Actually, everybody wants to enjoy the benefits of public goods be they defense goods, law and order, education etc., but no one wants to pay for them. At the same time, the consumers do not have any system of priority in the case of public goods.

Again the taste, preferences etc., of consumers are not relevant and the public authorities do not attach any importance to the consumers while producing and supplying public goods. As the people too may not show any interest or any inclination in the production of these goods, the government has the sole responsibility to decide about how much of these goods should be produced, the method of production and the technique of distribution.

Since the public goods are supplied to all the people irrespective of their ability and willingness to pay for them, the pricing system is useless and therefore, a method of compulsory payment will have to be designed to finance their cost of production.

3. Merit Wants

Certain types of collective wants such as educational facilities have been called as merit wants since they command overwhelming importance in the attainment of social welfare. Provision of public goods meant to satisfy such wants will help the economy to achieve a high level of efficiency and welfare. If education is left to the private sector and accordingly educational facilities are supplied by the private sector on the basis of cost of production, the educational facilities will cost so much that many people in the lower income brackets will not be able to get them. Many an intelligent but poor student will be denied educational facilities. This will reduce economic efficiency and social welfare

of the community. In the same way, if hospital facilities are provided by the private sector units, they will be so expensive that only the rich will be able to make use of them and vast majority of people belonging to middle and lower income groups will be denied these facilities. It is for this reason that the state should either supply these goods to the community or at least supplement private effort directly or indirectly- directly by government schools and colleges or indirectly by subsidizing education to make it within the reach of everybody.

The important difference between the satisfactions of merit wants and of social wants is that the former calls for interference with consumer preferences. Besides, the provision of merit wants will confer immediate benefits on those groups of people who are in immediate need of them but the community benefits in general as the society becomes more educated and healthier. It is for this reason that merit wants must have substantial element of social wants.

The above analysis of private costs and social costs is based on the objective of efficient allocation of resources of an economy between private and public goods with a view to maximize social welfare. The use of price mechanism to determine efficiency in the allocation of resources assumes the existence of free market. This type of analysis may be suitable to predominantly capitalist economy such as U.S.A. but is not applicable to a fully collectivist or partly socialist economies in which market mechanism does not either exist or is not allowed play a free role.

4. Common pool goods

Common pull goods are goods and services consumed individually and it is virtually impossible to prevent anyone from taking them freely. **For example:** Air, fish in the sea, etc.

5. Toll goods/club goods

Toll goods are goods and services consumed jointly, but the user must pay and those which will not pay easily be excluded from enjoying the use of the goods. **For example:** toll road (Addis Ababa to Adama), fire protection and ports, etc.



Activity 1.3

1. Briefly define the following terms & give examples for each.

- A. Public goods _____
- B. Private goods _____
- C. Common pull goods _____
- D. Toll goods _____

1.4 Scope of public finance

Pretest

Dear students, please guess intelligently the scope/ broad categories of public finance before reading the following section.

Public finance deals with the income and expenditure pattern of the Government. Hence, the substances concerned with these activities become its subject matter. The subject matter of the public finance is classified under five broad categories. They are;

1. Public revenue
2. Public Expenditure
3. Public debt
4. Financial administration
5. Economic stabilization

We shall now explain them briefly.

1. Public Revenue:

Under this category, the sources of the public revenue, principles of taxation, effects of taxes on the economy, methods of raising revenue and the like are dealt with.

Public revenue is the means for public expenditure. Various sources of public revenue are:

- a. Tax revenue, and
- b. Non-tax revenue

Increasing activities of the government are the cause of increasing public expenditure. Methods of public revenue and their volumes have significant impact on production and distribution of wealth and income in the country. It has effects on the nature and the volume of economic activities and on employment.

a. Tax revenue:

Taxes are compulsory payments to government without expectation of direct return or benefit to tax payers. It imposes a personal obligation on the taxpayer. Taxes received from the taxpayers, may not be incurred for their benefit alone. Tax revenue is one of the most important sources of revenue.

Taxation is the powerful instrument in the hands of the government for transferring purchasing power from individuals to government. The objectives of taxation are to reduce inequalities of income and

wealth; to provide incentives for capital formation in the private sector, and to restrain consumption so as to keep in check domestic inflationary pressures.

From the above discussion we can conclude that the elements of taxation are as follows:

1. It is a compulsory contribution
2. Government only imposes taxes
3. In payment of tax an element of sacrifice is involved
4. Taxation is aimed at welfare of the community
5. The benefit may not be proportional to tax paid
6. Tax is a legal collection.

The various types of taxes can be listed under three heads. First type can be titled taxes on income and expenditure which include income tax, corporate tax etc. The second is taxes on property and capital transactions and includes estate duty, tax on wealth, gift tax etc. The third head, called taxes on commodities and services, covers excise duties, customs duties, sales tax, service tax etc. These three types can be reclassified into direct and indirect taxes. The first two types belong to the category of direct taxes and the third type comes under indirect taxes.

b) Non-tax revenue:

This includes the revenue from government or public undertakings, revenue from social services like education and hospitals, and revenue from loans or debt service. To sum up, non-tax revenue consists of:

- | | |
|---------------------------|---------------------------------|
| i) Interest receipts | iii) Fiscal services and others |
| ii) Dividends and profits | |

2. Public Expenditure

Recently, there has been both quantitative and qualitative change in government's expenditure. This category deals with the principles of public expenditure and its effect on the economy etc.

Government of a country has to use its expenditure and revenue programs to produce desirable effects on national income, production, and employment. The role of public expenditure in the determination and distribution of national income was emphasized by Keynes.

The term "Public Expenditure" is used to designate the expenditure of government-central, state and local bodies. It differs from private expenditure in that governments need not pay for themselves or yield a pecuniary profit. Public expenditure plays the dual role of administration and economic achievement of a nation. Wise spending is essential for stability of government and proper earnings

are a prerequisite for wise spending. Hence planned expenditure and accurate foresight of earnings are the important aspects of sound government finance.

Public expenditure is done under two broad heads viz., developmental expenditure and non-developmental expenditure. The former includes social and community services, economic services, and grants in aid. The latter mainly consists of interest payments, administrative services, and defense expenses. Expenditure can also be classified into revenue and capital expenditure.

Plan and Non-plan Expenditure

Expenditure is classified under the following heads:

a. Non-plan Expenditure

Non-plan expenditure of central government is divided into revenue and capital expenditure. Under non-plan revenue expenditure we include interest payment, defense expenditure, major subsidies, interest and other subsidies, debt relief to farmers, postal deficit, police, pensions, other general services, social services, grants to states and union territories. Non-plan capital expenses include defense expenses, loan to PSUs, loans to states and union territories, foreign governments etc.

b. Plan expenditure

The second major expenditure of central government is plan expenditure. This is to finance the following

- i) Central plans such as agriculture, rural development, irrigation and flood control, energy, industry, and minerals, communication service and technology, environment, social service and others.
- ii) Central assistance for plans of the states and union territories.

Expenditure can also be categorized into revenue and capital expenditure.

Revenue expenditure relates to those, which do not create any addition to assets, and covers activities of government departments' services, subsidiaries and interest charges.

Capital expenditure involves that expenditure, which results in creation of assets. Finance ministry is responsible for plan expenditure. This includes grants to the state.

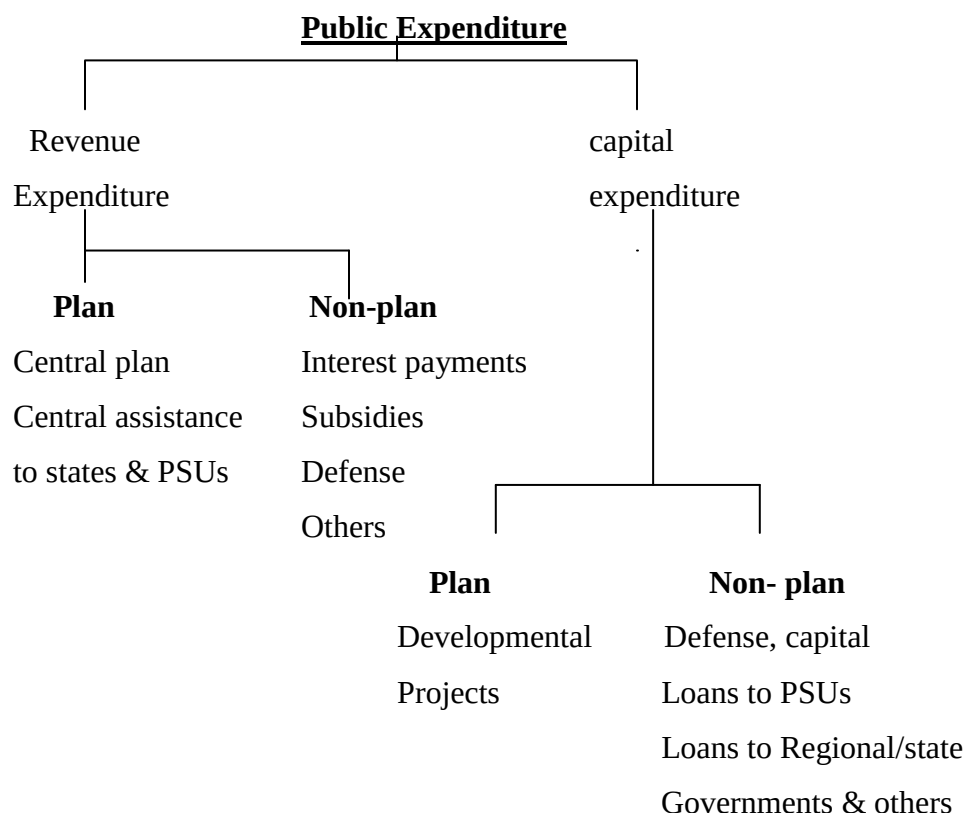
Hence the expenditures are classified as capital and revenue. Alternatively, these expenses can be reclassified into plan and non-plan expenditure.

Social expenditure

Government takes the responsibility of protecting the interests of the community as a whole and promotes the implementation of welfare programs. Government spends huge amounts for providing

benefits such as old age pensions, accident benefits free education and medical services. This expenditure on human resources comes under social expenditure.

Governments are moving towards the objective of achieving maximum social welfare. Expenditure on education, public health, welfare schemes for workers, relief and rehabilitation of displaced persons and such other services may not yield direct benefit in the short run. But in the long run they contribute to improvement in the quality at human resources. The main classifications of Government expenditure can be seen in the following diagram1.1.



2. Public debt

This category deals with the causes, methods and problems of public borrowings and its management. This includes both internal debt and external debt.

a. Internal debt

Increasing need of government for funds cannot be fully met by taxation alone in under developed and developing countries due to limited scope of taxation. Government therefore has to resort to alternate sources. Rising of debt is one such source. Debt, though involves withdrawal of resources by curtailing private consumption, has certain advantages. Transfer of funds from public to

government is voluntary. Loans do not reduce the wealth of the lenders. Debt raised for productive purpose will not be a burden on the economy.

There are many objectives of creation of public debt. Debt may be raised to meet the normal current expenditure, exigencies like war, finance productive government enterprise, finance public social welfare and economic development.

Capital receipts mainly consist of market borrowings, small savings and external loans, disinvestments of PSUs and recoveries of loans.

b. External Debt:

In under developed and developing countries, internal sources are limited. Under developed and developing countries, therefore go for external debt. The transfer of capital at international level may take the form of:

- i) Financial aid through grants and loans
- ii) Commodity aid
- iii) Technical assistance

External debt is an immediate source of funds for development. However, such debt has following drawbacks.

- i) Political subordination
- ii) Other obligation
- iii) Excess supply of goods and services in debtor country

However, such external inflows help to achieve faster growth.

4. Financial Administration:

This category includes the preparation of financial budget, the control and administrations of the budget relevant problems auditing etc. The term budget includes 'Annual Financial Statements' which incorporates all the annual statements of receipts and expenditures of the government.

5. Economic Stabilization

Generally, under developed countries have the following features.

1. Predominantly agriculture based economy
2. Low capital formation
3. Inferior technical know how
4. Low per capita income
5. Over population and poor health and educational facilities.
6. High propensity to consume leading to low capital formation.

This category analyses the use of public finance to bring the economic stability in the country. It studies the use of financial policies of the Government from the view of economic development.

Activity 1.4

Briefly explain the following major categories of public finance.

- | | |
|-----------------------|-----------------------------|
| 1. Public revenue | 4. Financial administration |
| 2. Public Expenditure | 5. Economic stabilization |
| 3. Public debt | |

1.5 The role of government in the economy

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Pretest

Dear students, would you list & briefly explain the role of the government in the economy before reading the following section?

We should know the role of the government to enable us to appreciate the importance of government sector. Government of a modern state generally undertakes the following functions:

1. Allocation Function:

The government operations basically involve the efficient provision of government funds in maximizing the welfare of the community. The government taxes the public and uses the amount in providing certain facilities and services considered essential by the by the people and the community. These facilities are such that they could not be provided by the people themselves such as defense, or they could be provided but only at a high cost such as education and Medicare. Fiscal operations of taxation and public expenditure have the effect of transferring resources form the public which would have been used for consuming private goods to produce public goods which would satisfy collective wants. The objective of fiscal operations is to provide for the proper allocation of resources between private and public goods so as to maximize social welfare.

2. Distribution function: In a free enterprise economy, distribution of income and wealth is unequal and many times it is grossly unequal resulting in exploitation of the lower income gropes. Inequality of income and concentration of economic power in the hands of a few are responsible for distorting production in favor of the rich and for reducing the social welfare of the community. Fiscal operations have been used to reduce the incomes and wealth of the rich (through progressive taxation) and using the money collected to raise the income and standard of living of the lower income group (through public expenditure}. The use of fiscal policy to reduce inequality of incomes and wealth has been quite common in many countries.

3. Stabilization Function: Modern economies are subject to fluctuations, viz., business boom and inflations on one side and business recessions and depressions on the other. Such fluctuations are not in the interest of the country. Fiscal operations have been used to moderate these fluctuations and if possible to eliminate them altogether. For instance, business booms and inflations are sought to be controlled through heavier taxation while business recession is sought to be checked through public expenditure. More specifically, government of a modern state performs the following activities, among others.

1. Security - both external and internal involving outlay for military, police and other protective services
2. Justice or settlement of disputes
3. The regulation and control of economy – including the services such as coinage,
 - a. Weights and measures, the business practices , operation of public sector
 - b. Undertakings
4. Social and cultural welfare through education, social relief, social insurance, health and other activities,
5. Conservation of natural resources,
6. Promotion of the unity of the state by control of transportation and communication,
7. Administration and financial system, government revenue expenditure and fiscal control,
8. Education and employment,
9. Housing,
10. Public health,
11. Upliftment of weaker sections of the society,
12. Restore social justice in the society, and many more activities or functions.

Therefore, the functions of modern governments are broadening due to socio- economic and political reasons. Therefore, to discharge these increasing functions, the government has to increase its expenditure. To meet out the enormous amount of expenditure it has to mobilize funds with the help of public finance policy. Hence, public finance has developed into an important branch of economics.

Activity 1.5

List & briefly explain the role of the government.

1.6 Fiscal federalism

Pretest

Dear students, do you explain the concept of Fiscal federalism before reading the following section?

1.6.1 The concept and meaning of Fiscal federalism

Fiscal federalism refers to the allocation of tax powers and expenditure responsibilities between the levels of government. Thus under fiscal federalism, any one individual is subject to the influence of the fiscal operations of different tiers of government. It basically concerned with the study of the distribution of expenditure responsibilities, the allocation of taxation power, intergovernmental transfers for adjusting fiscal imbalances, the management of regional borrowing and institutional mechanisms for fiscal relations between the levels of government. Tella (1999) states that fiscal federalism refers to the financial relationships between and among existing tiers of government; it includes the system of transfers or grants by which the federal government shares its revenues with the State and local governments. Therefore, fiscal federalism covers matters involving constitutional arrangements that lay down distributions of expenditure responsibilities and revenue raising capacities, as well as the mechanisms of adjusting horizontal and vertical imbalances. In addition, all tiers of government have joint responsibilities on fiscal policy either in stabilization of spending and taxes or, in debt management, such as policy of “bail-out”. Hence, procedures and institutional setups ensuring sub national borrowings, in particular and the issue of stabilization and management of economy, in general, could also be the subject matters of fiscal federalism

Nevertheless, the concept of fiscal federalism is not to be associated with fiscal decentralization in officially declared federations only; it is applicable even to non-federal states (having no formal federal constitutional arrangement) in the sense that they encompass different levels of government which have *de facto* decision making authority . However, this does not mean that all forms of governments are 'fiscally' federal; it only means that 'fiscal federalism' is a set of principles that can be applied to all countries which implementing 'fiscal decentralization' in their public sectors. Generally, fiscal federalism is a general normative framework for the assignment of expenditure and tax-raising responsibilities to different levels of government in a federation.

The central idea in fiscal federalism is that the various tiers of government relate financially in its concern for the execution of those responsibilities assigned to them by the constitution. These relationships influence the efficacy of intergovernmental fiscal relation between the various tiers of government involved. According to Ayoade (1980), there are six sets of relationships which include; National-State-Local, National-State, National-Local, State-Local, Inter States and inter local. The first four sets of relationship represent a vertical fiscal relationship while the latter two represent horizontal fiscal relationship. These relationships provide the basis for fiscal decentralization. Though, the dynamics of Federal-State-Local governments' interactions and the outcomes of the emerging fiscal game depend much on the history and political economy of the country.

Fiscal Federalism is characterized by the fiscal relations between central and lower levels of government. That is, it is manifest by the financial aspects of the devolvement o authority from the national to the regional and local levels. Fiscal federalism covers two interconnected areas. The first is the division of competence in decision making about public expenditures and public revenues between the different levels of government such as central, State and local governments. The second is the degree of freedom or decision making power enjoyed by sub-national authorities in the design and assessment of local tax base, tax rate and tax administration as well as in the determination of their expenditure needs. Therefore, at the time of undertaking the allocation of expenditure responsibilities and revenue raising powers to different levels of government in a federation, it is important to match the expenditure responsibilities with taxation powers of each level of government in order to improve the socio-economic welfare of people by enhancing good governance; promoting economic growth and poverty reduction; and improving efficiency of public service delivery.

According to Latvack and Wallich (2012), the major objectives of fiscal relations among various government levels in a federation are:

- ✚ To ensure correspondence between sub-national expenditure responsibilities and their financial resources (including transfers from central government) in order to carry out efficiently and effectively the functions assigned to them. Because, local governments (more close to citizens) are able to gather information about the preferences and needs of local people in more cheap and accurate manners than the central government. As a result, it enhances allocation efficiency by matching supply of public services with the preferences of local communities;

- ✚ To increase the fiscal autonomy of sub-national government by incorporating incentives for them to mobilize own revenue resources
- ✚ To ensure the macroeconomic management policies of central government are not undermined or compromised;
- ✚ To provide expenditure autonomy to sub-national government in appropriate areas in order to increase the efficiency of public spending and improve the accountability of sub-national officials to their constituents in the provision of regional and local public services. Because, , it promotes competition among local governments, by encouraging each and every one of them to provide a different menu of public goods to citizens and through experimentation and innovation of different cost-efficient-public services provision methods.
- ✚ To promote political participation and democratic values at the local level. Because, it provide opportunities to local communities to reflect their priorities, and to involving in the policy making process that affect their living conditions.
- ✚ To incorporate intergovernmental transfers that is administratively simple, transparent and based on objective, stable, non-negotiated criteria or formula;
- ✚ To provide 'equalization' payments to offset the differences in fiscal capacity among States and among local governments in order to enable the poorer sub-national governments to provide key public services at comparable tax rates;
- ✚ To incorporate mechanisms to support public infrastructure development and its appropriate financing:

Nevertheless, if fiscal federalism measures or principles are designed and implemented in a wrong way i.e. without considering the specific circumstances of a country such as economic, political, socio-cultural institutions; geographic and demographic conditions, it might bring negative impacts such as duplication of administrative costs by various levels of governments; bad governance and corruption through capturing of local government by local elites; inefficiency in provision of public services due to some public services are beyond the economic scale of local governments and weak administrative capacity at local levels; increases fiscal inequality due to mismatching of allocation of responsibility and revenue-raising capacity across regions; macroeconomic instability due to difficulty of coordination and harmonization of sub-national stabilization policy with national policy, and poor fiscal discipline at lower levels of governments. In addition, it poses considerable tension in relation with sharing of power between different echelons of government.

1.6.2 The Approaches of Fiscal Federalism

Fiscal federalism is basically concerns about the allocation of tax powers and expenditure responsibilities to the various tiers of government. There is no generally accepted framework or prescribed set of rules for allocation of tax-raising power and expenditure responsibilities that can be applied to all countries to determine optimal structure of fiscal decentralization. However, there are two alternative approaches of fiscal federalism in public finance literatures with opposite views related to the determination of optimal structure of fiscal decentralization in a federation. These are: First Generation Theory of Fiscal Federalism (FGTFF) and Second Generation Theory of Fiscal Federalism (SGTFF).

A. First Generation Theory of Fiscal Federalism (Traditional Approach)

The First Generation Theory of Fiscal Federalism (FGTFF) was introduced by the works or studies of four authors on public finance, namely, Tiebout's (1956) 'vote-by-own-feet' hypothesis, Olson's (1969) principle of fiscal Equivalence, Musgrave's (1959) trio of public sector functions, and Oates' (1972) decentralization theorem. These authors' contribution focused on the nature of public goods, the conceptualization of the roles of the private and public sectors and the active and positive role for the government sector, in terms of correcting various forms of market failure, establishing an equitable distribution of income, and stabilizing the economy at high levels of employment with stable prices as set in the Keynesian theory (Oates, 2005). As the result, they provided the first conceptual framework for allocation of the government roles or functions to different levels of government in a federation, which commonly known as First Generation Theory of Fiscal Federalism (FGTFF).

The main focus of FGTFF was on the failure of the market mechanism in providing public goods, which necessitated the intervention of the government to take the appropriate measures to handle the market failure. The first generation theorists investigating fiscal federalism tended to associate the process of fiscal decentralization with an enhancement in the overall degree of public sector responsiveness to a public demand and, ultimately, to an improvement in the economic efficiency of public economic activities, by better linking resource allocation with public preferences and needs. Thus, this fiscal federalism theory is takes only economic variables as determinant factors in assignment of expenditure responsibilities to different levels of government.

This theory of fiscal federalism (FFGFF) depends on the following assumptions:

- ❖ Public decision makers are benevolent social planner who has full information about the preferences of individuals and seek to maximize the welfare of entire society or citizen;
- ❖ The institutional environment is exogenously given or, at least, it has a neutral effect on the economy;
- ❖ Factor of production such as capital and labor are perfectly mobile and
- ❖ The borders between jurisdictions are not yet drawn, or at least they can be modified any time without excessive costs.

Accordingly, the first generation theorists regards sub-national jurisdictions as small and open economies whose abilities and interests do not necessarily coincide with those of the central government. First, the fiscal capacity disparities among sub-national jurisdictions cause undesirable internal migrations and inefficient resource allocation that result in social and political tensions.

Second, sub national expenditures that have a significant impact on demand or are particularly sensitive to cycles (e.g. unemployment benefits) may run counter to the stabilization objective of the center. In contrast, local governments which are more close to local people could improve the social welfare of citizens by matching the supply of public service with the preferences and condition of the local people and enhance the accountabilities and responsiveness of local authorities. For instance, Oates' well known decentralization theorem states that in the presence of diverse preferences and needs, provision of public services by a decentralized government structure generally will lead to increased citizen welfare. This is primarily due to the reason that local governments are in better position than the central government to administer and deliver public services to citizens as a result of the informational advantage they have about local conditions and preferences. This fact is reinforced by the mobility of households since as claimed by Tiebout (1956) individuals can vote with their feet and sort themselves into homogenous communities where their preferences are maximized

With regard to the revenue side of budget, this theory of fiscal federalism suggests that assignment of taxes should take account of the differences in taxpayer mobility among the various levels of government; horizontal and vertical fiscal gaps that necessarily arise from such an exercise should be filled with transfers and grants-in-aid. These latter instruments can also be used in a way to neutralize external effects resulting from the decentralized provision of public services. Finally, the FGFF

proposes to create optimal size jurisdictions that ensure a coincidence between the groups of decision-makers, taxpayers, and beneficiaries ('principle of fiscal equivalence'; OLSON, 1969)

This approach ignores the importance of the structure of political incentives stemming from institutions that may lead politicians to make decisions far from the most preferable or efficient ones. Moreover, this approach assumes that there is an inter-jurisdictional variation of tastes or preferences as well as the expression of preferences by voters. However, there seldom exists inter-jurisdictional variation of tastes, especially in developing countries, where the main issue is the fulfillment of basic needs.

B. Second Generation Theory of Fiscal Federalism (Political-Economic Approach)

It is important to be stated at the outset that FGFF and SGFF approaches are complementary rather than competing. As we discussed in above, FGFF focuses on the optimal design of fiscal institutions in the context of welfare maximization without respect to the incentives of political officials. In other words, FGFF assume that public sector bureaucrats are benevolent On the other hand , the Second Generation Theory of Fiscal Federation (SGFF) is extends and adapts FGFF lessons to the context of incentives and self-interested political officials by assuming that public sector bureaucrats have rent seeking behavior (leviathan). This means, unlike the FGFF, the SGFF assumes that government is a playing field of various interest groups and bureaucrats; as a result the behavior of elected officials and government decision-makers depends to a large extent on the institutions that define the framework for their action and the incentives they face. The turn of the twentieth century witnessed the emergence of the SGTFF, the basis of which originated outside the sphere of public finance literature, namely, public choice theory, the theory of the firm/organization, the economics of information, the principal–agent problem and the theory of the contract (Oates, 2005). Generally, this approach argues that the assignment of expenditure responsibilities and taxation power to different levels of governments should be made by considering not only the economic factors such as efficiency and equity but also the non-economic factors such as history, political traditions, public-choice, social and cultural values (Shah, 1994:14). As a result, it suggests that policy reformers should not to start from a blank slate when it comes to designing a country's intergovernmental fiscal structure, but to use the existing institutional framework in a country as a starting point for reforms, and to proactively incorporate elements of participatory and accountable governance and public administration into the design and practice of fiscal decentralization (Boex, 2009:10)

In general, the SGTFE has two main concerns. First, it considers that a world where political and fiscal institutions work under imperfect information and political agents have their own objective functions which are distinct from that of the “society” as a whole (Oates 2005). This means that public decision makers or politicians are driven purely by self-interest. As a result, they have incentives to achieve only their own objectives such as enhancement of power and influence, large staffs, and higher salaries by extracting resources from the economy. This consideration has obvious links to public choice theory – which was the main ‘non-core’ stream of the FGTFE (Volume, 2010). For instance, Brennan and Buchanan (1980), assumes the public sector as a monopolistic agent “Leviathan” that seeks to increase their own fiscal powers through extracting more revenue from the economy. This is because citizens have limited knowledge about the cost functions of public service provisions.

Brennan and Buchanan offer several principles to limit the leviathan behavior of government. One of the potential solutions is fiscal decentralization. They argue that fiscal decentralization could be the best strategy to discipline the expansionary tendency of the government (“Leviathan”) through the competition between regional and local governments. This means, like competition in private sector, competition among decentralized governments can limit the capacities of a monopolist central government to increase its control over the economy’s resources (Brennan and Buchanan, 1980:184). This is primarily due to mobility of taxable individuals across the regions of a nation, whereby the taxable individuals can penalize local governments that have incentive to inflate tax rate unnecessarily by relocate their living and/or business areas to other local governments that have relatively lower tax rates.

The second concern of SGTFE is the issue of asymmetric information and political agents, as some particular participants have more knowledge of local preferences, tastes and cost structure compared to others. In dealing with this issue, the second generation theorists introduced the framework of industrial organization and microeconomic theory. As the result, SGTFE focuses on the issue of balance between the degree of fiscal centralization and fiscal decentralization. In contrast with FGTFE, which acknowledges the general support of fiscal decentralization, SGTFE points to the dangers of going too far along this route.

There are two main motives that characterize SGTFE, namely, incentives and information. The two motives are instrumental in the realization of economic efficiency. On one hand, incentives are helpful in discouraging outward migration of people and firms from a jurisdiction. On the other hand, knowledge of local preferences and tastes is crucial to achieving economic efficiency when local

public goods and services are provided by sub-national governments. In common with FGTF, SGTF's logic for the design of fiscal transfers focuses on lowering the tax burden. But it also emphasizes allocating sufficient taxes to sub-national governments so that they have strong fiscal incentives to foster local economic growth (Weingast, 2006). The SGFF approach suggests that lower level governments are unable to foster local economic prosperity if they capture a significant increase in revenue along with that prosperity. Hence, SGFF advocates the redesign of transfer systems so as to allow significant horizontal equity while providing high marginal incentives.

Generally, the differences between the two generations/approaches are more based on style and emphasis than truly substantive. For instance, the FGFF is more abstract and theoretical as well as more normative or prescriptive, whereas the SGFF is more pragmatic, less bound to convention, and positive in approach. There are also other differences between the two approaches of fiscal federalism. First, both differ in treatment of institutional characteristics, for instance, the FGFF has focused more on governance structure and its relation to fiscal and economic matters such as number of levels of government, jurisdiction size, both expenditure and revenue assignments, while the SGFF has focused more broadly on the design of those structures such as political and fiscal institutions (Weingast, 2009). Second, they also differ on the method of financing sub-national governments' functions, for instance, the FGFF argued that revenue generation at the sub-national level should follow the benefit principle because it enhances government accountability and reduces induced distortions from taxing mobile tax bases. Thus, this approach treats grants as tools to close vertical and horizontal fiscal imbalances, and to internalize inter-jurisdictional spillover effects. Whereas, the SGFF second has focuses the effects of grants on regional incentives to economic growth, rent-seeking, and budget balance. As a result, it considers hard budget constraints, limits to issuing debt, and bankruptcy laws as devices to discipline and shape the incentive structure of sub-national governments.

Activity 1.6

1. Discuss the concept of Fiscal federalism.

2. List & explain the approaches of Fiscal federalism.

Unit Summary

- ✓ Public finance is the study of income and the expenditure of the government.
- ✓ There are both similarities and differences between public finance and private finance.
- ✓ Private goods refer to all those goods and services, which are consumed by people to satisfy their personal and private wants or needs.
- ✓ Collective wants are those which are demanded by all members of the community in equal or more or less equal measures.
- ✓ Certain types of collective wants such as educational facilities have been called as merit wants since they command overwhelming importance in the attainment of social welfare.
- ✓ Common pull goods are goods and services consumed individually and it is virtually impossible to prevent anyone from taking them freely.
- ✓ Toll goods are goods and services consumed jointly, but the user must pay and those which will not pay easily be excluded from enjoying the use of the goods.
- ✓ The subject matter of the public finance is classified under five broad categories. They are; 1. Public revenue 2. Public Expenditure 3. Public debt 4. Financial administration 5. Economic stabilization.
- ✓ Government of a modern state generally undertakes the following functions in the economy: allocation, distribution & stabilization.
- ✓ Fiscal federalism refers to the allocation of tax powers and expenditure responsibilities between the levels of government.
- ✓ There are two alternative approaches of fiscal federalism in public finance literatures with opposite views related to the determination of optimal structure of fiscal decentralization in a federation. These are: First Generation Theory of Fiscal Federalism (FGTFF) and Second Generation Theory of Fiscal Federalism (SGTFF).

Model Examination Questions

1. Define public finance and explain the ways that it differs from private finance.
2. Discuss similarity and dissimilarity between public and private finance
3. According to some writers the subject matter of the public finance is classified under five broad categories. Briefly list and discuss those categories.
4. List and discuss the elements of taxation
5. Show the main classifications of Government expenditure diagrammatically.

6. List and discuss the major role of government in the economy.
7. Discuss two approaches of fiscal federalism

Answers to Model Examination Questions

Dear students, please refer to the notes pages in the unit to get answers to the model Examination Questions.

UNIT TWO: MEANING AND CHARACTERISTICS OF TAXATION

- Unit Objectives
- Unit Introduction
- Contents:
 - 2.1 Historical Background of Taxation in the World
 - 2.2 History of Taxation in Ethiopia
 - 2.3 Taxation and Some Holy Books
 - 2.4 Meaning of Tax
 - 2.5 Stages in the Development of Levy of Tax
 - 2.6 General Characteristics of Tax
 - 2.7 Function of Taxes
 - 2.8 Objectives of Taxation
 - 2.9 Principles of Taxation/Theories of Taxation
 - 2.10 Approaches to taxation
 - 2.11 Canons of Taxation
 - 2.12 Classification of Taxes
 - 2.13 Direct and Indirect Taxes
 - 2.14 Tax Rates and Taxation System (Tax Rate Structures)
 - 2.15 Impact, shifting and incidence of tax
 - 2.16 Effects of Taxation
 - 2.17 Tax Evasion, Avoidance and Black Money
 - Unit Summary
 - Model Examination Questions
 - Answers to Model Examination Questions

Unit/ Learning Objectives

After learning this unit, students will be able to:

- ♣ Describe the Historical Background of Taxation in the World
- ♣ Explain History of Taxation in Ethiopia
- ♣ Understand Taxation and Some Holy Books

- ♣ Know the meaning of Tax
- ♣ List the stages in the Development of Levy of Tax
- ♣ Portray the general Characteristics of Tax
- ♣ Identify the function of Taxes
- ♣ State the Objectives of Taxation
- ♣ Be familiar with Principles of Taxation/Theories of Taxation
- ♣ Recognize the Approaches to taxation
- ♣ Explain Canons of Taxation
- ♣ Know the Classification of Taxes
- ♣ Distinguish b/n Direct and Indirect Taxes
- ♣ Understand the Tax Rates and Taxation System (Tax Rate Structures)
- ♣ Differentiate among Impact, shifting and incidence of tax
- ♣ Describe the Effects of Taxation
- ♣ Define & explain Tax Evasion, Avoidance and Black Money

Unit Introduction

Taxation is a system of raising money to finance government. All governments require payment of money - taxes - from people. Governments use tax revenues to pay soldiers and police, to build dams and roads, to operate schools and hospitals, to provide food for the poor and medical care to the elderly, and for hundreds of other purposes. Without taxes to fund its activities, government could not exist.

Taxation depends on concepts from law, accounting, economics, public financial management, politics, behavioral sciences, etc. Thus, taxation can be considered as a part of special fields of study such as law (specifically tax law), accounting (specifically tax accounting), public financial management, economics, politics and relevant others. The scope of taxation includes tax policies, tax theories, tax decisions, and tax administration.

2.1 Historical Background of Taxation in the World

Pretest

Dear students, do you describe the History of taxation in the world?

History of taxation for more than 2500 years has focused on two significant issues: who pays and what is taxed. For most of human history, taxes were paid by poor- peasants, slaves, colonists, or conquered peoples- to support the government and the wealthy classes. For as long as governments have existed, they have had to come up with ways to finance their activities. Methods of public finance have changed enormously over time. History of taxation in the world during different periods is discussed as follows;

1. Ancient Times (up to 5th Century AD)

In the ancient civilizations of Palestine, Egypt, Assyria, and Babylonia, individuals' property rights did not exist. The king was sole owner of everything in this domain, including the bodies of his subjects. Thus, instead of taxing individuals to support the government, the king could simply force them to work for him. Ancient kings earned income in the form of food from their lands and precious metals from their mines. If this income did not meet the king's demands, he might lead his armies into neighboring countries to confiscate their property. In societies that operated without money, the rulers taxed farmers by requiring that they hand over some proportion of their crops to the state. Poll taxes were a major source of revenue in Egypt under the Ptolemaic Dynasty (323 BC-300 BC).

The government of ancient Athens, Greece, relied on publicly owned silver mines, tribute from conquered countries, a few customs duties, and voluntary contributions from citizens for revenue. It levied poll taxes only on slaves and aliens (non citizens) and made failure to pay a capital crime.

In early years of Roman republic all Roman citizens paid a poll tax. However, Roman military victories brought in so much foreign tribute that the government exempted citizen from this tax in the 2nd century BC, after the public wars between Rome and Carthage. More than 100 years later, Emperor Augustus introduced land and, inheritance taxes. Succeeding emperors raised rates and found an increasing number of things to tax, including wheat and salt.

1 Medieval time (5th to 15th Century AD)

During the Middle Ages from about the 5th century AD to 15th century AD, taxation varied from, region to region. Europeans were subject to many forms of taxation, including land taxes, poll taxes, inheritance taxes, tolls (payments for the use of bridges, roads, or seaports), and miscellaneous fees and fines. Many people paid taxes in the form of money or crops directly to the local lord whose land they farmed.

Under the system of feudalism that dominated in Western Europe beginning; in about the 11th century, kings, noble and church rulers all collected taxes.

The Roman Catholic Church was a tax collector during the middle ages. One of the most important sources of church revenue was the tithe that is a compulsory payment, one-tenth of a person's harvest and lives stock. An important development towards the end of feudal period was the dramatic growth in the number and population of towns and cities. These urban centers collected revenues using taxes on property as well as sales taxes on certain items.

An important development toward the end of the feudalism was taxes on Property

Under the system of feudalism in Western Europe (11th Century):

- Kings, nobles, and church rulers all collected taxes.
- Kings derived income from their lands, from import and export duties, and from the various feudal dues and services owed by their vassals.
- Scutages - payments made in lieu of military service under King Edward of England
- Feudal nobility refused to pay scutages
- In 1215, Feudal nobility forced the king to sign the Magna Carta -the king agreed to collect scutages only with the "common consent"
- The Roman Catholic Church was a major tax collector during the middle ages – Tithe. The church also collected various fees, fines, and tolls.

2. Modern Period (16th Century AD to Date)

Over a period of time, feudalism faded and strong centralized states emerged in Europe, during 16th and 17th centuries. These states relied heavily on revenues generated by the king's own estates and by taxes on land. In England, the power of parliament grew steadily because the kings and queens had to

convene it frequently to obtain money. In 1689 the English bill of rights guaranteed that the king could not tax without parliament's consent.

By 18th century, England started imposing various taxes on transactions. As times passed, people became dissatisfied with this system of public finance for several reasons. In general people perceived that the burden of taxes fell mostly on the poor. In addition, tax systems did not generate as much revenue as the governing classes wanted. Finally, economists and political leaders began realizing that by reducing trade, tariffs created economic losses for society.

In the late 19th and early 20th centuries, concerns about both fairness and the ability of tax systems to generate sufficient revenue led governments to enact income tax, to finance the Napoleonic wars. The government discontinued the tax when the war ended in 1815, but revived it in 1842. The first progressive income tax, which imposed a greater tax burden on people with higher income, was introduced in Russia in 1853. Other countries introduced progressive income taxation in subsequent decades, including Britain in 1906, the United States in 1913, and France 1917. Although income taxes generated little revenue at first, today they play a major role in all modern tax systems.



Activity 2.1

1. Discuss the world history of taxation during different periods.

2.2 History of Taxation in Ethiopia

Pretest

Dear students, would you guess the history of taxation in Ethiopia?

A. Ancient Ethiopia

History of taxation in Ethiopia comes with the establishment of the government. The Aksum Kingdom, which was established in Northeastern Ethiopia, minted coins in 500 AD. This facilitated internal trades, external trades, and collection of taxes, which tells us that taxation was used starting from the Aksum Kingdom in Ethiopia.

B. Medieval Ethiopia

During the medieval period, in Ethiopia, taxation greatly varied from region to region and was often arbitrary. There had been different obligations that were considered to be taxes including compulsory

labor and compulsory hospitality. This was evident during 15th century AD at the time of **Emperor Zarayakobe**. From 15th to 19th century AD taxation was carried out in haphazard manner either in kind or services. It was also dependent on the will of the chief or the tax collector. At the middle of 19th century, during **Emperor Tewdros**, as per **Walter Plowden** who was friend and consultant of the emperor, "The taxes are numerous but varied according to the traditional customs of each village." The people pay certain portion in kind to the Ras, or other great chief and sometimes a regular tax in money. Besides, they must furnish oxen to plough the king's land. Their immediate governor then takes his share of every kind of grain (say a fifth) and feeds a certain number to demand oxen, sheep, goats, mules, butter, honey and every other requisite for subsistence.

Another type of taxation was embodied in the traditional Ethiopian system of compulsory hospitality in which the peasantry was legally obliged to feed house officials and other travelers through the countryside. Taxes on trade likewise 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 custom. Trade was also taxed at a series of internal customs posts (stations) called Kellas, which were much disliked by commercial community which, sometimes called for numerous quarrels between the traders and tax collectors- as the French Scientific Mission of the 1840s noted.

C. Modern Ethiopia

Later, all burdens on the peasantry discussed above were mitigated (reduced) by the first important reform carried out by Emperor Menilik II. At that time, a fixed tenth (tithe) was established rather than the undefined and arbitrary systems of agricultural taxes. The second major reform was the steady monetarization (monetization) of agriculture and other taxes.

- Emperor Haileselassie I continued the tax reforms started by Emperor Menilik II
- Modern tax collection procedure, tax schedules and the development of trained responsible bodies and regularly paid civil service came into existence.
- In 1943 G.C. (1935 E.C.) - a government body was established to collect taxes
- In 1944 - Proclamation No 60/1944 (1936 E.C) was enacted and issued to be used as a tax code in collecting tax from all individuals and their jobs
- In 1949 - Proclamation No 107/1949 (1941 E.C) amended Proclamation No 60/1944. This second proclamation excluded agricultural income from taxes and made a tax holiday of 5 years for persons or businesses with a capital balance of less than Br200,000.

- In 1954, Proclamation No 19/1954 (1946 E.C) was enacted and amended Proclamation No 107/1949.
- In 1961 - Proclamation No 173/1961 (1953 E.C) repealed Proclamation No 19/1954. Since then, there were few amendments to improve the tax proclamations and involved in changing tax rates from 35% up to 89%
- In the post-revolution period (1974 – 91) - significant major changes were made on the tax rate and structure of all types of taxes
- In 2002 - Proclamation No 173/1961 was repealed by Proclamation No 286/2002 (1994 E.C) after it served nearly 40 years. Proclamation No 286/2002, with subsequent amendments made on relevant matters, is currently in use in Ethiopia regarding income taxes.

Activity 2.2

1. Explain the world taxation in Ethiopia during the three consecutive governments.

2.3 Taxation and Some Holy Books

???

Pretest

Dear students, do you think the concept of Taxation was available in Some Holy Books?

A. The Bible and Taxation

- ❖ There are many evidences of taxation in the holy book bible. Different types of taxes were collected by the then governments in the **Holy Book Bible**.
- ❖ These include Income Tax (**Genesis 47:26**), Property Tax (**II Kings 23:35**), Special Assessment Tax (**II Chronicles 24:5**), Poll Tax (**Exodus 30:12**) and Indirect taxes (**Ezra 4:20**)

B. The Koran and Taxation

- ✚ In Koran, there are different contributions which are considered to be taxes. For examples, **Khums, Jizya and Zakat** are common contributions which can be considered as taxes.
- ✚ **Khums** is one fifth of any item which a Muslim acquires as wealth, income and property and which must be paid as an Islamic tax.

Activity 2.3

Briefly explain taxation as discussed in some Holy Books.

2.4 Meaning of Tax

???

Pretest

Dear students, would you define Tax?

A tax is “a compulsory charge imposed by the Government without any expectation of direct return in benefit ”.

In other words, a tax is a compulsory payment or contribution by the people to the Government for which there is no direct return to the taxpayers. Tax imposes a personal obligation on the people to pay the tax if they are liable to pay it. The general public should be taxed according to their ability to pay, and the people in the same financial position should be taxed in the same way without any discrimination.

Thus, tax can be defined as, "an involuntary fee or more precisely, "unrequited payment", paid by individuals or businesses to a government (central or local)". Taxes may be paid in cash or kind (although payments in kind may not always be allowed or classified as taxes in all systems). The means of taxation, and the uses to which the funds raised through taxation should be put, are a matter of hot dispute in politics and economics, so discussions of taxation are frequently tendentious.

A good tax system should not affect the ability and willingness of the people to work, save and invest. If not, it will affect the development of trade and industry and the economy as a whole. Thus, a sound tax system should contribute in the economic development of a country.

Hence, "taxation should not be like killing the goose that lays golden eggs".



Activity 2.4

Why tax can be defined as, "an involuntary fee or “unrequited payment”?

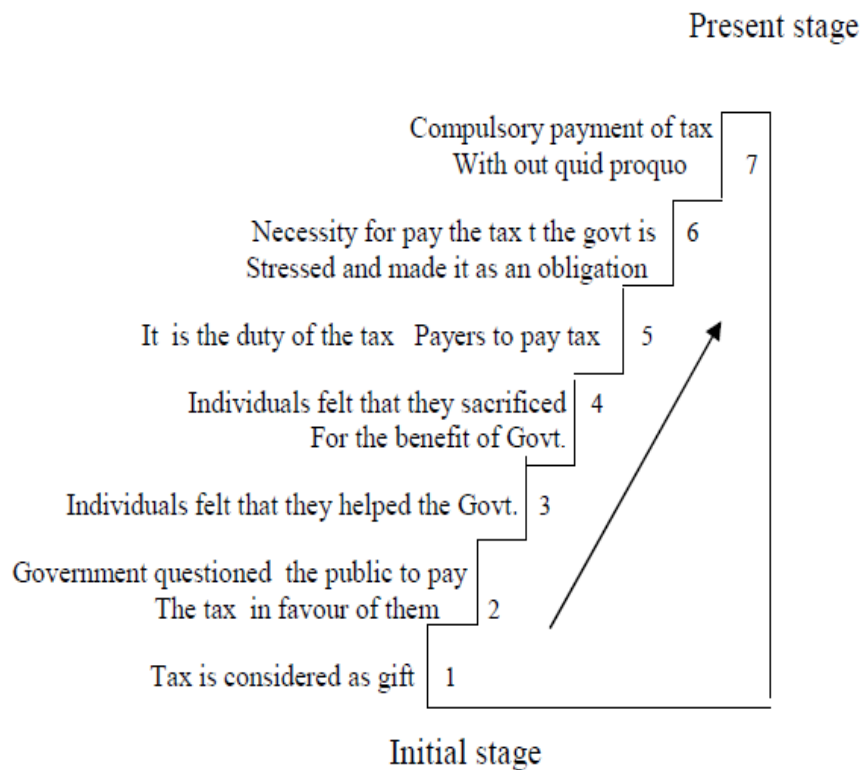
2.5 Stages in the Development of Levy of Tax

???

Pretest

Dear students, would you list Stages in the Development of Levy of Tax define Tax?

The levy of tax has crossed over various stages to reach the present state. Prof. E.R.A. Seligman has listed out the stages of development in this regard. We can understand the development in the levy of taxation from the following figure 2.1:



Stages in the Development of Levy of Tax

Activity 2.5

Comment on each stage in the Development of Levy of Tax.

2.6 General Characteristics of Tax

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Pretest

Dear students, mention Characteristics of Tax.

A tax has the following characteristics:

1. Tax is a Compulsory Contribution: Tax is a compulsory contribution by the taxpayers to the Government. The people whom the tax is levied cannot refuse to pay the tax. Once it is levied they have to pay it. Any refusal in this regard leads to punishments.

2. **Benefit is not the Basic Condition:** For the payment of tax, there is no direct return or quid proquo to the taxpayers. That is, people cannot expect any return in benefit for the amount of tax paid by them. Because, there is no relation between the amount of tax paid by the people and the services rendered by the Government to the taxpayers.
3. **Personal Obligation:** Tax imposes a personal obligation on the taxpayers. When a person becomes liable to pay the tax, it is the duty of him to pay it and in no way he can escape from it.
4. **Common Interest:** The amount of tax received from the people is used for the general and common benefit of the people as a whole. Now the Government has to render enormous range of social activities, which incur heavy expenditure. A part of the expense is sought to be raised through taxation of various types. Thus, taxes are said to be the sharing of common burden by the people.
5. **Legal Collection:** Tax is the legal collection. It can be levied only by the Government both Central and State.
6. **Element of Sacrifice:** Since the tax is paid without any return in benefit, it can be said that there is the prevalence of sacrifice in the payment of tax.
7. **Regular and Periodical Payment:** The payment of tax is regular and periodical in nature. It is levied for a fixed period usually a year. Thus, almost all the taxes are annual taxes. The payment of taxes should be regular also.
8. **No Discrimination:** Tax is levied on all people without any discrimination of caste, creed etc. but according to their ability to pay.
9. **Wide Scope:** Tax is levied not only on income but also on property and commodities. To enhance the revenue and to bring all the people under the tax net, the Government imposes various kinds of taxes. This enhances the scope of taxes.

Activity 2.6

List & explain the Characteristics of Tax.

2.7 Function of Taxes

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Pretest

Dear students, mention function of Taxes?

1. The Financing Function of Taxes

Traditionally, the primary purpose of a tax was to pay for goods and services provided by the government. The financing function of taxes remains important although taxes have other purposes today. Taxes are the main source of revenue or income for governments and provide the chief means of covering current costs or expenditures.

The major issue involving the financing function of taxes is their effect on the efficient use of scarce resources. Taxes divert resources away from alternative uses. These uses may be a source of lesser benefits than the uses to which these resources are put in the public sector. However, if taxes divert resources away from their best alternative use, they are a source of allocative inefficiency. The efficient distribution of resources to the public sector via taxes requires that benefits derived from government spending have a value equal to or greater than the alternative uses these resources would have in the private sector of the economy.

2. The Allocation Function of Taxes

In the financing function, the diversion of resources by taxes from the private sector is done under the presumption that resources are used efficiently in the private sector. Thus, the primary concern is to divert resources in a manner that does not interfere, or interferes the least, with the allocation of resources in the private sector. If resources are not efficiently allocated in the private sector, taxes can be purposely used to have non-neutral effects, that is, taxes can be used to change the allocation of resources.

3. The Redistribution Function of Taxes

The redistribution function of taxes raises the question of the appropriate way of distributing taxes among taxpayers. Taxes and tax rates can be selected in a manner that alters the pattern of income among taxpayers. Taxes can shift the pattern of income away from certain income groups and towards others. For example, progressive income tax rates take a higher percent of income for higher incomes than for lower; thus, they tend to reduce the after tax income of higher income groups more than they reduce the after tax income of lower income groups. Progressive income tax rates, then would be expected to shift the after tax income pattern away from higher income groups to lower

income groups. This effect, however, can be offset in part or in whole by tax deductions, credits, and the like which higher income groups can take advantage of in order to minimize their tax payments. Tax incidence studies try to find out whom really pays taxes that is, to find out who bears the real burden of taxation.

4. The Stabilization Function of Taxes

The stabilization function of taxes view taxes as a variable that can be altered to direct the economy toward economic stability; that is, full employment and a stable price level. An increase in taxes normally reduces private consumption and saving therefore reducing private spending. A decrease in taxes increases private consumption and saving and therefore has the opposite effect on private spending. Thus, taxes can play an important role in changing the level of private demand. When the economy is near or at full employment and is experiencing inflation, tax rates can be increased to reduce inflationary pressures. When the economy is experiencing declining real output and rising unemployment, tax rates can be cut in order to increase private spending. Taxes, then, can be viewed as a fiscal policy variable to be changed depending upon overall economic conditions. This role places taxes in quite a different perspective than the role in which they are traditionally seen simply as a method of finance. During periods of economic expansion, tax collections tend to automatically rise because of the growth in tax bases such as sales and income. This automatic growth in taxes tends to slow down the expansion. During periods of economic contraction, tax collections automatically decline because of the decline in sales and income in the economy. Therefore, even if tax rates are not changed during the ups and downs in the economy, tax collections automatically change in a way that tends to stabilize the economy.

2.8 Objectives of Taxation

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Pretest

Dear students, would please list general & specific objectives of taxation?

Government levies and collects taxes for various objectives. These objectives may be specific or general.

- 1. General Objectives:** Taxes are compulsory payments to the Government by the taxpayers. In the beginning, Government imposed taxes for three basic purposes viz., to cover the cost of administration, maintaining law and order in the country and for defense.

But, in modern days, there has been a sea change in the Government's expenditure pattern. Today, the Government is in the position to restore social justice in the society by way of providing various social services like education, employment, pension, public health, housing, sanitation and the development of weaker sections of the society. Besides the above, the Government announces heavy subsidies for agriculture and industry. Thus, Government requires more amount of revenue than before. Non-tax revenues are not sufficient to meet the entire expenditures. Hence, Government imposes taxes of various types.

Let us discuss the general objectives of taxation hereunder:

1. Raising Revenue: The basic purpose of taxation is raising revenue. To render various economic and social activities, Government requires large amount of revenue. To meet this enormous expenditure, Government imposes various types of taxes in addition to the non-tax revenue.

2. Removal of Inequalities in Income and Wealth: The welfare state aims at the removal of inequalities in income and wealth. By framing suitable tax policy, this end can be achieved. It is stressed in the Canon of Equality. In Ethiopia, the progressive taxation on income is the suitable examples in this regard.

3. Ensuring Economic Stability: Taxation affects the general level of consumption and production. Hence, it can be used as an effective tool for achieving economic stability. That is, by means of taxation the effects of trade cycle i.e. inflation and deflation can be controlled. During the period of boom or inflation, the excess purchasing power in the hands of people leads to rise in the price level. Raising the existing tax rates or imposing additional taxes can remove such excess purchasing power. Then the abnormal demand will be reduced and the economic stability can be achieved. At the same time, by providing grants, tax exemptions and concessions, production can be encouraged thereby inflation is controlled.

Likewise, during the period of depression or deflation, the role of tax policy in the economy is important. Reduction in the existing tax rates and removal of certain taxes, consumption can be induced which in turn results in increasing demand. This encourages business activities, and the economic growth can be achieved.

Thus, through properly devised tax system, the economic stability can be achieved by controlling the effects of trade cycle.

4. Reduction in Regional Imbalances: It is normal that certain parts of the country are well developed, whereas some other parts or states are in backward conditions. To remove these regional imbalances,

the Government can use tax measures. By way of announcing various tax exemptions and concessions to that particular backward regions or states, the economic activities in those areas can be induced and accelerated.

5. Capital Accumulation: Tax concessions or rebates given for savings or investment in provident funds, life insurance, unit trusts, housing banks, post offices banks, investment in shares and debentures of certain companies etc. lead to large amount of capital accumulation which is essential for the promotion of industrial development.

6. Creation of Employment Opportunities: More employment opportunities can be created by giving tax concessions or exemptions to small entrepreneurs and to the industries adopting labour-intensive techniques. In this way, unemployment problem can be solved to certain extent.

7. Preventing Harmful Consumption: Taxation can be used to prevent harmful consumption. By way of imposing heavy excise duties on the commodities like liquors, cigars etc. the consumption of such articles is reduced to a considerable extent.

8. Beneficial Diversion of Resources: The imposition of heavy duties on nonessential and luxury goods discourages the producers of such goods. The resources utilized for the production of these goods may be diverted into the production of other essential goods for which various tax concessions are given. This is called as beneficial diversion.

9. Encouragement of Exports: Now-a-days export oriented industries are encouraged by way of providing various exemptions like 100% relief from income tax, free trade zones etc. It results in the large earnings of foreign exchange.

10. Enhancement of Standard of Living: By way of giving various tax concessions to certain essential goods, the Government enhances the standard of living of people

2. Specific Objectives: The basic purposes of levying taxes are as follows: 1. To support the operation of that government itself. 2. To influence the macro economic performance of the economy, the government's strategy for doing this is called its fiscal policy. 3. To carry out the functions of the government such as national defense and providing government services. 4. To redistribute resources between individuals or classes in the population. Historically the nobility were supported by taxes on the poor modern social security systems and intended to support the poor by taxes on the rich. 5. To modify patterns of consumption or employment within an economy by making some classes of transaction more or less attractive.

Activity 2.8

List & explain the general and specific objectives of Taxation.

2.9 Principles of Taxation/Theories of Taxation

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Pretest

Dear students, would please explin Principles of Taxation?

Principles (theories) of taxation are the appropriate criteria to be employed in the development and evaluation of one country. The development of principle of taxation is essential in the application of the theory of economic welfare. The principles of taxation are the basic foundation or the basic theory of taxation that are used to frame a tax policy in any country. It is the basic philosophy of taxation that government must follow to have good taxation system. We would all like taxation to be neutral, equitable and efficient. Thus, the three basic principles/theories of taxation are:

- ✓ Principle of economic neutrality/theory of neutral taxation
- ✓ Principle of equity/theory of equity and
- ✓ Principle of efficiency/theory of efficiency

1. Principle of Economic Neutrality

The taxation system of a country must be economic neutral. That is the tax structure must be established in such a way to avoid the interference with the optimum allocation and use of resources or it must assist the attainment of optimum. Taxation must not create economic distortion. The tax distortion is the change in quantity of an item consumed, supplied or produced because of a tax on the item. To be neutral, taxation should not create distortion in an economy. Taxation should not have unnatural effects. The unnatural effect (changing human behavior) of taxation includes:

- ✓ Affecting the Consumer Choice
- ✓ Affecting the supply of Factors of Production

a. Affecting the Consumer choice:

Assume that the economy is optimal. In this case, introducing tax on one commodity but not on the other commodity, result in the relative price of the two commodities to be changed. A price change has two impacts; a substitution effect and income effect. To avoid effects and to have neutral taxation, government should levy taxes n such a way as to maintain the price of one commodity to be relatively

neither more expensive nor cheaper than the other commodity after taxation. Taxation that exempts some commodities or taxes them at a significantly lower rate than others is not neutral.

b. Affecting the Supply of Factors of Productions:

In economic system, labor is supplied by a household. The taxes may alter the relative desirability of work and leisure as the tax rate structure increases. There will be a shift of labor supply to leisure because the relative desirability of leisure increases when tax rate increases. The government should not increase tax rate until the point it affects labor, capital and land supply to have neutral taxation.

2. Principle of Equity (Theory of Equitable Taxation)

Taxes are judged on the criteria of equity/fairness. This principle requires that distribution of tax burden among various persons to agree accepted standard of equity. The tax burden should be fair and equal. There are two approaches or perspective show a government could be fair. The government may use one of the following to be fair:

✚ *Benefit Received Approach*

✚ *Ability - to - Pay Approach*

i. Benefit Received Approach/Perspectives

Under this approach, equity means equal treatment of person who received equal benefits from the government activities. The benefit received approach holds that taxpayers should be taxed in proportion to the benefits they received from the government in the form of goods and services. The major objection to benefit received approach of principle of equity is mostly the benefits or the outputs accrue to community than to individuals and therefore, difficulty arises in measuring the benefit. Besides, it is contrary to the whole philosophy of government welfare activities.

ii. Ability - to - Pay Approach/Perspectives

This approach demands the distribution of tax burden to be on the basis of ability to pay. Ability to pay means economic well being or overall level of enjoyed by the taxpayers. Fairness demands equal sacrifice by both rich and poor in support of government. Based on the ability to pay approach, equity requires person having the same ability to pay should pay equal amount of taxes and person who have greater ability to pay should pay more taxes to the government. On the basis ability to pay approach, equity is classified is classified in to:

➤ *Horizontal Equity*

➤ *Vertical Equity*

✚ **Horizontal Equity:** – means persons in like (similar) circumstance should be treated equally. That is person having the same amount of income, property, wealth; etc should be taxed to the same extent. For example, two people earning Br. 1,000 income each should pay the same amount of tax.

✚ **Vertical Equity** – means persons in unlike (different) circumstances should get relative treatment. A rich individual must pay taxes than would a poor do so. There is no ground to levy the same amount of tax on the person earning Br. 1,000 and Br. 2,000. Vertical equity can be achieved through progressive taxation system.

3. Principle of Efficiency

According to this principle, a Taxation System a country should be economically and administratively efficient.

- a. **Economic Efficiency** - taxation system of a country should be economical. That is the cost of collecting taxes should be minimum possible to tax collecting agencies. The cost of taxation should also be minimum possible to taxpayers. Taxpayers may incur costs such as salary, record keeping costs and other compliance costs. Economic efficiency also depends up on administrative efficiency.
- b. **Administrative Efficiency** – taxation system of a country should have sufficient number and competent staffs. Overall taxation should have effective administration.

Activity 2.9

List & explain the Principles (theories) of taxation. Which of these Principles (theories) do you suggest for countries like Ethiopia & why?

2.10 Approaches to taxation

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Pretest

Dear students, would please explain Approaches to taxation?

The study of taxation involves different approaches. To understand and appreciate the existing policies of taxation, one should know about these approaches. Let us have a brief idea about various towards the study of taxation hereunder.

1. Cost of Service Approach:

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

Limitations of Cost of Service Approach

This approach has the following limitations: (1) this principle cannot be accepted as the basis of taxation because it is very difficult to estimate the cost of service to every individual. For example, the government can estimate total expenditure on the defense of the country. But it is difficult to estimate the expenditure incurred by the government on the defense of a particular individual. (2) Secondly, the basis of cost service principle is not fair in a welfare state. If cost is taken as the basis of taxation, the government may not perform various functions which may be very much desirable for the welfare of the country as a whole e.g., relief in times of drought, flood and earthquake, free education and free medical facilities etc. Hence, the cost of service principle cannot be accepted as the basis of taxation. (3) Lastly, the cost of government services to individuals are fixed arbitrarily, which may not be justified.

2. Expediency Approach:

Generally every government imposes tax to fulfill its normal social obligations in the form of defense, maintenance of law and order and socio-economic growth, but in actual practice, the tax policy is determined by the pressures which are exerted on the government by different pressure groups in society. In practice, every legislature and every authority is pressurized by various

economic, social and political groups to orient its taxation policy in certain directions. Every group would try to resist a change that goes against its interests. The authorities, in many cases, have to adopt certain policies simply because there are pressures to that effect. The authorities have many times; reshape the tax structure depending upon the changing political strength of different economic groups. It is also clear that while choosing and imposing a tax, the authorities would be making a great blunder if they lose sight of the administrative feasibility, the cost of collection, and so on. Therefore when the government bends before the pressures of various pressure groups and formulates its tax policy accordingly, we call it the expediency approach.

Limitations of Expediency Approach:

This approach is criticized on the ground that to build up an entire tax system solely on the considerations of expediency must be full of pitfalls. In certain cases, such a tax policy may be able to yield certain good results like contributing to the equality of income distribution, or reducing regional disparities but such results would be purely accidental and not the fruits of any thoughtful efforts or plan. A taxation system has a role to play in helping the economy. It should be based on equity and should contribute towards augmenting welfare in general. But when the tax system ignores certain factors like economic growth, equity, economic stability etc., it is not likely to be helpful to the economy and would increase inequalities and socioeconomic injustice.

3. Socio-Political Approach: In contrast to the expediency approach, Adolph Wagner advocated an approach in which social and political objectives are the deciding factors for the distribution of tax burden. Wagner, like most Germans of those days, did not believe in individualist approach to a problem. He wanted that each economic problem should be looked in its social and political context. Accordingly, a tax system should not be designed to serve the needs of the individual members of the society. But it should be designed for the welfare of the society as a whole. He was in favor of using taxation for reduction in income inequalities and he advocated that all small incomes should be exempted from taxation. In other words, the tax structure should aim at achieving social objectives. He advocated that the government should follow the policy of progressive taxation. Wagner's ideas, though much criticized at that time, are now the hall-mark of modern states' fiscal policies. Taxation in a modern state is generally designed to curb inequalities. Progressive Taxation is the rule rather than the exception.

Adolph Wagner also advocated that the government should formulate a tax policy to achieve political objectives in the form of protecting the fundamental rights of the people. He advocated that the

government should provide protection to the life and property of the people by way of incurring expenditure on defense and maintenance of law and order. In the modern context, we may accept Wagner's stand by including other economic and social objectives of the society in which taxation could be a helpful tool. Taxation could curb cyclical fluctuations, unemployment, production of undesirable goods and services, monopolistic and restrictive trade practices and hoarding etc. Through taxation, government could also bring balanced growth between different regions. That way, the socio-political approach is far more meritorious than the expediency approach.

Both the expediency Approach and socio-political Approach have their merits, but they cannot be advocated as the basic policies in a tax system. Equity should be the main criterion of every tax system, without it, not only the tax system loses its fairness; it also becomes a source of social, economic and political unrest as well.

Limitations of Socio-Political Approach

Socio-Political Approach, though having the merit of equity, suffers from the following limitations:

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

4. Benefit Principle Approach:

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

According to this approach, the burden of taxation should be divided among the people in proportion to the benefits received from the state. The persons receiving equal benefits from the state should pay equal amount as taxes and those who receive greater benefits should pay more as taxes than those getting less benefits. The benefit theory, therefore, demands that on the ground of equity, the people should be taxed according to the benefits (Protection, hospitals, education, roads, irrigation etc.) they receive from the government and that the division or apportionment of taxes be in proportion to the

benefits received by each individual or group of individuals. Larger the benefits received, larger should be the amount of tax on the beneficiary concerned.

The benefit approach is, in fact, a combination of two Principles: (1) The cost of service principles, and (2) The value of service principle.

According to cost of service principles, the taxes should be divided in Proportion to the cost of services rendered by the state. As per value of service principle, every individual should contribute in proportion to the value of the services he has received from the government.

In fact, both the principles come to the same conclusion that the cost of services rendered by the government should be recovered from individuals in proportion to the benefits received by each of them.

Limitations of Benefit Principle Approach:

This benefit principle approach has the following limitations: (1) It is very difficult to estimate the benefit that an individual receives from the expenditure of the government, e.g., how much benefit an individual receives from the army, police and educational institutions cannot be exactly estimated. And therefore, the burden of taxation may not be equitable. Hence, this theory may be rejected. (2) If the basis of taxation is benefit, then the poor will have to pay higher taxes than rich because the poor derives greater benefits than rich from the expenditure of the government, e.g., the poor may be more benefited by the provision of free medical service and free education. And, therefore, on this ground also, this theory cannot be accepted as the basis of taxation. (3) Rich people have more capacity to pay taxes than poor; but according to this principle the per capita tax burden upon the rich and the poor is the same. This means regressive taxation. It is; therefore, clear that the benefit principle cannot ensure just distribution of burden of taxation among different sections of society. (4) The principle is also not conducive to general welfare which requires redistribution of income in favour of the poorer sections through public welfare programmes and services for their benefit. (5) A general objection to the whole approach is that this principle is not based on the concept of equity in' taxation. Taxes are not progressive in nature.

5. Ability to Pay Approach:

Ability to pay is interpreted as the money income of the tax payer. It is the most generally accepted theory. According to this theory each person should contribute to the income of the state in proportion to his ability to pay. Ability is the "ideal ethical basis of taxation. Every tax-payer should feel that he has made equal sacrifice in the payment of tax. The concept of ability to pay depends upon the bold

concept of equity in taxation. Equity implies just tax payment. When the tax payer is required to pay tax according to his ability to pay, it may be called equity in tax payment. As Dalton puts it, "the burden of taxation' should be so distributed that the direct real burden on all tax-payers is equal." According to Seligman, "the basic point of the ability to pay principle is that the burden of society should be shared amongst the members of the society so as to conform to the principle of justice and equity."

The ability to pay principle accepts the idea that tax is a compulsory payment to the government without any direct benefit. This approach considers revenue and public expenditure as two distinct entities. Public expenditures are for the "common good" and cannot be individually evaluated. The ability to pay principle points out that this collective expenditure should be distributed on the basis of "ability to pay" of the people and not on the basis of any benefits received.

According to this approach, a citizen has to pay taxes because he can, and his relative share in the total tax burden is to be determined by his relative paying capacity.

J .S Mill sharply rejected the benefit approach, based on the concept of protection of life and property. He concluded that application of benefit rule would lead to regressive taxation, as poor are more in need of protection. A quite different principle of taxation is thus needed. This new principle i.e. the principle of ability to pay is based on the dictum that all should be treated equally under law. Equality in taxation means equality in sacrifice which may be stated as the concept of equal sacrifice.

Justification to Ability Theory:

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

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

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

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

Index of Ability to Pay

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

The two approaches to measure the ability to pay are:

(1) Objective Approach

In view of the practical difficulties of sacrifice theories or subjective approach, some writers, especially American have presented an objective approach to measure the ability to pay. Prof. Seligman has used the 'faculty' to indicate ability in the objective sense. Thus, it is also known as faculty theory of ability to pay. The indices of ability to pay are as follows: (i) Property: Property or Accumulated wealth was considered as the index of ability to pay. It was considered that property in the form of land, buildings, gold, golden ornaments, etc., was a measure of a man's financial ability. Property gives security and insurance against risks. A person with property has a better ability to pay a tax than a person having no or very little property. Thus it was argued that taxation should be imposed on the basis of the extent of property possessed by the people. A person having larger wealth or property should be made to contribute more. Though property is an important source of income, yet, it cannot be considered as the primary test of ability because of the following reasons. "Firstly, property is an important source of income, but all property do not yield income." Secondly, the income from property is not continuous. Thirdly, income from property may vary on account of its nature, location, use etc., a house in a village may not yield anything, but it may be a good source of income in a town. Fourthly, property is taxed on its capital value, but if it does not yield income, the taxation may be unjust. Hence, it can be said that property may not be regarded as a primary test of ability to pay. (ii) Income: Income is one of the most accepted indices of ability to pay. Under this index, persons with higher incomes share a larger money burden of tax and lower incomes are taxed at lower rates. People with equal incomes are taxed at equal rates. According to Adam Smith, "The subject of every state ought to contribute towards the support of the government in proportion to their respective abilities." Only net income should be taxed. Gross income cannot be treated as an index of ability to pay. Secondly, it is necessary to classify income into - (i) earned income and (ii) unearned income. Income earned from work is treated as earned income and that from capital gains from sale

of shares, security and buildings etc., interest on savings and rent from immovable property, windfall, gains from gambling, races, lottery, etc. is treated as unearned income. It is argued that unearned income should be taxed heavily as compared with earned income, because unearned income discourages willingness to work. (iii) Size of the Family: While determining the tax paying ability of a person, the size of the family-should also be taken into account. A larger size of the family with a given income may have smaller tax paying ability than of a smaller size family, e.g., a bachelor possesses the higher tax paying ability than a married couple having four children while other things being the same. Though, the size of the family can be taken into account while determining the tax ability of an individual, but it cannot be taken as the primary measure of the tax paying ability. (iv). Consumption: Another objective index of ability to pay is the consumption expenditure of the members of the society. Sometimes, it is noticed that taxation on the basis of property and income is not equitable and can be manipulated to evade by the taxpayers in many ways. Hence Prof. Fisher and Prof. Nicholas Kaldor advocated taxation on expenditures. Firstly, consumption implies withdrawal of resources from the economy. A man's capacity to pay taxes, therefore, depends upon to what extent he withdraws resources to satisfy his consumption needs.

Secondly, a person spending large amounts to meet consumption (luxuries) has a greater ability to bear the burden of taxation. It is therefore, argued that persons with a higher consumption expenditure should contribute a larger share of total tax amount.

Thirdly, there has been a large scale evasion of taxes on income because of the concealment of income by the taxpayers. Since consumption of items especially consumption of items of luxury cannot be concealed, it is stressed that the consumption expenditure should be used as an index of ability to pay taxes.

Fourthly, it is difficult to locate the different sources of income of an individual. Therefore, his ability to pay cannot exactly be measured since the expenditure on consumption can be located without much difficulty, it would truly represent a man's capacity to spend and hence his ability to pay taxes. In spite of the fact that expenditure on consumption can be located to determine a person's ability to pay, yet it suffers from various limitations:

- (1) If the consumption expenditure of a person is taken as an index of his ability to pay then those who save and invest will escape the tax burden. This is against the canon of equity.
- (2) Lack of records of the consumption expenditure also creates a major difficulty in locating a person's consumption expenditure for taxation purposes.

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

At the end we may conclude by saying that the consumption expenditure like property cannot be a satisfactory index of ability to pay. It is only the income which is by far the most important determinant of a person's ability to pay. Income taxation is the most important source of revenue to the governments of developed countries. Property taxation is used as an additional source. Ethiopia depends largely on commodity taxation.

(2) Subjective Approach:

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

According to J.S.Mill, "The just distribution of tax share prevails when all individuals incur equal sacrifice while contributing to the common good. Here equal sacrifice refers to the sacrifice in terms of utility of income sacrificed by individuals in contributing to the common good.

Conan Stuart and Edge worth have advanced three concepts of equal sacrifice, viz.: (1) Equal Absolute Sacrifice (2) Equal Proportional Sacrifice (3) Equal Marginal Sacrifice.

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

(2) Equal Proportional Sacrifice: According to this concept also, no one is exempt from sharing the tax burden. In other words, each tax payer should sacrifice the same proportion of total utility or satisfaction derived from his total income. When the tax burden is distributed among the tax-payers in proportion to their money income, we call it equal proportional sacrifice. In this case, the sacrifice of the poorer section of society is quite higher because marginal utility of money is quite higher to them as compared to the richer section of the society. Thus, according to the principle of proportional

sacrifice, the direct real burden on every taxpayer would be proportionate to the economic welfare which he derives from the income. Hence, this concept cannot be considered as a system of just tax payment by the government.

(3) Equal Marginal Sacrifice: Edge worth and later Pigou concluded that least aggregate sacrifice' is the superior principle of tax distribution, not because it is equitable, but because it is derived directly from the basic utilitarian principle of maximum happiness. According to this concept, the tax burden is so distributed among different categories of tax-payers that the marginal sacrifice of all the tax-payers is equal. In other words, according to this concept, everyone whether rich or poor should feel the same pinch by paying the last Birr as tax. This implies that the tax payers should pay tax according to their money income, i.e. the rich should pay the tax at a much higher rate than poor.

According to Edge worth, marginal sacrifice and not the total sacrifice of the different tax-payers should be the same so that aggregate sacrifice for the community as a whole is the least. In other words, the welfare to all would be maximum.

According to Pigou, "Thus the distribution of taxation required to conform to the principle of least aggregate sacrifice is that which makes the marginal not the total sacrifice borne by all the members of the community equal." The object of the state is to maximize the economic welfare. Hence, taxes should be distributed in accordance with the Principle of least aggregate sacrifice, i.e., the marginal sacrifice imposed by way of taxation on each tax-payer is equal. In this approach the emphasis is on the welfare of the community. Musgrave and others consider it as the "ultimate principle of taxation." Thus this approach leads to progressive taxation.

Activity 2.10

List & explain the d/t approaches of taxation. Which of these approaches do you suggest for countries like Ethiopia & why?_____.

2.11 Canons of Taxation

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Pretest

Dear students, would please describe Canons of Taxation

The Government requires funds for the performance of its various functions. These funds are raised through tax and non-tax sources of revenue. Imposing tax on income, property and commodities etc.

raises tax revenues. In fact, tax is the major source of revenue to the Government. According to Adam Smith, "a tax is a contribution from citizens for the support of the Government".

No one likes taxes, but they are a necessary evil in any civilized society. Whether we believe in big government or small government, governments must have some resources in order to perform their essential services. So how does one go about evaluating a particular tax?

Taxation is an important instrument for the development of economy of the country. A good tax system ensures maximum social advantage without any hardship on taxpayers. While framing the tax policy, the government should consider not only its financial needs but also taxable capacity of the community. Besides the above, government has to consider some other principles like equality, simplicity, convenience etc. These principles are called as "Canons of Taxation". The following are the important canons of taxation.

I. Canons Advocated by Adam Smith;

1. Canon of Equality. 2. Canon of Certainty. 3. Canon of Convenience. 4. Canon of Economy.

II. Canons Advocated by Others:

5. Canon of Productivity. 6. Canon of Elasticity. 7. Canon of Diversity. 8. Canon of Simplicity. 9. Canon of Expediency. 10. Canon of Co-ordination. 11. Canon of Neutrality.

We shall now discuss them briefly.

I. Canons Advocated by Adam Smith:

No one has yet come up with a better set of criteria for judging a tax than the Canons of Taxation first proposed by Adam Smith more than two hundred years ago. Adam Smith in his book, "Wealth of Nations" has explained the four canons of taxation that are mentioned above. All accepts them as good taxation policy. We shall now explain them briefly.

1. Canon of Equality: According to this principle of Adam Smith, "the subjects of every state ought to contribute toward the support of the Government, as nearly as possible, in proportion to their abilities". That is, a good tax system should be based on the ability to pay of the people. That is, all people should bear the public expenditure in proportion to their respective abilities. Tax burden should be more on the rich than on the poor. Since the rich people can pay more for public welfare, more tax should be collected from richer section and less tax from the poor. The ability to pay may be determined either on the basis of income and wealth or on the basis of consumption i.e. luxury or necessity. In simple terms, canon of equality implies that when ability to pay is taken into

consideration, a good tax should distribute the burden of supporting government more or less equally among all those who benefit from government.

2. Canon of Certainty: Another important canon of taxation advocated by Adam Smith is certainty. According to him, "the tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, should be clear and plain to the contributor and every other person". It means the time, amount and method of payment should all be clear and certain so that the taxpayer can adjust his income and expenditures accordingly. This principle removes all uncertainties in the payment of tax and ensures smooth functioning of the tax department.

3. Canon of Convenience: In the canon of convenience, Adam Smith states that, "every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it". That is, the tax should be levied and collected in such a way that is convenient to taxpayer. For example, it may be in installments, land revenue may be collected at the time of harvest etc. This principle reduces the tendency of tax evasion considerably.

It includes the selection of suitable objects for taxation, and also the choice of convenient periods for requiring payment. The canon of convenience is a special form of the general principle that the public power should as far as possible adjust its proceedings to the habits of the community, and avoid any efforts at directing the conduct of the citizens in order to facilitate its own operations. The sacrifices that inconvenient methods of fiscal administration impose may indeed be treated as violations of both economy and equity.

4. Canon of Economy: The next important canon of taxation is economy. According to Adam Smith, "every tax ought to be so contrived as both to take out and keep out of the pockets of the people as the little as possible over and above what it brings into the public treasury of the state". This principle states that the minimum possible amount should be spent on tax collection and the maximum part of the collection should be brought to the Government treasury.

Taxation should be economical i.e. this should be much more than mere saving in the cost of collection. Undue outlay on the official machinery of levy is but one part of the loss that taxation may inflict. It is a far greater evil to hinder the normal growth of industry and commerce, and therefore to check the growth of the fund from which future taxation is to come. Thus the canon of 'Economy' is naturally sub-divided into two parts viz.1. 'Taxation should be inexpensive in collection', and 2. 'Taxation should retard as little as possible the growth of wealth'. It may also be remarked that there

is a close connection between "Economy" and "Productivity", since the former aids in securing the latter.

II. Canons Advocated by Others:

Other researchers of taxation at other times have added to Adam Smith's criteria. Some have noted that a tax should be adequate, meaning it should produce sufficient revenue to support whatever it is that citizens want their government to do. Some have argued for a "Benefit Principle" whereby the amount of tax each is called upon to pay bears some relationship to the benefits each taxpayer receives from government. Others have argued that a tax should be neutral in its effect on the way markets work. But Smith's Canons are the starting point for any serious evaluation of a tax. The various canons added by others are explained below:

5. Canon of Productivity: According to C.F. Bastable, the tax system should be productive enough i.e. it should ensure sufficient revenue to the Government and it should encourage productive activity by encouraging the people to work, save and invest.

6. Canon of Elasticity: The next principle advocated by Bastable is elasticity. The taxes should be flexible. It should be levied in such a way to increase or decrease the tax revenue depending upon the need. For example, during certain unforeseen situations like floods, war, famine, and drought etc. the Government needs more amount of revenue. If the tax system is elastic in nature, then the Government can raise adequate funds without any extra cost of collection.

The tax system should be elastic is a desirable canon of taxation. It may, indeed, be regarded as the agency for realizing at once "Productivity" and "Economy". Where the public revenue does not admit of easy expansion or reduction according to the growth or decline of expenditure, there are sure to be financial troubles. For this purpose some important taxes will have to be levied at varying rates. The particular taxes chosen will vary according to circumstances, but the general principle of flexibility should be recognized and adopted.

7. Canon of Diversity: According to this principle, there should be diversity in the tax system of the country. The burden of the tax should be distributed widely on the entire people of the country. The burden of the tax should be decentralized so that everyone should pay according to his ability. To achieve this, the Government should impose both direct and indirect taxes of various types. It should not depend upon one or two types of taxes alone.

8. Canon of Simplicity: This principle states that the tax system should be simple, easy and understandable to the common man. If the tax system is complex and vague, the taxpayer cannot estimate his tax liability and it will cause irregularities in the payments and leads to corruption.

9. Canon of Expediency: According to this principle, a tax should be levied after considering all favorable and unfavorable factors from different angles such as economical, political and social.

10. Canon of Co-ordination: In a federal set up like Ethiopia, Federal and State Governments levy taxes. So, there should be a proper co-ordination between different taxes imposed by various authorities. Otherwise, it will affect the people adversely.

11. Canon of Neutrality: This principle stresses that the tax system should not have any adverse effect. That is, it shouldn't create any deflationary or inflationary effects in the economy.

Applying Smith's Canons to any particular tax is largely a subjective undertaking. Yet, if one attempts to evaluate the principal taxes – that is, property tax, income tax, and sales tax – against Smith's Canons, one will quickly find that there is no such thing as a perfect tax. The property tax, for instance, scores fairly low on convenience and efficiency, but fairly high on certainty. The income tax scores fairly high on equality, but is costly to administer and is so complicated that it leaves much to be desired on certainty. A sales tax scores high on convenience, certainty, and efficiency, but poorly on equality. Because there is no perfect tax, an argument can be made that the best tax system is one that uses all three major types of taxes in small doses. By combining all three major types, it is possible to offset the weaknesses of each with the strengths of the others. In the final analysis, however, the standard for judging a tax is often political. In a democracy, when revenue must be raised, the tax selected is often based upon plucking the goose that squawks the least. Some have called this political test the other canon.

These are the general canons that experience seems to prescribe, and which should be observed in a well-ordered State. Besides, their simplicity has not saved them from frequent violation. Their value lies in their assertion of truths plain and intelligible to common understandings but for that very reason too often passed over. A system of taxation, which conforms to them, may without hesitation be pronounced a good one.

Where they are neglected and broken through, the evil consequences will be almost certainly conspicuous.

A further point deserves notice. There is at first sight a probability of conflict between the several canons. A productive tax may be inconvenient, as a convenient one may be unjust, and how, it may

be asked, is a solution of the difficulty to be reached? The plain answer is, by the surrender of the less important canon. The successful administration of the State is the final object, and therefore convenience, or even equity, may have to yield to productiveness. But though opposition is possible, agreement is on the whole the ordinary case. We have seen that economy increases productiveness, but so do certainty and convenience. Elasticity aids both productiveness and economy, while growing productiveness in turn permits better observance of all the other canons. There is thus a harmony in a properly administered financial system that tends to promote its improvement in the future.

In a democratic country, the political factors are also influencing the tax policy of government. While deciding an appropriate taxable system, the government has to follow the above-mentioned canons of taxation.

Activity 2.11

List & explain the d/t canons of taxation.

2.12 Classification of Taxes

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Pretest

Dear students, how do you classify taxes?

1. Classification Based on the Tax Bases

- A.** Income Taxes: are taxes levied on income of persons or businesses
- B.** Property Taxes: are levied on a property of Persons or businesses
- C.** Commodity Taxes: are taxes levied on commodities and services

2. Classification Based on ultimate burden of taxes (Based on Tax Impact, Tax Shifting and Tax Incidence)

- *Tax Impact* refers to the person who bears the money burden of tax in the first instance
- *Tax Incidence* refers to the person who ultimately bears the money burden of a tax
- *Tax Shifting* refers to the process by which the money burden of a tax is transferred from one person to another person.

Based on ultimate burden; taxes are classified into two: Direct Taxes and Indirect Taxes described as follows:

A. Direct Taxes: are taxes the impact and incidence of which fall on the same person. Direct taxes are taxes which cannot be shifted on to the others.

E.g. Employment income tax

B. Indirect Taxes: these are taxes the impact and incidence of which fall on different persons. The impact fall on one person and the incidence fall on another person. E.g. VAT

Dear learners, the details of Direct Taxes and Indirect Taxes will be discussed in the next section.

3. Classification Based on Tax Determinant

A. Ad-valorem Taxes: taxes are determined based on the value of the item to be taxed.

B. Specific Tax: are the taxes levied at a fixed amount, irrespective of the value of the goods and services

4. Classification Based on Number of Taxes

A. Single Tax: using only one tax in the country. It is a tax on one thing

B. Multiple Taxes: using many kinds of taxes in the country. The government of modern state uses diversified taxes to use advantage of it

5. Classification based on Taxing Authority

Taxes are classified into three based on taxing authority or taxing hierarchy: Federal Taxes, State Taxes, and Local Taxes

A. Federal Taxes: are taxes collected by Federal government tax agency

B. State Taxes: are taxes collected by Regional State governments

C. Local Taxes: are taxes collected by local tax authorities

Activity 2.10

Classify taxes based on d/t factors and explain each.

2.13 Direct and Indirect Taxes

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Pretest

Dear students, distinguish b/n Direct and Indirect Taxes?

Taxes are sometimes referred to as direct or indirect. The meaning of these terms can vary in different contexts, which can sometimes lead to confusion. In economics, direct taxes refer to those taxes that are paid by the person who earns the income. By contrast, the cost of indirect taxes is borne by someone other than the person responsible for paying them. For example, taxes on goods are often included in the price of the items, so even though the seller sends the payments to the government, the buyer is the real payer. Indirect taxes are sometimes described as hidden taxes because the purchaser of goods or services may not be aware that a proportion of the price is going to the government.

1. Direct Taxes

A direct tax is paid by a person on whom it is levied. In direct taxes, the impact and incidence fall on the same person. If the impact and incident of a tax fall on the same person, it is called as direct tax. It is borne by the person on whom it is levied and cannot be passed on to others. For example, when a person is assessed to income tax or wealth tax, he has to pay it and he cannot shift the tax burden to anybody else. In Ethiopia, Government levies the direct taxes such as income tax, tax on agricultural income, professional tax, land revenues, taxes on stamps and registrations etc. From the above discussion, it can be understood that the direct taxes levied in Ethiopia take the form of taxes on income and property.

Merits of Direct Taxes

Direct taxes have the following merits:

1. Ensures the Principle of Ability to Pay: Direct taxes are based on the principle of ability to pay. They fall more heavily on the rich than on the poor. The tax burden is distributed on different sections of the society in a just and equitable manner.
2. Reduces the Social and Economical Inequalities: Direct taxes reduce a disparity in the distribution of income and wealth. By adopting the progressive tax system, rich people pay on higher rates of adopting the progressive tax system, rich people pay on higher rates of taxation, while the poor pay on lower rates or given exemptions. This reduces the gap between the poor and rich to a considerable extent.
3. Certainty: Direct taxes satisfy the canon of certainty. In direct taxes, the time of payment, mode of payment, the amount to be paid etc. are made clear. Both the taxpayers and the Government know the amounts to be paid and the Government can estimate the revenue from these taxes.
4. Economy: The cost of collection of these taxes is low because the government adopts the different methods of collections like tax deduction at source, advance payment of tax etc. Besides, the taxpayers pay the amount of tax directly to government. Thus, the principle of economy is achieved in the case of direct taxes.
5. Elasticity: Direct taxes are elastic in nature. For example, when the income of the people increases, the tax revenue also increases. Moreover, during the unforeseen situation like flood, war etc. the government can raise its revenue by increasing the tax rates without affecting the poor.

6. **Educative Effect:** Direct taxes create civic consciousness among taxpayers. Since the taxpayers feel the burden of tax directly, they are interested in seeing that the Government properly spends the money. They are conscious of their rights and responsibilities as a citizen of the State.

7. **Control the Effects of Trade Cycles:** Direct taxes control the effects of trade cycles. They can be used as a tool to mitigate the effects of inflationary and deflationary trends by raising or reducing the tax rates.

Limitations of Direct Taxes

The following are the demerits of direct taxes:

1. **Arbitrary in Nature:** Direct taxes tend to be arbitrary because of the difficulty in measuring the ability to pay tax. Paying capacity of the people cannot be measured precisely. The levy is highly influenced by the policies of the Government.

2. **Difficulties in the Formulation of Progressive Tax Rates:** Direct taxes take the form of progressive taxation i.e. the tax rates increase with the rise in income. It is very difficult to formulate the ideal progressive rate schedules in this regard, since there is no scientific base.

3. **Inconvenience:** Under direct taxes, the taxpayer has to adhere to many legal formalities such as submission of the income returns, disclosing the sources of income etc. Moreover, he has to follow numerous accounting procedures which are difficult to comply with. Further, direct taxes have to be paid in lump sum and at times, advance payment of tax has to be made. This causes much inconvenience to the taxpayers.

4. **Possibility of Tax Evasion:** The high rates of direct taxes create the tendency to evade more. There is possibility for tax evasion by fraudulent activities. Thus, it is said that the direct taxes are the taxes on honesty.

5. **Limited Scope:** The scope of the direct tax is very limited. In Ethiopia, most of the people come under or below the middle-income category. If only direct tax is followed, these people cannot be brought into the tax net because of the basic exemption given. Thus, the Government cannot depend upon direct tax alone.

6. **Disincentive to Work, Save, and Invest:** When the taxpayer earns certain level, they have to pay more, because of the higher rate of taxes attributed to the higher slabs. This will in turn discourage them to work further, save and invest.

7. Expensive to Collect: Under direct taxes, each and every taxpayer is separately assessed. Thus, the large number of taxpayers to be contacted and assessed and the prevention of tax evasion make the cost of collection more expensive.

2. Indirect Taxes

Under indirect taxes, the impact and incidence fall on different persons. It is not borne by the person on whom it is levied and can be passed on to others. For example, when the excise duty is levied on the manufacturer of cement, he shifts the burden of tax to the consumers by raising the selling price. Here the impact of excise duty falls on the manufacturer and the incidence on the ultimate consumers. The person who is required to pay the tax does not bear its burden. Thus, indirect taxes can be shifted.

Merits of Indirect Taxes

Indirect taxes have the following merits:

1. Convenience: Indirect taxes are more convenient to the taxpayers. Since the tax is included in the selling price of the commodities, the consumer pays the tax when he purchases them. He pays the tax in small amounts (installments) and does not feel its burden. Thus, indirect taxes are quite convenient and less burdensome.
2. Wide Scope: While the people with income and wealth above a certain limit, are brought under the levy of direct taxes, indirect taxes are paid by all both poor and rich. Under indirect taxes, everybody pays according to their ability. The tax burden is not imposed on to the small section but it is widely spread. Thus, the indirect tax has wider scope.
3. Elastic: The revenue from the indirect taxes can be increased. Whenever the Government wants to raise its revenue, or lower it, it can be achieved by increasing and decreasing the rates of taxes on the commodities whose demand is inelastic.
4. Tax Evasion is Not Possible: Indirect taxes are included in the selling price of the commodities. So, evading of such tax becomes very difficult. If the person wants to evade the tax, it can be done only by refraining the consumption of the particular commodity.
5. Substantial Revenue: Indirect taxes yield substantial revenue to both Central and State Governments. The developing countries like Ethiopia are heavily dependent on indirect taxes. Direct taxes have a limited scope in these countries because of low per capita income.
6. Progressive: Indirect taxes can be made progressive by imposing lower rates of taxes or giving exemption to the necessary articles and heavy taxes on luxurious articles. Thus, indirect taxes also confirm the principle of equity.

7. **Effective Allocation of Resources:** Indirect taxes have great influence in the allocation of resources among different sectors of the economy. Resources allocation can be made effective by imposing heavy excise duties on low priority goods and by granting relief to industries producing high priority goods. This results into mobilization of resources from one sector to another positively.

8. **Discourages the Consumption of Articles Injurious to Health:** Indirect taxes discourage the consumption of certain commodities, which are harmful to health. By imposing very high rates of taxes on commodities like liquors, drugs, cigarettes etc., which are harmful to health, their consumption can be reduced.

Limitations of Indirect Taxes

The following are the demerits of indirect taxes:

1. **Ability to Pay Principle is violated:** Indirect taxes are not directly connected to the taxpayers' ability to pay. Therefore, both the rich and poor equally pay the tax. Thus, the principle of ability to pay is violated. Indirect taxes are regressive in nature.

2. **Uncertainty:** If indirect taxes are not levied on the commodities of common consumption and levied only on luxurious articles, they tend to be inelastic. The quantity demanded will be affected by the imposition of the taxes. Thus, the revenue generated from them is uncertain.

3. **Discourages Saving:** Indirect taxes are included in the selling price of the commodities. Hence, the people have to spend more on the purchase of the goods. This, in turn affects the savings of the people.

4. **High Cost of Collection:** Indirect taxes are uneconomical as they involve high cost of collection.

5. **Civic Consciousness is Not Created:** Under indirect taxes, taxpayers don't feel the burden of the tax. They are not aware of their contribution to the State. Thus, indirect taxes do not create the civic consciousness in the minds of the people.

6. **Inflationary:** The indirect taxes cause an increase in the price all around. The increase in the prices of raw materials, finished goods and other factors of production creates inflationary trends in the economy.

Differences between Direct and Indirect Taxes:

Direct and Indirect taxes differ among themselves on the following grounds:

1. **Shiftability of the Burden of Tax:** In the direct taxes, the impact and incidence fall on the same person. It is borne by the person on whom it is levied and is not passed on to others. For example,

when a person is assessed to income tax, he cannot shift the tax burden to anybody else, and he himself has to bear it.

On the other hand, in the case of indirect taxes, the impact and incidence fall on different persons. It is not borne by the person on whom it is levied. The burden of the tax can be shifted. For example, when the manufacturer of cement pays excise duty, he can shift the tax burden to the buyers by including the tax in the price of the cement.

2. Principle of Ability to Pay: Direct taxes conform to the principle of ability to pay. But, indirect taxes are also borne and paid by the weaker sections of the society. As such, these taxes do not conform to the principle of ability to pay.

3. Measurement of Taxable Capacity: In the case of direct taxes, tax-paying capacity is directly measured. For example, the taxable capacity for income tax is measured on basis of the income of the individual.

On the other hand, in the case of indirect taxes, taxable capacity is measured indirectly. The luxurious articles are levied at the higher rate of taxes on the assumption that they are purchased by the rich people. However, low rate is charged on the articles of common consumption.

4. Principle of Certainty: Direct taxes ensure the principle of certainty. Both the Government and the taxpayer know what amount is to be paid and the procedures to be followed. But in the case of indirect taxes, it is not possible. The taxpayer does not know the amount of tax to be paid and the Government cannot predict the quantum of revenue generated from the indirect taxes.

5. Convenience: Direct taxes cause much inconvenience to the taxpayers since they are to be paid in lump sum.

But the indirect taxes are paid by the consumers in small amounts as and when they purchase the commodities. Moreover, the taxpayers need not follow any legal formalities in the payment of tax. Thus, indirect taxes are more convenient to them.

6. Civic Consciousness: People felt the burden of direct taxes directly. The taxpayer is conscious of his contribution to the Government and interested in knowing whether the tax paid by him is properly used or not. In this way, it creates civic consciousness among the taxpayers.

But indirect taxes do not raise such consciousness among the taxpayers, because they pay the taxes indirectly.

7. Nature of Taxation: Direct taxes are progressive in nature. The rates of taxes go up with the increase in the tax base i.e. income of a tax payer.

But rich and poor irrespective of their income equally pay indirect taxes. Thus, they are regressive in nature.

8. Removal of Disparity in Income and Wealth: Since the direct taxes are progressive in nature, they reduce the disparities of income and wealth among the people to a considerable extent.

But indirect taxes have a negative effect. Actually they are widening the gap between the rich and poor when they are levied on the goods of common consumption.

9. Examples: The examples for direct taxes are income tax, wealth tax, gift tax, estate duty etc.

The examples for indirect taxes are customs duty, excise duty, sales tax, service tax etc.



Activity 2.13

Distinguish b/n direct & indirect taxes and explain the merits and demerits of each.

2.14 Tax Rates and Taxation System (Tax Rate Structures)

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Pretest

Dear students, what do you mean the terms Tax Rates and Taxation System?

Tax Rates

Tax system of a given country is expressed in terms of its tax rate. Tax rates can easily describe the policy of a country regarding taxes. Taxes are levied most often as percentage, called tax rate of certain value or tax base. An important distinction when talking about tax rate is to distinguish between marginal tax rate and the average tax rate.

There are four different types of tax rates:

✓ Statutory Rate

✓ Average tax rate

✓ Marginal tax rate,

✓ Effective tax rate

❖ **Statutory Rate:** The Statutory rates are the rates imposed by the statute or Laws or Proclamations

❖ **Marginal Tax Rate (MTR):** is the tax rate that applies to the taxpayer's last birr of taxable Income. It is the ratio of change in tax to taxable income. Marginal tax rate is the highest in comparison to average and effective tax rate for the same taxable income.

❖ **Average Tax Rate (ATR):** is the ratio of the amount of taxes paid to taxable income. That is the total tax paid divided by the total amount of taxable income.

- ❖ **Effective Tax Rate (ETR):** is the ratio of the amount of taxes paid to the total income. For economists income means any income received from different sources –not taxable income. The effective tax rate shows the effect of tax on the total income of the person.

Taxation systems (Tax rate structures)

Tax rate structure expresses the relationship between the tax rate and tax base in a country. The ability to pay taxes can be accurately measured with net income. It may consider as an appropriate basis for the allocation of tax burden between different sections of the society. To determine the appropriate tax system, various factors are to be considered. Currently nations are using four different types of tax systems:

- ✓ Proportional tax system
- ✓ Regressive tax system
- ✓ Progressive tax system
- ✓ Degressive tax system

Let us explain these systems one by one in detail.

1. Proportional Tax System

A proportional tax, also called a flat tax is a system that taxes all entities in a class typically either citizens or corporations at the same rate (as a proportion on income), as opposed to a graduated or progressive scheme. The term “Flat Tax” is one where the tax amount is fixed as a function of income and is a term mainly used in the context of income taxes.

Advocates say that a flat tax system may arguably have most of the benefits of a progressive tax, depending on whether the flat rate is combined with a significant threshold. Usually the flat tax is proposed to kick in at a certain income level, or to exempt income below that level, so that the lowest-income members of society pay no income tax. Technically, this is a two stage progressive tax rather than a flat tax.

Advocates of a flat tax claim that it will end unfair discrimination. They also argue that flat taxes are easier (and cheaper) to administer and comply with than complex, graduated taxes. Most political parties that advocate the introduction of a flat tax are on the right of the political spectrum.

Those who oppose a flat tax claim that it will benefit the rich at the expense of the poor. One argument is that, since most other taxes (sales taxes etc.) tend to be regressive in practice, making the income tax flat will actually make the overall tax structure regressive (i.e. lower-income people will pay a higher proportion of their income in total taxes compared with the affluent). Another argument can be made by looking upon the value of money to various groups and not simply the rate of

taxation. While the monetary value of a dollar (or other unit of currency) is the same for everyone, it is clearly “Worth” a lot more to someone who is struggling to afford food than to a millionaire. Taxing everyone at the same rate ignores the fact that richer people can give up more of their income, without ill effects. Moreover, it is debatable whether a flat tax would substantially simplify the tax system.

This implies that the rates of taxation should be the same regardless of the size of the income i.e. "the system in which the rates of taxation remains constant as the tax base changes".

Mathematically, it can be defined as follows: "The amount of tax payable is calculated by multiplying the tax base with the tax rate".

Tax Payable = Tax Base X Tax Rate

Thus, in the case of proportional tax systems "Multiplier remains constant with the changes in multiplicand (income)".

Merits of Proportional Tax System:

Proportional tax system has the following advantages: 1. It is simple in nature. 2. It is uniformly applicable. 3. Proportional taxation leaves the relative economic status of taxpayers unchanged. 4. It will avoid mistakes and drawbacks of progressive tax system.

Limitations of Proportional Tax System:

The following are the demerits of proportional tax system:

1. Inequitable Distribution: A system of proportional taxation would not lead to an equitable and just direction of the burden of taxation. This is because it falls more heavily on the small incomes than on the high incomes.
2. Inadequate Resources: The system of proportional taxation means that the tax rates for the rich and poor are the same. Hence, the government cannot obtain from the richer sections of the society as much as they can give.
3. Inelastic in Nature: Proportional tax system is inelastic in nature, because the government cannot raise the rate whenever it wants to raise the revenue. Proportional tax system suffers from the defects of inequitable distribution of the tax burden, lack of elasticity and inadequacy of funds for the increasing needs of the modern government. Hence, it is not practically and universally accepted.

❖ Arguments for and against proportional Taxation

- Proportional taxation 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.

- Proportional tax schedule is administratively simple. But, there is counter argument to this because the points at which tax collection is to take place become too numerous and administratively unmanageable.
- It is claimed that a proportional tax does not change the relative position of different tax-payers. It is neutral in terms of the allocation of resources of the economy to different uses. This type of reasoning is quite misleading. Because when the income of a tax-payer is reduced he adjusts his demand pattern for various goods and services. Example: (1) A richer person maintains his consumption by reducing his saving and supply of investment funds and the demand for capital goods would fall. This would retard the rate of economic growth.
- The poorer sections will have to reduce their consumption which is not good for their health and efficiency.

2. Progressive Tax System

A progressive tax or graduated tax is a tax that is larger as a percentage of income for those with larger incomes. It is usually applied in reference to income taxes, where people with more income pay a higher percentage of it in taxes. The term progressive refers to the way the rate progresses from low to high.

Each taxpayer faces two tax rates, his average income tax rate (the proportion of income spent in income taxes) and his marginal rate (the portion of each additional Birr in income that would be taken away in taxes). Progressivity of the income tax (higher rates for higher segments of income) means that marginal tax rates are generally higher than average rates.

Thus, the progressive tax system can be defined as "a system in which rates of taxation would increase with the increase in income i.e. higher the income, higher would be the rate of tax".

The rates of taxation increases as the tax base increases. The amount of tax payable is calculated by multiplying the tax base with tax rate. In this case, "the multiplier increases as the multiplicand (income) increases".

Merits of Progressive Tax System:

It is argued that if the utility gained from income exhibits diminishing marginal returns, then for the tax burden to be vertically equitable, those with higher incomes must be taxed at higher rate. The advantages of progressive tax system include the following:

1. **Equality in Sacrifice:** Under progressive tax system, the rate of taxation increases as the tax base increases. That is, the burden of taxation is heavy upon the rich than on the poor. People with higher income tend to have a higher percentage of that in disposable income, and can thus afford a greater tax burden. Thus, this system secures equality in sacrifice by ensuring the principle of ability to pay.
2. **Reducing the Inequalities of Income and Wealth:** Progressive tax system serves as a powerful instrument for reducing the inequalities of income and wealth.
3. **Economy:** In the progressive system, the cost of collection does not increase with the increase in the rate of taxes. Hence, it is justified on the grounds of economy.
4. **Elastic:** Progressive tax system is elastic in nature to meet the increasing public expenditure. The government can easily raise its revenue by increasing the rates of taxes. In the case of progressive taxation, raising the rates for the higher status alone can raise more revenue.
5. **Stabilizing the Economy:** Progressive tax system may be helpful in preventing the inflationary trends in the economy as it reduces the disposable income and purchasing power of the people. Thus, the inflationary trends can be checked and the economic stability can be achieved.

Limitations of Progressive Tax System:

The following are the demerits of progressive tax system:

1. **Ideal Progression is Impossible:** The main drawback of progressive taxation is that it is difficult to frame an ideal graduated progression in tax rates. They are arbitrary depending on the government's need for additional funds without taking into account the burden of people with different incomes.
2. **Progressive Taxation - a Graduated Robbery:** Progressive taxation is an unjust mode of taxation and a graduated robbery.
3. **Disincentive to Work:** It is argued that too progressive a tax rate acts as a disincentive to work.
4. **Discourages Savings and Investments:** Very high rates of progressive taxes used to discourage savings and investments. Since a major portion of the income is taken away by the state by way of taxes, the incentives to produce more and earn more are lost.
5. **Shifts the Total Economic Production of Society:** The progressive tax system shifts the total economic production of society away from capital investments (tools, machinery, infrastructure, research etc.) and toward present consumption goods. This could happen because high-income earners tend to pay for capital goods (through investment activities) and low-income earners tend to purchase consumables. Since, progressive tax system discourages savings and investments the

shifting of economic production of society could happen. Smithian theory says that spending more on consumption goods and less on capital goods will slow the rise of the standard of living.

❖ Arguments for and against progressive Taxation

Arguments For

- A very strong case for progressive tax rates exists in terms of ability to-pay and the corresponding sacrifice which taxation involves. This argument is based upon the assumption of the law of diminishing utility. But the problem is measurability of utility or the possibility of interpersonal comparisons.
- Progression can be advocated on the basis of social justice because it taxes the people according to their ability to pay.
- Progressive taxation acts as a built in stabilizer. i.e., it acts against an excessive upward or downward movement of income and prices.

Argument Against

- Progressive tax has been disputed on the grounds of non-measurability of utility and the impossibility of interpersonal comparisons of utility
- The benefit-received principle is against progressive taxation from the very beginning, because this principle requires the poor to pay more tax as he receives more benefit from the government.
- Progressive taxation is said to have negative bearing on the process of saving and capital accumulation in an economy, because it taxes more the rich who is the big saver in the economy.

In a poor, underdeveloped country raising resources through budgetary savings may necessitate the use of regressive taxes (or indirect taxes). Indirect taxes can be imposed on articles of mass consumption. Thus the low income majority will be captured by those taxes.

Because of this, the value of the property in the neighborhood will rise. This rise in the value will provide an unearned increment. Hence, the Government has a right to appropriate a part of this unearned increase. This appropriation is called as special assessment.

1. Regressive Tax System

A regressive tax is a tax which takes a larger percentage of income from people whose income is low. Often it is a fixed tax – every person has to pay the same amount of money, such as a *poll tax*. A poll

tax is a fixed tax for each person: since each person pays the same amount of money, it is a lower proportion for people with higher incomes.

In regressive tax system, the amount of tax is smaller as a percentage of income for people with larger incomes. Many taxes other than the income tax tend to be regressive in practice. For example, most sales taxes (since lower income people spend a larger portion of their income), excise duty etc. are regressive in nature if they are levied on the goods of common consumption.

Thus, regressive tax is a tax, which taxes a larger percentage of income from people whose income is low. It places more burdens on those with lower incomes.

It is the system in which the rate of tax declines with the increase in the income or value of property. The larger the assessee's income or property, the lower the percentage that he/she pays tax in regressive taxation. "The tax rate decreases as the tax base increases".

The amount of tax payable is calculated by multiplying the Tax Base with Tax Rate. The schedule of regressive tax rate is one in which the rates of taxation decreases as the tax base increases.

As regressive taxes fall more heavily on the poor section of the community, than on the richer section, it violates the principles of equity and social justice. That is, through regressive taxation, principle of equity and social justice cannot be followed. In a welfare country like Ethiopia, whose object is to establish a socialistic state without inequalities in the distribution of income and wealth, regressive taxation has no place.

Even non-income taxes can be regressive relative to income. The regressivity of a particular tax often depends on the propensity of the taxpayers to engage in the taxed activity relative to their income. To determine whether a tax is regressive, the income elasticity of the goods being taxed as well as the income-substitution effect must be considered.

2. Degressive tax system

Under this system, the rate of tax is mildly progressive up to a certain limit and thereafter it may be fixed at a flat rate. It is an alternative of progressive tax marked by a steadily declining rate of increase in the progressive tax rates, which are applied to the upper segments of the tax base. An incremental tax rate in each additional layer of tax bracket (marginal tax rate) decrease as the segment of the tax base increase.

The tax rate will increase gradually and reach the peak and thereafter, the marginal tax rate declines with each incremental. It is mixture of progressive and regressive taxation system. This can be used as incentives to work, save and invest.

The amount of tax payable is calculated by multiplying the Tax Base with the Tax Rate.

Activity 2.14

Distinguish b/n direct & indirect taxes and explain the merits and demerits of each.

2.15 Impact, shifting and incidence of tax

???

Pretest

Dear students, what do you mean the terms impact, shifting and incidence of tax?

The burden of a tax does not always lie on the person from whom it is collected. In many cases, it is borne by the other people also. Thus, the person who initially pays the tax may not be actually bearing its money burden as such. Hence, it is necessary to know who bears the immediate burden of tax and who bears the ultimate burden of tax. According to the law, the tax is collected from a particular individual or business unit, which has paid the tax in the first instance and may transfer it to someone else. If such a shifting of tax takes place, the original taxpayer has served only as a collecting agent.

In the process of taxing, three concepts are involved. They are as follows:

1. A tax may be imposed on some person.
2. It may be transferred by him to another person i.e. second person.
3. It may be ultimately borne by the second person.

This can be explained with the help of the model shown in Fig. 2.2.

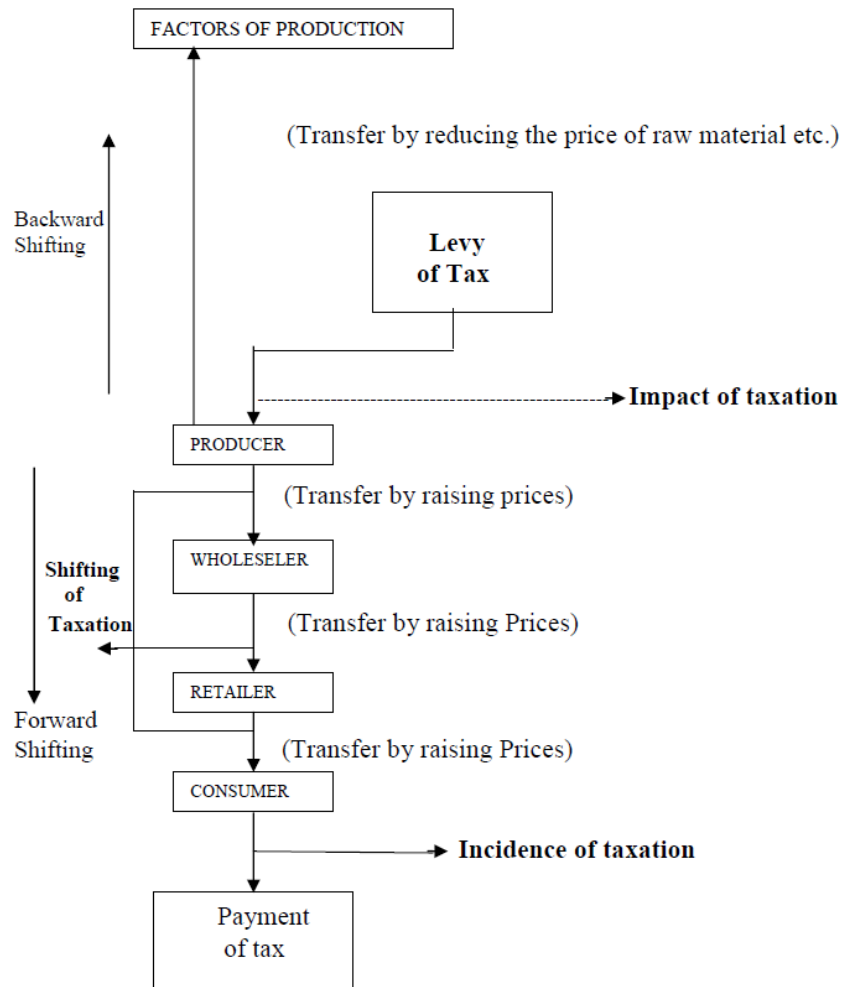


Fig: 2.2. Model of impact shifting and incidence of taxation

Thus, a) Impact of a tax is on the person who bears the money burden in the first instance.

b) Shifting of a tax refers to the process by which the money burden of a tax is transferred from one person to another person.

c) Incidence of a tax refers to money burden of a tax, which is on the person who ultimately bears it.

1. Impact:

The impact of a tax is on the person who pays the tax in first instance. In other words, the person who pays the tax to the government in the first instance bears its impact. Therefore, the impact of a tax is the immediate result of the imposition of a tax on the person who pays it in the first instance. It refers to the immediate burden of the tax and not to the ultimate burden of the tax.

2. Incidence:

Incidence of a tax means the final or ultimate resting place of the burden of the tax payment. It refers to the point at which "tax chickens finally come to the roost ". That is, the location of the ultimate tax burden. The incidence of a tax is different from its impact, which refers to the point of original assessment.

If an individual who pays the tax in the first instance finds that he cannot transfer or shift the burden of the tax to anybody else, then the incidence as well as the impact is on the same person. If the original or the first taxpayer is able to transfer or shift the tax burden to someone else, then the shifting of tax will be taken place. For example, the Government levies a tax say, excise duty on cement and collects the tax from the manufacturer of cement. Now, the impact of the tax is on the manufacturer. If he is able to pass on the money burden of the tax to the wholesaler by means of raising the price, then the manufacturer has shifted the tax i.e. he transferred the money burden to the wholesaler. This process continues and ultimately the consumer bears the money burden of the tax. Hence, the incidence is on the final consumer.

There are two major economic principles in the analysis of taxation. They are: (i) the incidence of the tax, and (ii) its effects on economic efficiency (referred to as the excess burden or welfare cost of the tax). These principles are applicable to all taxes.

Concepts of Tax Incidence: The main issue in the economic analysis of any tax is the identification of the individual or group of individuals on whom the burden of the tax rests. This is the incidence of the tax. There are two concepts of tax incidence. They are as follows:

1. Legal Incidence: The individual or group of individuals who have the legal responsibility for paying the tax to the government bears the legal incidence of the tax.
2. Economic Incidence: The individual or group of individuals, whose real income, welfare or utility is reduced by the tax, bears the economic incidence. The economic incidence is independent of the legal incidence; that is, those who bear the legal incidence may be different from those who bear the economic incidence. When the economic incidence differs from the legal incidence, the burden of the tax is said to be "Shifted".

The effects of a tax on the allocation of resources and on the distribution of income depend on the economic incidence, not the legal incidence.

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

A producer, upon whom a tax has been imposed, may shift the tax burden to the consumer or to the factors of production. If the producer shifts the tax burden to the consumer, it is known as "Forward Shifting". On the other hand, if the producer shifts the tax burden to the factors of production i.e. to the suppliers of raw materials etc., it is known as "Backward Shifting". The backward shifting can be taken place by compelling the supplier to reduce the price of raw materials etc.

4. Differences between Impact and Incidence:

1. The impact refers to the initial money burden of the tax. But the incidence refers to ultimate money burden of tax. 2. The impact is felt by the person from whom tax is collected. But the incidence is felt by the person who actually pays tax. 3. Impact can be shifted. But incidence cannot be shifted.

5. Theories of Tax Shifting or Incidence of Taxation:

The concept of shifting and incidence has undergone many changes. Different theories have been developed to determine the situations under which a tax is shifted. These theories can be classified into the following four broad categories:

1. The Traditional Theory. 2. The Concentration Theory. 3. The Diffusion Theory. 4. The Modern Theory.

1. The Traditional Theory:

Seligman considered that there are three different conceptions in the process of levying a tax viz., impact, shifting and incidence. As such, a tax may be imposed on some person and he may transfer it to another person. Ultimately, it may be borne by the second person or the second person may again transfer it to others by whom it is ultimately paid. That is, the person who bears the burden of tax in the last instance may not necessarily be the person who originally pays the tax.

Thus, shifting of taxation is the process of transfer of tax, while the impact lies on the person who pays it at the first instance. Incidence of a tax is the settlement of the burden on the final taxpayer who cannot shift it again.

2. The Concentration Theory:

This theory was developed by physiocrats in the 18th century. They believed that all types of taxes imposed on public ultimately fell on the particular class of people i.e. landowners or on the surplus income from land. They considered that agriculture was the only productive occupation giving rise to

economic surplus. According to them, there was no surplus in other occupations like trade, commerce etc. They firmly believed that a tax whether imposed on a person or on a commodity would ultimately fall on land through the process of shifting of the tax. That is, taxes imposed on non-agriculturists tended to be passed on to agriculturists.

They advocated a single tax on the net income of the land by abolishing all other taxes levied on the people. They make it on the grounds that it would simplify taxation; reduce the cost of collection and the tax charges on the landowners.

The theory of concentration has been criticized by the classical economists on the ground that agriculture is not the only productive occupation. They viewed that all economic activities are productive and a single tax on land cannot hold good in the modern welfare society. They argued that the burden of tax should be distributed equally in the society as a whole and not in a particular section of the society.

3. Diffusion Theory:

The French economists like Mansfield and Canard propounded this theory. It is entirely contrary to the concentration theory. It stated that the taxes are diffused among the members of the society. According to them, every tax is shifted and re-shifted till its burden eventually gets spread over the whole society.

According to Mansfield, "the tax is like a stone falling into a lake and making a circle, till one circle produces and give motion to another and the whole circumference is agitated from the centre".

Canard compared the levy of tax with extracting blood from human body. Even though, the blood is taken from a single vein, the loss is spread over the body as a whole and the body remains in equilibrium.

When the levy of tax gets diffused, no one can escape from its incidence. The diffusion of the tax occurs through the process of shifting and incidence. When a commodity is bought and sold, the tax gets partly shifted. Equilibrium is reached when the tax burden is equally distributed among all taxpayers. This theory does not suggest a single tax on land. But, tax diffusion is a time consuming process.

The main criticisms of this theory are as follows:

(a) All taxes cannot be shifted, because shifting of a tax can take place only under certain conditions. Thus, the ideas of diffusionists on the shifting of taxes are not practical. (b) The assumptions of the

theory are unrealistic in nature because perfect competition is not possible in real life. Hence, we cannot expect that the tax incidence will get diffused equally in the economy.

4. Modern Theory:

The modern theory is based on the marginal analysis of value and price as given by Marshall. The modern economists like Seligman, Edgeworth and others apply this theory to the shifting of tax. It possesses all the virtues of the earlier theories.

It advocates that tax should be imposed upon economic surplus. According to the modern economists, a tax is a part of cost of production and therefore, it enters into price. As such, shifting of tax occurs only through a change in price. Since price is determined by demand and supply, the shifting and incidence of taxes depend upon the process of pricing of commodities.

Therefore, a tax is necessarily included in the price of commodities. However, if the prices increase but not to the extent of taxes levied, it implies that some burden of tax is being borne by the sellers and some by the buyers. The incidence of taxation is divided between the sellers and buyers of commodities according to their relative elasticities of demand and supply. It can be generalized as follows:

1. If the elasticity of supply is equal to the elasticity of demand, the tax burden will be divided equally between the buyers and sellers. Here, the price is increased by half of the total tax.
2. If the elasticity of supply is greater than the elasticity of demand, then more tax burden will fall on the buyers. Here, the price is increased by more than half of the total amount of tax.
3. If the elasticity of supply is less than the elasticity of demand, then more tax burden will fall on the sellers. Here, the price is increased but less than the half of the total amount of tax.
4. If the demand is perfectly elastic and the supply is inelastic, then the whole incidence will fall on the sellers. Here, the price remains the same.
5. If the demand is perfectly inelastic and supply is elastic, then the whole incidence will fall on the buyers. Here, the price is increased by the full amount of the tax.
6. If supply is perfectly elastic and demand is inelastic, then the whole incidence will fall on the buyers. Here, the price is increased by the full amount of tax.
7. If the supply is perfectly inelastic and demand is elastic then the whole incidence will fall on the sellers. Here, the price remains unchanged.

Modern economists state that the shifting of the tax to the consumers of the commodity depends not only on the elasticity of demand and supply but also on some other factors like cost condition, time factor, nature of the market, trade cycles, nature and quantum of tax etc.



Activity 2.15

Explain the relationships among tax impact, incidence, & shifting by giving examples.

2.16 Effects of Taxation

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Pretest

Dear students, would you briefly summarize Effects of Taxation?

Taxation might have different effects in an economy. Now-a-days, revenue rising is not the only purpose of taxation. In a Welfare State, taxation has also been used as a tool of monetary policy to achieve socio-economic objectives. It is used to promote economic growth by controlling the effects of trade cycles and regulating the production and consumption. It has also been used to reduce the inequalities of income and wealth.

Economists have devoted considerable effort to studying the effects of taxes. In particular, they study how taxes affect people's behavior, including their choices in working, saving, and investing.

To understand the effect of any tax, one must first determine who bears the burden of the tax. This is not always an easy task. Suppose that the price of a chocolate doughnut is \$1.00. The government then imposes on sellers a tax of 10 cents per doughnut. A few weeks after its imposition, the tax causes the price to increase to \$1.10. The doughnut seller clearly receives the same amount per doughnut as he or she did before the tax—the tax has not made the seller worse off. Consumers pay the entire tax in the form of higher prices. On the other hand, suppose that after the tax the price increases to \$1.04. In this case, the seller keeps only 94 cents per doughnut, and is worse off by 6 cents per doughnut. Consumers are also worse off, however, because they have to pay 4 cents more per doughnut. In this case, retailers and consumers share the burden of the tax.

The way a tax affects people is called the *tax incidence*. The *statutory incidence* of a tax refers to the individuals or groups who must legally pay the tax. The statutory incidence reveals essentially nothing about a tax's real burden, because prices may change in response to a tax. In contrast, the *economic incidence* of a tax refers to its actual effects on people's incomes. The economic incidence

of a tax depends on how buyers and sellers of the commodity react when the tax is imposed. The more sensitive consumers are to changes in price, the easier it is for them to turn to other products when the price goes up, in which case producers bear more of the tax burden. On the other hand, if consumers purchase the same amount regardless of price, they bear the whole burden.

A. Labor supply

An economy's *labor supply* is the number of hours that people work. Taxes can affect the labor supply by influencing people's decisions about whether to work and how much to work. Suppose that an individual earns \$10 per hour, and the government imposes a 40 percent tax on earnings. Then after tax, the individual receives only \$6 per hour (\$10 minus \$4 in taxes). The impact of such a tax is hard to predict. On one hand, the tax lowers the cost to the individual of not working. For each hour of leisure, the individual gives up only \$6 instead of \$10. In effect, leisure has become cheaper, so the individual tends to consume more of it—that is, to work less. On the other hand, with a lower wage, the individual must work more hours to maintain the standard of living he or she had before the tax. Thus, the tax simultaneously leads to two effects that work in opposite directions.

However, empirical work—analysis based on observation of real-world data—has suggested two important general tendencies. First, for most men, the effect of taxes on hours of work is relatively small. Second, the work-related decisions of married women are quite sensitive to changes in taxes. Research suggests that a tax increase that lowered their wages by 10 percent would lower the number of hours that married women work by about 5 percent.

B. Saving

Saving is the portion of income that is not spent. Might taxes levied on returns to saving (such as interest and dividends) influence the amount people save? When a tax is levied on interest or dividends, it reduces the reward for saving. For example, if an individual earns 10 percent interest on a savings account and faces a 20 percent income tax rate, then he or she makes only an 8 percent return—the other 2 percent goes to the government. This effect tends to reduce the amount of saving that an individual does. On the other hand, when interest is taxed, an individual must save more to achieve any particular savings goal. For example, if parents regularly save money to accumulate enough for their child's college tuition payments, and taxes on interest increase, they must save more in order to reach their saving target. This effect tends to increase the amount of saving. Because the

two effects work in opposite directions, in theory an increase in the tax on interest can increase or decrease saving. Economists have devoted a great deal of effort to studying people's saving behavior. Although no firm consensus has emerged on the impact that changes in interest and dividend tax rates have on saving, a reasonable estimate is that such changes have a negligible effect.

C. Physical investment

Physical investment refers to the purchase by businesses of manufactured aids to production. Physical investment includes such items as machines, factories, computers, trucks, and office furniture. The return on a physical investment is the amount by which the investment increases the business's revenues. How do taxes affect physical investment? In effect, a tax on business income is a tax on the physical investment's return—the tax reduces the firm's income and thus the benefit from making the investment. Most economists believe that business taxes decrease the amount of physical investment by businesses.

Taxes also influence the types of physical investments that businesses make. This is because the government taxes returns on some types of investments at higher rates than others. These differences cause businesses to make investment decisions based on tax consequences, rather than whether they are sound from a business point of view. By distorting physical investment decisions, the tax system leads to an inefficient pattern of investment.

In the modern context, the effects of taxation may be summarized as follows.

1. Effects of Taxation on Production:

Taxation may affect either adversely or positively production in an economy. Increasing or decreasing the tax rate affects the ability and willingness to work, save and invest. All taxes must evidently come from the produce of land and labor, since there is no other source of wealth than the union of human exertion with the material and forces of nature. But the manner in which equal amounts of taxation may be imposed may very differently affect the production of wealth. Taxation, which lessens the reward of the producer necessarily, lessens the incentive to production; taxation, which is conditioned upon the act of production, or the use of any of the three factors of production, necessarily discourages production. Thus taxation, which diminishes the earnings of the laborer or the returns of the capitalist, tends to render the one less industrious and intelligent, the other less disposed to save and invest. Taxation, which falls upon the processes of production, interposes an artificial obstacle to the creation of wealth. Taxation which falls upon labor as it is exerted, wealth as it is used

as capital, and land as it is cultivated, will manifestly tend to discourage production much more powerfully than taxation to the same amount levied upon laborers, whether they work or play, upon wealth whether used productively or unproductively, or upon land whether cultivated or left waste.

Taxation can influence the production of a nation by influencing four basic factors. They are as follows:

a. Ability to work, save and invest. b. Willingness to work, save and invest. c. Diversion or allocation of resources between industries and places. d. On the size of the industries

Let us discuss these factors one by one.

a. Effects on the Ability to Work, Save and Invest:

Taxation transfers the money income from the public to the government and thereby reducing their purchasing power. The reduction in purchasing power reduces their ability to obtain necessities and luxuries of life.

Thus, the levy of taxes on people reduces their consumption of necessities and comforts, which lowers the standard of living. When the standard of living is affected, their efficiency and ability to work will also be adversely affected. This effect is strongly felt by the poor people. But the efficiency and ability to work of rich people is not so much affected by taxation.

The savings of the people depends upon their income. When income is reduced by taxation, savings will also be reduced. The ability of the people to invest largely depends upon their savings. When their savings are reduced by taxation, their ability to invest is also automatically reduced by taxation.

b. Effects of Taxation on willingness to Work, Save and Invest:

Taxation affects the desire of the people to work, save and invest. If the willingness of the people to work, save and invest is affected by taxation, the production will automatically be affected. It is universally recognized that direct taxes have more adverse effect on the willingness of the people to work, save and invest.

It is argued on the grounds of psychological reactions of the people. That is, when the higher progressive taxation is levied, the Government takes the major portion of their additional earnings back. This may create a tendency in the minds of the people not to take risk to work hard to earn such a meager income.

However, reasonable taxation may not have any such bad effect on the desire to work, save and invest.

c. Effects of Taxation on the Diversion of Economic Resources:

While the volume of production of a country depends upon the ability and willingness to work, save and invest, the pattern of production depends upon the allocation of economic resources between different industries and regions. Taxation can be used in the diversion of economic resources among the industries and regions. Thus, taxation can influence not only the size of production but also the pattern of production.

If the products of certain industries are taxed, their prices would rise and therefore, the demand for their product would reduce. And thereby, the profit is also reduced. This may result in the diversion of resources from these industries to some other industries whose products are subjected to no tax or low tax rate. This diversion of resources may change the composition and pattern of output of industries. The extent to the diversion of resources takes place from taxed industries to non-taxed industries will depend upon the elasticity of demand and supply of products of such industries.

The diversion may be beneficial diversion or harmful diversion. Taxation on the commodities that are injurious to the health like cigarettes and liquors may discourage their consumption, which in turn affects their production. The factors of production engaged in these industries may be diverted to some other industries producing goods of common consumption etc. This is a "Beneficial Diversion". The taxation on the goods of common consumption will increase their price. Hence, the consumption of such goods may be reduced. This will affect the production of these commodities, and the resources used in their production may be diverted to the production of some other commodities which may be in the nature of luxury or harmful to health. Thus, such a diversion of resources is harmful and is socially not desirable. It is known as "Harmful Diversion".

d. Effects on the Size of Industries:

When taxes are imposed without any discrimination on the commodities produced by both small and large-scale industries, the production of small-scale industries will be highly affected. This is because there cannot be any economies of large-scale operation. Thus, the cost of production of these industries will normally be high. If taxes are levied on par with the large-scale industries, the total selling price of small sized industries will increase further. This will affect the competitive efficiency of small-scale industries, which in turn affects the production, and survival of these industries.

Hence, tax concessions should be given to encourage the production of these industries.

2. Effects of Taxation on Distribution:

An important objective of taxation in most of the welfare states is to reduce the inequalities of income and wealth and to bring about an equal society. The effects of taxation on the distribution of income and wealth among the different sections of the society, depends upon two important factors. They are as below: I. Nature of Taxation, and II. Kinds of Taxes

I. Nature of Taxation:

The nature of taxation influences the distribution of tax among the different sections of the society. It includes proportional regressive and progressive nature of taxation.

(a) Effects of Regressive Taxation on Distribution: Under regressive taxation, the burden of taxation falls more heavily upon the poor than on the rich. Regressive taxation may increase the inequalities on the distribution of income and wealth. Hence, the burden of taxation is higher on the poor than on the rich. In effect, this system widens the gap between the rich and the poor.

(b) Effects of Proportional Taxation on Distribution: Under the proportional taxation, taxes are levied uniformly upon the rich and the poor. When the tax rate remains the same, it creates inequalities between them. However, if there is any increase in the income of these sections, the inequalities in distribution of income will also increase. The burden of taxation falls more heavily upon the poor than on the rich.

(c) Effects of Progressive Taxation on Distribution: Under the system of progressive taxation, the tax rates go up with the increase in the income. Thus, in this system, the inequalities in the income and wealth will be reduced. The major portion of the income and the wealth of the rich is taken away by way of higher tax rates. Hence, the progressive tax system tends to reduce the inequalities in the distribution of income and wealth.

II. Effects of Taxation on the basis of Kinds of Taxes:

The effects of taxation depend upon the kinds of taxes i.e. direct or indirect taxes.

(a) Effects of Direct Taxes on Distribution: Direct taxes take the form of taxation on the income and property. It attempts to reduce the income of the richer sections and transfers the income to the Government. The Government may use these resources to raise the standard of living of the poor. Therefore, all those taxes, which fall heavily upon the higher income groups, can have favorable distributional effects.

(b) Effects of Indirect Taxes on Distribution: Indirect taxes are levied on commodities. They fall heavily on the lower and middle-income groups who spend a large portion of their income on

commodities. In such a situation, indirect taxes have adverse distributional effects. However, indirect taxes may be made progressive if the necessities are exempted from taxation or levied on low tax rates, and luxuries are subjected to higher rates of taxes.

3. Effects of Taxation on Consumption:

Taxes increase the price of the taxed goods relative to the prices of untaxed or lower taxed goods. The increase in the relative price affects the taxpayer in two ways.

- A. **Income Effect:** The tax reduces the taxpayer's purchasing power or real income. It takes resources away from the taxpayer and transfers them to the government. This is often referred to as the direct burden of the tax.
- B. **Substitution (or Price) Effect:** The tax creates an incentive for the taxpayer to substitute less preferred but untaxed or lower-taxed goods for the more-preferred taxed good. The loss in consumer utility from this substitution is the excess burden (or welfare cost) of the tax.

Taxation influences the consumption as well. Such influence can be studied on the following grounds:

1. Influence the Allocation of Resource of Individuals:

Every individual has limited money income and allocates it to different uses. Taxation affects their allocation directly or indirectly. For example, the income tax reduces the money income of a consumer and forces him to buy a smaller volume of goods and it reduces the standard of living of the consumers. Likewise, a levy of indirect taxes on the goods of common consumption will affect the allocation of individual resources. Thus, taxes influence the allocation of resources of individuals.

2. Effects of Taxation on Consumption and Employment:

Taxation reduces the purchasing power of the people and it reduces their consumption. The decline in consumption leads to a decrease in effective demand for the goods and services, which in turn affects the production of these commodities. Ultimately, the reduction in consumption leads to a reduction in employment opportunities. For example, due to a rise in price, instead of getting two different commodities, the individual may buy more quantity of any one commodity to maximize the utility and his satisfaction.

3. Effects of Taxation on Consumption during Inflation and Depression:

Taxation has different effects in times of inflation and depression. During the time of inflation, the purchasing power of the people is reduced by a rise in the rates of existing taxes or imposition of new taxes. This would control the consumption and therefore, help in bringing up stability in prices.

During the period of depression, taxation may be reduced. As the result of the reduction on direct tax rates, the people will have more disposable income and higher purchasing power and a decrease in indirect taxes leads to the reduction of selling prices. Both of them encourage the total consumption of the people and thereby the economic activities are induced in the country.

4. Regulatory Effect of Taxation on Consumption:

Taxation may be used to regulate the production and consumption. Consumption can be regulated by taxing the production and use of certain commodities. For example, the object of some taxes may be to reduce the consumption of certain harmful commodities such as liquors, cigars etc.

4. Effects of Taxation on Stabilization of Economy

During abnormal prices rises (inflation), taxation can be used as a tool to stabilize the economy. Inflation is results of either demand pull or cost push. In demand pull inflation, the government should increase the tax so as to reduce the capacity of the people to purchase. In cost push inflation, the government uses taxation to minimize and control cost of production so as to reduce the price of goods and services.



Activity 2.16

Describe the effects of taxation & their consequences on economy.

2.17 Tax Evasion, Avoidance and Black Money

???

Pretest

Dear students, would you distinguish among Tax Evasion, Avoidance & Black Money?

1. Tax Evasion , and Avoidance

Tax avoidance and evasions constitute a problem in almost all the countries of the world. Tax avoidance is different from tax evasion, while evasion is against the law; avoidance is within the ambit of law.

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

By contrast tax avoidance is the legal exploitation of the tax regime to one's own advantage, to attempt to reduce the amount of tax that is payable by means that are within the law whilst making a full disclosure of the material information to the tax authorities. Tax avoidance may be considered as either the amoral dodging of one's duties to society or the right of every citizen to find all the legal ways to avoid paying too much tax. Tax evasion, on the other hand, is a crime in almost all countries and subjects the guilty party to fines or even imprisonment.

A. Tax Avoidance:

Tax avoidance means, “tax-payer may resort to a device within the ambit of law to divert the income before it accrues or arises to him”.

“Tax Avoidance has to be recognized that the person whether poor or wealthy has the legal right to dispose of his income so as to attract the least amount of tax”.

The tax avoidance can be defined as “escaping from the tax liability by using the available loop-holes of the tax laws”.

Thus, tax avoidance means legal minimization of tax burden by the taxpayers.

Examples for Tax Avoidance:

The following are the examples for tax avoidance:

1. Suppose a taxpayer's total income exceeds the maximum tax-free amount, then he has to pay the tax on such excess amount. But if he invests the excess amount in any of the approved schemes for which there is a relief in the tax law, he can save on tax altogether.
2. An individual sells his let out house property (long-term capital asset) for Birr.2, 000,000 making a capital gain of Birr 60,000. This capital gain would normally be taxed. But, if he invests the sale proceeds in a particular manner stipulated by law, he need not pay any tax.
3. Divorcing the wife on paper so that her income is not added together with husband's income is also a common device for tax avoidance.

B. Tax Evasion:

Tax evasion means fraudulent action on the part of the taxpayer with a view to violate civil and criminal provisions of the tax laws. It can be defined as “tax evasion implies the activities involving an element of deceit, mis-representation of facts, and falsification of accounts including downright fraud”.

Thus, it may be said that the tax evasion is tax avoidance by illegal means i.e. tax evasion is against the law and is an unsocial act.

There are two forms of tax evasion. They are as follows: 1. Suppression of income, and
2. Inflation of expenditure.

Examples for Tax Evasion: The following are the examples for tax evasion:

1. A trader makes a sale for Birr.20, 000 and does not account it, in his books under sales. He is evading tax.
2. An individual lends his money of Birr.50, 000 to another person at 20% interest per annum and does not include this income in his total income.
3. Under-invoicing of sales and inflation of purchases.
4. A manufacturing business employs 30 workers but include 2 more additional namesake workers (not in actual) in the muster roles. The sum shown as paid to such additional namesake workers will amount to evasion.

Human intelligence devises new methods of evasion and the Governments are constantly trying to remove the loopholes in the tax laws.

Causes of Tax Evasion:

The following are the important causes for Tax evasion:

1. Multiplicity of Tax Laws: A number of laws enacted for the recovery of a variety of taxes often leads to widespread tax evasion.
2. Complicated Tax Laws: Complicated tax laws are another reason for tax evasion. The tax laws contain a number of exemptions, deductions, rebates, relief, surcharges and so on. So, such complication in tax-laws is also a root-cause for the tax evasion.
3. High Rates of Taxation: High rates of taxes cause widespread tax evasion, because the greater the risk undertaken for the purpose of tax evasion, the greater is the reward.
4. Inadequate Information as to Sources of Tax Revenue: Lack of adequate information as to the sources of revenue also contributes to tax evasions. In Ethiopia, small businessmen and farmers rarely maintain any accounts of their income.
5. Investment in Real Property: Investment in real property, both movable and immovable, and concealment of its true ownership have also been a major cause for tax evasion. All these facilitate the channelizing of black money into profitable ways.
6. Ineffective Tax Enforcement: Lack of proper training and efficiency for the authorities enforcing the tax laws is also a major cause for widespread tax evasion.

7. Deterioration of Moral Standards: There has been deterioration in standards of moral behavior of people since independence. The values, which formed the basis of Society, are shown little respect. In this modern competitive world, the deterioration of moral standards, among the people leads to falsification of accounts, mis-representation of facts and fraudulent behavior.

Remedies for Tax Evasion:

If steps are not taken to reduce tax evasion, it may cause irreparable harm. The following are the remedies to prevent tax evasion.

1. Thorough Overhauling of Tax Laws: One of the main reasons for tax avoidance and tax evasion is loose drafting of tax laws which contain several loop-holes and weak points that enable the tax evaders to carry on the unlawful activities. Hence, it is necessary to re-draft the tax laws thoroughly without any loopholes and weak points.
2. Reduction in Tax Rates: The prevalence of high rates is the first and foremost reason for this tax evasion. Hence, the rate of tax should be reduced to a reasonable level.
3. Replacement of Sales Tax & Excise Duties with VAT: As the crosschecking is possible in the case of VAT, it is more effective. Hence, such tax can be introduced instead of sales and excise duties.
4. Tax on Agricultural Income: Agricultural income is exempted from income tax and for this reason it is used to convert the black money into white. In recent years, agricultural farms and orchards, and vineyards have come to be acquired by industrialists; film stars etc. because this enables their owners to whiten their black money. Tax evasions can be avoided by taxing the agricultural income at normal rates.
5. Maintenance of Proper Accounts: Maintenance of proper accounts should be made compulsory for persons whose business and professional income exceeds a prescribed limit. In the Income Tax law, a provision to this effect has been introduced recently.
6. Introduction of Expenditure Tax: In Ethiopia, expenditure tax is levied in the form of commodity taxation such as excise duties, VAT, Turnover tax etc. There is no personal expenditure taxation. However, it is recognized by all that if a tax is based on personal expenditure and if all effective machinery is devised to investigate and ascertain personal expenditure, tax evasion can considerably be reduced.
7. Tightening of Tax Enforcement: This may be said to be the crucial remedy if the penalties for violation of tax laws are strictly enforced, incidence of tax evasion could automatically be reduced.

2. Black Money:

Black money is a complex phenomenon. It has various connotations such as unaccounted incomes, tax-evaded incomes, undisclosed wealth and unrecorded gain and suppressed or number two accounts transactions. It is earned by violating the laws and going against the conscience by the very name itself. We can understand how the money is earned and this money carries a secret behind it.

The parallel economy or black economy as it is also known, is generally considered to be that area of economic activity, which remains “Underground”, concealed from the vision and approach of the State authorities responsible for earning economic policies and implementing them. It is usually referred to those perfectly legitimate activities, resulting in transactions either in kind or for payment, between individuals, which are then hidden, from the tax authorities. Activities in the black economy are therefore, primarily undertaken with a view to evade the payment of various direct and indirect taxes, especially the latter.

As the term and definition of the black economy is self-explanatory, obviously one can only estimate the size of the parallel economy, but even conservative estimates are mind-boggling. After having asked a number of analysts, economists and people in the various financial institutions, the figure that keeps popping up is that the parallel economy is easily three times as large as the legitimate or documented economy. While the figure does force us to think and reflect upon the ethical decay in society it also hints at the benefits if this sector of the economy could somehow be documented or channeled. However, the possible benefits of this are not really as significant as most people are led to believe by the estimated size of the parallel economy.

Black Economy:

Not only are the developing countries affected by black economies. The emergence and growth of parallel economies in recent decades in many countries of the world is notable. It reveals the growing immorality in human behavior across the globe. However, as compared to developed countries, developing nations suffer much more as a consequence of large and ever growing parallel economies.

Black Income and Black Wealth:

The National Institute of Public Finance and Policy of India in its report make a distinction between the black income and the black wealth. Conceptually, the black income is a flow and the black wealth is a fund or stock. The black income is generated over a period of time. The black wealth is an accumulated unaccounted income at any given point of time. The black money is black wealth held by the public in terms of currency as well as liquid bank deposits. A large portion of black wealth is

held in the form of real estate, gold jewellery, stocks in business, benami financial transactions, cash, inventories and foreign currencies and undisclosed holdings of foreign assets.

This black income in a macro sense is defined as the aggregate of taxable incomes not reported to tax authority. In essence, income-evading taxation is referred to as black income. Evasion of taxes of all varieties (excise duties, customs duties and sales tax) leads to black income. Second, black income could arise from both “Reportable” and “Non-reportable” sources. Non-reportable black income is called so because the manner in which it is generated is illegal e.g. income from crime, bribery, black marketing, wealth (jewellery, business assets, foreign currency, real estate-especially benami transactions). Reportable black income is generated through legitimate activities or transactions but is suppressed and not reported to the tax authorities so as to evade taxes that will be levied on it. Third, black income activity not only generates black income but also results in black consumption and black saving. Black saving when accumulated leads to Black Wealth.

Black Economy and Black Money:

“Parallel Economy” or “Black Economy” refers to the functioning of an unsanctioned sector in the economy whose objectives run parallel to, or in contradiction with the declared social objectives.

The black economy is said to have taken birth during the Second World War. In scarcity conditions, controls on the distribution and prices of goods in short supply led to the emergence of black markets and hoarding. Black market prices, which were higher than the controlled prices, led to the emergence of “Black Incomes”, popularly called “Black Money” or “Number Two” income. Dr. Raja Chelliah defines the black money income as “the sum total of transactions deliberately kept out of the books of accounts by household and business in the economy”.

We can define Black money as “that the money which has not been brought into account, the income not shown to the authorities’ wholly or partially i.e. unaccounted property or money can be called black money”.

Black income now comprises a significant and fast growing element in many economies. It is today an all-pervasive phenomenon that requires serious attention. When we talk of black income, an important point to be noted here is that it is not limited to the evasion of income tax; it is a heterogeneous category that extends to bribes, smuggling and even leakage.

Impact of Black Money in Ethiopian Economy

The effects of the black money are considered significant on the basis of the following: a) significant size compared to other major sectors or the size of the government. b) White economy cannot act as a

proxy for the total economy. c) Economic laws applicable to the totality of the economy and not a part of it. d) Sectoral implications. e) Failure of policy linked to it. f) Has led to a change in the economic policy paradigm.

Macro Economic Impact of Black Money:

The black money has the following macro effects on the economy: a) Failure of planning and resource mobilization and contradiction amongst other policies. b) Growth and stagnation and income distribution effect. c) Investment, unemployment and the multiplier. d) Inflation. e) Forces a change in the fiscal policy regime. f) Various budgetary deficits and debt trap. g) Raises transactions costs and leads to a high cost economy in spite of a low wage. h) Savings and investment raises. Consumption propensity falls. i) Import propensity rises. j) Monetary Policy - Velocities of circulation and stability properties of the multipliers.

Micro Economic Impact of Black Money:

The black money has the following micro effects in the economy. a. Aspects of Policy Failure. b. Social Sectors. Poor left at the mercy of the markets. c. Criminalization of society. d. Impact on National Security. e. Social Waste. Like ‘digging holes and filling holes’. f. Impact on the work ethic. g. Impact on the quality of products and exports. h. Reduces the individual's faith in state intervention. i. Increases the alienation of the individual from society which reduces faith in social actions. The ‘usual is the unusual and the unusual the usual’.

Measurement or Estimation of Black Money:

It is widely accepted that most of the country’s problems arise mainly from the tendencies unleashed by the large and growing unaccounted “Parallel Economy”. Any estimate of the size of undeclared clandestinely (secretly) held wealth; current income and capital flights would exceed the marginal levels of our savings and BOP deficits. Effective restraint of the black economy therefore becomes very important, as this would go a long way in improving the quality of growth. But for this an estimate of the “Parallel Economy” is a must.

Measuring black income is not an easy task. This may be due to non availability of reliable data. A number of individual and institutional efforts have been directed towards measurement of size and growth of black income in Ethiopia. To examine this serious national problem the Government of Ethiopia has made many efforts from time to time for estimating and control of black money. It is difficult to know the exact holdings of black money. But, from the several guesswork and estimates,

it is evident that black money is of a high magnitude in the Ethiopian economy and has been expanding at a rapid rate over the last two decades.

There are several alternative approaches to the estimations of black income. They are as follows: 1. Expenditure Approach. 2. Fiscal Approach. 3. Monetary Approach. 4. Physical input Approach. 5. Labour-market Approach. 6. National accounts Approach.

Sources of Black Income:

There are many ways and sources of generating black income that it is very difficult to list them all. Black money is also earned from perfectly legal and legitimate activities, but when the income is fully or partly concealed in order to evade the taxes, it is treated as black money.

The various research committees have identified that the following are the items, which generally deemed to generate black money:

1. Evasion of Personal Income Tax. 2. Evasion of Corporation Tax. 3. Real Estate Transactions. 4. Excise Duty Evasion. 5. Customs (Import) Duty Evasion. 6. Evasion of Sales Tax. 7. Black Income from Smuggling. 8. Black Income from Exports. 9. Black Income from Public Expenditure. 10. Black Income from Private Corporate Investor. 11. Film Industry. 12. Professions. 13. Constructions. 14. Selling of Licenses and Permits. 15. Other sources of black income are, (a) Gambling. (b) Bribes including illegal commissions, “cuts” and kickbacks. (c) Black marketing in goods in short supply such as steel, copper, coal and other items of industry quota of raw materials and imports. There is also the black market sale of import licenses and foreign exchange at a premium. (d) Financial transactions in the unrecognized sector of the money market. (e) Hotels and Restaurants. (f) Unaccounted stock market profits on black transactions carried on in the private account of stockbrokers. (g) Income earned through the adulteration of food items, drugs, country liquor, production and sale of cheap imitations, forgeries and frauds of various kinds. (h) Publishing Piracy. Hereunder, we shall discuss the important sources of generating black money in detail.

Sources Generating Black Money

Evasion of Income Tax:

When we talk of evasion of income tax, it could mean both personal income tax and corporation income tax. Income tax can be evaded by the following ways:

1. Suppressing True Income: It is well known that a large part of black income comes through illegitimate sources, whether it is bribes, smuggling, black marketing or other such sources.

Professionals like lawyers, doctors, architects, businessmen and even film stars and film producers are examples where the sources are legitimate but income is suppressed to evade tax.

2. Manipulating Business Expenditures and Profits: The corporate sector indulges in under-reporting of profits, overstating expenditures, non-reporting of production and excise, raising fictitious bills on companies. While under-reporting of profits helps evade tax, non-reporting production helps generate black income in cash and generally increases the promoters' wealth.

3. Misuse of Tax Exemptions and Deductions: It is known that agricultural income is exempted from tax. Many people divert their income to purchase of agricultural land, show high agricultural profits and avail tax exemptions. It is possible that the profits come from non-agricultural operations and are taxable but misuse of a facility helps evade tax and create black income.

Evasion of Excise Tax:

Excise Taxes are duties or taxes on the domestic manufacture of commodities. These are divided between Union excise duties and State excise duties. For the Central government tax revenues alone, Union Excise taxes are the second most important source of revenue, next only to customs duties.

Excise duty evasion is both widespread and large in many countries. The most common methods of evasion are:

1. Suppression of Production: This is especially true of small-scale industries such as electrical goods, steel furniture and utensils, plastics and art silk fabrics. It also takes place in medium-scale and large-scale industries. This can be done either by not fully accounting for raw materials or not keeping statutory records fully up-to-date.

2. Under Valuation: This is quite true of the organized sector and can be done with the help of invoicing the product or even showing certain expenses as technical expenses. Floating of benami agencies that either raise supplementary invoices or collect the differential in value from dealers is another method.

3. Misclassification of Goods: Tariff rates provide numerous classifications and sub-classifications carrying different rates of duty. Thus people indulge in misclassification as well as wrong declaration of goods. High-duty excisable goods often get billed as non-taxable items and then the difference in the market values of two kinds of items gets recovered in black.

Evasion of Customs Duties:

Methods of evasion of customs duties are broadly the same as those for excise duties (taxes) on the flow of goods traded both imports and exports of a country. Customs duties are levied and collected by the Central Government. Methods of custom duty evasion are:

1. Under Valuation: This is done by under-invoicing of imports, usually by arrangement with the foreign supplier of goods who, mostly, willingly obliges the importer, pays in foreign currency the full difference between the actual price and the lower invoiced price of the goods imported.
2. Misclassification/Wrong Declaration of Goods: False declarations about goods imported in the documents submitted to the customs are made and higher-duty goods are cleared on payment of lower duty charged on the wrongly declared goods.

Trade Controls and Foreign Exchange Leakage:

Excessive Import and Export Controls have also led to several kinds of illegal activities, such as the generation and use of unauthorized foreign exchange (through the faking of invoices) and smuggling. A rush for licenses also results in corruption, favoritism and bribes.

Foreign exchange leakage occurs as a result of high import tariffs or comprehensive foreign exchange control. These can occur through under-invoicing of exports, over invoicing of imports, inward remittances of foreign exchange through illegal channels, smuggling of goods such as silver, animal skins, antiques, narcotics and illegal purchase of foreign exchange from foreign tourists and others visiting Ethiopia.

Although a number of steps have been taken to control black income, foreign exchange leakage and corruption continue to be a disturbing feature of many economies.

Smuggling:

Smuggling refers to the illegal import or export of goods. The numerous controls and tariffs create profitable opportunities for trade by smugglers in several goods. It is generally said that the smuggling of goods into the country is more serious than the latter. Smuggling has, over the years, expanded at such a high rate that it has even attained the title of the “Third Economy”. Affluent sections of society whose wealth has increased rapidly - mainly through black income provide a ready market for smuggled goods. We can thus say that all factors responsible for growth of black income activities in the economy also encourage the increased smuggling of goods in a country by creating a demand for these goods. Smuggling causes loss of revenue to the Government (through evasion of customs duty, excise duty and income and wealth taxes), large illegal outflows of foreign exchange

and result in large amassing of funds by smugglers. These funds are not put to any socially productive use or investment.

Price and Distribution Controls:

Wherever operative, price and distribution controls, besides attaining the primary objective of keeping the price of essential commodities “Under Control”, have also been responsible in leading to black marketing operations i.e. the sale of goods at higher than listed prices, unaccounted sales -or, sales without bills or cash memos. Sometimes price and distribution controls also lead to excessive hoarding of essential commodities.

Industrial Licensing:

Industrial licensing has also contributed to creation of black income in many economies. Excessive industrial licensing over the years had put up barriers to the entry of fresh capital and enterprise. A few large industrial houses were preferred. Moreover, excessive delay and red-tapism in the process of clearing applications for licenses have also been prevalent. In many cases, this has been taken as indications for bribes. The Government had not organized any separate machinery to monitor the actual implementation of industrial licensing. Therefore, there have been many violations and creation of black income.

Other Sources:

1. Urban Real Estate: Transactions in urban real estate generate a large amount of black income every year. There could be many frauds in this business. First, there could understand the value of a transaction to evade a large part of tax liability. Second, encroachment on public land; third, acquisition of raw land for resale as housing plots, developments of this land for setting up a colony, sale of plots or houses or flats constructed on it, exceeding the legally permissible limit of the built up area on a given plot of land. All these, specifically, understanding the value of all such transactions-lead to black gains. Another method is to under-report rents. Benami transactions are rampant, as is the role of “Black Money” in the acquisition of urban real estate.
2. Leakage from Public Expenditure and Property: These leakages take the form of illicit and undeclared commissions or bribes (kickbacks or cuts). Also, most of the time, allocated funds for various anti-poverty programs never reaches the targeted people. Another aspect is pilferage or misappropriation of State Property.
3. Bribes: Bribes as a source of black income are common. These are used mainly to influence the decision of the authority dealing with a case, or the power to approve or recommend an application or

even to forward case files. This phenomenon of bribe taking leads to the spread of corruption from one work place to another.

Causes of Black Money

There are several causes for the generation of black money in the economy. The major contributory factors in this regard may be stated as under:

1. **High Rates of Taxation:** High rates of taxation are basically responsible for inducing tax evasion and consequent black money generation in the country. The prevailing high rates of taxation the economies are one of the main causes of black money.
2. **Corrupt Business Practices:** The corrupt business practice such as smuggling and other restrictive trade practices cause the existence of black money in the country. In an economy under the environment of scarcities, controls and inflation, hoarding and black marketing are always profitable which apparently generate black incomes.
3. **Controls and Regulations:** Though the Governments resorts to the economic policy of controls with a good intention of dealing with the problem of shortage and effecting a fair distribution of essential goods with equity, their improper implementation vitiates the very purpose of controls. In many countries, the Government fixed up prices of various essential consumer goods like kerosene, wheat flour, vegetable ghee, drugs, etc. Their prices are controlled and the distribution is regulated. Along with various controls on imports and exports, tight exchange control is also implemented. Such controls are implemented with licenses, permits and quotas. Thus there have been statutory controls combined with the bureaucratic and administrative controls. These all pervasive economic controls are also responsible for the intensification of black money attuned evils like corruption, procedural wrangles, delays, artificial scarcity, fraud, suppression etc. involved in the very network of the bureaucratic public administration.
4. **Political Corruption:** This makes the fight against black income growth very difficult and is closely linked with evasion of taxes and customs duties. The political bribing of party and Government members is a common phenomenon. Donations to political parties were banned in 1968 and this has prompted businessmen to fund political parties, especially the ruling party, with black money. Politics is the main weapon for fighting social ills; and when this weapon itself gets corrupted; chances of tackling black income get bleak. The Politics-business-crime nexus that exists in our society is a result of, and further accentuates black income generation.

5. Bureaucratic Corruption: Controls breed corruption. Loose and dishonest public administration becomes an easy prey of corruption.

Corruption and black incomes are inter-linked. Corruption makes it easy to earn and enjoy black money. Today, “Speed Money”, “Secret Commission”, “Paper Weight”, “Mithai”, “Hush Money” have become almost a routine for getting any work done, legal or illegal, at official levels.

6. Prohibition: Certain activities are usually forbidden by law such as gambling, production of illicit liquor, smuggling, traffic in illegal drugs, lending at exorbitant interest charges, money lending without proper license etc. When some individuals wish to undertake these activities, these will apparently go unreported and incomes so earned would be totally black.

7. Public Expenditure: the Government itself lives in the Glass House, as the rapid growth of its spending over the last two decades has been a major contributory factor in generating black money. Due to the rapid rise of public spending for multiple Governmental programmes and activities, the unscrupulous elements in public service and public life could find ample opportunities for amazing black income and wealth by dubious methods.

8. Inflation: The genesis of black money can also be found in the persistent inflation in the country, which has enhanced incentives and opportunities to earn such incomes. Inflation inevitably leads to growth of parallel markets and strengthens propensities to hide incomes and to evade taxes. Since inflation causes capital erosion, there is always a temptation to maintain dual accounts for tax evasion by “Diverting portion of inventories and output from white channels to black channels of deployment”. As the matter of fact, inflation is both the cause as well as consequence of the growth of black money in many economies.

10. Deficiencies of the Tax System: There are various lacunas in the tax system that encourages generation of black income. First, high personal Income Tax Rates cause people to try and evade taxes, and thus lead to generation of black income. The dilemma for the Government is that even efforts at lowering tax rates do not lead to larger payments of income tax by the higher income groups. Although there are a number of tax laws pertaining to income tax, sales tax, stamp duties, excise duties etc. enforcement is weak due to widespread corruption in these departments.

11. Quotas, Controls and Licenses: The “License, Quota that has dominated the system of controls has often led to the initiation of various ways of escaping these and, thus, the generation of black income.

12. **Generation of Black Income in the Public Sector:** There are huge investments marked for the public sector in every five-year plan. The usage of these has to be monitored by the bureaucrats in Government departments and public sector undertakings. A symbiotic relationship often develops between the contractors, bureaucrats and politicians. Costs are often artificially escalated and underhand deals generate black money.

13. **Inadequacy of Powers:** The inadequacy of the powers given to the tax enforcing authorities is another important cause for black money.

14. **Weak Deterrence:** Despite of adequate legal provisions to curb the growth of black economy in, it has persisted because of weak deterrence against tax evasion in practice. No serious action has been taken against detected cases of tax evaders. Till recently, too trivial penalties were imposed, too few prosecutions have been launched and even fewer have been convicted.

15. **Ineffective Enforcement of Tax Laws:** Ineffective enforcement of tax laws is also a cause for black money. Lack of proper training and inefficiency of the department people led to the creation of black money.

16. **Lack of Publicity:** Another reason for wide spread black money is said to be the secret provision of direct tax laws. At present, the department is statutorily prohibited from disclosing any information relating to a person's assessment. Thus, even if a person is caught and penalized for keeping black money, he can keep it as secret from every one.

17. **Deteriorated Public Morality:** Moral values and social attitudes of many people have changed during recent years. In today's society black marketers, smugglers, corrupt politicians, public officials and tax evaders are not condemned, but rather admired and envied for possessing black money power.

18. **Demonstration Effect:** The conspicuous consumption and luxurious life style of black moneyed people have created a sort of demonstration effect on many others to inspire for such consumption patterns.

Effects of Black Money: Black money is a socio-economic evil. The existence of rapidly growing black money in our economy has grave and disastrous consequences. The major effects of black money are discussed below:

1. **Dual Economy:** The outgrowth of black money over a long period of time has given rise to the perpetual growth of economic dualism comprising "Parallel" economy (black money economy) operating side by side with the "Official" or "Reported" economy on the country. The black economy

represents not less than one fifth of the aggregate economic transactions. There is also interaction between the reported and unreported activities such that it is difficult to identify black money from the white money economy. Such a “Parallel Economy” will ruin the entire economic development of the country.

2. Under-estimation: A large underground economy and growth of black income lead to under-estimation of the true size and incorrect picture of the economy by the officially compiled national income data. Since unreported economy is apparently excluded from the official records of the GNP the estimates of savings and consumption of nations to the national income and measurement of other macro-economic variables would be biased and misleading for accurate policy making and planning considerations.

3. Loss of Revenue to the Government: Black money is largely attributed to tax evasion. Its direct impact is the loss of the Government revenue. Since the Government fails to get sufficient tax revenue due to large-scale tax evasion, it is forced to resort to high taxation and deficit financing which again carry their ill-economic effects.

4. Under-mining the Equity: When the Government resorts to progressive direct taxation to maintain equity in the distribution of the tax burden, the tax evasion and growth of black money affect the very concept of social justice by not allowing the desirable reduction in inequalities of incomes. Again, when underground activities like smuggling etc. could not be taxed, the Government will impose higher taxes on officially sanctioned activities. Further, the tax evasion will also equally enjoy the public services without paying the due contribution; to that extent also social enquiry is undermined. The honest have to bear high tax burden to make up for the deficit in revenue caused by the tax evasion of black money makers.

5. Widening the Gap between the Rich and the Poor: Growth of the black economy causes regressive distribution of income in the society. When the black money grows faster, rich becomes richer and the poor become poorer. By way of concentration of income and wealth in few hands, the black money widens the gap between the rich and the poor.

6. Lavish Consumption Spending: Black money is disposed off by lavish spending on travels and tours, entertainment, ostentatious articles, financing of extravagant elections etc. This has also lead to many social evils and deteriorated the values of life of the common people.

7. Distortion of Production Pattern: The black money has altered the choice coefficients in the market in favor of luxuries, which lead to the diversification of productive resources from essential goods to the non-essential goods.

8. Distribution of Scarce Resources: Black money holders are always in a position to put their prior claim over the scarce goods in the market due to their readiness and ability to pay more, thereby depriving the honest and poor people from their legitimate share. This obviously reduces the net economic welfare of the society at large.

9. Deteriorate the General Moral Standards of the Society: Black money is largely responsible for the deterioration of general moral standards of the society. Black income generation implies a deviation from the accepted norms in society and from the point of view of the society is unethical.

Socially, we can say that the structure and ethos of a society undergoes a massive change. Social values of honesty, hard work, thrift and simplicity get eroded. Even the political institutions and organizations lose their credibility, as they also gradually become a part of the entire system of black income generation.

10. Average Effect on Production: As a consequence, the consumption pattern is tilted in favor of the rich and elite, at the cost of encouraging production of articles of mass consumption. A rise in overall consumption leaves fewer resources for investment in priority areas, having an adverse effect on production.

Remedies for the Black Money

The menace of ever raising black money in Ethiopian economy is very high. It is accepted by all that tax evasion generate black money. Such staggering extent of black money has activated a parallel economy in the country and it affects the vital sectors of the economy. The Government in the past has already tried certain measures with little success. If steps are not taken immediately to reduce the black money, it may ruin the entire economy of the country.

The important remedial measures for controlling black money are given below:

1. Demonetization: Demonetization of currency of high value could help to unearth the black money to a large extent. However, in order to solve the problem arise on account of demonetization, proper step should be taken. It is advocated for eroding a substantial part of black liquidity on the presumption that black income held in cash will not be presented for conversion. Demonetization may succeed in reducing the quantum of black money but it cannot prevent the generation of black money altogether.

2. Voluntary Disclosure Scheme: The Government may adopt the policy that those who voluntarily disclose their black income of the past to the taxation authorities will not be punished and penalties may be waived or minimized.

3. Raids: Income tax department's powers have to be considerably enlarged and it should be empowered to conduct raids on the premises and properties of the taxpayers or any other individuals and can seize the unaccounted income and wealth and take necessary legal actions against the tax evaders.

4. Rationalization of Controls: Since ill-devised controls are major causes of black money, it is essential to rationalize the control system. Recently, the Government has taken some steps in this direction by easing the licensing policy etc. But still there are many cumbersome rules and formalities and unnecessary control in many areas, which need to be effectively rationalized.

5. Taxation Reforms: Ethiopia needs a rationalized tax structure. A reduction in marginal tax rates, simplification of tax structure, taxation laws and improvements in tax administration will be helpful in the reduction of black money.

6. Vigorous Prosecution: The research also recommended that the department should completely re-orient itself to a more vigorous prosecution policy in order to instill a wholesome respect for the tax-laws in the minds of the taxpayers.

7. Rewards and Awards: In order to encourage the honest taxpayers and create a positive attitude in the minds of the people towards the payment of tax, this can be adopted.

The other qualifications considered for the purpose of the award are that the person concerned should not only pay the highest tax but should also file the returns in time, prompt payment of taxes including self-assessment tax without default, no penalty for concealment of income should have been levied, no prosecution for offenses under the Tax Proclamations and related provision of Criminal Code should have been launched, no search undertaken under the Direct Tax laws should have been conducted, and should have been co-operative with the department in the completion of assessments.

Besides the above, no official patronage or recognition or awards should be given to persons who have been penalized for keeping the black money or in whose case prosecution proceedings have been taken.

9. Publicity: In view of the deterrent effect, the nature of all persons in whose cases penalties have been imposed for the concealment of income, wealth etc. should be published in the gazettes as well

as in the press, giving details of their names, addresses and the amount of penalties etc. If the assessee is a company or firm, the names of all the Directors of the Company or Partners of the firm should be published.

10. Arousing Public Conscience: A special drive should be undertaken to arouse public conscience by enhancing the co-operation of the leaders in various walks of life.

11. Other Measures:

a. People should be educated with regard to real object of collections of taxes through press, radio, TV, and films. b. Steps should be taken to convince the taxpayers that the money collected through taxes is not spent wastefully but put to proper use.



Activity 2.17

1. Describe the concepts of tax avoidance, evasion and black money, their effects & remedial measures.

2. Why tax avoidance is not illegal act of tax payers? Explain by giving examples.

Unit Summary

- ◆ Taxation is a system of raising money to finance government.
- ◆ History of taxation in Ethiopia comes with the establishment of the government.
- ◆ A tax is “a compulsory charge imposed by the Government without any expectation of direct return in benefit ”.
- ◆ Government levies and collects taxes for various objectives. These objectives may be specific or general.
- ◆ Principles (theories) of taxation are the appropriate criteria to be employed in the development and evaluation of one country.
- ◆ The following are the important canons of taxation.
 - Canons Advocated by Adam Smith;
 1. Canon of Equality. 2. Canon of Certainty. 3. Canon of Convenience. 4. Canon of Economy.
 - Canons Advocated by Others:
 5. Canon of Productivity. 6. Canon of Elasticity. 7. Canon of Diversity. 8. Canon of Simplicity. 9. Canon of Expediency. 10. Canon of Co-ordination. 11. Canon of Neutrality.
- ◆ A direct tax is paid by a person on whom it is levied. In direct taxes, the impact and incidence fall on the same person.
- ◆ Under indirect taxes, the impact and incidence fall on different persons. It is not borne by the person on whom it is levied and can be passed on to others.
- ◆ Tax rates can easily describe the policy of a country regarding taxes.
- ◆ Tax rate structure expresses the relationship between the tax rate and tax base in a country.
- ◆ Impact of a tax is on the person who bears the money burden in the first instance.
- ◆ Shifting of a tax refers to the process by which the money burden of a tax is transferred from one person to another person.
- ◆ Incidence of a tax refers to the money burden of a tax, which is on the person who ultimately bears it.
- ◆ Taxation might have different effects in an economy. It is used to promote economic growth by controlling the effects of trade cycles and regulating the production and consumption.
- ◆ Tax avoidance is different from tax evasion, while evasion is against the law; avoidance is within the ambit of law

Model Examination Questions

1. Discuss the concept of tax and why essential for government?
2. List and discuss the elements of taxation
3. List and discuss at least six features of taxation.
4. Clearly discuss basic principles of Taxation.
5. What is basic difference between **benefit received approach** and **ability - to - pay approach**
6. List and discuss Canons taxation Advocated by Adam Smith.
7. What is basic difference between tax impact, tax shifting and tax incidence.
8. What is basic difference between direct and indirect tax and give examples.
9. List and discuss at least five merits of direct taxes.
10. Briefly list and discuss types of tax system and what are advantages and disadvantages of each types of tax system.
11. List and discuss at least three theories of tax shifting or incidence of taxation.
12. Discuss the effect of taxation in an economy.

Answers to Model Examination Questions

Dear students, please refer to the notes pages in the unit to get answers to the model Examination Questions.

UNIT THREE: PUBLIC FINANCE IN ETHIOPIA

- Unit Objectives
- Unit Introduction
- Contents:
 - 3.1 Principles of Federal Finance
 - 3.2 Modes of Allocation of Revenue Resources in Federal Government
 - 3.3 Disbursing and Transfer of Public Funds
 - 3.4 Objectives of Revenue sharing
 - 3.5 Basis for Revenue Sharing
 - 3.6 Budget and its Process in Ethiopia
 - 3.7 Budget Deficit
 - 3.8 Methods of Financing Deficit
 - 3.9 Objectives of Deficit Financing
 - 3.10 Effects of Deficit Financing
 - 3.11 Deficit financing in Ethiopia
- Unit Summary
- Model Examination Questions
- Answers to Model Examination Questions

Unit/ Learning Objectives

After learning this unit, students will be able to:

- ♣ Know the Principles of Federal Finance
- ♣ Explain Modes of Allocation of Revenue Resources in Federal Government
- ♣ Understand the concepts of Disbursing and Transfer of Public Funds
- ♣ State the Objectives of Revenue sharing
- ♣ Describe Basis for Revenue Sharing
- ♣ Analyze Budget and its Process in Ethiopia
- ♣ Explain Budget Deficit, its financing and effects in Ethiopia

• Unit Introduction

Where the government's functions are divided between two sets of authorities i.e. the Central Government, and the State Governments, it is called a federal system. A federation is an association of two or more states. The member states of a federation have the Union Government for the whole country and there are State Governments for the parts of the country.

A federation is a form of Government in which the political power is divided between the Central and State Governments such that each Government within its own area is independent of each other.

Federal finance refers to the system of assigning the source of revenue to the Central as well as State Governments for the efficient discharge of their respective functions i.e. clear-cut division is made regarding the allocation of resources of revenue between the central and state authorities.

3.1 Principles of Federal Finance

???

Pretest

Dear students, please guess intelligently the concept of federal system of finance?

In the case of federal system of finance, the following main principles must be applied: 1. Principle of Independence. 2. Principle of Equity. 3. Principle of Uniformity. 4. Principle of Adequacy. 5. Principle of Fiscal Access. 6. Principle of Integration and Co-ordination. 7. Principle of Efficiency. 8. Principle of Administrative Economy. 9. Principle of Accountability.

1. **Principle of Independence:** Under the system of federal finance, a Government should be autonomous and free about the internal financial matters concerned. It means each Government should have separate sources of revenue, authority to levy taxes, to borrow money and to meet the expenditure. The Government should normally enjoy autonomy in fiscal matters.

2. **Principle of Equity:** From the point of view of equity, the resources should be distributed among the different states so that each state receives a fair share of revenue. The allocation of resources should be made in such a way as to give equitable treatment to the individuals and business firms in different places.

3. **Principle of Uniformity:** In a federal system, each state should pay equal tax payments for federal finance. But this principle cannot be followed in practice because the taxable capacity of each unit is not of the same. Since this principle of uniformity emphasis on the uniformity of pattern of expenditure in all the states, equality of contribution imposes heavy burden on backward states.

4. Principle of Adequacy of Resources: The principle of adequacy means that the resources of each Government i.e. Central and State should be adequate to carry out its functions effectively. Here adequacy must be decided with reference to both current as well as future needs. Besides, the resources should be elastic in order to meet the growing needs and unforeseen expenditure like war, floods etc.

5. Principle of Fiscal Access: In a federal system, there should be possibility for the Central and State Governments to develop new source of revenue within their prescribed fields to meet the growing financial needs. In nutshell, the resources should grow with the increase in the responsibilities of the Government.

6. Principle of Integration and Co-ordination: The whole financial system of a federation should be well integrated. There should be a perfect co-ordination among different layers of the financial system of the country. Then only the federal system will prosper. This should be done in such a way to promote the overall economic development of the country.

7. Principle of Efficiency: The financial system should be well organized and efficiently administered. There should be no scope for evasion and fraud. No one should be taxed more than once in a year. Double taxation should be avoided.

8. Principle of Administrative Economy: Economy is the important criterion of any federal financial system. That is, the cost of collection should be at the minimum level and the major portion of revenue should be made available for the other expenditure outlays of the Governments.

9. Principle of Accountability: In a federal set up, the Governments both Central and States enjoy financial autonomy. Thus, in such a system each Government should be accountable to its own legislature for its financial decisions i.e. the Central to the Parliament and the State to the Assembly.



Activity 3.1

List & describe the principles of federal system of finance. W/c of these principles is/re effectively applied in Ethiopia?

3.2 Modes of Allocation of Revenue Resources in Federal Government

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Pretest

Dear students, please guess intelligently the scheme of allocation of financial resources between the centre and the states in federal Government?

In a federal Government, allocation of financial resources between the centre and the states is of great importance. While allocating the resources, the principles of uniformity, adequacy, autonomy, transference, administrative economy and federal control are to be followed. These principles are not exclusive. They are interdependent.

Modes of Allocation:

There are two types of allocation. They are as follows:

1. Independent System: Under this system, the units in a federation are deriving their revenue from absolutely different sources. There would be no concurrence or contact between the centre and the units.
2. Mixed System: Under this system, there would be concurrence and contact between the centre and the units. This system is divided into two viz., concurrent mixed system and the contact mixed system.

In the concurrent mixed system, both centre and the states have concurrent powers of taxation regarding certain sources. There would be no transfer of resources from the centre to the states.

In the contact mixed system, contact between the centre and the states is created. There would be assignments, subsidies, subventions or contributions.

Balancing Factors of Allocation:

Prof. Adarkar points out that it would be impossible to think about an independent system. The most desirable system of federal finance must ensure large measure of independence and adequacy. If either the centre or the states are not able to meet their requirements, it should be made good by certain balancing factors. The balancing factors are those, which would make good the financial inadequacy of either the centre or the states in a federation. They are as follows:

1. Assignments: Usually the Federal Government levies and collects certain taxes. But it is shared on an agreed basis with the states. Of course the distribution of this share between the states is very difficult. The basis of distribution may be as follows: 1. On the basis of actual collections from different states. 2. On the basis of population and 3. On the basis of economic backwardness of the states.
2. Subsidies: The states very often find themselves with financial stringency. They are granted certain subsidies by the center on account of the transfer of certain sources like customs or excises to the center.

3. Subvention: Subventions are grants-in-aid to redress certain inequalities between states. They are made for specific purposes. They should be spent for the purpose for which they are made. The spending of the amount would be under the supervision of the granting authority.

These are the bases and modes of allocation of funds between the center and the states. The distribution of financial sources in Ethiopia is based on the recommendations of the Ministry of Finance and Economic Development. Ethiopia is a federal state and the Central-Regional financial relations are based on the principle of federal finance. The word federation connotes the union of two or more states. In a federation we have on the one hand, the Federal Government or Central Government and on the other, the Constituent States. Federation may be defined as a form of political association in which two or more states constitute a political unity with a common Government, but in which these member states retain a measure of internal autonomy. Thus, in a federation, there is constitutional division of powers, functions and resources between central and the state governments. The two sets of governments are independent so far as their own functions and resources are concerned.

Ours is a system of federal finance, with center and states sharing responsibilities and resources. The areas of the government's budgetary operation (i.e. receipts and expenditures) between the centre and the states are demarcated. In addition there takes place financial transfer from the centre to the states. The sharing implied in the system has contributed a lot to the country's progress. But this has also given rise to many problems relating to center-state relationship.

In a federation two constitutionally independent fiscal systems operate upon the fiscal resources of the individual citizens. There is multiplicity of taxing and spending authority in a federation. It may be called multi-unit public finance. Thus, the federal finance faces the problem of 'financial arrangement' between the Central Government and States.

In federal system, the functions and duties of the State are divided between central and state governments and they are generally defined in the constitution. The federal system in Ethiopia comprises a central government and Regional Governments. These developments have potentially major implications for public finances in Ethiopia.



Activity 3.2

Why the mixed system is preferable to the independent system for countries like Ethiopia?

3.3 Disbursing and Transfer of Public Funds

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Pretest

Dear students, what are the essential components the structure of federal finance?

The structure of federal finance comprises two essential components. One is the division of powers between the Union and the states in respect of rising and disbursing of public funds the second relates to the transfer of funds from the center to the states.

The general principle on which the allocation of functions and duties are based is "whatever concerns the nation as a whole, principally external relations and interregional activities should be placed under the control of the central government and that all matters which are primarily of regional interest should remain in the hands of the Regional Government".

There are three principles that govern the division of taxes between the center and the states. One, taxes which have an inter-state base is levied by the union government; and taxes with a local base are levied by state governments. Two, there is the concurrent list falling within the jurisdiction of both the center and the states. Three, the residuary powers rest with the central government i.e. it has exclusive authority to impose taxes which are not specifically mentioned either in the state list, or in the concurrent list.

Pattern of Revenue Sharing:

Ethiopia has chosen the federal structure in which a clear distinction is made between the Union and State functions and sources of revenue, but residual powers, belong to the Center, although the States have been assigned certain taxes, which are levied and collected by them, they also share in the revenue of certain Federal taxes. In addition, the States receive grants-in-aid of their revenue from the Federal Government, which further increase the amount of transfers between the two levels of government. The transfer of resources from the Central government to the States is an essential feature of the present financial system.

Distribution of Revenues between Central and States

The present federal fiscal system in Ethiopia is of a recent origin. The distribution of revenues between the centre and states is followed on the basis of "Constitution of Ethiopia" and Proclamation No.33/1992-Proclamation "To Define sharing of Revenue between the Central Government and the National/Regional Self Governments". The Articles 96, 97, 98, 99 and 100 of The Constitution of Ethiopia make a clear demarcation of areas where the Central alone or State alone have authority to impose taxes. It contains a detailed list of the functions and financial resources of the Center and States.

Activity 3.3

By reading the relevant articles in the constitution, describe the revenue sharing patterns between the federal and states Governments of Ethiopia. Comment also on its fairness.

3.4 Objectives of Revenue sharing

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Pretest

Dear students, what are the Objectives of Revenue sharing between the central government and the National/Regional Governments?

The sharing between the central government and the National/Regional Governments shall have the following objectives: 1. Enable the central Government and the National/Regional Governments efficiently carry out their respective duties and responsibilities. 2. Assist National/ Regional Governments develop their regions on their own initiatives; 3. Narrow the existing gap in development and economic growth between regions; 4. Encourage activities that have common interest to regions.

Activity 3.4

Explain the Objectives of Revenue sharing between the central government and the National/Regional Governments

3.5 Basis for Revenue Sharing

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Pretest

Dear students, what are the basis of Revenue sharing between the central government and the National/Regional Governments?

The sharing of revenue between the central government and the National/ Regional governments shall take in to consideration the following Principles: 1. Ownership of source of revenue; 2. The National or Regional character of the sources of revenue; 3. Convenience of levying and collection of the tax or duty; 4. Population, distribution of wealth and standard of development of each region; 5. Other factors that are basis for integrated and balanced economy.

Categorization of Revenue

According to "Constitution of Ethiopia" and Proclamation No.33/1992-Proclamation, revenues shall be categorized as Central, Regional and Joint. That is there are three lists given in the Articles. They are as follows: 1. Central List, 2. Regional List, and 3. Joint/Concurrent List.

The important sources of revenue under "Constitution of Ethiopia" and "The Proclamation No.33/1992-Proclamation to define sharing of Revenue between the Central Government and the National/Regional Self Governments" are explained below.

1. Central List:

The sources of revenue are given under Federal/Central List, are as follows:

- a). Duties, tax and other charges levied on the importation and exportation of goods;
- b). Personal income tax collected from the employees of the central Government and the International Organizations;
- c). Profit tax, Personal income tax and sales tax collected from enterprises owned by the Central Government. (Now sales tax is replaced with VAT and Turnover taxes).
- d) Taxes collected from National Lotteries and other chance winning prizes;
- e). Taxes collected on income from air, train and marine transport activities;
- f). Taxes collected from rent of houses and properties owned by the central Government;
- g) Charges and fees on licenses and services issued or rented by the central Government;

2. Regional List:

The following shall be Revenues for the Regions:

- a). Personal income tax collected from the employees of the Regional Government and employees other than those covered under the sources of central government.
- b) Rural land use fee.
- c) Agricultural income tax collected from farmers not incorporated in an organization.
- d) Profit and sales tax collected individual traders.
- e) Tax on income from inland water transportation.
- f) Taxes collected from rent of houses and properties owned by the Regional Governments;
- g) Profit tax, personal income tax and sales tax collected from enterprises owned by the Regional Government;
- h) With prejudice to joint revenue sources, income tax, royalty and rent of land collected from mining activities.

i). Charges and fees on licenses and services issued or rented by the Regional Government;

3. Joint/Concurrent List:

The following shall be Joint revenues of the Central Government and Regional Governments:

- a) Profit tax, personal income tax and sales tax collected from enterprises jointly owned by the central Government and Regional Governments;
- b) Profit tax, dividend tax and sales tax collected from Organizations;
- c) Profit tax, royalty and rent of land collected from large scale mining, any petroleum and gas operations;
- d) Forest royalty.

4. Committee for Revenue sharing:

1. A committee accountable to Council of Ministers, whose function is to study conditions and submit recommendations guiding sharing of revenue shall be designated by the Prime Minister.
2. Members of the committee shall be: a) Central Government representatives concerned and;
b) Representative of the regional executive committee concerned with the agenda to be discussed.
- 3) Based on the objectives and principles indicated under this Article the committee shall study and submit its recommendations to the Council of Ministers on:
 - a) the percentages in which the joint revenues of the central Government and the National/Regional Governments shall be shared;
 - b) measures for resolving issues that may from time to time arise regarding sharing of revenues;
 - c) amendments or changes, as the case may be, to the revenue categorization.
- 4) The details of the duties and responsibilities of the committee shall be defined by the directives, to be issued by the council of ministers.

5. Subsidy:

National/Regional Governments, where deemed appropriate, shall receive subsidies from the Central Government. National/Regional Governments shall before the approval of their budget, submit to the Ministry of Finance and to The Ministry of Planning and Economic Development ,their subsidy request, together with the total expenditure required for the fulfillment of objectives given in the Proclamation.

The Ministry of Finance and Economic Development shall review the subsidy request submitted to them from the various Regions on the basis of the objectives and in relation to the Central Government revenue collection.

The amount of subsidy to be granted shall be on the basis of Budget Formula specified by the Ministry of Finance and Economic Development.

6. Relations of Tax Systems:

According to Article-8 of Proclamation No.33/1992-Proclamation, it is stressed that in order to avoid cascading incidence effect of the tax levied by the center and the regions and to enable the harmonized implementation there of the tax system shall have unified policy base.

The Ministry of Finance shall ensure that the tax Laws issued at both levels adhere to the provisions of this Article. Accordingly shall distribute Fiscal Policy Studies and Directives.

The tax rates levied on types of taxes jointly owned by the central Government and the Regional Governments shall be fixed by the Central Government.

7. Collection of Revenue:

Central Government revenues and revenues jointly owned by the Central Government and National/Regional Governments shall be collected by the Central Government revenue collection organs. However, whenever deemed necessary the collection of such revenues may be delegated to regional Governments. National/Regional Governments shall collect their own revenues.



Activity 3.4

Explain the basis of Revenue sharing between the central government and the National/Regional Governments & comment on its fairness.

3.6 Budget and its Process in Ethiopia

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Pretest

Dear students, what do know about Concept of Budgeting &its process in Ethiopia? The Concept of Budgeting in Ethiopia

The government budget represents a plan/forecast by government of its expenditures and revenues for a specified period. Commonly government budget is prepared for a year, known as a financial year or fiscal year. In Ethiopia the fiscal year is from July 7 of this year to July 6 of the coming year (Hamle 1-Sene 30 in Ethiopian calendar). Budgeting involves different tasks on the expenditures and revenues sides of government finance. On the side of expenditure, it deals with the determination of the total deals with the determination of the total size of the budget (i.e total amount of money for the

year), size of outlays on different functions, and the magnitude of outlays on various activities; on the revenue side, it involves the determination of the size of the overall revenue and foreign aid.

Furthermore, budgeting also address the issue of the budget deficit (i.e. the excess of outlays over domestic revenues), and its financing. Budgeting is not solely a matter of finance in the narrow sense. Rather it is an important part of government's general economic policy. Budget is not solely a description of fiscal policies and financial plans, rather it is a strong instrument in engineering and dynamiting the economy and its main objectives are to devise tangible directives and implement the long term, medium term, and annual administrative and development programs".

2. Budget Structures in Ethiopia

Budget structures are the formats that organize budget data. Budget data could be classified in different ways and for different purposes. In the early days, for instance, budget classification basically focused on providing a better understanding of the intentions and purposes of government for which funds were planned and to be spent. Later on, the budget structures started to be influenced largely by the issue of accountability. That is in addition to providing information on what the government proposed to do, the budget structures indicate the full responsibility of the spending agency. To this end the budget heads or nomenclatures the full responsibility of the spending agency. To this end the budget head or nomenclature of the budget are mostly mapped to each spending agency. This should not, however, imply unnecessarily extended and detailed structure (or mapping). Perhaps, due consideration must be taken to make the structure manageable and appropriate. The first classification of the budget is between revenue and expenditure.

I. Revenue Budget:

It represents the annual forecast of revenues to be raised by government through taxation and other discretionary measures, the amount of revenues raised this way differ from country to country both in magnitude and structure, mainly due to the level of economic development and the type of the economy.

In Ethiopia, the revenue budget is usually structured into three major headings: ordinary revenue, external assistance, and capital revenue. Hence, the funds expected from these three sources are proclaimed as the annual revenue budget for the country. The revenue budget is prepared by the Ministry of Finance (MoF) for the federal government and by Finance Bureaus for regional governments.

Ordinary revenues include both tax and not tax revenues. the tax revenues being direct taxes (personal income tax, rental income tax, business income tax, agricultural income tax, tax on dividend and chance wining, land use fee and lease); indirect taxes (excise tax on locally manufactured goods, sales tax o locally manufactured goods, service sales tax, stamps and duty); and taxes on foreign trade (customs duty on imported goods, duty and tax on coffee export). Non tax revenues include charges and fees; investment revenue; miscellaneous revenue (e.g. gins); and pension contribution. The second major item in revenue budget is external assistance. It includes: cash grants, these are grants from multilateral and bilateral donors for different structural adjustment programs; and technical assistance in cash and material form. The third item is capital revenue. This could be from domestic (sales of movable properties and collection of loans), external loan from multilateral and bilateral creditors mostly for capital projects, and grants in the form of counterpart fund.

II. Expenditures Budget:

Government expenditures for administration and developmental activities are handled through the expenditures budget. These expenditures are categorized into recurrent and capital expenditures. This categorization gained acceptance since the Great Depression of the 1930s. The recurrent budget which covers the current expenditures is financed in principle by taxation (more broadly by domestic revenue from tax and non tax sources), and the capital budget which covers the acquisition of newly produced assets in the economy is financed through external borrowing and grants.

The Expenditure Budget includes the following two types of Budgets:

1. Recurrent Budget 2. Capital Budge

1. Recurrent Budget: Financial proclamation 57/1996 and financial regulation 17/1997 defined only the capital budget, implicitly defining the recurrent one as a residual. To common practice, however, is to include in the recurrent budget expenditures of recurrent nature (like salaries of civil servants) and fixed assets with a multi-year life.

The recurrent budget is structured by implementing agencies (public bodies) under four functional categories: administrative and general services, economic services, social services, and other expenditures. All public bodies then fall under one of these functional categories. The budget hierarchy will then be down to sub agencies.

2. Capital Budget:

Capital budget is budget for capital expenditures. Financial proclamation 57/1996 defined capital expenditure as “an outlay for the acquisition f improvements to fixed assets, and includes

expenditures made for consultancy services.” Financial regulations 17/1997 further provided a detailed definition of capital expenditures to mean:

- a. The acquisition, reclamation, enhancement as laying out of land exclusive of roads, buildings or other structures;
- b. The acquisition, construction, preparation enhancement or replacement of roads, buildings and other structures;
- c. The acquisition, installation or replacement of movable plant, machinery and apparatus, vehicles and vessels;
- d. The making of advances, grants or other financial assistance to any person towards him/her on the matters mentioned in (a) to (c) above or in the acquisition of investments; and
- e. The acquisition of share of capital or loan capital in any body corporate;
- f. Any associated consultancy costs of the above.

The capital budget is presented under three functional groups viz., economic development, social development, and general development. Economic development includes production activities (agriculture, industry, etc.), economic infrastructure facilities (mining, energy, road etc.), commerce, communication, and so on. Social development includes education, health, urban development, welfare and so on. General development include services like cartography, statistics, public and administrative buildings, and the like.

2. The Budget Process in Ethiopia

Budgeting from the initial stage of forecasting the annual revenues and expenditures, to the final stage of approval of the annual budget by the Council of Peoples Representatives, passes through a sequential and an iterative process. This budgeting process includes:

- ✚ Preparation of the macro-economic and fiscal framework;
- ✚ Revenue forecast and determination of expenditure budget ceiling;
- ✚ Allocation of expenditure budget between Federal and Regional governments;
- ✚ Allocation of Federal government expenditure budget between recurrent and capital budgets:
- ✚ Budget call and ceiling;
- ✚ Budget review by MoF and MoED;
- ✚ Budget hearing and defense;
- ✚ Review and recommendation;
- ✚ Submission of the budget to the council of Ministers;

- ✚ Submission of the budget to the Council of Peoples' Representatives:
- ✚ Notification and publication of the budget; and
- ✚ Allotment.

The budget process thus includes all these stages, which obviously are sequential (one after the other) and iterative. Budget being a one-year plan prepared for the coming fiscal year it requires a time schedule (deadlines) for each and every processes that should strictly be adhered to. The time schedule is usually handled through the budget calendar. In effect the budget calendar is the major instrument to manage the budgetary process. The only dates proclaimed by law are the final approval and notification dates of the budget. Financial proclamation 57/1996 states that “the budget appropriation shall be approved by the council of peoples Representatives by Sene 30 (July 6) and all public bodies shall be notified by Hamle 7 (July 13). “The other deadlines in the process of budgeting will be set by the Ministry of Finance and Economic Development who are responsible for the preparation of the recurrent and capital budgets, respectively. The Ministry of Finance and Economic Development will notify the spending public bodies well ahead of time about the important deadlines, the budget ceiling and other information through the budget circular. The budgeting process usually took between six to eight months, and the Ministry of Finance and Economic Development (MoFED) will release the budget circular around November to December.

1. The budgetary process at the federal level

The budget processes at the Federal level follows sequential and iterative the steps. Let us briefly explain these steps one by one here under:

Step one - Macro-Economic and Fiscal Framework:

The preparation of the macro-economic and fiscal framework is basically a component of the recently initiated public investment program (PIP). It is a planning practice and as stated in Ministry of Economic Development, the macro-economic and fiscal framework determines the overall level of government expenditures based on policies related to the role of government in the economy, government deficits, and priorities for resource allocation between regions and sectors. For the Federal government the framework is a three years forecast and will be updated each year.

The framework is composed of macro-economic forecast and fiscal forecast. The macro-economic forecast gives the forecast of Gross Domestic product based on past performance and estimates for future years, and provides base line information in preparing the fiscal forecast. Financial Regulation 17/1997 gave the responsibility of preparing this framework to the MoFED. Whereas, the later,

establishes the level of total resources available for expenditure. It provides a more detailed forecast of revenue (both Federal and Regional), end projection of expenditure. Given the policy of no borrowing from domestic banks to finance budget deficit the level of expenditure mainly depend on the amount of resources to be raised in the form of domestic revenues and external fund that include counterpart funds. Once prepared by the concerned coordinating ministry, i.e. MoFED, it will be reviewed and approved by the Prime Minister's Office (PMO).

Step Two- Determination of Federal Government Expenditure and Subsidy to Regional Governments:

After the revenue and expenditure of the government are estimated through the fiscal framework, the PMO will decide on the shares of Federal government expenditures and subsidies Regional governments. it is known that, following the decentralization policy, Regional governments took grants from the Federal government in the form of subsidy. Once the amount of subsidy is known, the allocation among regions is determined on the basis of a formula. Initially the formula was composed of five parameters (population, level of development, revenue generating capacity, utilization capacity, and land area). At present, however, the formula takes account of three parameters: population, the level of development, and revenue generating capacity of each region which are given a relative weight of 60%, 25% and 15% respectively. This allocation will first be prepared by MoFED, then reviewed by the PMO and finally approved by the Council of peoples' Representatives.

Step three: Allocation of Federal Expenditure between Recurrent and Capital Budget

The practice in the allocation of recurrent and capital budget is to consider the latter as a residual. That is, first the amount of budget necessary to cover such recurrent expenditures like pensions, debt servicing, wages and non-wage operating costs will be determined. The balance will then be allotted to capital expenditures. This will be performed by the PMO in consultation with MoFED.

Step Four - Budget Call and Ceiling Notification:

This includes two items. They are:

a). Recurrent budget: MoFED will release the budget ceiling to the line ministries in a budget call. The budget call provides each ministry such information as the macroeconomic environment, an aggregate recurrent budget ceiling, and priorities to budget.

b). Capital Budget: MoFED issues detailed capital budget preparation guidelines to spending public bodies along with the ceilings provided to each line institution. MoFED will set the ceiling for each sector.

Step Five - Budget Review by MoFED:

This includes two items. They are:

- 1. Recurrent Budget:** Prior to a formal budget hearing, spending public bodies will submit their budget proposals to the MoFED -Budget Department. In consultation with spending public bodies, MoFED will prepare an issue paper on Major issues at each head level in the proposed budget. Here, spending public bodies can submit above the ceiling but need to have a compelling justification
- 2. Capital Budget:** The sector departments of MoFED review the capital budget requests from different public bodies. At this stage projects will be screened. If there exist a discrepancy between the respective sector department and the public body, a series of discussions will be held to reach agreement. After such a process the various sector departments of MoFED will submit their first round recommendation to the Development Finance and Budget Department of MoFED. Then it will be consolidated and prepared for the capital budget hearing and defense.

Step Six - Budget Hearing and Defense:

This includes two items. They are:

- 1. Recurrent Budget:** Spending public bodies defend their budget submission in a formal hearing with the MoFED. The issue paper will be the basis of the hearing. The hearing focuses on policies, programs and cost issues, when necessary it might involve discussion down to line item. Spending public bodies could also challenge the ceiling. Presenting the hearing will be ministers and/or vice ministers, heads of public bodies and the MoFED.
- 2. Capital Budget:** Spending public bodies will be called to defend their projects to a budget hearing convened by the PMO which will be chaired by the prime Minister or the deputy Prime Minister or the their economic advisers. The hearing customarily includes a review of status of the project, implementation capacity of the institution, compatibility with the countries development strategy and policy, cost structure, and regional distribution. A project description will be presented which includes objectives of the project, main activities of the project, status of the project, total cost, past performance of the project, source of finance, and whether the project is accepted or rejected by MoFED. On the basis of the discussion the respective sector departments of MoFED in consultations with the spending public body will further refine the capital projects.

Step Seven - Review and recommendation:

This includes two items. They are:

1. Recurrent budget: After the hearing is over, the budget committee of the MoFED will review the discussion and make a recommendation. If there is an increase (over ceiling) this will go to the PMO for approval.

2. Capital budget: After the hearing and defense with the PMO and MoFED, sector departments of MoFED will give a final recommendation to the development finance and budget department of MoFED. This will then be compiled and put in appropriate formats for submission to the council of ministers.

Step Eight: Submission to the council of Ministers:

At this stage the two budgets (recurrent and capital) will be consolidated, and MoFED will prepare a brief analysis of the total budget.

1. Recurrent budget: The recommended budget will be submitted to the deputy Prime Minister for economic affairs. This will first be reviewed by ministers and vice ministers in economic affairs, and then presented to the Prime Minister along with a brief. The Prime Minister may or may not make amendments and then the budget will be sent to the council of Ministers for discussion.

2. Capital Budget: A brief analysis of the capital budget will be prepared by MoFED on the final recommended budget and, along with the consolidated capital budget, will be submitted to the council of ministers. MoFED will defend the budget in the council. The council of ministers may make some adjustment and the draft capital budget will pass the first stage of approval.

Step Nine - Submission to the Council of Peoples' Representatives:

Once approved by the council of ministers, the Prime Minister will present both the recurrent and capital budget to the council of peoples' representatives. The budget will then be debated based on the recommendation of the budget of the committee.

Step Ten - Notification and Publication:

The approved budget will then get the legal status through the publication in the 'Negaret gazeta.' Spending public bodies will then formally be notified of their approved budget by line items from MoFED for recurrent and capital budgets, respectively. MoFED will notify spending public bodies through Form 3/1. Likewise, MoFED will inform through Form 3/2. Both Forms will be copied to the Treasury Department of the MoFED which disburse funds to spending public bodies. Until Form 3/1 is released spending public bodies are authorized to spend one-twelfth of the previous year's budget with no provision for new expenditures (e.g. new staff posts) in the case of recurrent budget. For

capital budget spending public bodies are authorized to use approved budget for ongoing projects even when Form 3/2 is not released.

The final stage of the budgetary process is to request spending public bodies to prepare adjusted work plan and cash flow for the approved budget. The adjusted work plan and cash flow will be verified by MoFED -for the recurrent budget-and by MoFED -for the capital budget, and then will be sent to the treasury Department of the MoFED.

Step Eleven - Supplementary Budget:

In the course of the budget year supplementary (additional) budget will be proclaimed when necessary, following almost the same process as the initial budget preparation. Likewise budget reallocation will be made mainly based on performance.

The budgetary process at the regional level

It is quite difficult to present the budget process at the Regional level in the way discussed for Federal Budgeting. At present the budget process followed by regions is not uniform. Hence, let us discuss the process of budgeting in a more general terms without referring to a particular region.

The process is more or less a mirror image of the Federal budget process. In place of MoFED the Regional Finance Bureau (RFB) is responsible for the preparation of the recurrent budget. While the Regional planning and Economic Development bureau (RPEDB) is responsible for the capital budget. At the higher level, the Regional council is the one responsible for the appropriation of the region's budget. One significant deviation is, the regional budget process starts at the woreda level and goes up to Zone and Region levels.

1. Pre-ceiling Budgeting:

Pre-ceiling budgeting is the budgeting practice at the woreda and zone levels before the region receives its subsidy/grant from the Federal government. The process is as follows: the woreda prepares a budget with no indicative or final ceiling from the Zone or the Region. The Finance Office will consolidate the budget of the sectoral offices and submit to the woreda council. The woreda executive committee will then form a budget committee to review the budget. This budget will be sent to the zone through two channels: one, the woreda council submit the budget to the zone executive committee,; second, the woreda sectoral offices send to the zone sectoral departments. The zone executive committee will then form a budget committee that will be chaired by the head of the Finance Department, to review the woredas' and zones' budget proposal.

In passing the budget to the region it will again be through two channels. The zone executive committee submits to the Region executive committee and the zone sectoral departments will submit to the region sectoral bureaus. The sectoral bureaus then prepare a budget submission to the Region Finance Bureau.

2. Post-ceiling Budgeting:

Following the notification of the subsidy from the Federal government, the regional public expenditure envelope will be determined based on the Federal subsidy, local revenue and local borrowing. Once the expenditure envelope is set, then it will be split up between recurrent and capital expenditures. The practice is similar to the Federal government, i.e. the allocation begins with recurrent expenditures and the balance of the envelope will be reserved for capital expenditures.

After this stage, different regions follow different approaches to allocate recurrent expenditure between salary and organization and management, and to allocate capital expenditure among the different sectors. In some regions the budget will be prepared up to line items at the region level, where as in some regions a lump sum will be allotted to zones that will be in turn allocated to woredas. At last, the budget will be published in the region's 'Negarit gazeta'.



Activity 3.6

1. List & explain the budget process the central government

2. List & explain the budget process the state governments

3. Do you think the budget preparation process is participatory in Ethiopia?

3.7 Budget Deficit

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Pretest

Dear students, what do you mean the term Budget Deficit?

A budget is considered as surplus or deficit according to the position of the revenue accounts of the government. Thus a surplus budget is one in which revenue receipts exceed expenditure charged to revenue account regardless of the gap in capital accounts; while a deficit budget is one in which expenditure is greater than current revenue receipts.

Budget deficit is the excess of total expenditure over total revenue of the government. The deficit financing denotes the direct addition to gross national expenditure through budget deficits whether the deficits are on revenue or capital accounts”. It implies that the expenditure of the government over and above the aggregate receipt of revenue account and capital account is treated as budget deficit of the government.

The meaning of deficit financing is different in different countries. In western countries, the budget gap, that is covered by loans is called deficit financing because, if the government borrows from the banks rather than from individuals the idle funds will be activated and there will be an increase in the total public expenditure and thus there will automatically be an deficit financing has been used in a different sense,. Here it is used to denote the direct addition to gross national expenditure as a result of budget deficit. Thus deficit financing can be defined as “the financing of a deliberately created gap between public revenue and public expenditure”. The government of Ethiopia has used deficit financing for acquiring funds to finance economic development. When the government cannot raise enough financial resources through taxation, it finances its developmental expenditure through borrowing from the market or from other sources.

Activity 3.7

Explain the concept of budget deficit.

3.8 Methods of Financing Deficit

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Pretest

Dear students, what are the Methods of Financing Budget Deficit?

There are four important techniques through which the Government may finance its budgetary deficits. They are as follows:

1. Borrowing from central bank
2. The running down of accumulated cash balances
3. The government may issue new currency
4. Borrowing from market or from external sources.

Under the first method, government borrows from central bank as per budgetary policy. In the second source, government spends from available cash balance,. In the third measure, government issues new currency for financing deficit. The last method is that government borrows from internal and external sources to finance its deficit.

Activity 3.8

What are the methods of financing budget deficit used by federal and regional governments of Ethiopia? _____.

3.9 Objectives of Deficit Financing

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Pretest

Dear students, state the Objectives of Deficit Financing?

1. Deficit financing has generally been used as a method of meeting the financial needs of the government in times of war, when it is considered difficult to mobilize adequate resources.
2. Keynes advocated deficit financing as an instrument of economic policy to overcome conditions of depression and to raise the level of output and employment.
3. The use of deficit financing has also been considered essential for financing economic development especially in under developed countries.
4. Deficit financing is also advocated for the mobilization of surplus idle and unutilized resources in the economy.

Activity 3.9

Explain the objectives of financing budget deficit used by federal and regional governments of Ethiopia? _____.

3.10 Effects of Deficit Financing

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Pretest

Dear students, explain the effects of Deficit Financing?

Deficit financing has both positive and negative effects in the economy as under:

1. Inflationary rise in prices: The most serious disadvantage of deficit finance is the inflationary rise of prices. Deficit financing increases the total volume of money supply. Unless there is proportional increase in production this can lead to inflation. When deficit financing goes too far it becomes self-defeating. There was inflationary pressure during the decade due to deficit financing.
2. Effects on distribution of wealth and income: The real income of wage earners gets reduced and that of entrepreneurs/ businessmen increased, leading to distribution of wealth in favour of business class
3. Faster growth: Country is able to implement the developmental plans through deficit financing thereby attaining faster growth.

4. Change in pattern of Investment: Deficit financing leads to encouragement for investment in certain fields like construction, luxury consumption inventory holding and speculation. This may lead to investment in undesirable fields.

5. Credit creation in banks: Inflationary forces created by deficit financing are reinforced by increase credit creation by banks.

Among various fiscal measures, deficit financing has been assigned an important place in financing developmental plan and various developing countries including Ethiopia resort to deficit financing to meet budgetary gaps.

Activity 3.10

Explain the positive and negative effects of financing budget deficit in the economy.

3.11 Deficit financing in Ethiopia

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Pretest

Dear students, identify the methods Deficit financing in Ethiopia?

Deficit financing in Ethiopia was mainly resorted to enable the Government of Ethiopia to obtain necessary resources for the plans. The levels of outlay laid down were of an order, which could not be met only by taxation or through a revenue surplus. The gap in resources is made up partly through external assistance. But when external assistance is not enough to fill the gap, deficit financing has to be undertaken. The targets of production and employment in the plans are fixed primarily with reference to what is considered as the desirable rate of growth for the economy. When these targets cannot be achieved through resources obtained from taxation and external borrowing, additional resources have to be found. Deficit financing is the easier option. It is important to emphasize the fact that deficit financing cannot create real resources which do not exist in the economy.

Activity 3.11

Explain the practical implementation of deficit financing Ethiopia.

Unit Summary

- ✓ In the case of federal system of finance, the following main principles must be applied: 1. Principle of Independence. 2. Principle of Equity. 3. Principle of Uniformity. 4. Principle of Adequacy. 5. Principle of Fiscal Access. 6. Principle of Integration and Co-ordination. 7. Principle of Efficiency. 8. Principle of Administrative Economy. 9. Principle of Accountability

- ✓ In a federal Government, allocation of financial resources between the centre and the states is of great importance. There are two types of allocation; Independent System & mixed system
- ✓ The structure of federal finance comprises two essential components. One is the division of powers between the Union and the states in respect of rising and disbursing of public funds the second relates to the transfer of funds from the center to the states.
- ✓ According to "Constitution of Ethiopia" and Proclamation No.33/1992-Proclamation, revenues shall be categorized as Central, Regional and Joint.
- ✓ The government budget represents a plan/forecast by government of its expenditures and revenues for a specified period.
- ✓ Budget structures are the formats that organize budget data.
- ✓ The first classification of the budget is between revenue and expenditure.
- ✓ In Ethiopia, the revenue budget is usually structured into three major headings: ordinary revenue, external assistance, and capital revenue.
- ✓ Government expenditures for administration and developmental activities are handled through the expenditures budget. These expenditures are categorized into recurrent and capital expenditures.
- ✓ Budgeting from the initial stage of forecasting the annual revenues and expenditures, to the final stage of approval of the annual budget by the Council of Peoples Representatives, passes through a sequential and an iterative process
- ✓ Budget deficit is the excess of total expenditure over total revenue of the government.
- ✓ There are four important techniques through which the Government may finance its budgetary deficits. They are as follows:
 - ☞ Borrowing from central bank
 - ☞ The running down of accumulated cash balances
 - ☞ The government may issue new currency
 - ☞ Borrowing from market or from external sources.
- ✓ Deficit financing has both positive and negative effects in the economy
- ✓ Deficit financing in Ethiopia was mainly resorted to enable the Government of Ethiopia to obtain necessary resources for the plans.

Model Examination Questions

1. How the government finance budget deficit? List and discuss at least four modes of financing deficit.
2. Discuss the budgetary process at the regional level
3. What is budgeting and list at least four function of budget. Discuss how it is prepared, passed and executed.
4. What are motives behind sharing revenue between central and regional government
5. List and discuss at least five principles of federal finance.
6. Do you think that surplus budget create negative opinion on Government? If you say Yes/No justify your reasons.
7. What are the objectives of deficit financing in Ethiopia?

Answers to Model Examination Questions

Dear students, please refer to the notes pages in the unit to get answers to the model Examination Questions.

UNIT FOUR: ETHIOPIAN TAX SYSTEM: DIRECT AND INDIRECT TAX

Unit/ Learning Objectives

After the completion of this unit, students will be able to:

- ◆ Understand the tax provision in Ethiopia
- ◆ Identify the direct and indirect taxes in Ethiopia
- ◆ Understand the determination and administration of income taxes in Ethiopia
- ◆ Explain tax basis, computation and administration of VAT, TOT and excises taxes.

Unit Introduction

Taxation is the major source of revenue for both regional and federal governments in Ethiopia. The taxation includes both direct and indirect taxes. The existence of collective consumption of goods and services necessitates putting some of our income into government hands. Such public goods like roads, power, municipal services, and other public infrastructures have favorable results on many families, business enterprises, industries and the general public.

Public goods are normally supplied by public agencies due to their natures of non-rivalry and non-excludability. The nature of consumption of public goods is such that consumption by one does not reduce consumption for others. Besides, consumption of public goods by an agent does not exclude others from doing same. Such nature of public goods therefore makes them impossible for private suppliers to avail them at market prices like other commodities. Government intervention in the supply of public goods is therefore inevitable and can only be done if the public pays taxes for the production and supply of such goods. Despite the fact that people need to pay taxes based on rationales of vertical and horizontal equities, it is not always the case that tax systems are comprehensible and transparent for tax payers especially for less literate business operators. The main purpose of this unit is to aware the students the different types of taxes existing in Ethiopia and some of the purposes for which the tax revenues are utilized.

The tax reforms of 2016 provides for these direct and indirect taxes in the following proclamations: Income tax proclamation 979/2016 and income tax regulation 78/2002; VAT proclamation 285/2002 and VAT regulation 79/2002; Excise tax proclamation 307/2002; Turnover-tax proclamation 308/2002 and Customs proclamation 622/2009

DIRECT TAX IN ETHIOPIA

Dear student, so far we have been discussing the theoretical concepts of taxation and classification of taxes. This section discusses the direct tax system in the Ethiopian and the types of direct tax.

The major direct taxes existing in Ethiopia includes: tax on income from employment, business profit tax, tax on income from rental of buildings, tax on interest income on deposits, dividend income tax, tax on income from royalties, tax on income from games of chance, tax on gain of transfer of certain investment property, tax on income from rental of property, rendering of technical services outside Ethiopia, agricultural income tax and land use tax. The taxes on earning of taxpayers during a given period of time are in general called income taxes. In Ethiopia incomes are taxed based on scheduler approaches of taxation where incomes are categorized in to different schedules based on their nature and sources for tax purpose. The working law on income taxation in Ethiopia, the Income Tax Proclamation No. 979/2008, has classified sources of income into four schedules. Accordingly, there are four schedules of income for tax purpose as it is provided in income tax proclamation.

The first schedule, Schedule A, income from employment; the second schedule, Schedule B income from rent of land and buildings used for purposes other than agricultural purposes; the third schedule, Schedule C income from business profit, professional and vocational occupations, the exploitation of woods and forests for lumbering purposes and from interest; finally, the fourth schedule, Schedule D, income from other income sources. By basing on these schedules, income was charged progressively. Employers were required to declare the incomes of employees and employees of more than one organization/institution were required to declare the total amount of their income from their employments. However, for comprehensive understanding, income taxes in Ethiopia readers are strongly advised to refer to the proclamation 979/2016.

4.1. EMPLOYMENT INCOME TAX ACCOUNTING (SCHEDULE A)

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Pretest

Dear students, what do you mean the term employment income?

What is employment income?

The primary goal of any income tax system is the equitable collection of revenue. To this effect, the Ethiopian government has taken measures to broaden the tax base and introduced new taxes and reformed the tax structure. As stated earlier, to meet the expenditures of government, the Government

of Ethiopia levies both direct and indirect taxes. One of the direct taxes, the employment tax, is levied and collected as per the proclamations issued from time to time.

Employment income tax is a tax on the earnings of an employee. Employees who earn birr 601 per month and above are liable to pay employment income tax. The government collects this tax from any individual employees, other than contractors, engaged whether on a permanent or temporary basis to perform services under the direction and control of the employer. Employment income includes any payment or gain in cash or in kind received from employment by the employee subject to certain exemptions

Employment Income is taxed under schedule “A”. The employment income tax deductible at source on the system known as PAYE (Pay As You Earn) in almost all the countries through the world. In employment income tax, the taxpayers are employees of private, non-governmental or governmental organizations. Employee shall mean, any individual, other than a contractor, engaged to perform services under the direction and control of employer either on a permanent or temporary basis. EIT is applied on residential status of 183 days. A person who is employed and generating employment income whether he/she is an Ethiopian or foreign citizen living in Ethiopia for more 183 days must pay employment income tax. As per Article 12 of Income Tax Proclamation No. 979/2016, employment income shall include any payments or gains in cash or in kind received from employment by an individual from all the employers. Employment income includes:

4.1.1. Components of Employment Income

A. Basic Salary or Wage

Basic salary or wage means a regular payment to which an employee is entitled in return for the performance of the work that he performs under a contract of employment this is payment received by the employee for regular or normal working hours. That is, the time during which a worker actually performs work or avails himself for work in accordance with law, collective agreement or work rules. The regular workings hours may vary from country to country and organization to organization even within the same country. In Ethiopia, Normal working hours shall not exceed eight hours per day or Forty eight hours a week.

Normal working hours: the time during which a worker actually performs work or avails himself for work in accordance with the law, collective agreement or work rules. But, payment like overtime payment, amount received by way of per-diem, hardship allowance, transport allowances, transfer expenses and similar allowance payable to the worker on the occasion of travel or change of his

residence, bonus, commission, other incentives paid for additional work results, service charge received from customers.

B. Overtime Work

Overtime work is a payment made to an employee for overtime work done during a specific payroll period. That is a payment made for the work done in addition to one's regular working hours. According to Article No. 66(1) of Labor Proclamation No. 377/2003, work done in excess of the normal daily hours of work shall be considered over time. To compute the overtime income, first we have to determine the Regular Hourly Rate. This is the payment per hour for regular or normal working hours. It is determined as follows:

- Regular Hourly Rate (RHR) = Basic Salary/Normal Working Hours
- Overtime Earning = OT Hrs. Worked @ (Ordinary Hourly Rate @ OT Rate)
- OHR = Basic Salary/normal working hours in a month

Where: RHR = Regular Hourly Wage Rate and OHR = Ordinary Hourly Rate

In Ethiopia, there are four over time payment durations. In addition to his normal wage, an employee who works over time shall be at least to the following overtime payments.

- 1. Ordinary hours:** For OT work b/n 6 am to 10 pm, $OHR = RHR \times 1.25$
- 2. Late Hours:** For OT work b/n 10 pm to 6 am, $OHR = RHR \times 1.5$
- 3. Rest Days:** For OT work on weekly rest days, $OHR = RHR \times 2$

A worker shall be entitled to a weekly rest period consisting of not less than twenty four non-interrupted hours in the course of each period of seven days. The employee rest day fall on Sunday and is granted simultaneously to all of the workers of the undertaking unless otherwise determined by a collective agreement to some other day of the week. We may assume employee rest days to be weekends. But, it can also be one of the week days. If the Rest day is for an employee is Thursday according to the collective agreement and then the employee is obliged to enter office on this day, he/she will be paid 2 times his RHR.

- 4. Holiday:** For OT work on public holidays, $OHR = RHR \times 2.5$

Ethiopia has more twelve public holidays. These holidays comprises historical memorial holidays of Christian origins and Muslim origins and National holidays designated by the law. A worker who is paid on a monthly basis will not be subjected a reduction in wages for not working on public holiday. If public holiday coincide with a rest day designated by a labor proclamation or any other special law, the workers shall be entitled to only one payment for working on such day.

- C. Allowances:** Allowances are special payments or benefits made to employees for various reasons. These may include, but not limited to, transportation allowance, house allowance, position allowance, hardship allowance, desert allowance, representation allowance, etc.
- D. Per-Diem:** Per-Diem is payment of daily expenses of an employee incurred for duty such as expenditures for food, bed, transportation (traveling expenses) and others.
- E. Bonus:** Payment made to employees of businesses as acknowledgment of employees' hard work and effort in generating beyond expected amount of profits/attractive profit because of best performance of the employees. Bonus allowed only once a year.
- F. Employment Termination Payment:** Under, Art. No. 36 to 41 any case of termination provokes payment obligations. Upon termination of employment contract, the following payments are made to employees:
- ◆ Severance Payment
 - ◆ Job Search Payment
 - ◆ Compensation Payment
 - ◆ Annual Leave Payment
 - ◆ Job Termination Bonus
- A. Severance Pay:** It is the payment made to an employee whose contract of employment is terminated as compensation of the service years. A worker who has completed his probation shall have the right to get severance pay from the employer in Ethiopia (Article 39 of Labor Proclamation 377/2003). The severance pay shall be thirty times his or her daily wages of the last week of service for the first year of service; for the service less than one year, severance pay shall be calculated in proportion to the period of service. If the worker has served for more than one year, payment shall be increased by one-third of the previous sum for every additional year of service, within the limit of a total amount of twelve months salary.
- B. Job Search Payment:** When a contract of employment is terminated for the reason that the undertaking ceases operation permanently due to bankruptcy or for any other cause and reduction of work force by the undertaking, the worker is entitled to be paid an additional severance pay of a sum equal to 60 multiplied by his average daily wage of the last week of service (two months basic salary).
- C. Compensation Payment:** A worker who terminates a contract of his employment on the ground that there is good cause to terminate a contract such as act committed by employer against the dignity and morals of employees, imminent danger threatening the worker's safety or health and

failure to fulfill obligations towards employee shall be paid a compensation 30 (thirty) times his/her daily wages of the last week of service (one month basic salary).

- D. Annual Leave Payment:** It is prohibited to pay wages in lieu of the annual leave. But, a worker whose contract of employment is terminated is entitled to pay for the leave he has not taken.
- E. Job Termination Bonus:** Sometimes organizations which are reducing work forces may give additional bonus to employees whose contract is terminated.

Who Pays Employment Income Tax?

Every employee is required to pay a portion of his/her monthly employment income in the form of tax to the government. Employers have an obligation to calculate and withhold the tax from each payment to an employee (employment income tax) and to pay to the tax authority the amount withheld during each calendar month.

Taxation on income and property occupies a prominent (important; famous) position in the fiscal policy of almost all countries of the world. The modern economy is characterized by the existence of a large number of taxpayers. These taxpayers include public enterprises, government, all corporations and other legal entities, branches of foreign companies, non-incorporated businesses, individual proprietorship, individuals, professionals and small traders. Revenue from individual income tax may not be a major portion of total government revenue in any country. Even if it is not a major revenue producer, its characteristics make it important for purposes of improving equity and income distribution.

Activity 4.1

1. What are components of employment income tax?

2. List and discuss at least four employment termination payment to employees upon termination of contracts.

4.1.2. Basic Legal Provisions of EIT

The legal provisions of employment income are taken from Income Tax Proclamation No. 979/2016 and Ethiopian Council of Ministers Income Tax Regulation No. 78/2002.

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Pretest

Dear students, what do you mean the term taxable employment income?

Taxable Employment Income and tax rates

At this point, you should give attention that employment income differs from taxable employment income in income tax provision. Employment income tax will be charged, levied and collected monthly on the basis of taxable employment income of every preceding month at the specified tax rate. If the payment received is for a period larger than a month, the tax payable shall be computed by prorating the income received over the number of months covered by such payment. Employment income attributable to the months of 'Nehassie' and 'Pagumen' is aggregated and treated as the income of one month.

Taxable employment income is the amount of income from employment which is subject to employment income tax. Taxable employment income from employment includes all payments in cash and in kind received by the employees in the country other than non-taxable incomes. In determining the taxable income, any income received from former employment and prospective employment, if any, shall also be included. However, it does not include exemptions

Employment Income Tax Exemptions

Exemptions are employment incomes, which are exempted from employment income tax. As per of Art 13 of Proclamation No 979/2016 the following payments in cash and benefits in kind are exempted from inclusion in monthly income for the determination of employment tax.

- A. Income from employment received by casual employees: Casual employees are those who do not regularly work under the same employer for a period of 12 months.
- B. Pension contribution, provident fund contributions and all forms of retirement benefits – not more 18% of basic salary
- C. Income from employment received by diplomatic and consular representatives; and other persons employed in any Embassy
- D. Income specifically exempted from income tax by any law in Ethiopia (Six hundred (600) birr of the monthly employment income of an employee).

- E. Payments made to a person as compensation or gratitude in relation to personal injuries suffered by that person; or the death of another person.

Council of Ministers exempted some of the incomes for economic, administrative or social reasons. The following categories of payments in cash or benefits in kind shall be excluded from computation of income taxable under Schedule “A” (Art. No.3 ECMR No. 78/2002):

- **Medical Allowance:** amounts paid by employers to cover the actual cost of medical treatment of employees.
- **Transportation Allowance:** allowances in lieu of means of transportation granted to employees under contract of employment. Transportation allowance exempted from tax payable for employee is only up to 1/4th (one forth) of the total salary of the employee and in any circumstances the amount of transportation allowance exempted from tax must not be more than Birr 2,200 (Two thousand Two hundred Birr). The permitted transportation allowance exempted from tax is only for the task which is carried out by moving from place to place due to the nature of the work and that is clearly stated in contractual agreement between the employer and employee.
- **Hardship Allowance/Disturbance Allowance:** Payment made to an employee as a result of change in work place
- **Per-diem Allowance (Daily Allowance):** Amounts paid to employees in reimbursement of travelling expenses incurred on duty. These payments may include expenditures on food, bed, transportation and others. Maximum of Br 225 or 4% of salary.
- **Traveling Expenses:** Amounts paid to employees resulted from elsewhere than the place of employment on joining and completion of employment or in case of foreign travelling expenses from or to their country, provided that such payments are made pursuant to specific provisions of the contract.
- **Board Allowances:** allowances paid to members and secretaries of boards of public enterprises and public bodies as well as members and secretaries of study groups set up by the federal or regional government.
- **Income of persons employed for domestic duties:** For example: monthly salary of House guards and house servants.
- Reimbursement made by the employer of traveling expenses incurred on duty by the employees.

- Allowances paid to members and secretaries of Boards of Public Enterprises, public bodies, and study groups set up by Federal or Regional Government.
- Income of persons employed for domestic duties.
- Persons employed in any embassy, legation(a diplomatic minister and staff), consulate, or mission of a foreign state who are nationals of that state and bearers of diplomatic passport
- Income specifically exempted from payment of tax by any law, international treaty; or agreement approved by the Minister of Finance and Economic Development or Council of Ministers Regulation for economic, administrative or social reasons.
- Income received as compensation or gratitude (appreciation of kindness; thankfulness) in relation to personal injuries or death of another person.

Remember that the above stated income types, whoever receives them, are not to be included in the taxable income to determine tax. For example, government employees in the country get a pension contribution given by the employer (i.e. the government) at a percentage less than 18%. It is known that the contribution towards pension by government is 7% in the country for civil servants. If you relate the rule to this, the employees need not pay tax to this contribution. Likewise, according to the above rule, daily workers who do not permanently work under the same employer need not pay the tax.

If any employer pays tax for employees, without being deducted from income, the said amount shall be added to the taxable income for the determination of tax. Earlier you have studied that income types that are subject to tax in the country are divided in to different schedules. Note that tax on employment income is listed as ‘Schedule A’ income tax as per the income tax proclamation No. 979/2016 or 979/2008.

4.1.3. Employment Income Tax Rate

Specific tax rates are provided in the prevailing income tax proclamation for calculating employment income tax. You know that tax rates are usually stated in percentages. Ethiopian tax rate is not an exception to this rule. Every employer is required to pay a specific percentage of the salary that he/she receives. Ethiopian employment income tax rate is a progressive tax rate which demands more revenue collection as the income increases. It also incorporates the vertical equity principle and the principles of productivity. The payment date is made convenient for the taxpayers, as they are required to pay taxes at the end of each month, the time when they get their salary. If you analyze the tax, you will see that the principle of certainty also is equally applied.

Every person having income from employment in any government or other private organization or non-Governmental organization, such as NGOS, and if his/her income from employment includes any payments or gain in cash or in kind which he/she receives from employers is supposed to pay income tax. Employment income tax rate is applied progressively to different tax brackets. The Ethiopian Employment Income Tax (**Schedule “A”**) has seven tax brackets. Article 11 of Income Tax Proclamation No. 979/2016 provides that the following tax rate schedule shall be applied on employment income.

Schedule “A”			
Employment Income Tax per Month			Tax Liability
TB	Over Birr	To Birr	Tax Rate
1 st	0	600	Exempt
2 nd	601	1650	10%
3 rd	1651	3,200	15%
4 th	3,201	5,250	20%
5 th	5,251	7,800	25%
6 th	7,801	10,900	30%
7 th	10,901	XXXX	35%

Table 3 Employment income tax rates

According to the above tax rate schedule, employees who earn up to 601 birr a month are below the threshold for paying employment income tax. It is presumed that this exemption has removed hundreds of thousands of low income employees from the tax roll. However, employees who earn 601 birr per month and above are liable to pay employment income tax. In order to impose a heavier tax burden on those employees who earn more, the government uses a progressive employment income tax system. Tax on income from employment has seven (6) bands or groups of rates. These are 10%, 15%, 20%, 25%, 30% and 35%. The minimum tax rate applied to income from employment is 10 percent while the maximum is 35 percent. These bands of rates in the above schedule are used to compute the tax due. While applying this rate, it should be made clear that from the taxable income, Birr 600 is not to be taxed. On the remaining, the first Birr 1050 is subject to tax at 10%, the next Birr 1550 is taxed at 15%, the next Birr 2050 is taxed at 20%, the next Birr 2250 is taxed at 25%, the next Birr 3100 is taxed at 30%, and any remaining amount of salary is taxed at 35%.

Who shall calculate and the tax due?

????

Pretest

Dear students, what do you know the authorized body to calculate tax due?

Unless the payment is tax-exempt, the employer is responsible for calculating and withholding the tax from every payment to an employee and to forward it to the Tax Authority. By the Tax Authority, we mean the Ethiopian Revenues and Customs Authority (ERCA) Head Office or any of its branch offices established in any part of Ethiopia and the tax authorities of the Regional State.

The tax to be paid to the Tax Authority by the employers can be transmitted through financial institutions delegated by the Authority or through electronically filing and payment system.

How employers can determine the tax due?

To determine the tax to be withheld, the employer may use a simple calculation method. In Ethiopia, employers can determine the tax to be withheld by following 3 key steps.

1. First add all the payments in cash and in kind made to their employees in a month.
2. Refer/consult a tax schedule (schedule that shows how much tax is owed for different amounts of income earned by the employee) to find the tax rate applicable on the income earned by the employee.
3. Multiply the taxable income by the tax rate and then minus the deductible fee: as indicated in the tax schedule.

Determination of Employment Income Tax

Employment income shall include any payments or gains in cash or in kind received from employment by an individual, including income from former employment or otherwise, from prospective employment. Income received in the form of wages does not include representation and other similar expenditures on social functions, guest accommodations, etc. (Article No. 12, EITP No. 979/2016).

You are now aware of the fact that some of the employment income types received by an employee are subject to employment income tax and some are exempted. At this stage, we focus on the determination of employment income tax of those who pay that is, by applying the tax rules. The process starts with identifying the income items an employee receives in a month.

It may include the basic salary, overtime earning, allowances in the form of transportation, medical, position, conveyance and the like. The sum total of the payment an employee gets is his/her gross employment income. As stated earlier, some of the above items are exempted from inclusion in

taxable income. Deduction of these items from gross income will result in a figure called ‘taxable employment income’, which refers to taxable employment income is the income subject to tax or the income on which tax is determined. The employer applies the prescribed tax rates so as to determine the amount of employment income tax for a given month.

Example 1: Assume that the monthly salary of ato Biruk is Birr 3,280. Ato Biruk is not entitled to have any other allowance and hence the gross income is equal to his taxable income. His tax will be calculated as follows.

Total taxable income.....	3,280
Less: the minimum amount not taxed.....	(600)
Remaining taxable income.....	2, 600
Less: First Birr 1050 taxed at 10% (1050 X 10%)	105.00
Remaining taxable income, taxed at 15 %(1550 X 15%)	232.50
Remaining taxable income is taxed at 20 %(80x205).....	16
Total tax of the month.....	<u>353.50</u>

Thus, ato Biruk is required to pay tax of Birr 353.50 for the month.

The above example takes only the basic salary in to account. In addition to this, if an employee gets allowances that are taxable, these should also be taken in to consideration to determine the tax. Because the step-by-step computation of tax (progression method) illustrated above consumes time, the tax authority has developed a short cut method to determine tax. This can be seen from the following table.

Tax bracket	Range of TEI	Tax Rate	EIT Calculation	Deduction
1 st	0-600	Exempt	N No Tax Payment	0.00
2 nd	601-1650	10%	EIT = (1650 – 600) @ 10%=105.00	60.00
3 rd	1651-3,200	15%	EIT = (3200 – 1,650) @ 15%=232.50	142.50
4 th	3,201-5,250	20%	EIT = 5250 – 3,200) @ 20%=410.00	302.50
5 th	5,251 -7,800	25%	EIT = 7800 – 5,250) @ 25%=637.50	565.00
6 th	7,801-10,900	30%	EIT =(10,900 – 7,800) @30%=930.00	955.00
7 th	Over 10,901	35%	EIT = (XXX–10,900) @ 35%=XXX	1500.00

(Where TEI stands for the taxable income and EIC stands for employment income tax

If we apply the short cut method for computing the employment income salary of ato Biruk, it will be as given below. Gross salary of Birr 3280 comes under the tax bracket that is subject to 20% tax rate. Therefore employment income tax = $3208 \times 20\% - 302.50 = \text{Birr } 353.50$

Example: The basic salaries, allowances, and overtime payment of six employees for the month Meskerem 2011 are given below.

Name	Basic salary (Birr)	Allowances (Birr)	Overtime (Hrs.)
Almitu	1,500	100	12
Gulema	4,250	-	-
Kassa	2,380	-	5
Nati	3,940	210	-
Mulu	1,280	250	8
Dawit	1,640	450	-

Additional information:

The allowances paid to Nati and Dawit are for housing and traveling (on duty) respectively

The total number of working hours is 176 in the month

Overtime of Alemitu is paid at 150%, and Kassa and Mulu are paid at 125% of normal pay

Required: Compute the pay roll tax of the individual employees.

Hint: $\text{Overtime pay} = \text{Hourly rate} \times \text{OT Hrs.} \times \text{OT rate}$

$\text{Hourly rate} = \text{Basic salary} / \text{No of working hrs. in a month}$

Solution

A. Overtime payments

Alemitu.....	$1,500/176 (12 \times 1.5) = 153.4$
Kassa.....	$2,380/176 (5 \times 1.25) = 84.5$
Mulu.....	$1,280/176 (8 \times 1.25) = 72.72$

B. Taxable Income

Alemitu	= 1,500+100+153.4= Birr 1,753.4
Gulema	= Birr 4,250
Kassa.....	2,380+84.5= Birr 2,464.50
Nati.....	3,940+210= Birr 4,150
Mulu.....	1, 280+250+72.72= Birr 1,602.50
Dawit.....	1, 640+450= Birr 2,100

C. Payroll tax (taxable income multiple by tax rate)

Alemitu.....	1,754.4 x 15% - 142.50 = Birr 120.50
Gulema.....	4,250 x 20% - 302.50 = Birr 547.50
Kassa.....	2, 380 x 15% - 142.50 = Birr 214.50
Nati.....	3,940 x 20% - 302.50 = Birr 485.50
Mulu.....	1,602.50 x 15% - 142.50 = Birr 97.875
Dawit.....	2, 100 x 15% - 142.50 = Birr 172.50

Computation of Taxable Employment Income (TEI)

Every person deriving income from employment is liable to pay tax on that income at the rate specified in Schedule "A". But, the first Br, 600 of employment income is excluded from taxable income. Employers have an obligation to withhold the tax from each payment to an employee and to remit the amount of the tax withheld to the tax authority during each calendar month. In determination of employment income, income attributable to the months of Nehassie and Pagumen shall be aggregated and treated as the income of one month (Art. No.10 of EITP No. 979/2016). Taxable Employment Income is defined as income which is subject to Employment Income Tax. It is determined as follows:

TEI = Gross Employment Income – Special Tax Exemption – Tax Allowances

- 1. Gross Employment Income:** refers to any income earned from employment sources regardless of the way it is earned.
- 2. Tax Exemptions:** Is employment incomes exempted from EIT. Tax Exemptions are classified into two: Direct/Special Exemptions and Personal Exemption

☞ **Direct/Special Tax Exemptions:** are income directly exempted by the income tax proclamation in Ethiopia for special reasons. For example: Hardship allowance, transportation allowance, medical allowance, etc.

☞ **Personal Exemption:** is a non-taxable income for each employee under Schedule “A” per month. It is common to all employees regardless of their employment income, which is Br 600 per month. It is considered an income taxable at rate of 0%.

3. Tax Allowances – are amounts which are allowed or permitted to be deducted from Gross Employment Income for different reasons. For example: Mortgage allowance (deductible mortgage interest) to encourage home ownership, child care allowance (investment made on children) to encourage childcare, Charitable allowance (Charitable contributions) to encourage giving and others. However, there is no tax allowance in Ethiopia so that the formula for calculating taxable Employment income can be modified to the following form:

$$\text{TEI} = \text{Gross Employment Income} - \text{Special Tax Exemptions.}$$

The detail calculation can be in one of the following two ways

Alternative 1: When all payments are made at the end of the month

Determination of Taxable Employment Income

Basic salary.....	Xxxxx
Overtime Pay.....	Xxxxx
Transport allowance.....	Xxxxx
Other allowances.....	<u>Xxxxx</u>
Gross Employment Income.....	Xxxxx
Less: Special Tax Exemptions.....	<u>(Xxxxx)</u>
Taxable Employment Income.....	Xxxxx

Alternative 2: Special Exemptions can be paid any time

Determination of Taxable Employment Income

Basic salary.....	xxxxx
Overtime pay.....	Xxxxx
Taxable Transport allowance.....	<u>xxxxx</u>
Other Taxable allowances	xxxxx

Example: Ato Zerihun is a finance officer at Dashen Bank. Ato Zerihun earns monthly salary of Br 12,800 for 160 Normal Working Hours and the Employer's Contribution to Provident Fund is 20% of Zerihun's basic salary. He has worked for 20 overtime hours in weekly rest days during the month.

Required: Determine his Taxable Employment Income

Solution: Determination of Taxable Employment Income	
Basic salary	12,800.00
Overtime Pay ($20 * 12,800 / 160 * 2$).....	3,200.00
Provident Fund ($12,800 * 20\%$).....	<u>2,560.00</u>
Gross Employment Income	18,560.00
Less: Provident Fund ($12,800 * 18\%$)	<u>(2,304.00)</u>
Taxable Employment Income (TEI)	<u>16,256.00</u>
Employment income tax ($16,256 * 0.35$)-1,500.....	(4,189.6)
Net pay(home take money).....	<u>12,066.4</u>

Example: Dr. Belay is head of Human resource department of ABC Plc. Assume the following

- ✚ He gets a monthly salary of Br 15,280 for 176 normal working hours;
- ✚ He worked 10 hours during the month of Sene 2006 and all overtime work was done on weekly rest days.
- ✚ He has position allowance of Br 1000
- ✚ He is entitled to receive a Transportation Allowance of Br 2,800.

Required: Determine the Taxable Employment Income of Dr. Belay

Solution :Determination of Taxable Employment Income	
Basic salary	15,280.00
Overtime Pay ($10 * 15,280 / 176 * 2$).....	1,736.37
Transportation Allowance	2,800.00
Position Allowance.....	<u>1,000.00</u>
Gross Employment Income	<u>20,016.37</u>
Less: Transportation Allowance	<u>(2,200.00)</u>
Taxable Employment Income (TEI)	<u>17,816.37</u>
Employment income tax ($17,816.37 * 0.35$) -1,500	(4,737.724)
Net pay(home take money)	<u>15,280.64</u>

4.1.4. Accounting For Employment Income Tax

Accounting for employment income tax is concerned with determination of Taxable Employment Income as we discussed earlier. Accounting is also concerned with:

- A. Determination EIT Base i.e. Taxable Employment Income
- B. Calculation of Employment Income Tax;
- C. Preparation of Employment Income Tax Declaration; and
- D. Recording Employment Income Tax Related Transactions

Recording transactions is an overlapping activity with payroll accounting but the tax accountant need not consider other transactions on the payroll

Dear learner, what are three methods determining employment income tax?

4.1.5. Methods of Determining Employment Income Tax (EIT)

A. Progression Method

The EIT is computed progressively applying the tax rates in Schedule “A”

TB	Range of TEI	TR	EIT Calculation
1st	0-600	Exempt	No Tax Payment
2 nd	601-1650	10%	$EIT = (TEI - 600) @ 10\% = 105.00$
3 rd	1651-3,200	15%	$EIT = (TEI - 1,650) @ 15\% = 232.50$
4 th	3,201-5,250	20%	$EIT = (TEI - 3,200) @ 20\% = 410.00$
5 th	5251 -7800	25%	$EIT = (TEI - 5,250) @ 25\% = 637.5$
6 th	7801 -10,900	30%	$EIT = (TEI - 7,800) @ 30\% = 930.00$
7 th	Over 10,901	35%	$EIT = (TEI - 10,900) @ 35\% = XXX$

B. Deduction Method

$EIT = (\text{Gross Employment Income excluding Direct exemptions} \times \text{Marginal Tax Rate}) - \text{Deduction}$

$EIT = (\text{Gross Employment Income excluding Direct Exemption} \times \text{Marginal Tax Rate}) - \text{Deduction}$

Table 4.1:1 Employment Income Tax under Deduction Method

TB	Range of TEI	Tax Rate	Deduction	EIT Calculation
1st	0-600	Exempt	0.00	No Tax Payment
2 nd	601-1650	10%	60	$EIT = TEI @ 10\% - 60$
3 rd	1651-3,200	15%	142.50	$EIT = TEI @ 15\% - 142.50$
4 th	3,201-5,250	20%	302.50	$EIT = TEI @ 20\% - 302.50$
5 th	5,251 -7,800	25%	565	$EIT = TEI @ 25\% - 565$
6 th	7,801 -10,900	30%	955	$EIT = TEI @ 30\% - 955$
7 th	Over 10,901	35%	1,500	$EIT = TEI @ 35\% - 1500$

C. Addition Method

$EIT = Addition + (\text{Marginal Taxable Employment Income} @ \text{Marginal Tax Rate})$

$EIT = Addition + (\text{Marginal Taxable Employment Income} * \text{Marginal Tax Rate})$ OR

$EIT = Addition + [(\text{Taxable Employment Income} - \text{Lower Tax Bracket}) @ MTR$

$EIT = Addition + (\text{Taxable Employment Income} - \text{Lower Tax Base}) @ MTR$

NB: The “Addition” is equal to the EIT amount payable on the Previous Tax Bracket

Table 4.1.2: Employment Income Tax under Addition Method

TB	Range of TEI	TR	Addition	EIT Calculation
1 st	0-600	Exempt	0.00	No Tax Payment
2 nd	601-1650	10%	0.00	$EIT = 0.00 + (TEI - 600) @ 10\% = 105$
3 rd	1651-3,200	15%	105.00	$EIT = 105.00 + (TEI - 1,650) @ 15\% = 337.50$
4 th	3,201-5,250	20%	337.50	$EIT = 337.50 + (TEI - 3,200) @ 20\% = 747.50$
5 th	5,251 -7,800	25%	747.50	$EIT = 747.50 + (TEI - 5,250) @ 25\% = 1,385$
6 th	7,801 -10,900	30%	1,385	$EIT = 1,385 + (TEI - 7,800) @ 30\% = 2,315$
7 th	Over 10,901	35%	2,315	$EIT = 2,315 + (TEI - 10,900) @ 35\% = XXX$

Example: Determine the EIT to be paid by Ato Girma for income of Br 3,600 for the month of Hamle, 1999 under the three Employment Income Tax calculation methods

- A. Progressive method
- B. Deduction method
- C. Addition method

A. Progressive method(Solution)

TB	Range of TEI	TR	EIT Calculation
1st	0-600	Exempt	No Tax Payment
2 nd	601-1650	10%	EIT = (1650 – 600) @ 10%=105.00
3 rd	1651-3,200	15%	EIT= (3200 – 1,650) @ 15%=232.50
4 th	3,201-3,600	20%	EIT = (3600 – 3,200) @ 20%=80
Total amount of tax paid by ato Girma is= 105 +232.50+80=417.50			

D. Deduction method(Solution)

TB	Range of TEI	TR	Deduction	EIT Calculation
1st	0-600	Exempt	0.00	No Tax Payment
2 nd	601-1650	10%	60	EIT = 1,650 @ 10% – 60= 105
3 rd	1651-3,200	15%	142.50	EIT = 3,200@ 15% – 142.50= 337.50
4 th	3,201-3600	20%	302.50	EIT = 3,600 @ 20% – 302.50= 417.5

E. Addition method(Solution)

TB	Range of TEI	TR	Addition	EIT Calculation
1 st	0-600	Exempt	0.00	No Tax Payment
2 nd	600-1650	10%	0.00	EIT = 0.00 + (1,650 – 600) @ 10%= 105
3 rd	1650-3,200	15%	105.00	EIT = 105.00 + (3,200 – 1,650) @ 15% =105+(1550@15%) = 105+232.5= 337.5
4 th	3,200-3,600	20%	337.50	EIT = 337.50+ (3,600 – 3,200) @20% =337.50+(<u>400@0.2</u>) = 337.5+80= 417.5

4.1.6. Severance Pay

Severance pay is compensation received by an employee from employer in connection with termination of his/her employment is taxable on receipt bases. There are two types of severance pay:

A. Normal Severance Pay

B. Extraordinary Severance Pay

A. Normal Severance Pay:

If an employee has given service to employer from minimum of five years & his/her contract of employment is terminated because of his/her initiation provided that she/he has no contractual obligation, relating to training, to serve more with employer, then employee is entitled to normal severance pay.

B. Extraordinary Severance Pay:

If an employee's employment contract is terminated by employer.

4.1.7. Employment Income Tax on Job Termination Payments

EIT on Severance Pay is computed as follows:

1. Determine total Severance Pay
2. Determine number of months with severance pay - total Severance Pay is divided by basic salary of employee at time Employment Contract is terminate
3. Determine EIT on Severance Pay per month using Schedule "A"
4. Determine the EIT on the total Severance Pay

Example: Assume that the contract of employment is terminated when the basic salary of an employee is Br 1,200.

Required: Compute the tax on the severance payment if the employee left the organization after serving for:

- A. 7 years
- B. 7 years and 9 months
- C. 35 years

Solution

- A. $1200 + (1200 * 6 * \frac{1}{3}) = 1200 + 2400 = 3600$
- B. $1200 + (1200 * 6 * \frac{1}{3}) + (1200 * 9 * \frac{1}{12} * \frac{1}{3}) = 1200 + 2400 + 300 = 3900$
- C. $1200 + (1200 * 34 * \frac{1}{3}) = 1200 + 13600 = 14800$

4.1.8. Administration: Declaration and Payment of EIT

The employer declares taxable employment income of his employees at the end of each month because the tax period for the tax is a month. Declaration is to be made within 30 days from the end of the month for which the tax is due. An employee, whose taxable income is exclusively from Schedule A, need not declare his taxable income himself. Employers shall withhold the tax on income from employment on payments they make to employees except from those who are not required to

pay tax as per the provisions of law. Withholding tax from the employees should be the primary obligation of the employer before any other amount is withheld from the payment.

Declaration should be made in a statement showing the required information regarding his employees within the stated period. The statement should contain details such as the name, address and TIN (Taxpayer Identification Number) of each employee, taxable income of the employee, the income tax, and any tax- exempt income received by the employee during the month. If a withholding agent (the employer) fails to withhold the tax, he will be liable to make the payment. Declaration of the tax should be accompanied by the payment.

Sometimes it happens that an employee may work with more than one employer. Those employees under more than one employer and the employees of an Embassy or legation, who are not exempted from payment of income tax, shall themselves declare their taxable income within 30 days from the end of each calendar month. Periodically, auditors from the tax office verify the personal income tax withholdings. The auditor conducts a number of tests in verifying that the taxpayer has deducted and remitted the correct amount of personal income tax withholding from his/ her employees. The procedure for verification is as follows.

Confirm the wages paid for the year from the financial statements, general ledger account, payroll journal, disbursement journal, annual individual wages summaries, and general journal entries

Confirm the accurate treatment of year-end accruals.

Review the taxpayer's provisions for taxable employee benefits and confirm the treatment for tax purposes.

- ✓ Test the reductions for tax deductions from employees to the tax tables.
- ✓ Confirm that the taxpayer has complied with any regulations regarding the payment in cash for day labor or casual labor.
- ✓ Confirm that the taxpayer has made the correct remittances to the revenue authority in the prescribed time frame
- ✓ The auditor has to provide details of underpayments or other issues for further verification to the regional administrations responsible for the administration of the personal income tax withholdings.

4.1.9. Administrative Penalties of EIT

Employers who fail to declare taxable employment income within the stipulated period will be punishable both for non-declaration and for non-payment because these are simultaneous procedures.

For administrative purposes, various fines are imposed for non-compliance according to the tax provisions. Those employers who fail to declare tax will be penalized with fines as given below:

- ☞ For the first 30 days of non-declaration, Birr 1000
- ☞ For the next 30 days of non-declaration, Birr 2000
- ☞ For every 30 days of non-declaration thereafter, Birr 1500

Because the declaration and payment of tax are simultaneous, those who are punished for non-declaration will also be punished for non-payment. The income tax proclamation provides for penalties in the case of non-payment as follows.

- ✓ 5% of amount unpaid on the first day after the due date
- ✓ 2%, additional, of tax unpaid on the first day of each month thereafter.
- ✓ Failure to declare and pay employment income tax will also result in payment of interest for the unpaid amount at 25% above the highest rate used for commercial purposes in the previous quarter.

4.2. RENTAL INCOME TAX IN ETHIOPIA (SCHEDULE “B”)

??? **Pretest**
Dear students, what do you mean the term rental income and what are components of rental income?

4.2.1. Rental Income and Rental Income Tax

Rental income includes all forms of income arising from rent of a building and rent of furniture and equipment if the building is fully furnished. The income tax proclamation No. 979/2008 or 979/2016 classifies income from renting of buildings as ‘schedule B’ income. Rental income tax is an income tax levied and charged on rental income of buildings. The proclamation also provides for collecting rental income tax from income earned by a lessor on giving buildings on rent. The income is determined as if the letting of building was a business activity and the income assessable under schedule ‘B’ will be the rental business income of the period of account.

Rental Income is taxed under Schedule “B” of Income Tax Proclamation No. 979/2016. This section is concerned with taxation of income generated by renting either residential or business buildings who so ever is the owner of building.

There are two parties involved in rental of buildings: **the lessor and lessee**. The **lessor** is the owner of the building, either business or person, who lets his building for use in return for payment. The **lessee** is the one who uses the building, empty or furnished, for payment according to the lease term. In

some conditions, there may be a third party between the lessor and the lessee called sub-lessor. The sub-lessor may not use the building for himself or may lease the building partly by using some parts of the building for himself. **The sub-lessor** enters in to contract with the lessor to lease a building and then he will lease to third party –the lessee- as the owner of the building. For tax purposes, the lessor will be held responsible if the sub-lessor is not carrying out his obligation. That is the owner of the building who allows a lease to sub-lease is liable for the payment of tax for which the sub-lessor is liable in the event the sub-lessor fails to pay.

Business or individuals may lease an empty or furnished building. Furnished building is a building with all necessary inside facilities such as furniture, equipment's, household utensils, etc. In the case of furnished building, the Gross Income is the sum of thereof for the building, furniture, equipment, household utensils, etc. in the case of business lease income from the lease of business, including goods, equipment's and building which are part of the normal operation of the business, shall be taxable under Schedule "C" rather than schedule "B".

Business lease is the lease of the whole business or one of the separate divisions of a business. For example, a business may lease one of the divisions having machineries, equipment's, buildings, vehicles, etc to some other business. This can be considered as a business lease so that taxable under schedule B.

Advance Payments: If the amount of rent paid to the lessor or sub-lessor covers a period longer than one (1) year, the total amount of income from such rent be attributable to fiscal year in which the payment was made, but the tax on such income payable for said fiscal year shall be computed by prorating the taxable income over the number of years covered by the amount paid.

Responsibility of the Local Administration: At the earlier of the time of construction of a rental building is completed or the building is rented, the owner and the builder are required to notify the administration of the 'kebele' in which the building is situated about such completion and the name, address and tax identification number of the person subject to tax on income from rental of the building. The kebele administration has the obligation to communicate this information or information obtained by the administration's own initiative to the appropriate tax authority.

4.2.2. Basic Legal Provisions for Rental Income Tax (RIT)

The legal provisions are taken from Income Tax Proclamation No. 979/2016 and Income Tax Regulation No. 78/2002. Income from rental of building shall be calculated as follows:

If the taxpayer leased furnished quarters, the amounts received attributable to the lease of furniture and equipment shall be included in Gross Rental Income. **Sub-lessor** shall pay the tax on the difference between income from sub-leasing and the rent paid to the lessor, provided that the amount received from the sub-lessor is greater than the amount payable to the lessor.

The above provision implies that in addition to the rent of building (and furniture, if any), the expenses incurred by the tenant for renovation or improvement of the property in accordance with the contract will be a part of the gross income of the lessor. Likewise, any other expense incurred by the lessee with the permission of lessor (and stated in the lease contract) will also be a part of gross income from leasing the property. For example, if the lessee spends Birr 170,000 to make addition to the building rented and if it is stated in the contract, the amount will be added to the gross income of the lessor. Sometimes, the lessor may allow the lessee to sublease the building to another party. In such cases, the lessor must get in writing, from the sub-lessor, which the lessee will pay tax for the additional income received. Failure on the part of sub-lessor for making tax payment will cause additional burden for the lessor to make that payment.

It is possible that the lessee may give advance rent payments for a time of more than one fiscal period to the lessor. Gross rental income for one fiscal period only is taken in to account, in that period, for determining tax. The remaining will be taxable in the next period. This is the case if the lessor keeps records for tax reporting purpose. When a building is constructed for the purpose of leasing, the owner and the contractor should inform the Kebele administration about its completion and the intention of giving it on lease. This is also needed when a contract of leasing is entered into before the completion of construction. The Kebele administration is responsible to pass the information to the tax office for tax purposes. It is the duty of Kebele administration to gather any such information and pass them to the tax office in case the parties concerned fail to do so.

Determination of Gross Rental Income

As per the proclamation, the following incomes are included in determining the gross income from rental businesses.

Components of Gross Rental Income: Gross Rental Income shall contain:

- ✚ All payments in cash and all benefits in kind received by the lessor (owner of the building) from the lessee;
- ✚ All payments made by the lessee on behalf of the lessor according to the contract of lease; for example if the lessee agreed to pay brokerage cost on behalf of the lessor.

- ✚ The value of any renovation or improvement made under the contract of lease to the land or building, where the cost of such renovation or improvement was borne by the lessee in addition to rent payable to the lessor;
- ✚ If the tax payer leased furnished quarters the amounts received attributable to the lease of furniture and equipment shall be included in Gross Rental Income in addition to the above rental incomes.

Determination of Taxable Rental Income and Tax

It is the difference between Gross Rental Income and deductions pursuant to part three of the ITP No.979/2016, taxable income from sources chargeable under Schedule B.

It is not the gross income received from leasing that is subject to tax. Certain items of expenses (deductible expenses) can be subtracted from gross rental income in order to arrive at the taxable rental income subject to tax. The deductions allowed depend on the fact that whether the lessor keeps necessary accounts or not. For this purpose we refer back to business income tax and recall those who are required to keep books and records compulsorily and who are not. Remember that out of the three categories of taxpayers, persons having annual turnover of more than Birr 500,000 and bodies are compulsory to keep documents for tax purposes. The same rule applies for taxpayers of rental income tax. Taxable rental income can be calculated as follows:

$$\boxed{\text{Taxable Rental Income} = \text{Gross Rental Income} - \text{Deductible Expense.}}$$

Deductible Expenses from Gross Rental Income

☞ Allowable deductions for taxpayers do not maintain books

The expenses allowable against the rental income are those incurred wholly or exclusively in connection with the leasing activity. Taxpayers who are not required to keep records can have the following deductions from gross income.

- ❖ Taxes paid with respect to the land and buildings being leased; except Rental Income Taxes
- ❖ For taxpayers not maintaining books of account, 50% or half (1/2) of the gross income received as rent for buildings, furniture and equipment as an allowance for repairs, maintenance and depreciation of such buildings, furniture and equipment. Even if other expenses are incurred by the lessor or lessee on behalf of the lessor, they will not be allowable as deduction.

☞ Allowable deductions for taxpayers maintain books of account

A taxpayer who maintains records can have deductions at any amount spent on earning and maintaining the rental income. The only point is that it should satisfy the tax office that the money is really spent for that purpose. Such expenses (deductions) include:

For taxpayers maintaining books of account, the expenses incurred in earning, securing, and maintaining rental income, to the extent that the expenses can be proven by the taxpayer and subject to the limitations specified in Art 23 of Proclamation No 979/2008 or 979/2016. A deductible expense for taxpayers maintaining books of account includes:

- ✚ Taxes paid on land and building, except income tax,
- ✚ Repairs and maintenance of building
- ✚ Depreciation of building, furniture, and equipment in accordance with their books of accounts and the regulation income tax proclamation.
- ✚ The cost of lease (rent) of land
- ✚ Interest on bank loan, taken for the building, at the rate permitted as per the income tax proclamation and National Bank of Ethiopia regulation
- ✚ Insurance premium paid on building.

In the computation of rental income tax, the individual rental income taxpayers can use the progressive method using schedule 'B' or deduction method.

4.2.3. Rental Income Tax Rate

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

- On rental income of **body (Corporations)** thirty percent (30%) of Taxable Rental Income
- On income of **persons** according to the Schedule B (hereunder)

Schedule "B"				
TB	Range of Rental Income		TRI	Tax Rate
1 st	0	7,200	-	Exempt (0%)
2 nd	7,201	19, 800	12,600	10%
3 rd	19, 801	38,400	18,6000	15%
4 th	38,401	63,000	24,600	20%
5 th	63,001	93,600	30,600	25%
6 th	93,601	130,800	37,200	30%
7 th	130,801	Xxxxx		35%

4.2.4. Accounting for Rental Income Tax

In this case, accounting is involved with the following tasks:

- ✚ Determination of Gross Rental Income and Taxable Rental Income
- ✚ Calculation of Rental Income Tax
- ✚ Preparation of Rental Income Tax Return

Determination of Gross Rental Income & Taxable Rental Income

Taxable rental income shall be determined as above for both empty building and furnished building. It is prepared for both lessors who keeps books of accounts and those do not keep book of accounts.

TRI for those Taxpayers Maintaining Books of Accounts

Rental Income Received.....	Xxxxx
Add: the following amounts	
Amount on the lease of furniture.....	Xxxxx
Amount on the lease of equipment's.....	xxxxx
Payments made by the lessee on behalf lessor	xxxxx
Cost renovation or improvement paid by the lessee.....	Xxxxx
Gross Rental Income.....	Xxxxx
Less: Rental Payment.....	(Xxxxx)
Net Rental Income.....	Xxxxx
Less: deductible expenses	
Land and building tax.....	xxxxx
Annual lease payment on land.....	xxxxx
Cost of repairs and maintenance	xxxxx
Depreciation of building.....	xxxxx
Depreciation of furniture and equipment	xxxxx
Interest on bank loans.....	xxxxx
Adverting expense to call tenant	xxxxx
Other expense, if any incurred to generate rental income.....	Xxxxx
Insurance premiums.....	xxxxx
Total deduction.....	(Xxxxx)
Taxable rental income.....	Xxx

TRI for those Taxpayers not maintaining Books of Accounts

Rental Income Received.....	XXXXX
Add: The Following Amounts	
Amount on the lease of furniture.....	XXXXX
Amount on the lease of equipment's	XXXXX
Payments made by the lessee on behalf lessor	XXXXX
Cost renovation or improvement paid by the lessee.....	XXXXX
Gross Rental Income.....	XXXXX
Less: Rental Payment.....	(XXXXX)
Net Rental Income (NRI).....	XXXXX
Less: Deductible Expenses	
Land and building tax, if any.....	XXXXX
Allowance for repairs, maintenance & depreciation (50%@GRI)...	XXXXX
Total deductible expense	(XXXXX)
Taxable Rental Income.....	XXXXX

4.2.5. Methods of Calculation of Rental Income Tax (RIT)

Sub-lessor shall pay the tax on the difference between income from sub-leasing and the rent paid to the lessor, provided that the amount received from the sub-lessor is greater than the amount payable to the lessor. In the computation of Rental Income Tax, the taxpayers can use the progressive method using Schedule **B** or Deduction Method

A. Progressive method: $RIT = (\text{Upper tax range (TRI)} - \text{lower tax range}) * \text{Tax rate}$

TB	Over	To	TR	RIT
1 st	0	7,200	Exempt	0.00
2 nd	7,201	19,800	10%	1,260
3 rd	19,801	38,400	15%	2,790
4 th	38,401	63,000	20%	4,920
5 th	63,001	93,600	25%	7,500
6 th	93,601	130,800	30%	11,340
7 th	130,801	Xxx	35%	XXX

B. Deduction Method: $RIT = \text{Taxable Rental Income} @ \text{Marginal Tax Rate} - \text{Deduction}$

TB	Over	To	Tax Rate	Deduction
1 st	0	7,200	Exempt	0.00
2 nd	7,201	19,800	10%	720.00
3 rd	19,801	38,400	15%	1,710.00
4 th	38,401	63,000	20%	3,630.00
5 th	63,001	93,600	25%	6,744.00
6 th	93,601	130,800	30%	11,460.00
7 th	130,801	xxxxx	35%	18,000.00

C. Addition Method: Under this method, Rental Income Tax is determined by multiplying any Taxable Rental Income above the minimum level of the Tax Bracket by the tax rate and adding the given addition for each tax bracket as follows:

TB	Over	To	Tax Rate	Addition
1 st	0	7,200	Exempt	$0.00 + (7,200 * 0\%) = 0.00$
2 nd	7,201	19,800	10%	$0.00 + (19,800 - 7,200 * 10\%) = 1,260$
3 rd	19,801	38,400	15%	$1,260 + (38,400 - 19,800 * 15\%) = 4,050$
4 th	38,401	63,000	20%	$4,050 + (63,000 - 38,400 * 20\%) = 8,970$
5 th	63,001	93,600	25%	$8,970 + (93,600 - 63,000 * 25\%) = 16,470$
6 th	93,601	130,800	30%	$16,470 + (130,800 - 93,600 * 30\%) = 27,810$
7 th	130,801	XXXX	35%	$27,810 + (XXXX - 130,800 * 35\%) = XXXX$

Example 1: Assume Ato Ayele, the owner of **GOLDEN BUILDING**, leased the Building at Br 2,000,000 per annum. In addition to this, the lessee will incur Br 100,000 per annum for repair and maintenance of the building. The cost of the building is Br 20,000,000 and the following expenses are incurred by the lessor: Cost of Lease payments on Land is 100,000, Land use and Building Property Tax of 20,000 and Other Deductible Cash Expenses of 5,200

Required: Compute GRI, TRI, and Rental Income Tax assuming

A. Ato Ayele maintains books of records

B. Ato Ayele doesn't maintain book of records

Solution (A) assuming Ato Ayele maintains books of records

Rental Income Received	2,000,000.00
Payments made by the lessee on behalf lessor	<u>100,000.00</u>
Gross Rental Income.....	<u>2,100,000.00</u>
Less: Deductible Expenses	
Cost of Lease payments on Land	100,000.00
Land use and Building Property Tax	20,000.00
Other Deductible Cash Expenses	5,200.00
Depreciation Expense (20,000,000*5%.....	<u>1,000,000.00</u>
Total Deductible Expenses	<u>1,125,200.00</u>
Taxable Rental Income.....	974,800.00
Less: Rental Income Tax (974,800.00*30%)	<u>292,440.00</u>
Net Income After Tax	<u>682,360.00</u>

Solution (B) assuming Ato Ayele doesn't maintain book of records

Rental Income Received	2,000,000.00
Payments made by the lessee on behalf lessor.....	<u>100,000.00</u>
Gross Rental Income	<u>2,100,000.00</u>
Less: Deductible Expense.....	
Cost of Lease payments on Land	100,000.00
Land use and Building Property Tax	20,000.00
Allowance for repair, maintenance 50% of GRI)	<u>1,050,000 (2,100,000*0.5)</u>
Total Deductible Expenses	<u>1,170,000</u>
Taxable Rental Income.....	930,000
Less: Rental Income Tax ...(930,000*35%-18,000)	<u>325,500,000</u>
Net Income After Tax.....	<u>604,500</u>

Example 2: Zeritu has given a building for rent on Hamle 1, 2010. The following data relate to the monthly rent, and taxes paid on land and building during the year.

Monthly rent	Birr 12,000
Rent paid on land	7,200
Tax paid on building	2,800

Required: Compute income tax on rental income tax of the Zeritu for the year ending Sene 30, 2010.

Solution: Assuming that Zeritu doesn't maintains books of account	
Annual gross income (12,000x 12).....	144,000
Less: Allowable deductions:	
Depreciation (0.5x 144,000).....	72,000
Rent paid on land	7,200
Building tax.....	2, 800
Total Allowable deductions.....	<u>82,000</u>
Taxable rental income	<u>62,000</u>
Rental income tax = 62,000X 30% 3,630-18,000.....	(18,600)
Net Income after Tax.....	<u>43,400</u>

NB: Here the taxpayer is not a body and therefore the progressive rate of tax is used. The taxable income comes under the tax bracket where the 30% tax rate is applied. The short cut method of tax computation is applied for computing tax.

4.2.6. Time for Declaration and Payment of Tax

The time allowed for declaration of taxable rental income and payment of taxis the same as that of schedule 'C' income tax. Remember that a taxpayer who has taxable income from rent shall declare the income

- ✚ Within 4 months after the end of fiscal year if he belongs to category 'A'
- ✚ Within 2 months after the end of fiscal period if he belongs to category 'B'
- ✚ Within 1 month after the end of the fiscal period for category 'C'

Payment of rental income tax should be made simultaneously with the declaration of taxable rental income. Provision of penalties for non-declaration and non-payment, and interest for non- payment

applied for the payroll tax and business income tax are equally applicable for schedule 'B' tax. Refunds of excess tax paid by the taxpayer, and payment of interest thereon are also applicable for rental income tax in the same manner as that of all direct taxes that are explained earlier. In circumstances where the tax office observes that the declaration made by the taxpayer is not acceptable, it may estimate tax by the best of their judgment. Thus, the estimated tax is the final tax that the taxpayer is obliged to pay.

4.3. BUSINESS PROFIT TAX (SCHEDULE "C")

Dera students, do you know business income and business income tax?

4.3.1. Business and Business Income Tax

Business income tax plays an important role in the public revenue of Ethiopian Government. Unlike the tax treatment accorded to businesses in many other countries, the Ethiopian business income tax regulations are applied to all forms of business enterprises-corporations, partnership, and sole proprietorship. For income tax purpose, the term business or trade refers to any industrial, commercial, professional or vocational(a strong feeling that ought to pursue a particular career) activity or any other activity recognized as trade by the Commercial Code of Ethiopia.

Business income tax refers to an income tax imposed on the taxable business income or net profit realized from entrepreneurial activity. It is an income tax charged on the profits of business enterprises on their activities arising each accounting period. At the end of each tax year, each business income taxpayer submits a Tax Return (tax declaration form) to the income Tax Authority. Income Tax Return is a statement containing statistical information filled in a preprinted form (provided by the tax authority in Ethiopia), and submitted to the Income Tax Office. It should contain full and true information about the income earned by the business income taxpayer.

Income from business is assessed under Schedule 'C' of the income tax proclamation No. 979/2008. Profits are assessed on a fiscal year basis. The budgetary year of the government is the fiscal year for tax purposes. Any person or body having business income realized from entrepreneurial activity is required to pay tax under Schedule 'C'. Those who are engaged in industrial, commercial, professional or vocational activity or any other trade are required to pay tax under this schedule. The tax is imposed on the taxable income of the preceding accounting year, which corresponds to the Ethiopian fiscal year. Business income tax is payable annually.

Definition of Taxable Business Income

Taxable business income shall mean the amount of income or profit from business activity which is subject to business income tax. It is the amount of income subject to business income tax after deductions of all expenses and other deductible items allowed under the income tax law. Taxable business income shall be determined per tax period on the basis of the profit and loss account or income statement, which shall be drawn in compliance with the Generally Accepted Accounting Principles (GAAP), subject to the provisions of income tax proclamation, regulation and directives issued by the Tax Authority. Since Ethiopia has currently adopted IFRS, this should also modified accordingly.

4.3.2. Legal Forms of Businesses and Taxable Entities

The legal provisions are taken from Income Tax Proclamation No. 979/2016 and Income Tax Regulation No. 78/2002. Business profit tax is paid by the business establishments regardless of Ownership of the business, forms of the business, size of the business and their nature.

According to Commercial Code of Ethiopia, there are seven forms of business organizations in Ethiopia:

- ✚ Sole Proprietorship – It is a taxable entity but not legal entity
- ✚ General Partnership – it is both taxable and legal entity
- ✚ Limited Partnership – it is both taxable and legal entity
- ✚ Joint Venture - It is a taxable entity but not legal entity
- ✚ Private Limited Company - it is both taxable and legal entity
- ✚ Share Company - it is both taxable and legal entity
- ✚ Co-operative - it is a legal entity but it may or may not be a taxable entity

4.3.3. CATEGORIES OF TAXPAYER

For the purposes assessment and collection of business tax, business income taxpayers are categorized in to three as per the provisions of the tax law. Businesses are categorized in to three for tax purposes. These are; Category “A” Taxpayers; Category “B” taxpayers and Category “C” Taxpayers. The categorization of taxpayers depends upon of the following points:

- ◆ Annual turnover or annual sales
- ◆ Maintenance of accounting records or books of accounts
- ◆ Requirements for registered vouchers (Source documents), etc.

- ◆ Number and types of financial statements to be prepared for tax purposes
- ◆ Tax Year
- ◆ Declaration of Income and time of payment of tax liability

4.3.3.1. Category ‘A’ Taxpayers

Category ‘A’ taxpayer includes any company incorporated under the laws of Ethiopia or a foreign country, and other entities. Those who are grouped under this category are required 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 provision and reserves together with the supporting documents.

Generally, Category ‘A’ Taxpayers are large businesses and shall include the following persons and bodies and in addition to this Category ‘A’ taxpayer must fulfill the following requirements:

- ✚ Any business having an annual turnover of Br 1,000,000 and more;
- ✚ Any company incorporated under the laws of Ethiopia or in a foreign country
- ✚ They have to maintain accounting records
- ✚ They have to use registered vouchers
- ✚ Shall submit to two statements to Tax Authority: a balance sheet and a profit & loss statement
- ✚ The tax year can be either the government fiscal year or the accounting year of the body
- ✚ They shall submit the Tax Declaration Form to the Tax Authority within 4 (four) months

4.3.3.2. Category ‘B’ Taxpayers

Category ‘B’ includes those being person or enterprises having annual income of more than Birr 500,000 and less than Birr 1,000,000. These taxpayers have to submit the profit and loss account together with the supporting documents.

Generally, Category ‘B’ Taxpayers are obligated fulfill the following requirements:

- ✚ Shall include any business having an annual turnover of Br 500,000 and less than 1,000,000.
- ✚ They have to maintain source documents and accounting records
- ✚ They have to use registered vouchers
- ✚ Shall submit only a profit and loss statement to the Tax Authority.
- ✚ The tax year can be either the government fiscal year or the accounting year of the body.
- ✚ They shall submit the Tax Declaration Form to the Tax Authority within 2 months.

4.3.3.3. Category ‘C’ Taxpayers

Category ‘C’ includes all taxpayers who are not listed in the other two categories.

- Category “C” Taxpayers are small businesses like retail shops, photocopy and secretarial services wood works, Fruit and Juice houses, etc. and include, unless already classified in Categories “A” and “B”, Taxpayer whose annual turnover is estimated by the Tax Authority as being up to Birr 500,000.
- Shall pay tax in accordance with Schedule “1” and “2” attached with Regulations No. 78/2002.
- Maintaining books of accounts is encouraged by the Tax Authority, but not mandatory.
- They are not required to use registered vouchers.
- They are not required to submit any financial statement to the tax authority.
- The tax year is the government fiscal year.
- Category “C” taxpayer shall be within the period of 7th day of July to the 6th day of August every tax year, declare to the Tax Authority. One month from the end of the tax year.

Note: It does not necessarily mean that all three categories remain constant at their position. If annual sales or revenue is increasing, category ‘C’ taxpayers may shift to category ‘B’ taxpayer and even to category ‘A’ and if their sales or revenue decreases the opposite become true. Share companies are always in category ‘A’ taxpayers regardless of the revenue amount or annual sales volume.

4.3.4. Record Keeping Requirements of Taxpayers

All persons who are engaged in business or trade (except category C) are required to keep a record of the following information:

- ✚ A record of business assets and liabilities including a registered fixed assets specifying the date and cost of acquisition, and the book value of assets
- ✚ A record of daily income and expenditures related to the business activity
- ✚ A record of purchases and sales of goods and services related to business activity specifying:
 - ◆ Items sold
 - ◆ Name of buyers and sellers
 - ◆ Using pre-numbered invoices containing vendor’s TIN.
- ✚ A record of trading stock on hand at the end of each accounting period including the type, quantity and cost of that stock as well as the method of valuation of that stock
- ✚ Any other document necessary for the assessment of tax

Though it is not obligatory for category ‘C’ to prepare and keep books of accounts, they are not prohibited from doing so. The tax authority encourages category ‘C’ taxpayers who keep books and records and, in such cases, tax is determined as per the books.

All taxpayers are obliged to keep the above-mentioned documents for a period of five (5) years after the end of the tax period. Any document prepared in a foreign language should be translated in to the official language and submitted thereon. Companies, partnerships and other business entities are required to submit a copy of the memorandum of association and the statutes. Any change made therein should be notified accordingly. The public auditors are also required to submit the audit report of their clients writing to the tax authority.

4.3.5. METHODS OF TAX ACCOUNTING AND TAX PERIOD

4.3.5..1. Methods of Tax Accounting

A taxpayer shall account for tax purposes on a Cash or Accrual Basis. But, for the purposes of ascertaining a person’s income accruing or derived during a tax period, the Timing of Inclusions and Deductions shall be made according to GAAPs and a Company shall account for tax purposes only on an accrual basis. The tax law prescribes both cash basis and accrual basis of accounting for business income taxpayers for tax purposes. However, companies are required to keep books on accrual basis. The tax authority should approve any change in the method of accounting of taxpayer if applied. The tax office has also to be convinced that such a change will clearly reflect the taxpayer’s income. The following are the tax accounting methods acceptable by the Ethiopian government and incorporated in its income tax law.

A. Cash Basis of Accounting

Taxpayers who use cash basis should recognize revenue when received or made available to them and expense when paid by them. When the cash basis of accounting is in operation, and the legal representative (or the one that claims to be the representative) of the taxpayer receives or pays cash, it shall be deemed that the payment is received or paid by the taxpayer. Under cash-Basis accounting revenue is recognized when received and expense is recognized when paid for tax purposes. Later on, if the said person refunds it, an appropriate adjustment will be made to the income of the taxpayer for that period.

B. Accrual Basis of Accounting

Taxpayers who use accrual basis should recognize revenue when it becomes receivable and expense when it becomes payable. An amount is treated as payable when the liability is incurred and can be measured with reasonable accuracy, but not before the economic performance. An economic performance (for tax purpose) occurs at the time when the service or property is provided (for acquisition of service property) or at the time the property is used (for use of property). This also occurs at the time when the payment is made in full. When an expense is incurred for a period beyond 12 months, it shall be proportionately distributed over the period of benefit. Under accrual-Basis accounting revenue is recognized when it is earned and expense is recognized when it is incurred.

C. Modified cash basis accounting

Modified cash basis accounting is a method that combines elements of the two major book keeping practice: cash basis and accrual base accounting. It seeks to get the best of both worlds, recording sales and expense for long-term assets on an accrual basis and those of short term asset on cash basis. The goal here is to provide clearer financial pictures without dealing with the cost of switching to full-blown accrual accounting. The modified cash method may only be used for internal purpose because it does not comply with international financial reporting standard (IFRS), or generally accepted accounting principles (GAAP).

D. Percentage –of-Completion

The basis of accounting for long-term construction contracts should be the percentage of completion method. The percentage of work completed and the revenue realized should be determined on a cost-to- cost basis.

4.3.5..2. Tax Accounting Period

Unlike employment income tax, the period used for assessment of business income tax is one fiscal year. The fiscal period starts on July 8 and ends on July 7. A business unit may prepare accounts for any period for accounting and reporting purposes. It is usually 12 months in length, but may be a bit shorter or longer. Whatever be the period taken for reporting purposes by the business unit, tax period is fixed for a period of 12 months ending July 7. But if the tax authority allows, a business unit may use another 12-month period for tax purposes. It is also possible that an enterprise may change the tax period with the permission of tax authority. In such cases, the period between the previous tax period and the new period is treated as a transitional period.

4.3.6. Business Income Tax Rates

Like employment income tax, specific tax rates are provided in the prevailing income tax proclamation for calculating business income tax. Businesses are chargeable to business income tax at two different tax rates. Accordingly, bodies (businesses that have separate legal personality) are chargeable to business income tax rate at 30% tax rate. On the other hand, unincorporated or individual businesses are taxed in accordance with the tax rates that range from 10% to 35% prescribed under schedule ‘C’ of income tax proclamation No. 979/2008.

Business Profit Tax is a tax on income from business activities in Ethiopia. Business Profit is taxed under Schedule C, 30% Flat Tax Rate or Presumptive Tax Assessment

1. Taxable Business Profit of body is taxable at the rate of 30 %.

Body shall mean any Company (Pvt. Ltd. Co. and Share Company), registered partnership, any public enterprise or public financial agency that carries out business activities.

2. Taxable business income of other taxpayers whose annual turnover is Br 100,000 or more shall be taxed in accordance with Schedule “C” hereunder.

Schedule “C”			
Taxable Business Income per Year			Business Income Tax
TB	Over Birr	To Birr	Tax Rate
1 st	0	7,200	Exempt (0%)
2 nd	7,200	19,800	10%
3 rd	19,800	38,400	15%
4 th	38,400	63,000	20%
5 th	63,000	93,600	25%
6 th	93,600	130,800	30%
7 th	130,800	*****	35%

These rates are used for taxpayers who do not come under the definition ‘body’. While determining the tax of an entity other than a body, the following short cut method may be applied.

Taxable income (annual) (In Birr)	Tax liability (In Birr)
0 – 1800	Nil
1801 – 7800	TI x 10% - 180
7801 – 16800	TI x 15% - 570
16801 – 28200	TI x 20% - 1410
28201 – 42600	TI x 25% - 2820
42601 – 60000	TI x 30% - 4950
60001 and above	TI x 35% - 7950

Where TI stands for Taxable Income)

Presumptive Tax: is a predetermined amount of tax paid by small businesses whose annual sale is less than Br 100,000. The tax is estimated by estimating annual sales (daily sales) and average profit.

Deductible Expenses (Allowable Deductions)

The following items of expenditures are allowed to subtract from gross revenue as per provisions of tax law and the Council of Ministers Regulation to determine taxable income of a given tax period.

- 1. Direct Cost of producing income:** The direct cost of producing the income such as the direct cost of manufacturing, purchasing, import, selling and other similar costs is allowed for deduction in determining taxable business income. To be more specific, the cost of trading stock sold or disposed off during a tax period shall be deducted from taxable income. Trading stock, for tax purposes, means any business asset used in the production process and becomes part of the product or that is held for sale. In accounting terms it can be described as the cost of purchases and inventory. The cost of trading stock disposed of during a tax period is determined on the basis of the average cost method or weighted average method.
- 2. Interest Expense:** Interest expense actually incurred for the operations of business is allowed for deduction. Such a deduction is permitted only if the National Bank of Ethiopia (NBE) recognizes the lending institution, or a foreign bank is to lend to enterprises in the country. It is to be noted that if the lender is a foreign bank, it should file a declaration to the tax authority stating the provision of loan. Likewise, the borrower shall withhold 10% of the gross interest and transfer the same to the tax authority within 2 months from the end of the fiscal year. Interest paid to a recognized financing institution shall be deducted up to in excess of 2% from the rate used between the National Bank of Ethiopia and the commercial banks. Generally, interest expense

shall not exceed Inter-Bank Interest Rate + 2%. To lending institutions recognized by the National Bank of Ethiopia, to foreign banks permitted to lend to enterprises in Ethiopia and to shareholders of Companies.

3. **General and administrative expenses:** General and administrative expenses incurred for earning, securing and maintaining the income shall also be deducted from gross income in calculating taxable income.
4. **Insurance Expense:** Premium payable (paid or incurred) on insurance directly connected with the business activity is also one type of business expenses allowed for deduction in determining taxable business income.
5. **Promotional Expense:** Expense incurred for the promotion of the business inside and outside the country is deductible expense. However, directives issued for this purpose set the maximum limit for this expense.
6. **Commission expense:** Commission paid for services rendered is allowed as deductibles. But the amount of deduction shall not exceed the normal rates provided by other similar businesses or persons.
7. **Payment to foreign head office:** Any payment made by a branch, subsidiary or associated company in Ethiopia to the foreign head office for services rendered (actually) is allowed as deductibles, provided that such a service cannot be rendered by any other person at a lower cost in the country.
8. **Salaries to Children of Proprietors or Partners:** Salaries, wages or other emoluments paid to the children of proprietors or members of partnership are eligible for deduction. This is permitted only if it is proved that the people possess the required qualification.
9. **Salaries to Partners:** Salaries and other personal emoluments paid to the manager or managers of a private limited company are eligible for deduction. However, if it is observed that this amount is comparatively high in view of the company's operations, the tax authority may disallow the excess payment for tax purposes.
10. **Representation Expense:** A representation expense over and above 10% of the salary of the employee is allowed for deduction in determining taxable business income.
11. **Retirement benefits:** Pension contribution, provident fund and all forms of retirement benefits contributed by employers in an amount that does not exceed 15% of the monthly salary of the employee is eligible to report as business expense.

12. Donations and Gifts: Donations and gifts given by the enterprise for charitable purposes are also allowed for deduction. There are conditions to deduct donations and gift expenses. Firstly, they must be given to welfare organizations with a record of outstanding achievement and a good accounting system showing the utilization of resources. Second, the payments must be made under emergency call issued by the Government to defend the country's sovereignty and integrity, to prevent manmade or natural catastrophe, epidemic, or any other similar cause. Third, the payment must be made for non- commercial education or health facilities. This shows that non-charitable gifts and donations are not allowed to deduct as expense for tax purposes. The tax law also gives some limit for such expenses to be deductible. Only an amount not exceeding 10% of the taxable income of the period will be allowed as deduction from gross revenue.

13. Bad Debts Expense (Uncollectible Accounts Expense): Bad debt of the enterprise incurred during the period. This is allowed only if the tax authority has been satisfied that the amount is not recoverable. It is deductible if the following conditions are met:

- Amount corresponding to the bad debt was included in the revenue during the year.
- The debt is written off/cancelled from the book of the taxpayer.
- The debt is not recoverable in any case after taking legal action.

14. Special Reserves for Finance Institutions – provisions for NPLs: Financial institutions are permitted to deduct special reserves from taxable income in accordance with the directives issued by NBE. However, the amount drawn from such reserves will be added to the taxable income of the institutions.

15. Participation deduction (Deduction for Reinvestment of Profit): The tax law and the Council of Ministers Regulation allow a deduction of reinvestment of profit of a resident company or registered partnership to raise the capital of another company or partnership subject to the following limits:

- ✚ The amount deducted should not exceed 5% of the taxable income.
- ✚ The investor must have at least 25% ownership in the new business unit by value or by number in the voting right.

On meeting the above requirements, the amount may be deducted from taxable income of that year. But if the taxpayer transfers the share or capital contribution in respect of which a deduction is allowed, such an amount shall be a part of taxable income in the year in which the transfer is made.

- 16.** Transportation Allowance paid to Employees not exceeding the limit 25% basic salary or not more than 2,200 in any circumstance.
- 17. Maintenance and Improvement Expense:** 50% of Depreciation Base at the end of the year.
- 18. Depreciation Allowance:** Depreciation allowance shall be granted only to taxpayers who keep satisfactory records showing the date and cost of acquisition of the asset and the total amount deducted for depreciation since the date of acquisition.

Method of Depreciation for Tax Purposes

A. Rates of Depreciation

Capital allowances or allowances for depreciation are given at statutory rates as qualifying expenses on certain fixed assets. In accounting, depreciation is the systematic write off of the cost of fixed assets over a period of time. The rationale for this is that the assets are being used up in the earning process and would wear out over the period of time and the charging of the cost would match the related revenue. The tax law also approves the necessity of allowing depreciation on fixed assets. The allowances are given not only on original cost but also on the book value of fixed assets. There are other categories of capital expenditure that attract capital allowances. These are the intangible assets. The following are the rates of depreciation allowed for fixed assets and intangible assets.

1. Fine Art, Antiques, Jewelry, Trading Stock and Other Business which are not subject to tear and wear shall not be depreciated
2. 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 5% (20 years).
3. The Acquisition or Construction cost, and the cost of Improvement, Renewal and Reconstruction, of intangible assets shall be amortized individually on a straight-line basis at ten percent (10%) (10 years) of the original cost
4. 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 at twenty five percent (25%) or (4 years).

- B. All other business assets like vehicles, machineries, earth moving machineries (loader, damper, etc), furniture, equipment's, etc shall be depreciated at twenty percent (20%) or (5 years).

Depreciation Base under Pooling Method

$$\text{Depreciation Base during the Tax Year} = \text{Book Value at the Beginning} + \text{Cost of Assets Acquired} - \text{Disposal of Assets}$$

- ◆ If the depreciation base is a Negative Amount, that amount shall be added to taxable profit and the depreciation base shall become zero.
- ◆ If the depreciation base does not exceed Br 1,000, the entire depreciation base shall be a deductible business expense

As can be seen from the explanation, building and intangible assets are permitted to depreciate on original cost. This may be compared to the straight-line method used for financial accounting purposes.

For assets for which the pooling method is used, the rate is applied to the depreciation base for the determination of depreciation. The cost of all software products and the cost of other assets other than building and intangible assets purchased by a business unit become a part of a pool of expenditure on which capital allowance may be claimed. When an addition is made, the pool increases; and on disposal, the pool is reduced by the sale proceeds.

The depreciation base is the book value of the assets in the pool on the opening day of the tax period, increased by the cost of acquisition, creation, renewal, etc. during the period, and reduced by the sales price of the asset disposed during the period. Any compensation received for loss incurred due to natural calamity and other involuntary conversion is deducted from the book value.

For example, if an asset in a particular pool having book value of Birr 20,000 is sold for Birr 30,000, the depreciation base for that particular pool will be reduced by Birr 30,000 in that period. While determining the depreciation base, if it becomes negative, it will be added to the taxable income. On the other hand, if the depreciation base is Birr 1,000 or less in any tax period, the entire amount is treated as depreciation for that period. Likewise, gain obtained as a result of revaluation of assets shall not be a basis for determining the depreciation base.

A careful examination of the whole process calls for comparing it to the declining balance method that we use for financial accounting purposes. The annual writing down allowance is given on a reducing balance basis in the pool brought forward at the beginning of the year.

B. Allowance for Repairs and Maintenance

In determining taxable business income, a deduction is permitted in respect of each category of business asset for maintenance and repairing expenses of business fixed assets belonging to that category for the actual amount of the expense. For each category of fixed assets, the actual expense incurred for the maintenance and repair is allowable up to 50% of the depreciation base at the end of the year. If the actual repairs and maintenance cost exceeds 50% of the depreciation base, the entire amount will be added to the depreciation base of the category.

C. Revaluation of Fixed Assets

According to the Regulation issued by the Council of Ministers, depreciation will be allowed as deduction only if the taxpayers keep satisfactory record and submit the same to the tax authority regarding the date and cost of acquisition and a record of the total amount of depreciation deducted on the asset so far. However, depreciation on assets which are not subject to wear and tear, such as fine art, antiques, jewelry, trading stock etc are not allowed. Besides, the revalued amount of fixed assets is not allowed for depreciation.

D. Transfers of Business Assets:

When an asset is sold, exchanged, or otherwise transferred, the gain or loss on such an activity is recognized as revenue for tax purposes. However, if the companies transferring the asset are parties to reorganization, it will not be treated as a disposal. Reorganization refers to a merger, an acquisition of 50% or more voting right of a resident company, or a division of a resident company, and a spin off.

Example 1: Assume ABC Spare Parts Pvt. Ltd. Co. uses the Tax Year Hamle 1 to Sene 30 and has the following plant assets: Computers, Information System, Software and Data Storage.

Date of Purchase	Acquisition Cost
Yekatit 10, 2003.....	16,000
Ginbot 01, 2003	6,000
Nehase 07, 2003.....	7,000
Tahsas 19, 2004.....	3,500

Instruction: Compute:

- A.** Depreciation Bas
- B.** Depreciation Expense for Tax Year Ending on Sene 30, 2003, 2004 and 2005 assuming that ABC Spare Parts Pvt. Ltd. Co. sold old Computer at Birr 3,000 on Megabit 23, 2005.

Solution

- A. Hamle 1, 2002-Sene 30,2003 (Yekatit 10, 2003 & Ginbot 01, 2003)
- B. Hamle 1, 2003-Sene 30,2004 (Nehassie 07, 2003 & Tahsas 19, 2004)
- C. Hamle 1, 2004-Sene 30,2005

A. Depreciation Base and depreciation expense

Depreciation base for Sene 30, 2003= = 16,000+6,000=22,000

Depreciation Expense for Sene 30, 2003 =22,000@25% = 5,500

Depreciation Base Sene 30, 2004 = BV Begin + Additions – Deductions
= (22,000-5,500) + 10,500 = 27,000

Depreciation Expense for Sene 30, 2004 =27,000@25%=6,750

Depreciation Base for Sene 30, 2005= BV Begin + Additions – Deductions
= (27,000-6,750) + 3,000 = 23,250

Depreciation Expense for Sene 30, 2005 = 23,250@25% = 5,812.50

Example 2: The following information relates to Zumra Company.

The book value of the pooled machineries in the opening balance sheet of the tax period as of Hamle 1, 2005 was Br. 85,000. During the tax year 2006, Zumra bought additional machines for Br. 50,000, received Br. 5,000 as compensation from the vendor since one of the machines does not work properly, paid Br 40,000 for maintenance of a machine, and sold an existing machine for Br. 10,000.

Required: Determine Depreciation base for the year ended Sene 30, 2006.

Solution

Depreciation Base = BV Beginning + Cost of Assets Acquired – Disposal Value
= 85,000+50,000-5,000+40,000-10,00 = 160,000

Non-Deductible Expenses

Non – deductible expenses, also called disallowable or non- allowable expenditures are by far the most common items that require adjustment to accounts. Non-deductible expenses are those expenses, which are not wholly or exclusively incurred for the business activity. Such expenses are disallowed because they are too remote from the purposes of trade, or because they have more than one purpose or because they are incurred for the purpose of another company's trade. Expenditure is regarded as being too remote from the trade when it is incurred in some other capacity than that of a trader. The income tax law and the Council of Ministers Regulation consider the following expenses not to be included in income statement for tax purposes.

- ✚ The cost of the acquisition, improvement, renewal and reconstruction of business assets that are depreciated pursuant to Article 23 of EITP No. 979/2016.
- ✚ An increase in the share capital of a company or the basic capital of a registered partnership.
- ✚ Voluntary pension or provident fund contributions over and above 18% of the monthly salary of the employee.
- ✚ Declared dividends and paid-out profit shares.
- ✚ Interest in excess of the rate used between the National Bank of Ethiopia and the commercial banks increased by two (2) percentage points.
- ✚ Damages covered by insurance policy.
- ✚ Punitive damages and penalties.
- ✚ The creation or increase of reserves, provisions and other special-purpose funds unless otherwise allowed by this Proclamation;
- ✚ Income Tax paid on Schedule C income and Recoverable or Refundable Value-Added Tax;
- ✚ Representation expenses over and above 10% of basic salary;
- ✚ Personal consumption expenses. This again not deductible in case of financial accounting report. If Br. 2,000 is registered as fuel expense in the book of the business and from this amount Br. 1,500 is incurred for business truck and the remaining amount Br. 500 is for owner's automobile, only Br. 1,500 will be considerable as deduction for both tax purpose and financial accounting purpose.
- ✚ Expenditures exceeding the limits set forth in Proclamation No 286
- ✚ Entertainment expenses, but deductible in case of financial accounting report.
- ✚ Donation or gift to other entities exceeding 10% and others not listed in the EITP No 979/2016.
- ✚ Sum paid as salary, wages or other personal emoluments to the proprietor or partner of the enterprises and to their spouses
- ✚ Expenditure for maintenance of other private properties of the proprietor or partner of the enterprises
- ✚ Losses not connected with or not arising out of the actively of the enterprise or extra ordinary losses. But this is deductible for financial reporting purpose (in Financial Accounting).
- ✚ Transportation allowance exceeding 25% of basic salary or Br. 2,200 which is so ever the lower.

It could be possible that the income statement prepared by business units contain any one or more of the items listed above. None of the items specified as non-deductible items can have a place in the income statement prepared for tax purposes. The accountant who prepares the income statement for tax purpose should exclude all the above items from the statement.

Tax exemptions

The following categories of income shall be exempted from payment of business income tax hereunder:

- ✚ Awards for adopted or suggested innovations and cost saving measures/Techniques. But, for financial reporting purpose it shall be added on revenue from formal business to arrive at total revenue.
- ✚ Public awards for outstanding performance.
- ✚ Income specifically exempted from income tax by the law in force in Ethiopia, by international treaty or by an agreement made or approved by the Ministry of Revenue.
- ✚ The revenue obtained by the Federal Government, Regional State Governments and Local Governments of Ethiopia; and the National Bank of Ethiopia from activities that are incidental to their operations.

Determination of Taxable Business Income

As mentioned earlier, taxable business income shall mean the amount of income or profit from business activity which is subject to business income tax. Taxable business income involves the determination of taxable revenue and allowable deductions. Taxable revenue is the difference between gross revenues and exemptions.

You have already studied in your preliminary courses that financial income for reporting purposes is determined according to the International Financial Reporting standards (IFRS). It is to be noted that the taxable income, on the other hand, is determined based on the tax law of every country. The taxable income is rarely the same figure as the profit shown in a business entity's income statement because the provisions of the tax law are different from the rules in the IAS/IFRS. These differences may be viewed due to the following reasons.

- ◆ Expenditures that have been charged in the income statement but which the tax law prevents from being an allowable deduction
- ◆ Profits (or income) taken in to the income statement but are not subject to tax.

The points mentioned above can be understood from the following discussion.

- ☞ IFRS allows the recognition of certain items for financial reporting purposes. But many tax laws do not allow including these items for tax purposes. Examples are:-
- ☞ Interest received on investments in government bonds is a financial income. But it is not taxable in many countries.
- ☞ Fines and expenses resulting from a violation of law are recognized for financial reporting purposes. But they are not permitted as expenses for tax purposes.
- ☞ Expenses incurred in getting a tax-exempt income are not deducted to determine taxable income though they are expensed for reporting purposes.

Generally, when such items are included in the income statement, adjustments regarding the items are made to the reporting income in order to arrive at the taxable income. In our country also, business units include all items (especially expenses) in the income statements. Some of these expenses may be allowed as deductibles as per the law and some may not be. In order to arrive at the taxable income under Schedule 'C', adjustments of the above items becomes essential. According to the current practice, the starting point for this purpose is the net income revealed by the income statement.

Accounting for Business Profit Tax is concerned with the following tasks:

1. Determination of Taxable Business Income according the legal Provisions
2. Computation of Business Profit Tax.
3. Adjusting Business Profit Tax.
4. Preparation of Tax Returns i.e. Profit and Loss Account and Balance Sheet.
5. Recording Transactions Related to the Business Tax Liability.

1. Determination of Taxable Business Income (Taxable Business Profit)

Taxable business income shall be determined per tax period on the basis of the profit and loss account or income statement, which shall be drawn in compliance with the Generally Accepted Accounting Standards, subject to the provisions of Ethiopian Income Tax Proclamation and the Directives issued by the Tax Authority. Accordingly, the Taxable Business Profit is the can be determined by subtracting costs & expenses from annual revenues.

$$TBP = \text{Annual Revenues} - \text{Cost of goods sold} - \text{Operating Expenses}$$

Example: XYZ Merchandising Enterprise is a Category “B” taxpayer. The enterprise reported Br 300,000 sales revenue; Br 200,000 Cost of goods sold and Br 62,000 operating expenses during the tax year ending Sene 30, 1997.

Required: Determine the Taxable Business Income and Business Profit Tax to be paid.

Solution

Taxable Business Income

Sales	300,000
Less: COGS	<u>200,000</u>
Gross profit	100,000
Less: Operating Expense	<u>62,000</u>
Taxable Business Income	38,000
Business Profit Tax	<u>3,990</u>
Net Income after Tax	<u>34,010</u>
Business Profit Tax to be paid= $(38,000 @ 15\%) - 1,710 = 5,700 - 1,710 = 3,990$	

4.3.7. Special Items that Reduces Business Profit Tax

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Pretest

Dear students, what do you know the special itema that reduce business profit tax?

There are tax provisions to pay taxes in advance under tax withholding system of the country and tax benefit as a result of loss carry forward and loss carry back. Thus, the business profit tax is adjusted for factors such as Loss Carry Forward and Loss Carry Back; Withholding of Business Profit Tax; Foreign Income Tax Credit and Investment Income Tax Credit.

4.3.7.1 Withholding Income Tax On Payments

Withholding income tax refers to the current payment of income tax at the time goods are imported and payments are made on account of supply of goods and certain services. The income tax proclamation provides for withholding tax on imports and on certain specific payments made by some organizations. The taxpayers are required to pay tax at the end of the fiscal year after subtracting tax withholdings, if any, made on their receipts. The following are the provisions for withholding income tax.

- A. ***Withholding income tax on Imports:*** Those taxpayers who import goods for commercial use are required to pay 3% of CIF (Cost, Insurance and Freight) value of goods as tax withholding to the Ethiopian Revenues and Customs Authority. If the tax withheld is less than the tax due on declaration, the taxpayer is required to pay the difference on declaration. Likewise, if the withheld tax is more than the tax due at the end of the tax period, the tax authority shall make a refund within 3 months of declaration. The amount collected as withhold tax is accounted for using the name, address, and TIN of the taxpayer.
- B. ***Withholding income tax on other payments:*** According to the Council of Ministers Regulation, the following persons, who are called withholding agents, are required to withhold tax of 2% of the gross payment that they make to the taxpayers. Organization having Legal Personality, Government Agencies, Private Nonprofit Institutions, and Non-Governmental Organizations (“NGOs”) shall withhold profit tax as the time of payments at two percent (2%) of the gross amount of the payment on supply of goods and services.

The entities (called the withholding agents) shall transfer the amount withheld to the government within 10 days from the last day of each month, in aggregate, indicating the TIN of the taxpayers from whom the tax is withheld. If, at the time of declaration, the tax withheld is less than the declared tax, the taxpayer has to make the remaining payment. On the other hand, if the declared tax is more than the tax due, the tax authority will refund the excess within 2 months. Failure to pay the refund will result in payment of interest by the tax authority at the market rate. Withholding income tax will be applicable to the payment for:

- A. Supply of goods for more than Birr 10,000 in any one transaction or contract
- B. Rendering of certain services involving more than Birr 500 in any one transaction or service.

The following are the services, the payment on which withholding income tax is required to be made.

- ✚ Consultancy services
- ✚ Designs, written materials, lectures and dissemination of information
- ✚ Lawyers, accountants, auditors, and other services of similar nature
- ✚ Sales persons, arts and sports professional, and brokers including insurance brokers and other commission agents
- ✚ Advertisement and entertainment programs for television and radio broadcasts
- ✚ Construction services
- ✚ Advertisements services

- ✚ Patents for scientific and intellectual works
- ✚ Rent for lease of machines, building, and other goods including computers
- ✚ Maintenance services
- ✚ Tailoring
- ✚ Printing, and
- ✚ Insurance

The withholding agent has the obligation to issue serially numbered receipts to persons from whom the tax is withheld. The agent shall supply the name and TIN of the taxpayer, the amount withheld and the total amount of payment made. For this purpose, the withholding agent should keep the records showing the payment made and tax withheld in his office. It is also required that such records should be kept for a period of 5 years and should be submitted to the tax authority as and when instructed by them.

Withholding Tax Declaration: the withholder is required to declare Withholding Income Tax Declaration on monthly basis. Withholding Tax Declaration Form has the following Four Sections: Taxpayer Information; Declaration Details; Tax Declaration Summations; and Taxpayer Certification

4.3.7.2 Loss Carry Forward and Loss Carry Back

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Pretest

Dear students, do you know the basic difference between loss carry forward and loss carry backward?

Loss Carry Back is a tax provision that allows operating losses to be used as a tax shield to reduce taxable income in prior.

Loss Carry Forward is a tax provision that allows operating losses to be used as a tax shield to reduce taxable income of the future years.

In Ethiopia, loss can be carried forward but not carried back except in long term construction contract. If the determination of taxable business profit results in loss during the tax year, the loss set-off against taxable profit in the next 3 (three) tax period's earlier losses being set-off before later losses. A net loss may be carried forward and deducted only for two periods i.e. only a loss of two periods and carried forward 3 years each for the two losses ($2 \times 3 = 6$ years).

4.3.7.3 Foreign Tax Credit and Investment Tax Credit

Foreign tax credit and investment tax credit are direct reduction from business profit tax to be paid.

Foreign tax credit: refers to reduction of business profit tax for income tax paid in foreign country from foreign source income.

Foreign Tax Credit

1. If during the tax period a resident derives foreign source income, the Income Tax payable by that resident in respect of that income shall be reduced by the amount of foreign tax payable on such income. The amount of foreign tax payable shall be substantiated by appropriate evidence such as a tax assessment, a withholding certificate or any other similar document accepted by the Tax Authority.
2. However, the reduction of the Income Tax provided in (1) shall not exceed the tax payable in Ethiopia that would otherwise be payable on the foreign source income.
3. In case of a taxpayer subject to Income Tax on Schedule C income, any reduction of tax prescribed in (1.) shall be limited to tax that would otherwise be payable in Ethiopia computed as if Art. 28 (loss carry forward) of Proclamation'979/2016 applied separately to each foreign country in respect of profit and losses derived from sources therein.
4. The reduction of tax prescribed shall be calculated separately in respect of each foreign country from which income or profit is derived.

Example: Dr. Adugna Abera, a resident in Black lion hospital who specialized in Bio chemistry, teaches medical students for 12 lecture hours in Kenya' and Botswana and derives the following income in the month of Tikmet 1998. His monthly basic salary in Black lion Hospital is birr.3, 500.

CountyGross income Tax paid in abroad

Kenya	15,000 Shilling	3,000 Shilling
Botswana	21, 000 Pula	8,000 Pula

He has also, brought appropriate withholding certificate accepted by the Tax Authority for tax paid in abroad. The average exchange rates during the period were as follows:

1Birr = 8 Kenya shilling and 1 Birr = 0.7 Botswana Pula

Required: How much tax is expected from him on income brought from abroad?

The reduction of tax prescribed shall be calculated separately in respect of each foreign country from which income or profit is derived.

Country	Gross income	Tax paid in abroad
Kenya	15,000 Shilling	3,000 Shilling
	=1875 birr	=375 birr

Proclamation 286, Article 70 stated that a taxpayer who derives income from different sources subject to the same schedule 'shall be assessed on the aggregate of such income. Hence, total gross income for the month calculated his basic salary birr 3,500 plus gross income obtained from Kenya birr 1875. The total gross income is birr 5,375.

$$\begin{aligned}\text{Total Income tax} &= (\text{Gross taxable income}) \times \text{Tax rate} - \text{Deduction} \\ &= (5,375 \times 25\%) - 565 = 778.75\end{aligned}$$

$$\begin{aligned}\text{Income tax on his basic salary} &= (\text{Basic salary}) \times \text{Tax rate} - \text{Deduction} \\ &= (3,500 \times 20\%) - 302.5 = 397.5\end{aligned}$$

Income tax payable to Ethiopia Tax Authority on such foreign source (Kenya) income is calculated as follows:

Total income tax:	Birr 778.75
Less: Tax paid on his basic salary	(397.500)
Income tax payable from foreign income:	381.25
Less: Tax paid in abroad:	(375.00)
Tax from foreign income	= 6.25

Country	Monthly gross income	Tax paid in abroad
Botswana	21,000 Pula	8,000 Pula
	=30,000 Birr	=11,428.57 Birr

Total gross income for the month is calculated his basic salary birr 3,500 plus gross income obtained from Botswana birr 30,000. The total gross income is birr 33,500.

$$\begin{aligned}\text{Total Income tax} &= (\text{Gross taxable income}) \times \text{Tax rate} - \text{Deduction} \\ &= (33,500 \times 35\%) - 1500 = 10,225\end{aligned}$$

$$\begin{aligned}\text{Income tax on his basic salary} &= (\text{Basic salary}) \times \text{Tax rate} - \text{Deduction} \\ &= (3,500 \times 20\%) - 302.50 = 397.5\end{aligned}$$

Income tax payable to Ethiopian Tax Authority on such foreign source (Botswana) income is calculated as follows:

Total income tax:	Birr 10,225
Less: Tax paid on his basic salary	397.5
Income tax payable from foreign income	9,827.5
Less: Tax paid in abroad:	11,428.57
Tax from foreign income	<u>= 0</u>

The Income tax paid by resident in abroad shall be reduced by the amount of foreign tax payable on such income, However, the reduction of the income Tax provided shall not exceed the tax payable in Ethiopia that would otherwise be payable on foreign source income.

The investment tax credit: refers to immediate reduction of business profit tax for some investment made during the tax period. In Ethiopia, there is no tax provision relating to investment tax credit.

Businesses can take advantage of foreign tax credit as per Art. 7 or Proclamation No.979/2016

Computation of TBI from GAAP Based Financial Statements

Particulars	Amount in birr
Taxable Business Profit from GAAP Based Income Statement.....	xxxxx
Add: Non-Deductible Expenses (If they are deducted)	
Depreciation on revalued assets.....	xxxxxx
Above 15% of the basic salary retirement contribution	xxxxxx
Declared dividends and paid-out profit Shares.....	xxxxxx
Interest in excess of the rate of specified in	
Proclamation No 286.....	xxxxxx
Damages covered by insurance policy	xxxxxx
Punitive damages and penalties.....	xxxxxx
Un-allowed provisions and reserves	xxxxxx
Income tax paid on Schedule “C” income.....	xxxxxx
Recoverable value-added tax.....	xxxxxx
Representation Expense above 10% of the Basic Salary.....	xxxxxx
Personal Consumption Expenses.....	xxxxxx
Entertainment Expenses	xxxxxx
Donation or gift made to organizations not listed	xxxxxx
Other expense if any.....	xxxxxx

Total Non-Deductible Expenses	XXXXXX
Less: Allowable Expenses (If not claimed)	
Expenses incurred for earning business income.....	XXXXXX
Depreciation Expense	XXXXXX
Irrecoverable Bad Debts Expense.....	XXXXXX
Total Deductible Expense.....	(XXXXXX)
Taxable Business Profit for tax purpose.....	XXXXXX

- ✚ For income tax purposes the taxpayer files the returns of income (statement of income in the prescribed Form) along with accounts. The statement furnished may not be correct in all respects. Hence, the taxable income is calculated in the following manner:
- ✚ If the tax payer has deducted any expense which is non-deductible, then such amount is to be added back with his net profit given in the furnished return of income. Likewise if the tax payer has not claimed any expense that is deductible, then such amount is to be deducted from the net profit shown in the accounts

4.3.8. Other Administrations Issues

4.3.8.1 Assessment of Business Income Tax

After having a deep knowledge about the determination of taxable income from business operations, it would be meaningful to know how tax can be computed. The income tax proclamation 979//2008 provides the tax rates that should be used for this purpose. The tax rate is applied on the assessed taxable income of the business unit. Once the declaration is made by the business unit, its accuracy is checked by the tax office through a process called tax assessment.

Tax assessment is a tax review by a tax official of the tax declaration and information provided by a taxpayer and a verification of the arithmetical and financial accuracy of the declared tax liability. Pursuant to the proclamation, each taxpayer is required to furnish the tax authority with all the information required for the assessment of income tax. This information should contain details about his operations, and relationship with other bodies that may be necessary for the declaration of income, or for supporting the books of accounts. The procedure for the assessment of business income tax takes two forms: assessment by books of accounts, and assessment by estimation

Assessment by books is 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 taxable income within the time required. Tax of those taxpayers who have different sources of income under schedule 'C' will be assessed on the aggregate of all income.

A. Assessment by Books of Accounts

If the taxpayer doesn't comply with the requirements of law in furnishing full information, the tax office gets the information from different sources such as government offices, private firms, and individuals for the purpose of assessment. In assessment, the tax authority shall initially assess the amount of taxable income and then impose the tax at the rate corresponding to this amount. When sending the assessment to the taxpayer, the tax office notifies him/her the amount of gross income, deductions thereon, taxable income, rate applied, taxes paid and due, any penalties chargeable as per the proclamation and interest, if any, and the name, address and TIN of the taxpayer. The tax authority shall also provide him/her with such explanation concerning the matters regarding taxable income, tax payable, and penalty.

As indicated in the previous discussion, the starting point in the assessment of taxable income is the net income disclosed by the income statement. Adjustments are made to it if it is not determined as per the provisions of the law. Those expenses which are included in the income statement but are not allowed are added back to the declared income. Likewise, any expense, which is allowed for tax deduction, but not included in income statement, will be included in the determination of taxable income. The taxable income so arrived is multiplied by the tax rate to compute tax from business activities. This may be summarized as follows:

Declared net income	XXX
Audit adjustments:	
Add: Expenses deducted but not allowed	XX
Income not indicated	<u>XXXX</u>
Less: Expenses not deducted but allowed	XX
Income not taxable	<u>XXXX</u>
Taxable Income	<u>XXX</u>
Business tax = Assessed Taxable income X Rate	

Example 1: The following income statement is submitted by ABC metal works enterprise (in brief) on Sene 30, 1995.

ABC metal works Enterprise	
Income statement	
Year ended Sene 30, 1995	
Sales	1,157,894
Cost of goods sold	1,064,218
Direct cost of production	<u>27,753</u>
Gross profit	65,923
Operating expenses	<u>27,002</u>
Profit before tax	<u>38,921</u>

On assessment, the tax office revealed the following points

1. Depreciation expense was over allocated by Birr230.
2. Capital expenditure of Birr 8580 was wrongly recorded in the income statement. Depreciation on this asset was Birr 715, not recorded in the income statement
3. Miscellaneous expenses include Birr 768 without any source document
4. Donations of Birr 200, penalty of Birr 80, and salary of proprietor Birr 580 were recorded in the income statement.
5. 25% of the telephone expenses (expense totaled Birr 552) were incurred for personal purposes.

Required: Compute the taxable income as per the income tax regulation, and determine the tax liability.

Solution	
Profit tax assessment	
Income statement	
For the year ended Sene 30, 1995	
Declared income	38,921
Audit adjustments:	
Add: Disallowed expenses	
Depreciation expenses	230
Capital expenditure less depreciation	7,865
Miscellaneous expenses	768
Donation expense	200
Penalty expense	80
Salary of proprietor	580
Telephone expenses	<u>138</u>
Adjusted income	<u>48,782</u>
Income tax	9684.6
(Tax=48782 X 30% - 4950 =9684.6)	

Example 2: XYZ Share Company declared the following taxable income for the year ended Sene 30, 1995.

Sales	4,631,576.40
CGS: Beg. Inventory	1,309,211.40
Purchases	4,194, 075.80
Year-end inventory	<u>(1,246,413.80)</u>
COGS	4,256,873.40
Gross profit	374,703.00
Operating expenses:	
Salary& admin. Expenses	64,393.54
Rent expenses	12,000.00
Stationary expenses	2,141.40
Depreciation Expenses	28,450.00
Communication expenses	6,067.80
Maintenance expenses	15,317.00
Insurance expense	3,309.08
Tax and fees	5,544.00
Interest expense	1,224.44
Miscellaneous expenses	<u>21,105.40</u>
Total operating expense	<u>159,553.38</u>
Net income before tax	<u>215,149.62</u>

Tax auditors, after a careful examination of the documents, revealed the following.

1. Expenditures without source documents amount to Birr 1,876.5
2. Rent of Birr 6,000 was paid for year 1996
3. Birr 1607 of insurance expense was paid for private purposes
4. Ending inventory was overstated by Birr 25,370
5. The documents produced for the payment of subscription Birr 850 was not reliable.
6. Birr 1,270 were incurred for the payment of membership fee for a sports club

7. Entertainment and donation were Birr 2,750 and Birr 5,000 respectively (included in miscellaneous expenses)
8. Expenses of Birr 15,350 were related to the sister concerns of the enterprise
9. Purchases of Birr 23,718.5 were without reliable documents.

Required: Compute the taxable income of the company for the year 1992 and the tax liability of the company for the year as per the Ethiopian income tax proclamation.

Solution:	
Declared income before tax	215, 149.62
Audit adjustments:	
Add: Expenditure without source documents	1,876.50
Prepaid rent	6,000.00
Personal insurance expense	1,604.00
Understated ending inventory	25,370.00
Payment for subscription	850.00
Membership fee	1,270.00
Entertainment expenses	2,750.00
Donation	5,000.00
Expenses of sister concerns	15,350.00
Purchases without source documents	23,718.50
Tax and fee	<u>5,544.00</u>
Taxable Income	<u>304,482.62</u>
Income tax =304,482.62 X 30%	Birr 91,344.79

4.3.8.2 Assessment Notification

On completion of assessment, a notification regarding the assessment of income tax, in writing, is provided to taxpayers in the following ways.

- **To resident individuals:** By registered post or in person. (In case 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.

- **To bodies:** by a registered letter to the body, or to any director or employee.
- **To non-residents:** by a registered letter to the agent or by affixing the notice on the residence or place of business.

B. Assessment by Estimation

The taxable income of category ‘C’ taxpayers will be determined through a standard assessment. It is a fixed amount of tax determined through the regulation (of Council of Ministers), considering variations such as type of business, business size and location. Category ‘C’ taxpayers have to declare taxable income between July 7 and August 6 every year, that is, before Hamle 30. The period for which the standard can be used and the revision thereon is determined by a directive issued by the Minister.

Category ‘C’ taxpayers should pay tax at fixed rate on the income estimated by the income tax authority. Such taxation, based on the same estimation, may continue from year to year until revised by the authority. The taxable income of taxpayers (where assessment by estimation is used) shall be estimated using their daily sales. Tax assessors are 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. The schedules of presumptive tax developed by the tax experts are used for collecting tax on category ‘C’ taxpayers. The process may be clear from the following illustration.

- ✓ **Step I:** Gather information on the daily sales of the taxpayer
- ✓ **Step II :** Multiply the daily sales figure by the number of business days a year to arrive at the estimated annual sales
- ✓ **Step III:** Locate the amount of tax payable by the taxpayer from the presumptive Tax schedule provided.

Example1: The following details relate to the activities of a printing press for the year ended Sene 30, 1992

- a) Estimated daily sales revenue Birr 625
- b) Number of working days in the year 345

Required: Estimate taxable income for the year and determine the tax liability of the taxpayer for the year

Solution: Annual sales revenue = 625 X345= Birr 215,625

Income tax = Birr 284,375 (Because annual sales between 215,625 and 500, 000 will be charged with Birr 284,375)

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 using certain indicators such as sales and purchases.

4.3.8.3 Declaration of Income

Taxpayers under schedule 'C' income have to follow the procedures stated in the tax law for declaring their taxable income. The period of declaration depends on the category to which they belong. The procedure may be summarized as follows.

- Taxpayers who are categorized as 'A' are required to declare their taxable income within four months from the end of the tax period.
- Those taxpayers who are categorized as 'B' are required to declare their taxable income within two months from the end of the tax period.
- Category 'C' taxpayers should declare taxable income together with the annual turnover, and the amount derived from the sources other than the main operation within 30 days from the end of the fiscal period

Declarations are to be made in prescribed forms provided by the Income Tax Authority accompanied by the required supporting evidences. The agents shall declare the taxable income of non-residents, who operate business through them. Declaration shall be made at the following places.

- To the Federal or Regional tax office
- To the tax office at the place the head office of the business is located when the taxpayer engages in more than one business activity.
- A non-resident shall declare the taxable income at the place where he derives most of his income.
- If a taxpayer engages in business in more than one region, taxable income shall be declared in the respective regions.

Payment of Tax

Taxpayers are required to pay tax simultaneously with the declaration of taxable income, net of tax withheld and foreign tax credit. Subsequently, after the assessment of tax, the tax authority should

refund the excess of tax paid over tax per assessment within 60 days of receiving tax declaration. If the payment of tax is not made within the time limit permitted, the taxpayers will be obliged to pay interest for the period from the due date to the date of payment. The interest for non-payment is set at 25% more than the highest commercial lending rate prevailed during the preceding quarter.

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

When a taxpayer fails to declare his taxable income within the period specified in the regulation, he will be liable to pay Birr 1,000 for the first 30 days of non-declaration. The penalty is Birr 2,000 for the next 30 days of non- declaration. Thereafter, Birr 1,500 will be charged for each 30 days for failure to declare the taxable income. When a taxpayer fails to pay tax within the due date, he/ she will be required to pay a penalty of 5% of the amount unpaid. An additional 2% penalty on the amount unpaid is imposed on the first day of each month for non- payment.

As stated earlier, the penalties for non- declaration and non- payment fall on the taxpayer at the same time because declaration and payment are to be made by a taxpayer on the same day. Non-payment will also result in payment of interest for the period of non-payment. The interest rate is fixed at 25% above the highest commercial rate of the preceding quarter.

4.3.9. Business Profit Tax Incentives For Entities In Ethiopia

4.3.9.2 Loss Carry Forward

If, in any tax year, the taxable income of a business unit becomes negative (business loss), it can be carried forward three (3) years to set off the taxable income of those future years. In the process of carry forward, earlier losses should be set off before later losses. Also, a continuous set off will be permitted only for a maximum period of six (6) years.

If the direct or indirect share capital of a body increases more than 25% (in value or number) when the loss carry back goes on, the right of set off ceases to apply. Loss carry forward will be permitted only if the tax authority accepts the books of accounts submitted by the taxpayer and confirms the existence of a business loss.

Example: The declared taxable income of ABC Share Company for the year ended Sene 30 year3 was Birr 13,768 (loss). In year 4 and Year 5, the company declared taxable income of Birr 11,376 and Birr 27,354, respectively. The declared income was in accordance with the tax rules as per the tax office. How much did the company pay in Yearr3, Year4, and Yearr5?

Solution:	
✚ Year3, declared loss	= Birr 13,768. <i>The company didn't pay tax due to the loss</i>
✚ Year4, declared income	= Birr 11,376
✚ Loss of Year 3 carried forward	= Birr 13,768
✚ Taxable income	= Birr (1,392). <i>The company didn't pay tax in Year 4</i>
✚ Year5, Taxable income	= Birr 27,354
✚ Loss of Year 3 carried forward	= Birr 1,392
✚ Taxable income	= Birr 25,962
✚ Income tax of Year 5 (25,962X 30%)	= Birr 7,788.6

In the above example tax rate used is 30%, because taxpayer is a 'body'. This provision is also applicable for business units engage in long-term construction contract. They are entitled to have an additional relief in connection with loss carry forward. That is, if loss cannot be fully set off with carry forward, it may be carried back to preceding years and applied against the income of those years.

4.3.9.2 Tax Holiday

The principal reason for introducing special tax incentives has been to encourage expansion of the modern sector of the economy. The most important incentives have taken the form of total or partial exemption from tax, and have been granted mainly in connection with income or profit and customs duties. Accordingly, the Government of Ethiopia has given the following tax incentives in connection with the business income tax. Organizations that are given investment licenses for the following investment activities are exempted from payment of income tax as summarized below.

4.4. OTHER INCOME TAXES (SCHEDULE “D”)

????

Pretest

Dear students, what do you mean other income and what are components of other income tax

People may get income from other sources in addition to (or other than) the income obtained from their employment, their business activities, or their renting activities. Examples of such income include money received from their investment on financial institutions and corporations, from providing expert services, through games of chance, by renting properties other than building, and profits from selling their properties. These income items cannot be included in any of the schedules such as ‘A’, ‘B’ or ‘C’, since these schedules are the items of revenue from specific sources. All sort of these incomes are taxable under the law in force in Ethiopia: the Income Tax Proclamation No. 979/2016 and the Income Tax Regulation No. 78/2002. Schedule D has no exemptions and deductions except capital gain. The Gross Income is considered as the Taxable Other Income and used to reckon (record) the tax liability on other income. The tax amount is withheld by the payer of schedule “D” Income such as Ethiopian National Lottery Administrations, Banks, book Publishing and Distribution Companies, Music Studios and others.

4.4.1. Withholding of Schedule “D” Income Tax on Payments

The Payer of any payment subject to tax under Schedule “D” shall withhold from the payment the amount of tax required by Schedule “D”. The obligation of the payer to withhold tax has priority overall other obligations to withhold amounts from payments to payee (the taxpayer). A payer shall pay the withheld tax to the tax authority within fifteen (15) days of the end of each calendar month, and each payment shall be accompanied by a statement with respect to each taxpayer who received payments during the month. The statement shall be in the form and furnished in the manner prescribed by the Tax authority and shall contain the following information.

- ◆ The name, addresses, and TIN of each taxpayer (person with schedule D income).
- ◆ Amounts of payments subject to tax under schedule D.
- ◆ Amounts of the tax withheld from the payments.

At time of making payments to a taxpayer, the payer shall furnish each taxpayer a tax withholding certificate (in the form of prescribed by the Tax Authority) showing the date of the payments and stating the information listed in Sub-Article (4), the taxpayer’s right to contest the amount of tax withheld and the manner of doing so. The tax withholding certificate is proof of the amount of tax withheld on payments subject to tax under schedule D.

Every Taxpayer who has Schedule D Income, not subject to withholding at source constituting a final tax, shall prepare a declaration of that income in a form prescribed by the Tax Authority. Taxpayers shall submit this declaration to the Tax Authority within two (2) months from the end of the Ethiopian Fiscal Year. The tax calculated in accordance with the declaration, after the Foreign Tax Credit has been reduced from the related Schedule D income subject to taxation during the year, shall be transferred by the taxpayer to the Tax Authority simultaneously with the Declaration Form. The amount of tax due for the year, as stated in the declarations, shall be the amount assessed by the Tax Authority unless the Tax Authority determines that an error or omission has been made.

4.4.2. Basic Legal Provisions on Other Income Tax

The legal provisions are taken from Income Tax Proclamation No. 979/2016.

Components of Other Income

4.4.3. Royalty Income (Article 31, EITP No. 979/2016)

Royalty income is the amount received for the use of a right. As per income tax proclamation No 979/2009, the term royalty means a payment of any kind received as a consideration for the use of or the right to use the following.

- A. Any copyright or literary, artistic or scientific work, including cinematography films, and films and tape for radio or television broadcasting
- B. Any patent, trademark, design or model or plan, secret formula or process
- C. Any industrial, commercial, or scientific equipment, or for information, concerning industrial, commercial or scientific experience.

Income from royalty is taxed at a flat rate of 5%. This tax is final tax in lieu of an income tax. It is the payer's responsibility to withhold tax on royalty income. The Withholding Agent who effects payment shall withhold the foregoing tax and account to the Tax Authority within the time limit set out in this proclamation and should be remitted to the tax office within 15 days of the end of each calendar month. Where the taxpayer resides abroad and the recipient is a resident, the recipient shall pay tax on the royalty income within the time limit set out in this proclamation. It is to be noted that on royalty income no special deductions are allowed for tax determination. That means, it is the gross income received from royalty that is subject to tax.

Example: ABC Textiles Company, an Ethiopian resident, entered into a technical collaboration agreement with Suji Textile Company, a Kenyan based company. The collaboration involved exchange of trade secrets for Br 1,500,000.

Required: Determine the Royalty Income Tax and the relevant journal entries assuming:

- A. The Kenyan firm (recipient) sold the secrets to the Ethiopian firm (withholding agent)
- B. The Ethiopian firm (recipient) sold the secrets to the Kenyan firm (withholding agent)

Solution A

Royalty Income Tax and the relevant journal entries assuming the Kenyan firm (recipient) sold the secrets to the Ethiopian firm (withholding agent)			
Computation of other Income Tax on Royalty Income			
Tax on Royalty = 5% of Royalty Income = 5% of 1,500,000 = 75,000			
	P/R	Debit	Credit
Patent		1,500,000	
Royalty Income Tax Payable			75,000
Cash.....			1,425,000
(To record the payment of royalty income to Kenyan firm)			
Royalty Income Tax Payable		75,000	
Cash			75,000
(To record the payment of the tax withheld to the tax authority)			

Solution B

Royalty Income Tax and the relevant journal entries assuming the Ethiopian firm (recipient) sold the secrets to the Kenyan firm (withholding agent)			
	P/R	Debit	Credit
Cash.....		1,500,000	
Royalty Income Tax Payable			75,000
Royalty Income			1,425,000
(To record the receipt of royalty income from Kenyan Firm)			
Royalty Income Tax Payable		75,000	
Cash			75,000
(To record the payment of tax on royalty income to the tax authority)			

4.4.4. Income from Rendering of Technical Services (Art 32, EITP No. 979/2016)

The term “technical service” means any kind of expert advice or technological service rendered. Residents of Ethiopia, who render technical services (expert services or advice) abroad and obtain income, are categorized here as taxpayers. The income received from rendering services abroad is taxed at a flat rate of 10%. The payer is obliged to withhold tax and remit to the tax office within 15 days of each calendar month. For example, an Ethiopian expert rendering his services in Djibouti and getting income for such service will be taxed at the stated tax rate. In circumstances where the payer resides abroad, the recipient has the obligation to make payment of tax on his income within the stated period. Here also no deductions are allowed. It is the gross income that is taxable under this head of income.

Example: Nati manufacturing Company has received an expert advice on the manufacturing process of sugar from the YBZ Inc., a UK based Company, and paid a compensation of Br 180,000 net of tax.

Required: How much is the tax to be paid to the Tax Authority? $(X - 0.1X) = 180,000$

Solution (A) Computation of other Income Tax on payment for technical service received			
Tax on Payment = 10% of Payment = 10% of 200,000* = 20,000			
*($X - 0.1X$) = 180,000 (Net of Tax)			
$0.9X = 180,000$ $X = 180,000 / 0.9$ $X = 200,000$			
To record the journal entries for the technical service rendered.			
	P/R	Debit	Credit
Technical Service Expense.....		200,000	
Technical Service Income Tax Payable			20,000
Cash			180,000
(To record the payment for the technical service rendered)			
Technical Service Income Tax Payable		20,000	
Cash.....			20,000
(To record the payment of the tax withheld to the tax authority)			

4.4.5. Dividend Income (Article 34, EITP No. 979/2016))

Persons who invest in shares of companies and getting return for their investment are obliged to pay this tax. The investments represent investment in share companies or private limited companies. Any person obtaining such income is taxed at a rate of 10%. This tax is a final tax in lieu of income tax. Tax on dividend is also a withholding tax. This means that, the payer of the revenue, that is, the company is required to withhold tax on behalf of the taxpayer and transfer the same to the tax office within the time specified. Like all other withholding taxes under schedule 'D' income tax on dividend is also to be paid within 15 days from the end of the calendar month.

It is to be noted that dividend is subject to double taxation in the country. You know that dividend is the amount of profit distributed by a company to its stockholders. This is part of the net income of the company. As per the business income tax, dividend is a non-deductible item for business tax purposes. Since it cannot be subtracted for determining taxable income under business income tax, it is taxed there together with the taxable business income. Again, when the net income is distributed to owners in the form of dividend, it is taxable as per the provisions of schedule 'D' income tax. The only difference is that the tax rates under the two situations are not the same.

Example: Ato Tizazu, the stockholder of a share company holds 2,500 shares of Birr 150 each. At the end of a fiscal year the company declared and paid dividend of Birr 75 per share. The tax payable by the stockholder on the dividend income is calculated as follows

Gross income from dividend = $2,500 \times 75 = \text{Birr } 187,500$

Income tax on dividend = $187,500 \times 10\% = \text{Birr } 18,750$

4.4.6. Interest Income on Deposits (Article 36, EITP No. 979/2016)

Interest earned on deposits in financial institutions is subject to tax under this provision. Those who invest in such investments and receive interest are obliged to pay tax at the rate of 5%, which is a final tax in lieu of income tax. Like the majority schedule 'D' taxes, tax on interest income is also a withholding tax. The distributor, i.e. the bank, withholds tax before making payment to the depositor. The withheld tax is to be transferred to the tax office within 15 days of the end of the calendar month in which the payment is made to the depositor.

Example: Ato **Wagaw** has a deposit with Commercial Bank of Ethiopia on which he is eligible to get interest of Birr 56,000 in a year. How much of this is withheld by CBE?

Solution: Tax withheld= $56,000 \times 5\% =$ Birr 2,800

4.4.7. Income from Games of Chance (Article 33, EITP No. 979/2016)

Those persons who receive income from games of chance winning (for example, lottery, tom bolas, and other similar activities) are the taxpayers of this category. As per the current tax law, income from winnings less than Birr 100 is not taxable. Winnings of Birr 100 and above are taxed at a rate of 15%. This tax is a final tax in lieu of income tax. As a withholding tax, the lottery administration withholds tax before making payment to the winner. The withheld tax is then transferred to tax office within 15 days of the end of the month.

Example: Ato **Getasew** won Birr 4,500,000 from Ethiopian National Lottery in Sene 2011. What is the amount of tax withheld by the lottery authority?

How much did Ato **Getasew** receive? $4,500,000 \times 0.15 = 675,000$

4.4.8. Income from Rental of Property (Article 35, EITP No. 979/2016)

In the earlier discussion, it was stated that there are leasing activities undertaken by people casually, which is not considered as continuous business activities. They perform such activities occasionally and earn income thereon. Example of such an activity is leasing furniture for certain ceremonial functions. Income received from such activity is not treated as rental income or business income. Tax on casual rental of property is not a withholding tax. Taxable income from this source is to be declared within two months from the end of the fiscal year. Accompanying declaration, payment should also be made by the taxpayer. Every person deriving income from the casual rental of property (including land building, or movable assets) not related to taxable business activity shall pay tax on the annual gross income at the rate of fifteen percent (15%). This tax is a final tax in lieu of a net income tax. For this purpose income from rental of property shall mean gross income derived by a person not engaged in a regular trade from casual rent of movable or immovable property.

Example: Ato Nahome Hunduma rented his Land Cruiser Toyota at Br 15,000 for three months to SS Tour and Travel Pvt. Ltd. Co.

Required: Determine the income tax to be withheld by the Payer SS Tour and Travel Pvt. Ltd. Co. and record the tax related transactions.

4.4.9. Capital Gain Tax (Article 37, EITP No. 979/2016)

As indicated in the first module, tax from gain on investment property, also called capital gains tax, is introduced in the country during the transitional period. The rules on capital gains tax prevailing in most countries can be characterized by marked differences. Some countries do not even tax capital gains. And for those who do, the approach used would vary. In some countries, capital gains are taxed as part of the income tax code, that is, as part of ordinary income. In others, capital gains are taxed separately and, thus, special rates are used.

1. What is Capital?

When asked what a capital is, most people would think of money, that is, the amount invested in a new business or the money used in buying shares or bonds. However, as some writers assert, “... for the purpose of understanding capital gains tax, it is wrong to think of capital as just financial assets. Capital is also physical investment – the plant, the factory. The fax machines and the other non-labor factors of production that make a business operate efficiently.” A fruit shop (like ET Fruit, for example) would not be able to exist without capital – the truck and the crates of fruits are the essential capitals that make the business operate. Other than money and physical investments, the concept of capital can also include technological innovations and even the glimmer of an idea that leads to the creation of a new business or product.

2. What are Capital Assets?

It has been asserted that almost everything one owns and uses for personal purposes or investment can be considered as a capital asset. This is somewhat a broad definition that could include one’s home, household furniture, jewelry, or even car. Note however that capital assets do not include supplies (i.e., paper and pens) or inventory (anything one regularly sells to customers during the ordinary course of business). For capital gains tax purposes, the “scope” of capital assets becomes narrower. However, there exists no “common list” as to what should be included under capital assets. What will be considered as capital asset for tax purposes varies across the world. For example, in the USA, a home, a farm or ranch and a work of art are considered capital assets. Other countries, including Ethiopia, do not have such wide tax base. But in most, if not all countries, (including Colombia, Mexico, and Nigeria) shares and bonds are commonly treated as capital assets. A few countries, however, only make a half-hearted attempt to tax the capital gains arising from real estate transactions. Within Ethiopian context, the term

‘capital assets’ refers only to (a) shares of companies and (b) urban houses or buildings held for business, factory and office.

1. Shares

The shares referred to in the proclamation would include those shares issued by share companies. For bonds, Ethiopia at present issues only short-term bonds in the form of Treasury bill. The use of these instruments is still in its infancy, owing principally to an economy that is still in the midst of transforming itself from a centrally-planned to a market-oriented economy and by extension, to a relatively undeveloped market.

2. Urban Houses/Buildings

Proclamation No. 47/1975 defines an urban house as “any house, whether fully constructed or under construction intended for dwelling or business or other purposes.” According to the current proclamation, the buildings situated within the urban range, if used for business purposes and are sold, the gain earned by the seller is subject to tax. It is to be noted that if the sale is of a residential house, the gain earned thereon is not taxable. The law also states that to be a residential house, the house must have been used at least for two years for residential purposes before its sale.

3. What are Capital Gains?

A capital gain is the rise or increase of the price of an asset over the period in which the asset is held. Such increase in value however is taxable only if it is realized; that is, the capital asset is sold. To illustrate the concepts of realized and unrealized gains: “... A realized capital gain is money in your pocket. If you bought shares at Birr 10 and sold at Birr 20, you realized a capital gain of Birr 10 per share. An unrealized gain is a gain that you have on paper, in other words, you bought a stock at Birr 10, still hold the shares, and at some date it’s trading at Birr 20. You have an unrealized capital gain as of that date of Birr10 per share, and because it’s unrealized, there are no tax implications.” Generally speaking therefore, for tax purposes, a capital gain is the income derived from the sale of a capital asset.

The capital gain from a sale is measured by the difference between the amount realized on the sale and the basis of the asset sold. Roughly, the amount realized is the amount received on the sale (i.e., the sales price) and the basis is the cost (i.e., the purchase price) of the asset, though it can be adjusted for various reasons. More specifically, in our context, the cost price of the

building is the cost registered with the appropriate government body at the time of its construction. Thus, there is a capital gain if the sales price is greater than the basis or cost. A capital loss occurs if the sales price is less than the basis or cost. A capital gain arises from the “increase in value upon the sale of shares and bonds and urban houses by persons or organizations.”

Due to various factors such as a limited bonds market, lack of appropriate regulating agencies, and a still undeveloped share market, capital gains tax are computed solely for urban houses. The discussion that follows will therefore focus only on gains arising from the sale of urban houses. Computation of the capital gains tax shall be based on the “value of the capital asset”, and such value defined as “the price for which the capital asset is sold,” adjusted for:

- Inflation in respect of building, and Taxes paid for the land and building.

These two adjustments or allowable deductions are permitted to determine the taxable income. As mentioned in the preceding section, current practice in Ethiopia only covers computation of capital gains for urban houses. Such computation is also more straightforward than what is stated in the previous capital gains proclamation. For instance, indexing for inflation is a seldom occurrence and adjustment for tax paid is practically non-existent. Thus, any gain arising from the sale of urban house is computed by this basic formula:

$$\text{Gain} = \text{Sales value of urban house} - \text{Cost of urban house}$$

4. Capital Gain Tax Rates

Income tax shall be payable on gains obtained from the transfer (sale or gift) of property described in this article at the following rates:

- a. Building held for business, factory, and office is 15% (fifteen percent).
- b. Shares of companies 30% (thirty percent).

Gains obtained from transfer of building held for residence shall be exempt. A building used for dwelling shall be exempt from capital gains only if such building is fully used for dwelling for two years prior to the date of alienation (the date of transfer).

The basis for computations of gains obtained from the transfer of properties shall be in the following manner as per the Regulations issued by the Council of Ministers:

1. When calculating the gain realized from the alienation of capital assets, the basis of calculation of the tax shall be the ***historical cost of the building or the par-value of the share, as appropriate.***
2. The gain obtained from the alienation of capital assets is the gain realized over the historical cost of the building or the par-value of the share, as appropriate.
3. When calculating the capital gain, inflation adjustment at a rate determined by the appropriate authority, in respect of buildings, taxes paid for the land and the building shall be allowed as deduction.
4. When calculating the capital gain realized from the alienation of buildings, the cost registered with the appropriate government body at the time of issuance of permit for the construction of building shall be taken to the cost of constructing the building.
5. Tax payable on gain realized from the alienation of buildings shall be applicable only the buildings in Municipal areas.
 - Any change of shares a resident company which is partly to Reorganization in exchange for share in another resident company which is also a party is not a disposal of the shares. The value of the shares given in exchange under Reorganization shall be equal to the value of the original shares.
 - Loss on the transfer of such property shall be reorganized and be available be to offset gain subject to the following limitations:
 - ✓ Loss on transfer may be used to offset gain on transfers of buildings or shares, but may not be used to offset any other income or gain. Unused losses may be carried forward indefinitely.
 - ✓ No loss shall be reorganized on transfer to associates within the meaning of Art. 2(4) of the ITP No. 979/2016.

Any person authorized by law to accept, register or in any way approve the transfer of capital assets shall not accept, register or approve the transfer before ascertaining that payment of the tax has been duly effected in accordance with this article.

A. Capital gain tax for Business Buildings	
Capital Gain Tax = Taxable Capital Gain @ 15%	
Selling Price of the building.....	xxxxx
Less: Cost of Building.....	(Xxxxx)
Gross Capital Gain.....	xxxxx
Less: Inflation Adjustment.....	xxxxx
Taxes paid for the land.....	Xxxxx
Taxes Paid for the Building.....	xxxxx
Loss carried on the Sale of Building	xxxxx
Total Deduction.....	<u>(Xxxxx)</u>
Taxable Capital Gain	<u>xxxxx</u>
Capital Gain Tax (Taxable Capital Gain @ 15%)	xxxxx

B. capital gain tax for Shares of Stock	
Capital Gain Tax = Taxable Capital Gain @ 30%	
Selling Price of the Share.....	xxxxx
Less: Par Value or Cost of Shares.....	(Xxxxx)
Gross Capital Gain.....	xxxxx
Less: Inflation Adjustment.....	xxxxx
Loss carried on the Sale of Shares.....	xxxxx
Total Deduction.....	<u>(Xxxxx)</u>
Taxable Capital Gain	<u>xxxxx</u>
Capital Gain Tax (Taxable Capital Gain @ 30%)	<u>xxxxx</u>

Example1: Consider the following information for Nile Share Company for the year 2006.

- ✚ In 2003, acquired 10,000 shares of Br 100 par for a total value of Br.1, 250,000
- ✚ In 2003, acquired two buildings with cost of Br.250, 000 each. The buildings were acquired for business purpose.
- ✚ During the year 2006, 500 shares were sold at a total value of Br.75, 000. One building which was acquired in 2003 was also sold at a consideration of Br.370, 000.

- ✚ Property tax paid for the building sold was Br.10, 000.
- ✚ For the last three years, the average inflation rate declared by the NBE is 10% for the three years period.

Required: Compute the Capital Gain tax for the year ended Sene 30, 2006.

Solution (A)computation of capital Gain and Taxable Capital Gain on Building Transfer		
Transfer Value of the building		370,000
Less: Allowable Deduction		
Historical cost of the building	250,000	
Inflation adjustment on historical cost of the building (250,000*10%)	25,000	
Property Taxes paid for the building	10,000	
Other expenses in connection with transfer	<u>0</u>	
Total allowable costs and expenses		<u>285,000</u>
Capital gain (loss) on building transfer		85,000
Less: Prior capital loss on transfer of buildings not offset		<u>(-0-)</u>
Taxable Capital gain on the transfer of the building		85,000
Capital Gain Tax on transfer of building (15% of TCG) (15% of 85,000)		<u>12,750</u>

Solution(B) Computation of capital Gain and Taxable Capital Gain on Share Transfer		
Transfer Value of shares		75,000
Less: Allowable Deduction		
Par value of the shares (500shares@Br100	50,000	
Inflation adjustment on Par value of the shares (50000*10%)	5,000	
Other expenses in connection with transfer	<u>-0-</u>	
Total allowable costs and expenses		<u>55,000</u>
Capital gain (loss) on share transfer		20,000
Less: Prior capital loss on transfer of shares not offset		<u>(-0-)</u>
Taxable Capital gain on the transfer of shares		<u>20,000</u>
Capital Gain Tax on the transfer of share(30% of TCG) (30% of 20,000)		6,000

Example: Ato Ayele acquired 10 shares of Trans Ethio Share Company for Birr 25,000 each and sold them at Birr 32000 each. How much does he pay as capital gains tax?

Solution
Selling price = $32000 \times 10 = \text{Birr } 320000$
Purchase price = $25000 \times 10 = \text{Birr } 250000$
Gain = $320000 - 250000 = 70000$
Capital Gains tax = $70000 \times 30\% = \text{Birr } 21000$

You have noted that some of the schedule ‘D’ taxes are withheld at source such as interest, dividend etc. For those taxes that are withheld the withholding agent, who withholds tax under the proclamation, is required to furnish details regarding the name, address, and TIN of each taxpayer, the taxable income and the amount of tax in each case. The payer of Schedule D income shall provide a withholding certificate to each taxpayer and this certificate is the proof of the amount of tax withheld.

INDIRECT TAXES IN ETHIOPIA

4.5. OVERVIEW OF VALUE ADDED TAX?

Value Added Tax (VAT) may be defined as “an indirect tax to be paid by the manufacturers or traders of goods and services on the basis of value added by them.” It is a general consumption tax assessed on the value added to goods and services. It is a general sales tax that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services. VAT is a transaction tax collected on all goods and services at all stages of production and distribution. Tax is collected on the Value added on each stage. Value added is the difference between value of sales and the value of purchases at that stage.

VAT is tax on value added to goods and services by enterprise at each stage of the production and distribution process. It arises whenever “Taxable person” makes supply of goods and services in the course of his business. Thus in some countries it is called “Good and Service Tax” or “GST”

VAT was invented by a French economist Maurice Laur, Director of the French Tax Authority, in 1954. VAT was invented because very high sales tax and tariffs encouraging cheating and smuggling. It is a government tax that is charged at each stage of production. For instance, when a company buys parts, then buys more parts - for each purchase, a separate VAT is paid. When a company exports into a VAT country, that company (or the company purchasing the products) must pay a VAT based on the value of the goods. There are nearly 140 countries that use the VAT system, with the average percentage being 15%.

It is a consumption tax because it is borne ultimately by the final consumer. It is not a charge on business enterprises. It is charged as a percentage of prices, which means that the actual tax burden is visible at each stage in the production and distribution chain. VAT is collected fractionally, via a system of deductions whereby taxable persons (i.e., VAT-registered businesses) can deduct from their VAT liability the amount of tax they have paid to other taxable persons on purchases for their business activities. This mechanism ensures that the tax is neutral regardless of how many transactions are involved.

VAT is a levy imposed on business at all levels of production and distribution of goods and services. It is determined on the basis of the increase in price, or value, provided by each stage in

the chain of distribution. Due to its efficiency in collection, compared to the ordinary sales tax, many governments started imposing VAT in recent years replacing sales tax.

In Ethiopia VAT introduced starting from 2003 G.C. or 1995 E.C. by replacing sales tax in our country and it indicated progressive development in contribution to government from then onwards.

- Value Added Tax (herein after VAT) is a tax on the Value Added
- It is an indirect tax on the value added
- A VAT may be defined as "a tax to be paid by the manufacturers or traders of goods and services is on the basis of value added by them".
- The value added by them is the difference between the receipts (from the sale) and payments made to various factors of production (land, labor, capital and organization)
- Manufacturer or Trader is not liable to pay the tax on the entire value of the commodity because the tax base for VAT is the Value Added.
- In Canada, VAT is known as “goods and service tax” or GST; and in Japan it is known as "Consumption Tax".
- VAT is an indirect tax, in that it is a tax collected from someone other than the person who actually pays the tax.

4.5.1. Comparison of Value Added Tax and Sales Tax

The most significant event in the evolution of tax structure in the last half of 20th century is the widespread introduction of the VAT in many developing countries and transition economies. In many countries VAT has been the center of tax policy and tax administration efforts. Originally introduced in France (1954), it is now a major part of the tax structure of most Western European Countries. In the early 1990s, the US government considered instituting a VAT to fund national health care programs.

The tax paid by the immediate distributor of goods and services charge tax on the prices of those items. Because the consumer ultimately pays a higher price for the taxed commodity, a VAT is essentially a hidden sales tax. If we examine how sales tax works, it can be seen that sales tax is collected by the person stands prior to the consumer in the chain of distribution (i.e. the retailer). On the other hand, as stated earlier, VAT is collected from all the parties in the channel of distribution. It doesn't mean that the tax collected from all these distributors in the form of VAT is greater than the sales tax collected at one particular stage. In fact, they are the same in amount.

Though different reasons are advocated for adopting VAT, the main argument for introducing it is the ability of VAT to raise increased revenue with less administrative cost than other types of taxes. The revenue rising potential of VAT has proven to be substantial even in countries having their early stages of economic development. VAT also ensures neutrality and treats imports and domestic trade in the same manner. It minimizes the disincentives to save and invest because the tax burden of VAT falls mainly on consumption. So the broad base of VAT doesn't alter the relative prices of alternative consumption goods and services. Moreover, evasion of VAT will be less, compared to other types of taxes.

The collection of tax begins with importers and producers and ends with the retailers. As a result, VAT collects the equal amount of tax on goods and services as a single stage sales tax. Though it is collected at different stages, it will finally rest with the consumers. Tax neutrality is achieved by giving credit for the tax paid on all purchases from registered suppliers against tax payable on sales. Imposition of tax on all goods and services avoids the consumption of tax-favored goods over the taxable goods. In addition, most of the cost of collecting tax is borne by the business rather than by the government.

Previously, many African countries relied on single stage sales tax on goods and services. Later, they shifted from single stage sales tax to VAT and experiences of those countries proved significant increase in their revenue. One of the key concerns in the introduction of VAT in those countries was the need for increasing revenue for government. The other reasons for the shifting may be summarized as follows.

- ☞ VAT broadens the tax base.
- ☞ It improves tax administration.
- ☞ It eliminates cascading of tax.
- ☞ It makes domestically produced goods more competitive in the international market.

4.5.2. Components of VAT

VAT has two principal components: **Input VAT** and **Output VAT**.

- **Input VAT** is the value added tax paid on purchases of taxable goods and services. It is the VAT paid on purchases.
- **Output Tax** is the Value Added Tax collected on the sale of taxable supplies (goods and services). It is the VAT collected on sales.

- ☞ During the specific period of time, the output tax may exceed the input tax or vice-versa. If the output VAT is greater than the input VAT, **the difference is the VAT Payable or Liability** to the tax authority. But if the input VAT is greater than the output VAT, **it will result in VAT Refundable or Credit.**

4.5.3. VAT Exclusive and Inclusive Price and Determination of VAT

- ❖ **VAT Exclusive Price:** In this case, purchases and sales are made Exclusive of VAT. When a VAT Return is prepared, the Output and Input Tax are determined by multiplying Sales and Purchases Price by the existing VAT Rate.

$$\text{✚ VAT} = \text{VAT Exclusive Price @ VAT Rate}$$

- ❖ **VAT Inclusive Price:** In this case, purchases and sales are made inclusive of VAT. When a VAT Return is prepared, the Output and Input Tax is determined by multiplying sales and purchases by the Ratio of VAT Rate to 1 Plus VAT Rate; For example if the VAT Rate is 15%, Sales and Purchases Price which are VAT Inclusive are multiplied by 15/115 which is the same as 0.15/1.15)

$$\text{✚ VAT} = [\text{VAT Inclusive Price}] @ [\text{VAT Rate} / (1 + \text{VAT Rate})]$$

4.5.4. Rates of VAT

The VAT rates applicable to taxable goods and services differ from country to country. Some countries have adopted VAT with a single rate and others with a multiple rate. Some countries also use VAT inclusive price and some others countries adopt VAT exclusive rate. In general, there are two types of VAT rates to charge taxable supplies: Standard vat rate and zero-vat rate. Standard Rate is a positive VAT rate set by a country's tax laws to charge VAT on taxable goods and services. For instance, the standard VAT rate in Egypt is 10%, in Cote-Devoir is 20%, in UK is 17.5% and in Algeria is 21%. Zero-Rate is a VAT rate of zero (nil). This means, a taxable person charges VAT at 0% on its sales. Hence, the taxable supplier does not have a tax liability on its sales but is allowed the credit (refund) for tax paid on its purchase to provide the supply.

A number of countries around the world are implementing Value Added Tax in order to increase their tax revenue. This is due to the fact that it is a broad based tax and could solve the problems such as distortion brought by other indirect taxes and loss of revenue. In the UK, VAT is charged on the value of supplies of taxable goods and services made and on imported goods. The main rate is 17.5% but a few supplies are charged at 5%. All traders must register for VAT if the value

of taxable supplies in the previous 12 months was more than 58,000 pounds or is likely to exceed this annual limit in the next 30 days. A registered taxpayer must charge VAT on customers on the sales. The tax period is 3 months and some big companies are required to submit VAT return monthly.

In Trinidad and Tobago, VAT was introduced in 1990 and the tax rate is 15%. Any sole proprietor, company partnership joint venture, and other incorporated bodies which conduct business and make commercial supply with a gross value in excess of \$200,000 in any 12 months are required to register for VAT. In Singapore, Australia, New Zealand, and Canada, this tax is called goods and services tax. A common VAT system is compulsory for the members of the European Union. The minimum rate is 15% although different rates are applied in member states of the European Union. The rates of VAT vary in different countries. For example, Luxemburg has 15% rate, Germany 16%, Spain 16%, Portugal 17%, Greece 18%, France 19.6%, Italy 20%, and Austria 20% and Ethiopia 15%.

4.5.5. VAT in Ethiopia

The policy of privatization introduced by the country and the emergence of free market economy again called for a change in the set up. Thus, in order to minimize the complexity of tax administration, to increase government revenue, to enhance taxpayer compliance, to encourage investment, and to improve the efficiency and effectiveness of the tax administration, the Government of Ethiopia has launched a tax reform program. One of the most important steps in the tax reform, among other things, was the shifting of sales tax to VAT. The VAT implementation program is almost complete and is introduced in the country from the beginning of 2003 G.C. Currently, the Ethiopian Revenues and Customs Authority (ERCA) administers Value Added Tax in the country. VAT Proclamation No. 285/2002 contains provisions for the determination of VAT in the country. The Council of Ministers Regulation No. 79/2002 also contains additional regulations for the implementation and operation of VAT. The newly amended VAT Proclamation No. 609/2008 also supports the earlier proclamation.

Tax Authority's role of collecting VAT and the concept of VAT are not cumbersome. Registered organizations (those who register for VAT) collect VAT from those traders to whom they supply goods or services. The amount collected is not revenue for them rather it belongs to the government. These registered organizations also pay VAT on the purchases they make, but it is not an expense for them. Before making payment (VAT) to the government, they set off the

VAT they have paid for their purchases against VAT they have collected from the sales revenue using documentary evidences or invoices.

4.5.6. Legal Provisions on VAT in Ethiopia

The legal provisions are taken from Value Added Tax Proclamation No. 285/2002 and Value Added Tax Regulation No. 79/2002. Most transactions involve supplies of goods and services. VAT is payable on taxable supplies made in Ethiopia by a taxable person in the course or furtherance of the taxable activity during an accounting period. The Analysis of this legal point is as follows:

A. Taxable Supplies made in Ethiopia

B. Taxable person refers to a taxpayer for VAT Purposes

C. Course or furtherance: an activity undertaken to develop, advance and progress the taxable activity by a taxable person is assumed to be undertaken in the course or furtherance of taxable activity. The supply of goods or rendering of services by an employer to his employees, including gratuitously, is a supply of goods or services in the course or furtherance of a taxable activity

D. Taxable Activity: any activity, which is carried regularly by any taxable person in Ethiopia whether or not for a pecuniary profit as long as it involves or is intended to involve in whole or in part the supply of goods or services to another person for consideration.

E. Accounting Period – is a calendar month.

4.5.7. VAT Registration

All the traders who distribute goods and services in the country are not required to register for VAT. Any person conducting a commercial enterprise or intending to conduct a commercial enterprise may apply to be registered for VAT. However, as per the country's VAT legislation, VAT registration is of two types: Mandatory and Voluntary Registration.

4.5.7.1. Mandatory Registration

Any person conducting a commercial enterprise or intending to conduct a commercial enterprise may apply to get registered for VAT. The term any person for purposes of VAT registration includes: Sole proprietor, Company, Partnership, Estate of the Deceased, Trust, Incorporated Body or Unincorporated Body or Club or Association, etc.

If the gross sales value or turnover of the enterprise, which is gross income for 12 calendar months, exceeds or is likely to exceed Br 1,000,000, the person conducting the enterprise must register for VAT with VAT Department of the ERCA. **It is calculated ongoing basis.** Turnover related to exempt supplies is not to be included in compulsory VAT registration.

4.5.7.2. Voluntary Registration

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

Consumers who buy goods and pay VAT should make sure that they have paid tax to a person who has registered for VAT. Lack of knowledge about VAT on the part of consumers may lead to unnecessary payment in the sense that they may sometimes pay tax to a trader who has not registered for VAT. As a precaution, it would be advisable to see the registration certificate or the registration number before making payment. Those who import goods (other than tax exempt) and services, and those who supply taxable items with turnover Birr 1,000,000 and above are the VAT collectors in the country as per law.

☞ Benefits of Voluntary Registration

Input VAT can be recovered if a person is registered for VAT. It will be therefore, beneficial to voluntarily register where the person makes mainly zero-rated supplies. In such case, Input VAT will be recovered and no VAT will be charged on zero-rated output.

Who pays VAT?

As a consumption tax, the final obligation for the payment of VAT rests on the buyer. The seller collects it together with the prices charged on the supplies. But the question here, are all the sellers responsible for collecting VAT and transfer to the tax office? Definitely the answer is no. Only specific category of distributors who supply goods and services are legally responsible to collect and transfer it. The category includes the following.

- ☞ In the case of supply of goods and services, the registered supplier.
- ☞ In the case of import of goods, the importer.
- ☞ In the case of import of services, the recipient of service.

The above category of distributors (in the case of import, the importers) collects VAT from consumers and gives it to the tax office within the time required by law. A person required to

register shall apply for registration in the prescribed form. Upon registration, the authority will issue a certificate of registration showing full details of registration within 30 days of the registration. Thereafter, the registered supplier is required to show the registration number (tax payer identification number) on all invoices issued.

4.5.8. Imposition of VAT

The section examines the goods and services distributed in the country for which VAT is to be paid. This helps you get the idea of what are the items on which VAT is not imposed. It also examines *tax-exempt supplies* or the supplies on which tax is not imposed.

Supplies (goods and services), which are liable to VAT, are called taxable supplies. From the date on which traders become registered suppliers, they must collect VAT on all supplies they make. A registered supplier is a supplier registered for VAT collection. .

Subject to the provisions of the VAT proclamation, there shall be levied and paid tax to be known as Value Added Tax, at the rate of 15 % of the value of:

- ☞ Every taxable transaction by a registered person
- ☞ Every import of goods, other than an exempt import

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, determined in accordance with the customs legislation of Ethiopia, plus the sum of duties and taxes (Custom Duty and Excise Tax) payable upon the import of the goods into Ethiopia, excluding VAT and income tax withholding.

4.5.9. Standard Rated Supplies

Standard rated supplies are those taxable supplies (goods and services) on which VAT is charged at a standard vat rate of value of supply. All supplies subject to VAT (taxable supplies) other than zero-rated and exempted supplies are standard rated supplies. These are supplies of goods or provisions of services which are neither exempt nor zero-rated and taxable at the standard rate of 15%.

4.5.10. Zero Rated Supplies

In addition to taxable supplies and tax-exempt supplies, the proclamation also provides for imposing VAT on the following supplies and imports at Zero percent.

- ☞ The export of goods or services to the extent provided in regulations

- ☞ The rendering of transportation or other services directly connected with international transport of goods or passengers,
- ☞ The supply of gold to the National Bank of Ethiopia; and
- ☞ A supply by a registered person to another registered person in a single transaction of substantially all of the assets of a taxable activity or an independent functioning part of a taxable activity

Note: On Zero Rated supplies the registered person can claim the Input Tax Credit on purchases either it is domestic or import. The input VAT will be recovered but no Output Tax will be reported for the sales.

4.5.11. VAT Exempt Supplies

Often people raise doubts as to the items on which VAT need not be paid. Yes, there are goods and services consumed by the common people on which VAT is not levied. These supplies are known as VAT exempt supplies. In other words, supplies, which are not liable to VAT are called exempt supplies. On such supplies VAT is not chargeable. These supplies are not taxable and hence are not part of the taxable turnover of the supplier. Unless the customers are aware of the fact certain goods are tax exempt, they will be misled and be required to pay VAT that actually they are not required to. As per VAT proclamation, the following supplies and imports are exempted from payment of VAT.

- ❖ The following types of supplies of goods (other than by way of export) or rendition of services, as well as the following types of imports of goods, are exempt from payment of VAT to the extent provided by regulation:
 - ☞ The sale or transfer of a used dwelling, or the lease of a dwelling
 - ☞ The rendering of financial services
 - ☞ The supply or import of National Or Foreign Currency (except for that used for numismatic purposes), and of securities
 - ☞ The import of gold to be transferred to the national bank of Ethiopia
 - ☞ The import or supply of prescription drugs and medical services
 - ☞ The rendering of educational services provided by educational institutions,
 - ☞ The supply of goods and rendering of services in the form of humanitarian aid,
 - ☞ The supply of electricity, kerosene, and water
 - ☞ Goods imported by the government

- ☞ Supplies of services by the post office
- ☞ The provision of transport be it public or freight
- ☞ Permits and License Fees
- ☞ Rendering by religious organizations of religious or church related services
- ☞ The import of goods to the extent provided under Schedule 2 of the customs tariffs regulations
- ☞ The supply of goods or services by a workshop employing disabled individuals;
- ☞ The import of supply of books and other printed materials;
- ☞ The Ministry of Finance and Economic Development exempted the following by directive after the proclamation: Bread, Injera and Milk
- ☞ Grains and their flours (As of March 2008)

Note: in case of exempt supplies, there is neither Input Tax nor Output Tax. This is to say that:

- ☞ No tax is collected when a person sells exempt goods and services
- ☞ No tax is paid when a person purchase exempt supplies

Any of the items mentioned above, if supplied by a supplier of goods and services or an importer, need not be added to turnover for the purpose of determining VAT.

4.5.12.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. The rendering of services incidental to an import of goods is part of the import of goods. A taxable transaction involving independent elements, one or more of which involves the separate supply of goods or rendering of services, which would be exempt from tax, is treated as separate transactions. An exempt transaction, which involves the separate supply of taxable goods or rendering of taxable services, is treated as separate transactions.

4.5.13. Adjustment of the Value of a Taxable Transaction

In relation to a taxable transaction made by a registered person adjustment of the value of a taxable transaction is allowed where:

- ☞ The transactions cancelled
- ☞ The nature of the transaction is changed
- ☞ The previously agreed consideration for the transaction is altered, whether due to a reduction of prices or for any other reason

- ☞ The goods or services are returned in full or in part to the registered person

No Credit is allowed for VAT:

- ☞ On a taxable transaction to, or import by, a person of a passenger vehicle
 - ✓ Unless the person is in the business of dealing in, or hiring of, such vehicles
 - ✓ Unless the person is engaged in the business of transporting passengers
- ☞ On a taxable transaction, 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
 - ✓ The person is in the business of providing taxable transactions involving transportation services.

4.5.14. 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 tax authority shall 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 credits shall be refunded by the tax 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

The Authority is not obliged to refund excess credits if the amount to be refunded is not more than 50 Birr. This amount can be carried forward and credited against tax due in the subsequent accounting period

4.5.15. Assessment of VAT

Value Added Tax is assessed on the value of taxable supplies in the country and payable by those who are required to collect it legally. As stated earlier, it is assessed on the taxable turnover of the supplier. While determining taxable turnover, zero-rated supplies and exempt supplies are excluded. Value Added Tax is assessed using the tax rate indicated in the proclamation with the

help of invoice. The section tries to give you an idea of the nature of *VAT invoice*, *the rate* used for VAT determination, and *how VAT is determined*.

Value of Supply (Basis of VAT)

Value of supply or basis of VAT refers to the amount of taxable supplies and imports to on which the VAT charge is based. It is the amount on which VAT is to be determined. A supply occurs when a VAT invoice is issued for a taxable transaction. According to Article 12 of VAT proclamation 285/2002, the value of supplies refers to the amount that the supplier receives or expected to receive in return for goods supplied or services rendered. In cases where the supply is made in exchange for other supplies, or if the supply is made without anything in return, the market value is treated as the value of supplies. The term value includes any tax, duty or any fee payable excluding VAT.

The value of taxable import is the customs value of goods determined in accordance with the customs regulation of Ethiopia plus the sum of duties and taxes payable upon import of goods, excluding VAT and income tax withholding.

4.5.15.1. VAT Record Keeping

For VAT purposes, records refer to accounting records, accounts, books, computer-stored information or any other documents. Record keeping for VAT purposes may refer to maintaining records and documents related to VAT. These may include the following:-

A. VAT Invoice

The document designed to capture VAT information is the VAT invoice. It is a document of proof for tax liability and is designed strictly in accordance with the requirements of law. This is a document issued by a registered supplier to the customers on making taxable supplies. The customers, if registered for VAT, can reclaim VAT charged on them using VAT invoice. Registered suppliers are required to keep copies of invoices they receive from their suppliers - showing input tax- and copies of invoice they issue -showing output tax- to avail reclaim of input tax. A VAT invoice contains the following information.

- ☞ Name and trade name of registered person
- ☞ TIN of registered person and purchaser
- ☞ Number and date of VAT registration certificate
- ☞ Name of goods shipped or services rendered
- ☞ Amount of taxable transaction

- ☞ Amount of excise tax for those goods that are subject to excise tax.
- ☞ Sum of VAT due
- ☞ Issue date of invoice
- ☞ Serial number of invoice

It is obligatory for a taxpayer to keep all documents that are used for VAT determination for a period of 10 years. The documents include:

- ☞ Records, accounts, and books,
- ☞ Computed stored information,
- ☞ Original VAT invoice received,
- ☞ copies of all invoices issued
- ☞ Customs declaration.

B. VAT Account

VAT registered person are required to keep records of all supplies and purchases made and received for each vat period covered by the vat returns called “VAT Account”. On this account input vats are debited and output vats are credited.

C. Debit and Credit Notes

Copies of debit and credit notes issued should be separately filed from Debit and Credit Notes received. They should be filed in order of date.

D. Purchase and Sales Records

A vat registered person must retain and file the following items separately and in order of date.

- ☞ Local purchases and the vat thereon;
- ☞ Imports and the vat thereon;
- ☞ All other purchases including exempt, zero-rated purchases and purchases from suppliers who are not registered for vat;
- ☞ Taxable sales at the standard rate and the vat thereon;
- ☞ Taxable sales at zero rate; and
- ☞ Exempt sales.

4.5.16. VAT Accounting Period

The period stipulated for the determination of VAT is the Ethiopian calendar month. VAT is determined on the taxable transactions of the month. As stated earlier, taxable transactions

include taxable purchases and taxable sales. Periodically taxpayers should submit the necessary documents to the tax authority for the purpose of VAT determination.

4.5.17. Accounting for VAT

Accounting for VAT is concerned with the following activities. A tax accountant shall:

- ✓ Identify the records to be kept for VAT purposes
- ✓ Determine the VAT Liability
- ✓ Record VAT Related Transactions in the Books of Accounts
- ✓ Preparation of VAT Return

Determination of the VAT Liability

As stated earlier, the country uses invoice/credit method for collection of VAT. Under this method, for an accounting period, the amount of tax payable or VAT Liability for any accounting period by a person who is registered or is required to register is the difference between the amounts of tax charged on taxable transactions i.e. the VAT charged on sales and the VAT paid on purchases of goods and services applying the Zero Rate or the Standard Rate.

Example1: The following data relate to an importer who acquired goods from a foreign supplier in the month of Hamle 1995 E C

✓ Cost of goods	Birr 520,000
✓ Freight paid on purchase	Birr 80,000
✓ Insurance	Birr 70,000
✓ Customs and other charges paid on clearing the goods	Birr 380,000
✓ Excise tax paid	Birr 134,000

Required: Compute VAT payable by the importer on the above items

Solution:

- ✓ Basis of tax = 520,000+80,000+70,000+380,000+134,000= 1,184,000
- ✓ Value Added Tax = 1,184,000X15% = 177,600

Example2: If a taxable person purchases birr 200,000 goods and services and sales Birr 300,000 taxable supplies during the month of Nehase, the VAT liability will be as follows:

Output Tax:

300,000 @ 15 % 45,000

Input Tax:

200,000 @ 15%	30,000
VAT Liability	15,000

Recording VAT Related Transactions in the Books of Accounts

Recording Purchases

-  Accounting entry is to credit the amount owed to the purchaser for the purchase plus VAT.
-  Purchases are charged as an expense to the trading account exclusive of VAT.
-  VAT element is debited to the VAT Account representing the Tax Authority as a debtor.
-  VAT on inputs and outputs should offset one against the other. Some input tax cannot be recovered.

Recording Sales

- Sales are debited to Debtor or Cash Account for the amount of the sales plus VAT
- Sales amount is credited to sales account exclusive of VAT
- VAT element is credited to VAT Account representing FIRA-VAT Department as a creditor.

Filing of VAT Return and Payment of VAT

It is obligatory for every taxpayer to file VAT Return for every accounting period whether or not tax is payable for that period. Such a return should be filed before the last day of the calendar month following the accounting period. Simultaneously VAT should be paid to the Tax Authority.

In situations where an understatement of tax is suspected of the taxpayer, the Authority itself assesses tax. This is done at any time within 5 years after the end of the accounting period. However, if a fraud or willful negligence is evidenced, the authority can assess tax at any time, as it considers convenient. Within 30 days of receiving the notice of assessment, the taxpayer shall pay tax or appeal on assessment. Otherwise, the taxpayer will be considered in default.

A number of penalties are imposed on taxpayers for non-compliance. This includes penalties for non-payment, non-filing, for failure to register, failure to issue invoices, for issuance of incorrect invoice, and for collection of VAT without registration. These penalties are imposed as part of the administrative measures and some of them will be described as follows.

Example: Tabor Ceramics Share Company made taxable purchases of Birr 230,000 and Birr 138,000 taxable import. It also made taxable sales of Birr 345,000.

Required: Determine the VAT Liability or VAT Refund assuming that the prices are VAT inclusive and a VAT rate is 15%.

Solution	
Particulars	Amounts
Output Tax (345,000 @ 15/115)	45,000.00
Input Tax:	
Domestic Purchases (230,000 @15/115)	(30,000.00)
Imported Purchases (138,000 @ 15/115)	(18,000.00)
VAT Refund (Input Tax – Output Tax)	3,000.00

Journal Entries:
Journal Entries (A)
Cash 345,000
Sales 300,000
VAT 45,000
Purchase 200, 000
VAT 30,000
Cash 230,000
Purchase 120,000
VAT 18,000
Cash 138,000

4.5.18. Administrative Penalties of VAT

The following penalties are imposed for violation in respect of value added tax:

- ☞ Where any person engages in taxable transactions without vat registration where vat registration is required, the vat registered person is penalized 100% of the amount of tax payable for the entire period of operation without vat registration.

- ☞ Where any person issued incorrect tax invoice resulting in a decrease in the amount of tax or increase in credit or in the event of the failure to issue a tax invoice, the person is penalized 100% of the amount of tax for the invoice or on the transaction.
- ☞ Where a person who is not registered for vat issues a tax invoice, the person is penalized 100% of the tax which is indicated in the tax invoice and is due for transfer to the budget but has not been transferred.
- ☞ Where a person fails to maintain records required, the person is penalized Birr 2,000 for each month or portion thereof that the failure continues.
- ☞ A person who fails to file a timely return is liable for a penalty equal to 5% of the amount of tax underpayment for each month or portion thereof during which the failure continues, up to 25% of such amount but limited to birr 50,000 for the first month or portion thereof in which no return is filed. Underpayment of tax is difference between the tax required to be shown on the return and amount of tax paid by the due date. In any event penalty may not be less than smaller of the two amounts such as 10,000 birr and 100% of the amount of tax required to be shown on the return.

☞ **Late Payment Interest**

The tax authority charges interest in addition to the penalty if any amount of tax is not paid by the due date, the person liable is obliged to pay interest on such amount for the period from the due date to the date the tax is paid. The interest rate is set at 25% over and above the highest commercial lending interest rate that prevailed during the preceding quarter.

4.6. ACCOUNTING FOR TURNOVER TAX

4.6.1. Introduction to Turnover Tax

This section familiarizes you with the supply of goods and services in the country that come under the coverage of turnover tax. As studied in the earlier unit, VAT covers only a portion of supplies in the country. The Value Added Tax Proclamation No. 285/2002 provides for imposing VAT on those persons whose annual taxable transactions exceed Birr 1,000,000. Such persons are required to register with the Tax Authority for the purpose of paying VAT.

However, to enhance fairness in commercial dealings and to make a complete coverage of the tax system, a turnover tax is imposed on those persons who are not required to register for VAT, but supply goods and services in the country. As a result, persons who are engaged in the supply

of goods and rendering of service (which are taxable), and who are not required to register for VAT have to pay turnover tax to the government on the value of goods they supply or on the value of services they render.

Turnover represents the total sales income from supply of goods and services. In order to be taxable, turnover from taxable supplies will only be considered. As stated earlier, taxable supplies are those supplies of goods and services for which turnover tax is levied as per the turnover tax proclamation. It is the base for the imposition of turnover tax. Currently, taxpayers categorized as 'B' and 'C' as per income tax proclamation No. 286/2002 and who are not required to register for vat come under the purview of turnover tax. Turnover tax, in the country, is computed as per the Turnover tax Proclamation No. 308/2002

It would rather be difficult to know the actual turnover of all the suppliers especially when traders do not have the habit of keeping books of accounts. Not only that, as we studied, the income tax proclamation allows category 'C' taxpayers pay tax even in the absence of books of accounts. This may create difficulty in determining the exact amount of turnover of those traders. Turnover tax of category 'B' taxpayers is computed based on the books of accounts, as it is compulsory to maintain books by them. As a solution to this problem, the sales turnover of category 'C' is estimated in accordance with the estimation technique used for income tax computation. As you know, for income tax purposes, the daily estimated sales of taxpayers is converted to annual sales by the use of total days that the taxpayers do their normal operations. The same amount of turnover is used both for income tax and turnover tax purposes.

Filing of Turnover Tax Return and Payment

Tax payers subject to Turnover Tax shall Pay the tax for every accounting period by the deadline for filing the Turnover Tax return. The Accounting period for the purposes of Turnover tax shall mean:

- ✓ For Category "A" taxpayers but are not required to register for VAT, the calendar month;
- ✓ For category "B" taxpayers, each three months period commencing from the first day of the Ethiopian fiscal year (tax year);
- ✓ For Category "C" taxpayers, the fiscal year is the accounting period. 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.

4.6.2. Legal Provisions on Turnover Tax

The legal provisions are taken from Turnover Tax Proclamation No. 308/2002

4.6.3. Rates of Turnover Tax

The supplies of category 'B' and 'C' taxpayers (turnover taxpayers) are not taxed at the same rate as that of value added tax. A less rate than the VAT rate is used for this purpose. Taxpayers, who are not registered for VAT, collect tax at the following rates by charging the amount on the price of taxable goods and services they supply.

- Two percent on Goods Sold Locally
- For Services Rendered Locally;
 - ☞ Two percent on Contractor, Grain Mills, Tractors and Combine-Harvesters.
 - ☞ Ten percent on others; these include services such as Consultancy, Training, Legal advice, Auditing, etc

Base of Computation of Turnover tax

The turnover determined for income tax purposes forms the basis for turnover tax determination. To make it clear, turnover tax is determined on the gross receipts that the suppliers receive from the supply of goods and rendition of services. All persons, who are not registered for VAT but supply goods or render services, except those who are not required to pay tax, are required to collect tax from the customers on their gross receipts and transfer it to the tax authority.

Tax Exempt Supplies (Article 7)

Remember that not all the goods and services supplied in the country are not subject to VAT. Likewise, there are some supplies that are exempt from paying turnover tax. While determining the turnover for tax purposes, these items are excluded. The following transactions which are exempt from vat are also exempted from payment of turnover tax.

- ☞ The sale or transfer of a dwelling use for a minimum of two years, or the lease of a dwelling;
- ☞ The rendering of financial services;
- ☞ The supply of National or Foreign Currency (except for that used for numismatic purposes) and of securities;
- ☞ The rendering by religious organizations of religious or other related services;
- ☞ The supply of prescription drugs specified in directives issued by the relevant government agency, and the rendering of medical services;

- ☞ The rendering of educational services provided by educational institutions, as well as child care services for children at pre-school institutions;
- ☞ The supply of goods and rendering of services in the form of humanitarian aid;
- ☞ The supply of electricity, kerosene, and water;
- ☞ The provision of transport;
- ☞ Permits and license fees;
- ☞ The supply of goods or services by a workshop employing disabled individuals if more than 60% of the employees are disabled; and
- ☞ The supply of books
- ☞ Bread, Injera and Milk are exempted by the Ministry of Finance and Economic Development.

4.6.4. Assessment of Turnover Tax

The Tax Authority determines turnover tax based on the books and records submitted by category 'B' taxpayers. However, if the authority finds that there exists an understatement of tax declaration, it makes an assessment of its own. Similarly, in situations where the taxpayer does not keep records or the submitted records are unacceptable, the assessment is made by the tax authority on the basis of information about the market price of goods and services. If the market price of a particular item is not available, the market price of similar goods (and services) will be used for this purpose.

Category 'C' taxpayers (who are not required to keep records as per proclamation 286/2002) pay a presumptive turnover tax. The total turnover for this purpose is determined as per income tax proclamation 286/2002. The provisions of the same proclamation are also followed for the preparation and delivery of assessment notification.

The tax authority examines the statements and records submitted by taxpayers and have the power to investigate the details of the same at any time by sending inspectors to the taxpayers' premises. The tax office may also require the custodian of documents, vouchers, and stock to come in person and provide the information if required. If it is necessary to gather information, the tax authority may contact other government offices for the purposes of tax determination. Objections to assessment can be made by giving appeal to Appeal Commission by depositing 50% of tax assessed.

When a taxpayer changes the name of business, address, place of business, constitution, or nature of the main taxable activity, it should be notified to the tax authority within 21 days of doing so.

4.6.5. Tax Period

Tax period is the period for which the turnover is determined and tax is levied. 'B' and 'C' categories of taxpayers are required to collect turnover tax. The Turnover Tax law provides two different tax periods for category 'B' and category 'C' taxpayers. The tax period of category 'B' taxpayers is three-month period commencing from the first day of the Ethiopian fiscal year (or if the tax authority permits, the first day of the Gregorian calendar). The tax period for category 'A' taxpayers who are not obliged to register for VAT would one month.

The tax period of Category 'C' is the Ethiopian fiscal year. Note that, for category 'C', the tax period for business tax and turnover tax remains the same. At the end of 'Sene' 30 every year, taxpayers must be ready for the payment of both the taxes.

Computation of Turnover Tax Liability

The computation of turnover tax is straight forward. The Gross receipt is multiplied by the tax rate either 2% or 10% to determine the Turnover Tax Liability.

Recording Transactions with TOT

For Category "A" and "B" Taxpayers who are required to keep the accounting records, the transactions can be recorded in two different ways. The first way is to record separately the Turnover Tax liability at the time each taxable transaction occurs. This may have the highest burden of Record keeping and Compliance cost on the taxpayers. The second is to make adjustment for all the transactions of the Tax period at the end of tax period by recording the transactions initially as sales

Example: XYZ Traders had taxable turnover of Birr 120,000 for the three-month ended on 'Hidar' 30, 1995. Assuming that the taxpayer belongs to category 'B', how much will be the turnover tax payable by the trader? Tax rate is 2%.

- | | |
|----------------------|---|
| ➤ Quarterly turnover | Birr 120000 |
| ➤ Tax rate | 2% |
| ➤ Turnover tax | $120000 \times 2\% = \text{Birr } 2400$ |

4.6.6. Declaration and Payment of Turnover Tax

Each taxpayer shall declare and pay tax within one month after the end of the accounting period. Accordingly, category ‘B’ is required to declare taxable turnover and pay tax within 30 days after every 3 months period and category ‘C’ within 30 days after the end of each fiscal year. For the purpose of declaration and payment, taxpayers are required to fill and file a Turnover Tax Return. Turnover Tax Return is a form prepared and supplied by the Tax Authority and is filled and filed by the taxpayers to the Tax Authority.

4.6.7. Administrative Penalties

Administrative penalties are imposed on taxpayers for non- declaration and non-payment in a similar manner with VAT proclamation 285/2002. Provisions of income tax proclamation 286/2002 are equally used for penalties under criminal offences.

4.7. EXCISE TAX IN ETHIOPIA

4.7.1. Excise Tax Meaning and Purposes

Different Governments levy excise taxes, which are sales taxes on specific goods and services. Excise taxes are also called selective sales taxes. Goods subject to excise taxes are mostly luxury items and harmful products. Excise taxes are applied either on a Per Unit Basis, such as per package of cigarettes or per litter or gallon of gasoline, or a fixed percentage of the sales price.

In Ethiopia Excise Tax was introduced in 1993 under Sales and Excise Tax Proclamation No. 68/1993 and this proclamation was repealed in 2002 through Excise Tax Proclamation No. 307/2002. Excise tax is payable either on production of goods listed in Excise Tax Rate Schedule or on the importation of the same goods from foreign countries. For Excise Tax purposes, the Taxpayer is either a person who is importing the goods or producing the goods. This person is liable to pay excise tax according to the Excise Tax Proclamation. Every taxpayer shall:

- ☞ Maintain books of accounts and supporting documents in accordance with proper accounting principle and in a manner acceptable to the Tax Authority;
- ☞ 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 the tax.
- ☞ Comply fully with requirements of the inspection of his premises by the delegate of the Tax Authority in accordance with Sub-Article 3 of Article 9 of this Proclamation.

- ☞ Comply fully with requirements of the inspection of taxpayer's premises by the delegate of the Tax Authority if The Tax Authority wants to inspect the taxpayer.
- ☞ Immediately communicate to the Tax Authority the type and address as well as the commencement and termination date of his business;
- ☞ Pay in full the tax due *Within 30 Days* from the date of termination where such business is terminated.

4.7.2. Base and Rates of Excise Tax (Article 5)

Selected items of goods in the schedule accompanying the proclamation, whether imported or produced within the country are liable to tax as per the new excise tax law. When the goods are imported, the importer is obliged to pay tax at the specific rate on the CIF of goods. CIF includes the Cost, Insurance, and Freight of the goods imported. On the other hand, tax on locally produced goods is determined by the cost of production. The cost of production includes direct material cost, direct labor cost, and overhead cost other than depreciation on machinery.

Excise tax is levied and paid at the rates indicated in the specific schedule provided in the excise tax proclamation No. 307/2002. The rates indicated in the proclamation are equally applied for goods imported and goods produced locally. The rates of tax range from 10% for textile items to 100% for perfumes and motor vehicles. The scope of excise tax proclamation is limited and applies to goods listed in the schedule. If you compare the previous tax declarations with that of the current year, you can observe a reduction in rate for almost all types of goods including a reduction in the highest tax rate from 150% to 100%. You may refer to the appendix given at the end of this unit for further references related to the rates of excise tax.

Who will Pay Tax and When?

One who pays excise tax, called the taxpayer, is the importer and producer respectively for import and production. The importer pays excise tax when the imported goods are cleared from the customs area. That means, the tax is to be paid together with the payment of customs duty. Sometimes the importer may not be financially stable to pay tax immediately on the arrival of the goods at the customs. In such cases, the tax office will permit to keep the goods in a government warehouse, up on request from the importer, until taxes are paid. Deposit of goods in the warehouse and withdrawal from the warehouse are permitted only with the consent of tax authority.

As stated earlier, excise tax on goods produced in the country is determined by the cost of production. The producer pays tax on locally produced goods. A person or body engages in production of goods that are subject to excise tax is required to pay tax within thirty (30) days from the date of production of such goods. For this purpose, each taxpayer submits details of production every month to the tax authority. Submission of information should be done in the form prescribed by the tax office.

When a taxpayer changes the nature of business, its address, place of business, or terminate the same, details should be communicated to the tax office within 5 days of such happening.

4.7.3. Assessment of Excise Tax

Local producers who are subject to excise tax are required to keep books and records as per the requirement of the tax law. And assessment of excise tax is done on the basis of the records submitted by the taxpayers. Such an assessment is made when the taxpayer keeps books properly in accordance with the requirement of law. Declaration of excise tax should be made monthly. When an understatement of tax is evidenced, an additional assessment becomes necessary. The tax office makes notifications regarding the additional assessment to the taxpayer and payment of tax is to be made within 30 days from the receipt of assessment notification.

For the purposes of assessment, taxpayers are required to keep all documents in accordance with accounting principles and submit the same in every 30 days to the tax office. In situations where the assessment cannot be made using books of accounts, it is done by estimation. This occurs when the taxpayer does not submit the books and documents or if the submitted documents are unsatisfactory as per the tax requirements. For assessment purposes, officials from tax office can require taxpayer to provide any information, or can enter into the premises or store of the taxpayer to gather the required data.

If an importer fails to pay tax on goods that are kept in warehouses after import, within six months from keeping the goods in a warehouse, the tax authority can dispose the goods and collect money due to them. Upon sale, any remainder in sales proceeds is transferred to the government treasury from where the taxpayer shall have a claim up to a period of five years.

4.7.4. Computation of Excise Tax

Excise tax payable is computed differently for goods produced locally and goods imported into the country. For imported items of goods subject to excise tax, the excise tax payable is the

product of CIF value of import and associated tax rate prescribed in the schedule. However, for locally produced goods subject to excise tax, the excise tax payable is determined by multiplying cost of production and associated tax rate prescribed in the schedule.

Computation of Excise Tax for Locally Produced Goods

Excise Tax Payable = Cost of Production @ the Tax Rate in Schedule “E”

Computation of Excise Tax Payable	
Raw Materials	xxxxx
Labor Cost.....	xxxxx
Factory Overhead Costs:	
Indirect Labor.....	xxxxx
Indirect Materials	xxxxx
Factory Insurance.....	xxxxx
Factory Supplies.....	Xxxxx
Factory Utilities.....	Xxxxx
Other Indirect Costs.....	Xxxxx
FOH Costs.....	xxxxx
Tax Base for Excise Tax.....	Xxxxx
Tax Rate from Schedule “E”.....	xx%
Excise Tax Payable.....	xxxxx

If the total amount FOH Cost that includes the Factory Depreciation (either depreciation on factory building or production machineries) is given, the factory depreciation shall be deducted to compute the base of computation of Excise Tax Payable as follows:

Computation of Excise Tax Payable	
Raw Materials	xxxxx
Labor Cost.....	xxxxx
FOH Costs.....	xxxxx
Total Production Cost	xxxxx
Less: Factory Depreciation.....	Xxxxx

Tax Base for Excise Tax	xxxxx
Tax Rate from Schedule “E”	Xx%
Excise Tax Payable.....	Xxxxx

Computation of Excise Tax for Imported Goods

The Ethiopian Customs Authority collects Excise Tax at Custom Station at the time of clearing. Excise Tax is a responsibility of FIRA. But The ECuA (Ethiopian Customs Authority) serves as an agent to Federal Inland Revenue Authority as far Excise Tax on imported Goods is concerned.

Excise Tax Payable = C.I.F @ the Tax Rate in Schedule “E”

Example1: Sunshine Traders, an import export firm in Ethiopia, imported textile items to the country in ‘Miazia’, 2006 E C. The cost, insurance, and freight of goods imported amount to Birr 320000, 80000, and 80000 respectively. How much does the firm pay as excise tax on this import?

☞ Total CIF = 320,000+80,000+80,000 = Birr 480,000

☞ Excise Tax = 480,000 X 10% = Birr 48,000

Example2: Tit Manufacturing Company produced 2,000 quintals of sugar in ‘Hidar’, 2007 E C. The company gives the following data regarding the cost of production of 2,000 quintals in the month.

Material used	Birr 875,000
Direct labor	Birr 102,000
Indirect labor	Birr 62,000
Heat, light, and power	Birr 72,000
Other factory cost	
(Other than depreciation of machinery)	Birr 68,000
Tax rate	33%
Required: Compute the excise tax payable by the company for the month’s production.	

Solution	
Total cost of production:	
Material used	Birr 875000
Direct labor	102000
Indirect labor	62000
Heat, light, and power	72000
Other factory cost	<u>68000</u>
Total cost	Birr <u>1179000</u>
Tax = 1179000 X 33% = Birr <u>389070</u>	

Goods to be liable to Excise Tax (produced locally or imported)

Ser.No.	Type of Product	Excise Tax Rate
1.	Any type of sugar (in solid form) excluding molasses	33 %
2.	Drinks ☞ All types of soft drinks except fruit juices ☞ Powder soft drinks ☞ Water bottled or canned in a factory Alcoholic Drinks ☞ All types of beer + stout ☞ All types of wine ☞ Whisky ☞ Other alcoholic drinks	40 % 40 % 30 % 50 % 50 % 50 % 100 %
3.	All types of pure alcohol 75%	
4.	Tobacco + tobacco products ☞ Tobacco leaf ☞ Cigarette, cigar, cigarillos, pipe tobacco snuff and other tobacco products	20 % 75 %
5.	☞ Salt	30 %

6.	☞ Fuel- Supper Benzene, Regular Benzene, Petrol, Gasoline and other Motor Spirits	30 %
7.	☞ Perfumes and toilet waters	100 %
8.	☞ Textile and textile products ✓ Textile fabrics, knitted or woven of natural silk, rayon, nylon, wood or other similar materials ☞ Textile of any type partly or wholly made from cotton, which is grey,. White, dyed or printed, in pieces of any length or width (except Mosquito net and Abudgedid) and including, blankets, bed sheets, counterpanes, towels, table clothes and similar articles and Garments	10 %
9.	☞ Personal garment made of gold, silver or other materials	20 %
10.	☞ Dish washing machines of a kind for domestic use	80 %
11.	☞ Washing machines of a kind for domestic purposes	30 %
12.	☞ Video decks	40 %
13.	☞ Television and video cameras	40 %
14.	☞ Television broadcast receivers whether or not combined with gramophone, radio, or sound receivers and reproducers	10 %
15.	☞ Motor passenger cars, station Wagons, utility cars, and Land Rovers, Jeeps pickups, similar vehicles (including motorized caravans), whether assembled ,together with their appropriate initial equipment: → Up to 1,300 c.c. → From 1,301c.c up to 1,800 c.c. → Above 1,800 c.c.	30 % 60 % 100 %
16.	Carpets	30 %
17.	Asbestos and asbestos products	20 %
18.	Clocks and Watches	20 %
19.	Dolls and toys	20 %

4.8. Accounting for Customs Duty

Introduction to Custom Duty

A tax levied on imports (and, sometimes, on exports) by the customs authorities of a country to raise state revenue, and/or to protect domestic industries from more efficient or predatory competitors from abroad. Customs duty is based generally on the value of goods or upon the weight, dimensions, or some other criteria of the item (such as the size of the engine, in case of automobiles).

Customs Duty is a duty or tax levied on Import and Export goods by the Ethiopian Government. Goods shall mean any commodities, personal effect and animals including money. Importation of goods shall mean bringing or cause to be brought, goods through the first custom station into Ethiopia and Exportation goods shall mean taking or cause to be taken out, goods through the final port of departure from Ethiopia.

Thus, Importation and Exportation indicates that goods are crossing Customs Area of Ethiopia. The Customs Area refers to the territory of Ethiopia or boundary of Ethiopia. The goods are crossing the Ethiopian border to outside or inside. The Duty is payable at Customs Stations. Customs station shall mean any place designated as customs office at the port of entry or exit of goods, transit routes or at customs area for the control of import and export goods, collection of duties and taxes; Customs Duty is the responsibility of Ethiopian Customs Authority. The Ethiopian Customs Authority has either a branch offices or customs stations in different part of the Customs Areas to collect the Customs Duty while the head office in Addis Ababa. It has also a police force called Customs Police to enforce the Customs Laws and the Collection of Customs Duty or Tariffs and to Control the Contraband. Customs Police shall mean an armed police force assigned by the Federal Police Commission to enforce customs laws under the command of the Authority.

☞ The Ethiopian Customs Authority shall have the following powers and duties:

- ✓ Customs Declaration is a Form prepared by the Customs Authority in which the details of import, export or transit goods are described for the accomplishment of customs formalities.
- ✓ **Customs Duty: Specific Duty and Ad valorem Duty**

- ☞ **Ad-valorem Taxes** are taxes or duties levied as a percentage of the Value of Goods and Services.
- ☞ **Specific Tax** is the taxes levied at a fixed amount, irrespective of the Value of the goods and services.

4.8.1. Basic Legal Provisions of Ethiopian Customs Duty

The Basis of Computation of Customs Duty – The basis of computation is the Duty Paying Value. Sometimes the Duty Paying Value can be the same as CIF Value.

Duty Paying Value (Article 47) – The duty paying value of any import or export goods shall be the Actual Total Costs of the goods.

Duty Paying Value of Imports (Article 48) - For the purpose of customs, the Duty Paying Value (DPV) for imported goods shall be the sum of the Transaction Value (Cost), Freight Cost and Insurance Premium that is paid to deliver the goods upped a prescribed customs port.

Deductibles from Import Value (Article 49)

The following adjustment costs shall be deducted from import values:

- ☞ Costs for damages in routes
- ☞ Costs for damages in customs warehouse.
- ☞ The value of destroyed goods by Customs Authority

Value of Export Goods: For customs purpose the value of export goods shall be the transaction value of the goods and the cost of transportation up to the port of exit.

Exchange Rate or Conversion of Currency

The conversion of currency is necessary for the determination of the customs value. The rate of exchange to be used shall be that duly published by the National Bank of Ethiopia every Monday and shall be applicable from Tuesday up to the next Monday.

Commodity Classification & Tariff Rate

- ☞ Any goods imported or exported shall be subject to:
- ☞ Pay duties and taxes according to the tariff of Harmonized Commodity Description and Coding system;

Duty Free Imports

- ☞ Goods may be imported or exported free from any duties and taxes in accordance with law or international agreement to which Ethiopia is a party or by an agreement made and permission given by the government.
- ☞ Any goods imported duty free may be sold or disposed to any person who enjoys similar privileges, or exported, without paying duties and taxes; or subject to pay customs duties and taxes at the rate and value prevailing during the time of sales or disposal, be transferred to any person.
- ☞ Where duty free imported goods are lost or damaged due to force major the importer shall report forthwith to the Authority, and if it is proved to the satisfaction of the Authority the whole or part of the duties and taxes may be cancelled.

4.8.2. Customs Valuation System

According to the new customs law, the primary basis for customs value in Ethiopian Customs Authority is "transaction value" as defined in Article 1 below

1. Transaction Value

- ☞ The transaction value method is the first method to be applied in customs valuation.
- ☞ Transaction value means the price actually paid or payable by the buyer for the goods when sold for export to the country of importation.

2. Transaction Value of Identical Goods

- ☞ If the customs value of the imported goods cannot be determined under the Transaction Value Method above, the customs value shall be the transaction value of identical goods sold for export to the same country of importation and exported at or about the same time as the goods being valued. "Identical goods" means goods, which are the same in all respects, including physical characteristics, quality and reputation.

3. Transaction Value of Similar Goods

If the customs value of the imported goods cannot be determined under the Transaction Value of the Goods and Transaction Value of the Identical Goods above, the customs value shall be the transaction value of similar goods sold for export to the same country of importation and exported at or about the same time as the goods being valued. "Similar goods" means goods

which, although not alike in all respects, have like characteristics and like component materials which enable them to perform the same functions and to be commercially interchangeable.

4. The Deductive Method

If the imported goods or identical or similar imported goods are sold in the country of importation in the condition as imported, the customs value of the imported goods under the provisions of this method shall be based on the wholesale unit price at which the imported goods or identical or similar imported goods are so sold in the greatest aggregate quantity, at or about the time of the importation of the goods being valued less all local costs incurred and taxes paid by the buyer.

5. The Computed Value Method

- The customs value of imported goods at this stage shall be based on a computed value. Computed value shall consist of the sum of:
 - ☞ The cost or value of materials and fabrication or other processing employed in producing the imported goods;
 - ☞ An amount for profit and general expenses equal to that usually reflected in sales of goods of the same class or kind as the goods being valued which are made by producers in the country of exportation for export to the country of importation;
 - ☞ The cost or value of all other expenses.
- If the customs value of the imported goods cannot be determined under the methods above, the customs value shall be determined using reasonable means consistent with the principles and general provisions of this procedure and on the basis of data available from free sources.
- With regard to Used Goods the procedure issued by the Federal Government Revenues Board shall be applicable

4.8.3. Duty and Taxes Collected at the Customs Station from Businesses

From businesses or commercial organizations, the following duty and taxes are collected at time of clearing from customs station:

- ☞ Customs Duty (Article 52 of Proclamation No 60/1997);
- ☞ Excise Tax (Article 6 (2) of the Excise Tax Proclamation No 307/2002);
- ☞ Value Added Tax (Article 5 of the VAT Proclamation No. 285/2002); and
- ☞ Withholding Tax (Article 52 of the Income Tax Proclamation No 286/2002)

Computation of Duty Paying and Taxable Value	
Cost, Freight Cost and Insurance.....	XXXXX
Add: The Following Items	
Commissions and brokerage costs incurred by the buyer.....	XXXXX
The cost of container and cost of packing the goods.....	XXXXX
The value of free goods and services.....	XXXXX
Royalties and license fees related to the goods.....	XXXXX
Loading, unloading and handling charges.....	XXXXX
Total Addition.....	XXXXX
Less: The Following Items	
Costs for damages in routes.....	XXXXX
Costs for damages in customs warehouse.....	XXXXX
Value of the goods destroyed or disposed.....	XXXXX
Total Deduction.....	XXXXX
Duty Paying Value and Taxable Value.....	XXXXX

4.9. STAMP DUTY TAX

Stamp duty is a tax that is levied on documents. Historically, this included the majority of legal documents such as cheques, receipts, military commissions, marriage licences and land transactions. A physical stamp (a revenue stamp) had to be attached to or impressed upon the document to denote that stamp duty had been paid before the document was legally effective. More modern versions of the tax no longer require an actual stamp.

4.10. SUR TAX

A tax levied on top of another tax. Surtax can be calculated as a percentage of a certain amount or it can be a flat dollar amount. Surtax is generally assessed to fund a specific government program, whereas regular income or sales taxes are used to fund a variety of programs. Thus, one unique feature of surtax is that it allows taxpayers to more easily see how much money the government is collecting

4.11. IMPORT AND EXPORT PROCEDURES IN ETHIOPIA

This page presents information about Ethiopian import and export procedures.

☞ Import Procedure

☞ Export Procedures

Import Procedures

One can find information on import procedures in Ethiopia in relation to the pre-shipment inspection on goods; applications submitted to commercial banks in Ethiopia to obtain import permit; modes of payment allowed for import, documentation requirements to effect payment and document checking and verification.

An importer who wishes to import goods to Ethiopia should pay through commercial banks. All payments above USD 2000 should be made through Letter of Credit or Cash against Document. Pre-shipment inspections apply for all imports from China.

Pre-shipment Inspection:

Goods imported are not required to be inspected prior to shipment except when they are imported from China or if the importer and the supplier have an agreement for pre-shipment inspections.

Pre-shipment Inspection on goods imported from China:

The Ministry of Trade has made arrangements with China Inspection and Quarantine Bureau (CIQ) so that the latter would carry out the inspections prior to shipment and issue the quality certificates.

Requirements,

- ☞ Pre-shipment Inspection requirement on all goods purchased from China implemented in effect since January 1, 2007
- ☞ Pre-shipment inspection certificate is one of the documents required to effect import payment from China.
- ☞ Pre-shipment Inspection certificate requirement is mandatory for all import purchases made from China in excess of USD 2,000
- ☞ Banks are required to insert requirement in the LC and also to insure that purchase order transmitted clearly depict to have CIQ inspection requirement.
- ☞ Banks cannot accept documents without CIQ certificate if goods are imported from China.

Import Payment

1. Foreign exchange can be availed by banks to any importer provided they can present one of these Industry License issued by Ministry of Industry (If applicable)
2. Investment License issued by Investment Agency
3. Import License issued by Ministry of Trade

Applications submitted for import should be accompanied by the Pro-forma Invoice / contracts from suppliers stating:

- ☞ The type of commodity
- ☞ Quantity of the commodity
- ☞ Price per unit
- ☞ FOB amount
- ☞ Freight if any
- ☞ Other charges
- ☞ No insurance payment is allowed for payment in Foreign Exchange, so the importer should make insurance arrangement locally.

Mode of payment allowed for import

1. Letter of Credit
2. Cash against document
3. Advance payment up to USD 5000

Documentation requirements to effect payment:

It is important that the required sets of documents that should be presented by the supplier to demand payment should be mentioned in the LC or Purchase order. The following are mandatory for payment and always mentioned in the LC or Purchase order:

1. A final invoice (commercial invoice) attested by the chamber of commerce of the country of the supplier
2. Original sets of Bill of lading, Airway Bill, Truck way bill, Railway Manifest (depending on the mode of transportation)
3. Country of origin invoice attested by the chamber of commerce of the country of the supplier
4. Packing list
5. Certificate of quality where appropriate

Importers who wish to import using CAD

1. Should first get approvals of their Bank on the purchase order they wish to pass to the supplier
2. The purchase order should clearly state document requirements and certificate to be attached.
3. Shipping documents normally required for import payments
4. Payment can only be released on CAD provided the importers get the prior approval from its bank.

On Document checking and verification

1. Banks shall have the responsibility to check documents and insure that goods shipped are in accordance with the L/C term or the purchase order issued (in case of CAD) which should clearly state the list of documents that should be presented .
2. If the documents presented are in compliance with the letter of credit terms or the purchase order approved (in case of CAD) then the documents shall be accepted and the payment will be released. If not, it will be kept in suspense pending receipt of clarification and amendments.

Export Procedures

Businesses that wish to export from Ethiopia should know the export procedures needed to obtain export permit by commercial banks; should prepare Application for Quality Testing and Certification to obtain Export Authorization Certificate from the Quality and Standards Authority of Ethiopia; should fill the Customs declaration. We have included all these export procedures in Ethiopia and also the VAT registration for exporters from Ethiopia and VAT rate applied on goods exported from Ethiopia.

Export permit by commercial banks

Documents required for Export Permit Approval:

- ☞ Duly signed contract by seller & buyer
- ☞ Undertaking letter of our customer that consignment will be settled within a maximum of 90 days from date of the Foreign Exchange Permit for Cash Against Document (CAD) mode of payment and Authenticated message of L/C opened for Letter Credit mode of Payment.
- ☞ Seller's invoice

- ☞ Export License Valid for the year
- ☞ Tax registration certificate (TIN certificate)
- ☞ Export permit application form duly filled, signed & stamped (as appropriate) by the customer.
- ☞ NBE (National Bank of Ethiopia) issues delinquent list of exporters periodically. Customer's name should not appear in the delinquent exporters list of NBE for the period. If the name appears, there should be subsequent list indicating the given customer has cleared all outstanding items at NBE.

In regards to payment, the exporters should: Know thoroughly the foreign counterpart's (buyer's) financial soundness, reliability, integrity, full address, etc.

Sales/Purchase contract should exist between the two parties (importer and exporter). (LC Mode of Payment) Go through text of L/C opened in their favor and make sure that compliance can be met without doubt. Otherwise, amendments need to be requested from opener as soon as L/C has been received or at the earliest - long before shipment of consignments. (CAD Mode of Payment) Follow up the payment, as non-payment or even delay of remittance above 90 days will put name of exporter in delinquent list freezing further exports until proceeds are received.

Application for Quality Testing and Certification:

When export products are ready, make arrangements for suitable packaging and apply to the Quality and Standards Authority of Ethiopia for quality testing, and acquire the Export Authorization Certificate.

Customs Declaration:

To avoid costly delays, the exporter declares all facts about the export consignment, and all supporting original documents should be forwarded to the Customs Clearing Agents to enable customs formalities and authorization of the dispatch of the export goods. Accordingly, the exporter must hand over the Export Permit, the copy of the Customs Declaration Annex form, the Ethiopian Customs Declaration form, the Certificate of Origin, and the special movement forms/certificates (the EURI Movement Certificate and the GSP form A) to the clearing agents.

Exporters, VAT and VAT Registration

According to the Value Added Tax Proclamation (285/2002) and the Regulation by the Council of Ministers on VAT (Regulation 79/2002), all exports of goods and services are liable to VAT

at the zero rates. This means that VAT is charged at 0% (or no VAT has to be charged). However, more importantly an exporter is entitled to reclaim the VAT on all the goods and services purchased to produce the exports.

But since this still means an exporter is still making taxable supplies even at a zero rate, the law requires the exporter to register if the turnover exceeds the registration limits.

4.12. Foreign Trade Taxes

Government levies five kinds of taxes on import items. These taxes are assigned on priority levels and are calculated in a sequential order. These taxes, in their sequential order, are

- ☞ Customs Duty
- ☞ Excise Tax
- ☞ VAT
- ☞ Surtax and
- ☞ Withholding Tax

Taxes on imported goods are collected by Ethiopian Revenues and Customs Authority (ERCA).

1.Custom Duty

Tariffs, also called duties or customs duties, are taxes levied on imported or exported goods. Import duties are considered consumption taxes because they are levied on goods to be consumed. Import duties also protect domestic industries from foreign competition by making imported goods more expensive than their domestic counterparts. In the United States, import duties were the largest source of federal revenues until the introduction of the income tax in 1913. Today they account for only a small portion of federal revenues. .

Tax levied on imports (and, sometimes, on exports) by the customs authorities of a country to raise state revenue, and/or to protect domestic industries from more efficient or predatory competitors from abroad. Also called tariff, duty is based generally on the value of goods (called ad valorem duty) or upon the weight, dimensions, or some other criteria of the item (such as the size of the engine, in case of automobiles).

Customs is an authority or agency in a country responsible for collecting and safeguarding customs duties and for controlling the flow of goods including animals, personal effects and hazardous items in and out of a country. Depending on local legislation and regulations, the import or export of some goods may be restricted or forbidden, and the customs agency enforces these rules.

In economics, a duty is a kind of tax, often associated with customs, a payment due to the revenue of a state, levied by force of law. It is a tax on certain items purchased abroad. Properly, a duty differs from a tax in being levied on specific commodities, financial transactions, estates, etc., and not on individuals; thus it is right to talk of import duties, excise duties, death or succession duties, etc., but not of income tax as being levied on a person in proportion to his income.

Customs duty is a kind of indirect tax which is realized on goods of international trade. In economic sense, it is also a kind of consumption tax. Duties levied by the government in relation to imported items are referred to as import duty. In the same vein, duties realized on export consignments are called export duty. Tariff which is actually a list of commodities along with the livable rate (amount) of Customs duty is popularly understood as Customs duty.

Duty-free is the term that is often used to describe goods bought at ports and airports that do not attract the usual government taxes and customs duties. Some countries impose allowances in order to restrict the number of Duty-free items that one person can import into the country. These restrictions often apply to tobacco, wine, spirits, eau de toilette, gifts and souvenirs. Often foreign diplomats and UN officials are entitled to Duty-free goods. Duty-free goods are imported and stocked in what is called Bonded warehouse.

Evasion of Customs Duties takes place mainly in two ways. In one, the trader under-declares the value so that the assessable value is lower than actual. In a similar vein, a trader can evade Customs duty by understatement of quantity or volume of the product of trade. Evasion of Customs duty may take place without or in collaboration of Customs officials. Evasion of customs duty does not necessarily constitute smuggling.

Customs duties are payable on imports by all persons and entities without duty-free privileges. The main regulation on customs duty is Proclamation No. 38/1993, which has introduced a harmonized system of classification of goods. The rate of customs duty ranges from 0 to 40%

There are no taxes on export products (except coffee) or services from Ethiopia.

Ethiopia has treaties with Italy and Kuwait to avoid double taxation, and discussions on similar treaties are under way with several other countries. Intra-company charges, involving the local subsidiary and the parent company abroad, are allowed, provided they are incurred through arm's-length transactions.

✓ **Incentive**

To encourage investment, Ethiopian government has developed a range of incentives investors engaged in new enterprises and expansion across a range of sectors. Incentives include:

Customs Import Duty

A 100% exemption from the payment of import customs duties and other taxes levied on imports is granted to all investment capital goods, such as plant, machinery and equipment, as well as spare parts worth up to 15% of the value of the imported investment capital goods, provided that the goods are not produced and not available locally in comparable quantity, quality and price.

Investment capital goods imported without the payment of import customs duties and other taxes levied on imports may be transferred to another investor enjoying similar privileges.

Exemptions from customs duties or other taxes levied on imports are granted for raw materials necessary for the production of export goods. Taxes and duties paid on raw materials are drawn back at the time of export of finished products. The duty drawback scheme applies to all taxes at the time of import and to those paid on local purchases.

Ethiopian Revenues and Customs Authority collects customs duty only on import items and as no tax on export is levied except on export of certain hides and skins of animals which is 150%. (To increase domestic leather products such as Shoes, Purses, readymade garment, etc.) Customs Duty has 6 bands or groups of rates which are applied to imported goods. These bands of rates are 0%, 5%, 10% 20%, 30% and 35% and the base of custom duty is CIF value.

Excise Tax

Excise Tax is levied on selected items when produced locally or imported from abroad. The tax rate ranges from 10% in the case of textiles and television broadcasting receivers to 50% in the case of alcohol. Excise tax is payable on goods produced locally by the producer within a period of three days from the date of production, and on goods imported from abroad by the importer at the time of clearing the goods from the customs net.

Excise tax is levied whenever excisable goods are imported into the country or whenever they are locally produced. The base of excise tax on imported goods is cost + insurance + freight + customs duty Excise Tax is levied on selected goods like luxury goods and basic goods which are demand in elastic.(No change in quantity demanded when price goes up or down).

Excise duties are levied on the production of selected commodities while most of the excise duties are levied by the central government, the state government is also empowered to levy on a few items like liquor, drugs etc.,

Excise duties have now become an important source of revenue of the central government.

Excise duty is mainly levied;

- ✚ With a view of curtailing home consumption so that, more goods are available for export purpose.
- ✚ To discourage the use of scarce resources on production of non-essential, luxurious goods this may be imposed.
- ✚ Yet the most important goal is raising revenue for financing various development schemes

Objectives of Levying Excise Duty:

Excise duty is a duty levied on commodity produced within the country or imported for sale or consumption within the country.

The basic objectives of excise duties are given below:

1. Raising revenue for economic growth
2. Discouraging consumption of non-essential goods
3. To curb activities contributing to pollution, etc

<i>N.B . The Government of Ethiopia is currently reforming excise tax structures/rates.</i>
--

1. VAT

VAT is levied on every imported item unless exempted by the appropriate law or directive, The base of computing VAT on imported items is CIF + Custom + Excise Tax.

2. Sur Tax

It is a special type of indirect tax which is levied , charged and collected by the federal government of Ethiopia on all goods imported except those exempted by the surtax law.(Regulation, No 133/2007).

Sur Tax is a tax imposed to carry out a specific purpose by the government. In Ethiopia, for example, Sur Tax was declared to be imposed on imports (since April 9, 2009) in order to build the financial capacity of the government for interventions and to solve the rise in the cost of

living which is affecting consumers with low and medium income level. Surtax rate is 10%. The base for surtax is CIF + Custom + Excise Tax + VAT of all goods imported into the country.

The following items are exempted from Surtax: Fertilizer, Petroleum and lubricants, Motor vehicles for freight and passenger and other special purpose motor vehicles, air craft, spacecraft, and part thereof, Capital (investment) goods and some medicines, raw materials and other goods which are already decided by law to be tax free.

3. Withholding Tax

Withholding tax is imposed on the import of goods for commercial use. The amount collected on imported goods shall be 3 % of the sum of cost, insurance and freight (CIF value).

The following are exempted parties from Withholding tax

- ☞ Federal and regional government offices
- ☞ Nonprofit and nongovernmental organizations and associations,
- ☞ Privileged individuals to import their personal effects free of duty pursuant to the directive issued by ERCA
- ☞ Individuals and organizations allowed to import duty-free items pursuant to category two of the customs tariff. (E.g. Those importing palm oil)
- ☞ Individuals and organizations who are exempted from income tax by federal and regional investment authority.
- ☞ Federal and regional government offices
- ☞ Nonprofit and nongovernmental organizations and associations,
- ☞ Privileged individuals to import their personal effects free of duty pursuant to the directive issued by ERCA
- ☞ Individuals and organizations allowed to import duty-free items pursuant to category two of the customs tariff. (E.g. Those importing palm oil)
- ☞ Individuals and organizations who are exempted from income tax by federal and regional investment authority.

Comprehensive Activity Exercise

1. The following information was extracted from the ERCA-customs declaration.

Importer; CLT PLC

Exporter; TIANJIN INTERNATIONAL TRADING CO.LTD (CHINA)

Imported item; Tobacco products

Quantity of imported item; 793,000 packages

Total invoice mount (transaction value); USD 33,306.00

Rate of exchange; 31.50

Insurance cost including revenue stamp; Br.504.40

Freight charge; Br. 36,036.54

Customs duty rate; 35% of CIF value of import

Sur tax rate; 10%

VAT rate; 15%

Warehousing & labor charges by Comet Transport Plc before VAT; Br. 650.26

Required;

- | | |
|------------------------------|---------------------------------|
| 1. The mount of excise tax | 4. The mount of withholding tax |
| 2. The mount of customs duty | 5. The mount of import Sur tax |
| 3. The mount of VAT | |

Unit summary

This unit discussed the system and types of taxes in the Ethiopian context. Accordingly, the major types of taxes in Ethiopia include direct taxes, indirect taxes and stamps duty. Personal income taxes, business profit tax, taxes on income from rental of building, other income tax are major types of direct taxes that the Ethiopian government uses as sources of revenue. The issue of tax assessment under each category of tax was also discussed in the unit. The major category of indirect taxes include: turnover tax, excise tax, value added tax and customs duty. Custom duty tax, Stamps duty, foreign trade tax, surtax is also one source of the income for Ethiopian government and import and export procedures in Ethiopia was discussed.

☞ Model Examination Questions

1. What is employment income, employment income tax and what are components of employment income.
2. List and discuss four durations to compute overtime payment in Ethiopia.
3. List and discuss five types' employment termination payment to employees upon termination of employment contract.

4. What is the basic difference between gross employment income and taxable employment income?
5. How employers can determine the tax due?
6. What is the basic difference between special exemption and personal exemption?
7. What are methods of determining employment income tax?
8. What are severance pay and discuss types of severance pay to employees?
9. What is rental income and what are parties involved in rental of building?
10. List components of gross rental income.
11. What is the basic difference between gross rental income and taxable rental income?
12. Clearly differentiate turn over tax and value added tax.
13. List and discuss categories of taxpayer and what are requirements for their categorization?
14. List and discuss methods of tax accounting.
15. What are Allowable Deductions business profit taxes?
16. What is presumptive tax and who is payers of presumptive tax?
17. What is basic difference between VAT inclusive and VAT exclusive price?
18. Discuss special items that reduce business profit tax?
19. Discuss components of the other income.
20. What is the basic distinction between input VAT and output VAT?
21. Outline and discuss two types VAT registration in Ethiopia.
22. Differentiate zero rated supplies and standard rated supplies.
23. What is basic difference between VAT and excise tax?
24. What is basic difference between foreign trade tax and stamp duty tax?

Answers to module examination question

Dear students, please refer to the notes pages in the unit to get answers to the model Examination Questions.

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ARBAMINCH UNIVERSITY

CONTINUING AND DISTANCE EDUCATION PROGRAM

ASSIGNMENT FOR PUBLIC FINANCE & TAXATION

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Instructions

This is assignment paper for the course *Public Finance and Taxation* which you are expected to do on your own. It carries *30 points*. The assignment paper should be completed and sent to the *Continuing and Distance Education Program Coordination Office for evaluation*.

The assignment has **Two Parts**: Part I contains ten multiple choice questions out of 10% and Part II with nine discussion questions out of 20%. Write your answers to all parts on separate answer sheet and Begin your answer to each numbered question on a separate page. Answer the questions as soon as *directly* and *concisely* and write legibly.

Please do not forget to write your *Name, ID No.* and *Address* on this cover page and also your **Name** and **ID Number** on each page of your answer sheet.

PLEASE

SUBMIT YOUR ASSIGNMENT WITH YOUR FINAL EXAM!!

ASSIGNMENT

PART I: MULTIPLE CHOICE QUESTIONS

Choose the correct answer from given alternatives and put your answer in the separate answer sheet provided. (0.5 point each)

1. Which one of the following is/are common features of public finance & private finance?
 - A. Adjustment of income and expenditure and rescheduling of expenditure
 - B. Pressure, publicity and nature of benefit
 - C. Borrowing, economic choice and maximum satisfaction
 - D. Balancing of income & expenditure
 - E. All except A&B
 - F. All except A&D
2. If a good is nonexclusive, people:
 - A. Vote to have the maximum possible amount provided by government.
 - B. Buy the good according to their demand curve and the good's price.
 - C. Not care if the good generates negative externalities.
 - D. Try to be "free riders".
3. The market system does not produce public goods because:
 - A. There is no need or demand for such goods
 - B. Private firms cannot stop consumers who are unwilling to pay for such goods from benefitting from them
 - C. Public enterprises can produce such goods at lower cost than can private enterprises
 - D. Their production seriously distorts the distribution of income
4. Capital expenditures are
 - A. Incurred on building durable assets, like highways, multipurpose dams, irrigation projects, buying machinery and equipment.
 - B. Non recurring type of expenditures in the form of capital investments.
 - C. Expected to improve the productive capacity of the economy.
 - D. None
5. Public finance a deals with all of the following, ***EXCEPT***:
 - A. The problems of adjustments of income and expenditure of the government
 - B. The Rising of necessary funds for incurring expenditure
 - C. The income and expenditure pattern of the public authorities

- Public Finance And Taxation Assignment For Continuing And Distance Education Page 2

- C. Fiscal operations are actions taken by government to implement issuance of public debt instrument and public debt management.
- D. Fiscal operations have been used to reduce incomes and wealth of rich through regressive taxation.
- E. All except C&D F. All except D
12. Tax incidence refers to
- A. Whether a tax is progressive, proportional, or regressive
 - B. How often a tax is collected
 - C. The person or group who ends up paying a tax
 - D. How a tax is collected
13. The tax system in Ethiopia is basically:
- A. Regressive
 - B. Progressive
 - C. Digressive
 - D. Proportional
14. One of the following statements is not correct.
- A. Under progressive tax system, the rate of tax diminishes as the income of an individual increases.
 - B. Regressive system of taxation, the poorer section of society is taxed at higher rates than the richer sections.
 - C. In a digressive tax, the rate of progression is in the same proportion as the income.
 - D. Under ad valorem, the tax is imposed on commodity according to its value
15. What's the difference between a tax and a tariff?
- A. Taxes are charged on income while tariffs are charged on sales.
 - B. Taxes are collected internally while tariffs are collected on imports.
 - C. Taxes are a form of public revenues while tariffs are a form of public debt.
 - D. Taxes are spent on social support programs while tariffs are spent on national defense
16. The taxes Ethiopia levies on tobacco products, alcoholic beverages, and gasoline are known as _____ taxes.
- A. Corporation Franchise
 - B. General Sales
 - C. Excise
 - D. Gross Receipts
 - E. Severance

17. All of the following are from the same category of taxes but one:

A. Value Added Tax

D. Excise Tax

B. Turn Overtax

E. None

C. Capital Gain Tax

18. Ato Abebe has paid birr 134.4 for dinner in Lalibela restaurant. The bill includes a service charge of 10% on selling price and Turn Over tax of 2%. The balance of Turn Over tax is

A. 3.10

C. 2.40

B. 2.60

D. 3.20

19. Goods are purchased at 15% VAT inclusive price of birr 85,502.50. The amount of input VAT on the transaction is:

A. 10,250.50

C. 13,125.50

B. 11,152.50

D. None

PART II: DISCUSSION QUESTIONS

Respond to the following questions with your best possible answer. You can use examples to support your responses.

1. Describe at least four basic characteristics of taxation *(2 Points)*

2. Differentiate Direct taxes from indirect taxes. List at least two examples to each *(2 Points)*

3. Define public finance and explain the ways that it differs from private finance *(2 Points)*

4. Briefly discuss at least two principles of taxation advocated by Adam Smith *(2 Points)*

5. **List and discuss** at least four roles of budgetary policy in economic development *(2pts)*.

6. Discuss the burdens of public debt and objectives of public debt management *(3 Points)*

7. Does deficit financing necessarily lead to inflation? Justify your answer *(3 Points)*

8. What are motives behind sharing revenue between central and regional government **(2pts)**

9. How the government finance budget deficit? List and discuss at least four modes of financing deficit. **(2pts)**
