



WOLLO UNIVERSITY
COLLAGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE

DISTANCE MODULE FOR DEGREE PROGRAM

Public Finance and Taxation Accounting
(AcFn 3171)

Prepared By: Enyew Alemaw (Ph.D. candidate)

Editor: Tsega zemen (MSc, Assistant professor)

Distance Education Program

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ABOUT THE COURSE

Course Number	AcFn3171
Course Title	Public Finance & Tax Accounting
Degree Program	BA Degree in Accounting and Finance
Module	Public Finance and Taxation
Module No and Code	M17; AcFn-M3171
ETCTS Credits	5
Credit Hours	3
Course Objectives & Competences to be Acquired	<p>Upon the successful completion of this module, students should be able to:</p> <ul style="list-style-type: none">• Discuss the essence of public finance and taxation in theory and in Ethiopian context• Apply basic Ethiopian tax concepts to various circumstances relating to the employment, business and other income taxes <p>Apply basic Ethiopian tax concepts to various circumstances relating to VAT, turnover tax, excise taxes, and custom duty</p>

Course Description	<p>The course focuses on the taxing 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. The topics covered include: Introduction to public finance, tools of public finance mainly taxation, analysis of the finance system of the Federal Democratic Republic of Ethiopia with emphasis on the Taxation System.</p>
Evaluation modalities	Weights
Assignment	35%
Tutorial attendance	5%
Final exam	60%
Total	100%

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CHAPTER ONE: BASICS OF PUBLIC FINANCE

Chapter Objectives

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



- ☞ *Define public finance*
- ☞ *Understand the scope of public finance*
- ☞ *Distinguish public finance from private finance*
- ☞ *Discuss the role of government to the economy and society*
- ☞ *Realize the role of fiscal policy*

1.1. Definition of public finance

Public finance is a very old science and different economists have defined in different ways. Some of the most commonly used definitions of public finance are shown as follows:

“Public finance is concerned with the income and expenditure of public authorities and with the adjustment of one to the other.” Huge Dalton

“Public finance deals with the provision custody and disbursement of resources needed for conduct of public or government functions.” Lutz

“Public finance is a science which deals with the activity of the state in obtaining and applying the material means necessary for fulfilling the proper functions of the state.” Carl Plehn

“Public finance is the study of the principles underlying the spending and raising of funds of public authorities.” Findley Shirras

“The government, considered as a unit, may be defined as the subject of study of public finance. More specifically, public finance studies the economic activity of government as a unit.” Buchanan

“Public finance deals with expenditure and income of public authorities of the state and their mutual relations as also with the financial administration and control.” Bastable

Most of the authors argued that public finance is a study of income and expenditure of the central, state, and local governments. Government performs many functions which the individual cannot or do not perform. Therefore, raising of funds for the expenditure and their

disbursement constitutes the subject of public finance. It is also known as fiscal operations of the treasury. Thus, fiscal operations and fiscal policies are integral part of public finance.

Activity

Question 1: What is public finance?

1.2. Scope of Public Finance

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

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

A. Public Revenue

Under this division, the sources of the public revenue, principles of taxation, effects of taxes on the economy, methods of raising revenue and the like are included. Public revenue includes all incomes irrespective of the source they are obtained from. There are various sources of public revenue and these sources can be categorized in two major classes;

- i. Tax revenues
- ii. Nontax revenues

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.

i. 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.

Generally, taxation has the following elements:

- a. It is a compulsory contribution
- b. Government only imposes taxes
- c. In payment of tax an element of sacrifice is involved
- d. Taxation is aimed at welfare of the community
- e. The benefit may not be proportional to tax paid
- f. Tax is a legal collection.

☞ Taxes are compulsory payments to government without expectation of direct return or benefit to tax payers.

ii. 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 interest receipts, dividends and profits, fiscal services and others.

Activity

Question 2: List the tax and non-tax revenues?

B. Public expenditure

The term “*public expenditure*” is used to refer 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 in 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.

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

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 defence expenses. Expenditure can also be classified into revenue and capital expenditure.

C. Public debt

A government can obtain income through loans and public borrowings. The loans raised in a particular year constitute receipts or revenues for that year. It is an income of a capital nature, while the provision for repayment of the capital sum for the year constitutes expenditure of a capital nature. The study of public debt includes the methods and objectives of public borrowings, management of public debt and burden of public-internal and external.

Methods of public debt are an important instrument of not only raising funds but also, for meeting increasing government expenditure, for securing economic stability, increasing public borrowings during the periods of inflation and liquidation of public debt during the period of depression, borrowings from the people during inflation and borrowings from banks during depression and so on. Public debt can be classified as internal 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 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 financial aid through grants and loans, commodity aid and 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.

D. Financial administration and control

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

Thus, financial administration and control include the following: (i) Study of budgets and their procedure. (ii) Budget as an instrument of securing certain objectives, such as promotion of employment, economic growth with stability, welfare of the weaker sections, infrastructural development for promoting private investments etc. (iii) Financial and physical controls through different fiscal tools for controlling private expenditure in the economy to avoid the effects inflation deflation, recession etc.

Note: <i>The main scope of public finance may be summarized as revenues, expenditure, debt, financial administration and economic stabilization.</i>

E. Economic stabilization

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

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

1.3. The role of the government in the economy and society

A. Economic Significance

Economic stability and maintenance of full employment are the two main goals of public finance in advance countries like the U.K. and the U.S.A. For developing countries economists argued that the fiscal policies should be formulated for the rapid economic development. Public finance occupies great significance in under developed or developing country. According to R.J. Chelliah, “Public Finance has a positive and significant role in the context of economic development.” The importance of public finance in under developed/developing country are discussed as follows:

a. Capital Formation

The first and the foremost aim of public finance is to promote capital formation because the economic development of the country depends on the rate of capital formulation. In developing countries, the government’s economic policy should concentrate on production and fiscal policy should act as a tool of capital formation. For rapid capital formation, the government should incur expenditure on the establishment of basic and heavy industries, infrastructural development, such as power projects, transport sector, means of communications etc.

b. Economic Stabilization

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

c. Increase employment

Public finance plays an important role in increasing employment. In underdeveloped or developing country, major problem faced by the people is the problem of unemployment. This problem leads to low standard of living, poverty, backwardness, ignorance etc. It is the function of public finance to provide employment opportunities. Therefore, expenditure should be incurred by the government for increasing employment and for achieving full employment. To generate employment, public expenditure should be incurred on setting up new industries,

encouraging small-scale and cottage industries through financial subsidies, expenditure on training schemes etc.

d. Balanced Regional Development

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

e. Reduction in Economic Inequalities


One of the major problems of developing countries is the unequal distribution of income and wealth. There is a gap between the rich and the poor. Public finance has an important role to play in this context. To bring about equitable distribution of income and wealth, the government should follow the system of progressive taxation. In other words, the government should impose heavy taxes on the richer section of society and the amount realized from the rich should then be spent on the poor by way of providing them social services such as free education, medical facilities, public utilities like road, water facility, recreation facilities etc.

f. Mobilization of Resources

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

g. Optimum Utilization of Resources

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

 *The roles of the government can be summarized as allocation, distribution and stabilization roles.*

B. Social Significance

2. **Social justice or equitable distribution of income and wealth:** is another responsibility of the government in its public finance operations. There is a wide gap between the rich and the poor in the least developed countries. In other words, luxury items purchased mainly by the rich should be subjected to higher rates of taxation, and necessary items should be exempted from taxation.

Social justice also requires investment expenditure on the establishment of enterprises in the public sector. By doing so, the government would be able to produce goods of mass consumption to make cheap goods available to the people.

3. **Satisfaction of social wants and merit wants:** another significant point of public finance is the satisfaction of social or collective wants and merit wants. Wants are divided under three heads: private Wants, Social Wants or Collective Wants and Merit Wants.

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

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

c. Merit Wants

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

measures, maternity benefits etc. Satisfaction of these wants for the poor increases their productivity efficiency and there by their income.

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

Activity

Question 3: Write the roles of the government in social aspects?

4.1. Similarities and difference between Public Finance and Private Finance

Finance in general means public as well as private finance. Public finance relates to the money-raising and income-expenditure functions of the government. Private finance refers to the income-expenditure phenomenon of an individual or private business firm. By private finance we mean the financial problems and policies of an individual economic unit. It is a convention to look into similarities and dissimilarities between the two so as to provide an analytical foundation for the decision-making aspects of public finance.

Similarities

a. Satisfaction of human wants: Both the public and private finance have the same

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

b. Maximum advantage: Both the public finance and private finance try to secure maximum advantage or maximum benefit. An individual or a corporation or a private business firm tries to obtain maximum advantage from his expenditure. Similarly, the government also tries to obtain maximum good of the people by incurring expenditure on the society.

c. Borrowings: Another similarity between the public and private finance is that many times


both have to be obtained from the market in the form of borrowings whenever the expenditure of either the government or any individual or firm exceeds their income/revenue.

d. Engagement in similar activities: Both the private and public sectors are engaged in

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

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

f. Balancing income and expenditure: Both individual and Government have incomes and expenditures and trying to balance each other.

 *Public finance and private finance are similar in satisfaction of human wants, maximum advantage, borrowings, engagement, problem of economic choice and balancing income and expenditure.*

Differences

i. 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.

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

iii. Allocation of resources: In private finance, the individual can allocate or distribute his/her 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.

iv. Adjustment of income and expenditure: In private finance, an individual first considers his/her income and then decides about his/her expenditure. However, in public finance, the

government first estimates the volume of expenditure and then tries to find out the methods of raising the necessary income to satisfy these expenditures. Thus, private finance tries to adjust its income to expenditure, whereas the public finance tries to meet the expenditure by raising income.

v. Nature of benefit: The private finance aims at individual benefit i.e. the benefit of an individual or a household. But the public finance aims at collective benefit, i.e. the benefit of the nation as a whole.

vi. Postponement of expenditure: In private finance, the individual can postpone or even avoid certain expenditure, as he/she likes. But, in public finance, the government cannot avoid certain commitments like social welfare measures and cannot postpone the certain expenses like relief measures, defense, etc.

vii. 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 for expenditure in public finance is influenced and controlled by the economic policy of the government.

viii. Nature of Perspective: In private finance, the individual struggles for immediate and quick return. Since his/her life span is definite and limited, he/she gives emphasis for 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 of its income for the promotion of future benefits. Therefore, private finance has a short-term perspective whereas the public finance has a long-term perspective.


ix. Nature of Budget: In private finance individuals prefer surplus budget as virtue and a deficit budget is undesirable to them. But, the overnment does not prefer a surplus budget. If the government bring 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.

x. Coercion: Individuals and businesses cannot use force to raise their income whereas the government (public finance) can use in the form of imposing taxes to get income i.e. taxes are compulsory in nature. It is an obligation of the tax payers. No one can refuse to pay taxes if he/she is liable to pay them. In addition, the government can undertake any of the existing private business by way of nationalization, which is not possible in the hands of individuals.

xi. 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. Publicity strengthens the confidence of the people in the government.

xii. Audit: In the private finance, audit of the financial transactions of the individuals is not always necessary. But, the accounts of the governments are subject to audit and inspection.

 **Note:** *Nature of resources, motivation of expenditure, allocation of resources, adjustment of income and expenditure, nature of benefit, postponement of expenditure, influence on expenditure, nature of perspective, nature of budget, coercion, publicity and audit are the major differences between public finance and private finance.*

4.2. Fiscal policy

Fiscal policy is also called budgetary policy. In broad term, fiscal policy refers to the segment of national economic policy which is primarily concerned with the receipts and expenditures. It includes raising financial resources and spending them. Resources are obtained through taxation and borrowing from both internally and abroad. Spending is done mainly for defence, development and administration activities. Financial accounts of the income and expenditure position are shown in budgetary statement. Budget can act as an important tool of economic policy. The state by its policy of taxation-regulated expenditure can influence the economic activities and development.

Fiscal policy relates to taxation, government spending, government borrowing and management of government debt government's decision makings. Fiscal policy in these different decisions deal with the flow of funds out of the private spending and saving stream into the hands of government and the recycle funds from government into the private economy.

Fiscal policy deals directly with matters which immediately influence consumption and investment expenditure. Therefore, it influences the income, output and employment in the economy. Fiscal policy is primarily concerned with the aggregate effects of public expenditure and taxation on income output and employment.

Fiscal policy should balance the economy by sustaining the consumption in the economy for developed countries and help for rapid economic development and an equitable distribution of the income between rich and poor in developing countries.

Chapter summary

Public finance is a study of income and expenditure of the central, state, and local governments. Fiscal operations and fiscal policies are integral part of public finance. Public revenue, public expenditure, public debt, financial administration and control, and economic stability are the financial activities under the scope of public finance.

Capital formation, economic stabilization, increase employment, balanced regional development, reduction in economic inequality, mobilization of resources and optimum utilization of resources are the roles of the government in the economy. While, social justice or equitable distribution of income and wealth, satisfaction of social wants and merit wants, merit wants, fiscal policy to curb or prevent undesirable wants are the social roles of the government.

The similarities between public finance and private finance can be summarized as satisfaction of human wants, maximum advantage, borrowings, engagement in similar activities, problem of economic choice, balancing income and expenditure. Nature of resources, motive of expenditure, allocation of resources, adjustment of income and expenditure, nature of benefit, postponement of expenditure, influence on expenditure, nature of perspective, nature of budget, coercion, publicity, audit are the differences between public finance and private finance.

Self-examination questions

1. Public finance has to do with all of the following activities of the government except
 - A. Stabilization activities
 - B. Allocation activities
 - C. Competition with private sector
 - D. Distribution activities
2. Which of the following is not the economic role of the government?
 - A. Increase employment
 - B. Fiscal policy to curb or prevent undesirable wants
 - C. Balanced regional development
 - D. Reduction in economic inequalities
3. The most important source of revenue to the states is _____.
 - A. Gifts
 - B. Taxes
 - C. Donations
 - D. Loan
4. The income of the state is referred to as _____.
 - A. Public revenue
 - B. Public debt
 - C. Public expenditure
 - D. Public loan
5. Which is the main objective of a tax?
 - A. Increase in consumption
 - B. Increase in production
 - C. Raising public revenue
 - D. Reduction in capital formation

Discussion questions

1. Define public finance clearly.
2. Discuss how public finance is different from public finance.
3. Explain the roles of the government in the economy.
4. Elucidate the scope of public finance

Glossary of Terms

Coercion- the practice of forcing another party to act in an involuntary manner by use of force or threat.

Taxes- compulsory payments to government without expectation of direct return or benefit to tax payers.

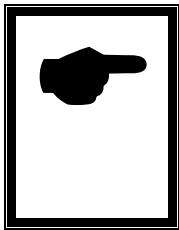
Public expenditure- refer the expenditure of government

Fiscal policy- national economic policy which is primarily concerned with the receipts and expenditures

CHAPTER TWO: MEANING AND CHARACTERISTICS OF TAXATION

Chapter Objectives

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



☞ *Familiar with the meanings and objectives of taxation*

☞ *Understand the principles of taxation*

☞ *Classify taxes in different ways*

☞ *Discuss the tax structures*

☞ *Know shifting and incidence of taxation*

☞ *Differentiate tax evasion, avoidance and delinquency*

2.1. Meaning of tax

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

A tax, in the modern time, therefore is a compulsory levy and those who are taxed have to pay the sums irrespective of corresponding return of services or goods by the government. It is not a price paid by the tax-payer for any definite service rendered or a commodity supplied by the government. The tax-payers do get many benefits from the government but no tax-payer has a right to any benefit from the public expenditure on the ground that he is paying a tax. The benefits of public expenditure may go to anyone irrespective of the taxes paid.

Therefore, taxes are compulsory payments to government without expectation of direct return or benefit to the tax-payer.

2.2. Objectives of Taxation

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

- i. Raising revenue:** to render various economic and social activities, a government needs large amount of revenue and to meet this government imposes various types of taxes.
- ii. Removal of inequalities in income and wealth:** government adopts progressive tax system and stressed on canon of equality to remove inequalities in income and wealth of the people.
- iii. Ensuring economic stability:** taxation affects the general level of consumption and production. Hence, it can be used as effective tool for achieving economic stability. Governments use taxation to control inflation and deflation
- iv. Reduction in regional imbalances:** If there is regional imbalance with in the country, governments can use taxation to remove such imbalance by tax exemptions and tax concessions to investors who made investment in under developed regions.
- v. Capital accumulation:** Tax concession or tax return given for savings or investment in provident funds, life insurance, investment in shares and debentures lead to large amount of capital accumulation, which is essential for the promotion of industrial development.
- vi. Creation of employment opportunities:** the governments might minimize unemployment in the country by giving tax concession or exemptions to small entrepreneurs and labor-intensive industries.
- vii. Preventing harmful consumptions:** the government can reduce harmful things on the society by levying heavy excise tax on cigarettes, alcohols and other products, which worsen people's health.
- viii. Beneficial diversion of resources:** governments impose heavy tax on non- essential and luxury goods to discourage producers of such goods and give tax rate reduction or exemption on most essential goods. This diverts produce's attention and enables the country utilize to utilize the limited resources for production of essential goods only.
- ix. Encouragement of exports:** Governments enhance foreign exchange requirement through export oriented strategy. These provide a certain tax exemption for those exporters and encourage them with arranging a free trade zones and by making a bilateral and multilateral agreement.
- x. Enhancement of standard of living:** the government also increases the living standard of people by giving tax concessions to certain essential goods.

➤ Raising revenues, removal of inequality in income and wealth, ensuring economic stability, reduction of regional imbalance, capital accumulation, employment creation, prevention of harmful consumption, diversity of resources, encouraging export and enhancing living standards are the objectives of tax.

2.3. Characteristics of Tax

A tax has the following general 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. This means people cannot expect any return in benefit for the amount of tax paid. 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 as personal obligation on the taxpayers. When a person becomes liable to pay the tax, it is the duty of him/herself to pay it and no way he/she 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 a days the governments are rendering enormous range of social activities, which incur heavy expenditure. Part of these expenses are 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. Thus, individuals cannot levy tax.
- 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, most of the taxes are levied annually. The payment of taxes should be also regular.
- 8. No Discrimination:** Tax is levied on all people without any discrimination of caste, creed etc. but it should be 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 system, the government imposes various kinds of taxes. This enhances the scope of taxes.

2.4. Components of tax

The components of taxes can be summarised as follows:

- ❖ Each tax must have a base upon which it is levied
- ❖ Each tax must have a tax filling unit that is responsible for paying the tax
- ❖ Taxes must have a rate that is applied to the base to determine the amount owes
- ❖ Unless they are imposed on individual transactions, taxes must have during which the base the base measured and the tax is collected
- ❖ Each tax must have administrative arrangements for the collection tax.

Activity

Question 4: Define taxation?

2.5. Principles of taxation

A tax system for achieving certain objectives chooses and adheres to certain principles which are termed its characteristics. A good tax system therefore, is the one of which designed on the basis of an appropriate set of principles.

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"*.

A good tax system ensures maximum social advantage without any hardship on taxpayers. In establishing the tax policy, the government should consider not only its financial needs but also taxable capacity of the community and government has to consider some other principles. These principles are called as canons of taxation. The following are the important canons of taxation.

Canons Advocated by Adam Smith

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. A good tax system should be based on the ability to pay of the people. 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

According to Adam Smith, the tax each individual bound to pay is 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 all should be clear and certain so that the taxpayer can adjust his/her income and expenditures accordingly. This principle removes all uncertainties in the payment of tax and ensures smooth functioning of the tax department.

Principles of taxations advocated by Adam smith

- ☞ *Principle of equity*
- ☞ *Principle of certainty*
- ☞ *Principle of convenience*
- ☞ *Principle of economy*

3. 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. 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 adjust its proceedings to the habits of the community as far as possible 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.

☞ *Principles of taxation are called canons of taxation*

4. Canon of 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. Thus, the canon of economy is sub-divided into two parts viz.,

4.3. Taxation should be inexpensive in collection, and

4.4. Taxation should retard as little as possible the growth of wealth.

Canons Advocated by Others

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

6. Canon of elasticity: advocated by Bastable and it states that 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, 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.

Elasticity canon may, indeed, be regarded as the agency for realising at once productivity and economy. When the public revenue does not admit of easy expansion or reduction according to the growth or decline of expenditure, there will 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 circumstance.

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 decentralised so that every one should pay according to his/her 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 viewpoints such as economical, political and social.

10. Canon of coordination: In a federal set up like Ethiopia, federal and state governments may levy taxes. So, there should be a proper coordination between various authorities in imposing taxes. Otherwise, it will affect the the tax payer (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.

Activity

Question 5: Differentiate canon of diversity from canon expediency?

2.6. Tax Classifications

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.

2.6.1. Direct Taxes

A direct tax is paid by a person on whom it is levied. Under the direct taxes, the impact and incidence fall on the same person. Direct tax 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/she has to pay it and he/she cannot shift the tax burden to anybody else. In Ethiopia, the government levies the direct taxes such as income tax, tax on agricultural income, professional tax, land revenues, taxes on stamps and registrations etc. The direct taxes levied in Ethiopia take the form of taxes on income and property.

Advantages of Direct Taxes

- 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 economic inequalities:** Direct taxes reduce a discrepancy in the distribution of income and wealth. By adopting the progressive tax system, rich people will pay on higher rates of taxation, while the poor pay on lower rates or gives exemptions. This reduces the gap between the poor and rich to a considerable extent.

3. **Certainty:** Direct taxes satisfy the canon of certainty. The time of payment, mode of payment, the amount to be paid etc. are made clear for direct taxes. 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 direct taxes is low because the government adopts the different methods of collections like tax deductions 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

- a. **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.
- b. **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.

- c. 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/she 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.
- d. 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, the direct taxes are the taxes on honesty.
- e. 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 (system) because of the basic exemption given. Thus, the government cannot depend upon direct tax alone.
- f. 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 lumps. This will in turn discourages them to work further, save and invest.
- g. 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.

2.6.2. 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 to others. For example, when the excise duty is levied on the manufacturer of cement, he/she shifts the burden of tax to the customers by raising the selling price. Here the impact of excise duty falls on the manufacturer and the incidence on the ultimate customers. The person who is required to pay the tax does not bear its burden. Thus, indirect taxes can be shifted.

Merits of indirect taxes

- 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/she purchases

them. He/she 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 the ability to pay. The tax burden is not imposed 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. Thus, the indirect taxes are elastic in their nature.
- 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

- 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:

i. Shiftability of the burden of tax: the impact and incidence of direct taxes fall on the same person. Direct taxes are 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/she cannot shift the tax burden to anybody else, and him/herself has to bear it.

On the other hand, the impact and incidence of indirect taxes 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, it can shift the tax burden to the buyers by including the tax in the price of the cement.

ii. Principle of ability to pay: Direct taxes conform to the principle of ability to pay. For example, now people having income above 600 Ethiopian Birr are only liable to pay employment income tax. But indirect taxes are borne and paid by the poorer part of the society also. As such, these taxes do not conform to the principle of ability to pay.

iii. 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 products are levied at the higher rate of taxes on the assumption that they are purchased by the rich persons only. However, low rate is charged on the goods of common consumption.

iv. 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.

v. 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 indirect tax. Thus, indirect taxes are more convenient to tax payers

vi. 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.

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

viii. 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. Indirect taxes are widening the gap between the rich and poor when they are levied on the goods of common consumption.

2.7. Types of Tax Structure

Activity

Question 6: Distinguish direct taxes from indirect taxes

Tax structures differ from country to country. This is mainly due to the fact that the socio-economic developments of countries vary from one another. There are different types of tax structures (system) which are applied by the governments on different taxes. These are progressive, regressive, proportional and degressive tax structures.

1. Progressive tax structure: 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.

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 increase as the tax base increases. Thus, the amount of tax payable is calculated by multiplying the tax base with tax rate. The following table indicates an illustrative progressive employment income tax system of Ethiopia.

<i>S. No.</i>	<i>Taxable income base</i>	<i>Tax rate</i>
1	0-600	Exempted
2	601-1650	10%
3	1651-3200	15%
4	3201-5250	20%
5	5251-7800	25%
6	7801-10,900	30%
7	Above 10,900	35%

Note: *The tax rate increases as the tax base income increase.*

Merits of progressive tax system

The advantages of progressive tax system include the following:

- i. Equality in Sacrifice:** Under progressive tax system, the rate of taxation increases as the tax base increases. This means 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.
- ii. Reducing the inequalities of income and wealth:** Progressive tax system serves as a powerful instrument for reducing the inequalities of income and wealth.
- iii. 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.
- iv. 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.
- v. 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:

- a. 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.
- b. Progressive Taxation - a Graduated Robbery:** Progressive taxation is unfair mode of taxation and a graduated robbery.
- c. Disincentive to Work:** It is argued that too progressive tax rate acts as a disincentive to work.


d. 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 way of taxes, the incentives to produce more and earn more are lost.

e. 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.

2. Regressive tax structure: this is the direct opposite of progressive tax structure. Means, as the tax base of the tax payer decreases, the tax rate increase. Thus, the rich will pay less tax than the poor. 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 burden 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 income or property, the lower the percentage that the tax payer will pay as tax. The following table indicates an illustrative regressive tax system.

<i>S. No.</i>	<i>Taxable income base</i>	<i>Tax rate</i>
1	Below 1,000	30%
2	1001-8,000	25%
3	8,001-30,200	15%
4	30,201 above	10%

 *The tax rate decreases as the tax base increases.*

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.

3. Proportional tax structure:

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 (progressive) scheme. The term “*flat tax*” is one in which the tax amount is fixed as a function of income and is a term mainly used in the context of income taxes.

Scholars who advocates this system says 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 than complex, graduated taxes. Most political parties advocated that the introduction of a flat tax is on the right of the political range. 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 remain constant as the tax base changes. For example, the tax rate may be 10% of the income.

Merits of proportional tax system

Proportional tax system has the following advantages:

- a. It is simple in nature.
- b. It is uniformly applicable
- c. Proportional taxation leaves the relative economic status of taxpayers unchanged
- d. It will avoid mistakes and drawbacks of progressive tax system

Limitations of proportional tax system

The following are the demerits of proportional tax system:

i. Inequitable distribution: A system of proportional taxation would not lead to an equitable and fair distribution of the burden of taxation. This is because it falls more heavily on the small incomes than on the high incomes.

ii. 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.

iii. 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.

4. Digressive tax structure: in this type of tax structure, the tax rate will progressive up to a certain level of income of the taxpayers and then become constant after the maximum level of their income range. Digressive tax is a mix between the progressive and proportional tax systems. In the case of digressive tax, the tax rate is increased firstly with increase in income and then, the rate remains flat or constant with further increase in income.

Activity

Question7: What is proportional tax system?

2.8. Impact, incidence and shifting of taxes

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:

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

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.

2.8.1. 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.

2.8.2. 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.

2.8.3. 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.

Differences between Impact and Incidence:

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

2.9. Tax evasion, avoidance and delinquency

Tax evasion: Tax evasion is a method of saving tax liability by a taxpayer through fraudulent means or by directly violating tax laws. Tax evasion is illegal, unethical, uneconomical and highly risky since it may result in penalty, imprisonment, and closing of business, hence taxpayers shall find all the legal ways to avoid paying too many taxes and by no means tax evasion is acceptable by the government because it involves criminal activity. Evasion can take place in a number of ways. Individuals may choose to understate or hide their true income. They may also overstate their tax deductions. Tax evasion is meant to be deliberate acts of non-compliance resulting in payment of lower taxes than are actually owed. Therefore, not paying ‘ones’ lawful share of tax is evasion of income.

There are two forms of tax evasion. They are as follows:

- 1. Suppression of income, and
- 2. Inflation of expenditure.

Causes of Tax Evasion

The following are the important causes for Tax evasion:

- i. **Multiplicity of tax laws:** A number of laws enacted for the recovery of a variety of taxes often leads to widespread tax evasion

- ii. 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. For example: the Income Tax Act has 28 chapters and 298 sections including sub-sections. So, such complication in tax-laws is also a root-cause for the tax evasion
- iii. 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.
- iv. 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.
- v. 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 channelising of black money into profitable ways.
- vi. 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.
- vii. Deterioration of moral standards:** There has been deterioration in standards of moral behaviour 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 behaviour.

Remedies for Tax Evasion

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 recognised 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.

Tax Avoidance: Tax avoidance, which denotes the taxpayers' ingenuity to arrange his affairs in a proper manner so as to reduce the incidence of tax, is legal. As long as the provisions of the law are not violated and transactions properly recorded, any attempt to minimize tax using those accounting methods and principles that may useful to report less taxable income of the taxpayers is acceptable.

Tax Delinquency: means the amount of tax uncollected in the previous fiscal period especially in property tax. It may happen if the taxpayer unable to pay property tax due to bankrupt. If the taxpayer can survive its loss for the coming year, the tax authority will collect both the current year tax as well as delinquent tax otherwise it will be considered as un collectible revenue by the authority.

Activity

Question 8: Elaborate the difference between tax evasion and tax avoidance?

Chapter summary

Taxes are compulsory payments to government without expectation of direct return or benefit to the tax-payer. The objectives of taxes raising revenues, removal of inequality in income and wealth, ensuring economic stability, reduction of regional imbalance, capital accumulation, employment creation, prevention of harmful consumption, diversity of resources, encouraging export and enhancing living standards.

Compulsory contribution, benefit is not the basic condition, personal obligation, common interest, legal collection, element of sacrifice, regular and periodical payment no discrimination and wide scope are the objectives of taxes. Canon of equity, convivence, and certainty and economy are principles of taxation advocated by Adam Smith. However, productivity, elasticity, diversity, simplicity, expediency, coordination and neutrality are the canons advocated by others.

Tax structures differ from country to country. This is mainly due to the fact that the socio-economic developments of countries vary from one another. There are different types of tax structures (system) which are applied by the governments on different taxes. These are progressive, regressive, proportional and degressive tax structures.

The tax may be 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.

Self-examination questions

1. The tax rate increases as the tax base income increase under
 - A. Regressive tax system
 - B. Proportional tax system
 - C. Progressive tax system
 - D. Digressive tax system
2. 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.
 - A. Canon of equity
 - B. Canon of convivence
 - C. Canon of certainty
 - D. Canon of economy
3. _____conform to the principle of ability to pay
 - A. Direct tax
 - B. Indirect tax
 - C. Excise tax
 - D. Custom duties
4. If the producer shifts the tax burden to the factors of production (the suppliers of raw materials) it is known as
 - A. Tax impact
 - B. Tax incidence
 - C. Backward shifting
 - D. Forward shifting
5. _____ means the amount of tax uncollected in the previous fiscal period
 - A. Tax avoidance
 - B. Tax evasion
 - C. Tax structure
 - D. Tax delinquency

Discussion questions

1. Write the objectives of taxation.
2. Elaborate the advantages of direct taxes over indirect taxes.
3. Explain the limitations of indirect taxes.
4. Discus the disadvantages of progressive tax system.
5. Elucidate the causes of tax evasion.

Glossary of Terms

Principles (canon) of tax- the philosophies that a tax system must adhere to.

Direct taxes- those taxes paid by the person who earns the income.

Tax incidence- the ultimate burden of the tax.

Impact of tax -the immediate burden of the tax

Tax evasion- illegal way of avoiding tax

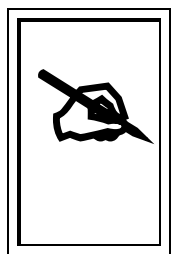
Tax shifting-the process by which the burden of a tax is transferred from one person to another.

Tax delinquency- the amount of tax uncollected in the previous fiscal period

CHAPTER THREE: PUBLIC FINANCE IN ETHIOPIA

Chapter Objectives

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



- ☞ *Understand the features of Ethiopian federal finance*
- ☞ *Appreciate revenue and expenditure assignments*
- ☞ *Comprehend intergovernmental transfers and borrowings*
- ☞ *Discuss the trends of Ethiopian public revenues, expenditures, debts, deficit and grants*
- ☞ *Understand budget and its process in Ethiopia*

3.1. Features of Ethiopian Federal Finance

Federalism is a system of government in which there is division of powers and functions between federal government and several regional governments, each of which in its own sphere coordinates with the others and each of which acts directly on the people through its administrative machinery.

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.

Ethiopia is a federal state which comprises of a central government and ten Regional Governments namely Tigray, Afar, Amhara, Oromiya, Somali, Benishangul Gumuz, Southern nations nationalities, Gambela, and Harare. There are also two city administrations Addis Ababa and Dire Dawa. As a federal country, the functions and duties of the government are divided between central and state governments and they are generally defined in the constitution.

The form of government is parliamentary having both federal and state governments with legislative, executive, and judicial powers. Federalism requires decentralization of government decision making and implementation involves delegating more power to the decentralized divisions of the government. The goal of this strategy is to speed up government action and to deliver a more suitable package of services needed by the locality.

One component of federalism is fiscal federalism (federal finance) which gives local governments some taxing power and expenditure responsibility, and allows them to decide on the level and structure of their expenditure budgets. The main goal of fiscal decentralization is to move governance closer to the people, and this does requires strengthening local government finances. Fiscal decentralization requires local governments with some autonomy to made independent fiscal decisions.

Federal finance refers to the system of assigning the source of revenue to government.

Principles of Federal 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 organised 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.

Modes of Allocation of Revenue Resources 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:

- ✓ On the basis of actual collections from different states.
- ✓ On the basis of population and
- ✓ 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 Economic Development.

Fiscal federalism has four components:

- ✓ Revenue Assignment
- ✓ Expenditure Assignment
- ✓ Intergovernmental Transfer
- ✓ Borrowing

3.2. Revenue Assignment

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 regional 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 centre and states.

3.2.1. Objectives of Revenue sharing

The sharing between the central government and the Regional Governments has the following objectives:

- ❖ To enable the central Government and the Regional Governments efficiently carry out their respective duties and responsibilities.
- ❖ To assist Regional Governments, develop their regions on their own initiatives;
- ❖ To narrow the existing gap in development and economic growth between regions;
- ❖ To encourage activities those, have common interest to regions.

3.2.2. Basis for Revenue Sharing

The sharing of revenue between the central government and the national/ regional governments takes in to consideration the following principles:

- ☞ Ownership of source of revenue
- ☞ The National or Regional character of the sources of revenue;
- ☞ Convenience of levying and collection of the tax or duty;

- ☞ Population, distribution of wealth and standard of development of each region;
- ☞ Other factors that are basis for integrated and balanced economy.

3.2.3. Categorization of Revenue

According to constitution of Ethiopia revenues are categorized as central, regional and joint. 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;

The following shall be Revenues for the Regions:

1. Personal income tax collected from the employees of the Regional Government and Employees other than those covered under the sources of central government.
2. Rural land use fee.
3. Agricultural income tax collected from farmers not incorporated in an organization.
4. Profit and sales tax collected individual traders.
5. Tax on income from inland water transportation.
6. Taxes collected from rent of houses and properties owned by the Regional Governments;
7. Profit tax, personal income tax and sales tax collected from enterprises owned by the Regional Government:
8. With prejudice to joint revenue sources, income tax, royalty and rent of land collected from mining activities.
9. Charges and fees on licenses and services issued or rented by the Regional Government;

The following are Joint Taxes:

- ✓ Profit tax, personal income tax and sales tax collected from enterprises jointly owned by the central Government and Regional Governments;

- ✓ Profit tax, dividend tax and sales tax collected from Organizations;
- ✓ Profit tax, royalty and rent of land collected from large scale mining, any petroleum and gas operations;
- ✓ Forest royalty

3.2.4. Collection and Allocation of Joint Revenues

The federal government collects both the federal and joint revenues. The joint revenue is shared based on a decision made by a committee appointed by the prime minister and consisted of representatives of both levels of governments. The following table shows how the joint revenue is shared between the federal government and regional government.

<i>Jointly Established Enterprises</i>	Federal Government	Regional Government
Profit Tax	In proportion to their respective capital contribution	
Employment Income Tax	50%	50%
Value-added Tax	70%	30%
Turnover Tax	70%	30%
Excise Taxes	70%	30%
<i>Companies</i>		
Profit Tax	50%	50%
Dividend Income Tax	50%	50%
Value-added Tax	70%	30%
Turnover Tax	70%	30%
Excise Taxes	70%	30%
<i>Mineral, Petroleum and Operation</i>		
Profit Tax	50%	50%
Royalty	60%	40%

3.3. Expenditure Assignment

The federal structure of Ethiopia allocates functions and responsibilities, and hence expenditure, to federal government and regional governments. Art 51 of the Constitution entrusts the federal government with power subject to national defense, international or foreign relations, citizenship, immigration and naturalization; interstate commerce, postal and telecommunication services, weights and measures, domestic currency coinage and foreign

currency usage, banking, patents and copyrights, operation of air, rail and water transports and highways linking two or more states, enacting labour, electoral, procedural, criminal, and commercial codes. Art 52 (2) assigns to regional governments such power and functions as enacting and executing the state constitutions; establishing state police, maintaining public peace and order; administration of land and other natural resource within the region; and formulating and executing economic and social development policies, strategies and plans of the state. The states also have power over areas of education, health and agriculture. Both regional governments and federal government are required to cover expenditure to be incurred in connection with their respective functions and responsibilities.

3.4. Intergovernmental Transfer (Subsidy)

As can be evidently observed from the revenue and expenditure assignments addressed in the Constitution, the lucrative (profitable) sources of revenue in Ethiopia are assigned to the federal government while a wide range of expenditure responsibilities are reserved to the regions. This resulted in significant vertical fiscal imbalance between the federal and regional governments. Besides, the adoption of the federal system has created autonomous regions that vary enormously in area, population size, infrastructure, human and institutional capacity and socio-economic status. As a result, there is an extensive difference in the fiscal capacities of these regions. Recognizing the inevitability of fiscal imbalances resulting from the division of powers in the constitution, the disparities in population, natural resources as well as human and institutional capacities among regions, the Constitution lays down legal basis for fiscal transfer-the transfer of money from central government to regional governments. Annually there is a formula-based unconditional transfer of money from the federal government to regional governments. The federal budget subsidies to each region for 2005 and 2006 EC budget year are presented below.

Region	2005/6 EC Budget Year		2004/2005 Budget Year	
	%age Share	Subsidy Amount	%age Share	Subsidy Amount
Tigray	7.18%	3,088,268,676	7.18%	2,611,318,629
Afar	3.15%	1,354,881,104	3.15%	1,145,634,217
Amhara	23.17%	9,965,903,234	23.17%	8,426,776,134
Oromiya	32.50%	13,978,932,028	32.50%	11,820,035,577

Somali	8.14%	3,501,184,822	8.14%	2,960,464,296
Benishagul Gumuz	2.10%	903,254,070	2.10%	763,756,145
SNNP	20.10%	8,645,431,808	20.10%	7,310,237,388
Gambela	1.50%	645,181,478	1.50%	545,540,104
Harari	1.00%	430,120,985	1.00%	363,693,402
Dire Dawa	1.16%	498,940,343	1.16%	421,884,347
Total		43,051,558,548		36,369,340,239

3.5. Borrowing

Regional governments are not allowed to borrow from abroad. It is the federal government that has the power to borrow from abroad. They can, however, borrow internally from banks to meet the cash flow timing problem. Borrowing internally from banks requires the permission of MOFED. When regional governments experience budget shortfall in any fiscal year the federal government may give them loan in the form of advance to be charged to their budgetary subsidy of the following year.

3.6. Trends of Ethiopian Government Finance

3.6.1. Recent trends of government revenues

According to the following table, in the past four-year tax revenue has raised on average 36%. In 2006/07 tax revenue was 10.1% of GDP, it has dropped to 8.6% (2008/09), but it picked up to 11.5 in 2010/11 fiscal year. Generally, grant performance is going down, however Protection of Basic Sectors (PBS) is better, due to the global economic crisis. The economic performance and the tax policy reform effort in the past ten years, which was supported by IMF and the recent tax administration effort are a key to the recent tax revenue performance.

Table 1: Government Revenues and Grant in Millions of Birrs (2004-2011 EFY)

	2006/07	2007/08	2008/09	2009/10	2010/11
Total Revenue and Grants	29380	39705	54637	66240	85611
Domestic Revenue	21796	29794	40184	53864	69120
Tax revenue	17353	23801	29008	43318	58981

<i>(annual growth rate)</i>		37	22	49	36
Direct taxes	5167	7015	9868	14906	19550
Indirect taxes	12186	16785	19139	28412	39431
Domestic indirect taxes	3997	5092	7325	10727	15705
Import duties & taxes	8189	11693	11814	17685	23726
Non-tax revenue	4444	5993	11176	10546	10139
Grants	7583	9911	14454	12376	16491
(In percent of GDP)					
Total Revenue and Grants	17.1	16.0	16.3	17.3	16.7
Domestic Revenue	12.7	12.0	12.0	14.1	13.5
Tax revenue	10.1	9.6	8.6	11.3	11.5
Non-tax revenue	2.6	2.4	3.3	2.8	2.0
Grants	4.4	4.0	4.3	3.2	3.2
GDP at current market price	171989.0	248302.7	335392.0	382938.6	511157.0

3.6.2. Recent trends of government expenditure

Table 2: Government expenditure in Millions of Birrs (2007-2011 EFY)

	2006/07	2007/08	2008/09	2009/10	2010/11
Total Expenditure	35607	46915	57774	72598	93832
Current expenditure	17165	22794	27176	32537	40535
Capital expenditure	18442	24121	30599	40061	53297
o/w Pro-poor Expenditure (rec+Cap)	22360	30050	36213	47789	62378
(percentage share of total expenditure)	63	64	63	66	66
Education	8411	10012	12761	17249	23345
Health	2350	3405	3873	4693	6307
Agriculture	5113	6209	7502	6994	8246

Road	5001	8286	9804	13973	18543
water	1484	2139	2272	4882	5938
	(In percent of GDP)				19.0
Total Expenditure	20.7	18.9	17.2	18.4	
Current expenditure	10.0	9.2	8.1	8.5	7.9
Capital expenditure	10.7	9.7	9.1	10.5	10.4
<i>o/w Pro- poor Expenditure (rec+Cap)</i>	<i>13.0</i>	<i>12.1</i>	<i>10.8</i>	<i>12.5</i>	<i>12.2</i>
<i>Education</i>	<i>4.9</i>	<i>4.0</i>	<i>3.8</i>	<i>4.5</i>	<i>4.6</i>
<i>Health</i>	<i>1.4</i>	<i>1.4</i>	<i>1.2</i>	<i>1.2</i>	<i>1.2</i>
<i>Agriculture</i>	<i>3.0</i>	<i>2.5</i>	<i>2.2</i>	<i>1.8</i>	<i>1.6</i>
<i>Road</i>	<i>2.9</i>	<i>3.3</i>	<i>2.9</i>	<i>3.6</i>	<i>3.6</i>
<i>water</i>	<i>0.9</i>	<i>0.9</i>	<i>0.7</i>	<i>1.3</i>	<i>1.2</i>
	<i>171989.0</i>	<i>248302.7</i>	<i>335392.0</i>	<i>382938.6</i>	<i>511157.0</i>
<i>GDP at current market price</i>					

During 2004/05 fiscal year about 57% of the total government budget was allocated to the poverty reducing sectors and this amount picked up to level of 64.2% in 2007/08 but goes down a bit in 2008/09 to 63.1% budget and pick up again 66 percent in fiscal year just finished 2010/11.

Moreover, the donor communities had also made an agreement with the government and channelled the entire untied grant to support these sectors through Protecting Basic Services project (PBS) since 2006. Hence during the past four years tremendous improvements had been witnessed in both quantity and quality of basic services.

3.6.3. Recent trends of government financing

Table 3: General Government Financing, 2006/07-2010/11 (in million Birrs)

	2006/07	2007/08	2008/09	2009/10	2010/11
Total Revenue and Grants	29380	39705	54637	66240	85611

Domestic Revenue	21796	29794	40184	53864	69120
Grants	7583	9911	14454	12376	16491
Total Expenditure	35607	46915	57774	72598	93832
Overall balance including grants	-6227	-7210	-3137	-6358	-8221
Overall balance excluding grants	-13811	-17121	-17591	-18734	-24712
Financing	6227	7210	3137	6358	8221
External (net)	1913	2396	3176	4131	7798
Domestic(net)	6246	6580	-417	1758	111
Residual	-1931	-2774	-95	-228	-1146
(In percent of GDP)					
Total Revenue and Grants	17.1	16.0	16.3	17.3	16.7
Domestic Revenue	12.7	12.0	12.0	14.1	13.5
Grants	4.4	4.0	4.3	3.2	3.2
Total Expenditure	20.7	18.9	17.2	19.0	18.4
Financing	3.6	2.9	0.9	1.7	1.6
External (net)	1.1	1.0	0.9	1.1	1.5
Domestic	3.6	2.7	-0.1	0.5	0.0
248302.					
GDP at current market price	171989.0	7	335392.0	382938.6	511157.0

3.8. Budgeting and its process in Ethiopia

3.8.1. 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 size of the budget (i.e. total amount of money for the year), size of expenditures on different functions, and the extent 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 it's 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”.

3.8.2. 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 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.

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 differs 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 non- 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 on 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.

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 of the economy is financed through external borrowing and grants. The Expenditure Budget includes the following two types of Budgets:

1. Recurrent Budget, and
2. Capital Budget.

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 of 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 anybody corporate;
- f. Any associated consultancy costs of the above.

Capital budget could thus broadly be described as an outlay on projects that result in the acquisition of fixed assets and the provision of development services (Ministry of planning and Economic Development, 1993:4). It should therefore be need that, capital budget as a wider coverage than simple outlays in fixed investments, since it includes expenditure on development services like agricultural research and transfer payments related to a project.

The capital budget is presented under three functional groups such as 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 includes services like cartography (the act of drawing map), statistics, public and administrative buildings, and the like.

3.8.3.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 a 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.

Methods of Financing Deficit

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

- i.** Borrowing from central bank
- ii.** The running down of accumulated cash balances
- iii.** The government may issue new currency
- iv.** 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.

Objectives of Deficit Financing

The following are the major objectives of deficit financing.

- a. 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.
- b. Keynes advocated deficit financing as an instrument of economic policy to overcome conditions of depression and to raise the level of output and employment.
- c. The use of deficit financing has also been considered essential for financing economic development especially in under developed countries.
- d. Deficit financing is also promoted for the mobilization of surplus idle and unutilized resources in the economy.

Effects of Deficit Financing

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

- 1. Inflationary (rise in prices) effect:** 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 favor 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.

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.

3.8.4. 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. Peterson summarized the budget process into three phases: analysing, fitting, and implementing. The analysis phase is the assembly and integration of financial data which might include processes from the formulation of macro-economic and fiscal framework to the allocation of expenditure budget between Federal and Regional governments. The fitting phase is the process of prioritizing activities to fit with policy and reducing a budget to a ceiling.

Referring to the budgeting processes outlined above this might range from the processes of allocation of Federal government expenditures budget between recurrent and capital budget down to the submission of the budget to the council of peoples' Representatives. The final phase, implementing, is distributing and using the allocation, i.e. the notification and publication of the budget, allotment and the monitoring processes.

Budget being a one-year plan prepared for the coming fiscal year it requires a time schedule (deadlines) for each and every process 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. Thus far we don't have an authoritative and binding budget calendar that could force all public bodies involved in the process of budgeting. 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 sine 30th (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 MOF and MOED who are responsible for the preparation of the recurrent and capital budgets, respectively. The MOF and MEOD 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 MOF and MOED will release the budget circular around November to December.

The Budgetary Process at the Federal Level

The budget processes at the Federal level follows sequential and iterative the steps. These steps can be explained with the help of the following Chart. 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 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 Ministry of Economic development (MoED). Whereas, the later, establish 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 depends 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 ministries, i.e. MoF and MoED, 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 MoED, 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 MoF and MoED.

Step Four - Budget Call and Ceiling Notification:

This includes two items. They are:

- a. **Recurrent budget:** MoFD 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:** MoED issues detailed capital budget preparation guidelines to spending public bodies along with the ceilings provided to each line institution. MoED will set the ceiling for each sector.

Step Five - Budget Review by MoF and MoED:

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 MoF-Budget Department. In consultation with spending public bodies, MoF 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 MoED review the capital budget requests from different public bodies. At this stage projects will be screened. If there is 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 department of MoED will submit their first-round recommendation to the Development Finance and Budget Department of MoED. 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 MoF. 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 MoFD.

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 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 MoED. On the basis of the discussion the respective sector departments of MoED 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 MoFD 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 MoED, sector departments of MoED will give a final recommendation to the development finance and budget department of MoED. 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 MoFD 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 MoED on the final recommended budget and, along with the consolidated capital budget, will be submitted to the council of ministers. MoED 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 MoF and MoED for recurrent and capital budgets, respectively. MoFD will notify spending public bodies through Form 3/1. Likewise, MoED will inform through Form 3/2. Both Forms will be copied to the Treasury Department of the MoFD 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 MoFD-for the recurrent budget-and by MoED-for the capital budget, and then will be sent to the treasury Department of the MoFD.

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 MoFD 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 may 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'.

Chapter summary

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. Fiscal federalism has four components viz. revenue assignment, expenditure assignment, intergovernmental transfer, borrowing. Independence, equity, uniformity, adequacy, fiscal access, integration and co-ordination, efficiency, administrative economy and accountability are the principles of federal finance.

Ethiopian government revenues are categorized as central, regional and joint. The sources of revenue are given under federal/central. The federal government collects both the federal and joint revenues. The joint revenue is shared based on a decision made by a committee appointed by the prime minister and consisted of representatives of both levels of governments. The government budget represents a plan/forecast by government of its expenditures and revenues for a specified period. In Ethiopia, the revenue budget is usually structured into three major headings: ordinary revenue, external assistance, and capital revenue.

Enabling the central government and the regional governments efficiently carry out their respective duties and responsibilities, assisting regional governments, develop their regions on their own initiatives, narrowing the existing gap in development and economic growth between regions, encouraging activities those, have common interest to regions are the objectives of revenue assignments.

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. Capital budget is budget for capital expenditures. Capital budget could thus broadly be described as an outlay on projects that result in the acquisition of fixed assets and the provision of development services.

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.

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.

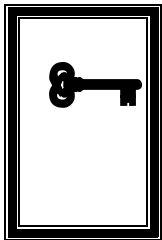
Self-examination questions

1. Agricultural income tax is a source revenue to
 - A. State government
 - B. Federal government
 - C. Local government
 - D. All of the above
2. Identify the joint revenue for both central and state governments
 - A. Taxes collected from national lotteries and other chance winning prizes
 - B. Tax on income from inland water transportation.
 - C. Profit and sales tax collected individual traders.
 - D. profit tax, dividend tax and sales tax collected from organizations
3. Which of the following statement is correct?
 - A. The federal government that has no power to borrow from abroad
 - B. Regional governments are allowed to borrow from abroad
 - C. Regional governments can borrow internally from banks to meet the cash flow problem
 - D. Regional governments cannot borrow from federal government during budget shortfall.
4. _____represents the annual forecast of revenues to be raised by government through taxation and other discretionary measures.
 - A. Expenditure budget
 - B. Revenue budget
 - C. Recurrent budget
 - D. Capital budget
5. The financing of a deliberately created gap between public revenue and public expenditure is
 - A. Budget deficit
 - B. Budget surplus
 - C. Budget processing
 - D. Budget timing

CHAPTER FOUR: ETHIOPIAN TAX SYSTEM

Chapter Objectives

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



- ☞ *Understand the structure and administration of Ethiopian tax system*
- ☞ *Know the income tax laws and practices*
- ☞ *Realize about consumption taxes*
- ☞ *Elaborate the stamp duties*
- ☞ *Understand foreign trade taxes*

4.1. Structure of Ethiopian tax system and administration

Tax revenue is the vital governments' revenue in any world. The Ethiopian government collects diversified type of tax from its citizens in order to fulfill public goods and services and improve the living standards of the society. To do this, the government of Ethiopia delegated to one government institution called Ethiopian Revenue and Custom Authority (ERCA) in order to establish tax rules, regulations, and policies; administer and collect tax revenue to the government. ERCA is established starting from at federal level up to the kebele level.

Powers and Duties of Tax Authority (Article-38)

The implementation and enforcement of this proclamation and of regulations issued hereunder shall be the duty of the tax authority.

Notwithstanding anything to the contrary in any other law, the Tax Authority shall be empowered to investigate any statements, records and books of account submitted by any taxpayer at any time by:

- a) Sending duly accredited inspectors to the place of business or practice of the tax payer to check same or any vouchers, stocks of other material items of the taxpayer;
- b) requiring the taxpayer or any employee thereof who has access to or custody of any information, records or books of account to produce the same and to attend during normal office hours at any reasonably convenient tax office and answer any questions relating thereof;

- c) Requiring any person including municipality, Body, Financial Institution Department or Agency of Federal or Regional Government to disclose particulars of any information or transactions, including any lending or borrowing which it may have relating to the taxpayer.

Confidentiality of Tax Information (Article-39)

The Tax Authority and all persons who are or have been its agents or employees shall maintain the secrecy of all information except such information as are required by the Commercial Code of Ethiopia to be published by trade gazette, on particular taxpayers received by them in an official capacity, and may disclose such information only to the following persons:

- i. Employees of the Tax Authority, for the purpose of carrying out their official duties;
- ii. Law enforcement agencies, for the purpose of the prosecution of a person for tax violations;
- iii. Courts, in proceedings to establish a person's liability for tax, penalties, or interest, or in any criminal case;
- iv. Tax authorities of a foreign country, in accordance with an international treaty to which Ethiopia is a party.

Information concerning a taxpayer may be disclosed to another person with the taxpayer's written consent.

Code of Conduct for Tax Authority Employees (Article-40)

- 1. Each employee of the Tax Authority shall
 - a. Be honest and fair, treating each taxpayer with courtesy and respect;
 - b. Apply the law, regulations and rulings to each case on the basis the objective facts in that case, showing no partiality to members of his family or to friends;
 - c. Refrain from participating in any determination that will affect his or his spouse's tax liability;
 - d. Where either a known family relationship or a business interest might influence any determination he must, as an employee, make public (in the manner provided by regulations) such relationship or interest;
 - e. Subject to Article 39 protect the confidentiality of any tax or duty information, and
 - f. Not solicit or accept any bribe or perform any other improper act relating to the duty to determine or collect any tax.

No employee of the Tax Authority shall act as a tax accountant or consultant or accept employment from any person preparing tax declarations or giving tax advice. Generally, tax revenues in our country Ethiopia is collected by both federal and regional governments.

1. Central or Federal government tax revenues

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 government tax revenues

The following shall be Revenues for the Regions:

- i. Personal income tax collected from the employees of the Regional government and employees other than those covered under the sources of central government.
- ii. Rural land use fee.
- iii. Agricultural income tax collected from farmers not incorporated in an organization.
- iv. Profit and sales tax collected individual traders.
- v. Tax on income from inland water transportation.
- vi. Taxes collected from rent of houses and properties owned by the Regional governments;
- vii. Profit tax, personal income tax and sales tax collected from enterprises owned by the Regional government:
- viii. With prejudice to joint revenue sources, income tax, royalty and rent of land collected from mining activities.
- ix. Charges and fees on licenses and services issued or rented by the Regional government.

3. Joint tax revenues

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

4.2. Income Taxes

The following the different types of income taxes implemented recently in Ethiopia.

4.1.1 Schedule ‘A’ Income: Employment Income

Any remuneration paid by an employer to his employee in consideration of his services is called salary. It includes the value of fringe benefits provided by the employer.

Every person deriving income from employment is liable to pay tax on that income at the rate specified in Schedule A-Article 11.

Tax Rate (Article-11):

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

Schedule A

Employment income (per month) Birr		Employment income tax Rate	Deductions
0	600	0 (Exempted)	Nil
601	1650	10	60
1651	3200	15	142.5
3201	5250	20	302.5
5251	7800	25	565
7801	10,900	30	955
Above 10,900		35	1500

Determination of Employment Income (Article-12):

- 1) 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 or from prospective employment.
- 2) The type of taxable fringe benefits and the manner of their assessment shall be determined by Regulations to be issued by the Council of Ministers.
- 3) Income received in the form of wages does not include representation and other similar expenditures (on social functions, guest accommodations, etc.)

Exempted Incomes (Article-13)

The following categories of income shall be exempt from payment of income tax hereunder:

- (a). Income from casual employment:** income from employment received by casual employees who are not regularly employed provided that they do not work for more than one(1) month for the same employer in any twelve(12) months period;
- (b). Contribution of retirement benefits by employers:** pension contribution, provident fund and all forms of retirement benefits contributed by employers in an amount that does not exceed 15 % (fifteen percent) of the monthly salary of the employee;
- (c). Reciprocity, income from employment:** subject to reciprocity, income from employment, received for services entered in the exercise of their duties by:
 - (i) Diplomatic and consular representatives, and
 - (ii) Other persons employed in any Embassy, Legation, Consulate or Mission of a foreign state performing state affairs, who are national of that state and bearers of diplomatic passports or who are in accordance with international usage or custom normally and usually exempted from the payment of income tax.
- (d) Specifically, exempted income:** income specifically exempted from income tax by:
 - i. any law in Ethiopia, unless specifically amended or deleted by this

Proclamation;

ii. International treaty; or

iii. An agreement made or approved by the Minister.

(e) Exempted income by regulations: The Council of Ministers may by regulations exempt any income recognized as such by this Proclamation for economic, administrative or social reasons.

(f) Payments as compensation: payments made to a person as compensation or gratitude in relation to:

(i) Personal injuries suffered by that person;

(ii) The death of another person.

4.2.2. Schedule ‘B’ Income: Income from Rent of Buildings

Under the Schedule ‘B’ the basis of charge is the rental income received from the property. That is, Income tax shall be imposed on the income from rental of buildings. Every person deriving income from rent of buildings is liable to pay tax on that income at the rate specified in Schedule B-Article 15.

Schedule B

Total rental income (per year)		Rental income tax rate	Deductions
0	7200	0	Nil
7201	19,800	10	720
19,801	38,400	15	1710
38,401	63,000	20	3630
63,001	93,600	25	6780
93,601	130,800	30	11,460
Above 130,800		35	18,000

Determination of Income Tax Rate (Article-16)

1) Income from rental of building shall be computed as follows:

(a) If the tax payer leased furnished quarters the amounts received attributable to the lease of furniture and equipment shall be included in income.

(b) Sub-lessors 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.

(c) The following amounts shall be deducted from income in computing taxable income:

(i) Taxes paid with respect to the land and buildings being leased; except income taxes; and

(ii) for taxpayers not maintaining books of account, one fifth (1/5) 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;

(iii) 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 by this Proclamation, deductible expenses include (but are not limited to) the cost of lease (rent) of land ,repairs , maintenance, and depreciation of buildings, furniture and equipment in accordance with Article 23 of this Proclamation as well as interest on bank loans, insurance premiums.

2) The owner of a building who allows a lessee to sub-lease is liable for the payment of the tax for which the sub-lessor is liable, in the event the sub-lessor fails to pay.

3) At the earlier of the time construction of a rental building is completed or when 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 (or persons) subject to tax on income from rental of the building. The Keble administration has the obligation to communicate this information or information obtained by the administration's own initiative to the appropriate tax authority.

Example: Mr. X has a building that is available for rent in year 2012. The following are the details of the property lease out

❖ He has let out for twelve months

❖ Actual rent for a month is birr 30,000

- ❖ He paid 15% of the actual rent received as land taxes and 3% as other taxes
- ❖ He spent birr 10,000 for maintenance of the building

Depreciation Schedule				
Type	Year	Original Cost	Addition	Total Cost
building	2012	3,000,000.00	---	3,000,000.00
Equipment	2012	150,000.00	---	150,000.00
Computer & accessory	2012	100,000.00	60,000.00	160,000.00

Required: Compute the taxable rental income and tax liability assume

- A. Mr. X does not maintain any books of accounts in this regard
- B. Mr. X has maintained books of accounts

Solution (A):

Annual rental income (birr 30,000*12 months) -----360,000

Less: allowable deductions

- Land tax (lease) (15% of 360,000) -----54,000
- Other taxes (3% of 360,000) -----10,800
- Maintenance (1/5 of 360,000) -----72,000 (136,800)

Taxable rental income.....**223,200**

Tax liability = (Taxable income x Tax rate)- deduction

= Birr (223,200 x 35%)-18,000

= **Birr 60,120**

Solution (B): Depreciation Schedule

1. For building 300,000 x 0.05=15,000
2. For Equipment 15,000 x 0.20= 3,000
3. For computer 16,000 x 0.25 = 4,000

Annual rental income (birr 30,000*12 months) ----- 360,000

Less: allowable deductions

- Land tax (15% of 360,000) -----54,000
- Other taxes (3% of 360,000) -----10,800
- Maintenance -----10,000

- Dep Expense Building-----15,000
- Dep Expense Equipment-----3,000
- Dep Expense computer-----4,000----- (96,800)

Taxable rental income..... **263,200**

Tax liability = (Taxable income* Tax rate) - Deduction

= (Birr 263,200 x 35%) - 18,000

= **Birr 74,120**

4.2.3. Schedule ‘C’ Income: Business Income

Income Tax shall be imposed on the taxable business income realized from entrepreneurial activity. Business means manufacture or purchase and sale of a commodity with a view to make profit. It includes any trade, commerce or manufacture or any other adventure or concern in the nature of entrepreneurial activity. It is not necessary that there should be a series of transactions in a business and it should be carried on permanently. Neither repetition nor continuity of similar transactions is necessary. Profit of an isolated transaction is also taxable under this Schedule, provided that it is a venture in the nature of business or trade. In this connection, it is important that the intention of purchase or manufacture should be sell at a 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 this Proclamation and the directives issued by the Tax Authority.

Tax Rate

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

2) Taxable business income of other taxpayers shall be taxed in accordance with the following Schedule C.

Total Business Income (per year) Birr		Business income Tax rate	Deductions
0	7200	0	Nil
7201	19,800	10	720

19,801	38,400	15	1710
38,401	63,000	20	3630
63,001	93,600	25	6780
93,601	130,800	30	11,460
Above 130,800		35	18,000

1. Deductible and non-deductible expenses

Non-Deductible Expenses for business profit tax

1) The following expenses shall not be deductible:

(a) The cost of the acquisition, improvement, renewal and reconstruction of business assets that are depreciated pursuant to Article 23 of this Proclamation;

(b) An increase of the share of capital of a company or the basic capital of a registered partnership;

(c) Voluntary pension or provident fund contributions over and above 15% of the monthly salary of the employee.

(d) Declared dividends and paid-out profit shares;

(e) Interest in excess of the rate used between the National Bank of Ethiopia and the commercial banks increased by two (2) percentage points.

(f) Damages covered by insurance policy;

(g) Punitive damages and penalties;

(h) The creation or increase of reserves, provisions and other special-purpose funds unless otherwise allowed by this Proclamation;

(i) Income Tax paid on Schedule C income and recoverable Value-Added Tax;

(j) Representation expenses over and above 10% of the salary of the employee;

(k) Personal consumption expenses;

(l) Expenditures exceeding the limits set forth by this Proclamation or regulations issued hereunder.

(m) Entertainment expenses;

(n) Donation or gift.

2. Notwithstanding the provisions of Sub-Article (1) (n) of this article, the Council of Ministers may by Regulations allow donations or gifts provided for public use to be deducted.

3. Interest paid to shareholders on loans and advances shall not be deductible to the extent that the loan or advances in respect of which the interest paid exceeds on average during the tax period four times the amount of the share capital. This sub-

Article does not apply to banks and insurance companies.

4. In the case of bodies other than companies, Sub-article (3) above shall apply as if for the reference to share capital there were substituted a reference to basic capital.

Deductible expenses of business profit tax

1. Operating expenses

In the determination of business income subject to tax in Ethiopia, deductions shall be allowed for expenses incurred for the purpose of earning, securing, and maintaining that business income to the extent that the expenses can be proven by the taxpayer and subject to the limitations specified by this Proclamation.

2. Trading Stock (Article-22)

a. For the purposes of ascertaining the income of a person for a tax period from a business, there shall be deducted the cost of trading stock of the business disposed of by the person during that period.

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

c. The term “trading stock” means any business asset that is either used in the production process and becomes part of the product, or that is hold for sale.

3. Depreciation (Article-23)

Depreciation means decrease in the value of assets by wear and tear, caused by their use in the business over a period of time. Its cost is spread over its anticipated life by charging depreciation every year against the profits of the business.

4. Assets eligible for Depreciation

Assets eligible for Depreciation are (i) Building, Plant and machinery (iii) Furniture.

1) In the determination of taxable business income, the owner of the business assets may deduct depreciation for business assets.

2) Fine art, antiques, jewellery, trading stock and other business assets not subject to wear and tear and obsolescence shall not be depreciated.

3) The acquisition or construction cost, and the cost of improvement, renewal and reconstruction, of buildings and constructions shall be depreciated individually on a straight-line basis at five per cent (5%).

4) The acquisition or construction cost, and the cost of improvement, renewal and reconstruction, of intangible assets shall be depreciated individually on a straight-line basis at ten percent (10%)

5) 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: twenty-five (25%).

(b) All other business assets: twenty percent (20%).

6) In each category as referred to in Sub-Article (5), the rate of depreciation specified in that Sub-Article shall be applied to the depreciation base of the category.

7) The depreciation base shall be the book value of the category as recorded in the opening balance sheet of the tax period:

(a) Increased by the cost of assets acquired or created and the cost of improvement, renewal and reconstruction of assets in the category during the tax period.

(b) Decreased by the sales price of assets disposed of and the compensation received for the loss of assets due to natural calamities or other involuntary conversion during the tax period.

8) If the depreciation base does not exceed Birr 1,000 the entire depreciation base shall be a deductible business expense.

9) If a revaluation of business assets takes place, no depreciation shall be allowed for the amount of the revaluation.

10) In determination of taxable business income a deduction is permitted in respect to each category of business assets for the maintenance and improvement expenses of business assets belonging to that category for the actual amount of then expenses, but not in excess of twenty percent (20%) of the depreciation base of the category at the end of the year. Any actual expenses exceeding this twenty percent (20 %) shall increase the depreciation base of that category.

5. Transfer of Business Assets (Article-24)

- i. When assets used in a business are sold, exchanged, or otherwise transferred, gain or loss is recognized on the transfer.
- ii. Transfers of business assets among companies which are parties to reorganization are not treated as a disposal of the property.
- iii. The value of business assets held by a company or companies which are parties to a reorganization is the same as the value of such assets immediately before the reorganization. Similarly, the balance value of any depreciation categories shall be carried over.
- iv. ‘reorganization’ means:
 - a) a merger of two or more resident companies;
 - b) the acquisition or takeover of fifty percent (50%) or more of the voting shares and fifty percent (50%) or more of all other shares by value of a resident company solely in exchange for shares of a party to the reorganization;
 - c) the acquisition of fifty percent (50%) or more of the assets of a resident company by another resident company solely in exchange for voting participations with no preferential rights as to dividends of a party to the reorganization;
 - d) A division of a resident company into or more resident companies; or
 - e) A spin-off

The Tax Authority shall ensure that the merger, acquisition, takeover, division, or spin-off is not having tax avoidance as a principal objective.

- v. The rules of Sub-Article (1) – (4) shall not apply to the transfer of assets described under Article 23(5).
- vi. Loss shall not be recognized on the transfer of a business asset to related person within the meaning of Article 2(24).

Bad Debts (Article-25):

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

- a) An amount corresponding to this debt was previously included in the income;
- b) The debt is written off in the books of the taxpayer; and
- c) Any legal action to collect the debt is not recoverable.

Special Reserves for Finance Institutions (Article-26):

In the determination of taxable business income of finance institutions, a deduction shall be allowed for special (technical) reserves in accordance with the directives issued by the National Bank of Ethiopia; the business income, however, shall be increased by amounts drawn from such reserves.

Participation Deduction (Article-27)

- a. If a resident company or partnership reinvests the profit it earned to raise the capital of another company or partnership subject to the conditions in Sub-Article (2) and (3); such amount shall be deductible from its taxable income.
- b. The deduction mentioned in letter (a) of Sub-Article (1) shall apply to shares of resident companies that are subject to taxation under Schedule C and in which the investing body has a shareholding of at least twenty-five percent (25%), by value or by number, in the share capital or the voting rights.
- c. The deduction mentioned in letter (b) of Sub-Article (1) shall apply to basic capital of resident registered partnerships that are subject to taxation under Schedule C and in which the investing body holds at least twenty-five percent (25%) by value of basic capital.

d. The Council of Ministers shall by regulations determine the manner in which the incentive granted in this Article shall be applied.

6. Loss Carry forward (Article-28)

- i. If the determination of taxable business income results in a loss in a tax period, that loss may be set off against taxable income in the next five (5) tax periods, earlier losses being set off before later losses.
- ii. If during a tax period the direct or indirect ownership of the share capital or the voting rights of a body changes more than twenty-five percent (25%), by value or by number, Sub-Article (1) shall cease to apply to losses incurred by that body in that tax period and previous tax periods.
- iii. A net operating loss may be carried forward and deducted only for two periods of three years.

7. Transfer Pricing :(Article- 29)

- a) Where conditions are made or imposed between persons carrying on business in their commercial or financial relations which differ from those which would be made between independent persons, the Tax Authority may direct that the income of one or more of those related persons is to include profits which he or they would have made but for those conditions. The Tax Authority shall do so in accordance with the directives to be issued by the Minister.
- b) In order to ensure the just and efficient application of this Article the Tax Authority may conditions if necessary, the specified conditions between related persons do not differ from those which would be made between independent persons.

8. Exemptions (Article- 30)

The following categories of income shall be exempt from payment of business income tax hereunder:

- i. Awards for adopted or suggested innovations and cost saving measures, and
- ii. Public awards for outstanding performance tax any field.
- iii. 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 Minister.
- iv. The revenue obtained by:
 - ❖ The Federal, Regional and Local Governments of Ethiopia;
 - ❖ The National Bank of Ethiopia from activities that are incidental to their operations shall be exempt from tax on Schedule C income.

Example 1; Melat enterprise, unincorporated business has reported earnings before tax of birr 80,000 at the tax year ended Sene 30,2012.

Required

- A. Determine the amount of business income tax?
- B. Record necessary journal entries?

Solutions:

$$\begin{aligned}\text{Business income tax} &= (80,000 \times 10\%) - 720 \\ &= 8,000 - 720 \\ &= \underline{7,280}\end{aligned}$$

To record recognition of income tax expense;

Income tax expense 7,280

Income tax payable 7,280

To record payment of tax;

Income tax payable..... 7,280

Cash 7,280

Example 2: Ato.Mesfin is the proprietor of a business. His P/L A/C for the period ended June 2004 is as follows.

Profit and Loss Account for the Period 1st December 2003 to 30th June 2004.

Particulars	Amounts (in Birr)
Sales	100,150,200
Less - Cost of sales	<u>87,300, 457</u>
Gross profit	12,849,743
Transport service profit (loss)	(420,102)
Add: other income	<u>10,225</u>
	12,439,866

Expenses:

Administrative Expenses	100,068	
Selling and distributing Expenses	2,042,322	
Bank Interest and charges	34,217	
Audit fees	27,000	
Provision for stock obsolescence	<u>41,987</u>	
		<u>2,155,564</u>
Profit for the Year		10,284,302
Provision for Profit tax		<u>3,600,000</u>
		6,684,302
Legal Reserve		<u>60,640</u>
Balance carried forward to balance Sheet		<u>6,623,662</u>

Note:

The following information are available from the records of the firm.

1. Gross Loss on consignment sales Birr. 81,491.
2. Vehicle rent overstatement Birr.6,700
3. Rental and general Expenses for sister company Birr.22,500
4. Advertise expenses include Birr. 8,700 spent for sister company.

Required: Compute the adjusted business profit and tax liability of the firm for the year.

Particulars	Amounts (Birr)
[Profit as per the external auditors report	10,284,302
Add: Disallowed items	
1. Gross loss on consignment sales	81,491
2. Vehicle rent overstatement.	6, 700
3. Rental and General Expenses for sister company	22,500
4. Advertisement expense made for sister company	8,700
5. Provision for stock obsolescence	<u>41,987</u>
Adjusted profit	<u>10,122,924</u>
Tax Liability for the year at 35% = Birr. 3,525,023.40	

Example 3: The following information is obtained from Tossa private limited company.

The book value of a pool of computer in the opening balance sheet of the tax period as of Hamle 1, 2012 was birr 150,000. During the year 2012:

- Tossa bought data storage equipment for birr 75,000, software products for birr 50,000.
- The existing computer was upgraded and renewed for birr 12,000.
- Tossa has also received Birr 15,000 as compensation from Haron computer, supplier, since some of storage equipment are not functioning.
- Tossa also sold two old computers and received birr 8,500

Required:

1. Determine depreciation base of computer?
2. Determine depreciation expense of computer
3. Record necessary journal entries

Solution:

Beginning balance of book value.....	150, 000	
Add: Storage equipment	75,000	
Software product	50,000	
Upgrading.....	12,000	137,000
Subtotal -----		287,000
Less: Compensation.....	15,000	
Cash proceed from selling.....	8,500	<u>23,500</u>
Depreciation base for tax		263,500 (1)
Depreciation expense = 0.25x 263,500 =	<u>65,875</u> (2)	
Journal entries (3):		
Depreciation expense of Computer.....	65,875	
Accumulated depreciation of Computer		65,875

4.2.4. Schedule ‘D’ Income: Other Incomes

Any income which is taxable under the Income Tax Proclamation but does not find place under any of the remaining three Schedules of income (i.e., Schedules A, B and C) will be taxable under this residuary Schedule “D” Other Incomes.

The following incomes shall be chargeable to income tax under the Schedule-D:

Royalties (Article- 31)

The term “royalty” means a payment of any kind received as a consideration for the use of ,or the right to use, any copyright of literary, artistic or scientific work, including cinematography films and films or tapes for radio or television broadcasting, any patent, trade work, design or model, plan secret formula or process, or for the use or for the right to use of any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience. It is taxable as follows:

Rate of tax

Royalties shall be liable to tax at a flat rate of flat rate of **5%**

1. The amount of tax shall be withheld and paid to the Tax Authority by the payer. That is 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.
2. Where the payer 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 This tax is a final tax in lieu of a net income tax.

Income from Rendering of Technical Services (Article- 32)

The term “technical service” means any kind of expert advice or technological service rendered. All payments made in consideration of any kind of technical services rendered outside Ethiopia to resident persons in any form shall be liable to tax under this Article- 32

Rate of tax: It is Taxable at a flat rate of 10%. The amount of tax shall be withheld and paid to the Tax Authority by the payer.

Income from Games of winning a Chance (Article- 33)

Every person deriving income from winning at games of chance (for example, lotteries, tom bolas, and other similar activities) shall be subject to tax.

Rate of tax: It is Taxable at the rate of 15% except for winnings of less than 100 Birr.

- a. The payer shall withhold or collect the tax and account to the Tax Authority in the manner provided in Article 67.
- b. This tax is a final tax in lieu of income tax.

Dividends (Article- 34)

Every person deriving income from dividends from a share company or withdrawals of profits from a private limited company shall be subject to tax under Article 34.

Rate of tax: It is Taxable at the rate of 10%

1. The withholding Agent shall withhold or collect the tax and account to the Tax Authority.
2. This tax is a final tax in lieu of income tax.

Income from Rental of Property (Article- 35)

Every person deriving income from the casual rental of property (including any land, building, or moveable asset) not related to a business activity taxable under Article 17 shall pay tax on the annual gross income.

Rate of tax: It is Taxable at the rate of 15%. This tax is a final tax in lieu of a net income tax.

Interest Income on Deposits (Article- 36)

As per Article 36, every person deriving income from interest on deposits shall pay tax.

Rate of tax: It is Taxable at the rate of 5%

- 1) The payer shall withhold the tax and account to the Tax Authority in the manner provided in Article 67.
- 2) This tax is a final tax in lieu of income tax.

Gain on Transfer of Certain Investment Property (Article- 37)

Income Tax shall be payable on gains obtained from the transfer (sale or gift) of property described in this Article at the following rates:

Rate of tax

a) building held for business, factory, office 15% (fifteen percent)

b) shares of companies 30% (thirty percent)

1) Gains obtained from the transfer of building held for residence shall be exempt.

2) The basis for computation of gains obtained from the transfer of properties described in this Article shall be determined by Regulations to be issued by the Council of Ministers.

3) Any exchange of shares in a resident company which is a party to a reorganization – as defined in Article 24(4) – in exchange for share in another resident company which is also a party is not a disposal of the shares.

4) The value of the shares given in exchange under Sub-Article (4) shall be equal to the value of the original shares.

5) Loss on the transfer of such property shall be recognized and be available to offset gain subject to the following limitations:

(a) Loss on transfers under this Article may be used to offset gain on transfers under this Article, but may not be used to offset any other income or gain.

Unused losses may be carried forward indefinitely.

(b) No loss shall be recognized on transfer to associates within the meaning of Article 2(4).

6) 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 the payment of the tax has been duly affected in accordance with this Article.

Unexpected profit tax: this type of profit may be obtained arbitrary rather than the effort of the taxpayers and the tax rate will be specified based on the nature of the profit by the minister

Entertainment income tax: this type of tax is obtained from those foreign business firms that render entertainment services like football, series film, and so on. The tax rate is 10% of the taxable income.

4.2.5. SCHEDULE 'E' EXEMPT INCOME

According to article 65 of federal income tax proclamation number 979/2016 the exempted taxes are regulated differently named as schedule E.

Exempt Income

1. The following amounts are exempt income for the purposes of this Proclamation:
 - a) Subject to the limits set forth in the directive to be issued by the Minister in regard to items specified under number (2), (3), (4) and (6) of this paragraph following benefits provided to an employee:
 1. an amount paid by an employer to cover the actual cost of medical treatment of an employee;
 2. an allowance in lieu of means of transportation granted under a contract of employment
 3. a hardship allowance;
 4. transport expenses and per diem payments to an employee travelling on a tour of duty;
 5. travelling expenses paid to an employee recruited from place other than the place of employment on joining or completion of employment, including, in the case of a foreign employee, travel expenses from and to their country of origin, but only if the travel expenses have been paid pursuant to specific provisions of the employee's contract of employment;
 6. food and beverages provided for free to an employee by an employer conducting a mining, manufacturing, or agricultural business;
 7. allowances paid by the Government of the Federal Democratic Republic of Ethiopia to employees engaged in public service in a foreign country
 - b) allowances paid to members and secretaries of boards of public enterprises, public bodies, or study groups established by the Federal or a State Government or City administration;
 - c) contributions by an employer to a pension, provident, or other retirement fund for the benefit of an employee provided the monthly total of contributions does not exceed 15% of the monthly employment income of the employee;
 - d) a pension to the extent exempt from tax under the Public Servants Pension Proclamation or the Private Organization Employees' Pension Proclamation;

- e) an amount derived by the Federal, or a State or Local Government of Ethiopia, or the National Bank of Ethiopia, from activities that are incidental to official operations;
 - f) an amount exempts from tax to the extent provided for under an international agreement;
 - g) an amount exempt from tax to the extent provided for under a provision (referred to as an “exemption provision”) in an Agreement entered into by the Government of the Federal Democratic Republic of Ethiopia when the following conditions are satisfied: (1) the agreement is for the provision of financial, technical, humanitarian, or administrative assistance to the Government; and (2) the Minister has concurred, in writing, with the exemption provision;
 - h) a public award for outstanding performance in any field or an award granted under Article 135 of the Tax Administration Proclamation;
 - i) an amount as compensation for personal injury or the death of another person;
 - j) subject to Article 59 of this proclamation, a cash amount, or the value of asset, acquired by gift or inheritance, other than a gift that is employment, rental or business income;
 - k) a scholarship or bursary for attendance at an educational institution;
 - l) maintenance or child support payments;
 - m) the income of a non-profit organization other than business income that is not directly related to the core function of the organization;
 - n) a cash indemnity allowance paid by an employer to an employee, but only to the extent that the allowance compensates the employee for shortfalls on money counts;
 - o) an amount that is specifically exempted from income tax under a law in force in Ethiopia;
 - p) salaries paid to domestic servants;
 - q) payments made by Contractors engaged in petroleum operations to their sub-contractors.
2. The Council of Ministers may, by regulations, exempt any income for economic, administrative, or social reasons.

4.2 Consumption Taxes

Taxes that are categorized under consumption taxes are VAT, TOT and Excise tax which are discussed below

4.3.1. Value-Added Tax (VAT)

VAT is a tax on consumer expenditure. It is collected on business transactions and imports. A taxable person can be an individual, firm, company, as long as such a person is required to be registered for VAT.

Most business transactions involve supplies of goods or services. VAT is payable if they are:

- Supplies made in Ethiopia;
- Made by a taxable person;
- Made in the course or furtherance of a business;
- Are not specifically exempted or zero-rated.

The Value Added Tax would be levied 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; and
- ✚ Import of services.

A person who carries on taxable activity and is not registered is required to file an application for VAT registration with the Authority if:

- ❖ At the end of any period of 12 calendar months the person made , during that period, taxable transactions the total value of which exceeded 500,000 Birr; or
- ❖ At the beginning of any period of 12 calendar months there are reasonable grounds to expect that the total value of taxable transactions to be made by the person during that period will exceed 500,000 Birr.

Registration procedure:

- ✓ A person applying to register for VAT is required to do so in such a form as is established by the implementation directives issued by the Ministry of Revenue;
- ✓ When a person carrying out taxable transactions files an application to be registered for VAT, the Authority is required to register the person in the VAT register, and to issue a certificate of registration within 30 days of the registration;
- ✓ A person registered for VAT is required to use his taxpayer identification number on all VAT invoices, and on all tax returns and official communications with the Authority.

There is a VAT invoice prepared by the Ministry of Revenue containing the following information:

- Full name of the registered person and the purchaser, and the registered;
- Person's trade name, if different from the legal name;

- Taxpayer identification number of the registered person and the purchaser;
- Number and date of the VAT registration certificate;
- Name of the goods shipped or services rendered;
- Amount of the taxable transaction;
- Amount of the excise on excisable goods;
- Sum of the VAT due on the given taxable transaction;
- Issue date of the VAT invoice, and
- Serial number of the VAT invoice.

The registered person is required to issue the VAT invoice to the purchaser of goods or services upon the supply or rendering, but not later than 5 days after the transaction.

Record Keeping Requirement

A registered person or any other person liable for VAT under the proclamation shall maintain for 10 years in Ethiopia:

- Original tax invoices received by the person;
- Copy of all tax invoices issued by the person;
- Customs documentation relating to imports and exports;
- Accounting records; and
- Any other records as may be prescribed by the Minister of Revenue by directive.

Administrative Penalties

The following penalties are imposed for violations of the VAT Proclamation:

- Where any person engages in taxable transactions without VAT registration where VAT registration is required; 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; 100% of the amount of tax for the invoice or the transaction;
- Where a person who is not registered for VAT issues a tax invoice ; a penalty of 100% of the tax which is indicated in the tax invoice and is due for transfer to the budget but has not been transferred; and

- Where a person fails to maintain records required; 2,000 Birr 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. The penalty is limited to 50,000 Birr for the first month (of portion thereof) in which no return is filed. 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 is set at 25% over and above the highest commercial lending interest rate that prevailed during the preceding quarter. The following types of supplies of goods (other than by way of export) or rendering of services, as well as the following types of imports of goods are exempt from payment of VAT:

- ✓ Sale, transfer or the lease of a used dwelling;
- ✓ Rendering of financial services;
- ✓ Supply/import of national/foreign currency and of securities;
- ✓ Import of gold to be transferred to the National Bank;
- ✓ Rendering of religious organizations or church services;
- ✓ Import or supply of prescription drugs specified in directives issued by Minister of health, rendering of medical services;
- ✓ Educational services provided by educational institutions, or child care services for children at pre-school institutions;
- ✓ Supply of goods and rendering of services in the form of humanitarian aid, as well as import of goods transferred to state agencies of Ethiopia and public organizations for the purpose of rehabilitation after natural disasters, industrial accidents, and catastrophes;
- ✓ Supply of electricity, kerosene, and water;
- ✓ Goods imported by the government, organizations, institutions or projects exempted from duties and other import taxes to the extent provided by law or by agreement;
- ✓ Supplies by the post office authorized under the Ethiopian Postal Services Proclamation, other than services rendered for a fee or commission;
- ✓ Provision of transport; Permits and license fees;
- ✓ Supply of goods or services by a workshop employing disabled individuals if more than 60 % of staff are disabled;
- ✓ Import or supply of books and other printed materials.

Example: Assume you bought a product that has original cost (price purchase from supplier) Br. 10,000;

Required: Calculate the VAT amount and Net price of the product.

Solution:

$$\begin{aligned}\text{Tax amount (liability)} &= (\text{Original Cost} \times \text{VAT rate})/100 \\ &= (10,000 \times 15)/100 = \text{Br. } 1,500\end{aligned}$$

$$\begin{aligned}\text{Net price} &= \text{Original Cost} + \text{tax Amount} \\ &= 10,000 + 1,500 = \text{Br. } 11,500.\end{aligned}$$

4.3.2. Turnover Tax

The Turnover Tax would be payable on goods sold and services rendered by persons not registered for Value Added Tax. The rate of Turnover Tax is

- 2% on goods sold locally;
- for services rendered locally: 2% on contractors, grain mills, tractors and combine-harvesters; 10% on others.

The base of computation of the Turnover Tax is the gross receipts in respect of goods supplied or services rendered. A person who sells goods and services has the obligation to collect the Turnover Tax from the buyer and transfer it to the Tax Authority. Hence, the seller is principally accountable for the payment of the tax. In accordance with the Turnover

Tax Proclamation No. 979/2016, the following would be exempted:

- ✚ Sale or transfer of dwelling used for a minimum of two years, or the lease of a dwelling;
- ✚ Rendering of financial services;
- ✚ Supply of national or foreign currency and of securities;
- ✚ Rendering by religious organizations of religious or other related services;
- ✚ Supply of prescription drugs specified in directives issued by the relevant government agency, and the rendering of medical services;
- ✚ Rendering of educational services provided by educational institutions;
- ✚ Supply of goods and rendering of services in the form of humanitarian aid;
- ✚ Supply of electricity, kerosene and water;
- ✚ Provision of transport;
- ✚ Permits and license fees;

- ✚ Supply of goods or services by a workshop employing disabled individuals (if more than 60% of the employees are disabled);
- ✚ Supply of books.

Assessment of the Tax

- ❖ If after review by the Tax Authority, it appears that a person has understated his tax obligation, the Authority can issue an additional assessment;
- ❖ If, for any reason, the books of account are unacceptable to the Tax Authority, or if the tax payer fails to submit same when requested by the Authority, or if no books of account and supporting documents are maintained, the Tax Authority would assess the tax on the basis of information available;
- ❖ A presumptive turnover tax would be payable by Category “C” tax payers who are not required to keep records. The base for the presumptive turnover tax would be the total turnover used as base for the income tax;
- ❖ The assessment made would be prepared in an assessment notification and be delivered to the taxpayer;
- ❖ If the Authority makes an additional assessment and within 30 days of notice the person assessed does not pay the additional assessment or appeal the assessment the person is in default;
- ❖ If the Tax Authority fails to assess the tax and notify the taxpayer of the amount still due within five years from the date of declaration and payment of the tax by the taxpayer the tax so paid would be final and conclusive. In case where the taxpayer has not declared his income or has submitted a fraudulent declaration, no time limit provided in any other law shall bar the assessment of the tax by the Tax Authority.

4.3.3. Excise Tax

It is believed that this tax should be imposed on luxury goods and basic goods, which are demand inelastic. It is also believed that imposing the tax on goods that are hazardous to health and which are causes to social problems will reduce the consumption thereof.

Objectives of Levying Excise Duty

Excise duty is a duty levied on commodity produced within the country 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. Discouraging consumption of certain essential goods
4. Levy of duties where direct taxation is not possible
5. Curbing inflationary trends in the economy
6. Promotion of small scale industries
7. Proper allocation of scarce resources
8. Provide assistance to industries in distress
9. Encouragement of exports
10. Equitable distribution of income and wealth
11. Recouping losses arising from assistance and subsidies to specified industries.

The excise tax would be imposed on goods imported or either produced locally in accordance with Excise Tax Proclamation No.1186/2020.

The base of computation of Excise Tax is the fair value of production for goods produced locally and goods imported.

Obligations of the taxpayer:

- Maintaining books of accounts and supporting documents in accordance with proper accounting principles and in a manner acceptable to the Tax Authority;
- Submit every 30 days to the Tax Authority, in a form which would be supplied by the Authority, a declaration containing the necessary information for the proper collection of the tax;
- Comply fully with the requirements of inspection of his premises by the delegates of the Tax Authority;
- 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.

4.4. Stamp Duty

The following instruments shall be chargeable with stamp duty:

- Memorandum and articles of association of any business organization, cooperative or any other form of association;

- Award; Bonds; Warehouse bond;
- Contract and agreements and memoranda;
- Security deeds;
- Collective agreement;
- Contract of employment;
- Lease, including sub-lease and transfer of similar rights;
- Notarial acts;
- Power of attorney;
- Documents of title to property.

Time and Manner of Payment 1) The stamp duty would be paid:

1) The stamp duty would be paid:

- ✚ On memorandum and articles of association, before or at the time of registration;
- ✚ on awards, before or at the time of issuance of the award;
- ✚ on contracts or agreements, before or at time of signature;
- ✚ on leases or sub-leases, before or at the time of signature;
- ✚ on notarial(attorney) acts, at the time of issuance;
- ✚ on security deeds, before or at the time of signature;
- ✚ On documents of title to property, before or at the time issuance is effected.

2) The payment of stamp duty

- ✚ Under Birr 50 would be effected by affixing stamp of appropriate value to the instrument;
- ✚ when the stamp duty exceeds Birr 50 or where the type and nature of instrument so requires, the Federal Government Revenue Board may by directive provide;
- ✚ that stamp duty be paid by means other than affixing stamp.

Tax rate

S.no.	Instruments chargeable with stamp duty	Basis of Valuation	Rates of Stamp Duty
1	Memorandum and articles of association of any business organizations, or any association: ✚ upon 1st execution ✚ upon any subsequent execution	Flat Flat	Br.350 Br.100
2	Memorandum and articles of association of cooperatives: ➤ upon 1st execution	Flat	Br.35

	➤ upon any subsequent execution	Flat	Br.10
3	Award	On value	➤ determinable value; 1% ➤ un determinable value; Br 35
4	Bonds	On value	1%
5	Contracts and agreements and Memoranda	Flat	Br 5
6	Security deeds	On value	1
7	Collective agreement: ➤ on 1st execution ➤ on any subsequent execution	Flat Flat	Br. 350 Br. 100
8	Contract of employment	Salary	1%
9	Lease including sub-lease and transfer thereof	On value	0.5 %
10	Notarial act	Flat	Br 5
11	Power of attorney	Flat	Br 35
12	Register title to property	On value	2%

Penalty

Any person

- Executing or signing, otherwise than as a witness, a document chargeable with stamp duty without the same being stamped,
- Who, with intent to defraud the appropriate payment of duty, conceals facts bearing on the true nature of any instrument, shall be liable on conviction to a fine not less than Birr 25,000 and not exceeding Birr 35,000 and to rigorous imprisonment for a term not less than 10 years and not more than 15 years.
- Any person who: Appointed to sell stamps or stamped papers, disobeys regulations issued under this proclamation; or
- Not so appointed, sells or offers for sale stamps or stamped papers; shall be liable on conviction to a fine not less than Birr 5,000 and not exceeding Birr 20,000 and to rigorous imprisonment for a term not less than 5 years and not more than 10 years.

Exemptions

- ❖ The Ministry of Revenue may for good cause grant exemption from payment of stamp duty;
- ❖ Public bodies on which the Federal Government of Ethiopia Financial Administration Proclamation No. 57/1996 applies shall be exempt from payment of stamp duties;

- ❖ Goods imported for sale by traders having import license shall be exempt from payment of stamp duty when first registered in the name of the trader;
- ❖ Documents may be exempted from the payment of stamp duty in accordance with international agreements and conventions approved by the Government;
- ❖ Subject to reciprocity, the Minister may grant embassies, consulates and missions of foreign states exemption from payment of stamp duty; **Share** certificates shall be exempt from stamp duty payable on the register of title of property.

4.5. Custom Duties (Import and Export taxes)

Customs taxes, also known as tariff duties, are classified into import duties and export duties. Import duties are imposed on imported articles and are collected from the importers at the time foreign goods enter the country. Import duties may be levied to

- (a) discourage the import of particular commodities which compete with locally produced goods - such import duties are called protective duties; and
- (b) to raise revenue for the Government - known as revenue duties.

But it should be remembered that even protective duties will bring in revenue for the Government. The protective tariff duty will generally be at a high rate so as to impose a price disadvantage upon the imported goods.

4.6. Categories of Taxpayers

Taxpayers are classified into the following three major categories:

- 1) Category “A” Taxpayers
- 2) Category “B” Taxpayers
- 3) Category “C” Taxpayers

1. Category “A” Taxpayers

This category of taxpayers includes:

- a) Any company incorporated under the laws of Ethiopia or in a foreign country;
- b) Any other business having an annual turnover of Birr 1,000,000 or more.

Category “A” taxpayers are required to submit to the Tax Authority, at the end of the year, a balance sheet and a profit and loss statement and the following details:

- a) Gross profit and the manner in which it is computed;
- b) General and administrative expense;
- c) Depreciation expense; and
- d) Provisions and reserves.

In addition, these taxpayers should register with the Tax Authority the type and quantity of vouchers they use before having such vouchers printed.

Any printing press before printing vouchers of taxpayers shall ensure that the type and quantity of such vouchers is registered with the Tax Authority. Note

(1) the tax declaration period for category “A” taxpayers are after 4 months of the end of the fiscal period; i.e., up to Tikmet 30.

(2) The amount tax will be assessed based on books of accounts.

2. Category “B” taxpayers

Unless already classified in category “A”, any business having an annual turnover of over Birr 500, 000 and less than Birr 1,000,000 would be classified under Category “B” taxpayers. This category of taxpayers should submit to the Tax Authority only profit and loss statement at the end of the year.

Note: (1) the tax declaration period for category “B” taxpayers is after 2 months of the end of the fiscal period; i.e., up to Pagume 5 or 6

(2) The amount tax will be assessed based on books of accounts.

3. Category “C” Taxpayers

Unless classified in Categories “A” and “B”, those businesses whose annual turnover is estimated up to Birr 100, 000 are classified under this category of taxpayers.

Note: (1) the tax declaration period for category “C” taxpayers is after 1 month of the end of the fiscal period; i.e., Hamle 30.

(2) The amount of tax will be assessed by estimation.

4.7 Tax penalty

Penalty for Late Filing or Non-Filing (Article-86): [A taxpayer who fails to file a timely tax declaration is liable for a penalty equal to:

- (a) 1,000 Birr for the first thirty (30) days (or part thereof) the declaration remains unfilled);
- (b) 2,000 Birr for the next thirty (30) days (or part thereof) the declaration remains unfilled);
- (c) 1,500 Birr for each thirty (30) days (or part thereof) thereafter that the declaration remains unfilled.

Penalty for Understatement of Tax (Article-87)

1) If the amount of tax shown on a declaration understates the amount of tax required to be shown, the taxpayer is liable for a penalty in the amount of 10% (ten per cent) of the understatement or 50% (fifty per cent) if the understatement is considered substantial in accordance with Sub-Article (2) of this Article).

2) The understatement is considered substantial if it exceeds the smaller of the following two amounts:

- (a) twenty-five percent (25%) of the tax required to be shown on the return; or
- (b) 20,000 Birr.

3) The penalty shall continue to apply until, the Appeal Commission or a Court, as the case may be, shall have rendered its final decision.

Penalty for Late Payment (Article-88)

A taxpayer who fails to pay tax liability on the due date is subject to:

- (a) a penalty of 5% (five percent) of the amount of unpaid tax on the first day after the due date has passed: and

(b) an additional 2% (two percent) of the amount of the tax that remains unpaid on the first day of each month thereafter.

Penalty for Failure to keep Proper Records (Article-89)

1. The taxpayer shall be liable for a penalty of 20% of the tax assessed if he failed to keep proper books of account, records, and other documents regarding a certain tax year.

2. If the Tax Authority finds that a taxpayer has failed for two consecutive tax year, to keep proper books of account, records, and other documents:

(a) the licensing authority shall forthwith suspend the taxpayer's license on notification by the Tax Authority;

(b) if in a subsequent year, the Tax Authority again finds that the taxpayer has failed to keep proper books, records and documents, the licensing authority shall revoke the taxpayer's license on notification by the Tax Authority;

(c) A finding by the Tax Authority that the taxpayer's failure justifies notification of the licensing authority for purposes of suspension or revocation of the taxpayer's license shall for all purposes of this Proclamation be treated as an assessment and notification may not be sent to the licensing authority until the Tax Authority's finding is final.

Penalty for Failure to Withhold Tax (Article-90)

1) A withholding agent who fails to withhold tax in accordance with this Proclamation is personally liable to pay to the Tax Authority the amount of tax which has not been withheld, but the withholding agent is entitled to recover this amount from the payee.

2) The tax withholding liability imposed by this Proclamation shall be treated as a tax liability for purposes of any Article providing taxpayers with the right to contest the amount of tax due or to recover tax paid.

3) In addition to any amount for which a withholding agent is liable under Sub-

Article (1), an agent who fails to withhold tax in accordance with this

Proclamation shall be liable for a penalty of 1,000 Birr for each instance of failure to withhold the proper amount.

4) A penalty of Birr 1,000 is imposed on the following individuals:

(a) a manager who knew or should have known of the failure described in Sub-

Article (1);

(b) a chief accountant or another senior officer who is responsible for supervision or control of withholding procedures and who knew or should have known of the failure described in Sub-Article (1), or whose improper supervision failed to prevent it.

Penalty for Failure to Meet TIN Requirements (Article-91)

Taxpayers failing to meet the requirements for TIN are subject to the following penalties:

1. a withholding agent who makes a payment to a person who has not supplied a TIN is required to withhold thirty percent (30%) of the amount of the payment.

2. A taxpayer who has not supplied the TIN to the withholding agent, in addition to what is stipulated under Sub-Article (1) of this Article is liable to pay a fine of 5,000 Birr or the amount of the payment, whichever is less.

4.8 Appeal procedure

Review Committee (Article-104)

Members of the Review Committee shall be appointed by the Minister of Revenue or the competent authority of the regional government, as appropriate, upon the recommendation of the head of the Tax authority.

Powers and Duties of Review Committee (Article-105)

1) The Review Committee shall be accountable to the head of the Tax Authority and shall have the following duties:

(a) to examine and decide on all applications submitted by tax payers for compromise of penalty, interest, and waiver of tax liability;

(b) to gather any written evidence or information relevant to the matter submitted;

(c) to summon any person, who directly or indirectly has dealt with the assessment, to appear before it for questioning him about the case under its investigation; and

(d) to review determination made by the Tax Authority for accuracy, completeness, and compliance with this Proclamation.

2) The Committee shall only review applications submitted to it within 10 days of receipt of tax assessment notification

3) The Head of the Tax Authority may approve the recommendations or remand the case, with his observations, to the committee for further review.

Right of Appeal against Assessment of Income (Article-107)

1) Any taxpayer who objects to an assessment may appeal to the Tax Appeal

Commission (hereinafter referred to as the “Appeal Commission”) upon the fulfilment of the requirements hereunder.

2) No appeal shall be accepted by the Appeal Commission, unless:

(a) A deposit of thirty-five percent (35%) of the disputed amount is made to the Tax Authority; and

(b) The appeal is lodged with the Appeal Commission within thirty (30) days following the day of receipt of the Assessment Notice or from the date of decision of the Review Committee.

Decision of Appeal Commission (Article-111)

1) After reviewing the case, the Appeal Commission shall issue a written decision setting out the TIN of the appellant and the date of decision, the names of the panel members and the panel’s chair person, and a statement of the decision.

2) The statement of the Commission’s decision shall include:

(a) the holding (whether the appellant’s claim is justified and accepted partly or wholly, whether the claim is remanded with instructions to the tax Authority; and the amount the appellant is required to pay, if any, and other necessary details of appellant’s liabilities);

(b) the factual findings, citation to the applicable law, legal interpretation, a conclusion on

each relevant issue presented; and any dissenting opinion.

(c) a summary of the appellant's appeal rights.

3) The decision shall be signed by the panel members present, and the Seal of the Appeal Commission shall be affixed thereon.

4) The Appeal Commission may decide ex-parte where:

(a) any appellant fails to give counter reply when necessary, or to appear before it on two occasions, after lodging appeal; or

(b) the Tax Authority, after receiving the memorandum of appeal, fails to give reply or to appear before it on two occasions.

Appeal from Decision of Appeal Commission (Article-112)

1. Any party dissatisfied with the decision of the Appeal Commission may appeal to the competent court of appeal on the ground that it is erroneous on any matter of law within 30 days from the date of receipt of the written decision of the Appeal Commission.

2 The court of appeal shall hear and determine any question of law arising, on appeal and shall, after reaching its decision thereon, return the case to the Commission.

3. An appeal to the next court of appeal from the decision of the lower court of appeal may be made by either party, within thirty (30) days of the decision of the lower court of appeal.

4. A taxpayer's appeal shall not be accepted by the court unless at the time the appeal is lodged, the taxpayer has paid the tax liability determined by the Appeal Commission.

Establishment of Appeal Commission (Article-113)

1. The following Tax Appeal Commissions shall be established:

(a) Federal Appeal Commission, at the Federal level;

(b) Regional Appeal Commission, in each Regional Government town;

(c) Zonal Appeal Commission, in each Zonal town; and

(d) Woreda Appeal Commission, in each Woreda Administrative town.

2. Notwithstanding the provisions of Sub-Article (1), if the Regional Government finds it unnecessary to have a separate Appeal Commission at any of the above mentioned levels, it shall make an arrangement in such a way that such areas may be covered by the Appeal Commission established in the neighbouring locality.

3. The Federal Appeal Commission shall be accountable to the Minister of Justice;

City administration, appeal commissions to the executive organs of city administration, region, zone woreda, as the case may be.

Appointment of Members ((Article-114)

1) Members of Appeal Commission at every level shall be appointed from among persons having good reputation, acceptability, integrity, general and professional knowledge, and from among persons who have not committed any offense in connection with tax and tax administration.

2) The Minister of Justice or executive organs of city administrations and regions, as the case may be, shall issue directives setting out the criteria to be applied in the selection, appointment and composition of members of Appeal Commissions.

3) On the basis of said directive members of the appeal commissions and panels shall be selected and appointed by the Minister of Justice or the appropriate city administration, regional, zonal or woreda executive organ, as the case may be.

4). The Appeal Commission's President shall be appointed by appropriate entities listed under Article 113(3) above.

5. Each Appeal Commission may have more than one (1) panel. In such cases each panel shall have five (5) members and shall elect one (1) member to serve as Chair person.

6. The person term of office of an Appeal Commission member shall be two (2) years. A member appointed to chair an Appeal Commission or a panel shall serve in that capacity for two (2) years or the remaining period of that other member's term if he is a substitute.

7. The Chairperson and other members of the Commission shall be entitled to receive such attendance fees for sitting on panels as shall be fixed from time to time by the Minister or the Executive body of the Region, as appropriate.

Powers and Duties of Appeal Commission and of its Chairperson (Article-115)

1. The Appeal Commission shall have the authority:

(a) to confirm, reduce, or annul any assessment appealed against on the basis of established factual grounds and the law, and make such further consequential order thereon as may seem just and necessary for the final disposition of the matter;

(b) to instruct the Tax Authority or the taxpayer to submit new facts, if any; and

(c) to order the Tax Authority or the taxpayer or any other person or governmental department or agency, as the case may be, to produce supporting evidence relevant to the taxpayer's allegation.

2. An Appeal Commission's Chairperson shall:

(a) Make preliminary examination of memoranda of appeal;

(b) Prepare the agenda for the panel;

(c) Preside over and guide the proceedings;

(d) Ensure that the arguments are properly recorded in the minutes and that the decision conforms to the prescribed form; and

(e) Submit an annual report about the accomplishment (performance) of the commission he presides over.

Chapter summary

Ethiopian government collecting diversified type of tax from its citizens in order to fulfil public goods and services and improve the living standards of the society. The government has 5 tax schedules namely schedule A (employment income tax), B (income from rental of building), C (income from business activities), D (other income) and E (exempted income according to proclamation number 979/2016).

Any remuneration paid by an employer to his employee in consideration of his services is called salary. It includes the value of fringe benefits provided by the employer. Income tax shall be imposed on the taxable business income realized from entrepreneurial activity.

The turnover tax would be payable on goods sold and services rendered by persons not registered for value added tax. It is believed that Excise tax is should be imposed on luxury goods and basic goods, which are demand inelastic. VAT is a tax on consumer expenditure. It is collected on business transactions and imports.

Sample self-test examination

1. Which of the following is not true about VAT in Ethiopia?
 - A. VAT is collected on business transactions and imports.
 - B. VAT is a tax on consumer expenditure.
 - C. Educational services provided by educational institutions are not exempted from VAT
 - D. Rendering of religious organizations or church services are exempted from VAT
2. Which of the following is not exempted income according to proclamation 979/2016?
 - A. an amount paid by an employer to cover the actual cost of medical treatment of an employee
 - B. Maintenance or child support payments
 - C. Salaries paid to domestic servants
 - D. Position allowance

3. Identify the correct link
 - A. Schedule D employment income
 - B. Schedule E exempted income
 - C. Schedule A income from rental of building
 - D. Schedule B business income
 - E. Schedule C other income
4. _____ means a payment of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work.
 - A. Business
 - B. Income
 - C. Royalty
 - D. Copy right
5. A tax imposed on luxury goods and basic goods, which are demand inelastic.
 - A. Excise tax
 - B. VAT
 - C. Turnover tax
 - D. Sales tax

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Appendix 1: Answer key for self-test questions

Chapter One: 1. C. 2. B. 3. B. 4. A. 5. C.

Chapter Two: 1. C. 2. B. 3. A. 4. C. 5. D.

Chapter three: 1. A. 2. D. 3. C. 4. B. 5. A.

Chapter four: 1. C 2. D. 3. B. 4. C. 5. A.

Appendix 2: Individual assignment questions (35%)

Part I: Choose the best answer for the following questions (1.5 pt. each)

1. The burden of direct taxes is borne by
 - A. Rich person
 - B. Poor person
 - C. On whom it is levied
 - D. None of these
2. Which of the following is not a direct tax?
 - A. Personal Income Tax
 - B. Service tax
 - C. Wealth Tax
 - D. Corporate Income Tax
3. The following is an example of commercial non-tax revenue
 - A. Gifts and Grants
 - B. Fees
 - C. Fines
 - D. Surpluses
4. The following is not a characteristic of a tax
 - A. It is a compulsory payment
 - B. Every tax involves a sacrifice by tax payer
 - C. There is a quid-pro-quo between the tax payer and the Government.
 - D. Refusal to pay tax is a punishable offence.
5. The following is a characteristic of indirect tax
 - A. The impact and incidence are not on the same person
 - B. It is levied on income
 - C. Taxes are progressive in nature
 - D. All of the above
6. The following is a characteristic of a direct tax
 - A. Incidence may be shifted
 - B. Imposes more burden on poor
 - C. The impact and incidence are on the same person
 - D. All of the above
7. Impact of a tax refers to
 - A. Final money burden
 - B. Immediate money burden
 - C. Indirect real burden
 - D. None of the above
8. Which is not a part of indirect tax
 - A. Excise Duty
 - B. Sales Tax
 - C. Entertainment Tax
 - D. Corporate income Tax

9. Which is not a demerit of indirect taxes
- | | |
|---------------------------|------------------------------|
| A. Unjust to poor | C. A tool of economic policy |
| B. Inflationary in nature | D. High administrative cost |

Part II: Discussion questions (16 pt.)

1. Explain the canons of taxation briefly
2. Explain the four types tax structures
3. Write the difference between direct and indirect taxes
4. Discuss the merits and demerits of tax structures
5. Differentiate private finance from public finance
6. Elaborate the following indirect taxes in Ethiopia
 - A. Value added tax
 - B. Excise tax
 - C. Turnover tax

Part III: show the necessary steps for the following workout question (5.5 pt.)

Assume that company "A" is engaged by supplying raw materials to manufacturing enterprises such as company "B". After completing the manufacturing process, company "B" sold finished goods to the wholesaler- company "C". Company "D" is a retailer and acquired finished goods from the wholesaler and sold to the final users of the goods or consumers. Assume again all of the above companies are VAT registered and the selling prices for company for the same goods are Birr 100,000; Birr 500,000; Birr 580,000; and Birr 650,000 for company "A", company "B", company "C", and company "D" respectively. Based on the above given information answer the following question based on the current Ethiopian tax rate.

1. How much is the amount of VAT for company "A"?
2. How much is the amount of VAT for company "B"?
3. How much is the total amount of VAT that should be collected by the tax authority from the above three companies for this specific transaction?