PUBLIC FINANCE AND TAXATION

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PREFACE

Today, tax has become a part and parcel of all economic activities of human beings. Every man, willingly or unwillingly, pays an amount of money in the form of tax on the products he uses basically. Besides, he pays tax on his income, wealth, etc.

Students of Accounting and Finance, who deeply involve themselves in all the fields of finance, are in dire need of knowing about tax both direct and indirect and the underlying principles behind their levy. Without the knowledge of tax, it becomes futile to study a course pertaining to business and finance. So, a study of tax is indispensable to the students of Accounting and Finance, which paves ways for knowing about the fundamental principles of taxation.

On recognizing the same, the Department of Accounting and Finance, FBE, Addis Ababa University has introduced the Course **"Public Finance and Taxation**" for the budding Finance students. This Study Material is intended to cater to the needs of the students in understanding the basic concepts and principles of taxation and public finance in such a way that they may be easily intelligible.

The chapters have been strengthened, updated and modified to improve, clarify and arouse an enthusiastic interest in the subject of "**Taxation**". Care has been taken to reduce the complex vocabulary to the minimum. Charts and diagrams are liberally used to enable the students to capture the essence of the concepts and ideas at a glance.

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There exists an intrinsic connection between the common good on the one hand and structure and function of public authority on the other. The moral order, which needs public authority in order to promote the common good in human society, requires also that the authority be effective In attaining that end.

POPE JOHN XXIII

PART-I
PUBLIC FINANCE

CHAPTER-I
INTRODUCTION

1.1. Introduction

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

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

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

1.2. Private Goods:

Private goods refer to all those goods and services, which are consumed by people to satisfy their personal and private wants or needs. They relate to articles of food, clothing, shelter, recreation, transportation, communication etc. These goods are priced in the market on the basis of their cost of production on the one side and the nature of demand on the other. All those who want them and are willing to pay the market price will buy them. Those who do not want them or who are not in a position to pay for them will be excluded from the consumption of these goods. In other words there is no compulsion that every one will have to buy them. Thus distribution of these goods is based on effective demand and market price. As a result, only those who do demand the private goods will pay for their cost of production on a voluntary basis. Thus, private goods are divisible in the sense that price mechanism divides people in to two groups, viz., those who want to consume them and those do not; and private goods are subject to the principle of exclusion; in the sense that price mechanism excludes the group of people who are not willing to consume a particular good.

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

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

1.3. Public Goods:

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

It is important to recognize two features of public goods. First, they can not be divided and their benefits can not be shared between the people on the basis of each man's requirements. In other words, unlike private goods, public goods are not divisible but have to be collectively consumed. If public goods are made available to meet collective wants , the question is : who will pay for them or in what proportion will they bear the cost of production of these goods and services.

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

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

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

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

1.4. Merit Wants:

Certain types of collective wants such as educational facilities have been called as merit wants since they command overwhelming importance in the attainment of social welfare. Provision of public goods meant to satisfy such wants will help the economy to achieve a high level of efficiency and welfare. If education is left to the private sector and accordingly educational facilities are supplied by the private sector on the basics of cost of production, the educational facilities will cost so much that many people in the lower income brackets will not be able to get them. Many an intelligent but poor student will be denied educational facilities. This will reduce economic efficiency and social welfare of the community. In the same way, if hospital facilities are provided by the private sector units, they will be so expensive that only the rich will be able to make use of them and vast majority of people belonging to middle and lower income groups will be denied these facilities. It is for this reason that the state should either supply these goods to the community or at least supplement private effort directly or indirectly- directly by government schools and colleges or indirectly by subsidizing education to make it within the reach of every body.

The important difference between the satisfactions of merit wants and of social wants is that the former calls for interference with consumer preferences. Besides, the provision of merit wants will confer immediate benefits on those groups of people who are in immediate need of them but the community benefits in general as the society

becomes more educated and healthier. It is for this reason that merit wants must have substantial element of social wants.

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

1.5. FUNCTIONS OF MODERN GOVERNMENT AND FISCAL OPERATIONS:

It was only in the 20th century and particularly after Keynes demonstrated the necessity of state interference for stabilizing an economy and to bring about full employment that the full importance of fiscal operations of tax, public expenditure and public debt policy was appreciated. The social economic consequences of fiscal operations are quite elaborately explained in detail in later chapters- effects of taxation, effects of public expenditure, effects of public debt and public debt management and fiscal policy and economic development. We should know the role of the government to enable us to appreciate the importance of government sector. Government of a modern state generally undertakes the following functions:

1.5.1. Allocation Function:

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

proper allocation of resources between private and public goods so as to maximize social welfare.

1.5.2. Distribution function:

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

1.5.3. Stabilization Function:

Modern economies are subject to fluctuations, viz., business boom and inflations on one side and business recessions and depressions on the other. Such fluctuations are not in the interest of the country. Fiscal operations have been used to moderate these fluctuations and if possible to eliminate them altogether. For instance, business booms and inflations are sought to be controlled through heavier taxation while business recession is sought to be checked through public expenditure.

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

1.6. Public Finance:

The study of state is called **"Public Finance".** Public finance is the study of income and the expenditure of the government. Rising of necessary funds for incurring expenditure constitutes the subject matter of public finance. The methods of public finance have certain effects on economic life and can, therefore, be used as an instrument

for bringing about desired social and economic changes. Public finance also deals with the problems of adjustments of income and expenditure of the government .I t is also known as fiscal operations of the treasury. Thus, fiscal operations and fiscal policies are integral part of public finance.

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

Hence, it can be defined as the science that deals with the nature and principles of the income and expenditure of the government.

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

1.7. Scope of Public Finance:

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

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

We shall now explain them briefly.

1.7.1. Public Revenue:

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

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

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

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

a. Tax revenue:

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

Taxation is the powerful instrument in the hands of the government for transferring purchasing power from individuals to government. The objectives of taxation are to reduce inequalities of income and wealth; to provide incentives for capital formation in the private sector, and to restrain consumption so as to keep in check domestic inflationary pressures.

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

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

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

b) Non-tax revenue:

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

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

1.7.2. Public Expenditure:

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

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

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

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

Plan and Non-plan Expenditure:

Expenditure is classified under the following heads:

a. Non-plan Expenditure:

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

b. Plan expenditure:

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

i) Central plans such as agriculture, rural development, irrigation and flood control, energy, industry, and minerals, communication service and technology, environment, social service and others.

ii) Central assistance for plans of the states and union territories.

Expenditure can also be categorized into revenue and capital expenditure. Revenue expenditure relates to those, which do not create any addition to assets, and covers activities of government departments' services, subsidiaries and interest charges. Capital expenditure involves that expenditure, which results in creation of assets. Finance ministry is responsible for plan expenditure. This includes grants to the state.

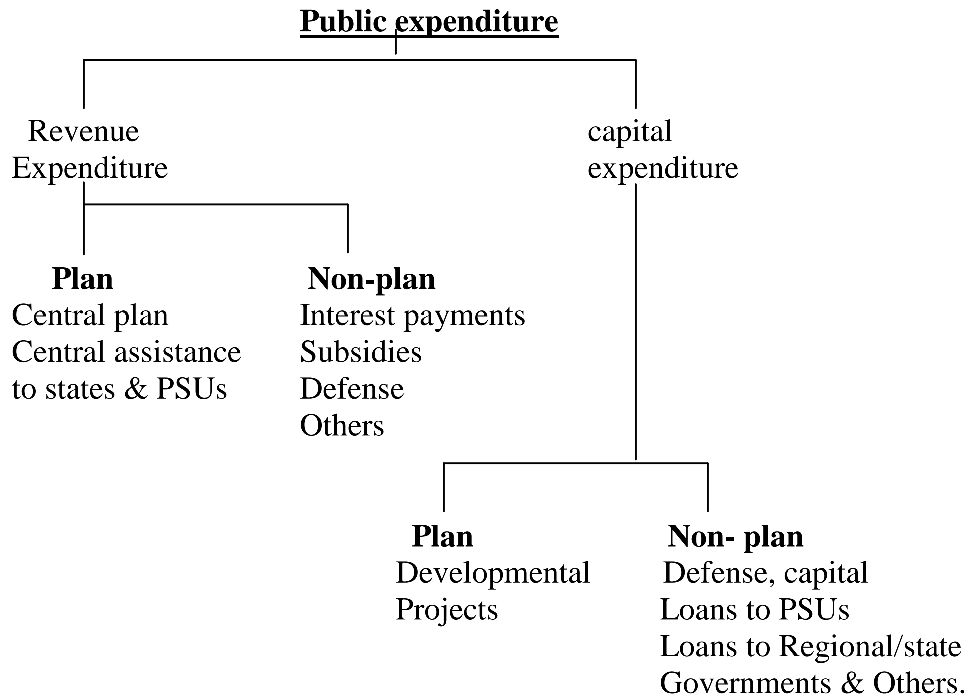
Hence the expenditures are classified as capital and revenue. Alternatively, these expenses can be re-classified into plan and non-plan expenditure.

Social expenditure:

Government takes the responsibility of protecting the interests of the community as a whole and promotes the implementation of welfare programs. Government spends huge amounts for providing benefits such as old age pensions, accident benefits free education and medical services. This expenditure on human resources comes under social expenditure.

Governments are moving towards the objective of achieving maximum social welfare. Expenditure on education, public health, welfare schemes for workers, relief and

rehabilitation of displaced persons and such other services may not yield direct benefit in the short run. But in the long run they contribute to improvement in the quality at human resources. The main classifications of Government expenditure can be seen in the following diagram.



1.7.3. Public debt:

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

a. Internal debt:

Increasing need of government for funds cannot be fully met by taxation alone in under developed and developing countries due to limited scope of taxation. Government therefore has to resort to alternate sources. Rising of debt is one such source. Debt, though involves withdrawal of resources by curtailing private consumption, has certain advantages. Transfer of funds from public to government is voluntary. Loans do not reduce the wealth of the lenders. Debt raised for productive purpose will not be a burden on the economy.

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

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

b. External Debt:

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

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

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

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

However, such external inflows help to achieve faster growth.

1.7.4. Financial Administration:

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

1.7.5. Economic Stabilization

Generally under developed countries have the following features.

1. Predominantly agriculture based economy
2. Low capital formation
3. Inferior technical know how
4. Low per capita income
5. Over population and poor health and educational facilities.

6. High propensity to consume leading to low capital formation.

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

1.8. Fiscal policy:

Fiscal policy is also called as budgetary policy. In broad terms, fiscal policy refers to that segment of national economic policy, which is primarily concerned with the receipts, and expenditures of these receipts and expenditures. It follows that fiscal policy relate to those activities of the state that are concerned with raising financial resources and spending them. Resources are obtained through taxation and borrowing both within the country and from abroad. Spending is done mainly on defense development and administration. 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.

Private outlay is insufficient to produce maximum national income. An increase in state outlay beyond its revenue can increase national income. Keynes emphasized the effects of government revenue and expenditure upon the economy as a whole and argued that they should be used deliberately and consciously to secure economic stabilization. This underscores the importance of budget in economic development.

Fiscal policy relates to the governments decision making with respect to the following: 1.Taxation 2.Government spending 3.government borrowing and 4.management of government debt. The policy relates to government decisions, which influence the degree and manner in which funds are withdrawn from private economy. Basically fiscal policy in these different facets 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.

It is thus obvious that fiscal policy deals quite 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. In developed economies the propensity to consume leads to stability. Excess saving by the community leads to lowering of demand for goods and services resulting in sub optimal employment level. Fiscal policy should balance the economy by sustaining the consumption in the economy.

In under developed and developing countries main objectives are rapid economic development and an equitable distribution of the income. Fiscal policy can be an important instrument for attaining these objectives. Fiscal policy influences the economy by the amount of public income that is received and on the other by the amount and direction of public expenditure. The important fiscal means by which resources can be raised for the public exchequer are taxation, borrowing from public and credit creation. These means must be used in harmonious combination so as to produce the best overall effects on the economic life of the people in terms of economic progress and social welfare.

1.8.1. Role of Fiscal Policy in the Economic Development:

1. In under developed and developing countries development is the main concern. The primary task of fiscal policy in an under developed and developing countries is to allocate more resources for investment and to restrain consumption.

2. The fiscal policy should reduce the economic inequalities of income and wealth. This can be achieved by taxation and public distribution measures. Poverty and unity cannot co exist. Therefore fiscal policy should attempt economic development of the socially unfortunate to bring about national unity. Private section is not interested in investing in social and economic overheads. Investments in social and economic overheads like education, medical facilities, infrastructure, dams etc. are very essential to accelerate the rate of economic growth.

3. In under developed and developing countries the requirement of growth demands that fiscal policy has to be used progressively for raising the level of investments and savings rather than keeping the consumption level. In under developed

and developing countries fiscal policy has to be used as an instrument of resource mobilization. In order to attain growth with stability the goal of fiscal policy should be promotion of highest possible rate of capital formation and should reduce the actual and potential consumption. Further fiscal policy should encourage private investment and attract foreign funds for development projects.

4. The existing pattern of investment may differ from the optimum pattern of investment. Thus it becomes a responsibility of government to undertake investments in such a way that it is most beneficial for the people of the country.

5. Fiscal policy should control inflation within tolerable levels since inflation mostly affects the poor.

In under developed and developing countries there exist regional imbalances in addition to social inequalities. Fiscal policy should aim at reducing both regional and social imbalances by directing investments to less developed regions. Their marginal propensity to consume is very high. Therefore, a small increment in investment can bring manifold employment due to multiplier effect.

Fiscal policy should direct available resources for providing basic physical, infrastructural needs like irrigation, roads, basic industries, railways, ports, telecommunications etc. Fiscal policy should assign high priority to the creation of overhead capital. Spending of the government should also take care of education and health of the community. Returns on these investments are long-term and private sector cannot provide above investments.

Therefore government of a country through its fiscal policy is able to increase rate of investment and also alter the pattern of investment. It follows that the main role of fiscal policy in an under developed and developing countries is to expand productive capacity by raising the level of real capital including skills as well as plants and equipment and to check the demand generating effect of expanding investment. In developed countries its role is to expand both production capacity as well as the level of aggregate monetary demand in relation to their economic growth. In under developed

countries the better approach is to transfer resources to capital formation without inflation.

Fiscal policy through its different measures such as taxation policy budgetary policy, public debt policy and a co-ordination with monetary policy can direct the economic destiny of a nation. Fiscal policy can be used to mitigate the effects of trade cycles such as inflation and depression.

1.9. Public finance Vs Private finance

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

1.9.1. Similarities between Public Finance and Private Finance:

1. Satisfaction of Human Wants: Individual is concerned with the personal wants, while the Government is concerned with the social wants. Thus, both the private and public finance have the same objective, viz, the satisfaction of human wants.

2. Balancing of Income and Expenditure: Both individual an Government have incomes and expenditures and trying to balance each other.

3. Maximum Satisfaction: Both private and public finance aim at maximum satisfaction.

4. Borrowing a Common Feature: As and when the current incomes becomes insufficient to meet the current expenditure, the individuals and Governments rely upon borrowings. Both of them are having loan repayment plans.

5. Economic Choice a Common Problem: Both the individual and Government face the problem of economic choice. That is their sources of revenue are limited, comparing with their expenditure. Hence they have to satisfy the unlimited ends with limited means.

1.9.2. Dissimilarities between Public Finance and Private Finance

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

1. Adjustment of Income and Expenditure:

In private finance, the individual first considers his income and then decides about his expenditure.

But the case of public finance, the government first estimates the volume of expenditure and then tries to find out the methods of raisins the necessary income

That is the private finance tries to adjust its income to expenditure, whereas the public finance tries to meet the expenditure by raising income.

2. Nature of Benefit:

The private finance aims at individual benefit ie the benefit of individual household.

But the public finance aims at collective benefit, i.e. the benefit of the nation as a whole.

3. Postponement of Expenditure:

In private finance, the individual can postpone or even avoid certain expenditure, as he likes.

But in the case of public finance, the Government cannot avoid certain commitments kike social welfare measures and thus cannot postpone the certain expenses like relief measures, defense, etc.

4. Allocation of Resources:

In private finance the individual can allocate or distribute his income to various expenditure in such as way to get the maximum satisfaction.

But it is not possible in the case of public finance; Government cannot aim at maximum satisfaction on the expenditures made.'

5. Motive of expenditure:

In the case of private finance, the individual expects return in benefit from the expenditure made.

But the government cannot expect return in benefit from various expenditures made.

That is profit or benefit is the motive of private finance whereas the social welfare

and economic development is the motive of public finance.

6. Influence on expenditure:

The expenditure pattern of private finance is influenced by various factors such as customs, habits culture religion, business conditions etc.

But the pattern of expenditure of public finance is influenced and controlled by the economic policy of the Government.

7. Nature of Perspective:

In private finance, the individual strives for immediate and quick return. Since his life span is definite and limited he gives importance to the present or current needs and allots only a little portion of income for the future.

But, the Government is a permanent organization and is the caretaker of the present and the future as well. Thus, the Government allots a considerable amount fof its income for the promotion of future interests.

That is private finance has a short-term perspective whereas the public finance has a ling term perspective.

8. Nature of Budget:

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

But the Government does not prefer a surplus budget. If the Government 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.

9. Nature of resources:

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

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

10. Coercion:

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

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

11. Publicity:

Individuals do not like to disclose their financial transactions to others. They want to keep them secret.

But, the Government gives the greatest publicity to its budget proposals and the allocation of resources to different heads. It is widely discussed. Publicity strengthens the confidence of the people in the Government.

12. Audit:

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

CHAPTER-II

BUDGET AND FINANCING

The word Budget originally meant the moneybag or the public purse. The word now means, "Plans of government finances submitted for the approval of the legislature". The budget reflects what the government intends to do. The budget has become the powerful instrument for fulfilling the basic objectives of government. The budget covers all the transactions of the central government.

Budget is a time bound financial program systematically worked out and ready for execution in the ensuing fiscal year. It is a comprehensive plan of action, which brings together in one consolidated statement all financial requirements of the government. The budget goes into operation only after it is approved by the parliament. A rational decision regarding allocation of resources to satisfy different social wants requires considerable thinking and planning. Thus budget is an annual statement of receipts and payments of a government.

2.1. Functions of Budget:

The functions of budget include the following:

a) Proper allocation of resources: - to relate expenditure decisions to specified policy objectives and to existing and future resources.

b) to relate all major decisions to the state of the national economy.

c) Long term economic growth: - to ensure efficiency and effectiveness in the implementation of government programs.

d) To facilitate legislative control over the various phases of the budgetary process.

e) Equitable distribution of income and wealth and

f) Securing economic stability and full employment.

It implies that the objective of budget policy is to take corrective measures or to adopt regulatory policies to remove imperfection or inefficiencies of market mechanism. Besides, the objective of the budget policy is to make provision of social goods or the

process by which total resources are divided between private and social goods. It means that the objective of budget policy is to ensure equitable distribution of income and wealth. This may be termed as distribution function. Third objective of budget policy is to maintain a high level of employment, reasonable degree of price stability and an appropriate rate of economic growth.

To implement its economic functions government raises revenues through taxation. Fees and charges, and spend them on different programs and activities. This process of rising revenues and spending by government is performed through budgeting. Budget thus stands for the yearly plans/forecasts of government revenues and expenditures. The budgeting process starts from the initial stage of preparing the annual revenues and expenditures forecast and end at the stages of approval by the higher government body followed by its implementation.

2.2. The Concept of Budgeting in Ethiopia:

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

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

2.3. Budget Structures in Ethiopia:

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

2.3.1. Revenue Budget:

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

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

Ordinary revenues include both tax and not tax revenues. the tax revenues being direct taxes (personal income tax, rental income tax, business income tax, agricultural income tax, tax on dividend and chance wining, land use fee and lease); indirect taxes (excise tax on locally manufactured goods, sales tax o locally manufactured goods, service sales tax, stamps and duty); and taxes on foreign trade (customs duty on imported goods, duty and tax on coffee export). Non tax revenues include charges and fees;

investment revenue; miscellaneous revenue (e.g. gins); and pension contribution. The second major item in revenue budget is external assistance. It includes: cash grants, these are grants from multilateral and bilateral donors for different structural adjustment programs; and technical assistance in cash and material form. The third item is capital revenue. This could be from domestic (sales of movable properties and collection of loans), external loan from multilateral and bilateral creditors mostly for capital projects, and grants in the form of counterpart fund.

2.3.2. 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 n the economy is financed through external borrowing and grants.

The acceptance to this categorization of expenditures is related to the general change in the perception of deficit. Prior to the 1930s, budget deficits were considered to be reprehensible and indicate bad financial management. Over the years, however, the cardinal rule of balanced budget was changed in favor of cyclical budget, and functional finance.

This change in the rule of budgeting, in turn, resulted in several approaches to measuring and understanding the deficit some of the concepts that were developed include:

a. the public debt concept of deficit,
b. the net worth concept of deficit,
c. the overall deficit, and
d. the concept of domestic deficit.

To illustrate these four approaches of measuring deficit, we can employ a simplified budget balance given in Table -1 below:

Table-1: A Simplified Budget Balance

Revenues	Expenditures
A. Tax and Non Tax Revenues	C. Recurrent Expenditure
B. Net Borrowing	D. Capital Expenditure
A + B	C + D

The public debt concept of deficit defines budget deficit as the difference between revenue (A) and recurrent expenditures (C) and capital expenditures (D) this measure A-(C+D) is equal to net borrowing (B), and the budget is considered to be balanced if net borrowing remains unchanged from previous years or is equal to zero. This approach illustrates, the understanding prior to 1930s, which emphasized balanced budget as a prudent fiscal policy.

The emergence of active fiscal policy: The emergence of active fiscal policy (i.e. government could borrow as long as that liability is matched by an increase in assets) right after the depression led to the development of the net worth concept of deficit. Referring to the Table above, the net worth is defined as the difference between recurrent expenditures and revenues (C-A), which is equal to the excess of net borrowing over capital expenditures (B-D) this measure of deficit requires the division of expenditures into current and capital budgets, with the latter being financed by borrowing.

The concept of the overall deficit or balance has several connotations and methods construction. The common practice is to put revenues, expenditures, and borrowing as distinct groups as in Table 2. Each budget category may then be related economic activity being computed as a ratio of GDP, which then becomes a first approximation and an important single measure of the impact of government fiscal operations.

Table- 2: The Overall Budget Deficit

The Overall Budget Deficit

A. Revenues
- Tax revenues
- Non Tax revenues
- Grants

B. Expenditures
- Recurrent Expenditures
- Capital Expenditures

C. Overall Deficit (A-B)

D. Financing
1. Foreign Debt
2. Domestic Debt
   - Non Bank Borrowing
   - Commercial Banks
   - Central Bank

The domestic balance concept is a family of the overall budget deficit and became prominent after the oil price increases in 1973/74. The basic argument being, in countries that had large revenues, expanded incomes from government expenditures placed strains on the domestic economy and spurred inflationary pressures. In such cases, budget surpluses will have an expansionary effect. Under such circumstances the overall budget deficit or surplus measure would be misleading to guide government policy. In fulfilling the requirements of oil producing countries and others in similar circumstances, the technique of splitting the domestic balance is the component of the overall balance from which external budget transactions have been excluded.

The separation of recurrent and capital budget should, therefore, be viewed in terms of the net worth argument above. The definition of these two budgets has been a common problem in most countries, however. The problem relates to delineating, which specific expenditures need to be included in the recurrent budget and which ones in the capital budget. In practice three criteria have been in use to define budget into capital and recurrent. These are sources of finance, object of expenditure, and nature of activity.

Capital budgets were originally defined by western governments by the source of finance, i.e., capital expenditures are financed from loan not current revenue. The object of expenditure refers to the particular activities to be performed with that budget like, formation of fixed assets, study and design, salaries of civil servants, etc. the third criteria, the nature of activity, refers to whether the activity is short term (i.e. project) or on going (that may not terminate in a specific period), and objective specific.

In Ethiopia the definition of recurrent and capital budgets follow some combination of these criteria. That is:

1. Recurrent budget is to be covered by domestic revenue from tax and non-tax sources. But the economy could borrow to meet its capital budget.

2. The financial proclamation 57/1996 and financial regulations 17/1997 defined capital budget based on the object f expenditure. Accordingly capital budget equals capital expenditure which equals fixed assets and consultancy services.

3. Short-term activities that are project in nature are included in capital budget while those activities that are recurring and continuous in nature are put in the recurrent budget. In some instances activities with a very long life period have been entertained in the capita budget. Since fiscal year 1994/95 efforts have been exerted to identify many such projects that have been categorized under recurrent budget (projects in Education, health and Agriculture sectors). The exercise does not seem complete, as there are projects with recurring nature (e.g. Agricultural Research) though attempts have been made to isolate the investment components.

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 ten be down to sub agencies.

2. Capital Budget:

Capital budget is budget for capital expenditures. Financial proclamation 57/1996 defined capital expenditure as "an outlay for the acquisition f improvements to fixed assets, and includes expenditures made for consultancy services." Financial regulations 17/1997 further provided a detailed definition of capital expenditures to mean:

a. The acquisition, reclamation, enhancement as laying out of land exclusive of roads, buildings or other structures;

b. The acquisition, construction, preparation enhancement or replacement of roads, buildings and other structures;

c. The acquisition, installation or replacement of movable plant, machinery and apparatus, vehicles and vessels;

d. The making of advances, grants or other financial assistance to any person towards him/her on the matters mentioned in (a) to (c) above or in the acquisition of investments; and

e. The acquisition of share of capital or loan capital in any body corporate;

f. Any associated consultancy costs of the above.

Capital budget could thus broadly be described as an outlay on projects tat 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 viz., economic development, social development, and general development. Economic development includes production activities (agriculture, industry, etc.), economic infrastructure

facilities (mining, energy, road etc.), commerce, communication, and so on. Social development includes education, health, urban. Development, welfare and so on. General development include services like cartography, statistics, public and administrative buildings, and the like.

2.3.3.Line Item Budget:

Capital budget, on the other hand is prepared by activity/project. This will be performed by categorizing projects spectrally at the top, then grouping them by programs and sub-programs. For instance, the "National Fertilizer project" is detailed as follows under the sector agricultural development.

700 Economic Development

710 Agricultural Development

712 Peasant Agriculture Development

712/02 Crop Development

712/02/02 National Fertilizer Project.

Ultimately, however, the budget for both recurrent and capital will be presented by line items (or code of expenditures). Thus, the budget for the sub agency or department in the case of recurrent will be prepared by such line items as salaries, office supplies, etc. Similarly, the capital budget for projects will be prepared by such line items as surveys and designs, equipment and machinery, operating cost, and so on.

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Line item budget has a number of advantages: First, it promotes control since the budget is detailed down to particulate expenditure items. The use of the budget of one line item for another may require the verification of MoF and MoED. So, the spending public bodies will not have the right to spend the budget as they want. Second, it is simple to manage. The major drawback of line item budget, however, is it fives more emphasis to inputs not outputs. At present, however, the civil service Reform Program in

its component of budget reform is trying to address the issue of output. To move from the existing input based (line item) budgeting to that of cost center and performance budgeting, efforts are being made to consolidate the recurrent and capital budgets by line item (i.e. to use the same line items for both recurrent and capital budgets) and to map the budget into the organizational structure of the implementing bodies.

Preparing the budget this way by line items is usually referred to as line item budgeting. Hence, our recurrent and capital budgets are prepared by line items. Budget request and disbursement are then performed by line items.

2.4. 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 al these stages, which obviously are sequential (one after the other) and iterative. Peterson summarized the budget process into three phases: analyzing, 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 paste, 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 processes hat 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 al public bodies involved in the process f 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 MEDaC who are responsible for the preparation of the recurrent and capital budgets, respectively. The MoF and MEDaC 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.

2.4.1. 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 a three years forecast and will be updated each year.

The framework is composed of macro-economic forecast and fiscal forecast. The macro-economic forecast gives the forecast of Gross Domestic product based on past performance and estimates for future years, and provides base line information in preparing the fiscal forecast. Financial Regulation 17/1997 gave the responsibility of preparing this framework to the Ministry of Economic development (MoED). Where as, 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 depend on the amount of resources to be raised in the form of domestic revenues and external fund that include counterpart funds. Once prepared by the concerned coordinating 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, how ever, 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 fist 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: MoF will release the budget ceiling to the line ministries in a budget call. The budget call provides each ministry such information as the macro-economic 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 exist a discrepancy between the respective sector department and the public body, a series of discussions will be held to reach agreement. After such a process the various sector departments of 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 MoF.

2. **Capital Budget:**

Spending public bodies will be called to defend their projects to a budget hearing convened by the PMO which will be chaired by the prime Minister or the deputy Prime Minister or the their economic advisers. The hearing customarily includes a review of status of the project, implementation capacity of the institution, compatibility with the countries development strategy and policy, cost structure, and regional distribution. A project description will be presented which includes objectives of the project, main activities of the project, status of the project, total cost, past performance of the project, source of finance, and whether the project is accepted or rejected by 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 MoF 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 MoF 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 vise 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. MoF 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 MoF 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 on going 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 MoF-for the recurrent budget-and by MoED-for the capital budget, and then will be sent to the treasury Department of the MoF.

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.

2.4.2. 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 with out referring to a particular region.

The process is more or less a mirror image of the Federal budget process. In place of MoF 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 counsel 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 fallow 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'.

2.5. Budget Deficit:

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

Budget deficit is the excess of total expenditure over total revenue of the government.

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

The meaning of deficit financing is different in different countries. In western countries, the budget gap, that is covered by loans is called deficit financing because, if the government borrows from the banks rather than from individuals the idle funds will be activated and there will be an increase in the total public expenditure and thus there will automatically be an deficit financing has been used in a different sense,. Here it is used to denote the direct addition to gross national expenditure as a result of budget deficit.

Thus deficit financing can be defined as "the financing of a deliberately created gap between public revenue and public expenditure". The government of Ethiopia has used deficit financing for acquiring funds to finance economic development. When the government cannot raise enough financial resources through taxation, it finances its developmental expenditure through borrowing from the market or from other sources.

2.5.1. Methods of Financing Deficit:

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

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

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

2.5.2. Objectives of Deficit Financing:

1. Deficit financing has generally been used as a method of meeting the financial needs of the government in times of war, when it is considered difficult to mobilize adequate resources.

2. Keynes advocated deficit financing as an instrument of economic policy to overcome conditions of depression and to raise the level of output and employment.

3. The use of deficit financing has also been considered essential for financing economic development especially in under developed countries.

4. Deficit financing is also advocated for the mobilization of surplus idle and unutilized resources in the economy.

2.5.3. Effects of Deficit Financing:

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

1. Inflationary rise in prices: The most serious disadvantage of deficit finance is the inflationary rise of prices. Deficit financing increases the total volume of money supply. Unless there is proportional increase in production this can lead to inflation. When deficit financing goes too far it becomes self-defeating. There was inflationary pressure during the decade due to deficit financing.

2. Effects on distribution of wealth and income: The real income of wage earners gets reduced and that of entrepreneurs/ businessmen increased, leading to distribution of wealth in favour of business class

3. Faster growth: Country is able to implement the developmental plans through deficit financing thereby attaining faster growth.

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

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

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

2.5.4. 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 emphasis the fact that deficit financing cannot create real resources which do not exist in the economy.

2.6. Categories of Revenues to Government:

The revenues of the Government can be classified into two ways. They are:

1. On the basis of mode of collection and
2. On the basis of nature of revenue.

Let us see these classifications one by one here under:

2.6.1. Revenue on the Basis of Mode of Collection:

It can be shown with the help of the following chart:

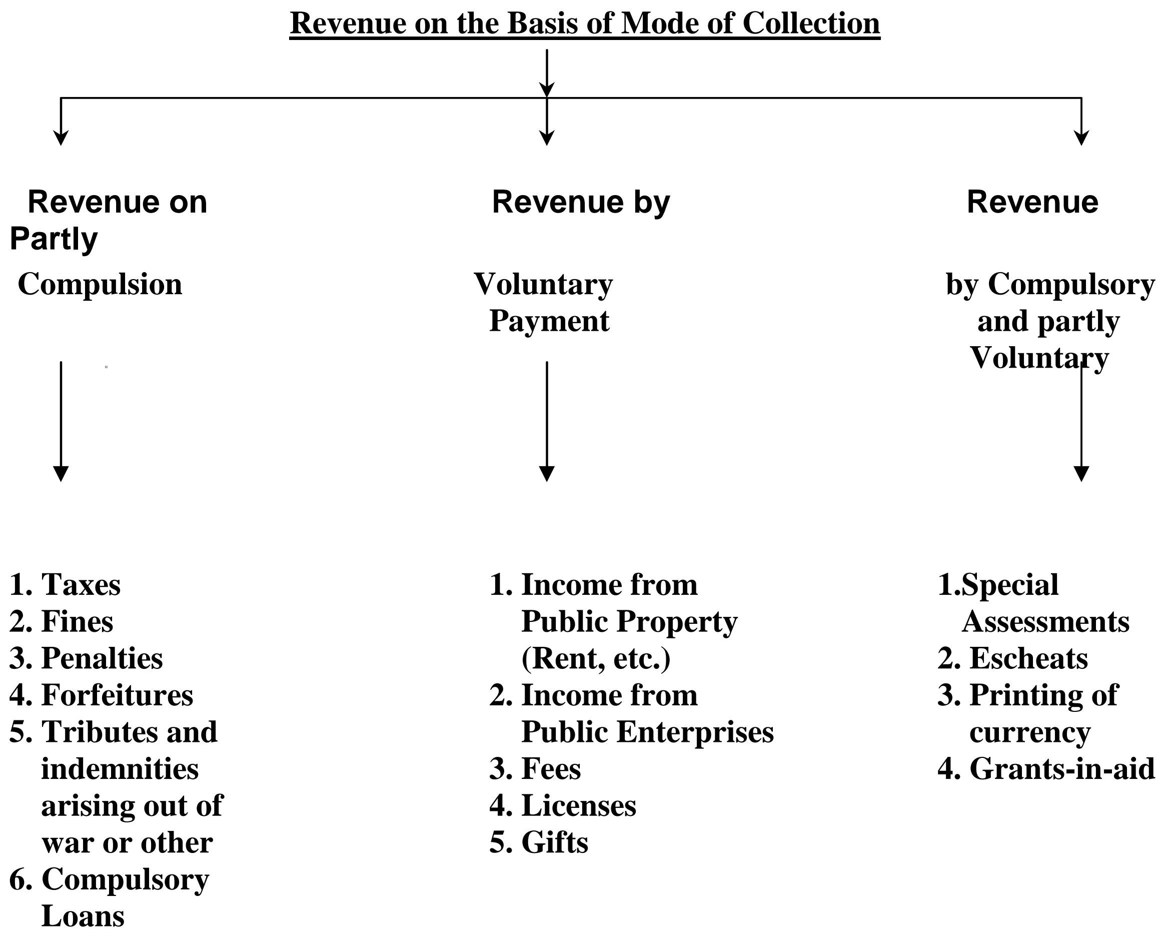


Fig. 1.1

2.6.2. Revenue on the basis of Nature:

The revenues on the basis nature can be classified as in the following Figure 1.2.

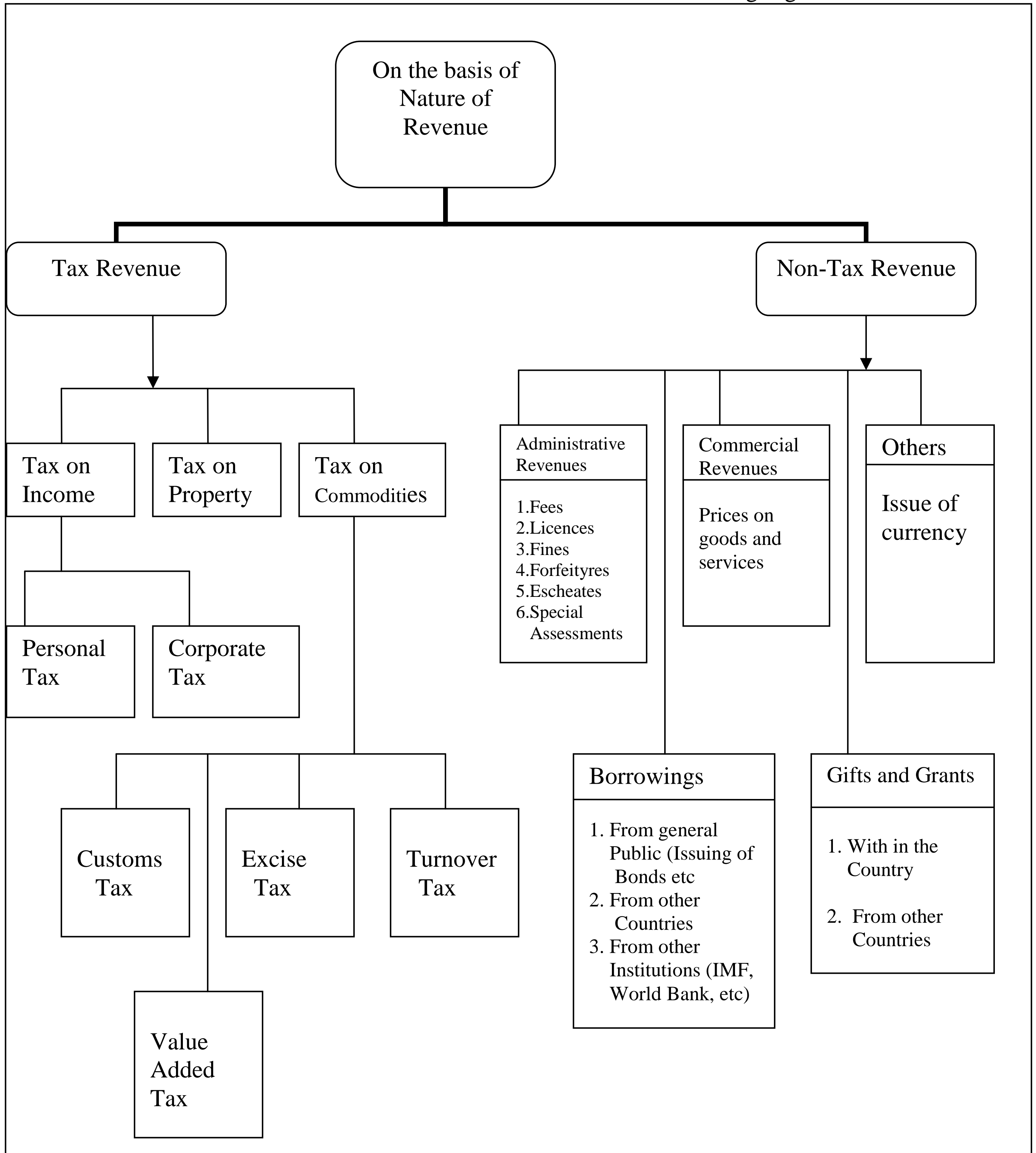


Figure 1.2.

Of these two types of classifications of revenues the classification of revenues based on the nature is considered as the ideal classification. Let us explain these items one by one.

2.6.2.1. Tax Revenue:

The revenue from tax includes the following:

1. **Tax on Income:** The Government imposes two types of taxes on income. They are:

    a). Tax on personal income, and

    b). Tax on corporation profits.

The personal income tax is levied on the net income of individuals, firms and other association of persons. The tax on the net profits of the joint stock companies is known as corporation tax.

2. Taxes on Property:

It is the tax revenue from properties including rental income tax land use tax etc.

3. Taxes on Commodities:

The important taxes levied by the Government on commodities are:

a) Customs Duty,

b) Excise Duty,

c) Value Added Tax

d) Turnover Tax

- Customs Duty includes both import and export duties. These duties are levied when the goods cross the boundaries of the country.
- Excise duties are levied on the commodities produced in the country. Excise duties now constitute the single largest source of revenue to the Union Government.
- Value Added Tax is levied by the Government on the commodities sold at a specified percentage on the value of sales.

- Turnover Tax is levied by the Government on the sales which are not covered under VAT.

2.6.2.2. Non-Tax Revenues:

The following categories of revenue are included under non-tax revenue.

Administrative Revenue: It includes the following:

(1) Fees: It is the compulsory payment made by the individuals who obtain a definite service in return. Fees are charged by the Government to bear the cost of administrative services rendered by it. These services are rendered for the benefit of general public. It includes court fee, registration fee, etc.

(2) Licenses: A license fee is collected not for any service rendered, but for giving permission or a privilege to those who want to do a special or specified work. It is charged on the grounds of control of certain activities.

(3) Fines and Penalties: Fines and penalties are imposed as a form of punishment for the mistakes committed such as violation of the provisions of law, etc. The basic aim behind them is to prevent the people from making mistakes. A fine is also compulsory like a tax, but it is imposed more as a deterent than as a source of revenue.

(4) Forfeitures: Forfeiture means the penalty imposed by the courts on the persons who have not complied with the notice served by it or for the breach of contract or has failed to pay the dues in time, etc.

(5) Escheats: The property of a person having no legal heirs and dying intestate, will be taken possession of by the Government. That is, the Government can take over the property of a person who dies without having any legal heirs or without keeping a will. But, it cannot be considered as a main source of revenue to the Government.

(6) Special Assessment: According to Prof. Seligman, special assessment means "a compulsory contribution levied in proportion to the special benefit derived to defray the cost of the specific improvement to property undertaken in the public interest". Thus, it is a compulsory payment or contribution. It is levied in proportion to the special benefits derived to bear the cost of specific

improvement to property. Whenever the Government has made certain improvements, somebody will get benefited. For example, irrigation facility, road and drainage facility, etc.

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

(7) Gifts and Grants: Gifts are voluntary contributions from Non-Government donors to the Government for various purposes like drought relief, defense, national relief, promotion of family planning, etc. Grants are usually given by one Government to another. For example, in a federal set up, the Union Government provides grants to the State Governments to carry out their functions and fulfillment of obligations. Moreover, the Government of one country may receive grants from other country.

CHAPTER-III
TAX- BASICS

3.1. Meaning of Tax:

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

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

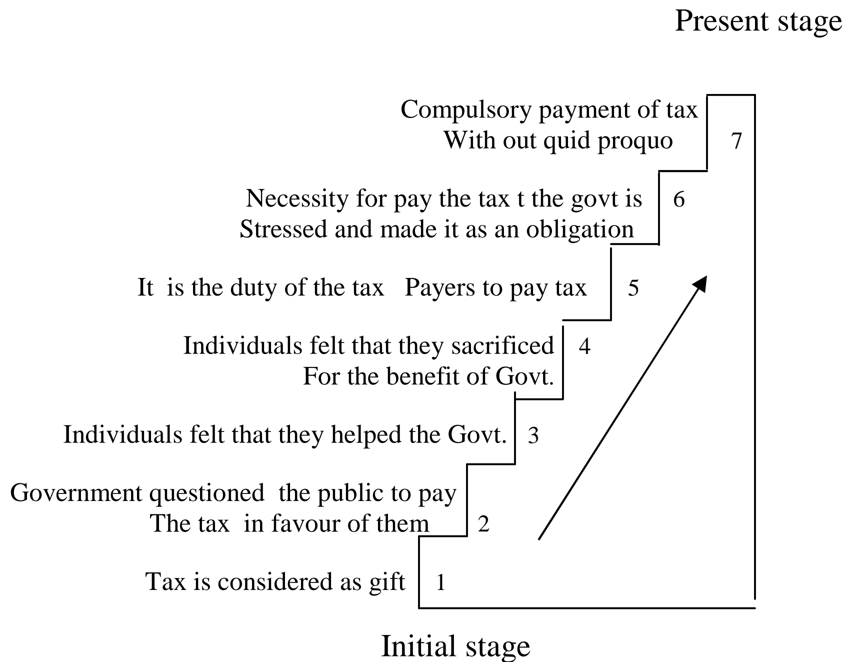
Thus, tax can be defined as, "*an involuntary fee or more precisely, "unrequited payment", paid by individuals or businesses to a government (central or local)*". Taxes may be paid in cash or kind (although payments in kind may not always be allowed or classified as taxes in all systems). The means of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

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

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

3.2. Stages in the Development of Levy of Tax:

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



Stages in the Development of Levy of Tax

3.3. General Characteristics of Tax:

A tax has the following characteristics:

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

2. **Benefit is not the Basic Condition:** For the payment of tax, there is no direct return or *quid proquo* to the taxpayers. That is, people cannot expect any return in benefit for the amount of tax paid by them. Because, there is no relation between the amount of tax paid by the people and the services rendered by the Government to the taxpayers.

3. **Personal Obligation:** Tax imposes a personal obligation on the taxpayers. When a person becomes liable to pay the tax, it is the duty of him to pay it and in no way he can escape from it.

4. **Common Interest:** The amount of tax received from the people is used for the general and common benefit of the people as a whole. Now the Government has to render enormous range of social activities, which incur heavy expenditure. A part of the expense

is sought to be raised through taxation of various types. Thus, taxes are said to be the sharing of common burden by the people.

5. **Legal Collection:** Tax is the legal collection. It can be levied only by the Government both Central and State.

6. **Element of Sacrifice:** Since the tax is paid without any return in benefit, it can be said that there is the prevalence of sacrifice in the payment of tax.

7. **Regular and Periodical Payment:** The payment of tax is regular and periodical in nature. It is levied for a fixed period usually a year. Thus, almost all the taxes are annual taxes. The payment of taxes should be regular also.

8. **No Discrimination:** Tax is levied on all people without any discrimination of caste, creed etc. but according to their ability to pay.

9. **Wide Scope:** Tax is levied not only on income but also on property and commodities. To enhance the revenue and to bring all the people under the tax net, the Government imposes various kinds of taxes. This enhances the scope of taxes.

Components of Taxes

- **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 owing.**
- **Unless they are imposed on individual transactions, taxes must have a period during which the base is measured and the tax collected.**
- **Each tax must have administrative arrangements for the collection of tax.**

3.4. Objectives of Taxation:

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

3.4.1. Specific Objectives:

The basic purposes of levying taxes are as follows:

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

3.4.2. General Objectives

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

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

Let us discuss the general objectives of taxation hereunder:

1. **Raising Revenue:** The basic purpose of taxation is raising revenue. To render various economic and social activities, Government requires large amount of revenue. To

meet this enormous expenditure, Government imposes various types of taxes in addition to the non-tax revenue.

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

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

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

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

4. **Reduction in Regional Imbalances:** It is normal that certain parts of the country are well developed, whereas some other parts or states are in backward conditions. To remove these regional imbalances, the Government can use tax measures. By way of announcing various tax exemptions and concessions to that particular backward regions or states, the economic activities in those areas can be induced and accelerated.

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

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

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

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

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

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

3.5. APPROACHES TO TAXATION:

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

3.5.1. Cost of Service Approach:

Cost of Service Approach is one of the oldest principles, advocated for the distribution of the tax burden. According to this theory, the basis of taxation should be the cost incurred by the Government on different services for the benefit of the individual tax-payers. Each tax-payer has to pay the tax equal to the cost of service to him. It means, the higher the cost, the higher should be the tax rate and vice-versa. In other words, according to this theory, the citizens are not entitled to any benefits from the state and if they do receive any, they must pay the cost thereof. The government acts like a producer

of a commodity who charges the price from his customers equal to the amount of cost of production of the commodity. By adopting this approach, the government gives up its basic protective and welfare functions. Its only job is to recover the cost of service. The state is not concerned with the problems of income distribution. No effort is made by the government to improve income distribution or no notice is taken of the policy of levying taxes according to the cost of service principle. This deteriorates the income distribution further. If this approach is adopted, quite a few sources of public revenue will be ruled out like taxes on capital gains, unearned increments, gifts, expenditure, excise duties and sales tax etc. welfare activities including all sorts of relief activities will also be ruled out.

Limitations of Cost of Service Approach:

This approach has the following limitations:

(1) this principle can not be accepted as the basis of taxation because it is very difficult to estimate the cost of service to every individual. For e.g., the government can estimate total expenditure on the defense of the country. But it is difficult to estimate the expenditure incurred by the government on the defense of a particular individual.

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

(3) Lastly, the cost of government services to individuals are fixed arbitrarily, which may not be justified.

3.5.2. Expediency Approach:

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

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

Limitations of Expediency Approach:

This approach is criticized on the ground that to build up an entire tax system solely on the considerations of expediency, must be full of pitfalls. In certain cases, such a tax policy may be able to yield certain good results like contributing to the equality of income distribution, or reducing regional disparities but such results would be purely accidental and not the fruits of any thoughtful efforts or plan.

A taxation system has a role to play in helping the economy. It should be based on equity and should contribute towards augmenting welfare in general. But when the tax system ignores certain factors like economic growth, equity, economic stability etc., it is not likely to be helpful to the economy and would increase inequalities and socio-economic injustice.

3.5.3. Socio-Political Approach:

In contrast to the expediency approach, Adolph Wagner advocated an approach in which social and political objectives are the deciding factors for the distribution of tax burden. Wagner, like most Germans of those days, did not believe in individualist approach to a problem. He wanted that each economic problem should be looked in its social and political context. Accordingly, a tax system should not be designed to serve the needs of the individual members of the society. But it should be designed for the welfare of the society as a whole. He was in favour of using taxation for reduction in income inequalities and he advocated that all small incomes should be exempted from taxation. In other words, the tax structure should aim at achieving social objectives. He advocated that the government should follow the policy of progressive taxation. Wagner's ideas,

though much criticized at that time, are now the hall-mark of modern states's fiscal policies. Taxation in a modern state is generally designed to curb inequalities. Progressive Taxation is the rule rather than the exception.

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

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

Limitations of Socio-Political Approach:

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

(1) This concept is more of academic nature than of much practical relevance. This is proved by the fact that in spite of the fact that the government follows the policy of progressive taxation, the gap between the rich and the poor has been increasing at a very fast rate.

(2) This policy has encouraged Jot of tax evasion either on account of loopholes or by adopting such methods that lead to tax evasion. The problem of taxation has led to the operation of a parallel economy which is causing inflation in economy.

3.5.4. Benefit Principle Approach:

Benefit principle approach was accepted by the political theorists of the 17th century. Taxation in those times was considered as a price for the services rendered by

the state. The entire philosophy was based on the contract theory of the state. According to this approach the state provides goods and services to the members of the society and they contribute to the cost of these supplies in proportion to the benefits received. It is an exchange relationship.

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

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

The benefit approach is, in fact, a combination of two Principles:

(1) The cost of service principles, and

(2) The value of service principle.

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

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

Limitations of Benefit Principle Approach:

This benefit principle approach has the following limitations:

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

rejected.

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

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

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

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

3.5.5. Ability to Pay Approach:

Ability to pay is interpreted as the money income of the tax payer. It is the most generally accepted theory. According to this theory each person should contribute to the income of the state in proportion to his ability to pay. Ability is the "ideal ethical basis of taxation. Every tax-payer should feel that he has made equal sacrifice in the payment of tax. The concept of ability to pay depends upon the bold concept of equity in taxation. Equity implies just tax payment. When the tax payer is required to pay tax according to his ability to pay, it may be called equity in tax payment. As Dalton puts it, "the burden of taxation' should be so distributed that the direct real burden on all tax-payers is equal." According to Seligman, "the basic point of the ability to pay principle is that the burden of society should be shared amongst the members of the society so as to conform to the principle of justice and equity."

The ability to pay principle accepts the idea that tax is a compulsory payment to the government without any direct benefit. This approach considers revenue and public expenditure as two distinct entities. Public expenditures are for the "common good" and

cannot be individually evaluated. The ability to pay principle points out that this collective expenditure should be distributed on the basis of "ability to pay" of the people and not on the basis of any benefits received.

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

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

3.5.5.1.Justification to Ability Theory:

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

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

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

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

3.5.5.2.Index of Ability to Pay:

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

The two approaches to measure the ability to pay are:

(1) Objective Approach

In view of the practical difficulties of sacrifice theories
or subjective approach, some writers, specially American'
have presented an objective approach to measure the ability to pay. Prof. Seligman has used the 'faculty' to indicate ability in the objective sense. Thus, it is also known as faculty theory of ability to pay.

The indices of ability to pay are as follows:

(i) Property: Property or Accumulated wealth was considered as the index of ability to pay. It was considered that property in the form of land,-buildings, gold, golden ornaments, etc., was a measure of a man's financial ability. Property gives security and insurance against risks. A person with property has a better ability to pay a tax than a person having no or very little property. Thus it was argued that taxation should be imposed on the basis of the extent of property possessed by the people. A person having larger wealth or property should be made to contribute more. Though property is an important source of income, yet, it cannot be considered as the primary test of ability because of the following reasons. "Firstly, property is an important source of income, but all property do not yield income." Secondly, the income from property is not continuous. Thirdly, income from property may vary on account of its nature, location, use etc., a house in a village may not yield anything, but it may be a good source of income in a tow~. Fourthly, property is taxed on its capital value, but if it does not yield income, the taxation may be unjust. Hence, it can e said that property may not be regarded as a primary test of ability to pay.

(ii) Income: Income is one of the most accepted indices of ability to pay. Under this index, persons with higher incomes share a larger money burden of tax and lower incomes are taxed at lower rates. People with equal incomes are taxed at equal rates. According to Adam Smith, "The subject of every state ought to contribute towards the support of the government in proportion to their respective abilities." Only net income should be taxed. Gross income cannot be treated as an index of ability to pay. Secondly, it is necessary to classify income into - (i) earned income and (ii) unearned income. Income earned from work is treated as earned income and that from capital gains from sale of shares, security and buildings etc., interest on savings and rent from immovable

property, windfall, gains from gambling, races, lottery, etc. is treated as unearned income. It is argued that unearned income should be taxed heavily as compared with earned income, because unearned income discourages willingness to work.

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

(iv).Consumption: Another objective index of ability to pay is he consumption expenditure of the members of the society. Sometimes, it is noticed that taxation on the basis of property and income is not equitable and can be manipulated to evade by the tax-payers in many ways. Hence Prof. Fisher and Prof. Nicholas Kaldor advocated taxation on expenditures. Firstly, consumption implies withdrawal of resources from the economy. A man's capacity to pay taxes, therefore, depends upon to what extent he withdraws resources to satisfy his consumption needs.

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

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

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

In spite of the fact that expenditure on consumption can be located to determine a person's ability to pay, yet is suffers from various limitations:

(1) If the consumption expenditure of a person is taken as

an index of his ability to pay then those who save and invest will escape the tax burden. This is against the canon of equity.

(2) Lack of records of the consumption expenditure also creates a major difficulty in locating a person's consumption expenditure for taxation purposes.

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

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

3.5.6. Subjective Approach:

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

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

Conan Stuart and Edge worth have advanced three concepts of equal sacrifice, viz.:

(1) Equal Absolute Sacrifice

(2) Equal Proportional Sacrifice

(3) Equal Marginal Sacrifice.

(1) Equal Absolute Sacrifice: Under the concept of equal absolute sacrifice, each tax-payer should make equal absolute sacrifice, i.e. the total disutility of a tax should be equal for all tax-payers. In other words all should be treated equally under law as well as in all affairs of government. According to J.S. Mill, equity in taxation means equality in sacrifice. When the total tax Payable by tax-payers is equally divided among them without regard to their money income, it may be stated as the application of the principle

of Equal Absolute Sacrifice. In this case the total sacrifice in the form of payment of tax is equally divided among the tax-payers without regard to their ability to pay. This may prove to be highly regressive in nature as the quantum of sacrifice on the part of the tax payers with lower money income may be the highest. Hence, most economists have strongly rejected the concept.

(2) Equal Proportional Sacrifice: According to this concept also, no one is exempt from sharing the tax burden. In other words, each tax payer should sacrifice the same proportion of total utility or satisfaction derived from his total income.When the tax burden is distributed among the tax-payers in proportion to their money income, we call it equal proportional sacrifice. In this case, the sacrifice of the poorer section of society is quite higher because marginal utility of money is quite higher. to them as compared to the richer section of the society. Thus, according to the principle of proportional sacrifice, the direct real burden on every taxpayer would be proportionate to the economic welfare which he derives from the income. Hence, this concept cannot be considered as a system of just tax payment by the government.

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

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

According to Pigou, "Thus the distribution of taxation required to conform to the principle of least aggregate sacrifice is that which makes the marginal not the total-sacrifice borne by all the members of the community equal." The object of the state is to maximize the economic welfare. Hence, taxes should be distributed in accordance with

the Principle of least aggregate sacrifice, i.e., the marginal sacrifice imposed by way of taxation on each tax-payer is equal. In this approach the emphasis is on the welfare of the community. Musgrave and others consider it as the "ultimate principle of taxation." Thus this approach leads to progressive taxation.

3.6. Canons of Taxation:

The Government requires funds for the performance of its various functions. These funds are raised through tax and non-tax sources of revenue. Imposing tax on income, property and commodities etc. raises tax revenues. In fact, tax is the major source of revenue to the Government. According to **Adam Smith**, "*a tax is a contribution from citizens for the support of the Government*".

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

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

I. Canons Advocated by Adam Smith

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

II. Canons Advocated by Others:

5. Canon of Productivity.
6. Canon of Elasticity.
7. Canon of Diversity.

8. Canon of Simplicity.
9. Canon of Expediency.
10. Canon of Co-ordination.
11. Canon of Neutrality.

We shall now discuss them briefly.

3.6.1. Canons Advocated by Adam Smith:

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

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

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

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

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

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

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

1. '*Taxation should be inexpensive in collection*', and
2. '*Taxation should retard as little as possible the growth of wealth*'.

It may also be remarked that there is a close connection between "**Economy**" and "**Productivity**", since the former aids in securing the latter.

3.6.2. Canons Advocated by Others:

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

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

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

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

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

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

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

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

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

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

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

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

A further point deserves notice. There is at first sight a probability of conflict between the several canons. A productive tax may be inconvenient, as a convenient one may be unjust, and how, it may be asked, is a solution of the difficulty to be reached? The plain answer is, by the surrender of the less important canon. The successful administration of the State is the final object, and therefore convenience, or even equity, may have to yield to productiveness. But though opposition is possible, agreement is on the whole the ordinary case. We have seen that economy increases productiveness, but so do certainty and convenience. Elasticity aids both productiveness and economy, while growing productiveness in turn permits better observance of all the other canons. There is thus a harmony in a properly administered financial system that tends to promote its improvement in the future.

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

3.7. Direct and Indirect Taxes:

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

3.7.1. Direct Taxes:

A direct tax is paid by a person on whom it is levied. In direct taxes, the impact and incidence fall on the same person. If the impact and incident of a tax fall on the same person, it is called as direct tax. It is borne by the person on whom it is levied and cannot

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

3.7.1.1. Merits of Direct Taxes

Direct taxes have the following merits:

1. **Ensures the Principle of Ability to Pay:** Direct taxes are based on the principle of ability to pay. They fall more heavily on the rich than on the poor. The tax burden is distributed on different sections of the society in a just and equitable manner.

2. **Reduces the Social and Economical Inequalities:** Direct taxes reduce a disparity in the distribution of income and wealth. By adopting the progressive tax system, rich people pay on higher rates of adopting the progressive tax system, rich people pay on higher rates of taxation, while the poor pay on lower rates or given exemptions. This reduces the gap between the poor and rich to a considerable extent.

3. **Certainty:** Direct taxes satisfy the canon of certainty. In direct taxes, the time of payment, mode of payment, the amount to be paid etc. are made clear. Both the taxpayers and the Government know the amounts to be paid and the Government can estimate the revenue from these taxes.

4. **Economy:** The cost of collection of these taxes is low because the government adopts the different methods of collections like tax deduction at source, advance payment of tax etc. Besides, the taxpayers pay the amount of tax directly to government. Thus, the principle of economy is achieved in the case of direct taxes.

5. **Elasticity:** Direct taxes are elastic in nature. For example, when the income of the people increases, the tax revenue also increases. Moreover, during the unforeseen situation like flood, war etc. the government can raise its revenue by increasing the tax rates without affecting the poor.

6. **Educative Effect:** Direct taxes create civic consciousness among taxpayers. Since the taxpayers feel the burden of tax directly, they are interested in seeing that the

Government properly spends the money. They are conscious of their rights and responsibilities as a citizen of the State.

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

3.7.1.2. Limitations of Direct Taxes:

The following are the demerits of direct taxes:

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

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

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

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

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

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

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

3.7.2. Indirect Taxes

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

3.7.2.1. Merits of Indirect Taxes:

Indirect taxes have the following merits:

1. **Convenience:** Indirect taxes are more convenient to the taxpayers. Since the tax is included in the selling price of the commodities, the consumer pays the tax when he purchases them. He pays the tax in small amounts (installments) and does not feel its burden. Thus, indirect taxes are quite convenient and less burdensome.

2. **Wide Scope:** While the people with income and wealth above a certain limit, are brought under the levy of direct taxes, indirect taxes are paid by all both poor and rich. Under indirect taxes, everybody pays according to their ability. The tax burden is not imposed on to the small section but it is widely spread. Thus, the indirect tax has wider scope.

3. **Elastic:** The revenue from the indirect taxes can be increased. Whenever the Government wants to raise its revenue, or lower it, it can be achieved by increasing and decreasing the rates of taxes on the commodities whose demand is inelastic.

4. **Tax Evasion is Not Possible:** Indirect taxes are included in the selling price of the commodities. So, evading of such tax becomes very difficult. If the person wants to evade the tax, it can be done only by refraining the consumption of the particular commodity.

5. **Substantial Revenue:** Indirect taxes yield substantial revenue to both Central and State Governments. The developing countries like Ethiopia are heavily dependent on

indirect taxes. Direct taxes have a limited scope in these countries because of low per capita income.

6. **Progressive:** Indirect taxes can be made progressive by imposing lower rates of taxes or giving exemption to the necessary articles and heavy taxes on luxurious articles. Thus, indirect taxes also confirm the principle of equity.

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

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

3.7.2.2. Limitations of Indirect Taxes:

The following are the demerits of indirect taxes:

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

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

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

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

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

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

3.7.3. Differences between Direct and Indirect Taxes:

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

1. Shiftability of the Burden of Tax: In the direct taxes, the impact and incidence fall on the same person. It is borne by the person on whom it is levied and is not passed on to others. For example, when a person is assessed to income tax, he cannot shift the tax burden to anybody else, and he himself has to bear it.

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

2. Principle of Ability to Pay: Direct taxes conform to the principle of ability to pay. For example, now people having income above Birr.150 pm, only is liable to pay income tax.

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

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

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

4. Principle of Certainty: Direct taxes ensure the principle of certainty. Both the Government and the taxpayer know what amount is to be paid and the procedures to be followed.

But in the case of indirect taxes, it is not possible. The taxpayer does not know the amount of tax to be paid and the Government cannot predict the quantum of revenue generated from the indirect taxes.

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

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

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

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

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

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

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

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

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

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

3.8. IMPACT, SHIFTING AND INCIDENCE OF TAX:

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

which has paid the tax in the first instance and may transfer it to some one else. If such a shifting of tax takes place, the original taxpayer has served only as a collecting agent.

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

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

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

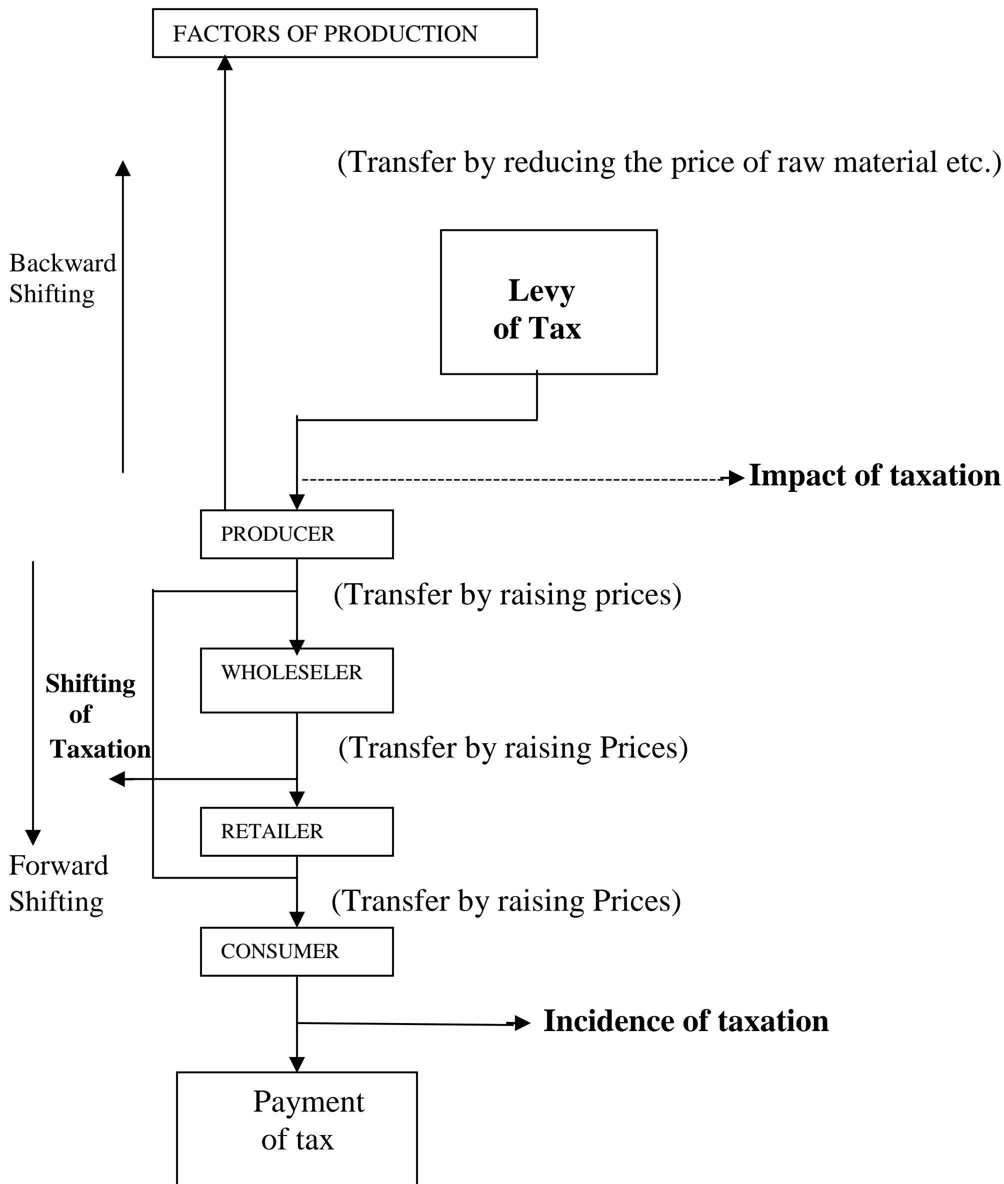


Fig: 3.2. MODEL OF IMPACT SHIFTING AND INCIDENCE OF TAXATION

Thus,

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

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

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

3.8.1. 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.

3.8.2. 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.

3.8.3. 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.

3.8.4. Differences between Impact and Incidence:

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

3.8.5. Theories of Tax Shifting or Incidence of Taxation:

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

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

3.8.5.1. The Traditional Theory:

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

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

3.8.5.2. The Concentration Theory:

This theory was developed by physiocrats in the 18th century. They believed that all types of taxes imposed on public ultimately fell on the particular class of people i.e. landowners or on the surplus income from land. They considered that agriculture was the only productive occupation giving rise to economic surplus. According to them, there was no surplus in other occupations like trade, commerce etc. They firmly believed that a tax whether imposed on a person or on a commodity would ultimately fall on land through the process of shifting of the tax. That is, taxes imposed on non-agriculturists tended to be passed on to agriculturists.

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

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

3.8.5.3. Diffusion Theory:

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

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

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

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

The main criticisms of this theory are as follows:

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

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

3.8.5. 4.Modern Theory:

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

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

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

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

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

3.9. Effects of Taxation:

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

Thus, in the modern context, the effects of taxation, which are shown in Figure 3.3, may be summarized as follows.

3.9.1. Effects of Taxation on Production:

All taxes must evidently come from the produce of land and labour, since there is no other source of wealth than the union of human exertion with the material and forces of nature. But the manner in which equal amounts of taxation may be imposed may very differently affect the production of wealth. Taxation, which lessens the reward of the producer necessarily, lessens the incentive to production; taxation, which is conditioned upon the act of production, or the use of any of the three factors of production, necessarily discourages production. Thus taxation, which diminishes the earnings of the labourer or the returns of the capitalist, tends to render the one less industrious and intelligent, the other less disposed to save and invest. Taxation, which falls upon the processes of production, interposes an artificial obstacle to the creation of wealth. Taxation which falls upon labour as it is exerted, wealth as it is used as capital, land as it is cultivated, will manifestly tend to discourage production much more powerfully than taxation to the same amount levied upon labourers, whether they work or play, upon wealth whether used productively or unproductively, or upon land whether cultivated or left waste.

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

1. Ability to work, save and invest.
2. Willingness to work, save and invest.
3. Diversion or allocation of resources between industries and places.
4. On the size of the industries.

Let us discuss these factors one by one.

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

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

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

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

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

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

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

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

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

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

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

The diversion may be beneficial diversion or harmful diversion. Taxation on the commodities that are injurious to the health like cigarettes and liquors may discourage their consumption, which in turn affects their production. The factors of production engaged in these industries may be diverted to some other industries producing goods of common consumption etc. This is a "**Beneficial Diversion**".

The taxation on the goods of common consumption will increase their price. Hence, the consumption of such goods may be reduced. This will affect the production of these commodities, and the resources used in their production may be diverted to the production of some other commodities which may be in the nature of luxury or harmful to health. Thus, such a diversion of resources is harmful and is socially not desirable. It is known as "**Harmful Diversion**".

3.8.1.4. Effects on the Size of Industries:

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

increase further. This will affect the competitive efficiency of small-scale industries, which in turn affects the production, and survival of these industries.

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

3.8.2. Effects of Taxation on Distribution:

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

1. Nature of Taxation, and
2. Kinds of Taxes.

3.8.2.1.Nature of Taxation:

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

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

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

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

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

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

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

(b) Effects of Indirect Taxes on Distribution: Indirect taxes are levied on commodities. They fall heavily on the lower and middle-income groups who spend a large portion of their income on commodities. In such a situation, indirect taxes have adverse distributional effects. However, indirect taxes may be made progressive if the necessaries are exempted from taxation or levied on low tax rates, and luxuries are subjected to higher rates of taxes.

3.8.3. Effects of Taxation on Consumption:

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

1. **Income Effect:** The tax reduces the taxpayer's purchasing power or real income. It takes resources away from the taxpayer and transfers them to the government. This is often referred to as the direct burden of the tax.

2. **Substitution (or Price) Effect :** The tax creates an incentive for the taxpayer to substitute less preferred but untaxed or lower-taxed goods for the more-preferred taxed good. The loss in consumer utility from this substitution is the excess burden (or welfare cost) of the tax.

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

1. Influence the Allocation of Resource of Individuals:

Every individual has limited money income and allocate it to different uses. Taxation affects their allocation directly or indirectly. For example, the income tax reduces the money income of a consumer and forces him to buy a smaller volume of goods and it

reduces the standard of living of the consumers. Likewise, a levy of indirect taxes on the goods of common consumption will affect the allocation of individual resources. Thus, taxes influence the allocation of resources of individuals.

2. Effects of Taxation on Consumption and Employment:

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

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

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

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

4. Regulatory Effect of Taxation on Consumption:

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

CHAPTER-IV
TYPES OF TAXES

4.1. TAX ON INCOME:

Apart from personal income tax, corporate income tax has become a prominent form of revenue to modern Governments. The joint stock company-also known as the business corporation - has a separate legal entity and the net income or profit earned by the company is taxed by the Government. Such a tax is called corporate income tax or simply corporation tax.

Arguments for Corporation Tax:

Economists have generally defended the corporation income tax as a necessary and important element in a progressive tax system and have argued that the economic effects are desirable or at least less harmful than other alternative sources of revenue:

(i) The Corporation tax is justified on the ground that it is a change for the social benefit or privilege of doing business. The joint stock company owes all its rights, power and benefits to the grant of franchise by the state. Among the special principles are: easy transfer of ownership, perpetual life, etc. These features make it easy for Business Corporation to grow in size and power and to tap new sources of finance and new markets. The tax on company profits is sought to be justified for these privileges enjoyed by companies.

(ii) Many of the services provided by the Government for the general public are mostly meant for the corporate sector - e.g., public health and public education, made use of by working classes, maintenance of law and: order which protects property, enforces contracts, prosecutes fraud etc. These are social costs which are wholly or partly assignable to business and industry. Corporate taxation is sought to be justified on this ground.

(iii) Some have used the ability principle to justify corporate taxation. For one thing, corporate profits constitute an important source of large incomes and fortune and hence of economic inequality. For another, they constitute an important source of idle savings. Consequently taxation on them seems to be justified.

All these three arguments in favour of corporate income tax - benefit principle, allocation of social costs and ability principle - are not significant. The real justification is that the corporation. tax is well established in practice and brings in good revenue to the Government. Besides, the Corporation tax has high administration convenience.

Arguments against Corporation Tax:

Public corporations raise many serious objections to the levy of taxes on corporate taxes.

First, the corporate income tax results in double taxation - the profits of a public limited company are taxed partly as tax on company profits and partly on the shareholders of the company on their dividend income. This objection can be easily answered. For one thing, the company and the shareholders are different legal persons and have separate incomes and, therefore, there cannot be double taxation. For another, imposition of two or more taxes on the same income does not necessarily constitute double taxation. A person may pay property tax on the value of his property and also pay income tax on the income which he receives from the property there is no double taxation here.

Secondly, the burden of the corporate income tax is shifted forward on to the consumers of the products produced by the corporations. Accordingly the burden of the corporation tax is borne, not by the companies, but by the public who also pay the income tax. This argument is not valid, as the corporation tax is levied on net profits.

Thirdly, investment in risky business enterprises will be discouraged by the tax on company profits. This is true to some extent but this does not mean that the profits of companies cannot be taxed at all.

Finally, corporation income tax is said to be discriminatory in the sense that the tax falls on the ordinary shareholders, while the preference shareholders will get away free. It may also be pointed out that corporate profits tax will encourage firms to finance themselves through debentures rather than through equity shares. There is some validity in this argument but there is nothing intrinsically wrong in taxing the net profits of companies.

An evaluation of both arguments for and against corporate taxation shows clearly that there is a good case for corporation tax in modern economies particularly from the

point of economic desirability, administrative feasibility and political expediency.

4.2. WEALTH / CAPITAL TAX:

There is much confusion and ambiguity attached to wealth tax, also Called as capital tax or property taxation. As distinct from income-tax which is tax on income and is paid out of income, wealth tax can be distinguished into:

(a) that which is assessed on capital but paid out of income.

(b) that which is levied on capital and paid out of capital.

In this group there are two types of taxes; the first is the capital levy which may be levied once and for all, let us say, during an emergency or immediately after a war to payoff the huge public debt; the second is the tax imposed every time wealth is inherited by one person from another, commonly known as the death duty.

There are three different types of capital taxes or wealth taxes, *viz., (a)* an annual capital tax or annual tax on net wealth, *(b)* a capital levy, and *(c)* death duty.

An annual capital tax is a regular annual charge assessed on the basis of the net wealth of the individual. No distinction is made between the various forms of wealth or capital. A capital levy, on the other hand, is assessed on the capital or wealth of a taxpayer (this is similar to annual capital tax) but is a once for all charge. While the annual capital tax is a regular annual feature, capital levy is extremely irregular and mayor maynot be levied even once in a generation. A death duty is a recurrent tax assessed on the capital of a taxpayer, recurrent in the sense that every time property is inherited, the tax has to be paid. At the same time, it is a non-recurrent tax. All these three exhibit two essential characteristics: *(a)* they are assessed on capital, and *(b)* they are general in nature because they are assessed with reference to the capital worth of a taxpayer and not to any specific item out of taxpayer's total capital.

Arguments for Wealth Tax:

Wealth-both real wealth and claims-refers to the value of goods, claims and property rights which may be owned. While income is a flow, a stream, wealth is a stock, a fund. Since the welfare of an individual depends upon the income which he enjoys as well as the wealth he owns it is suggested that wealth also should be taken as basis for taxation at least as complementary base to income. The possession of wealth confers many obvious advantages on the owner. Between two persons who are getting the same income one

from labor and the other from wealth, the latter enjoys several special advantages. For instance, the person whose income comes from wealth will be able to maintain himself even when his income ceases, for he can dispose of his property. Secondly, he is not compelled to save as his wealth itself is a manifestation of past saving. Finally, property confers social prestige and hence source of satisfaction by itself. Thus, the basic justification of wealth tax is that personal wealth is a good base for direct taxation.

(i) Equity Argument. Equity in taxation remands that tax burden is imposed according to taxable capacity. For a long time income of a person has been regarded as the criterion of a person's taxable capacity. But economists and statesmen have now come to accept the fact that income taken by itself is an inadequate yardstick of taxable capacity as between *(a)* Labor income and property income, and *(b)* different property owners.

(ii) Economic Argument. An annual tax on property or wealth is superior to income-tax because the former will not have a disincentive effect. Suppose, there are two individuals with the same accumulated wealth Birr.1,000,000, and suppose further the first has invested his money in equity shares with highly fluctuating income while the second has invested in government bonds yielding 9 per cent. The first individual may get an income of 18 *per* cent on an average but the difference of 9 per cent over the safe return may be taken as a return for the assumption of risk. But income-tax does not make allowance for risk taking and taxes the additional income of the person with investment in equity shares. Clearly, therefore, it discriminates against risk taking and places too much burden on the person willing to take the risks of business development and allows those with low interest and high grade secularities to go comparatively lightly. Under the annual wealth tax, properties with the same value, irrespective of their yield, would bear the same tax.

Arguments against Wealth Tax:

However, many arguments have been given by critics on the same grounds on which the advocates have supported and justified the introduction of wealth tax. The fact that very few countries have so far adopted the wealth tax probably explains the opposition to the tax by many interested persons.

(i) The first criticism against the wealth taxis that it is not equitable. The wealth tax, the critics assert, imposes a heavy burden upon persons who have wealth but little or no

current income. Not all property yields an income; in such a case, a tax on non-income-yielding property will force a man to pay it even though he may not have an income to pay it with. Sometimes, property values may be going down because of a general depression when high 'exeniptiol1s may be called for.

(ii) The wealth tax discourages productive enterprise. It has, however, been shown by many competent economists that an amount of money taken from a taxpayer by way of income-tax has more discouraging effect than an equivalent amount of money taken by way of property tax.

(iii) The wealth tax has been held to be a poor tax from the administrative point of view. Two special problems have been mentioned, *viz.,* the problem of discovery and the problem of valuation. The problem of discovery implies the high possibility of understatement and concealment of property. This is, really, no criticism because if property is concealed then the income arising from that property is also automatically concealed. If the income is known, then the property behind that income will also be known. . Thus, the introduction of wealth tax does not create any additional administrative problem. The problem of valuation implies that property will have to be valued every year.

4.3. ESTATE DUTY AND INHERITANCE TAX:

The receipt of a gift or a bequest (gratuitous transfer during lifetime is referred to as “gift” while transfer on death is “bequest”) constitutes and economic gain and thus increases the economic wellbeing of the recipient. Such receipts constitute income, in whatever way it is defined but traditionally, they have never been subject to income tax but have been brought under separate tax legislations. The estate duty or death tax or death duty is a form of personal tax on property which is levied when property passes from one person to another at the time of the death of the former. Though the revenue yield of death duty may considerably be small, it is valued very much for its so-called social effects. Death taxes assume two major forms-one is called the estate duty and the other is known as the inheritance tax. The estate tax or the extant duty is a levy upon the entire estate left by a deceased person, while the inheritance tax is a levy upon the separate shares of the estate transferred to the beneficiaries. Generally, an estate duty provides for a single uniform exemption, though it can also allow specific exemptions

according to the number of dependants and in relationship between the deceased person and the dependants. Be sides, the rates are graduated and the tax brackets will apply to the net estate as a whole.

On the other hand, an inheritance tax has three general characteristics: (a) there is no elaborate classification of heirs; (b) the inheritance tax provides specific exemption; (c) there is a special scale of rates for each class.

A closer examination of the two types of death duty will bring out their merits and demerits. The estate duty, for instance, is simpler and more productive, for it avoids entirely the exceedingly complicated task of determining the value of estates where the transfer of estate may be subject to many conditions and qualifications. But the estate tax does not give special weight to the ability to pay of the beneficiary. On the other hand, the inheritance tax takes into account the relation between the deceased and the heirs and the share of each heir. Thus, it gives special weight to the ability to pay of the heir, so that the immediate heirs such as the widow or the sons will be asked to bear a lighter burden as compared to remote relations. Hence, the inheritance tax is considered as a refinement of the estate duty.

Arguments for Estate Duties:

The most important argument' in favour of estate taxes is based *on equity-the principle of ability to pay.* As we have pointed out earlier, property is regarded as a suitable basis for taxation and death tax is a personal tax on property. Further, it is generally regarded that the transference of wealth at the time of death of the deceased person is a strategic time for the State to assert to claim for a shire in wealth. It is easy to argue that the concept-of ability is, to clear here in the sense that the target can be either the deceased or the heirs. Besides, it may be pointed out that the timing of death taxes. may not always be opportune to the successor particularly if the survivor is the widow. However, the more remote the heir from the deceased, the greater is the ability of the former to pay. He finds himself with wealth which he did not probably expect. His receipt of the property seems to be a proper occasion for the State to obtain a contribution to the national exchequer.

Another argument in favour of death taxes is that inheritance constitutes an unearned income to the heirs. The heirs have received an income which is the fruit of somebody else's labor and sacrifice. At best, a successor is entitled to adequate support and

education till he reaches his maturity, but beyond that what. he receives is special privilege. The more remote is the relationship between the deceased and the heir, the more does the inheritance become unearned.

Again, death duties are sought to be justified on the ground that they tend *to correct a bad distribution of wealth* which is a special feature of all free economies. Most people will regard as highly inequitable the fact that some individuals are sufficiently fortunate to inherit so much property that they never need to work. Besides, these persons may contribute nothing toward the welfare of the economy. The death duty is used with the definite purpose of reducing the volume of wealth passed on at the time of death.

Finally, the death duty is a useful and necessary addition to income tax. It reaches earnings from such securities and earnings which are exempt from the income-tax and other property or income which may have avoided taxation during the owner's lifetime. Besides, the death duty has the advantage of easy assessment and collection.

Arguments against Estate Duties:

It is argued that a large number of bequests pass from the deceased to his widow or minor children and, therefore, the receipt of title of the property does not represent a real improvement in the economic wellbeing of the recipient. Even before the receipt of the title, the beneficiaries had full use of the property. Besides, the death of the person has actually removed the chief source of family income. Accordingly, the beneficiaries are worse off and the imposition of a duty is, thus, considered unjust. This argument has considerable force but it is more an argument in favour of a special treatment of bequests and gifts rather than against the imposition of death tax as such. Further, some bequests represent completely unexpected or windfall gains which may be considered to represent a far greater tax paying ability than usual income.

The most important argument against death duty is that it has adverse effect on capital formation. 'Freedom to dispose of one's property is a necessary incentive to the accumulation of capital. When a person knows that a part of his wealth-may be a good part of it, if it is large-will be taken by the government, he will lose his interest in accumulating wealth. The incentive to save and accumulate is, thus, adversely affected by the imposition of death duty. Further, death duty will impinge upon the ability to save. It cuts into past savings that would otherwise have gone to the heirs and they would diminish the latter's capacity for future saving.

It is also argued that the death duty may break up effective productive units and thus affect national income. There can be any number of instances to show how small and independent business units are broken up at the death of the owner. As a result of the death duty, the small businesses are forced to sell themselves away to large monopoly concerns. Moreover, efforts to keep estates liquid in preparation for a death tax may discourage their use in risk taking enterprises. However, businessmen have many methods-insurance, gifts before death, etc.-to meet death taxes.

4.4. COMMODITY TAXES

Commodity taxes have been designed to distribute the cost of government activity in proportion to consumption expenditures. In effect, they are designed to do indirectly what a personal expenditure tax will do directly. Commodity taxes may be levied on the production and sale of commodities and are collected from the sellers. Generally, these taxes push up the prices of the goods taxed and consumers bear the tax in the form of higher prices of the goods they buy. Commodity taxation may be sales taxes, excise taxes and customs duties (import and export taxes).

4.4.1. SALES TAX

In a sense, sales tax (also called transfer tax and turnover tax) is as old as organized States. But, as a fiscal measure, it became popular only after the end of World War I. By the end of World War II nearly 30 countries had adopted general sales tax. This was in spite of the opposition to the tax on theoretical grounds. Even in the 1920's, Seligman, a well-known authority on public finance, wrote: "The general sales tax is a discredited remnant of an outworn system; it is essentially undemocratic in nature; and it would, if enacted, exaggerate rather than attenuate the present inequalities of wealth and opportunity”. The main reason why the sales tax, in spite of opposition, has become one of the important sources of public revenue is its high productivity. For governments looking for additional sources of finance to meet their ever-expanding needs, the sales tax was most welcome.

The present day sales taxes may be classified into three major groups.The multiple-stage and single-stage taxes apply to all stages in production and distribution; in other words, to all transactions from initial production to final sale to the consumers. In practice, however, the multiple-stage tax may not apply to all stages; a few stages may be

exempt or may be subject to rates lower than the basic figure. The single-stage taxes apply to commodities only once in production and distribution channels. Such types may be either on the sale by the manufacturer or on the sale by the wholesaler or on the sale by the retailer. Finally, the value-added tax has characteristics of both multiple and single-stage taxes, since "it involves the multiplication of the tax rate but produces the same overall distribution on commodity as a single-stage tax."

Arguments for Sales Tax:

While the proponents of direct taxes have attempted to show that sales taxation-in fact, all indirect taxation-is "irrational in design and unfair and capricious in incidence,"- those who support sales taxation contend that it is the easiest to pay and the least hard on incentives.

(1) The sales tax does not lessen the incentive to save as does the income-tax. The burden of sales tax will be concentrated more heavily upon those persons who will be compelled to reduce consumption more than savings.

(2) Sales tax-in fact, all consumption taxes-is defended on the ground that it makes everyone contribute to the government exchequer.

(3) Sales tax, as also other commodity taxes, are the only way by which the fluid population can be expected to pay towards the general services of the government. The fluid population will consist of all types of persons who come to the towns *from* rural areas arid from other countries not for settlement but for temporary stay.

(4) During the war and other inflationary periods, a general sales tax is defended on the ground that it would check inflationary pressure. But it is possible to argue that sales tax with high rates will induce persons to ask for and secure higher wages and salaries and as a result the inflationary pressure upon prices may be 4ncreased rather than diminished.

(5) The sales tax, like all other commodity taxes, is hidden in the prices of goods purchased and is paid automatically. One of the primary reasons for the rapid development of sales taxes is the relative ease and effectiveness of administration of sales taxation as compared to income taxes.

Arguments against Sales Tax:

The basic and the most widely used argument against sales tax is that it is highly

regressive-it collects more from people with small incomes, than from the rich. Since the tax is shiftable to the consumer, it tends to place a heavy burden on all those whose expenditure on taxable goods constitutes a relatively high percentage of their income. In practice, this results in great injustice. It is a well-known fact that the lower income groups spend a large percentage of their income on consumption and consequently they have to bear a heavy burden of sales taxation.

Further, the sales tax tends to burden large families more heavily than smaller families with the same income. Hence, the sales tax is considered crude and regressive, and from the point of view of equity, is not justified. It may be pointed out further that if the general sales tax includes food and other necessaries also, its regressive nature will further worsen. But most countries generally exclude necessaries from the scope of sales tax.

John Due has given four reasons to show that in practice sales taxes even when levied in the most. Satisfactory from, will result in iniquity:

(a) The taxes are rarely universal so that those who consume only untaxed goods need not bear any, burden at all.

(b) The shifting of the tax is not likely to be complete or exact, so that either the business units will have to bear part of the burden or consumers will have to pay more than the amount of the tax.

(c) Even with complete shifting, the tax may not comprise a uniform percentage of retail prices of various goods.

(d) The sales taxes may result in wage increases which may not be uniform in all cases.

All the above four factors indicate that the burden of taxation will always fall heavily upon the poorer sections of the community and thus sales taxes will be regressive. However, Sales taxation has not only come to stay but has become a very important source of revenue. It can even be used to restrict consumption of harmful goods or some particular items. It can be used as a source of capital formation. It is superior to excise taxation though normally considered inferior to income-tax.

Sales Tax in Developing Countries As has already been indicated, the sales tax does not restrict saving and Capital formation as much as income-tax normally does. In fact, sales taxes falling upon income meant for consumption have the tendency to restrict consumption and thus bring about a higher ratio of saving and capital formation. This

argument has the greatest significance for developing countries because of the latter's low capital equipment in relation to their manpower. Again, in developing economy, sales taxation may be used as an instrument to check inflationary pressures. Sales taxes, along with, other taxes, can be used to mop up the excess purchasing power of the people and also to reduce the demand of the public for goods and services. But such a policy has its own limitations. Finally, the sales tax is ideally suited to a developing country.

(a) The low income groups dominate such an economy and the cost of collection of income-tax will be quite high; accordingly, such a country should depend less on income-tax and more on sales tax.

(b) The standard of tax administration is relatively low in a developing country and consequently increasing reliance on sales tax becomes imperative.

4.4.2. VALUE ADDED TAX:

The VAT belongs to the family of sales tax. A VAT may be defined as "*a tax to be paid by the manufacturers or traders of goods and services on the basis of value added by them*". It is not a tax on the total value of the commodity being sold but on the value added to it by the manufacturer or trader. They are not liable to pay the tax on the entire value of the commodity. But they have to pay the tax only on the net value added by them in the process of production or distribution.

A Tax to be paid by the Manufacturers or Traders of Goods and Services on the basis of Value Added by them

Thus, the value added by them is the difference between the receipts (from the sale) and payments made to various factors of production (land, labour, capital and organisation) in the form of rent, wages, interest, and profits.

4.4.2.1. Forms or Kinds of Value Added Tax:

The value added tax can be determined in different forms. It may vary depending upon the form of tax base. The forms may differ on the items to be included in the tax base.

The common types of VAT are given below:

1. Consumption Type
2. Income Type
3. Production and

Let us explain the meaning of these forms one by one.

1. Consumption Type: In this type of VAT, apart from the non-capital inputs purchased, the capital equipments purchased is also considered. As such, the firm is allowed to deduct the entire value of the capital equipments purchased during the year. This type provides 100% depreciation, which is equivalent to tax exemption.

Thus,
Tax Base = Gross Value - Total Value of Inputs Purchased (Capital and non-capital)

2. Income Type: According to this form, the firm is allowed to deduct the depreciation on the capital goods (during the year) apart from the full value of its non-capital purchases. Here, the firms cannot deduct the entire value of the capital goods purchased during the year but they can deduct the respective amount of depreciation attributable to that year.

Thus, the tax base is calculated as follows:

Tax Base = Gross Value – (Value of non-capital Purchase +Depreciation on
on capital goods for that year)

This variety clearly gives the proper net value added.

3. Production Type: In this type, instead of total value of inputs purchased, the value of non-capital purchases alone is allowed to deduct for determining the tax base. That is, to compute the value added by the firm, depreciation on capital goods is not allowed.

Thus, the tax base under this type will be:

Tax Base = Gross Value - Value of non-capital goods Purchased

Since depreciation is not allowed, it is not considered as a good system and is not popular and universally accepted.

Example: Now we can explain the concepts of VAT with the help of the following example. Let us assume a consumer product is clothing and the number of stages involved is six before it reaches the ultimate consumers and the rate of tax is 10%.

No.	Stage	Receipts Birr.	Value Added	Tax 10%
1.	Farmer	700	700	70
2.	Ginner	1, 000	300	30
3.	Spinner	1, 500	500	50
4.	Weaver	2, 100	600	60
5.	Wholesaler	2, 300	200	20
6.	Retailer	2, 400	100	10
			2, 400	240

In the above example the total value added is Birr.2 400.

From the above table, it can be understood that there are six stages involved in the process of converting cotton into clothing and before it reaches ultimate consumer. The ginner buys cotton from the farmer at a price of Birr.700 per quintal and sells the cotton after ginning to the spinner for Birr.1, 000. The Spinner, for converting the cotton into yarn, has added Birr.500. The weaver converts the yarn into clothing, which he sells to the wholesaler for Rs.2, 100 per bale of clothing. The wholesaler has added value of Birr.200 and sells the clothing to retailer for Birr.2, 300. The retailer finally sells the clothing to the consumer for Birr.2, 400. The remaining value of Birr.100 (difference between price of wholesaler and that of retailer) represents value added by the retailer.

From the above example, it can be observed that the value added tax is assessed at each stage of production and distribution.

Arguments for Value Added Tax

The VAT is supported on the basis of the following arguments:

1. **Easy to Administer:** Since the impact of VAT system is like the single point sales tax system, the administration becomes easier.

2. **Effective and Efficient:** The VAT replaces inefficient and poorly administered taxes such as taxes on capital goods and those that reduce the tax base and involved in difficult administration. Hence, it is considered as more effective and efficient.

3. **Neutrality:** VAT is expected to be perfectly neutral in the allocation of resources i.e. in the forms of production and commercialization. Thus, it helps the economy in adopting the forms of production that are economically more suitable.

4. **Reduce Tax Evasion:** In the case of VAT, the tax is divided into several parts depending on the number of stages of production and sale. Thus, the possibility and intention to evade tax is considerably reduced.

5. **Possibility of Crosschecking:** In VAT system, cross checking becomes possible. When a firm purchases raw material from another firm and pays tax on such purchase, it has to maintain records about from whom it purchased goods and the amount of tax paid by it etc. The firms maintaining these records alone can reclaim the tax already paid. The other firm also has to maintain such records. This obligation makes tax evasion difficult.

6. **Less Tax Burden:** Under VAT, the tax is collected in small fragments at different stages of production and sale. Hence, the taxpayers feel the burden of the tax less.

7. **Encourages Exports:** Under VAT system, the tax burden is less and it reduces the cost of production. Such a reduction in the prices of commodities increases the competitive efficiency of the firms in the global market.

Besides, to promote exports, the Government may refund the taxes paid on the exportable goods. It is possible only when the tax paid is easily identifiable. In the system of VAT, it is easy to separate the tax from the cost of production, which is not possible in the case of other taxes. In this way, it encourages the exports.

8. **Improves Productivity:** In the system of VAT, a firm has to pay tax even though it runs into loss. It cannot claim any exemption for loss because it pays taxes on the value produced and not on profits. So the firms will always try to improve their performance and reduce the cost of production. As a result, the overall productivity of the country will be improved.

9. **Burden of Tax is Shared by all Factors:** The value added tax falls on the wages, interest, rent and profits. As such, the burden of tax is shared by all factors of production.

10. Non-distortionery: Under VAT system, exemption is allowed to the minimum. The tax net is wide enough to cover almost everything. Hence, it proves to be non-distortionnery.

11. Major Source of Revenue: In most of the countries, the value added tax contributes a considerable amount of revenue to the Government. This makes it a reliable and valuable source of revenue.

Arguments against VAT:

VAT system has the following disadvantages:

1. **Not a Simple and Easy System:** VAT System is not easy and simple to adopt in under developed countries where the tax administrative set-up is inefficient and inexperienced to understand any complicated tax structure.

2. **Requires Advanced Economic Structure:** The proper implementation of VAT system requires advanced financial and economic structure and the firm should be in the habit of keeping proper accounts. Hence, it becomes difficult to implement the system in all types of economy.

3. **Possibility of Tax Evasion:** The VAT system largely depends upon the co-operation of the taxpayers because crosschecking is not possible always. Hence, there is a greater possibility for tax evasion.

4. **Uneconomical:** This system involves high cost of administration, assessment, verification, collection etc. Hence, it is highly uneconomical.

5. **Does not Increase Efficiency:** In a scarce economy i.e. economy of shortages where speculation is practiced, hoarding and non-competitive price rise are common, the producers will not increase their efficiency. The goods will be purchased irrespective of their high price and inferior quality. Thus in such an economic condition, VAT will not increase efficiency.

6. **Lesser Revenue:** The revenue collected under VAT system is far less than the revenue collected under the multi-point turnover tax system.

7. **Additional Burden:** Under VAT system, the manufacturers and shopkeepers have to observe various legal formalities in the form of maintaining various records,

accounts books etc. The verification of those records puts additional burden to the tax enforcing authorities.

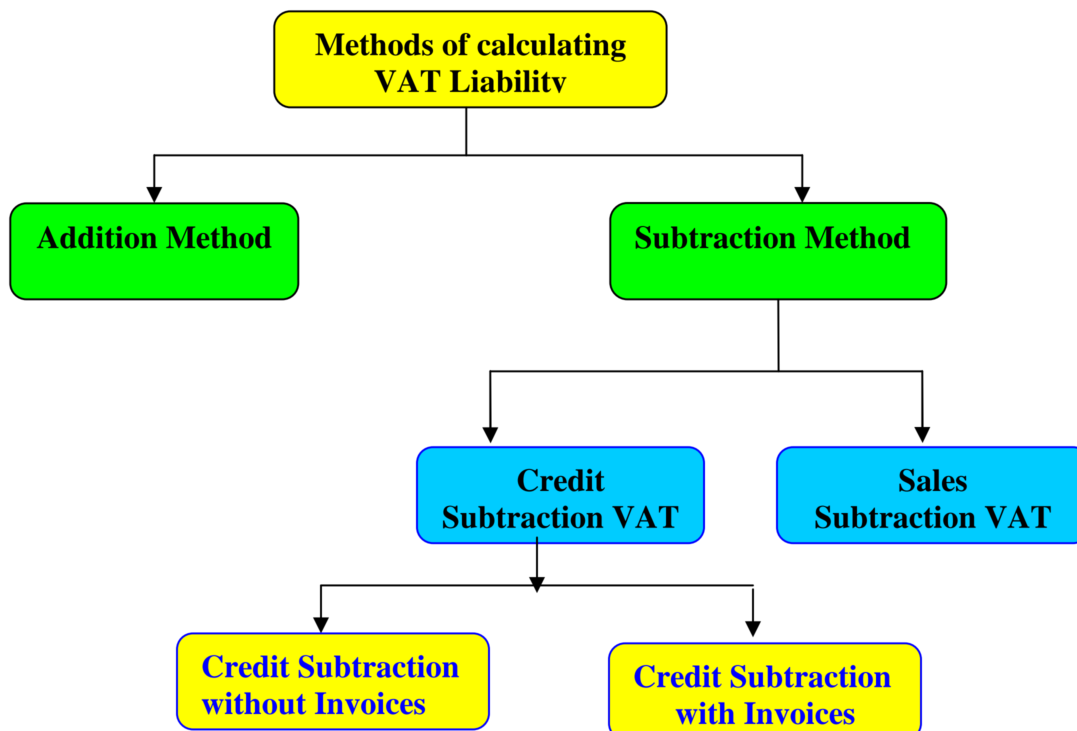
8. **Inflationary in Nature:** Under VAT system, the tax burden will be less which results into surplus income in the hands of consumers. Thus, there is a possibility for wide spread inflation in the economy. But, this argument does not hold good. Because, VAT itself cannot be inflationary and the other accompanying policies of the Government might make it so.

9. **Regressive in Nature:** According to **Allan A. Tait**, a straight forward single rate VAT, with few exemption would tax lower income households more heavily than the higher income household. Thus, it is considered as regressive in nature.

Even though the VAT system is suffering from the above said drawbacks, the benefits sought are more and it can be applied to the Ethiopian economy after rationalisation, modification and restructuring of the system. Various Tax Reforms Committees and other eminent economists advocated this system as suitable to the prevailing economic conditions of the developing countries.

4.4.2.2. METHODS OF CALCULATING VAT LIABILITY:

The value added by a firm can be calculated in any one of the following two methods:



A business subject to VAT can calculate its tax liability under an addition method or one of two subtraction methods.

(i) Addition Method: Under this method, the value added by a firm i.e. the tax base is determined by adding the payments made by the firm to the various factors of production such as wages, rent, interest and profits i.e., add together the various elements that make up value-added. It is not used and has not been proposed at the national level in any country.

(ii) Subtraction Method: In this method, the value added by the firm is determined by subtracting the cost of production from the sales receipts of the firm. That is, subtract the cost of goods purchased from sales the value can be calculated.

The subtraction method can be subdivided in to two methods. They are:

- Credit-subtraction VATs and
- Sales subtraction method.

Again the Credit Subtraction method can be divided in it two, Viz.,

i) Method of Credit Subtraction without Invoices and
ii). Method of Credit Subtraction with Invoices.

The first method of credit subtraction VAT is European style VAT that relies on invoices and is used with some variations almost all over the world. The other method of Credit- subtraction used in Japan as consumption tax does not rely on invoices. The Sales subtraction VAT method is not common in use elsewhere.

Example:

Now we shall explain these concepts with the help of the following example

Let us assume that a business firm "A", sells taxable supplies and makes a taxable sales of Birr.80,000, and has taxable purchases of Birr.50,000 plus Birr.5,000 for the same period. We shall also assume that the firm has imported supplies for Birr.10,000 and paid Birr.1,000 as VAT on import. For this purpose it is assumed that the firm pays Birr.15,000 compensation to workers, pays Birr.3,000 in interest and rent expenses and has Birr.4,000 as a profit for VAT purposes. With a 10% VAT rate, the firm's net VAT liability for the period is Birr.2,000, calculated as follows.

1.Credit Subtraction VAT- Credit Invoice VAT

VAT Liability of Firm "A"

Particulars	Amount Birr.
Output Tax on sales **80,000 x 10% (Rate of Tax)**	**8,000**
Input Credit: **Taxable Purchases - 50,000 x 10%** **Taxable imports - 10,000 x 10%**	**(5,000)** **(1,000)**
Net VAT Liability for the Period	**2,000**

2.Credit Subtraction VAT- Without Invoices

VAT Liability of Firm "A"

Particulars	Amount Birr.
Output Tax on sales 80,000 x 10% (Rate of Tax)	8,000
Input Credit: Taxable Purchases - 55,000 x 10/110 Taxable imports - 11,000 x 10/110	(5,000) (1,000)
Net VAT Liability for the Period	2,000

<u>Subtraction VAT</u>

VAT Liability of Firm "A"

Particulars	Amount Birr.
Taxable Sales	**88,000**
Taxable Purchases: Domestic Imports	 **(55,000)** **(11,000)**
Tax Base	**22,000**
Tax Rate	**9.0909%**
Net Vat Liability for the Period	**2,000**

Addition Method VAT

Particulars	**Amount Birr.**
Taxable Sales	88,000
Expenses:	
Compensation	(15,000)
Interset & Rent Expenses	(3,000)
Purchases	(66,000)
Profit for VAT Purposes	4,000

VAT Liability of Firm "A"

Particulars	Amount Birr.
Compensation	15,000
Interset & Rent Expenses	3,000
Profit for VAT Purposes	4,000
Tax Base	22,0000
Tax Rate	9.0909%
Net VAT Liability for the Period	2,000

Where uniform rates exist *(15%* in our example), the two methods ie., addition and subtraction methods yield identical results in terms of tax revenue. While tax evasion through exaggeration of cost is possible under the first method, it is not possible under the tax credit method, since there is the need to submit vouchers of tax paid. The tax

credit system is, therefore, superior and is being followed in many developed and developing countries.

4.4.2.3. Common Debate on VAT:

In Ethiopia, there is a controversial opinion regarding **"whether VAT increases the selling price for consumer in Ethiopia or not".** It is raised upon the fact that some goods (same brand and quality), which are sold by the VAT registered sellers, are available at lesser prices with the non-VAT registered sellers. In other words, the selling price of some commodities is less with the Non– VAT registered sellers or firms. Of course, it may be true. But, we should know the fact and regulation behind the levy of VAT in Ethiopia. If VAT and Turnover Taxes are levied and implemented on its basic foundation, this type of issue or difference of opinion will not arise and the position will be reverse.

VAT DOES NOT INCREASE SELLING PRICE - EXAMPLE:

Let us now see these concepts with the following example.

There are two firms namely A and B. Of these two firms, Firm- A is VAT registered and Firm-B is VAT unregistered. Let us assume that, their purchases during the period is Birr.5,290 (including VAT) per unit and the value added by them are Birr.500 respectively. Now, we shall see how does the VAT is beneficial to the ultimate consumer. The rate of VAT and Turnover Tax is 15% and 2% respectively.

Computation of Final selling Price

Particulars	FIRM-A (VAT Registered) (Birr)	FIRM-B VAT (Un-Registered) (Birr)
Factory cost (Purchases)	5290	5290
Add: Value Added by the firms	500	500
	5790	5790
Less: Input Credit (VAT) (5290/115) x 15	690	-------
	5100	5790
Add: VAT @15% (5100 x 15%)	765	------
	5865	5790
Add: Turn Over Tax @ 2%	---------	115.8
Final selling Price	5865	5905.8

Note: The Net VAT Liability is equal to the tax calculated on the Value added by the firms. That is, 500 x 15% = 75 [which is equal to Output tax – input tax credit (765 – 690 = 75)].

From the above example, it can be seen that the selling price under non- VAT regime is higher to that of under VAT levied regime. If there is any difference prevailing in the market scenario and shows higher selling price under VAT, then, it is not the flaw on the part of the levy of VAT, but it is in the implementation of the same. The Ministry and the Authorities concerned are vehemently trying and initiating capacity building measures to remove the problems in this regard. After the proper implementation of these measures, all relevant issues will be solved. Hence, it should be noted that the motive of the Government and the Ministry concerned regarding the levy of VAT is not to increase

the selling price, but to ensure the 'ability to pay' principle of taxation and there by maintain the price at the reasonable level. The method of VAT adopted in Ethiopia requires certain reforms to strengthen it further.

4.4.3. EXCISE TAX:

Excise duty can be defined as a tax duty on some produced goods either at some stage of production or before their sale to domestic customers. That is, these taxes are imposed upon the production of particular goods or groups of goods. These goods are intended for sale or consumption with in the country. Excise duties are levied on the production of selected commodities while most of the excise duties are levied by the central government, the state government is also empowered to levy on a few items like liquor, drugs narcotics etc, Excise duties have now become an important source of revenue of the central government. Excise duty is mainly levied with a view of curtailing home consumption so that, more goods are available for export purpose. To discourage the use of scare resources on production of non-essential, luxurious goods this may be imposed. Yet the most important goal is raising revenue for financing various development schemes.

Objectives of Levying Excise Duty:

Excise duty is a duty levied on commodity produced with in 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.

1. Raising revenue for economic growth:

Excise duty provides a rich source of raising revenue for financing economic development of the country. Whenever there is a need for revenue for financing was or development programmer, excise duty is greatly relied upon.

2. Discouraging consumption of non-essential goods:

Whenever excise duties are raised on certain commodities, the prices of such commodities naturally go up. As a result consumption tends to be curtailed. For example, Government may levy high excise duty with a view to curtailing consumption such as cigarettes, liquors etc. which are harmful to health.

3. Discouraging consumption of certain essential goods:

Curtailment of consumption of some essential items leads to saving of domestic resources. This in turn helps exports.

4. Levy of duties where direct taxation is not possible:

Where certain items cannot be brought within the scope of direct taxation, imposition of excise duties brings revenue for the government**.**

5. Curbing inflationary trends in the economy:

Government imposes more excise duties as a means to maintain economic stability. In order to reduce the excess purchasing power of people, during inflationary period, the existing rate of excise duty may be increased. In this way it is used as a measure to curb the inflationary trends in the economy.

6. Promotion of small scale industries

Excise duty helps in promoting village and small scale industries, Government can assist these industries by means of exemption from excise duty or preferential rates of excise duty on the product of village and small scale industries, ie, it helps the small scale industries to face and withstand the competition from large scale industries by increasing the competitive efficiency.

7. Proper allocation of scarce resources:

Imposing high rates of excise duty affects the production. For example, if the burden of excise duty falls heavily on the production of a particular type of goods, the selling price of such goods will be increased. Eventually, the demand for those goods

would come down. As a result of the decreasing demand, the production of these goods is discouraged and the firms engaging in the production of these goods will be induced to produce the essential commodities. Thus, Government can use excise duty as a means to preserve scarce resources of national importance.

The difference between excise and sales taxation is essentially one of degree rather than of kind. While the actual excise taxes are confined to a small number of goods with varying rates, sales taxes are general and apply to a very large number of goods and the rate of taxation will be generally the same. For instance, the excise duty on tobacco may be at one rate, while on matches or petrol may be at a different rate. On the other hand, sales tax may be the same, say 5 per cent, for all the commodities which come under the scope of sales taxation. Again, excise taxes are imposed upon *activities,* while sales taxes are imposed on sales.

In the case of excise duties on luxury goods, the payment is made by the higher income groups who have the ability to pay taxes. In this sense, excise taxes which fall on the rich may be justified from the point of view of equity. If the luxury goods to be taxed are carefully selected, it should be possible to avoid the heavy burden on the poor and the repressiveness of the usual sales taxes. It is also argued that luxury goods are those which are not really necessary for a reasonable living standard and, therefore, expenditure on such unnecessary goods may be deemed as a more suitable basis for taxation than total expenditure. But luxury excises are subject to many limitations:

(a) Luxury excises discriminate between people on the basis of preferences. Those who have higher preferences for certain goods are taxed more while others who may be equally rich but who do not have preference for them, will go tax free.

(b) It is difficult to choose really luxury goods. What is a necessity for one group may be a luxury for another group.

In the case of *sumptuary excises,* main justification is that they prevent the excessive use of certain harmful goods, like liquor, tobacco, etc. The effects of excessive use of liquor upon a person's health or his work or his dependants are well known. Hence, it is easy to justify sumptuary excise.

But these excise taxes are criticized mainly on three grounds:

(a) They place a heavy burden on the great majority of persons who use the

commodities only moderately.

(b) In considering a commodity really harmful or unnecessary, a moral judgment is involved. The use of morality basis of taxation can never be justified in economic theory and is generally regarded as flimsy.

(c) The burden on the lower income groups is very high and hence sumptuary excise taxation is regressive.

Apart from the usual criticisms against sumptuary excise taxation, one criticism which is normally forgotten and hence not properly emphasized but which is equally important is evasion of these taxes. Whenever excise taxes become excessive and oppressive, they lead to illicit production of liquor, bootlegging and smuggling.

The *benefit-based excise taxes* are the least disputed, though, sometimes, they too are criticized. The provision of road is essentially a commercial service which the government provides, and to finance the construction and attendance of which they charge the users of roads through an excise duty on petrol. Petrol consumption varies directly with mileage driven; it is typically greater with more expensive cars than with lighter ones and with heavier vehicles than with lighter ones. Besides, the tax can be collected without any evasion and avoidance.

The primary criticism against excise taxes is based on the ground that they have a tendency to bring about a reallocation 'of resources away from the optimum. For instance, when the prices of particular goods are raised because of imposition of excise' duties, the demand may decline and consequently production may decline too. The sumptuary excises are actually designed to check production of goods which are not conducive to the welfare of the community. But it is not possible to argue in the same manner for other excises. What actually can happen is that when an excise duty is imposed upon the sale of a particular commodity, some of the marginal buyers will cease to buy the commodity or will buy less of it and buy other commodities instead. Accordingly, they have failed to obtain optimum satisfaction from their incomes, not only that, the government will not have gained any revenue. Thus, as a result of the excise duty, the production of other goods will increase and if previously the economy has achieved optimum allocation of resources, a poorer allocation will result because of the imposition of the excise duty.

4.4.4. Customs 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.

CHAPTER-V

TAXATION SYSTEMS

5.1. PROPORTIONAL, PROGRESSIVE AND REGRESSIVE TAX SYSTEMS

The ability to pay taxes can be accurately measured with net income. It may be considered as an appropriate basis for the allocation of tax burden between different sections of the society. To determine the appropriate tax system, various factors are to be considered.

The tax systems may be summarized as follows:

1. Proportional Tax System.
2. Progressive Tax System.
3. Regressive Tax System.

Let us explain these systems one by one in detail.

5.1.1. Proportional Tax System:

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

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

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

Those who oppose a flat tax claim that it will benefit the rich at the expense of the poor. One argument is that, since most other taxes (sales taxes etc.) tend to be regressive

in practice, making the income tax flat will actually make the overall tax structure regressive (i.e. lower-income people will pay a higher proportion of their income in total taxes compared with the affluent). Another argument can be made by looking upon the value of money to various groups and not simply the rate of taxation. While the monetary value of a dollar (or other unit of currency) is the same for everyone, it is clearly "**Worth**" a lot more to someone who is struggling to afford food than to a millionaire. Taxing everyone at the same rate ignores the fact that richer people can give up more of their income, without ill effects. Moreover, it is debatable whether a flat tax would substantially simplify the tax system.

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

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

Tax Payable = Tax Base X Tax Rate

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

Economically, it can be explained as follows:

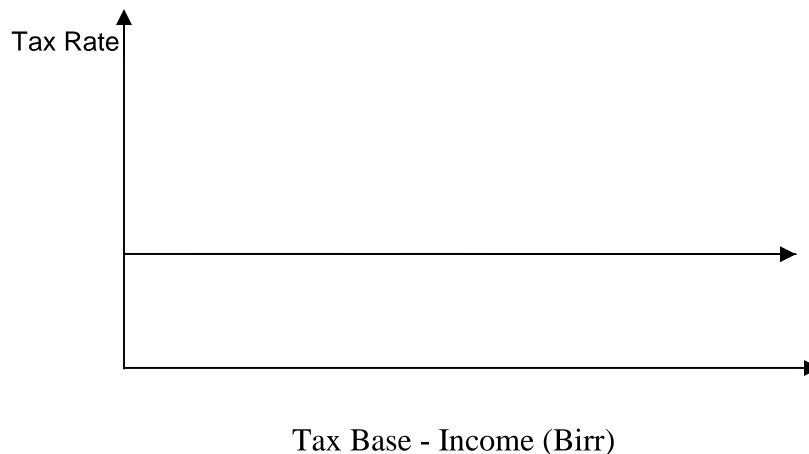
Example: Proportional Tax System:

Proportional Tax System

Tax Base Birr	Tax Rate in %	Amount of Tax (in Birr)
1500	10	150
6500	10	650
14000	10	1400
23500	10	2350
35500	10	3550
50000	10	5000

Table 2.1 - Proportional Taxation

Graphically, it can be explained as follows:



Tax Base - Income (Birr)

FIG. 5.1 - PROPORTIONAL TAX SYSTEM

Merits of Proportional Tax System:

Proportional tax system has the following advantages:

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

Limitations of Proportional Tax System:

The following are the demerits of proportional tax system:

1. **Inequitable Distribution:** A system of proportional taxation would not lead to an equitable and just direction of the burden of taxation. This is because it falls more heavily on the small incomes than on the high incomes.

2. **Inadequate Resources:** The system of proportional taxation means that the tax rates for the rich and poor are the same. Hence, the government cannot obtain from the richer sections of the society as much as they can give.

3. **Inelastic in Nature:** Proportional tax system is inelastic in nature, because the government cannot raise the rate whenever it wants to raise the revenue. Proportional tax system suffers from the defects of inequitable distribution of the tax burden, lack of elasticity and inadequacy of funds for the increasing needs of the modern government. Hence, it is not practically and universally accepted.

5.1.2. Progressive Tax System:

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

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

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

The rates of taxation increases as the tax base increases. This can be explained mathematically as follows.

The amount of tax payable is calculated by multiplying the tax base with tax rate as shown below:

Tax Payable = Tax Base x Tax Rate

In this case, "*the multiplier increases as the multiplicand (*income*) increases*".

Economically, this can be explained as under:

Progressive Tax System

Employment income		**Income Tax (per month) payable**
Over Birr	**to Birr**	%
0	150	**Exempt threshold**
151	650	10
651	1400	15
1401	2350	20
2351	3550	25
3551	5000	30
Over 5000	****	35

Table 2.2 - Progressive Taxation

From the above example, we can easily understand about the progressive tax system where the rate of tax increases with the increase in tax base.

Graphically, it can be explained as follows:

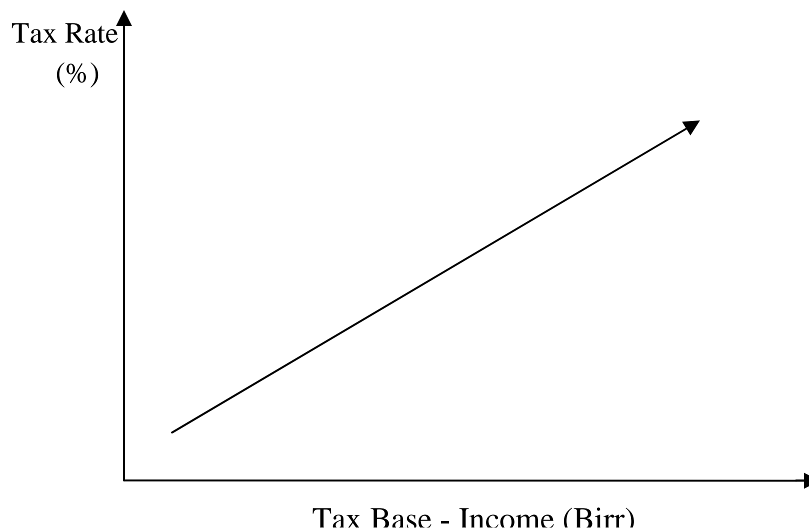


Fig. 5.2 – Progressive Tax System

Merits of Progressive Tax System:

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

1. Equality in Sacrifice: Under progressive tax system, the rate of taxation increases as the tax base increases. That is, the burden of taxation is heavy upon the rich

than on the poor. People with higher income tend to have a higher percentage of that in disposable income, and can thus afford a greater tax burden. Thus, this system secures equality in sacrifice by ensuring the principle of ability to pay.

2. **Reducing the Inequalities of Income and Wealth:** Progressive tax system serves as a powerful instrument for reducing the inequalities of income and wealth.

3. **Economy:** In the progressive system, the cost of collection does not increase with the increase in the rate of taxes. Hence, it is justified on the grounds of economy.

4. **Elastic:** Progressive tax system is elastic in nature to meet the increasing public expenditure. The government can easily raise its revenue by increasing the rates of taxes. In the case of progressive taxation, raising the rates for the higher status alone can raise more revenue.

5. **Stabilising the Economy:** Progressive tax system may be helpful in preventing the inflationary trends in the economy as it reduces the disposable income and purchasing power of the people. Thus, the inflationary trends can be checked and the economic stability can be achieved.

Limitations of Progressive Tax System:

The following are the demerits of progressive tax system:

1. **Ideal Progression is Impossible:** The main drawback of progressive taxation is that it is difficult to frame an ideal graduated progression in tax rates. They are arbitrary depending on the government's need for additional funds without taking into account the burden of people with different incomes.

2. **Progressive Taxation - a Graduated Robbery:** Progressive taxation is an unjust mode of taxation and a graduated robbery.

3. **Disincentive to Work:** It is argued that too progressive a tax rate acts as a disincentive to work.

4. **Discourages Savings and Investments:** Very high rates of progressive taxes used to discourage savings and investments. Since a major portion of the income is taken away by the state by way of taxes, the incentives to produce more and earn more are lost.

5. **Shifts the Total Economic Production of Society:** The progressive tax system shifts the total economic production of society away from capital investments (tools,

machinery, infrastructure, research etc.) and toward present consumption goods. This could happen because high-income earners tend to pay for capital goods (through investment activities) and low-income earners tend to purchase consumables. Since, progressive tax system discourages savings and investments the shifting of economic production of society could happen. Smithian theory says that spending more on consumption goods and less on capital goods will slow the rise of the standard of living.

5.1.3. Regressive Tax System:

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. Larger the assessee's income or property, the lower the percentage that he pays as tax in regressive taxation.

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

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

Tax Payable = Tax Base x Tax Rate

The schedule of regressive tax rate is one in which the rates of taxation decreases as the tax base increases. The following table and diagram will explain the concept of regressive taxation.

Regressive Tax System

Income Birr	Rate of Tax (%)	Tax To be Paid (Birr)
4000	20	800
6000	15	900
12000	12	1440
15000	10	1500

Table 5.3 - Regressive Taxation

Diagrammatically, it can be explained as follows:

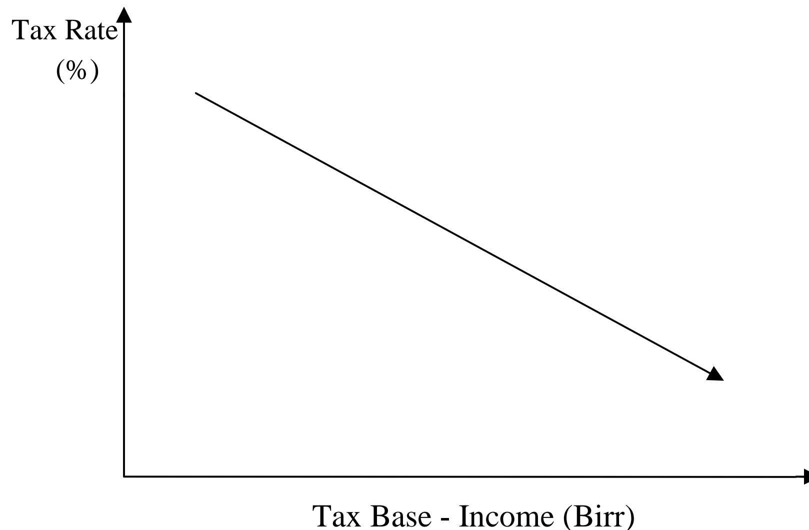


Fig. 5.3 – Regressive Tax System

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

Even non-income taxes can 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.

5.1.4. DEGRESSIVE TAX SYSTEM

Under this system, the rate of tax is mildly progressive up to a certain limit and thereafter it may be fixed at a flat rate.

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

$$\text{Tax Payable} = \text{Tax Base} \times \text{Tax Rate}$$

The concept of degressive taxation can be explained with the help of the following table.

Tax Base Income (Birr)	Tax Rate %	Tax Liability (Birr)
4000	20 %	8, 000
6000	21 %	12, 600
12000	22 %	26, 400
15000	23 %	34, 500
20000	23 %	46, 000

TABLE- 5.4. DEGRESSIVE TAXATION

Diagrammatically, it can be explained as follows:

Fig. 5.4. - Degressive Taxation

This system is not popular and is universally not applicable.

5.2. ADVALOREM AND SPECIFIC DUTIES.

There are two kinds of duties levied on the commodities. Generally, it is levied on the goods crossing the national boundaries. They are:

1. Advalorem duty - on the basis of value.

2. Specific duty - on the basis of measurement.

5.2.1. Advalorem Duty:

It is levied on the basis of value of the commodities. Advalorem means, "**In proposition to value**". This is levied as a certain percentage on the value of commodity to be taxed. For example, when a TV set is imported, customs duty may be levied at say 200 % on the value of the TV set. The weight, length or bulky of the goods imported are irrelevant for this purpose. Thus duty payable will be calculated only on the total value of the goods to be taxed and not on its weight, length, bulky etc.

5.2.1.1. Merits of Advalorem Duty:

Advalorem duty is recommended for the following reasons:

1. **Value of the Commodities can be Easily Found Out:** Customs duty under this form is imposed on the value of commodities. The value of imported articles can be more easily found than their weight, size, bulky etc.

2. **Keeps the Tax Burden Steady:** Advalorem duty keeps the burden of tax steady. During the times of boom, the tax liability tends to rise and in times of recession, the tax liability also goes down.

3. **Higher Revenue during Inflation:** Advalorem duty brings higher revenue during the periods of rising prices, because when the price tends to increase the revenues yield also increases.

5.2.1.2. Demerits of Advalorem Duty:

The following are the important drawbacks of advalorem duty:

1. **Difficult to Administer:** Advalorem duty is very difficult to administer. Under this form, customs duty is imposed on the value of the commodity. But in practice, it is

very difficult to estimate the value of thousands of articles imported from a large number of countries.

2. **Difficult to Estimate Value:** Even if the value of goods is ascertained, there is a chance for controversy whether F.O.B. (Free on Board) or the C.I.F. (Cost Insurance Freight) or local selling price should be taken into account for levy of duty.

3. **Difficult to Predict Quantum of Revenue:** The Government cannot correctly predict the quantum of revenue yield from customs duties since under the advalorem basis, revenue yield will rise or fall depending on the rise or fall of the value of goods. Hence, there is no certainty with regard to the rationalisation of budget estimate of this revenue.

5.2.2. Specific Duty:

It is levied as to the weight, length, bulky or some other unit of measurement of the commodity concerned. The value of goods imported or exported is not important for this purpose. Only weight, length, bulky etc. of the commodities decide the quantum of duties.

5.2.2.1. Merits of Specific Duty:

1. **Less Chance of Tax Evasion:** Specific duty is imposed on units of measurement, which are easily ascertainable. So, there is less chance of tax evasion.

2. **Easy to Administer and Collect:** Specific duties are easier to administer and collect. Once it is possible to identify the goods, it is easy to administer and collect.

3. **Certainty in the Amount of Duty:** Specific duty helps the importer to know exactly the amount of duty he will have to pay in respect of consignment. For example, when he imports certain quantities of oil, he can easily and correctly calculate the amount of duty, as it is related to the quantity of oil imported.

4. **Certainty in the Quantum of Revenue:** Government can also easily predict the quantum of revenue yield from customs duties, because these are related to quantity of the goods to be imported.

5.2.2.2. Demerits of Specific Duty:

1. **Static in Revenue Yield:** Specific duties keep the revenue yield static in nature i.e. it will not generate large volume of revenue during the inflationary periods.

2. **Tax Burden Increase in Depression:** Tax burden of specific duties increases in depression. In time of recession, specific duties tend to increase the tax burden, because there is an overall downward trend in prices, taxes will be imposed only on the basis of the commodities' weight or length or bulky etc., and not on the actual value of the commodity.

5.2.3. Differences between Advalorem Duty and Specific Duty:

Advalorem duty is levied on a certain percentage on the value of the commodity to be taxed and weight, length or bulky of the goods are not important for this purpose. Specific duty is levied according to the weight, length, bulky or some other unit of measurement of the commodity concerned.

The following are the differences between advalorem and specific duty:

DIFFERENCES BETWEEN ADVOLEROM AND SPECIFIC DUTY

ADVALOREM DUTY	SPECIFIC DUTY
1. Basis of levy	
Advalorem duty is levied on the certain percentage on the value of commodity to be taxed	Specific duty is levied as to the weight, length, bulky, etc. of the commodity to be taxed.
2. Administration of Duty	
It is very difficult to administer. Thus the duty is levied on the value of commodity. But, in practice it is very difficult to estimate the value of thousands of commodities imported from a large number of countries	It is easier to administer and collect. Once it is possible to identify the goods, it is easy to levy and collect tax.

3. Prediction of Quantum of Revenue	
Under advalorem duty, the government cannot correctly predict the quantum of revenue yield	Under specific duty, the Government can easily predict the quantum of revenue yield.
4. Chance of Tax Evasion	
Under advalorems duty, the government cannot correctly predict the quantum of revenue yield.	Under specific duty, unit of measurement of commodities i.e weight, length, bulketc, can be ascertained at any time. Hence there is less chance of tax evasion.
5. Tax Burden	
Advalorem duty keeps the burden of tax steady i.e during the times of boom the tax liability tends to rise in time of recession, the liability also goes down.	Specific duty does not keep the tax burden steady. For example, in time of recession, there is an overall downward trend in prices, tax will be imposed only on the basisi of commodities weight, lengthetc, and not on the value of the commodity. Hence, specific duty increase the tax burden during that period.
6. Revenue Yield	
Advalorem duty brings higher revenue during the period of rising prices. Because when the price tends to increase, the revenue yield also increases.	Under specific duty, revenue yield is of static in nature.

5.3. Single Point and Multi-point Tax Single Point tax

5.3.1. Single Point Tax:

Single Point taxation means imposition of tax at only one point between the production and the sale of goods to ultimate consumers. The tax is levied at only one point between the point of production (first point) and the point of ultimate sale to consumption (final point). At the first point, sales tax for example is levied, when the sale

of commodity takes place for the first time in the territorial limit of the concerned State. At the final point, the tax is imposed at the last stage of sale to the consumers. Thus, a single point tax is levied either at the first stage or at the final stage.

5.3.2. Multi-Point Tax:

Multi-point taxation means that the tax is levied at all stages of sale of the commodity. Tax is levied and collected whenever goods are sold at every point of sale.

5.3.3. Difference between Single Point Tax and Multi-point Tax:

The following are the differences between Single Point Tax and Multi-point Tax systems:

1. **Facility of Collection:** Single point tax is easy to enforce and collect, but multi-point tax is difficult to enforce and collect because of number of points at which it is collected.

2. **Payment of Tax on Tax:** Under single point tax system, tax is paid on the price of the product, which does not include tax as one of its component. Hence, the payment of tax on tax is not occurred, whereas in multi-point tax system in each subsequent point, tax is paid on the price which includes the tax paid at the proceeding points also. Thus, the payment of tax on tax is occurred.

3. **Point of Levy:** Under single point tax system, the tax is levied at only one point either at the first point or at the final point, whereas under multi-point tax system, the tax is levied at all points of sale till it is sold to the consumers.

4. **Capital Requirements:** In single point sales tax system, the capital requirements are low. But in multi-point sales tax, the manufacturer or dealer of every stage is required to raise capital not only for the actual cost of manufacture or purchase but also for payment of tax. As a result, interest on such additional capital also becomes a part of the cost at this point and which has a further rise in price. Hence, the capital requirement under this system is high.

5. **Price for the Consumer:** Under single point tax, the price paid by the consumer is less than the price paid under multi-point tax system. The price paid by the consumer under multi-point sales tax includes cost of the products and tax paid by the previous sellers. The price paid by the consumer under multi-point sales tax is more than price paid under single point tax.

6. Quantum of Revenue: From the revenue angle, single point system generates less amount of revenue when comparing with multi-point tax system. In multi-point tax system, more revenue can be raised than that of the single point tax system.

7. Chance for Tax Evasion: Under single point tax system, the possibility for tax evasion is more, whereas under Multi-point tax system, it is difficult to evade tax.

8. Rate of Tax: Usually, under single point tax system, the rate is high, whereas in the case of multi-point tax system, the rates of taxes are low.

9. Administration: The number of dealers to be assessed under single point tax is very small. Hence, it is convenient to administer this system.

But the administration of multi-point tax is difficult because large number of dealers is to be dealt with.

10. Exemption: The number of goods exempted under single point tax is more.

But the number of goods exempted under multi-point tax is less.

5.4. Types of Tax Rates:

The different types of tax rates are as follows:

1. Statutory Rate:

The Statutory rates are the rates imposed by the statute or Laws or Proclamations. For example in Ethiopia the following are the statutory rates for Income tax under Income tax Proclamation.

Schedule A

Employment income		**Income Tax (per month) payable**
Over Birr	**to Birr**	%
0	150	**Exempt threshold**
151	650	10
651	1400	15
1401	2350	20
2351	3550	25
3551	5000	30
Over 5000	****	35

2. Marginal Rate:

The Marginal rates are the rates imposed on each additional Birr earned within each tax bracket.

Example: Ato.Mesfin has the actual income of Birr.6400.The deductions and exclusions as per Income Tax Proclamation amounts to Birr.2400.
His taxable income = 6400-2400= 4000.

His tax liability:

-0 % on first	-------------------	150 Birr =	Nil
-10 % on next	-------------------	500 Birr =	50
-15 % on next	-------------------	750 Birr =	112.5
- 20% on next	--------------------	950 Birr =	190
-25% on next	---------------------	1200 Birr =	300
-30% on balance (4000-3550)---		450 Birr =	135

Total Tax liability			787.5
			=======

Here, in this case, Marginal Tax Rate = 30%

3. Average Rate:

Average tax rate is the fraction of total income earned that is paid in taxes. It is not our income per se, but our income as determined by the Proclamation.

Average tax rate = tax paid / Taxable Income x 100

= 787.5/ 4000 x 100 = 19.69%

4. Effective Rate

Effective tax rate is calculated as follows:

Effective rate = tax paid / actual income x 100

Effective rate = tax paid / actual income (787.5 / 6400) x 100 = 12.3%

CHAPTER –VI

FEDERAL FINANCE

6.1. Federalism:

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

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

6.2. Federal Finance:

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.

6.3. 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.

6.4. 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.

6.4.1. Balancing Factors of Allocation:

Prof. Adarkar points out that it would be impossible to think about an independent system. The most desirable system of federal finance must ensure large measure of independence and adequacy. If either the centre or the states are not able to meet their

requirements, it should be made good by certain balancing factors. The balancing factors are those, which would make good the financial inadequacy of either the centre or the states in a federation. They are as follows:

1. **Assignments:** Usually the Federal Government levies and collects certain taxes. But it is shared on an agreed basis with the states. Of course the distribution of this share between the states is very difficult. The basis of distribution may be as follows: 1.On the basis of actual collections from different states. 2. On the basis of population and 3.On the basis of economic backwardness of the states.

2. **Subsidies:** The states very often find themselves with financial stringency. They are granted certain subsidies by the center on account of the transfer of certain sources like customs or excises to the center.

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

These are the bases and modes of allocation of funds between the center and the states. The distribution of financial sources in Ethiopia is based on the recommendations of the Ministry of Economic Development.

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

Ours is a system of federal finance, with center and states sharing responsibilities and resources. The areas of the government's budgetary operation (i.e. receipts and expenditures) between the centre and the states are demarcated. In addition there takes place financial transfer from the centre to the states. The sharing implied in the system

has contributed a lot to the country's progress. But this has also given rise to many problems relating to center-state relationship.

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

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

6.4.2. Disbursing and Transfer of Public Funds:

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

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

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

6.4.3. Pattern of Revenue Sharing:

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

6.5. Distribution of Revenues between Central and States:

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

6.5.1. Objectives of Revenue sharing:

The sharing between the central government and the National/Regional Governments shall have the following objectives:

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

6.5.2. Basis for Revenue Sharing:

The sharing of revenue between the central government and the National/ Regional governments shall take in to consideration the following Principles:

1. Ownership of source of revenue;

2. The National or Regional character of the sources of revenue;
3. Convenience of levying and collection of the tax or duty;
4. Population, distribution of wealth and standard of development of each region;
5. Other factors that are basis for integrated and balanced economy.

6.5.3. Categorization of Revenue:

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

1. Central List,
2. Regional List, and
3. Joint/Concurrent List.

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

6.5.3.1. Central List:

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

a). Duties, tax and other charges levied on the importation and exportation of goods;

b). Personal income tax collected from the employees of the central Government and the International Organizations;

c). Profit tax, Personal income tax and sales tax collected from enterprises owned by the Central Government. (Now sales tax is replaced with VAT and Turnover taxes).

d) Taxes collected from National Lotteries and other chance winning prizes;

e). Taxes collected on income from air, train and marine transport activities;

f). Taxes collected from rent of houses and properties owned by the central Government;

g) Charges and fees on licenses and services issued or rented by the central Government;

6.5.3.2. Regional List:

The following shall be Revenues for the Regions:

a). Personal income tax collected from the employees of the Regional Government and employees other than those covered under the sources of central government.

b) Rural land use fee.

c) Agricultural income tax collected from farmers not incorporated in an organization.

d) Profit and sales tax collected individual traders.

e) Tax on income from inland water transportation.

f) Taxes collected from rent of houses and properties owned by the Regional Governments;

g) Profit tax, personal income tax and sales tax collected from enterprises owned by the Regional Government:

h) With prejudice to joint revenue sources, income tax, royalty and rent of land collected from mining activities.

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

6.5.3.3. Joint/Concurrent List:

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

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

b) Profit tax, dividend tax and sales tax collected from Organizations;

c) Profit tax, royalty and rent of land collected from large scale mining, any petroleum and gas operations;

d) Forest royalty.

6.5.4.Committee for Revenue sharing:

1. A committee accountable to Council of Ministers, whose function is to study conditions and submit recommendations guiding sharing of revenue shall be designated by the Prime Minister.

2. Members of the committee shall be:

a) Central Government representatives concerned and;

b) Representative of the regional executive committee concerned with the agenda to be discussed.

3) Based on the objectives and principles indicated under this Article the committee shall study and submit its recommendations to the Council of Ministers on:

a) the percentages in which the joint revenues of the central Government and the National/Regional Governments shall be shared;

b) measures for resolving issues that may from time to time arise regarding sharing of revenues;

c) amendments or changes, as the case may be, to the revenue categorization.

4) The details of the duties and responsibilities of the committee shall be defined by the directives, to be issued by the council of ministers.

6.5.5. Subsidy:

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

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

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

6.5.6. Relations of Tax Systems:

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

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

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

6.5.7. Collection of Revenue:

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

National/Regional Governments shall collect their own revenues.

Let us see the present position of revenue sharing arrangements between Federal Government and Regional States regarding jointly established companies, Private companies and Minerals and petroleum.

SHARING OF REVENUE BETWEEN FEDERAL GOVERNMENT AND REGIONAL STATES

Sl.No	Types of Joint Revenue	Revenue Sharing Formula	
		Federal Government	**Regional States**
1.	**Jointly Established Companies**		
	1.1. Profit Tax	As per Capital Share	As per Capital Share
	1.2. Employee Income Tax	50%	50%
	1.3. Indirect Taxes	70%	30%
2.	**Private Companies**		
	2.1. Profit Tax	50%	50%
	2.2. Indirect Taxes	70%	30%
	2.3. Dividends	50%	50%
3.	**Minerals and Petroleum**		
	3.1. Profit Tax	50%	50%
	3.2. Royalty	60%	40%

CHAPTER-VII

TAX EVATION, AVOIDANCE AND BLACK MONEY

7.1. TAX AVOIDANCE AND EVASION:

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

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

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

7.1.1. Tax Avoidance:

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

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

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

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

Examples for Tax Avoidance:

The following are the examples for tax avoidance:

1. Suppose a taxpayer's total income exceeds the maximum tax-free amount, then he has to pay the tax on such excess amount. But if he invests the excess amount in any of the approved schemes for which there is a relief in the tax law, he can save on tax altogether.
2. An individual sells his let out house property (long-term capital asset) for Birr.2,00,000 making a capital gain of Birr 60,000. This capital gain would normally be taxed. But, if he invests the sale proceeds in a particular manner stipulated by law, he need not pay any tax.
3. Divorcing the wife on paper so that her income is not added together with husband's income is also a common device for tax avoidance.

7.1.2. Tax Evasion:

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

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

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

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

Examples for Tax Evasion:

The following are the examples for tax evation:

1. A trader makes a sale for Birr.20, 000 and does not account it, in his books under sales. He is evading tax.
2. An individual lends his money of Birr.50, 000 to another person at 20% interest per annum and does not include this income in his total income.
3. Under-invoicing of sales and inflation of purchases.

4. A manufacturing business employs 30 workers but include 2 more additional namesake workers (not in actual) in the muster roles. The sum shown as paid to such additional namesake workers will amount to evasion.

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

7.2. Causes of Tax Evasion:

The following are the important causes for Tax evasion:

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

2. **Complicated Tax Laws:** Complicated tax laws are another reason for tax evasion. The tax laws contain a number of exemptions, deductions, rebates, relief, surcharges and so on. 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.

3. **High Rates of Taxation:** High rates of taxes cause widespread tax evasion, because the greater the risk undertaken for the purpose of tax evasion, the greater is the reward.

4. **Inadequate Information as to Sources of Tax Revenue:** Lack of adequate information as to the sources of revenue also contributes to tax evasions. In Ethiopia, small businessmen and farmers rarely maintain any accounts of their income.

5. **Investment in Real Property:** Investment in real property, both movable and immovable, and concealment of its true ownership have also been a major cause for tax evasion. All these facilitate the channelising of black money into profitable ways.

6. **Ineffective Tax Enforcement:** Lack of proper training and efficiency for the authorities enforcing the tax laws is also a major cause for widespread tax evasion.

7. **Deterioration of Moral Standards:** There has been deterioration in standards of moral 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.

7.3. Remedies for Tax Evasion:

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

1. **Thorough Overhauling of Tax Laws:** One of the main reasons for tax avoidance and tax evasion is loose drafting of tax laws which contain several loop-holes and weak points that enable the tax evaders to carry on the unlawful activities. Hence, it is necessary to re-draft the tax laws thoroughly without any loopholes and weak points.

2. **Reduction in Tax Rates:** The prevalence of high rates is the first and foremost reason for this tax evasion. Hence, the rate of tax should be reduced to a reasonable level.

3. **Replacement of Sales Tax & Excise Duties with VAT:** As the crosschecking is possible in the case of VAT, it is more effective. Hence, such tax can be introduced instead of sales and excise duties.

4. **Tax on Agricultural Income:** Agricultural income is exempted from income tax and for this reason it is used to convert the black money into white. In recent years, agricultural farms and orchards, and vineyards have come to be acquired by industrialists; film stars etc. because this enables their owners to whiten their black money. Tax evasions can be avoided by taxing the agricultural income at normal rates.

5. **Maintenance of Proper Accounts:** Maintenance of proper accounts should be made compulsory for persons whose business and professional income exceeds a prescribed limit. In the Income Tax law, a provision to this effect has been introduced recently.

6. **Introduction of Expenditure Tax:** In Ethiopia, expenditure tax is levied in the form of commodity taxation such as excise duties, VAT, Turnover tax etc. There is no personal expenditure taxation. However, it is 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.

7.4. BLACK MONEY:

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

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

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

7.4.1. Black Economy:

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

7.4.2. Black Income and Black Wealth:

The National Institute of Public Finance and Policy of India in its report makes a distinction between the black income and the black wealth. Conceptually, the black income is a flow and the black wealth is a fund or stock. The black income is generated over a period of time. The black wealth is an accumulated unaccounted income at any given point of time. The black money is black wealth held by the public in terms of currency as well as liquid bank deposits. A large portion of black wealth is held in the form of real estate, gold jewellery, stocks in business, benami financial transactions, cash, inventories and foreign currencies and undisclosed holdings of foreign assets.

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

7.4.3. Black Economy and Black Money:

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

The black economy is said to have taken birth during the Second World War. In scarcity conditions, controls on the distribution and prices of goods in short supply led to the emergence of black markets and hoarding. Black market prices, which were higher than the controlled prices, led to the emergence of "**Black Incomes**", popularly called "**Black Money**" or "**Number Two**" income.

Dr. Raja Chelliah defines the black money income as "*the sum total of transactions deliberately kept out of the books of accounts by household and business in the economy*".

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

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

7.5. Impact of Black Money in Ethiopian Economy:

The effects of the black money are considered significant on the basis of the following:

a) Significant size compared to other major sectors or the size of the government.
b) White economy cannot act as a proxy for the total economy.
c) Economic laws applicable to the totality of the economy and not a part of it.
d) Sectoral implications.
e) Failure of policy linked to it.
f) Has led to a change in the economic policy paradigm.

7.5.1. Macro Economic Impact of Black Money:

The black money has the following macro effects on the economy:

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

7.5.2.Micro Economic Impact of Black Money:

The black money has the following micro effects in the economy.

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

7.5.3.Measurement or Estimation of Black Money:

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

Measuring black income is not an easy task. This may be due to non-availability of reliable data. A number of individual and institutional efforts have been directed towards measurement of size and growth of black income in Ethiopia. To examine this serious national problem the Government of Ethiopia has made many efforts from time to time for estimating and control of black money. It is difficult to know the exact holdings of black money. But, from the several guesswork and estimates, it is evident that black money is of a high magnitude in the Ethiopian economy and has been expanding at a rapid rate over the last two decades.

There are several alternative approaches to the estimations of black income. They are as follows:

1. Expenditure Approach.
2. Fiscal Approach.
3. Monetary Approach.
4. Physical input Approach.

5. Labour-market Approach.
6. National accounts Approach.

7.6. Sources of Black Income:

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

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

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

Hereunder, we shall discuss the important sources of generating black money in detail.

7.7. Sources Generating Black Money:

7.7.1. Evasion of Income Tax:

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

1. **Suppressing True Income:** It is well known that a large part of black income comes through illegitimate sources, whether it is bribes, smuggling, black marketing or other such sources. Professionals like lawyers, doctors, architects, businessmen and even film stars and film producers are examples where the sources are legitimate but income is suppressed to evade tax.

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

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

7.7.2. Evasion of Excise Tax:

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

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

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

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

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

7.7.3. Evasion of Customs Duties:

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

1. **Under Valuation:** This is done by under-invoicing of imports, usually by arrangement with the foreign supplier of goods who, mostly, willingly obliges the importer, pays in foreign currency the full difference between the actual price and the lower invoiced price of the goods imported.

2. **Misclassification/Wrong Declaration of Goods:** False declarations about goods imported in the documents submitted to the customs are made and higher-duty goods are cleared on payment of lower duty charged on the wrongly declared goods.

7.7.4. Trade Controls and Foreign Exchange Leakage:

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

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

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

7.7.5. Smuggling:

Smuggling refers to the illegal import or export of goods. The numerous controls and tariffs create profitable opportunities for trade by smugglers in several goods. It is generally said that the smuggling of goods into the country is more serious than the latter. Smuggling has, over the years, expanded at such a high rate that it has even attained the title of the "**Third Economy**". Affluent sections of society whose wealth has increased rapidly - mainly through black income provide a ready market for smuggled goods. We can thus say that all factors responsible for growth of black income activities in the economy also encourage the increased smuggling of goods in a country by creating a demand for these goods. Smuggling causes loss of revenue to the Government (through evasion of customs duty, excise duty and income and wealth taxes), large illegal outflows of foreign exchange and result in large amassing of funds by smugglers. These funds are not put to any socially productive use or investment.

7.7.6. Price and Distribution Controls:

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

7.7.7. Industrial Licensing:

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

7.7.8. Other Sources:

1. **Urban Real Estate:** Transactions in urban real estate generate a large amount of black income every year. There could be many frauds in this business. First, there could understand the value of a transaction to evade a large part of tax liability. Second, encroachment on public land; third, acquisition of raw land for resale as housing plots, developments of this land for setting up a colony, sale of plots or houses or flats constructed on it, exceeding the legally permissible limit of the built up area on a given plot of land. All these-specifically, understanding the value of all such transactions-lead to black gains. Another method is to under-report rents. Benami transactions are rampant, as is the role of "**Black Money**" in the acquisition of urban real estate.

2. **Leakage from Public Expenditure and Property:** These leakages take the form of illicit, and undeclared commissions or bribes (kickbacks or cuts). Also, most of the time, allocated funds for various anti-poverty programs never reaches the targeted people. Another aspect is pilferage or misappropriation of State Property.

3. **Bribes:** Bribes as a source of black income are common. These are used mainly to influence the decision of the authority dealing with a case, or the power to approve or recommend an application or even to forward case files. This phenomenon of bribe taking leads to the spread of corruption from one work place to another.

7.8. Causes of Black Money:

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

1. **High Rates of Taxation:** High rates of taxation are basically responsible for inducing tax evasion and consequent black money generation in the country. The prevailing high rates of taxation the economies are one of the main causes of black money.

2. **Corrupt Business Practices:** The corrupt business practice such as smuggling and other restrictive trade practices cause the existence of black money in the country. In an economy under the environment of scarcities, controls and inflation, hoarding and black marketing are always profitable which apparently generate black incomes.

3. **Controls and Regulations:** Though the Governments resorts to the economic policy of controls with a good intention of dealing with the problem of shortage and

effecting a fair distribution of essential goods with equity, their improper implementation vitiates the very purpose of controls. In many countries, the Government fixed up prices of various essential consumer goods like kerosene, wheat flour, vegetable ghee, drugs, etc. Their prices are controlled and the distribution is regulated. Along with various controls on imports and exports, tight exchange control is also implemented. Such controls are implemented with licenses, permits and quotas. Thus there have been statutory controls combined with the bureaucratic and administrative controls. These all-pervasive economic controls are also responsible for the intensification of black money attuned evils like corruption, procedural wrangles, delays, artificial scarcity, fraud, suppression etc. involved in the very network of the bureaucratic public administration.

4. Political Corruption: This makes the fight against black income growth very difficult and is closely linked with evasion of taxes and customs duties. The political bribing of party and Government members is a common phenomenon. Donations to political parties were banned in 1968 and this has prompted businessmen to fund political parties, especially the ruling party, with black money. Politics is the main weapon for fighting social ills; and when this weapon itself gets corrupted, chances of tackling black income get bleak. The Politics-business-crime nexus that exists in our society is a result of, and further accentuates black income generation.

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

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

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

7. Public Expenditure: the Government itself lives in the Glass House, as the rapid growth of its spending over the last two decades has been a major contributory factor in

generating black money. Due to the rapid rise of public spending for multiple Governmental programmes and activities, the unscrupulous elements in public service and public life could find ample opportunities for amazing black income and wealth by dubious methods.

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

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

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

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

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

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

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

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

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

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

7.9. Effects of Black Money:

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

1. **Dual Economy:** The out growth of black money over a long period of time has given rise to the perpetual growth of economic dualism comprising "**Parallel**" economy (black money economy) operating side by side with the "**Official**" or "**Reported**" economy on the country. The black economy represents not less than one fifth of the aggregate economic transactions. There is also interaction between the reported and unreported activities such that it is difficult to identify black money from the white money economy. Such a "**Parallel Economy**" will ruin the entire economic development of the country.

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

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

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

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

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

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

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

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

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

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

7.10. Remedies for the Black Money:

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

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

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

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

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

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

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

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

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

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

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

9. Publicity: In view of the deterrent effect, the nature of all persons in whose cases penalties have been imposed for the concealment of income, wealth etc. should be published in the gazettes as well as in the press, giving details of their names, addresses and the amount of penalties etc. If the assessee is a company or firm, the names of all the Directors of the Company or Partners of the firm should be published.

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

11. Other Measures:

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

CHAPTER-VIII

DOUBLE TAXATION

Today, with enormous range of expenditure outlays, the Governments cannot depend upon a single tax. Because it will not provide sufficient revenue to meet their financial needs. Moreover, with the single tax, the Government cannot achieve the principles of equality, ability to pay and equitable distribution of income and wealth among the people. Thus, the principle of multiple taxation is recommended whereby the Government may resort to various direct and indirect taxes to attain their objectives both fiscal and social.

But such multiple taxation should not lead to double taxation. Double taxation occurs when the Government levies taxes on the same base in more than one way. Hence, double taxation can be defined as, "*taxation of the same tax base twice either by one authority or by different authorities*". Here, the two taxes should be levied with reference to the same period.

8.1 Examples of Double Taxation:

1. Mr. X earns his income in Etiopia and U.S.A. If both the Governments levy taxes on his entire income, it is considered as double taxation i.e. international double taxation, because he has to pay tax in two countries on the same income.
2. The Government of a country levies taxes on the profits of a company before the distribution of dividends. Thereafter, it taxes the individual shareholders on the dividends received by them. Then it becomes a double taxation. Here the company and shareholders are taxed on the same income.

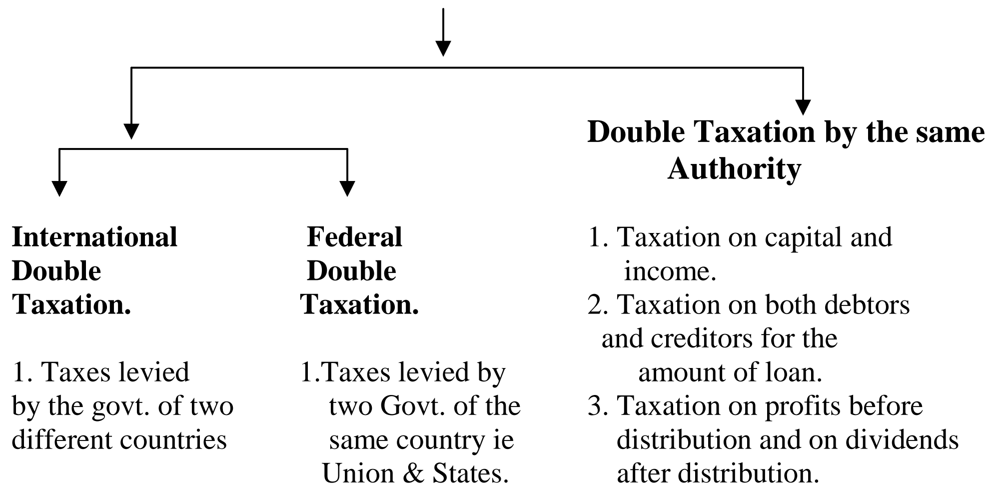
Hence, double taxation means, taxing the same tax twice and it may be of international or federal double taxation.

8.2. Kinds of Double Taxation:

Double taxation can be classified on the following ways:

1. Double Taxation by different authorities.
2. Double Taxation by the same authority.

The components of these kinds are explained with the chart given in Fig. 5.1.



Let us explain these kinds one by one.

1. **Double Taxation by Different Authorities:** When the same tax base is levied by two different taxing authorities either international or federal, it becomes a case of double taxation.

(a) International Double taxation: This type of double taxation occurs when the Governments of different countries levy on the same tax base. The scope of a tax determines the incidence of its burden. It includes both direct and indirect taxes. Generally the income tax, wealth tax and customs duty cause such international double taxation.

(b) Federal Double Taxation: This kind of double taxation occurs when the Governments within a country levy tax on the same base. When the Union Government and State Governments of a country levy tax on any one tax base, it is called federal double taxation.

2. **Double Taxation by the Same Authority:** Such a double taxation occurs when a Government either Union or State levies on the same tax base twice. The tax on capital and income, debtors and creditors on the amount of loan, on the profits before and after distribution and the like are the notable examples in this regard.

8.3. Effects of Double Taxation:

Generally, double taxation is not liked by the taxpayers and is highly criticised by the economists. It will affect the economy of the country directly and indirectly. The main effects of double taxation are given below:

1. **Injustice to the Taxpayers:** Double taxation causes injustice to the taxpayers. It discriminates among the different taxpayers.

2. **Does not Conform to the Principle of Ability to Pay:** In case of double taxation, the tax system does not conform to the principle of ability to pay. Because when both the Central and State Governments tax the same group on the same tax base, the principle of ability to pay is violated.

3. **Does not Ensure the Principle of Equity:** When the Union and State Governments levy taxes on the same commodities especially on the necessities, it will broaden the gap between the rich and the poor. Thus, the double taxation violates the principle of equity also.

4. **Discourages the Ability to Work, Save and Invest:** Double taxation increases the price of the commodities and leaves the people with lower disposable income. This in turn affects the standard of living of the people and thereby reduces their ability to work, save and invest.

5. **Discourages the Small-scale Industries:** When the taxes are uniformly levied without any exemption to small-scale sector, the competitive efficiency of them will be affected. Because of a rise in their prices, they can not compete with the large-scale industries in the market.

6. **Discourages Exports:** It may be due to federal double taxation. When the same commodities are taxed both by Union and State Governments, their price will automatically be increased which in turn affects the export market.

7. **Affects the Overall Economic Development of the Country:** Since double taxation affects the individual economic activities, the whole economic development will be affected. In such a situation, the Government cannot use the taxation as a weapon, boost the sick industries and to curb the effects of trade cycles in the economy.

8.4. Remedies for Double Taxation:

To remove the effects of double taxation, the following remedial measures can be adopted. They can be classified on the following two categories:

8.4.1. Remedies for the Problem of International Double Taxation:

(a) Agreement for Mutual Exemption: The countries may enter into an agreement to exempt the income of non-residents when they take the income outside.

(b) Basis for Incidence: The double taxation can be avoided when the taxes are levied either on residential status or on citizenship and not on the both.

(c) Special Measures: Some special measures should be devised so that the Governments of two countries may tax different parts of the income earned by a person.

8.4.2. Remedies for Internal or Federal Double Taxation:

The following are the remedies to avoid internal or federal double taxation:

(a) Separate List: There should be a separate list of taxes that can be levied by the Union Government and State Governments.

(b) Co-ordination between the Fiscal Policies: There should be a perfect co-ordination between the fiscal policies of the Union and the State Governments. And the problem of double taxation can be solved through the centralisation of finance. This can be done by getting the final approval from the Central Finance Minister for the State budgets.

(c) Avoiding Overlapping of Taxes: There should not be any overlapping of taxes. The problems of double taxation can be solved to a considerable extent if due consideration is given in this regard. To avoid the double taxation caused by overlapping of sales tax and excise duties, they may be replaced by a centrally administered value added tax.

In Ethiopia, the problem of double taxation is considerably reduced because of the provisions made in the Ethiopian Constitution. Articles 96, 97, 98, 99, 100, 101, and 102 of the Constitution, there is a separate list for the Federal Government, State Governments and Concurrent List. There are specific Articles for revenue sharing and principles of taxation.

8.5. Methods of Elimination of Double Taxation:

Many a times situation arises whereby same income is taxed twice; i.e. in the State of Residence as well as in the State of Source. In order to eliminate double taxation two methods are used. They are:

1. Exemption Method, and
2. Credit Method.

8.5.1. Exemption Method:

The exemption methods include the following:

(a). Full Exemption Method:

Under this method, income earned in the State of Source is fully exempt in the State of Residence.

(b). Exemption with Progression:

Under this method, income from State of Source is considered by the State of Residence only for the rate purpose.

8.5.2.Credit Method:

The credit methods include the following

(a). Full Credit:

Total tax paid in the State of Source is allowed as Credit against the tax payable in the State of Residence.

(b). Ordinary Credit:

State of residence allows credit of tax paid in the State of Source only to that part of income tax, which is attributable to the income taxable in the State of Residence.

(c). Method of Tax Sparing:

State of Residence allows credit for deemed tax paid on income, which are otherwise exempt from tax in the State of Source.

8.5.3. Illustration- Double Taxation Elimination Methods:

Let us understand these methods with the help of an example.

- Income derived by "A" from
  State of Residence Birr. 1, 00, 000
- Income derived by "A" from
  State of Source Birr. 50, 000

Total Income of A: Birr..1, 50, 000

Tax rates are : State of Source @ 40% flat rate.
State of Residence Up to Birr..1,00,000 @ 30% and between Birr.1 lakh & 2 lakhs @ 35%.

Tax paid in State of Source on Birr. 50, 000 = Birr..20, 000
(@ 40% on Rs.50, 000)

Tax paid in State of Residence = Birr..47, 500
on Birr.1, 50, 000. (@ the rates specified)

Tax Liability in State of Residence under various Methods of Elimination of Double Taxation:

1. Full Exemption Method:

State of Residence levies tax only on domestics income i.e. tax on Birr.1, 00, 000 @30% = Birr.30, 000. It does not levy any tax on income earned in the State of Source (i.e. on Birr.50, 000 in this case). In other words, it exempts income earned in the State of Source from its tax. Similarly, tax is levied by the State of Source only in respect of income, earned therein. As a result, double taxation of income is automatically eliminated.

2. Exemption with Progression:

Domestic income of Birr.1, 00, 000 will be taxed at the rate applicable to total Income i.e. Tax on Birr.1, 00, 000 @ 35% (rate applicable to slab of Birr.1, 50, 000) = Birr.35, 000. This offers partial exemption compared to the Full Exemption Method.

3. **Full Credit:**

Tax payable on total income in the State of Residence will be as below:

Birr.1, 50, 000 on slab basis	Birr.47, 500
Less: Credit for tax paid in the State of Source	Birr.20, 000
Tax Liability in State of Residence	Birr.27, 500

4. **Ordinary Credit:**

At first, tax liability on total income is worked out in the State of Source. However, such credit is restricted to the amount of tax attributable to the income from the State of Source i.e. 35% of Birr.50,000 = Birr.17, 500.

Tax payable on Birr.1, 50, 000	Birr.47, 500	(slab basis)
Less: Tax paid in the State of Source	Birr.20, 000	
Maximum Deduction Restricted to (35% on Rs.50, 000)	Birr..17, 500	
Tax Liability	Birr..30, 000	

5. **Tax Sparing:**

Now let us assume for a moment that Mr. A has tax free export income of Birr..30, 000 in the State of Source. In this situation, a deemed tax credit for Birr.12, 000 (being 40% Rs.30, 000) will be granted by the State of Residence. Usually, DTAA prescribes the exact nature of such tax-free income and or relevant provisions of the domestic law, covered by this method.

8.6. Double Tax Avoidance Agreements:

Article on elimination of Double Taxation assumes great significance, as it is the central point of any Treaty. Treaties generally use combination of various methods for granting relief from double taxation. It is also a powerful tool for the purpose of Tax Planning. In fact, it serves well the ultimate objective of Treaty namely overall minimization of tax burden or avoidance of same income being taxed by two countries.

This brings in harmony and equity in tax legislation and bids good-bye to the famous dictum in the taxation statutes that Tax and Equity are strangers.

1. Present Day Scenario and Need for Tax Treaties:

Due to advances in communication and technology, the world has become a global village. No nation can afford to remain in isolation. For survival in a competitive environment, one has to view the entire world as market and create a niche for one's products in the international market. The need of the hour is to integrate the national economy with the international economy. This gives rise to full-fledged joint ventures in place of limited participation, creating production and marketing bases in different countries with diverse political systems and tax regimes. Movement of capital and cross border transactions become common place. The transnational corporations are the vehicles used for the purpose.

Every nation has sovereign right to tax its residents on their worldwide incomes. As a result, the income of an organisation can get taxed both in the home country (country of its origin) as well the host country (country where it has its operations). In such an environment, cost of operating worldwide would become prohibitive and the benefits of international trade, and competitive cost advantages would be lost. Double taxation is harmful for movement of capital, technology and people.

In civilised society, in home country tax is an obligation and in host country tax is a cost. There is need to achieve tax efficiency. The Double Tax Avoidance Agreements come into play to mitigate the hardships caused by taxing the same income twice, in a home country as well as in the host country.

Tax Treaties remove the obstacles and try to achieve balance and equity. They aim at sharing of tax revenues by the concerned states on a rational basis without causing undue hardships to the taxpayers operating internationally. Tax Treaties do not altogether eliminate double taxation, but reduce the incidence to tolerable extent.

2. Advantages of Tax Treaty:

Tax Treaties clearly lay down the provisions for taxing of income under various heads. There is less room for ambiguity. For instance, business profits are taxable in the host country only if there is “Permanent Establishment” as defined in the Treaty.

3. Treaty Models:

There are three different types of models.

They are OECD Model, U N. Model and the U.S.Model.

(a): OECD Model:

The emergence of present form of OECD model convention can be traced long back to 1927, when the fiscal Committee of the League of Nations prepared the first draft of Model Form applicable to all countries. In 1946, the model convention was published in Geneva by the Fiscal Committee of U.N. Social and Economic Council and later by the Organisation for European Economic Co-operation (OEEC) in 1963. However in 1961, the Organisation for Economic Co-operation and Development (OECD) was established, with developed countries as its members, to succeed the OEEC and OECD approved the draft presented to the OEEC. In 1977, final draft was prepared in the present form.

OECD model is essentially a model treaty between two developed nations. This model gives emphasis on the right of State of Residence to tax.

(b).U.N. Model:

In 1968, United Nations set up *ad hoc* groups of experts from various developed and developing countries to prepare a draft model convention between developed and developing countries. In 1980, this group finalised the U.N. Model Convention in its present form.

U.N. Model is a compromise between the source principle and residence principle. However, it gives more weight to the source principle as against residence principle of OECD model. U.N. Model is designed to encourage flow of investments from developed countries to developing countries. It takes into account sharing of tax-revenue with the country providing capital.

(c). U.S. Model:

U.S. Model is different from the OECD and U.N. Model in many respects. For example, Indo-U.S. Treaty provides for Permanent Establishment Tax (Article 23) and Limitation on benefits (Article 24), which are unique to this Treaty as also provision for taxing Capital Gains (Article 13) as per domestic law. Thus U.S. Model has made its own identity through radical departure from the usual clauses of the Treaty under OECD Model and the U.N. Model.

PART-II

TAX ATION IN ETHIOPIA

Income Tax Proclamation
Proclamation No. 286/2002

Income tax is a very important direct tax. It is an important and most significant source of revenue of the government. The government needs money to maintain law and order in the country; safeguard the security of the country from foreign powers and promote the welfare of the people. It is the foremost duty of the government to bring out welfare and development programs which will bridge the gap between the rich and the poor. All this requires mobilization of fund from various sources. These sources may be direct or indirect. Income tax being a direct tax, is an important tool to achieve balanced socio economic growth by providing concessions and incentives in income tax for various development purposes.

What is Income Tax?

Income tax is a monthly/annual tax levied in every month/year at the prescribed rates, on every person in respect of his income for the relevant month/year. The income is determined with reference to the person's residential status and the place of accrual or the receipt of income.

Who is liable to pay income tax?

Every person whose taxable salary income for a month exceeds the minimum taxable limit is liable to pay employment income tax and every other person whose taxable income for a year exceeds the minimum taxable limit is liable to pay income tax (rental or business or other income tax) to the Federal government during the month/year on the income at the rates in force.

Scheme of Taxation:

Under the Income Tax Proclamation, a person has to pay income tax on his income of a particular month/year provided it exceeded a certain minimum limit prescribed in the proclamation. The total income is computed on the basis of the residential status of the person.

Sources of Income (Article-6):

Income taxable under this proclamation shall include, but not limited to:

a) income from employment;
b) income from business activities;
c) income derived by an entertainer, musician, or sports person from his personal activities;
d) income from entrepreneurial activities carried on by a non-resident through a permanent establishment in Ethiopia;

e) income from movable property attributable to a permanent establishment in Ethiopia;
f) income from immovable property and appurtenances thereto, income from livestock and inventory in agriculture and forestry, and income from usufruct and other rights deriving from immovable property is uch property is situated in Ethiopia;
g) income from the alienation of property referred to in(e);
h) dividends distributed by a resident company;
i) profit shares paid by a resident registered partnership;
j) interest paid by the national, a regional or local Government or a resident of Ethiopia, or paid by a non-resident through a permanent establishment that he maintains in Ethiopia;
k) license fees (including lease payments, and royalties paid by a resident or paid by a non resident through a permanent establishment that he maintains in Ethiopia.

The above sources of income are grouped under the following four Schedules:

Schedules of Income (Article-8):

The proclamation provides for the taxation of income in accordance with four schedules.

- Schedule 'A' Income from employment;
- Schedule 'B' Income from rental buildings;
- Schedule 'C' Income from business;
- Schedule 'D' Income from other sources including:
  - royalties;
  - income paid for services rendered outside of Ethiopia;
  - income from games of chance;
  - dividends;
  - income from casual rental of property;
  - interest income;
  - specified non-business capital gains.

Every person having income as defined above shall pay income tax in accordance with this Proclamation.

Important Definitions (Article-2):

Under ChapterI-Section-1(Article-2) of the Income Tax Proclamation 286/2002, definitions of important terms used in the Proclamation have been given, some of which are as under:

1. **Person:** The term Person shall mean any individual, body, or association of persons (including a business representative residing and doing business in Ethiopia on behalf of the principal).
2. **Body:** The term Body" shall mean any company, registered partnership, entity formed under foreign law resembling a company or registered partnership, or any public enterprise or public financial agency that carries out business activities including body of persons corporate or unincorporated whether created or

recognized under a law in force in Ethiopia or elsewhere and any foreign body's business agent doing business in Ethiopia on behalf of the principal.

3. **Association of persons:** The term "Association of persons" shall mean the association of individuals or an association that includes one or more members who are not individuals, but not including any association falling within the definition of "body".

4. **Related person:** The term "Related person" means:

(i). a natural person and,

(a) any relative of that natural person; or

(b) a trust in respect of which such relative is or may be a beneficiary; or

(ii). a trust and a person who is or may be a beneficiary in respect of that trust; or

(iii). a partnership, joint venture, or unincorporated association or body or private company; and

(a) any member thereof; or

(b) any other person where that person and a member of such partnership, joint venture, or unincorporated association or body, or private company as the case may be, are related persons in terms of this definition; or

(iv). an incorporated company, other than a close corporation and

(a) a person, other than and incorporated company, where that person or that person and a person a person related to the first mentioned person in terms of this definition controls 10 percent or more of;

(i). the right to vote in the first mentioned company; or

(ii). the rights to distributions capital or profits of the first-mentioned company, either directly or through one or more interposed companies, partnerships, or trusts; or

(b) any other incorporated company in which the first mentioned person referred to in (a) or that person and a person related to that first mentioned person in terms of this definition controls 10 percent or more of:

(i) the right to vote in the first mentioned company, or

(ii) the rights to distributions of capital or profits of the first-mentioned company, either directly or through one or more interposed companies, partnerships, or trusts; or

(c) any person where that person and the person referred to in (a) or the other incorporated company referred to in (b) are related persons in terms of this definition; or

(d) any person related to the person referred to in (c) in terms of this definition; or

(v) a registered person and a branch or division of that registered person which is separately registered under Article 16, sub-article(5) as a registered person.

5. Relative: The term Relative in relation to a natural person; means:

(i). the spouse of the person; or

(ii).an ancestor, lineal descendant, brother, sister, uncle, aunt, nephew, niece, stepfather, stepmother, stepchild, or adopted child of that person or of the spouse, and in the case of an adopted child the adoptive parent; or

(iii). the spouse of any person referred to in paragraph (ii) and for the purposes of this definition, and adopted child is treated as related to her adoptive parent within the first degree of consanguinity.

6. Business or Trade: The term Business or Trade shall mean any industrial, commercial professional or vocational activity or any other activity recognized as trade by the Commercial Code of Ethiopia and carried on by any person for profit.

7. Taxpayer: The term Taxpayer shall mean any person subject to tax under this Proclamation.

8. Withholding Agent: The term Withholding Agent shall mean any person with a tax collection obligation under this proclamation.

9. Permanent Establishment: The term Permanent Establishment shall mean a fixed place of business through which the business of a person is wholly or partly carried on. The following shall, in particular, be considered to be a permanent establishment:

(a) an administrative, branch, factory, workshop, mine, quarry or any other place for the exploitation of natural resources, and a building site or place where construction and/ or assembly works are carried out.

(b) A person shall be considered not to have a permanent establishment if that person:

(i) uses facilities solely for the purpose of storage or display of goods or merchandise belonging to that person;

(ii) maintains a stock of goods or merchandise belonging to that person solely for the purpose of storage or display;

(iii)maintains stock of goods or merchandise belonging to that person solely for the purpose of processing by another person;

(iv)maintains a fixed place of business solely for the purpose of purchasing goods or merchandise or a collecting information for that person’s business;

(v) maintains a fixed place of business solely for the purpose of carrying on, for that person’s business, any other activity of a preparatory or auxiliary character.

(c). Notwithstanding the provisions of sub-Articles (a) and (b) above,

where an agent, other than an agent of an independent status to whom letter (e)below applies, acts on behalf of a person and has, and habitually exercises, an authority to conclude contracts in the name of that person and has ,and habitually exercise, an authority to conclude contracts in the name of that person, that person shall be treated as if it has a permanent establishment in respect of any activities which the agent undertakes for the person at the place at which those activities are carried on, unless the activities of such agent are limited to those mentioned in letter (b) above which if exercised through a fixed place of business, would not make that fixed place of business a permanent establishment.

(d). A person shall not be treated as if it has a permanent establishment where it merely carries on its business activities through a broker, general commission agent or any other agent of an independent status, provided that such agents are acting in the ordinary course of their business.

(e) The fact that a company controls or is controlled by another company shall not of itself constitute either company a permanent establishment of the other.

10. **Income:** The term Income shall mean every sort of economic benefit including non-recurring gains in cash or in kind, from whatever source derived and in whatever form paid credited or received.

11. **Taxable Income:** The term Taxable Income shall mean the amount of income subject to tax after deduction of all expenses and other deductible items allowed under this Proclamation and Regulations issued there under;

12. **Employee:** The term Employee shall mean any individual, other than a contractor, engaged (whether on a permanent or temporary basis) to perform services under the direction and control of the employer;

    (a). Unskilled Employee shall mean an employee who has not received vocational training, does not use machinery or equipment requiring special skill, and ho is engaged by an employer for a period aggregating not more than 30 days during a calendar year;

    (b). Contractor shall mean an individual who is engaged to perform services under an agreement by which the individual retains substantial authority to direct and control the manner in which the services are to be performed.

13. **Tax Authority:** The term Tax Authority shall mean the Federal Inland Revenue Head Office or any of its branch offices established in any part of Ethiopia and the tax authorities of the Regional states.

14. **Minister:** The term Minister shall mean the Minister of Finance and Economic Development and “Ministry” shall mean the Ministry of Finance and Economic Development.

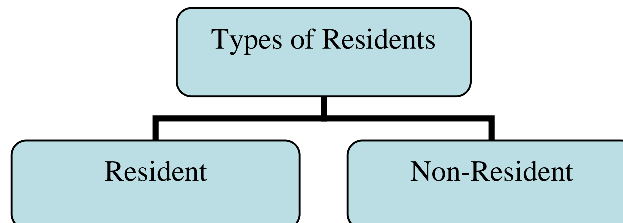
15. **Fiscal Year:** The term Fiscal Year shall mean the budgetary year of the Ethiopian Government.

Residence and Tax Liability
(Article-5)
Basis of Charge-Scope of Income Liable to Tax

The scope of taxable income of a tax payer is determined with reference to his residence in Ethiopia in a period of 12 calendar months. In other words, the total income of each person is based upon his residential status. The residential status of a tax payer is determined with reference to his residence in a period of 12 calendar months. It is immaterial what type of resident a tax payer is during this said period. Residence and citizenship are two different things. The incidence of tax is subject to residential status and nothing to do with citizenship excluding the cases given in this Proclamation. An Ethiopian may be non-resident and a foreigner may be resident for income tax purposes. The residential status of a person may change from year to year.

Different Types of Residents:

On the basis of residential status, the tax payers are classified in to two categories, viz:



There are separate rules for determining the residential status of different kinds of taxpayers. The different kinds of taxpayers are individuals and a body. It is not necessary that the residence of a person should always be the same. He can be resident in one year and non-resident in the next year.

1. Residential Status of Individuals:

The residential status of an individual is determined on the basis of the provisions stated here under:

1. An individual shall be resident in Ethiopia, if he:
   (a) has a domicile within Ethiopia;
   (b) has an habitual abode in Ethiopia; and/ or
   (c) is a citizen of Ethiopia and a consular, diplomatic or similar official

of Ethiopia posted abroad.

2. An individual, who stays in Ethiopia for more than 183 days in a period of twelve (12) calendar months, either continuously or intermittently, shall be resident for the entire tax period.

2. Residential Status of Body:

The residential status of an individual is determined on the basis of the provisions stated here under:

A body shall be resident in Ethiopia, if it:

(a) has its principal office in Ethiopia;

(b) has its place of effective management in Ethiopia; and/or is registered in the trade register of the Ministry of Trade and Industry or Trade bureaux of the Regional Governments as appropriate.

3. Resident person includes a permanent establishment of a non-resident person in Ethiopia.

Residential Status and Scope of Application(Article-3):

1. This Proclamation shall apply to residents of Ethiopia with respect to their worldwide income.

2 The Proclamation shall apply to non-residents of Ethiopa with respect to their Ethiopian source income.

Foreign Tax Credit (Article-7):

1) If during the tax period a resident derives foreign source income, the Income Tax payable by that resident in respect of that income shall be reduced by the amount of foreign tax payable on such income. The amount of foreign tax payable shall be substantiated by appropriate evidence such as a tax assessment, a withholding certificate or any other similar document accepted by the Tax Authority.

2) However, the reduction of the Income Tax provided by Sub-Article (1) shall not exceed the tax payable in Ethiopia that would otherwise be payable on the foreign source income.

3) In the case of a taxpayer subject to Income Tax on Schedule C income, any reduction of tax prescribed by Sub-article (1) shall be limited to the tax that would otherwise be payable in Ethiopia computed as if Article 28 (loss carry forward) of this Proclamation applied separately to each foreign country in respect of profit and losses derived from sources therein.

4) The reduction of tax prescribed by this Article shall be calculated separately inspect of each foreign country from which income or profit is derived.

Foreign Exchange Transactions (Article-9):
All net gains and losses arising from any transactions in foreign exchanges shall be brought to account for tax purposes as additions to taxable income or deductible losses in the year in which they are realized.

SECTION - II

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.

Taxable Income (Article-10):
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		**Income Tax (per month) payable**
Over Birr	**to Birr**	%
0	150	**Exempt threshold**
151	650	10
651	1400	15
1401	2350	20
2351	3550	25
3551	5000	30
Over 5000	****	35

It can be explained as follows:

Schedule A

No	Employment Income /Per-months/		Tax Rate	Deduction In Birr
	Over Birr	**To Birr**	%	ETB
1	0	150	**Exempt Threshold**	
2	151	650	10	15.0
3	651	1400	15	47.5
4	1401	2350	20	117.5
5	2351	3550	25	235.0
6	3551	5000	30	412.5
7	Over 5000	*****	35	662.5

According to Article 10 of the Income Tax Proclamation, the employers have an obligation to withhold the tax from each payment to an employee, and to pay to the Tax Authority the amount withheld during each calendar month. In applying the preceding, income attributable to the months of Nehassie and Pagumen shall be aggregated and treated as the income of one month.

Example:

Ato.Mesfin received a Salary of ETB 500 pm during the year 2005.compute the tax liability and the amount received by him after the withholding of tax by the employer from his salary:

Salary = 500

$$\frac{500 \times 10}{100} - 15$$

Tax liability = 35

Net salary received by Ato.Mesfin= 500-35 = 465 Birr

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 endered 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 a gratitude in relation to :

(i) personal injuries suffered by that person;

(ii) the death of another person.

Examples:

1. Ato. X an employee in a company is drawing Birr.2500 pm as salary plus HRA at 10% of his salary during the year 2004-05. He is also getting the medical allowance of Birr.400 pm, commission 250 Birr pm. He is provided free of charge a sweeper whose wages are Birr150 pm and a gardener whose wages are 250 birr pm. Compute his taxable salary for the month and tax payable for the same.

Particulars	Taxable income Birr	Non-Taxable Income Birr
Salary	2500	----
HRA	250	-----
Medical Allowance	-----	400
Commission	250	----
Sweeper and gardener		
Cook:		150
Gardener		250
	-----------	-----------
Taxable income	3000	800
	=======	=======

2. The following are the particulars of income of Ato.Feleke for the year 2004-05.

   i) Salary Birr. 7000pm
   ii) H.R.A Birr.450 pm
   iii) M.A Birr. 75 pm
   iv) Special Allowance Birr.60 pm
   v) Employee's contribution to Provident Fund 15% of salary
   vi) Employer's contribution to the Fund at 15% of salary
   vii) He is provided wit free lunch during office hours.
   viii) The employer has given him the use of Feat car which he uses for official purposes. The employer meets all the expenses which amount to Birr.400 pm during the year.

   Compute the employment income of Ato.Feleke for the month.

Particulars	Taxable income Birr	Non-Taxable Income Birr
Salary	7000	----
HRA	450	-----
Medical Allowance	-----	75
Spl. allowance	60	----
Employer's Contribution to P.F		1050
Free lunch	------	------
Car facility (benefit in kind)		4800
Taxable income	7510	5925

SECTION - III

SCHEDULE 'B' INCOME: INCOME FROM RENT OF BUILDINGS

Taxable Income (Article-14):

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.

Tax Rate (Article-15):

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

(a) on income of bodies thirty percent (30%) of taxable income,
(b) on income of persons according to the Schedule B (hereunder)

Schedule -B

No	Taxable Income from Rental (per year)		Income Tax Payable
	Over Birr	**to Birr**	**%**
1	0	1800	**Exempt Threshold**
2	1,801	7,800	10
3	7,801	16,800	15
4	16,801	28,200	20
5	28,201	42,600	25
6	42,601	60,000	30
7	Over 60,000	******	35

It can be explained as follows:

Schedule - B

No	Taxable Rental Income form Buildings / Per Year		Tax Rate	Deduction In Birr
	Over Birr	**To Birr**	%	ETB
1	0	1800	**Exempt Threshold**	
2	1,801	7,800	10	180
3	7,801	16,800	15	570
4	16,801	28,200	20	1410
5	28,201	42,600	25	2820
6	42,601	60,000	30	4950
7	Over 60,000	******	35	****

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 administrations own initiative to the appropriate tax authority.

Method of Computation of Rental Income from Buildings:

Particulars		Amount ETB	Amount ETB
Rental Income Received		****	
Add: Amount received on the			
i) lease of furniture	***		
ii)lease of equipment	*** →	*** →	*****
Less: Deductions:			
i) Taxes paid on land and buildings leased	----	***	
ii) For those not maintain books of Accounts Allowance for repair, maintenance and depreciation(1/5 of gross income)	----	***	
(or)			
iii) For those maintain books of Accounts Expenses on			
a) cost of lease of land	- ---	***	
b) Repairs	----	***	
c) maintenance	-----	***	
d) depreciation of building, furniture and equipments	-----	***	
e) interest on bank loans	-----	***	
f) insurance premiums	-----	*** →	*****
Taxable Income from rent of Buildings			*******

1. Ato.Merrit has a house property in Addis. He has let out the house for the residential purposes. The following are the details of the property let out.
   a. Actual rent received Birr.900 pm.
   b. Fair rental value of the house Birr.1200 pm
   c. He has paid 15% of the rent received as land taxes and 2% as other taxes to the regional government
   d. He spent Birr.780 for repairs of that house
   e. He does not maintain any books of accounts in this regard.

   Compute the income from house property for the year 2004-05.

Particulars	Taxable income Birr	Non-Taxable Income Birr
Actual rent (900 x 12)	10,800	------
Land Tax (10,800 x .15)	(1620)	------
Other taxes (10,800 x .02)	(216)	-------
Repair (10,800x 1/5)	(2160)	-----
	6804	------
	========	=======

2. Ato. Desalean owns four houses. The details regarding which are as follows:

    a. The first house of the annual rental value (FMV) of Birr.4400 was occupied by him for his own residence.
    b. The second house of the annual rental value of Birr.5600(FMV) was let out at Birr.400 pm. He paid Birr 600 as interest on money borrowed for the construction of the house, Birr.80 as land tax and Birr.200 as insurance premium of the house.
    c. The FMV of the third house is Birr.1600 pm and its actual rent is 1400 birr pm. But in respect of this house maintenance charge of Birr.1600 per year including repair charges.
    d. The fourth house, the FRV of which is Birr.6000 pa was let out at 600 pm. It remained vacant for 4 months. The unrealized rent in respect of this house during the year was Birr.1200, which satisfies the conditions for claiming this loss.

    Find out the income from house property for the year 2004-05.

(a) Not Taxable

(b)

Particulars	Taxable income Birr
Actual rent (400 x 12)	4,800
Land Tax	(80)
Interest	(600)
Repair and maintenance (4,800x 1/5)	(960)
Taxable income	3160

(c)

Particulars	Taxable income Birr
Actual rent (1400 x 12)	16,800
Repair and maintenance (16,800x 1/5)	(3360)
Taxable income	13440

(d)

Particulars	Taxable income Birr
Actual rent (600 x 8)	4,800
Repair and maintenance (4,800x 1/5)	(960)
Taxable income	3840

SECTION - IV

SCHEDULE 'C' INCOME: BUSINESS INCOME

The provisions regarding income chargeable under the Schedule-C are contained in Articles 17 to 30 of the Income Tax Proclamation. Before studying these provisions it is necessary to understand the meaning of the terms business.

Scope of Business Income (Article-17):
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 (Article-18):

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 (Article-19):

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.

Schedule - C

No	Taxable Income from Business (per year)		Income Tax Payable
	Over Birr	**to Birr**	**%**
1	0	1800	**Exempt Threshold**
2	1,801	7,800	10
3	7,801	16,800	15
4	16,801	28,200	20
5	28,201	42,600	25
6	42,601	60,000	30
7	Over 60,000	******	35

It can be explained as follows:

Schedule -C

No	Taxable Business Income / Per Year		Tax Rate	Deduction In Birr
	Over Birr	To Birr	%	ETB
1	0	1800	**Exempt Threshold**	
2	1,801	7,800	10	180
3	7,801	16,800	15	570
4	16,801	28,200	20	1410
5	28,201	42,600	25	2820
6	42,601	60,000	30	4950
7	Over 60,000	******	35	****

Deductible Expenses (Article-20):

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.

Non-Deductible Expenses (Article-21):

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.

Trading Stock (Article-22):

1) 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.
2) 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.
3) 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.

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.

Assests eligible for Depreciation:

Assests 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, jewelry, 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 tow 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 of each category of business assets for the maintenance and improvement expenses of business assets belonging to that category for the actual amount of the 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.

Transfer of Business Assets (Article-24):

1) When assets used in a business are sold, exchanged, or otherwise transferred, gain or loss is recognized on the transfer.
2) Transfers of business assets among companies which are parties to a reorganization are not treated as a disposal of the property.
3) 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.
4) ‘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.

5) The rules of Sub-Article (1) – (4) shall not apply to the transfer of assets described under Article 23(5).
6) 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):

1) 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.

2) 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.

3) 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.

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

Loss Carry forward (Article-28):

1) 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.

2) 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.

3) A net operating loss may be carried forward and deducted only for two periods of three years.

Transfer Pricing :(Article- 29)

1) 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.
2) In order to ensure the just and efficient application of this Article the Tax Authority may make agreements in advance with persons carrying on entrepreneurial activities, subject to conditions if necessary, the specified conditions between related persons do not differ from those which would be made between independent persons.

Exemptions (Article- 30):

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

1. Awards for adopted or suggested innovations and cost saving measures, and

2. Public awards for outstanding performance tax any field.

3. 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.

4. 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.

Method of Computation of Taxable Income from Business:

For income tax purposes the taxpayer files his return of income (statement of income in the prescribed Form) along with accounts. the statement furnished may not be correct in all respects. Hence, the taxable income is calculated in the following manner:

If the tax payer has deducted any expense which is non-deductible under Article 21, then such amount is to be added back with his net profit given in the furnished return of income. Likewise if the tax payer has not claimed any expense that is deductible under Articles 20, 22,23,25,26 or 27, then such amount is to be deducted from the net profit shown in the accounts. This can be explained as under:

Particulars	Amount ETB	Amount ETB
Net Profit as per the Statement of Income		*****
<u>Add:</u> Expenses Non-Deductible(under Article-21) (If deducted by the Tax payer in the Statement of Income submitted)		
i. Cost of acquisition, improvement, renewal and reconstruction of business assets that are depreciated pursuant to Article 23	****	
ii. an increase of the share of capital of a company or the basic capital of a registered partnership	****	
iii. Voluntary pension or provident fund contributions over and above 15% of the monthly salary of the employee.	****	
iv. declared dividends and paid-out profit shares(stock dividends)	****	
v. interest in excess of the rate of National Bank of Ethiopia and the commercial banks increased by two (2) percentage points.	****	
vi. damages covered by insurance policy	****	
vii. punitive damages and penalties	****	
viii. creation or increase of reserves, provisions and other special-purpose funds unless otherwise allowed by this Proclamation	****	
ix . Income Tax paid on Schedule C income	****	
x. Recoverable Value-Added Tax	****	
xi. Representation expenses over and above 10% of the salary of the employee	****	
xii. personal consumption expenses	****	
xiii. Entertainment expenses	****	
xiv. Donation or gift.	****	
xv. Other Expenses if any	****	******
		******
<u>Less:</u> Allowable Expenses(If not claimed by the Tax payer):		
i. Expenses incurred for earning business income	****	
ii. Depreciation	****	
iii. Bad debts irrecoverable	****	
iv. Other expenses if any	****	****
		******
<u>Less:</u> Incomes not chargeable under Schedule-C (If included by the Tax payer in the Statement of Business Income submitted)		
i. Income from rental of buildings	****	
ii. Dividend incomes	****	
iii. Royalties	****	
iv. Chance winnings including lottery and race winnings	****	
v. Interest income on deposits	****	
vi. other incomes if any	****	******
Taxable Income from business		******

Example:

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	Birr	Birr
Sales		100,150,200
Less - Cost of sales		87,300, 457
Gross profit		12,849,743
Transport service profit (loss)		(420,102)
Add: other income		10,225
		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	41,987	
		2,155,564
Profit for the Year		10,284,302
Provision for Profit tax		3,600,000
		6,684,302
Legal Reserve		60,640
Balance carried forward to Balance Sheet		6,623,662

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.

You are requested to find out the adjusted business profit and tax liability of the firm for the year.

TAX COMPUTATION

Particulars	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	41,987
Adjusted profit	10122924
	========

Tax Liability for the year @ 35% = Birr.3543023.40

= =

SECTION - V

SCHEDULE 'D' INCOME: OTHER INCOMES

This is the last and residuary Schedule of income. 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.

Incomes chargeable under this Schedule of income:

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

1. 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

3. This tax is a final tax in lieu of a net income tax.

2. 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.

3. Income from Games of 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.

1. The payer shall withhold or collect 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.

4. 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.

5. 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.

6. 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.

7. 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 effected in accordance with this Article.

Chapter II
Procedural Provisions

Section I - General Provisions

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.

1. 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:

(a) employees of the Tax Authority, for the purpose of carrying out their official duties;

(b) law enforcement agencies, for the purpose of the prosecution of a person for tax violations;
(c) courts, in proceedings to establish a person's liability for tax, penalties, or interest, or in any criminal case;

(d) 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.
2) 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.

Co-operation of other Entities (Article-41):

All Federal and Regional government authorities and their agencies, Bodies, Kebele Administrations and Associations shall have the duty to co-operate with the Tax Authority in the enforcement of this Proclamation.

Powers of the Minister (Article-42):
In addition to any powers specifically vested in him in this Proclamation the Minister of Finance and Economic Development may:

(a) enter into agreement with other Government for the avoidance of double taxation on activities or transactions liable to tax in the territories of both parties;

(b) in his discretion, waive tax up to an amount of birr 100,000 in cases of grave hardship due to natural or supervening calamity or disaster, or in

cases of exceptional personal hardship not attributable to negligence or any failure on the part of the taxpayer to discharge any duty under this Proclamation; and

(c) no amount of tax in excess of Birr 100,000 shall be waived except with the approval of the Council of Ministers.

(d) Issue Directives for the better implementation of this Proclamation and Regulations issued there under.

TIN Requirement (Article-43):

(a) Every person having a tax obligation is required to obtain a tax payer identification number ("TIN"), but in no case may a person obtain more than one TIN.

(b) No taxpayer is to be charged a fee for obtaining a TIN.

(c) The registration process shall proceed according to the timetable to be prescribed by directives to be issues by the Tax authority.

Supplying TIN to the Tax Withholding Agent (Article-44):

A person subject to tax withholding is required to supply the TIN to the withholding agent. When paying over the withheld tax, the withholding agent shall list the taxpayer's TIN number along with the amount of tax withheld with respect to that taxpayer.

Business Licenses (Article-45):

1. A person obtaining a license to carry on a business occupation is required to supply the TIN to the licensing authority. All public bodies and institutions issuing a business or occupational license shall not issue or renew such license unless the taxpayer has supplied the TIN.

2. Notwithstanding Sub-Article (1) the licensing authority may not require the taxpayer to supply a TIN if according to the registration schedule distributed as per Article 43 shows that the date for his registration is not yet due.

Directives (Article-46):

The Minster of Revenue is hereby empowered to issue directives to provide procedures for TIN registration of taxpayers. In accordance with those directives, the Tax Authority shall prepare a schedule of registration for a TIN, which shall inter alia contain specific dates for registration of a given class of taxpayers, and shall distribute copies of the timetable to all licensing authorities.

Change of Address and Cessation of Business (Article-47):

1) Any taxpayer who makes a change of address shall notify the Tax Authority of the change within thirty (30) days.

2) Any taxpayer who ceases a trade or business activity shall notify the Tax Authority within thirty (30) days that the activity has ceased. In the case of a cessation of activity, any declaration of income required by this Proclamaion to be filed at the end of a tax year, shall be filed no later than sixty (60) days after the activity has ceased. Any tax due for the period in which the cessation occurred shall be paid on or before the declaration due date determined under this provision.

   Where:

   (a) any income is derived by a person in a tax year from any business, activity, investment or other source that has ceased either before the commencement of the year or during the year, and

   (b) if the income had been derived before the business, activity, investment or other source ceased it would have been chargeable to tax under this Proclamation,

   (c) this Proclamation shall apply to the income on the basis that the business, activity, investment or other source had not ceased at the time the income was derived.

Record Keeping Requirement (Article-48):

1) All persons who are engaged in a business or trade as defined in Article 2(5), or who own buildings held all or in part for rental, except for Category C taxpayers shall keep books and records.

2) A person who is required to keep books and records in accordance with Sub-Article (1) shall keep the following information:
   (a) a record of the business assets and liabilities, including a register of fixed assets showing the date of acquisition the cost of acquisition, and the current book value of each asset;
   (b) a record of all daily income and expenses related to the business activity and the matter to which they relate;
   (c) a record of all purchases and sales of goods and services related to the business activity showing:
      (i) the particular goods and services sold;
      (ii) the name of the buyers and sellers or providers in such a manner that they can be identified by the Tax Authorities;
      (iii)and using pre-numbered invoices containing the vendor's tax identification number;

(d) a record of trading stock on hand at the end of the accounting period, including the type quantity and cost of that stock as well as the method of valuation of theat stock;

(e) any other document relevant for the determination of the tax liability.

3. If a taxpayer has certain books or records in a foreign language, the Tax Authorities may require that they be translated into one of the official languages of Ethiopia at the taxpayer's expense.

4. The books and records mentioned in Sub-Article (2) shall be kept by the taxpayer for a period of ten (10) years after the end of the tax period to which they relate.

Submission of Memorandum of Association (Article-49):

Companies, partnership and other business organizations shall submit to the Tax Authority a copy of their memorandum of association and statutes and shall notify the Tax Authority of any subsequent change therein.

Public Auditors (Article-50):

1) Any auditor, when requested by the Tax Authority in writing shall submit the audit report of his clients.
2) Where any auditor fails to submit the report within the time specified in the letter referred above, the Tax Authority shall notify the Licensing Authority to withdraw the license of the auditor.

Section II
Withholding Procedures

Withholding of Tax on Employment Income (Article-51):

An employer shall withhold tax from every payment to an employee, unless the payment is expressly made tax-exempt by this Proclamation. The obligation of an employer to withhold tax has priority over all other obligations to withhold any other amounts from payments to an employee. The rules of withholding of tax are as follows:

1. An employer shall pay the withheld tax to the Tax Authority within thirty (30) days of the end of each calendar month, and each payment shall be accompanied by a statement with respect to each employee who derives taxable income for the month.
2. The statement shall be in the form and furnished in the manner prescribed by the Tax Authority, and shall contain the following information:

   (a) the name, address, and TIN of each employee;
   (b) the amount of taxable income derived by each employee from the employment;
   (c) the amount of the tax withheld from that income, and
   (d) the amount of any tax-exempt income derived by the employee.

Collection of Tax on Imports (Article-52):

A current payment of income tax shall be collected on Schedule C income at the time of import of goods for commercial use, and the collected amount treated as tax withheld that is creditable against the tax payer's income tax liability for the year.

1) The amount collected on import of goods shall be three percent (3%) of the sum of cost, insurance, and freight ("CIF value").

2) If the amount of income tax collected on the import of goods results in underpayment of business income tax due for the year, as determined at the time of declaration of income tax, the taxpayer is required to pay the difference with the declaration. If the amount represents an overpayment of income tax due for the year, the Tax Authority shall after ensuring the accuracy of the books and records refund the taxpayer the amount overpaid within 3 months period.

3) The tax collected under this Article shall be recorded and accounted – for using the taxpayer's name, address, and TIN; provided, however that if a taxpayer is not required to obtain a TIN the records shall be kept using only the taxpayer's name and address until such time as the taxpayer supplies a TIN to the collecting agency.

Withholding of Income Tax on Payments (Article-53):

1) Organization having legal personality, government agencies, private nonprofit institutions, and non-governmental organizations ("NGOs") shall withhold income tax on payments which by Regulations to be issued by the Council of Ministers are subject to withholding Tax.
2) The amount withheld shall be two per cent (2%) of the gross amount of the payment.
3) Within ten days from the last day of each month, the withholding agent shall transfer to the government the amount required to be withheld on payments made during the month. The withholding agent's aggregate monthly transfer shall be accompanied by a statement lising separately each specified person to whom payments were made; the person's TIN; the monthly total of payments made to that person; and the amount of income tax withheld results in government with respect to that person.
4) If the amount of income tax withheld on payment to specified person results in underpayment of income tax actually due for the year, as determined at the time of declaration of income tax, the taxpayer is required to pay the difference with the declaration. If the amount of income tax withheld results in overpayment of income tax actually due for the year, the Tax Authority shall refund the taxpayer within the time and in the manner prescribed under Article 76.
5) If a withholding agent fails to withhold or under withholds he shall be made to pay the full amount of the tax to the Tax Authority.

Withholding of Schedule "D" Income Tax on Payments (Article-54):

The payer of any payment subject to tax under Schedule "D" shall withhold from the payment the amount of tax required by Schedule "D".

1) The obligation of the payer to withhold tax has priority over all other obligations to withhold amounts from payments to a payee (the taxpayer).
2) A payer shall pay the withheld tax to the Tax Authority within fifteen (15) days of the end of each calendar month, and each payment shall be accompanied by a statement with respect to each taxpayer who received payments during the month.
3) The statement referred to in Sub-Article (3) shall be in the form and furnished in the manner prescribed by the Tax Authority, and shall contain the following information:
   (a) the name, address, and TIN of each taxpayer;
   (b) the amount of payments subject to tax under Schedule D;
   (c) the amount of the tax withheld from the payments.

4) At the time of making a payment to a taxpayer, the payer shall furnish each taxpayer a tax withholding certificate (in the form prescribed by the Tax Authority) showing the date of the payment and stating the information listed in Sub-Article (4); the taxpayer's right to contest the amount of tax withheld; and the manner of doing so.

5) The tax-withholding certificate is proof of the amount of tax withheld on payments subject to tax under Schedule D.

Issuance of Identification Card (Article-55):

The Tax Authority shall issue identification cards to Withholding Agents.

Record of Payments and Tax Withheld (Article-56):

1) A withholding agent shall maintain, and make available for inspection by the Tax Authority, records showing, in relation to each fiscal year:

   (a) Payments made to a payee, and
   (b) Tax withheld from those payments.

2) The withholding agent shall keep the records referred to in Sub-Article (1) for five (5) fiscal years3 after the end of the fiscal year to which the records relate.

3) The Tax Authority may require a withholding agent to furnish a copy of the records to be maintained under Sub-Article (1) in the manner, form and at the intervals prescribed by the Tax Authority.

Adjustment To Tax Due For year And Withholding Agent's Indemnity (Article-57):

1) Except for tax withheld with respect to final taxes, withheld tax (or tax paid currently under Article 53 or Article 54 or collected on import under Article 52 is included in ascertaining a taxpayer's tax due for the tax year.

2) A withholding agent who has withheld under this Proclamation and remitted the amount withheld to the Tax Authority is treated as having paid the withheld amount to the payee for the purposes of a claim by the taxpayer for payment of the amount withheld.

Section III
Tax Accounting Principles

Method of Accounting (Article-58):

Subject to this Proclamation, for the purposes of ascertaining a person's income accruing or derived during a tax period, the timing inclusions and deductions shall be made according to generally accepted accounting principles. The basics of this rule are as follows:

1) a taxpayer shall account for tax purposes on a cash or accrual basis.
2) A company shall account for tax purposes on an accrual basis.
3) A person may apply, in writing, for a change in that person's method of accounting and the Tax office may, by notice in writing, approve the application but only if satisfied that the change is necessary to clearly reflect that person's income.
4) If the person's method of accounting is changed, adjustments to items of income, deduction, or credit shall be made in the tax period following the change, so that an item is not omitted or taken in account more than once.

Cash-Basis Accounting (Article-59):

1) A person who is accounting for tax purposes on a cash basis shall account for amounts to be included in calculating that person's income when they are received by, or made available to that person.
2) An outgoing or expense is incurred by a person who is accounting, for tax purposes, on a cash basis when it is paid by that person.

Accrual-Basis Accounting (Article-60):

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1) A person who is accounting for tax purposes on an accrual basis shall account for amounts to be included in ascertaining that person's income when they are receivable by that person.
2) An outgoing or expense is incurred by a person who is accounting for tax purposes on an accrual basis when it is payable by the person.
3) Subject to this Proclamation, and amount is receivable by a person when that person becomes entitled to receive it, even if the time for discharge of the entitlement is postponed or the entitlement is payable by installments.
4) Subject to this Proclamation, an amount is treated as payable by a person when all the events that determine liability have occurred and the amount of the liability can be determined with reasonable accuracy, but not before economic performance with respect to that amount occurs.

5) For the purposes of Sub-Article (4), economic performance occurs:
   (a) with respect to the acquisition of services or property, at the time the services or properties are provided;
   (b) with respect to the use of property, at the time the property is used; or
   (c) in any other case, at the time that person makes payment in full satisfaction of the liability.

Prepayments (Article-61):

Without prejudice to Article 21 of this Proclamation, a deduction for an outgoing or expense incurred on a service or other benefit which extends beyond twelve months including cost of lease of land, shall be allowed proportionately over the tax periods to which the service or other benefit relates.

Claim of Right (Article-61):

1) A taxpayer who is accounting for tax purposes on a cash basis shall treat an amount as received and an outgoing or expense as paid, even though that person is not legally entitled to receive the amount or liable to make the payment, if that person claims to be legally entitled to receive, or legally obliged to pay the amount.
2) Where Sub-Article (1) applies and that person later refunds the amount received or recovers the outgoing or expense paid, an appropriate adjustment shall be made to that person's income of the tax period during which the refund or recovery occurs.
3) A person who is accounting for tax purposes on an accrual basis shall treat an amount as receivable and an outgoing or expense as payable even though that person is not legally entitled to receive that amount or liable to make the payment, if that person claims to be legally entitled to receive, or to be legally obliged to pay the amount.
4) Where Sub-Article (3) applies and that person later ceases to claim the right to receive the amount or to claim an obligation to pay the outgoing or expense, an appropriate adjustment shall be made to that person's income of the tax period during which that person ceases to make the claim.

Long Term Contracts (Article-63):

1) In the case of a person accounting for tax purposes on an accrual basis, the timing of inclusions in and deductions from income relating to a long-term contract of a business of that person shall be accounted for on the basis of the percentage of the contract completed during any tax period.
2) The percentage of completion is determined by comparing the total costs allocated to the contract and incurred before the end of the tax period with the estimated total contract costs including any variations or fluctuation.
3) Where during the tax period in which a long-term contract of a business is completed the person carrying on the business:
   (a) incurs a loss; or
   (b) has an unrelieved loss available for carrying forward under Article 28(1);
   which is attributable to the long-term contract, the Tax Authority may allow the loss to be:

(c) carried back to preceding tax periods, and
(d) applied against an amount by which inclusions in the income of the business relating to the long-term contract for that period exceed deductions there from.

4. A loss incurred by a person in carrying on a business during a tax period is attributable to a long-term contract of the business to the extent that deductions allowed in ascertaining the income from the business relating to the long-term contract for that period exceed inclusions in ascertaining that income.

5. In this Article, "Long-term contract" of a business of a person means a contract for manufacture, installation, or construction, or in relation to each, the performance of related services, which is not completed within the tax period in which work under the contract commenced, other than a contract estimated to be completed within twelve (12) months of the date on which the work under the contract commenced.

Section IV
Declaration and Assessment

Tax Year (Article-64):

The tax year for the Income tax purposes is as follows:

1) Unless otherwise provided, the period for tax assessment ("tax year") shall be the fiscal year, that is, the one-year period from 1st Hamle to 30th Sene.
2) The tax year of a person is:
   (a) in the case of an individual or an association of individuals, the fiscal year;
   (b) in the case of a body, the accounting year of the body.
3) A body shall not change its accounting year unless it obtains prior approval, in writing, from the Tax Authority and complies with any condition that may be attached to the approval.
4) The Tax Authority may, by notice in writing, revoke an approval granted to a company under Sub-Article (3) if the body fails to comply with any of the conditions attached to the approval.
5) Where the tax year of a person changes as a result of Sub-Article (3) or (4), the period between the last full tax year prior to the change and the date on which the new tax year commences shall be treated as a separate tax year, to be known as the "transitional Year."

Certificate and Assessment of Schedule A Income (Article-65):

The tax-withholding certificate issued by an employer to an employee shall be proof that tax in the amount stated was withheld on the employee's Schedule "A" income of the amount stated.

1) The amount of tax withheld on an employee's Schedule A income, paid to the Tax Authority and accompanied by the employer's statement (as required by Article 51) shall be the amount assessed by the Tax Authority effective on the

date the tax is paid, and subject to later amendment if the Tax Authority determines that an error or omission has been made.

2) In the case of an employee whose taxable income for a tax year consists exclusively of Schedule "A" income, no declaration of income is required.
3) Notwithstanding the preceding, an employee working for more than one employer or an employee of international organization having diplomatic immunity or working in embassies, missions and other consular establishments of a foreign government shall himself declare and pay taxes on his schedule "A" income with the time prescribed under Article 51(3).
4) If an employer finds out that his employee has more than one employment income and if he ascertains that the other employer(s) have not aggregated said income, he shall aggregate and withhold the tax thereon.

Declaration and Assessment of Schedule B and C Income (Article-66):

1) Every taxpayer who has Schedule B or Schedule C income shall prepare a declaration of his income in a form prescribed by the Tax Authority. Taxpayers shall submit the tax declaration to the Tax Authority at the time of submitting the balance sheet, and the profit and loss account for that tax year within the time prescribed below:

   (a) Category A taxpayers within 4 months from the end of the taxpayers tax year.
   (b) Category B taxpayers within 2 months from the taxpayers tax year.

2) The type of records to be submitted to the Tax Authority in accordance with Sub-Article (1) above shall be determined by Regulations to be issued by the Council of Ministers.
3) The tax calculated in accordance with the tax declaration reduced by the tax with held in accordance with Articles 52 and 53 of this Proclamation and the amounts provided by Article 7 (foreign tax credit) of this Proclamation during the tax year, shall be transferred by the taxpayer to the Tax Authority simultaneously with the tax declaration.
4) Any excess payments over the tax calculated according to Sub-Article (3) of this Article shall be refunded by the Tax Authority to the taxpayer within ninety (90) days of becoming satisfied on the tax declaration.
5) The amount of tax due for the year, as stated in the declaration, shall be the amount assessed by the Tax Authority although the Tax Authority may determine that an error or omission has been made and therefore may issue an amended assessment.

Declaration and Assessment of Schedule D Income (Article-67):

1. Every taxpayer who has Schedule D income, not subject to withholding at source constituting a final tax, shall prepare a declaration of that income in a form prescribed by the Tax Authority. Taxpayers shall submit this declaration to the Tax Authority within two (2) months from the end of the Ethiopian Fiscal Year.
2. The tax calculated in accordance with the declaration, after the amounts provided by Article 7 (foreign tax credit) paid during the year with respect to the Schedule D

income subject to declaration having been reduced, shall be transferred by the taxpayer to the Tax Authority simultaneously with the declaration.

3. The amount of tax due for the year, as stated in the declaration, shall be the amount assessed by the tax Authority unless the Tax Authority determines that an error or omission has been made.

Standard Assessment for Category C Taxpayers (Article-68):

1) A standard assessment method shall be used to determine the income tax liability of Category C taxpayers.
2) The standard assessment shall be a fixed amount of tax determined in accordance with a Council of Ministers Regulations establishing a schedule of standard assessment amounts that reflect variations in the type of business, business size, and business location. The taxpayer shall pay the tax determined in accordance with standard assessment on the 7th day of July to the 6th day of August every year, unless, the taxpayer requested and is allowed to make installment payments in accordance with Council of Ministers Regulations.
3) The period during which the standard assessment amount will be used and the basis for the revised amount shall be determined by a directive to be issued by the Minister. The Minister shall distribute the revised standard assessment to the tax Authorities.

Assessment by Estimation (Article-69):

1) If no records and books of accounts are maintained by the taxpayer, or if, for any reason, the records and books of accounts are unacceptable to the Tax Authority, or if the taxpayer fails to declare his or its income within the time prescribed by this Proclamation, the Tax Authority may assess the tax by estimation.
2) The manner of assessing tax by estimation shall determined by directives to be issued by the Minister of Revenue.

Aggregation (Article-70):

A taxpayer who derives income from different sources subject to the same schedule shall be assessed on the aggregate of such income.

Limitations (Article-71):

1) if a taxpayer has submitted a declaration of income within the time limit and manner as prescribed in this Proclamation, the Tax Authority has five (5) years to amend the assessment. The five-year assessment period runs from the due date of the declaration.
2) If a taxpayer has submitted a declaration in the manner required by this Proclamation, but after the due date for making a declaration, the Tax Authority has five (5) years to amend the assessment. The five years assessment period runs from the date the declaration was received by the Tax Authority.
3) In case where the taxpayer has not declared his income or has submitted a fraudulent declaration, not time limit provided in any other law shall bar the assessment of the tax by the Tax authority.

Section V
Assessment Notification

Contents of Assessment Notification (Article-72):

Every assessment notification shall contain the following elements:

4) gross income and deductions applicable under this Proclamation;
5) taxable income;
6) rates applicable or percentage;
7) taxes paid and due;
8) any penalty or interest;
9) the taxpayer's name, address, and TIN; and
10) a brief explanation of the assessment and a statement of the taxpayer's rights.

Service of Tax Notices (Article-73):

Income tax assessment notices or other notices issued by the Tax Authority to any taxpayer shall be communicated in writing as follows:

(a) In the case of a resident individual, by registered letter or by delivery to the taxpayer in person, or if he is absent, to any adult member of his family or any person employed by him at his residence, or place of business or professional practice, provided that, if, no person can be found to accept such service, then, the same may be effected by affixing the notice to the door or other available part of the said residence or place of business.

(b) In the case of a resident body, by registered letter to the registered address of the body or by delivery to any director or employee of the body at any of its places of business.

(c) In the case of non-resident persons, to their agent or agents in Ethiopia, or by affixing to the door or other available part of the residence or place of business of such agent if he could not be served in person; provided that, if in any case none of these measures are effective, service may be discharged by the publication in any newspaper in which Court notice may be advertised. The cost of such publication shall be charged to the taxpayer.

(2) Any assessment of income tax duly served on the taxpayer shall become final when:

(a) the taxpayer fails to pay the tax due or to lodge his or its appeal with the tax Appeal Commission within thirty (30) days from the date of receipt of an assessment notice or from the date of receipt of an assessment notice or form the date of decision of the review committee,

(b) the time for appealing the decision of the Tax appeal Commission has expired; or

(c) the Court of Appeal renders its final decision.

(3) A taxpayer who does not pay the final assessment as provided under Sub-article (2) of this Article is in default.

SECTION - VI
PAYMENT

Tax payable when Due (Article-74):

Any tax (including withheld or collected tax) that is to be paid to the Tax Authority by a stated date shall be payable on that date. Failure to make a timely payment shall result in the imposition of interest and the late payment penalty.

Interest (Article-75):

1. If any amount of tax is not paid by the due date, the taxpayer is obliged to pay interest on such amount for the period from the date the tax is due to the date it is paid.

2. The interest rate under Sub- article (1) of this article is set at 25% (twenty five Percent) over and above the highest commercial lending interest rate that prevailed during the preceding quarter.

3. Interest shall be collected in the same manner as the tax to which it relates.

Credit and refund (Article-76):

1. Where the Tax Authority is satisfied that tax has been paid by a person, whether by withholding, installments, or otherwise, in excess of the person's tax liability to which the payment or payments relate, the Tax Authority shall:
   (a) Credit the overpaid tax against any liability of that person in respect of:
      (i) other taxes under this Proclamation;
      (ii) withholding of tax under this proclamation;
      (iii) any other amount due to the tax Authority under this Proclamation; or any other tax law; and
   (b) Refund the remainder to that person within 90 days of becoming satisfied.

2. The Tax payer shall be entitled to an interest set at the highest commercial lending interest rate increased by 25% (twenty five percent) that prevailed during the preceding quarter if he/it has not received the refund within the time prescribed under Sub-article(1) (b) of this Article.

3. Without limiting the generality of Sub-Article (1) of this Article, a person may apply for a refund under this Article. A refund application shall be made to the Tax Authority in writing within three (3) years of the later of :
   (a) The date on which the Tax Authority has served the notice of assessment to which the refund application relates, or
   (b) the date on which the tax or interest was paid.

4. The Tax Authority shall, within forty-five (45) days of making a decision on a refund application under Sub-Article 2, serve on the person applying for the refund a notice in writing of the decision.

5. A person dissatisfied with a decision referred to in Sub-Article 4 may challenge the decision only through, the appeal procedure as though the decision were that of an assessment.

SECTION VII
COLLECTION ENFORCEMENT

Seizure of Property to Collect Tax (Article-72):

1. subject to Sub-Article (4) of this Article if any person liable to pay any tax imposed by this proclamation is in default under Article 73(3), it shall be lawful for the Tax Authority to collect such tax 'and such further amount as shall be sufficient to cover the expenses of the seizure' by seizing any property belonging to such person. Seizure may be made on the accrued salary or wages of any employee, including a government employee, by serving a notice of seizure on the officer who has the duty of paying the salary or wages.

2. For purposes of this Section; the team "Seizure" includes seizure by any means, as well as, collection from a person who owes money or property to the taxpayer. Except as provided in sub-Articles (3) and (6), a seizure shall extend only to property possessed and obligations existing at the time the seizure is made. The Tax authority may request a police officer to be present during seizure. Where the Authority seizes any property as provided hereinabove, it shall have the right to sell the seized goods at public auction or in any other manner approved by the authority within not less than 10 days after the seizure, except that when the goods seized are perishable the authority can sell the goods after any reasonable period having regard to the nature of the goods.
3. Whenever any property on which seizure had been made is not sufficient to satisfy the claim for which seizure is made, the Tax authority may, thereafter and as may be necessary, proceed to seize other property, liable to seizure, of the person against whom the claim exists until the amount due, together with all expenses, is fully paid.
4. Seizure may be made under Sub-Article (1) of this Article on employee's remuneration. or other property of any person with respect or any unpaid tax only after the Tax Authority has notified such person in writing of its intention to make such seizure. The notice shall be delivered not less than thirty (30) days before the day of the seizure.
5. If the Tax Authority makes a finding that the collection of the tax is in jeopardy, a demand for immediate payment of such tax may be made by the Tax Authority and, on failure or refusal to pay the tax, collection thereof by seizure shall be lawful without regard to the 30-days period provided in Sub-Article (1) and the days provided in sub-Article (4).
6. The effect of a seizure on employee remuneration payable to a taxpayer shall be

continuous from the date such seizure is first made until the liability out of which such seizure arose is satisfied or becomes unenforceable by reason of lapse of time.

7. The following shall be exempt from seizure:

    i. such amount of employee remuneration or other periodic income payable to an individual as does not exceed the exempt amount according to Schedule A; and
    ii. all other income and property that are not liable to attachment or lien under Ethiopian law.

Enforcement of Seizure (Article-78):

1. Any person in possession of (or obligated with respect to) property subject to seizure on which a seizure has been made shall, unless such property is, at the time of such demand, subject to an attachment or execution under any judicial process or is encumbered by law with the preferred right of other creditors as stipulated under Article 30, on the demand of the Tax authority surrender such property (or discharge such obligation)
2. Any person who fails or refuses to surrender any property subject to seizure, on demand of the Tax Authority, shall be personally liable to the government in a sum equal to the value of the property not so surrendered, but not exceeding the amount of taxes for the collection of which seizure has been made (together with costs and interest on such sum).
3. In addition to the personal liability imposed by Sub-article (2), if the failure or refusal to surrender is without reasonable cause, such person shall be liable for an additional charge equal to fifty percent (50%) of the amount recoverable under Sub-Article (2).
4. Any person in possession of property who surrenders or makes payment in accordance with this Article shall be discharged from any obligation or liability to the delinquent taxpayer or to any other person arising from such surrender or payment.

Production of Books (Article-79):

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

Preferential claim to Assets (Article-80):

1. From the date on which tax becomes due and payable under this Proclamation, subject to the prior secured claims of creditors, the Authority has a preferential claim over all other claims upon the assets of the person liable to pay the tax until the tax is paid.
2. Where a person is in default of paying tax, the Authority may, by notice in writing, inform that person of the Authority's intention to apply to the Registering Authority to register a security interest in any asset situated in Ethiopia which is owned by that person, to cover any unpaid tax in default, together with any expense incurred in recovery proceedings.

3. If the person on whom a notice has been served under Sub-article (2) fails to pay the amount specified in the notice within 30 days after the date of service of the notice, the Authority may, by notice in writing, direct the Registering Authority that the asset, to the extent of the defaulter's interest therein, shall be the subject of security for the total amount of unpaid tax.
4. Where the Authority has served a notice on the Registering Authority under Sub-Article (3), the Registering Authority shall, without fee, register the notice of security as if the notice were an instrument of mortgage over or charge on such asset, as the case may be, and such registration shall, subject to any prior mortgage or charge, operate while it subsists in all respects as a legal mortgage over or charge on the land or building to secure the amount due.

Jeopardy Assessment (Article-81):

In exceptional cases where the Tax Authority has reasonable grounds to believe that the collection of tax is in jeopardy, and where a state of urgency exists, the Tax Authority may issue an administrative order to the Bank with a statement of justification supplementing its order to block the accounts of the taxpayer and secure information thereon, and may make an immediate assessment of tax for the current period; provided, however; that the Tax Authority shall obtain court authorization within ten (10) days from the date of issuance of its administrative order and further that such powers may only be used to elucidate information relevant to the assessment.

Priority of claim on Tax Withheld (Article-82):

1) Tax withheld by a withholding agent under this Proclamation:

   i. is held by the withholding agent in trust for the Tax Authority:
   ii. is not subject to attachment in respect of a debt or liability of the withholding agent; and
   iii. in the event of liquidation or bankruptcy of the withholding agent, does not form part of the estate in liquidation, assignment, or bankruptcy and the Tax Authority has a first claim before any distribution of property is made.

2) An amount that a withholding agent is required under this Proclamation to withhold from a payment is:

   (a). a first charge on that payment; and
   (b). withheld prior to any other deduction which the withholding agent may be required to make by virtue of an order of any court or any other law.

Taxpayer Safeguards (Article-83):

Any property seized under this Section shall be seized, held, and accounted for only by the Tax Authority No other agency of the government may require the property seized under this section to be transferred or given over to it for any cause whatsoever. If any property seized under this Section is sold, any portion of the proceeds in excess of the taxpayer's liabilities under this section shall be returned promptly to the owner of the property.

SECTION VIII
REWARDS AND ADMINISTRATIVE PENALTIES

Rewards for Verifiable Information (Article-84):

1) Where a person provides a verifiable and objective information of tax evasion through concealment, under reporting, fraud or any other improper means, the informer shall be granted up to twenty percent (20) of the amount of tax evaded at the time of collection of the said tax.

2) The informer shall not be entitled to such a reward where:
   (a) he/she has participated in the tax evasion; or
   (b) where such reporting is part of his/her employment duty.

3) Details shall be provided by the directives of the Tax Authority

Reward for Outstanding Performance (Article-85):

1) The Tax Authority shall reward tax payers and tax officers for outstanding performance and discharge of duties.

2) Details shall be provided by the directives of the Minister of Revenue.

Penalty for Late Filing or Non-Filing (Article-86):

A taxpayer who fails to file a timely tax declaration is liable fro 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.

Collection of And Appeal Against Penalties (Article-92):

Administrative penalties shall be paid on notice and demand by the Tax Authority and shall be assessed and collected in the same manner as taxes. Any references, in this Proclamation, to "tax imposed" shall be deemed to include administrative penalties imposed.

Exoneration of Taxpayer from Liability (Article-93):

In the event that errors that led to incorrect determination and execution of tax obligations are corrected independently before commencement of a tax examination, the taxpayer shall be released from liability, with the exception of paying the tax and interest.

SECTION - IX
CRIMINAL OFFENCES

Procedure in Tax Offence Cases (Article-94):

A tax offence is a violation of the criminal law of Ethiopia and shall be charged, prosecuted, and appealed in accordance with the Ethiopian criminal procedure law.

TIN Violations (Article-95):

If a person subject to tax is convicted of obtaining more than one TIN, that person shall be liable to pay a fine of not less than 20,000 Birr and not more than 50,000 Birr and to imprisonment of five (5) years per additional TIN obtained.

Tax Evasion (Article-96):

A taxpayer who evades the declaration or payment of tax commits an offense and, in addition to the penalty for the understatement of income referred to in Article 86, may be prosecuted and, on conviction, be subject to imprisonment for a term of not less than five (5) years.

Making False or Misleading Statements (Article-97):

1. A tax payer who:
    (a). makes a statement, to an officer of the Tax Authority, that is false or misleading in a material particular; or

    (b). omits from a statement made to an officer of the Tax Authority any matter or thing without which the statement is misleading in a material particular; commits an offence and is liable on conviction.

2. Where the statement or omission is made without reasonable excuse,
    (a) and if the inaccuracy of the statement undetected may result in the underpayment of tax by an amount not exceeding 1,000 Birr, the tax payer shall be liable to a fine of not less than 10,000 Birr and not more than 20,000 Birr, and imprisonment for a term of not less than one (1) year and not more than three (3) years, and
    (b) If the underpayment of tax is in an amount exceeding Birr 1,000, he shall be liable to a fine of not less than twenty thousand Birr and not more than 100,000 Birr and imprisonment for a term of not less than three(3) years and not more than five (5) years.

3. Where the statement or omission is made knowingly or recklessly,
    (a) and if the inaccuracy of the statement undetected may result in an underpayment of tax by an amount not exceeding 1,000 Birr, to a fine of not less than 50,000 Birr and not more than 100,000 Birr, or imprisonment for a term of not less than five (5) years and not more than ten (10) years; and

    (b) If the underpayment of tax is in an amount exceeding Birr 1,000, to a fine of not less than 75,000 Birr and not more than 200,000 Birr, or imprisonment for a term of not less than ten (10) years and not more than fifteen (15) years.

Obstruction of Tax Administration (Article-98):

1) A person who,
    (a) obstructs or attempts top obstruct an officer of the Tax Authority in the performance of duties under this Proclamation, or
    (b) otherwise impedes or attempts to impede the administration of the Proclamation,

    commits an offence and is liable on conviction to a fine of not less than 10,000 Birr and not more than 100,000 Birr, and imprisonment for a term of two (2) years.

3) The following and similar other actions are considered to constitute obstruction:
    (a) refusal to satisfy a request of the Tax Authority for inspection of documents, reports, or other information related to a taxpayer's income-producing activities;
    (b) non-compliance with a Tax Authority request to report for an interview;
    (c) interference with a tax officer's right to enter the taxpayer's business premises.

Offences by Tax Authority Employee (Article-99):

Any person employed for carrying out the provisions of this Proclamation who:

(a) directly or indirectly, asks for or receives in connection with any of the officer's duties, a payment or reward, whether pecuniary or otherwise, or promise or security for that payment or reward, not being a payment or reward to which the officer is lawfully entitled to receive, or
(b) enters into or acquiesces in an agreement to do or to abstain from doing permit ,conceal, or connive at any act or thing whereby the tax revenue is or may be defrauded, or which is contrary to the provisions of this Proclamation or to the proper execution of the officer's duty;
(c) exceeds the authority conferred upon the Tax Authority or misuses such authority; commits an offence and is liable, on conviction, to a fine of not more than 50,000 Birr and to imprisonment for a term of not less than ten (10) years and not more than twenty (20) years.

Unauthorized Tax Collection (Article-100):

Any person who is not authorized to collect tax under this Proclamation collects or attempts to collect tax (or an amount the person describes as tax) commits an offence and is liable, on conviction, to a fine of not less than 50,000 Birr and to imprisonment for a term of not less than five (5) years and not more than ten (10) years.

Aiding or Abetting (Article-101):

A person who aids, abets, incites, or conspires with another person to commit a violation against this Proclamation also commits an offence under this proclamation and shall be subject to prosecution, and shall on conviction be liable to a fine and imprisonment not in excess of the amount of fine or period of imprisonment provided for the offence aided or a betted.

Offences by Entities (Article-102):

1) Subject to the provisions of Sub-Article (3) of this Article, where an entity commits an offence, the manager of that entity at the time of the Commission of the offence is treated as having committed the same offence and is liable to a fine and imprisonment under this Proclamation.
2) Subject to the provisions of Sub-Article (3) of this Article, where an entity commits an offence by failing to pay an amount of tax, including an amount treated by this Proclamation as though it were tax, every person who is the manager of that entity at that time, or was a manager within six (6) months prior to the date of commission shall jointly and severally, be liable with that entity and that other person to the Tax Authority for the amount.

3) Sub-Articles (1) and (2) do not apply where:

   (a) the offence is committed without such person's knowledge or consent; and

   (b) such person has exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances to prevent the commission of the offence.

4) Any person who refuses to supply goods or render services to a withholding agent, by reason of him withholding an amount of tax from the payment to that

person, shall personally be liable to a fine of not less than Birr 5,000 and not exceeding Birr 10,000 and to imprisonment for a term of not less than one year and not more than two years.

5) In Sub-Articles (1) and (2), “manager” means,

(a) in the case of a partnership, a partner or manager of the partnership or a person purporting to act in either of those capacities;
(b) in the case of a body, a director, manager, or officer of the company or a person purporting to act in any of those capacities; and
(c) in the case of an association of persons, a manager or a person purporting to act in that capacity.

Publication of Names (Article-103):

1. The Authority shall from time to time publish by notice in daily Gazettes a list of persons who have been convicted of offences under Articles 93 to 101.
2. Every list published in terms of Sub-Article (1) shall specify:

(a) the name and address, of the enterprise or of the person;
(b) such particulars of the offence as the Authority may think fit:
(c) the tax period or tax periods in which the offence occurred;
(d) the amount or estimated amount of the tax evaded; and
(e) the amount, if any, of the additional tax imposed.

SECTION X
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.

Waiver of Penalty (Article-106):

The Review Committee may waive administrative penalties in accordance with the directives issued by the Minister of Revenue.

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 fulfillment 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.

Date of Lodging Appeal (Article-108):

The date on which an appeal is submitted shall be the date of:

(a) its registration by the archives of the Appeal Commission if it is delivered other than by registered mail; or
(b) registration by the post office if sent by registered mail.

Contents of Memorandum of Appeal (Article-109):

1) The memorandum of appeal shall be submitted in duplicate and shall include:
   (a) a statement of the specific subject matter of the appeal and the reason for the appeal:
   (b) the taxpayer's name, address and TIN, and
   (c) as attachments, any relevant supporting documents and a photocopy of the receipt for the appeal deposit.
2) Where any one of the first three conditions under Sub-Article (1) is missing, the Appeal Committee shall require the appellant to correct the deficiency within five (5) days, failing of: which the appeal shall be rejected.

Service of Documents (Article-110):

1) Prior to the first hearing of any appeal:
   (a) a copy of the memorandum of appeal shall be served on the Tax Authority by the Appeal Commission; and
   (b) the Tax Authority shall submit its reply to the Appeal Commission while at the same time giving a copy thereof to the appellant.
2) The appellant shall have the burden of proof with a view of establishing his or its claim.

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 Commissions 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-part 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 neighboring 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.

Burden of Proof (Article-116):

The burden of proving that an assessment is excessive or that a decision of the Authority is wrong lies on the person objecting to the assessment or decision.

Power to Issue Regulations and Directives (Article-117):

1. The Council of Ministers shall issue regulations for the proper implementation of this Proclamation.
2. The Minister of Finance and Economic Development shall issue directives for the carrying out of any power delegated to him under this Proclamation.

Section XI
Transitional Provisions

Transitional Provisions (Article-118):

1. All repealed laws hereunder, shall continue to apply to all liabilities that are already due and payable upon the coming into force of this Proclamation or are accrued in respect of income from trade, business profession, vocations or any other activity taxable there under.

2. All existing Tax Appeal Commissions shall continue to function until such time as new Tax Appeal Commission has been established in accordance with the provisions of this Proclamation.

Repealed and Inapplicable Laws (Article-119):

(a) The Income Tax Proclamation No. 173 of 1961 and all amendments thereto are hereby repealed.
(b) Payment of Tax on Gains from Capital Proclamation No. 108/1994 is hereby repealed.
(c) Federal Tax Appeal Tribunal Establishment Proclamation No.233/2001.
(d) All laws which are inconsistent with this Proclamation shall not apply shall not apply on matters covered under this Proclamation.

Effective Date (Article-120):

This Proclamation shall come into force as of the 4th day of July 2002, and shall apply to all income paid, received or earned from Hamle 1/1994 E.C. onward.

Done at Addis Ababa, this 4th day of July, 2002

Girma Wolde Giorgis
President of the Federal
Democratic Republic of Ethiopia

VAT PROCLAMATION
PROCLAMATION NO. 285/2002
VALUE ADDED TAX PROCLAMATION

The VAT is a broad based tax on the consumption of goods and services. It is collected at all stages in the production and distribution process beginning with the importers and producers of raw materials and ending with the retailers

- Cascading of the tax (i.e. tax on tax) is avoided by providing for a credit for the tax paid at the preceding level.
- Unlike the sales tax system, whereby relief is granted only to raw materials used directly in the production of goods, under a VAT, relief is granted for tax paid on capital goods, distribution and administration inputs.
- Sales of exported goods are not subject to the VAT.

SECTION ONE

General

Definitions (Article -2):

For the purpose of this Proclamation the following terms are defined:

1. **Accounting period:** The term Accounting period means a calendar month. The month of Nahase and Pagumen shall be aggregated and treated as one calendar month;
2. **Agent:** The term “Agent" means any person who acts on behalf of and on instruction from another person;
3. **Association of persons**: The term "Association of persons" means an association of individuals or an association that includes one or more members who are not individuals, but not including any association falling within the definition of "body";
4. **Authority:** The term "Authority" means the Federal Inland Revenue Authority;
5. **Body:** The term "Body" means any company, registered partnership, entity formed under foreign law resembling a company or registered partnership, or any public enterprise or public financial agency that carries out business activities including body of persons corporate or unincorporated whether created or recognized under a law in force in Ethiopia or elsewhere, and any foreign body's business agent doing business in Ethiopia behalf of the principal:
6. **Export:** The term “Export" means taking goods out of Ethiopia;
7. **Goods:** The term “goods" means all kinds of corporeal movable or immovable property, thermal or electrical energy, heat, gas, refrigeration, air conditioning, and water, but does not include money;
8. **Money :** The term "Money" means:
   1. a coin or note that is legal tender in Ethiopia; or
   2. a bill of exchange, bank draft, promissory note, postal order, or money order; or
   3. a stamp, from or card that has a monetary value and is sold or issued by the Government for the payment of any fiscal charge leveled under any

law except here the coin, note, stamp, from, or card is disposed of as a collector's piece, an investment article, or an item of numismatic interest;

9. **Import of Goods:** The term "Import of Goods" means bringing goods into Ethiopia according to the customs legislation;
10. **Permanent Establishment:** The term "Permanent Establishment" means a fixed place of taxable activities through which those activities of a person are wholly or partly carried on. The following shall, in particular, be considered to be a permanent establishment, an administrative office, branch, factory, workshop, mine quarry or any other place for the exploitation of natural resources, and a building site or place where construction and/or assembly works are carried out;
11. **Person:** The term "Person" means any natural person, sole proprietor, body, joint venture, or association of persons (including a business representative residing and doing business in Ethiopia on behalf of the principal):
12. **Registering Authority:** The term "Registering Authority" means a person appointed under any law to issue a license, permit, certificate, concession, or other authorization;
13. **Related person:** "Related person" means:
    1. a natural person and
        a) any relative of that natural person; or
        b) a trust in respect of which such relative is or may be a beneficiary, or
    2. a trust and a person who is or may be a beneficiary in respect of that trust; or
    3. a partnership, joint venture, or unincorporated association or body or private company and-
        a) any member thereof, or
        b) any other person where that person and a member of such partnership, joint venture, or unincorporated association or body, or private company as the case may be, are related persons in items of this definition; or
    4. an incorporate company, other than a closed corporation :and
        a) a person, other than an incorporated company where that person or that person and a person related to the first mentioned person in terms of this definition controls 10 percent or more of-
            1. the voting power in the first-mentioned company; or
            2. the rights to distributions of capital or profits of the first-mentioned company, either directly or through one or more interposed companies, partnerships, or trusts; or
        b) any other incorporated company in which the first mentioned person referred to in (a) or that person and a person related to that first mentioned person in terms of this definition controls 10 percent or more of-
            1. the voting power in the first-mentioned company; or
            2. the rights to distributions of capital or profiles of he first-mentioned company, either directly or through one or more interposed companies, partnerships, or trusts; or
        c) any person where that person and the person referred to in (a) or the other incorporated company referred to in (b) are related persons in terms of this definition; or

d) any person related to the person referred to in (c0 in terms of this definition; or

5. a registered person and a branch or division of that registered person which is separately registered under Article 16 Sub-Article(5); or
6. any branches or divisions of a registered person which are separately registered under Article 16 Sub-Article (5);

14. Relative: The term “Relative", in relation to a natural person, means

1. the spouse of the person; or
2. an ancestor, lineal descendant, brother, sister, uncle, aunt, nephew, niece, stepfather, stepmother, stepchild, or adopted child of that person or her spouse, and n the case of an adopted child her adoptive parent; or
3. the spouse of any person referred to in paragraph (2) and for the purposes of this definition, any adopted child is treated as related to the adoptive parent within the first degree of consanguinity;

15. Resident person: The term "Resident person" shall have the meaning given to it under the Income Tax Proclamation;

16. Services: The term "Services" means work done for others, which does not result in the transfer of goods;

17. Supply: The term "Supply" means the sale of goods or the rendition of services, or both;

18. Supply of Goods: The term "Supply of Goods" has the meaning assigned to it under Article 4:

19. Rendition of Services: The term "Rendition of Services" has the meaning assigned to it under Article 4:

20. Tax or VAT: The term "Tax" or "VAT" shall mean Value Added Tax;

21. Taxable Activity: The term "Taxable Activity" has the meaning assigned to it under Article 7 Sub-Article 6;

22. Taxable Transaction: The term "Taxable Transaction" has the meaning assigned to it under Article 7 Sub-Article (3);

23. Tax officer: The term "Tax officer" means

1. the General Manager of the authority; or
2. a person in the service of the Authority or the Ethiopian Customs Authority; or
3. a police officer or official of the Ethiopian Police Force, acting on behalf of the Authority under this Proclamation; or
4. an employee or official of the Ethiopian Postal Services, acting on behalf of the Ethiopian customs Authority who administers this Proclamation: and

24. Tax invoice: The term "Tax invoice" has the meaning assigned to it under Article22.

Taxpayers (Article-3):

For the purpose of this Proclamation, the following persons are taxpayers:

a) a person who is registered or is required to be registered, referred to as a registered person;

b) a person carrying out taxable import of goods to Ethiopia, with respect to such import;

c) a non-resident person who performs services without registration for VAT and who is subject to taxation under Article 23, with respect to such services.

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

Supply of Good and Rendition of Services (Article-4):

VAT is a tax on consumer expenditure. It is collected on business transactions and imports. 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.

According to this Proclamation the terms "supply of goods" and "rendition of services" are explained as follows:

1. Supply of goods:

The Supply of goods includes:

(i). a sale of goods;

or

(ii) . a grant of the use or right to use goods, whether with or without a driver, pilot, crew, or operator, under a rental agreement, credit agreement, freight contract, agreement for charter, or any other agreement under which such use or right to use is granted:

or

(iii). a transfer or provision of thermal or electrical energy, gas, or water;

2. Rendition of services:

A rendition of services means anything done which is not a supply of goods or money, including:

1. the granting, assignment, cessation, or surrender of any right

   or

2. making available a facility or advantage.

Other Provisions relating to Supply of Good and Rendition of Services:

- if a registered person purchased goods or services accompanied by a VAT payment and received (or has the right to receive) appropriate credit, the application of those goods or services to a use other than a use in the course or furtherance of a taxable activity is considered to be a supply of goods or services by that person in the course of furtherance of a taxable activity.

- The supply of goods or rendering of services by an employer to his employees, including gratuitously, is a supply of goods or services in the course or furtherance of a taxable activity.
- If a registered person's VAT registration is canceled, his goods (including capital goods as provided under Sub-Article (8) on hand at the time the cancellation takes effect are considered to be supplied at cost in a taxable transaction taking place at that time if the registered person claimed or had a right to claim a tax credit with respect to the acquisition of the goods under Article 21.
- Notwithstanding the other provisions of this Article, the supply of a good by a person who acquired such good in a transaction subject to VAT, but who was not entitled to a credit for the VAT on the acquisition of the good by reason of the operation of Article 21, is not considered a taxable transaction. If a credit was partially allowed on the acquisition of the good, then the amount of the taxable transaction is reduced proportionally according to the portion of the credit that was disallowed.
- The value of returnable packaging is not included in the taxable amount, except in the case of sales at retail. Retailers may reduce their taxable transactions by amounts shown to have been paid by them as refunds for returned containers.
- This Proclamation applies to the supply of goods and rendering of services carried out by a nonresident in Ethiopia through a permanent establishment in Ethiopia or through the Internet.
- For purposes of Sub-Article (4), the cost of capital goods (determined asset-by-asset) treated as supplied at the time of de-registration is equal to the cost of such goods, multiplied by the fraction, the numerator of which is the number of years of useful life remaining and the denominator is the total useful life of the goods. For this purpose, the useful lives shall be determined under directives issued by the Minister of Revenue.
- The disposal of a taxable activity as a going concern, or a part of a taxable activity that is capable of separate operation, is a supply of goods made in the course or furtherance of such taxable activity, and the transferee succeeds to the rights and obligations of the supplier with respect to the assets transferred.
- The council of Ministers may provide in regulations for the treatment of other transaction as supplies of goods or rendition of services.

Mixed Supplies (Article-5):

The following are considered as mixed supplies:

1. A supply of goods or rendering of services, which is incidental to a (main) supply of
   goods or rendering of services, is treated as part of the latter.
2. The rendering of services incidental to an import of goods is part of the import of goods.

3. A taxable transaction involving independent elements, on or more of which involves the separate supply of goods or rendering of services, which would be exempt from tax, is treated as separate transactions. An exempt transaction, which involves the separate supply of taxable goods or rendering of taxable services, is treated as separate transactions.

Taxable Activity (Article-6):

"Taxable activity" means an activity, which is carried continuously or regularly by any person:

1. In Ethiopia, or
2. Partly in Ethiopia,

Whether or not for a pecuniary profit, that involves or is intended to involve, in whole or in part, the supply of goods or services to another person for consideration.

SECTION TWO
Imposition of tax and Transactions Exempted from the Tax

Imposition of Tax (Article-7):

If a business unit whether a person or body or association of person is engaging in the business and sells goods (supply of goods) or if it is doing something for someone else and is paid for doing it (making a supply of services), it is likely that it is making taxable supplies. When a business unit is registered, VAT is chargeable on all the taxable supplies it makes. There are two rates of tax. The standard rate which is 15% and the zero rate, which is 0%.

The standard rate is levied on the following:

a) every taxable transaction by a registered person; and
b) every import of goods, other than an exempt import; and
c) an import of services as provided in Article 23.

Transactions charged with tax at a rate of Zero percent:

Supplies of zero- rated goods or services are business transactions which VAT is chargeable at 0% (in effect no VAT is charged). Zero rate supplies are taxable supplies although no VAT is charged and the value of these supplies forms part of the taxable turnover for registration purposes.

The business unit can claim full Input Tax (tax paid on purchases) credit related to its zero rated supplies. If it makes only zero-rated supplies, it can be able to claim refunds from FIRA/VAT.

The following taxable transaction s shall be charged with tax at a rate of Zero percent:

a) the export of goods or services to the extent provided in regulations;
   - Goods are treated as exported from Ethiopia if the goods are delivered to or made available at an address outside Ethiopia as

evidenced by documentary proof from ECuA acceptable to the FIRA/VAT.

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

b) the rendering g of transportation or other services directly connected with international transport of goods or passengers, as well as the supply of lubricant and other consumable technical supplies taken on board for consumption during international flights;

c) the supply of gold to the National Bank of Ethiopia; and

Exempt Transactions (Article-8):

Supplies of exempt goods and services are business transactions on which VAT is not chargeable at either the standard or zero-rate. Exempt Supplies are not taxable supplies and do not form part of the taxable turnover for VAT registration purposes. If a business unit makes only exempt supplies then it can not be registered for VAT.If it makes taxable and exempt supplies, it cannot reclaim the Input Tax (tax paid on purchases) related to the exempt supplies.

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 to the extent provided by regulation:

a) the sale or transfer of a used dwelling, or the lease of a dwelling. That is the sale,
transfer or lease of immovable property, except for the following:-
  - the sale or transfer of hotel or holiday accommodation;
  - the sale or transfer of newly constructed residential property, unless the property has been occupied as a residence for at least two years.

b) the rendering of financial services. Financial services include:
  - granting, negotiating and dealing with loans, credit guarantees, and any security for money, including management of loans, credit or credit guarantees by the grantor.
  - transactions concerning deposits and current accounts, payments, transfers, debts, cheques and negotiable installments other than debt collection and factoring;
  - transactions relating to share, stocks, bonds, and other securities other than custody services;
  - management of investment funds

c) the supply or import of national or foreign currency (except for that used for numismatic purposes), and of securities;

d) the import of gold to be transferred to the National Bank of Ethiopia;

e) the rendering by religious organizations of religious or church related services;

f) the import or supply of prescription drugs specifies in directives issued by the Minister of Health, and the rendering of medical services;

g) the rendering of educational services provided by educational institutions, as well as child care services for children at pre-school institutions;
h) the supply of goods and rendering of services in the form of humanitarian aid, as well as import of goods transferred to state agencies of Ethiopia and public organizations for the purpose of rehabilitation after natural disasters, industrial accidents, and catastrophes;
i) the supply of electricity, kerosene, and water:
j) goods imported by the government, organization s, institutions or projects exempted from duties and other import taxes to the extent provided by law or by agreement.
k) supplies by the post office authorized under the Ethiopian postal Services Proclamation, other than services rendered for a fee or commission;
l) the provision of transport;
m) permits and license fees;
n) the import of goods to the extent provided under Schedule 2 of the Customs Tariffs Regulations;
o) the supply of goods or services by a workshop employing disabled individuals if more than 60 percent of the employees are disabled; and
p) the import of supply of books and other printed materials to the extent provided in regulations.

For purposes of this Article:

a) "Commercial rental establishment" means:

1. Accommodation in any hotel, motel, inn, boarding house, hostel, or similar establishment in which lodging is regularly or normally provided to five or more persons at a daily, weekly, monthly, or other periodic charge;
2. Accommodation in any house, flat, apartment, or room, which is regularly or systematically leased or held for lease as residential accommodation for continuous periods not exceeding 45 days in the case of each occupant of such house, flat, apartment, or room, if the total annual receipts and accruals from the lease thereof exceeded 24,000 Birr, or there are reasonable grounds for believing that such total annual receipts and accruals will exceed that amount;
3. Accommodation in any house, flat, apartment, room, caravan, houseboat, tent, or caravan or camping site which constitutes an asset, including a leased asset of a business undertaking or a separately identifiable part of a business undertaking Carrie on by any person who:

b). "dwelling" means any building, premises, structure, or any other lace, or any part thereof, used predominantly as a place of residence or abode of any natural person or which is intended for use as a place of residence or abode of any natural person, together with any appurtenances belonging thereto and enjoyed therewith, but does not include a commercial entail establishment;

A supply of goods or services is not an exempt supply when the supply would be charged with tax at the rate of Zero percent under Article 7.

The Minister of Finance and Economic Development may be directive exempt other goods and services.

Zero-Rated Supplies Vs Exempt Supplies:

Zero rate tax is charged at 0%. That is, zero-rating supply is charged with VAT at 0% but credit can be taken for VAT paid on purchases used to make the supply. But in the case of exempt rate tax is where no tax is charged at all. Therefore, Exempt Supplies are not liable to VAT and are not taxable supplies and do not form part of the taxable turnover for VAT purposes. A person making only exempt supplies cannot be registered for VAT. Exempt rate supplies are outside the VAT system so it does not attract Input Credit or Refund.

SECTION THREE

Place, Time and Value of Supplies

Place of Supply of Goods (Article-9):

If a supply involves goods being transported, the supply takes place at the location of the goods when transportation tarts. In other cases, the supply of goods takes place at he location where the goods are transferred. A supply of electric or thermal energy, gas, or water takes place where the goods are received, except that if these are exported from Ethiopia, the supply is considered to take place in Ethiopia.

Place of Rendering of services (Article-10):

The place of rendering of services is the location of the taxable activity of the person who renders the services. As such the place of rendering of services is:

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

contract to perform the service tat are described in this Sub-Article.

Time of Supply (Article-11):

Article-11 states about the time of supply of goods and services. According to this Article,

1 .A supply occurs when a VAT invoice issued for that transaction..

2. Notwithstanding the provisions of Sub-Article the supply will be considered as having taken place--
   a) at the time the goods are made available to the recipient, sold or transferred, or the services are rendered: or
   b) in the case of a delivery of goods that involves shipment of the goods, when the shipment starts.

3 Notwithstanding the provisions of Sub-Article (1) and (2), if payment is made in advance of the time described in Sub-Article (2) (a) or (s) (b), and if a VAT invoice is not issued within 5 days after the date of payment, the supply will be considered as having taken place at the tie payment is made.
   - For this purpose, if two or more payments are made for a supply, each payment is treated as made for a separate supply to the extent of the payment.

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

5. if a registered person purchased goods or services accompanied by a VAT payment and received appropriate credit, the application of those goods or services to a use is considered to be a supply of goods or services by that person in the course of a taxable activity and the time of the supply is the time when the use or consumption of goods or services begins.

6. Supply of goods or rendering of services by an employer to his employees is a supply of goods or services in the course of a taxable activity and the time the supply occurs is the time of supply of the goods or rending of the services to the employee.

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

8. The time when other supplies occur may be provided by directives issued b the Minister of Revenue.

Value of a supply (Article-12):

1. The value of a supply is determined according to the amount the person receives or is entitled to receive in return for the supply of goods or

rendering of services, whether from the customer or any other person (including any duty, taxes, or other fee payable), but without including VAT.

2. if the person receives or is entitled to receive goods or services in exchange for a supply of goods or a rendition of services, the value of the supply includes the market price of these goods or services(including any duty, taxes, or other fee payable) , but without including VAT.
3. In a case where the person receives or is entitled to receive nothing of value in exchange for a supply of goods or a rendition of services (including that of goods remaining on hand in the case of a cancellation of registration, but not including supply of business samples0), the value of the supply is the market price of the goods or services supplied or rendered (including and duty, taxes, or other fee payable), but without including VAT.
4. In the case of consumption or use of goods or services, other than in connection with a taxable activity according to Article 4, Sub-Article (3) , as well as in the case of a supply or rendering to an employer's employee according to Article 4, sub Article (4) the value of the supply is the cost price of the goods or services supplied (including any duty, taxes, or other fee payable), but without including VAT.

5. The Minister of Revenue may issue a directive to provide for the calculation of the value of a service for supplies not covered in this Article.

Adjustment of the value of a Taxable Transaction (Article-13):

1. This Article applies where, in relation to a taxable transaction made by a registered person:
    a) the transactions cancelled;
    b) the nature of the transaction is changed;
    c) the previously agreed consideration for the transaction is altered, whether due to a reduction of prices or for any other reason; or
    d) the goods or services are returned in full or in part to the registered person.

2. If a registered person has, as a result of the occurrence of one or more of the events described above :
    a) Provide a VAT invoice and the amount of VAT shown on the invoice is incorrect, or
    b) Shown an incorrect amount of VAT on a VAT return, then necessary adjustment is to be made as specified in Article 20, sub-Article (2) or Article 21, Sub-Article (7).
3. Where a tax invoice has been issued in respect of the supply by a registered person to a person and the amount of VAT shown as tax charged on the invoice exceeds the tax properly chargeable in respect of the supply, then the registered person making the supply shall provide the other person(recipient of supply) a tax credit note containing the particulars

specified in this regard. A Person shall not provide a tax credit note in any circumstances other than this.

4. Where a tax invoice has been issued in respect of the supply by a registered person to a person and the tax properly chargeable for that exceeds the amount of tax charged in that invoice, then the registered person shall provide the recipient a tax debit note containing the particulars specified in this regard.A person shall not provide a tax debit not in any circumstances other than this.

5. A registered person shall only issue one tax credit note or tax debit note for the above mentioned situation. If a registered person(recipient of supply) has lost the original tax credit note or tax debit note and requested for another note, then the registered person who made the supply may provide a copy of a note clearly marked "copy".

6. A tax credit note as required in this Article shall contain the following particulars:
   - (a) the words "tax credit note" in a prominent place;
   - (b) The name, address, and taxpayer identification number of the registered person making the supp;
   - (c) The name, address, and taxpayer identification number of the recipient of the supply;
   - (d) the value of the supply shown on the tax invoice, the correct amount of the value of the supply, the difference between those two amounts, and the tax charged that relates to that difference;
   - (e) a brief explanation of the circumstances giving rise to the issuing of the tax credit note;
   - (f) information sufficient to identify the taxable supply to which the tax credit note relates.
   - (g) information sufficient to identify the taxable supply to which the tax credit note relates.

7. A tax debit note as required in this Article shall contain the following particulars:
   - a) the words "tax debit note" in a prominent place;
   - b) the name, address, and taxpayer identification number of the registered person making the supply;
   - c) the name, address, and taxpayer identification number of the recipient of the supply;
   - d) the date on which the tax debit note was issued;
   - e) the value of the supply shown on the tax invoice, the correct amount of the value of the supply, the difference between those two amounts, and the tax that relates to that difference;
   - f) a brief explanation of the circumstances giving rise to the issuing of the tax debit note; and
   - g) information sufficient to identify the taxable supply to which the tax debit note relates.

SECTION FOUR
Time and Value of Imports

Time of the Imports of Goods (Article-14):

An import of goods takes place when the goods are entered into the customs declaration.

Value of a Taxable Import (Article-15):

The value of a taxable import is the customs value of the goods, determined in accordance with the customs legislation of Ethiopia, plus the sum of duties and taxes payable upon the import of the goods into Ethiopia, excluding VAT and income tax withholding.

In the case of services considered part of an import under Article 5, their value, without VAT, is added to the value as mentioned above.

SECTION FIVE
Registration

Obligatory Registration (Article-16):

Every person who carries on taxable activity has to register himself with the VAT Authority. In other words, any person conducting a commercial enterprise or intending to conduct a commercial enterprise may apply to be registered for VAT if –

a) at the end of any period of 12 calendar months the person made taxable transactions the total value of which exceeded 500,000 Birr;

or

b) 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.

The term every person for purposes of VAT registration includes:-

- Sole proprietor.
- Company
- Partnership
- Estate of the deceased
- Trust
- Incorporated body or
- Unincorporated body
- Club or Association

Commercial Enterprise: Commercial enterprise means any business of whatever nature and it includes all. For example the following are the commercial enterprises for the purpose of VAT:

- Ordinary business e.g. shop, contractors, manufactures, wholesalers, etc.,
- Trades and Professions, e.g. Builders, Engineers, Accountants, Lawyers etc.
- Activities of non-profit making bodies e.g. Societies, Associations, sporting Clubs, etc.

A person required to register compulsorily shall file an application for registration no later than the last day of the month after the end of the period or the last day of the month of the period as the case he may be. The Minister of Finance and Economic Development may by directive increase or decrease the threshold provided for under this Article. Turnover related to exempt supplies as listed in the law is not to be included in the total for deciding if VAT registration is compulsory.

Voluntary Registration (Article-17):

A person, who carried o taxable activity and is not required to be registered for VAT, may voluntarily apply to the Authority for such registration. He is entitled to apply for registration if he regularly supply or render at least 75% of his goods and services to registered persons.

Voluntary registration is at the discretion of FIRA/VAT and also the person must be regularly supplying or rendering at least 75% of its goods and services to registered persons. FIRA/VAT can also refuse to register any person who:-

- has no fixed place of abode or business;
- does not keep proper accounting records,
- has no bank account;
- has previously been registered for VAT purposes but failed to perform his duties under the VAT law.

Registration Procedure (Article-18):

In determining whether a person has an obligation to register under this Article:

a) the authority may aggregate the value of taxable transaction made by one person with the value of taxable transactions made by the other person where both persons are related persons; and

b) the value of the person's taxable transactions is determined under Article 12.

Application for Registration:

Application for registration should be made in prescribed form. A person applying to register for VAT is required to do so in such a form as is established by the implementation directive issued by the Minister of Revenue. The application has to be

sigbed by the appropriate person in the commercial enterprise. For example it is to be signed by the proprietor of the business in the case of Sole proprietor.

Application for compulsory as well as voluntary registration must be made on form VAT –"APPLICATION FOR VAT REGISTRATION''. This is issued by FIRA/VAT. Once an application for registration has been made,

Additional Places of Business:

A registered person who conducts taxable activity in a branch or division shall be registered only in the name of the registered person. But upon application in writing by a registered person operating in corporate form, the Authority may authorize the registered person to register one or more of its branches or division as separate registered persons where the Authority is satisfied that the branch or division maintains an independent accounting system and can be separately identified by the nature of its activities or location. The registration of a branch or division is subject to such conditions and restrictions as the Minister of Revenue may deem fit.

Certificate of Registration:

The registering authority will ensure that application is in conformity with provisions of VAT Proclamation. The authority can make necessary enquires. For example,(a) particulars given are correct,(b) supplies requested for registration are eligible for inclusion. After the Authority is satisfied, it is required to register the person in the VAT register and the person will be issued a Certificate of Registration in the prescribed form within 30 days of the registration. This certificate should be kept at each additional place of business in the country. . If registration is disallowed FIRA/VAT will notify the person and the reasons for the refusal are explained.

Contents of Certificate of Registration:

VAT registration certificate containing such details as:

a) the full name and other relevant details of the registered person;
b) the date of issuance of the certificate;
c) the date from which the registration takes effect;
d)the registered person's taxpayer identification number.

Date of Registration:

Registration takes place on one of the following dates, depending on which date comes first:

a) in case of obligatory registration, on the first day of the accounting period following the month in which the obligation to apply for registration arose;
b) in the case of voluntary registration, on the first day of the accounting period following the month in which the person applied for registration.
c) on the date selected by the registered person on his application for registration.

The Authority is required to establish and maintain a VAT register containing details of all persons registered for VAT. If a person is required to register for VAT and has not

applied to be registered, the Authority may register the person on its own initiative and send to the registered person the certificate as mentioned in this Article. A person registered for VAT is required to use his taxpayer identification number(TIN) on all VAT invoices, and on all returns and official communications with the Authority.

Cancellation of Registration (Article-19):

The registered person must cancel his registration if: _

- he close down or sell business. If he has more than one business and is not closing down or selling them all, he may not be able to cancel – it will depend on the level of taxable turnover of the remaining businesses.
- he ceases to make taxable supplies of goods or services as part of a business activity if his legal status changes, for example:
    - he is a sole proprietor and now forms a partnership;
    - he dissolve a partnership and run the business as a sole proprietor;
    - the sole proprietorship or partnership is replaced by an incorporated company;
    - the company is wound up and replaced by a partnership or sole proprietorship.
- he stopped making taxable supplies for any other reason (e.g. if a VAT registered sole proprietor dies, his executors have the responsibility of canceling his registration).

A registered person can apply to have his registration for VAT canceled if he has ceased to make taxable transactions. He may apply for cancellation at any time after a period of three years from the date of his registration if the registered person's total taxable transactions in the period of 12 months from the beginning reasonably are expected to be not more than 500,000 Birr.

The cancellation of VAT registered takes effect at the time the registered person ceased to make taxable transaction or, if the registered person has not ceased to do so, at the end of the accounting period during which the person applies to the Authority.

The VAT/FIRA will notify the person if the application is acceptable and the date from which the registration is to be cancelled. The FIRA/VAT will send a final VAT Return for the period up to the date of cancellation of the registration. The person will then complete the return in the normal way and include any tax due on stock and assets. The VAT Registration Certificate will be surrendered to the FIRA/VAT office with the final return. The FIRA/VAT office will then confirm the final cancellation of the registration after satisfying themselves with the final return. If a person's registration for VAT is canceled, the Authority is required to remove the person's name and all other details from the VAT register.

Consequences of cancellation of Certificate of Registration:

The following are the legal consequences of the cancellation of Certificate of Registration:

- From the date the registration is cancelled the person cannot charge VAT or issue tax invoices for any supplies made.
- After registration is cancelled he cannot claim a refund of VAT incurred on any goods or services purchased.
- The VAT treatment of business stock and assets would depend on why the registration was cancelled.

  i). If he is closing the business, or continuing to trade below the registration limits, he must account for VAT on all stock and assets on hand at the close of business on the day his registration is cancelled.

  ii). He should value goods on which tax is due at a fair current market price in their present condition and account for the VAT on his final return which will be issued by the VAT office.

  This means that there will be no tax liability in respect of:-

  - goods bought from unregistered persons;
  - passenger automobile including spare parts unless he is in the business of dealing in or hiring such vehicles;
  - goods purchased for entertainment unless he is in the business of providing entertainment ;
  - goods not bought for business purposes;
  - if he is transferring stocks and assets as part of a transfer of a business as a going concern.

- The person must keep all the business records related to his VAT registration for a period of at least ten years

SECTION SIX
Calculation of Tax Payable

When a business unit is registered, VAT is chargeable on all the taxable supplies it makes. There are two rates of tax. The standard rate which is 15% and the zero rate, which is 0%.

The standard rate is levied on the following:

a) every taxable transaction by a registered person; and

b) every import of goods, other than an exempt import; and

c) an import of services as provided in Article 23.

Tax payable for Tax Period (Article-20):

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

transactions and the amount of tax creditable.

Where VAT payable exceeds VAT actually indicated by the registered person, the amount of the excess is treated as VAT due for the accounting period and is added to the amount of tax payable for the accounting period.

Tax Credit (Article-21):

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

Where only a part of the supplies made by a registered person during a tax period are taxable transactions, the amount of tax creditable for that period is determined as follows:

a) in respect of a supply or import received which is directly allocable to the making of taxable transactions, the full amount of tax payable in respect of the supply or import shall be allowed as a credit;
b) in respect of a supply or import received which is directly allocable to the making of exempt transaction, no amount of tax payable in respect of the supply or import. Shall be allowed as a credit, or
c) in respect of a supply or import received which is used both for the making of taxable transactions, the rules of apportionment of the credit shall be determined by a directive to be issued by the Minister or Revenue.

No credit is allowed for VAT:

a) on a taxable transaction to, or import by, a person of a passenger vehicle:

    1. unless the person is in the business of dealing in, or hiring of, such vehicles, and the vehicle was acquired for the purposes of such business, or
    2. unless the person is engaged in the business of transporting passengers for hire and the vehicle was acquire and are licensed for that purpose;

"Passenger vehicle" means a road vehicle designed or adapted for the transport of eight or fewer seated persons, including a double cab vehicle,

b) on a taxable transaction, or import by, a person of goods or services acquired for the purposes of entertainment or providing entertainment, unless-

    1. the person is tin the business of providing entertainment and the supply or import relates to the provision of taxable transactions involving entertainment in the ordinary course of that business; or

2. the person is in the business of providing taxable transactions involving transportation services and the entertainment is provided to passengers as part of the transportation services; or

"entertainment" means the provision of food, amusement, recreation, or hospitality of any kind by a registered person whether directly or indirectly to any person in connection with a taxable activity carried on by the registered person.

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

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

A beneficiary of the Duty Draw-Back Scheme is not entitled to a refund of VAT paid on imports to the extent that the beneficiary claims a credit under this Article for tax on imports.

Tax Invoices (Article-22):

A person registered for VAT carries out a taxable transaction is required to issue a VAT invoice to the person who receives the goods or services. A person who is not registered for VAT does not have the right to issue a tax invoice. The important aspects of Tax Invoices are as follows:

1. 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.

2. Where a registered recipient who has not received a tax invoice may request the registered supplier in writing within 60 days after the date of the supply, to provide a tax invoice in respect of the taxable transaction, and the supplier must comply within 14 days after receiving the request.

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

4. In case a registered person supply goods or render services at retail, to the purchasers who are not registered under VAT, then a receipt or simplified form of VAT invoice (as per the directive issued by the Minister of Revenue) may be used instead of a VAT invoice.

Contents of VAT invoice:

A VAT invoice is a document executed in the form stipulated by the Minister of Revenue and 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;
- the issue date if the VAT invoice, and
- serial number of the VAT invoice.

The Minister of Revenue may by directive waive a registered person's obligation to issue a receipt or tax invoice for cash sales if the total consideration for the entire supply does not exceed 10 birr.

Reverse Taxation (Article-23):

If a nonresident person who is not registered for VAT in Ethiopia renders services in Ethiopia for a customer, the rendering of services is taxed according to this Article. The customer for this Article is any person registered in Ethiopia for VAT or any resident legal person. In this circumstances, (unless the service is exempt from tax under Article 8) the customer shall withhold the tax from the amount payable to the non-resident. The amount of tax is determined by a method of calculation to be determined by Regulations issued by the Council of Ministers.

If the customer is registered for VAT, the tax withheld is payable at the time for filling of the VAT return for the accounting period in which the transaction took place. The payment document for the withheld tax is considered to be a VAT invoice, and gives the customer the right to a VAT credit.

If the customer is not registered for VAT, he is required to pay the withheld tax in the manner prescribed by the implementation directives issued by the Minister of Revenue within 30 days of the date of payment to the non-resident.

In the case of the import of property owned by a nonresident for lease, where the lease payments are subject to VAT under this Article, the lessee may claim a VAT credit for the tax paid on the import upon the agreement of the nonresident owner. In this event,

the lessee is treated as the taxpayer and is responsible for VAT payable upon the subsequent supply of the property. This Article does not apply to an import of services to the extent that the nonresident supplier of the services pays the tax imposed on the import of services.

Transaction by Agent (Article-24):

A supply of goods or rendering of services by a person as agent ("proxy") for another person ("principal") is considered as a transaction made by the principal. Both Agents principal shall be held liable to pay the tax according to the provisions of this proclamation. This rule does not apply to services rendered by an agent to the principal. It also does not apply to the supply of goods in Ethiopia by a resident agent of a non-resident person who is not registered for VAT in Ethiopia. In this case, for purposes of VAT the supply is considered as carried out by the agent.

Special Rules (Article-25):

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

SECTION SEVEN

Administrative Procedures

Filling of Tax Return and Payment of VAT (Article-26):

According to this Article, every registered person is required:

a). to file a VAT Return every month whether or not tax is payable in respect of that period. The period covered by the return is called a tax period.

b). He has to fill in details of the supplies made and received in that period and pay the total tax owed to FIRA/VAT, or claim a further credit or repayment of tax as the case may be.

The VAT return for every accounting period shall be filed no later than the last day of the calendar month following the accounting period.

In case where a registration takes place with retroactive effect the registered person is required to pay VAT for taxable transactions taking place since the coming into effect of the registration and is entitled to a VAT credit according to credit procedures for registered persons. In addition, the corresponding transactions are to be reflected on the first return filed by the registered person and are considered as taking place during the

month to which the return relates, In this event the registered person is entitled to issue VAT invoices for the transactions shown on the return.

VAT on taxable imports is collected by the Ethiopian Customs Authority in accordance with this proclamation and the customs legislation of Ethiopia under the procedure contemplated for customs duty.

VAT Refund (Article-27):

If at least 25 percent of the value of a registered person's taxable transactions for the accounting period is taxed at a zero rate, the Authority shall refund the amount of VAT applied as a credit in excess of the amount of VAT charged for the accounting period within a period of two months after the registered person files an application for refund, accompanied by documentary proof of payment of the excess amounts.

In the case of other registered persons, the amount of VAT applied as a credit in excess of the amount of VAT charged for the accounting period is to be carried forward to the next five accounting periods and credited against payments for these periods, and any unused excess remaining after the end of this five-month period shall be refunded by the Authority within a period of two months after the registered person files an application for refund, accompanied by documentary proof of payment of the excess amounts.

In all cases where an amount refunded to a person is established by the Authority to have been made erroneously, the Authority may demand the return of such amount.

The Minister of Finance and Economic Development shall determine the manner in which and the amount of the tax collections that will be retained for VAT refunds.

Where the Authority is satisfied that a person who made an application for refund has overpaid tax, the Authority shall:

a) first apply the amount of the excess in reduction of any tax, levy, interest, or penalty payable by the person under this Proclamation, the Customs Proclamation, the income Tax Proclamation, or the Sales and Excise Tax Proclamation; and

b) then repay any amount to be refunded is more than 50 birr.

If a registered person is entitled to a refund and the Authority is satisfied that the person has overpaid tax, then if the Authority does not pay the refund by the date specified, the Authority shall pay interest at 25% over and above the highest commercial lending interest rate that prevailed during the preceding quarte

Responsibility for Administration and Reporting (Article-28):

The responsibility for the correct calculation and timely payment of VAT and presentation of a return to the Authority by the prescribed deadline rests on the taxpayer

or other person in accordance with this Proclamation, and in cases where the collection of VAT is in the competence of the Ethiopian customs Authority, in accordance with the customs legislation of Ethiopia.

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

Assessment of Tax (Article-29):

If, after review by the Authority, it appears that a person has understated his tax obligation, the authority shall issue an additional assessment: -

a) within 5 years after the end of the accounting period concerned;

b) in the case of fraud or gross or willful negligence, notwithstanding any limitation in any other law, at any time.

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

SECTION EIGHT

Collection Enforcement

Powers and Duties of Tax Administration (Article-30):

The implementation and enforcement of this Proclamation and of Regulations issued hereunder shall be the duty of the Authority.

The Authority shall be empowered (notwithstanding anything to the contrary in any other law) to investigate any statements, records and books of account submitted by any person at any time by:

a) sending duly accredited inspectors to check the statements, records and books of account, or any vouchers, stocks or other material items at the person's place of business or practice;

b) requiring the person or any employee 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 reasonable convenient tax office and answer any questions relating thereto:

c) requiring any person including a municipality, body, financial institution, department or agency of Federal or? Regional government to disclose particulars of any information or transactions;

Seizure of Property to collect Tax (Article-31):

If any person liable to pay any tax imposed by this Proclamation is in default it shall be lawful for the Authority to collect such tax (and such further amount as shall be sufficient to cover the expenses of the seizure) by seizing any property belonging to such person.

- For purposes of this Section, the term" seizure" includes seizure by any means (including the collection from a person who owes money or property to the person liable for VAT). A seizure shall extend only to property possessed and obligations that existing at the time the seizure is made. The Authority may request a police officer to be present during the seizure. The Authority seizes any property shall have the right to sell the seized goods at public auction or in any other manner approved by the Authority not less than 10 days after the seizure, except that when the goods seized are perishable, the authority can sell the goods after any reasonable period having regard to the nature of the goods.
- Whenever any property on which seizure had been made is not sufficient to satisfy the claim for which seizure is made, the Authority may (thereafter and as may be necessary), proceed to seize other property of the person (against whom the claim exists) until the amount due from such person, together with all expenses, is fully paid.
- Seizure may be made on property of any person in default with respect to any unpaid tax only after the Authority has notified such person in writing of the intention to make such seizure. The notice shall be delivered not less than thirty (30) days before the day of the seizure.
- If a seizure has been made or is about to be made on any property, any person having custody or control of any books or records containing evidence or statements relation to the property subject to seizure shall, on demand of the Authority, exhibit such books or records to the Authority.
- Any person in possession of property subject to seizure shall, on the demand of the Authority, surrender such property to the Authority, except such part of the property subject to a prior secured claim of creditors and subject to an attachment or execution under any judicial process.
- Any person who fails or refuses to surrender any property subject to seizure, on demand of the Authority, shall be personally liable to the government in a sum equal to the value of the property not so surrendered, but not exceeding the amount of tax for the collection of which seizure has been made (together with costs and interest on such sum).
- In addition to the personal liability imposed by this Article, if the failure or refusal to surrender is without reasonable cause, such person shall be liable for an additional charge equal to fifty percent (50%) of the amount recoverable.
- Any person in possession of property who surrenders or makes payment in accordance with this Article shall be discharged from any obligation or liability (to the delinquent person or to any other person) arising from such surrender or payment.

Preferential Claim to Assets (Article-32):

From the date on which tax becomes due and payable under this Proclamation (subject to the prior secured claims of creditors), the Authority has a preferential claim upon the assets of the person liable to pay the tax until the tax is paid.

- Where a person is in default of paying tax, the Authority may, by notice in writing, inform that person of the Authority's intention to apply to the registering Authority to register a security interest in any asset, which is owned, by that person, to cover any unpaid tax in default, together with any expense incurred in recovery proceedings.
- If the person on whom a notice has been served under this Article fails to pay the amount specified in the notice the Authority may, by notice in writing, direct the Registering Authority that the asset, to extent of the defaulter's interest therein, shall be the subject or security for the total amount of unpaid tax.
- Where the Authority has served a notice on the Registering Authority shall, without fee, register the notice of security as if the notice were an instrument of mortgage over or charge on, as the case may be, such asset, and such registration shall, subject to any prior mortgage or charge, operate while it subsists in all respects as a legal mortgage over or charge on the asset to secure the amount due.

Collection of Tax from recipients of supply (Article-33):

Where, in consequence of a fraudulent action or misrepresentation by the recipient of a taxable transaction from a registered person, the registered person incorrectly treated the transaction, as an exempt or zero-rated transaction, the Authority may raise an assessment upon the recipient for the amount of unpaid tax in respect of the transaction, together with any interest or penalty that has become payable.

The Authority shall serve notice of tax charged under this Article on the recipient specifying:

a) the tax payable;

b) the date the tax is due and payable: and

c) the time, place, and manner of objection to the assessment.

An assessment raised under this Article is treated as any tax charged for all purposes of the proclamation. For this purpose, any amount recovered from the recipient is to be credited against the liability of the registered person and any amount recovered from the registered person is to be credited against the liability of the recipient.

Where an amount of tax, interest, or penalty is paid by the registered person, the registered person may recover the amount paid from the recipient.

Jeopardy Assessment (Article-34):

In exceptional cases where the Authority has reasonable grounds to believe that the collection of tax is in jeopardy, and where a state of urgency exists, the Authority may issue an administrative order to a bank with a statement of justification supplementing its order to block the accounts of the person liable for tax and secure information thereon, and may make an immediate assessment of tax for the current and any prior accounting period; provided that the Authority shall obtain court authorization within ten days from the date of issuance of its administrative order and further that such powers may only be used to elucidate information relevant to the assessment.

Taxpayer Safeguards (Article-35):

Any property seized, held and accounted for only by the Authority. No other agency of the government may require the property seized under this Section to be transferred or given over to it for any cause what so ever. If any property seized under this Section is sold, any portion of the process in excess of the person's liabilities shall be returned promptly to the owner of the property.

Duties of Receivers (Article-36):

In this Article, "receiver" means a person with respect to an asset in Ethiopia and includes:

a) a liquidator of a company;

b) a receiver appointee out of court or by a court;

c) a trustee for un rehabilitated insolvent;

d) a mortgage in possession:

e) an executor of a deceased estate

f) any other person conduction a business on behalf of a person legally incapacitated.

A receiver shall, in writing, notify the Authority within 14 days after being appointed to the position or taking possession of an asset in Ethiopia, whichever first occurs.

The Authority may, in writing, notify a receiver, of the amount which appears to the Authority to be sufficient to provide for tax which is or will become payable by person whose assets are in the possession of the receiver.

A receiver----

a) shall aside, out of the proceeds of sale of an asset, the amount specified by the Authority under this Article or such lesser amount as is subsequently agreed on by the Authority;

b) is liable to the extent of the amount set aside for the tax of the person who owned the asset; and

c) may pay any debt that has priority over the tax referred to in this Article notwithstanding any provision of this Article.

A receiver is personally liable to the extent of any amount required to be set aside under this Article for the tax referred to and to the extent that the receiver fails to comply with the requirements of this Article.

SECTION NINE

Record

Record keeping (Article-37):

A registered person or any other person liable for tax under this proclamation shall maintain for 10 years in Ethiopia-

a) original tax invoices received by the person,

b) a copy of all tax invoices issued by the Peron,

c) customs documentation relating to imports and exports by the person,

d) accounting records; and

e) any other records as may be prescribed by the Minister of

For these purposes, records means accounting records, accounts, books, computer-stored information, or any other documents.

Notification of Changes (Article-38):

Every registered person shall notify the Authority, in writing, of:

1. any change in the name, address, place of business, constitution, or nature of the principal taxable activity or activity or activities of the person; and

2. any change of address from which, or name in which, a taxable activity is carried on by the registered person, Within 21 days of the change occurring.

Service of Notice (Article-39):

A notice or other document issued, served, or given by the Authority under this proclamation, shall be communicated in writing as follows:

a) **In the case of a resident individual**:

- by registered letter or

- by delivery to the taxpayer in person, or

- if he is absent to any adult member of his family or

- any person employed by him at his residence or

- any person employed by him at his place of business or professional practice

If no person can be found to accept such service then the same may be effected by affixing the notice to the door or other available part of the said residence or place of business:

b) **In the case of a resident body:**

- by registered letter to the registered address of the body or

- by delivery to any director or employee of the body at any of its places of business: and

c) **In the case of non-resident persons**:

- by registered letter to the their agent or agents in Ethiopia or

- by affixing to the door or other available part of the riddance or place of business of such agent if the could not be served in person.

If in any case none of the measures specified are effective, service may be discharged by the publication in any newspaper in which court notices may be advertised, with the cost of such publication to be charged to the taxpayer.

SECTION TEN

Appeal procedure

Review Committee (Article-40):

Members of the Review Committee shall be appointed by the Minister of Revenue upon the recommendation of the Head of the Authority.

Powers and Duties of the Review Committee (Article-41):

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

a) to examine and decide on all applications submitted by tax payers for compromise of penalty and interest and on the tax assessed;

b) to gather any written evidence of 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 determinations made by the Authority for accuracy, completeness, and compliance with this proclamation.

The Head of the Tax Authority may approve the recommendations or remand the case, with his observations, to the committee for further review. The committee shall only review application Submitted to it within 10 days of receipt of tax assessment notification.

Waiver of Penalty (Article-42):

The Review Committee may waive administrative penalties in accordance with the directives issued by the Minister of Revenue.

Appeal (Article-43):

Any person who objects to an additional assessment made by the Authority has the right to appeal, within 30 days from the receipt of that assessment notification, or from the date of decision of the Review Committee to the Tax Appeal Commission by depositing in cash with the Authority am amount equal to 50%of the additional tax assessed.

If a person appeals in accordance with Sub-Article (1) and the Tax Appeal Commission determines that the person is liable for the additional assessment, he shall b in default unless he pays within thirty (30) days of the decision of the commission.

If no appeal is made within the period prescribed in Sub-Article (1) of this Article, the Additional assessment of the tax made by the Authority shall be deemed to be correct and final and shall be immediately payable.

Without prejudice to Sub-Article (1) of this Article, the provisions of the income Tax proclamation, concerning appeals shall, mutate mutants; apply to appeals regarding taxes imposed by this proclamation.

Burden of Proof (Article-44):

The burden of proving that an assessment is excessive or that the decision of the authority is wrong is on the person objection to the assessment or decision.

SECTION ELEVEN

Administrative Penalties

Penalties (Article-45):

The following penalties are imposed for violations of this proclamation:

a) Where any person engages in taxable transactions without VAT registration where VAT registration is required-100 percent of the amount of tax payable for the entire period of operation without VAT registration;

b) Where any person issued incorrect tax invoice resulting in a decrease in the amount of tax or increase in accredit or in the event of the event of the failure to issue a tax invoice-100 percent of the amount of tax for the invoice or on the transaction;

c) Where a person who is not registered for VAT issues a tax invoice-a penalty of 100 percent of the tax which is indicated in the tax invoice and is due for transfer to the budget but has not been transferred; and

d) where a person fails to maintain records required under Article 37-2,000 Birr for each month or portion thereof that the failure continue.

Penalties for Late Filing (Article-46):

Except as otherwise provided in this Proclamation, a person who fails to file a timely return is liable for a penalty equal to 5 percent of the amount of tax underpayment for each month (or portion thereof) during which the failure continues, up to 25 percent of such amount.

The penalty under Sub-Article (1) of this Article is limited to 50,000 Birr for the first month (or potion thereof) in which no return is filed.

For purposes of this Article, an underpayment of tax is the difference between the tax required to be shown on the return and the amount of tax paid by the due date.

In any event the penalty may not be less than smaller of the two amounts:

a) 10,000 Birr,

b) 100 percent of the amount of tax required to be shown on the return.

Late Payment Interest (Article-47):

If any amount of tax is not paid by the due date, the person liable is obliged to pay interest on such amount for the period from the due date to the date the tax is paid.

The interest rate of this Article is set at 25% (twenty five percent) over and above the highest commercial lending interest rate that prevailed during the preceding quarter.

SECTION TWELVE

Criminal Offences

Procedure in Tax Offence Cases (Article-48):

A tax offence under this Section 12 is a violation of the criminal law of Ethiopia and shall be charged, prosecuted, and appealed in accordance with Ethiopia criminal procedure law.

Tax Evasion (Article-49):

A person who evades the declaration or payment of tax, or a person who, with the intention to defraud the government, applies for a refund he is not entitled to, commits and offence and, in addition to any penalty under Section 11, may be prosecuted and, on conviction, be subject to a term of imprisonment of not less than five (5) years.

Making False or Misleading Statements (Article-50):

1. a taxpayer who:
   a) makes a statement to a tax officer of the Authority that is false or misleading in a material particular, or

   b) omits from a statement made to an officer of the Authority any matter or thing without which the statement is misleading in a material particular, commits an offence and is liable on conviction.

2. Where the statement or omission is made without reasonable excuse,

a) and if the inaccuracy of the statement were undetected may result in an underpayment of tax by an amount not exceeding 1,000 Birr, to a fine of not les than 10,000 Birr and not more than 20,000 Birr, and imprisonment for a term of not less than one (1) year and not more than three (3) years, and

b) if the underpayment of tax is in an amount exceeding 1,000 Birr, to a fine of not less than 20,000 Birr and not more tan 100,000 Birr and imprisonment for a term of not less than three (3) years and not more than five (5) years,

3. Where the statement or omission is made knowingly or recklessly:

a) and if the inaccuracy of the statement were undetected may result in an underpayment of tax by an amount not exceeding 1,000 Birr, to a fine of not less than 50,000 Birr an not more tan 100,000 Birr, or imprisonment for a term of not less than five (5) years and not more than ten(10) years; and

b) if the underpayment of tax is in an amount exceeding 1,000 Birr, to a fine of not less than 75,000 Birr and not more than 200,000 Birr, or imprisonment for a term of not less than ten (10) years and not more than fifteen (15) years.

Obstruction of Administration (Article-51):

1. a person who,

a) obstructs or attempt to abstract an officer of the Authority in the performance of duties under this proclamation, or

b) otherwise impedes or attempts to impede the administration of the Proclamation,

Commits an offence and is liable on conviction to a fine of not less than 1,000 Birr and not more than 100,000 Birr, and imprisonment for a term of two (2) years;

2. For purposes of Sub-Article (1), the following and similar other actions are considered to constitute obstruction:

a) refusal to satisfy a request of the Authority for inspection of documents reports, or other information related to a taxpayer's income-producing activities:

b) noncompliance with an Authority request to report for an interview:

c) interference with a taxation officer's right to enter the taxpayer's business premises.

Failure to Notify (Article-52):

A person who fails to notify the Authority of a change as required by Article 38 commit an offence and is liable on conviction:

a) where the failure was made knowingly or recklessly, to a fine of not less than 10,000 Birr and to imprisonment for one year; or

b) in any other case, to a fine of not less than 5,000 Birr and to imprisonment for six months.

Offenses by Tax Officer (Article-53):

1. Any tax officer or former taxation officer employed in carrying out the provisions of this Proclamation who,

   a) directly or indirectly asks for, or receives in connection with any of the taxation officer's duties, a payment or reward, whether pecuniary or otherwise, or promise or security for hat payment or reward, not being a payment or reward which the officer is lawfully entitled to receive, or

   b) enters into or acquiesces in an agreement to do or to abstain from doing, permit, conceal, or connive at any act or thing whereby the tax revenue is or may be defrauded or which is contrary to the provisions of this Proclamation or to the proper execution of the taxation officer's duty,

   Commits an offence and is liable on conviction to a fine not less than 50,000 Birr and to imprisonment for a term of not less than ten (10) years and not more than twenty (20) years.

2. A tax officer or former tax officer employed in carrying out the provisions of this proclamation, except such information is required by the commercial Code of Ethiopia to be published in the Trade Gazette, who,

   a) discloses to any person or that person's representative, any matter in respect of another person, that may, in the exercise of the taxation officer's powers of the performance of the taxation officer's duties under the said provisions, come to the taxation officer's knowledge; or

   b) permits any other person to take access to records in the possession or custody of the Authority, except in the exercise of the taxation

office's powers or the performance of the officer's duties under this proclamation or by order of a court;

Commits an offence and is liable on conviction to a tune of not less than 10,000 Birr and to imprisonment for a term of not less than two (2) years and not more than five (5) years.

3. Nothing in this Article shall prevent a taxation officer from disclosing-

   a) any document or information to-

      I. any person where the disclosure is necessary for the purposes of this Proclamation or any other fiscal law;

      II. the Auditor-General where the disclosure in necessary for the performance of duties entrusted to it by law;

      III. the competent authority of the government of another country with which Ethiopia has entered into an agreement for the avoidance of double taxation or for the exchange of information, to the extent permitted under the agreement;

      IV. the Ethics and Anti-Corruption commission where the disclosure is necessary for the performance of duties entrusted to it by law.

      V. a law enforcement agency not described above where the Minister of Revenue issues written authorization to make disclosures necessary for the enforcement of the laws under the agency's authority; or

   b) information, which does not identify a specific person to any person in the service of the State in a revenue or statistical department where such disclosure is necessary for the performance of the person's official duties.

Unauthorized VAT collection (Article-54):

Any person not authorized to collect tax under this proclamation whop collects or attempts to collect tax (or an amount the person describes as tax) commits an offence and is liable on conviction to a fine of not less than 50,000 Birr and to imprisonment for a term of not less than (5) five years and not more than (10) ten years.

Aiding or Abetting (Article-55):

A person, who aids, abets, insights, or conspires with another person to commit a violation of this Proclamation also commit a violation of this proclamation. That person may be subject to prosecution and, on conviction, to a fine and imprisonment, not in

excess of the amount of fine or period of imprisonment provided for the offence aided or abetted.

Offences by Entities (Article-56):

1. Subject to Sub-Article (3), where an entity commits an offence, every person who is a manager of that entity at that time is treated as having committed the offence and is liable to a penalty under this Proclamation.

2. Subject to Sub-Article (3), where an entity commits an offence by failing to pay an amount of tax, including an amount treated by this Proclamation as though it were tax, every person who was manager of the entity at that time or was a manager within 6(six) months prior to the date of commission is jointly an severally liable with that entity and that other person to the authority for the amount.

3. Sub-Articles (1) and (2) do not apply where,

   a) the offence is committed without that person's knowledge or consent; and

   b) that person has exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances to prevent the commission of the offence.

4. In Sub-Articles (1) and (2); "manager" means,

   a) in the case o a partnership, a partner or manager of the partnership or a person purporting to act in either of those capacitates;

   b) in the case of a company, a director, manager, or officer of the company or a person purporting of act in any of those capacities; and

   c) in the case of an association of persons, a manager or a person purporting to act in that capacity.

Offences by Receivers (Article-57):

1. A person who fails to comply with the requirements of Article 36, Sub-Article (4) commits an offence and is liable on conviction to a fine of 5,000 Birr and to imprisonment for (1) one year.

2. Where a person is convicted of an offence under Sub-Article 1(one) for failing to set aside an amount as required under Sub-Article (4) of Article 36, the court may, in addition to imposing a fine and prison sentence, order the convicted person to pay, to the Authority, an amount not exceeding the amount which the person failed to set aside.

Improper Tax Debit and tax Credit Notes (Article-58):

1. A registered person who fails to provide a tax credit note or tax debit note as required by this Proclamation, commits an offence and is liable on conviction, to a fine of 10, 000 Birr and to imprisonment for (1) one year.

2. A person who provides a tax credit note or tax debit note otherwise than as provided for in this Proclamation commits an offence and is liable on conviction,

   a) where the failure was made knowingly or recklessly, to a fine of 20,000 Birr to imprisonment for (3) three years; or

   b) in any other case, to a fine 10,000 Birr and to imprisonment for (1) one year.

Publication of Names (Article-59):

1. The Authority shall from time to time publish by notice in the Gazette a list of persons who have been convicted of offences under any of the Articles 48 to 58.
2. Every list published in terms of Sub-Article (1) shall specify--
   a) the name, address, and principal enterprise of the person;
   b) such particulars of the offence as the Authority may thin fit;
   c) the tax period or tax periods in which the offence occurred;
   d) the amount or estimated amount of the tax evaded; and
   e) the amount, if any, of the additional tax imposed.

Summary of Offences and Punishments

Procedure in Tax Offence Cases (Article-48):

A tax offence under this Section is a violation of the criminal law of Ethiopia and shall be charged, prosecuted, and appealed in accordance with Ethiopia Criminal Procedure Code of Ethiopia. The nature of offences and punishments are given in the following Table:

Summary of Offences and Punishments

Article	Nature of Offence	Punishment
Article 49	Tax Evasion	Penalty under Section 11 and imprisonment of not less than five years.
Article 50	Making False or Misleading Statements: 1. Where the statement or omission	

	is made without reasonable excuse: i. inaccuracy of the statement which results in an underpayment of tax by an amount not exceeding 1,000 Birr. ii. inaccuracy of the statement which results in an underpayment of tax by an amount exceeding 1,000 Birr. 2 Where the statement or omission is made knowingly or recklessly: i. inaccuracy of the statement which results in an underpayment of tax by an amount not exceeding 1,000 Birr. ii. inaccuracy of the statement which results in an underpayment of tax by an amount exceeding 1,000 Birr.	A fine of not less than 10,000 Birr and not more than 20,000 Birr, and imprisonment for a term of not less than one year and not more than three years. A fine of not less than 20,000 Birr and not more than100,000 Birr and imprisonment for a term of not less than 3 years and not more than 5 years. A fine of not less than 50,000 Birr and not more than100,000 Birr, and imprisonment for a term of not less than 5 years and not more than 10 years. A fine of not less than 75,000 Birr and not more than 200,000 Birr, and imprisonment for a term of not less than 10 years and not more than 15 years.
Article 51	Obstruction of Tax Administration: • obstructs or attempts to obstruct an officer of the Authority in the performance of duties	A fine of not less than 1,000 Birr and not more than 100,000 Birr, and imprisonment for a term of 2 years.
Article-52	Failure to Notify: • Where the failure was made knowingly or recklessly	A fine of not less than 10,000 Birr and imprisonment for one year. A fine of not les than

	• In ay other case	5,000 Birr and imprisonment for six months.
Article-53	Offences by Tax Officer: • directly or indirectly asks for, or receives a payment or reward which the officer is lawfully entitled to receive (or) • enters into or acquiesces in an agreement to do or to abstain from doing any act or thing whereby the tax revenue is or may be defrauded. • discloses to any person any matter in respect of another person and permits any other person to have access to records in the possession or custody of the Authority	a fine of not less than 50,000 Birr and to imprisonment for a term of not less than 10 years and not more than 20 years. a fine of not less than 50,000 Birr and to imprisonment for a term of not less than 10 years and not more than 20 years. a fine of not less than 10,000 Birr and to imprisonment for a term of not less than 2 years and not more than 5 years.
Article-54	Unauthorized Tax Collection.	A fine of not less than 50,000 Birr and to imprisonment for a term of not less than 5 years and not more than 10 years.
Article-55	Aiding or Abetting or conspires with another person to commit a violation of this Proclamation.	A fine and imprisonment, not in excess of the amount of fine or period of imprisonment provided for the offence aided or abetted.
Article-56	Offences by Entities - an offence by failing to pay an amount of tax.	Every person who was a manager of that entity at that time or was a manager within six (6) months prior to the date of commission is jointly and severally liable with that entity to the Authority for the amount of tax.
Article-57	Fails to comply with the requirements of Article 36.	A fine of 5,000 Birr and to imprisonment for 1 year.

		In addition to the fine and imprisonment, the court may order the convicted person to pay to the Authority, amount not exceeding the amount which the person failed to set aside.
Article-58	Improper Tax Debit and tax Credit Notes: i) A registered person who fails to provide a tax credit note or tax debit note as required by this Proclamation.	A fine of 10, 000 Birr and to imprisonment for (1) one year.
	ii). A person who provides a tax credit note or tax debit note otherwise than as provided for in this Proclamation: a). where the failure was made knowingly or recklessly. b). in any other case	-a fine of 20,000 Birr to imprisonment for (3) three years. -a fine 10,000 Birr and to imprisonment for (1) one year

SECTION THIRTEEN

Miscellaneous Provisions

Schemes for obtaining Tax Benefits (Article-60):

In this Article:-

"scheme" includes an agreement, arrangement, promise, or undertaking whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings, and any plan, proposal, course of action, or course of conduct; and "tax benefit" includes

a) a reduction in the liability of any person to pay tax;

b) an increase in the entitlement of a person to an amount of tax creditable under Article 21 or to a refund of tax; or

a) any other avoidance or postponement of liability for the payment of tax.

Notwithstanding anything in this Proclamation, if the Authority is satisfied that a scheme has been entered into or carried out where-

a) a person has obtained a tax benefit in connection with the scheme; and

a) having regard to the substance of the scheme, it could be concluded that the person, or one of the persons, who entered into or carried out the scheme, did so for the sole or dominant purpose of enabling the person to obtain the tax benefit, the Authority may determine the liability of the person who has obtained the tax benefit and of any other person related with the scheme as if the scheme had not been entered into or carried out, or in such manner as in the circumstances the Authority considers appropriate for the prevention or reduction of the tax benefit.

Currency Conversion (Article-61):

1. For purpose of this Proclamation, all amounts of money are to be expressed in Birr.

2. Where an amount is expressed in a currency other than Birr,

   a) in the case of imports, the amount shall be converted at the exchange rate as determined under the customs legislation of Ethiopia: or

   b) in all other cases, the amount shall be converted at the exchange rate that applies between the currency and the Birr at the time the amount is taken into account under this Proclamation.

Registration of Goods (Article-62):

Where any form of registration is require under nay law i respect of goods, no registering authority responsible for such registration under such law shall effect such registration upon change of ownership or importation into Ethiopia of the register able goods unless the person applying for registration produces to such registering authority: -

a) a customs /declaration showing that tax which is payable under this proclamation has been paid in respect of the import of the goods into Ethiopia, or a Customs document showing that no tax is payable under the Proclamation in respect of such importation of the register able goods in consequence of which the registration is required; or

b) a declaration, in such form as the Authority may prescribe, issued by any registered person who supplied such goods in consequence of which the

registration is required, certifying that the tax payable under this Proclamation has been, or will be, paid by such person: or

c) a certificate issued by the Authority, to the effect that the supply or import of the register able goods was an exempt supply or exempt import.

Transitional Provision (Article-63):

1. A registered person who, within 6 months prior to the coming into force of this proclamation, has goods taxed as per the previous law at his disposal, shall be entitled to a tax benefit under Article 21 of this Proclamation:

2. The manner in which the credit granted under this Article is to be applied shall be determined by Regulations to be issued by the Council of Ministers.

Directives and Regulations (Article-64):

The Council of Ministers shall issue regulations for the proper interpretation of this Proclamation or for the carrying out of any powers delegated to it under this Proclamation, and the Minister of Finance and Economic Development shall issue directives for the proper implementation of this Proclamation.

Repeal (Article-65):

1. The Sales and Excise Tax Proclamation No.68/93 (as amended) shall be rescinded as from the day on which this Proclamation becomes of full force and effect.

2. Tax payable under the Sales and Excise Tax Proclamation but unpaid until the day this Proclamation comes into force shall continue to be collected pursuant to said Proclamation.

Entry into Force (Article-66):

This Proclamation shall come into force as of the 1st day of January 2003.

Done at Addis Ababa this 4th day of July 2002.

VAT REGULATION

REGULATIONS ISSUED PURSUANT TO THE

VALUE ADDED TAX PROCLAMATION

Council of Ministers Value Added Tax Regulations No.79/2002.

CHAPTER ONE

General

Short Title (Article-1):

These Regulations may be cited as the "Council of Ministers Value Added Tax Regulations No.79/2002.

Definitions (Article-2):

In these Regulations, unless the context requires otherwise;

1. "Authority", means the Federal Inland Revenue Authority ("FIRA"),
2. "Customs Authority" means the Ethiopian Customs Authority;
3. "Minister" and "Ministry" shall mean the Minister of Revenue and the Ministry of Revenue, respectively.
4. "Proclamation" means the Value Added tax Proclamation No.285/2002; and
5. "Tax" or "VAT," means the Value added Tax impose by the Value Added tax Proclamation.

Supply of Goods or Rendition of Services (Article-3):

1. For purposes of Article 4,Sub-Article (3) of the Proclamation treats the supply of goods or the rendition of services to employees as supplies in the course or furtherance of a taxable activity; and therefore taxable unless the transaction is exempt under Article 8 of the Proclamation.
2. A supply of goods or services to employees are treated as supplies for consideration and therefore may be taxed, even if the employee did not pay (or paid less than market value) for the goods or services.
3. If an employer:
   a) provides an employee a cash advance,
   b) pays a supplier on behalf of the employee; or
   c) reimburses an employee

   for the cost of goods or services provided as a fringe benefit, the employer is not entitled to claim any portion of the cost as a tax credit because the goods or services provided to the employee are not used in connection with the employer's taxable activity.

4. If an employer was denied a tax credit on the purchase of goods or services (such as a passenger vehicle), the supply of those items to an employee is not a supply in connection with a taxable activity and therefore is not subject to tax.
5. If a registered person supplies an exempt service (such as a medical service at a company-run clinic) to an employee, the service is not subject to tax and the employer is not entitled to tax credits under Article 21 of the Proclamation for tax on purchases allocable to the exempt services.
6. Where goods supplied under an installment sale or finance lease (collectively referred to as a credit agreement) are repossessed, the repossession is a supply of the good by the debtor under the credit agreement to the person exercising the right of repossession, and where such debtor is a registered person, the supply is made in the course or furtherance of the debtor's taxable activity unless such goods did not form part of the assets held or used by the debtor in connection with that taxable activity.
7. The sale of a lottery ticket by the National Lottery Administration is a supply of services.
8. Where a supply consists both of a supply that is charged with tax at a positive rate and a supply that is charged with tax at a Zero rate, each part of the supply's treated as a separate supply, unless one part is incidental to a main supply within Article 5, Sub-Article (1) of the Proclamation.
9. The rendition of services by an employee to an employer by reason of employment is not a supply.
10. The provision of goods on consignment and the transfer of goods to a person in a representative capacity is not a supply.
11. The removal of goods from a bonded manufacturing warehouse or any supply of goods subject to an export trade duty incentive scheme under proclamation No.249/2001 is treated as a supply of those goods in the course or furtherance of a taxable activity in Ethiopia. If the goods are sold into the domestic market, the supply is taxable at the standard rate, and if the foods are sold for export within Article 7, sub-Article (2) (a) of the Proclamation, the supply is taxable at the zero rate.
12. A supply of goods or the rendition of services to a person as agent for a principal is treated as a supply to the principal.

Taxable Activity (Article-4):

- For purposes of the definition of a taxable activity under Article 6 of the Proclamation, anything done in connection with the commencement or termination of a taxable activity is treated as carried out in the course or furtherance of that taxable activity.
- Taxable activity does not include:
    a) an activity carried on by a natural person essentially as a private recreational pursuit or hobby or an activity carried on by a person other than a natural person which would, if carried on by a natural

person, be carried on essentially as a private recreational pursuit or hobby; or

b) an activity to the extent that the activity involves the making of exempt supplies.

Tax on Imports of Goods (Article-5):

- Except where the proclamation provides to the contrary, the provisions of the customs proclamation, relating the import transit coastwise carriage clearance of goods and payment and recovery of duty, with such exceptions, modifications, and adaptations as the Minister may by directive prescribe, shall apply, so far as relevant, to the tax charged under the Proclamation on the import of goods.
- Where tax is payable on an import of goods, the importer shall, upon such entry, furnish the Customs Authority with an import declaration and pay the tax due on the import.
- The import declaration shall-
  a) be in the form prescribed by the Customs Authority,
  b) state the information necessary to calculate the tax payable in respect of the import, and
  c) be furnished in the manner specified by the customs Authority.
- The Customs Authority-
  a) shall collect at the time of import and on behalf of the Authority, any tax due under the proclamation on an import of goods and, at the time, obtain the name and the taxpayer identification number, if any, of the importer, and the invoice values in respect of the import; and
  b) shall make arrangements with the Ethiopia postal Services to perform functions on behalf of the customs Authority in respect of tax on imports that arrive through the postal services.
- Goods covered by an export trade duty incentive scheme under proclamation No. 249/2002 are not subject to tax at the time of import, except that tax is payable upon import if the importer is covered by the duty draw-back scheme.

Time of Supply (Article-6):

1. Article 3, Sub-Article (6) of these Regulations, treats the repossession of goods under a credit agreement as a supply of the goods. The supply occurs:
   a) on the day that the goods are repossessed, or
   b) when the debtor may, under any law, be reinstated in his rights and obligations under the credit agreement, on the day after the last day of any period during which the debtor may under such law be so reinstated.
2. Article 4, Sub-Article (9) of the proclamation treats, as a supply of goods, the transfer of a taxable activity (or a portion of a taxable activity) as going concern, The supply occurs when the transfer under that sub-Article (9) occurs.

3. Article 3, sub-Article (8) of the Regulations, treats the removal of goods subject to an export trade duty incentive scheme under proclamation No.249/2002 (including a sale into the domestic market) as a supply of those goods in the course or furtherance of a taxable activity in Ethiopia. The supply of those goods occurs when the goods are supplied in the domestic market, or when the goods are exported, if they are supplied for export

7. Value of a supply (Article-7):

1. The value of a supply may be reduced by any price discounts or rebates allowed and accounted for at the time of the supply of goods or the rendition of services. Post-supply price adjustments must be accounted for in accordance with Article 13 of the proclamation.
2. Where a portion of the price of a supply represents tax imposed by the proclamation that is not accounted for separately, the value of the supply is the price reduced by an amount equal to the product of the tax.
3. If a registered person converts a portion of, or an entire good or service from use in a taxable activity to a different use and the person was allowed a tax credit in respect of the acquisition of those goods or services, Article 4, Sub-Article (2) of the Proclamation treats the change in use as a supply of the goods or services in the course or furtherance of a taxable activity. The Minister of Revenue may issue directives on the value of a supply resulting from a change in use under this Sub-Article.
4. The value of a supply of goods under an installment sale or finance lease (a credit agreement) is the cash value of the supply. The "cash value", in relation to supply of goods under a credit agreement, means-
   (a) Where the seller or lessor is a bank or other financial institutional amount equal to the sum of:
      i. The consideration paid by the bank or other financial institution for the goods, or the market value of the goods, which ever is the greater, and
      ii. Any consideration for erection, construction, assembly, or installation of the goods borne by the bank or other financial institution; or

   (b) Where the seller or lessor is a supplier, an amount equal to the sum of:
      i. The consideration for which the goods are normally sold by the supplier for cash; and
      ii. Any consideration for erection, construction assembly, or installation of the goods borne by the supplier.

5. Where the debtor is deemed to make a supply of goods under Article 3, Sub-Article (6) of the Regulations as a result of the repossession of goods under a credit agreement, the value of the supply is an amount equal to the

balance of the cash value of the supply that has not been recovered at the time of the supply.

6. The balance of the cash value of the supply under sub-Article (5) is the amount remaining after deducting from the cash value so much of the sum of the payments made by the debtor under the credit agreement as, on the basis of an apportionment in accordance with the rights and obligations of the parties to such agreement, may properly be regarded as having been made in respect of the cash value of the supply.

7. The value of goods subject to an export trade duty incentive scheme under proclamation No. 249/2001:

   (a) That are removed for export, or

   (b) Are supplied but not exported is the market value of the goods

8. Article 4,Sub-Article (11) of the proclamation provides that where the recipient of a zero-rated transfer or a going concern under Article 7, Sub-Article (2) (d) of the proclamation, acquired some of the goods in that transfer for a purpose other than to make taxable transactions,

9. The value of the supply under Article 7, Sub-Article (8) of these Regulations shall be the consideration for the acquisition of the taxable activity, reduced by an amount which bears to the amount of such consideration the sane ratio as the intended use or application of the taxable activity for making taxable transaction bears to the total intended use or application if the taxable activity.

Obligatory or Voluntary Registration and Procedure (Article-8)

1. The Authority may waive the requirement under Article 16 or the Proclamation to register where the Authority is satisfied that the value of a person's taxable transactions exceeds or will exceed the amount specified under Article 16, Sub-Article (1) of the proclamation solely as a consequence of-

   a) a cessation, or substantial and permanent reduction the size or scale, of a taxable activity carried on by the person; or

   b) the supply of capital goods that are being replaced with other capital goods to be used in the taxable activity carried on by that person.

2. Article 18, Sub-Article (4) of the Proclamation provides for the date that registration becomes effective. While the registering person may select the date that the registration is to become effective, the Authority, in its sole discretion, may change that date to the beginning of an accounting period.

Division Registration (Article-9):

1. A registered person and its separately registered division, and separately-registered divisions of a head office registered person, are "related persons" for purposes of the proclamation.

2. A separately registered division must file a VAT return for ach accounting period (Article 26 of the Proclamation). Each separately registered part of

the entity is subject to all of the obligations imposed on a registered person, but it remains a part of the entity.

3. A registered person may apply for divisional registration if a single registration requiring a single VAT return imposes an onerous compliance burden on the registered person. The authority, in its sole discretion, shall decide if the applicant will experience real difficulties in submitting a single VAT return.

4. A registered person may request that some, but not all divisions be registered separately, and those not registered separately treated as part of the entity's registration.

5. The Authority may withhold any refund under Article 27, Sub-Article (5) (a) of the proclamation to a separately registered division in order to satisfy the tax, levy, interest, or penalty payable by the entity or another division.

6. Supplies made by a separately registered division to the head office or between separately registered divisions are treated as supplies between related persons for tax purposes, the supplier must issue tax invoices for those transactions in accordance with the proclamation, and the recipient can claim tax credits on the purchases to the extent provided under Article 21 of the Proclamation.

7. Expense allocated by the head office to a separately registered division may be treated as taxable supplies by the head office.

8. Transactions between the head office and separately registered divisions may be closely scrutinized by the Authority to prevent the use divisional registration to obtain unintended tax benefit referred to in Article 60 of the proclamation.

9. Separate divisional registration is discretionary with the Authority and, to be eligible, the head office applicant must satisfy all of the following conditions;

   a) The applicant must be a registered person for VAT purposes, but not a person who voluntarily registered under Article 17 of the Proclamation;

   b) The application must be in writing and include the applicant's taxpayer identification number the VAT certificate number:

   c) The applicant must conduct its operation as an incorporated company;

   d) The applicant will experience an onerous compliance burden if it must submit a single return for its entire business operations. The applicant must describe in detailed the problems likely to be encountered if divisional registration is not approved, and the reasons why a consolidated VAT return for the entire business for each accounting period cannot be submitted by the due date for each tax period;

   e) The division for which separate registration is requested must maintain an independent accounting system. This requires the division to

record its receipts and payments and produce financial statements separate from its head office and/or other divisions:

f) The applicant must already be preparing divisional accounts before consolidation them.

g) The division for which separate registration is requested must be separately identified by reference to the nature of its activities or its location:

h) Each division must use the same accounting period and the same year-end date as the entity.

10 The Authority may impose additional conditions before approving an application for divisional registration, or may impose different conditions on a newly registering entity.

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

13. Each separately registered division will be issued a taxpayer identification number and VAT Certificate number that identify it as a division of the entity.

14. For purposes of the registration threshold under Article 16 of the Proclamation, the supplies of each separately registered division are included as supplies of the entity.

15. The Authority may require the allocation of tax credits under Article 21, Sub-Article (22) (c) of the Proclamation to be made on an entity basis, rather than on a division-by-division basis.

16. The home office registered person may apply in writing for the cancellation of the separate registration of a division, or the Authority may initiate a cancellation of a divisional registration. The following rules shall apply:

a) Unless the Authority approves a shorter period, the separate registration of a division must remain in effect for not less than two years;'

b) If an entity or a division ceases to satisfy any of the conditions imposed on divisional registration, the entity must notify the Authority in writing of the change within 30 days of the date any condition to be met;

c) The Authority may cancel a divisional registration if the conditions are no longer satisfied or if the Authority believe that cancellation is necessary for the protection of the revenue;

d) The Authority shall have sole discretion to determine if the divisional registration shall be allowed to continue;

e) The cancellation of divisional registration shall be effective from the date specified by the Authority.

Cancellation of Registration (Article-10):

1. A registered person must apply for cancellation of registration within 30 days of the date the person ceases to make taxable transactions.
2. The application for cancellation under sub-Article (1) shall be in writing, shall state the date upon which the person ceased to make taxable transactions, and shall state whether or not that person intends to make taxable transactions within 12 months from that date.
3. The Authority shall approve an application for the cancellation of registration under (2) unless the Authority has reasonable grounds to believe that the person will make taxable transactions at any time within 12 months from the date of cessation.
4. While the cancellation of registration generally takes effect on the date of cessation, if the Authority is satisfied that the registered person did not make taxable transactions from the date the registration took effect, the Authority can cancel the registration retroactive to that effective date,
5. When registration is cancelled, to the extent provided under Article 4, Sub-Article (4) of the Proclamation, the registered person may be deemed to have sold the goods on hand in a taxable transaction.
6. Any obligation or liability under the Proclamation, including the furnishing of returns, of any person in respect of anything done by that person while the person was a registered person, is not affected by cancellation of the person's registration.

Tax Credit Rules (Article-11):

1. No tax credit is allowable under Article 21 of the Proclamation unless:
    a) a tax invoice, or debit or tax credit note, in relation to the supply, has been provided in accordance with Articles 22,23, or 13 of the proclamation and the registered person claiming the tax credit is holding that supporting document (unless an invoice is not required) at he time many return in respect of the supply is furnished; and
    b) a customs the registered person claiming the credit at the time any return is respect of the import is furnished as prescribed under the customs Proclamation, or a document issued by the Customs Authority evidencing payment of tax in relation to an import holds Declaration.
2. The cost incurred to begin or terminate a taxable or exempt activity are taken into account in calculation the allowable tax credit under Article 21 of the Proof the Proclamation.
3. Article 21, Sub-Article (3) (a) of the proclamation, denying a tax credit on the acquisition of a passenger vehicle, dose not apply to a commercial truck or other vehicle designed and used primarily for the carriage of goods.
4. For purposes of Article 21, Sub-Article (3) (b) of the Proclamation, a tax credit is not allowed for VAT on the purchase by a registered person of

restaurant meals for executive, employees, or customers, or for VAT on the rental of a lodge and the charge for food at a retreat for employees. The disallowance rule does not apply to purchases of "entertainment' by a registered person engaged in the business of selling "entertainment" (such as a restaurant) if the purchases are used directly in the provision of taxable entertainment.

5. A person who registers after VAT become effective can claim credit for tax on goods on hand when the registration takes effect if the goods were acquire within the six month period before the effective date, and the goods are to be used in a taxable activity carried on by the person after registration.

6. Where the total tax credits available to registered person for an accounting period exceed the total amount of tax chargeable on taxable transactions for that period, the amount of the excess is dealt with in accordance with the refund rules under Article 27 of the Proclamation.

Reverse Taxation (Article-12):

1. The value of an import of services taxable under Article 23 of the Proclamation generally is the amount of the consideration that the recipient is obliged to pay for the services, except that if the supplier and the recipient are related persons, the value of the import is its market value.

2. Where a portion of the consideration charged for imported services taxable under Article 23 of the proclamation represents tax that is not accounted for separately, the value of the import is the consideration under (1), reduced by an amount equal to the tax fraction multiplied by that consideration. The tax fraction is r(100=r), where "r" is the rate of tax applicable under Article 7, Sub-Article (1) of the Proclamation.

Transactions by Agent (Article-13):

1. Where a taxable transaction has been made by an agent on behalf of the agent's principal as specified under Article 24, Sub-Article (1) of the Proclamation, and the recipient of the taxable transaction is a registered person, the agent may issue a tax invoice in accordance with the proclamation in relation to the transaction; and the principal shall not also issue a tax invoices in relation to the taxable transaction.

2. Where a taxable transaction has been made to an agent on behalf of the agent's principal and the principal is a registered person, at the request of the agent, a tax invoice in relation to the taxable transaction may be issued to the agent; and a tax invoice shall not also be issued to the principal in relation to the taxable transaction.

Form and Manner of Filing Returns(Article-14):

A return required by Article 26 of the Proclamation shall be in the form prescribed by the Authority, and shall:

a) state the information necessary to calculate the tax payable for the accounting period in accordance with Article 20 of the Proclamation, and

b) be furnished in the manner prescribed by the Authority.

VAT Refund (Article-15):

1. Article 27, Sub-Article (5) (b) of the Proclamation provides the Authority is not obliged to refund excess credits if the amount to be refunded in not more than 50 Birr. If the amount eligible for refund is 50 Birr or less, this amount can be carried forward and credited against tax due in the subsequent accounting period.

2.Where a registered person applying for a tax refund has failed to furnish a require return, the Authority may withhold payment of any amount refundable under Article 27 of the Proclamation until the registered person furnishes such return.

3. If the Authority does not pay the refund in a timely manner as provided under Article 27, Sub-Article (6), the Authority shall pay interest calculated from the date on which the refund was due until the date on which the payment of the refund is made.

Assessment of Tax (Article-16):

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

a) a person fails to furnish a return as required by Article 26 of the Proclamation fails to furnish an import declaration as required by Article 5 of the Regulations;

b) the Authority is not satisfied with a return or import declaration furnished by a person;

c) the Authority has reason to believe that a person has become liable for the payment of an amount of tax but has not paid such amount;

d) a person, other than a registered person, supplies goods or services and represents that tax is charged on the supply;

e) a registered person supplies goods or services and the supply is not a taxable transaction or is a taxable transaction charted with tax at the rate of zero percent and, in either case, the registered person represents that a positive rate of tax is charged on the transaction; or

f) the Authority has determined the liability of any person in terms of Article 60, Sub-Article (2) of the Proclamation.

2. The person assessed:

a) in the case of an assessment under Sub-Article (1) (d) or (e) of this Article, is the person making the supply; or

b) in the case of an assessment under Sub-Article (1) (f) of this Article, is the person whose liability has been determined under Article 60, Sub-Article (2) of the Proclamation; or

c) in any other case, is the person required to account for the tax under the Proclamation.

3. In making an additional assessment under Article 29 of the Proclamation, the Authority may estimate the tax payable by a person.

4. Where an additional assessment has been made under Article 29 of the Proclamation, the Authority shall serve a notice of the assessment on the person assessed, which notice shall include-

a) the tax payable; and

b) the date the tax is due.

5. The production of a notice of assessment under Sub-Article (4) of this Article or a certified copy of a notice of assessment is receivable in any proceedings as conclusive evidence that the assessment has been duly made.

6. No assessment or other document purporting to be made, issued, or executed under the Proclamation or this Regulations shall be:

a) Quashed or deemed to be void or void able for want of form; or

b) affected by reason of mistake, defect, or omission therein,

if it is, in substance and effect, in conformity with the proclamation or this Regulation and the person assessed, or intended to be assessed or affected by the document is designed in it according to common understanding.

Seizure of Property (Article-17):

1.While the Authority must give 30 days notice under Article 31, Sub-Article (4) of the Proclamation before seizing property of a person in default, after making reasonable enquiries, the authority does not have sufficient information to identify the person on whom the notice should be served, the notice shall be deemed to have been served and then it shall proceed to seize the property.

2.The Authority may authorize the delivery of goods seized under Article 31,of the Proclamation to the owner of the goods or the person who had custody or control of the goods immediately before seizure, where that person pays the tax or other amount due that gave rise to the seizure.

Transitional Rules (Article-18):

1.In this Article:

a) "Qualifying goods" means an import or purchase of goods, including capital goods;

b) "repealed legislation" means The Sales and Excise Tax Proclamation No.68/93: and

c) "sales tax" means the sales tax imposed under the sales and Excise Tax proclamation No.68/93.

2.The repealed legislation, including the rules governing the levy, payment, assessment, reporting, and recovery of those taxes, continues to apply to a supply or import that takes place prior to the date on which the Proclamation comes into force.

3. Every appointment made under the repealed legislation and subsisting at the date of commencement of the Proclamation shall be deemed to be an appointment made under the proclamation;

4.Notwithstanding Article 21, Sub-Article (1), of the proclamation in calculating the amount of tax payable by a registered person in respect of the first accounting period after the tax becomes effective, the registered person may claim as an amo9unt creditable under Article 21, an amount equal to the sales tax calculated in accordance with Sub-Article (6) of this Article and creditable under Sub-Article (7) of this Article.

5. For purposes of Sub-Article (5) of this Article,

I. Where a registered person held, at the end of the last business day prior to the date the value added tax comes into force, qualifying goods being goods acquired not more than six (6) months before the tax comes into force: and

II. The Authority is satisfied that sales tax has been charged to the person on a sales invoice and paid on the acquisition or import of those goods, and the sales tax has not been rebated,

the amount of the creditable sales tax shall be the amount of such taxes paid on such goods, bur with respect to each item qualifying for the tax shall not exceed the amount of tax which would have been payable had the goods been subject to tax chargeable under the proclamation.

6. If, in any tax period, a registered [person has sales tax creditable under Sub-article (5) of this Article, the amount creditable is deemed to be tax creditable under Article 21 of the Proclamation and is subject to the provisions of article 27 of three proclamation relating to the excess of credits over the amount of tax charged for the accounting period.

7.No credit shall b allowed under Sub-Article (5) of this Article for any sales tax paid in respect of the acquisition of any goods if the VAT imposed on a supply or import in acquisition of those goods after the effective date of the Proclamation would not be creditable under Article 21 of the Proclamation.

8.A person may claim a credit under Sub-Article (5) of this article for sales tax paid on qualifying goods on hand on the date on which the Proclamation comes into force, only of the person is a registered person as of such date.

9.A person claiming a credit under Sub-Article (5) of this article shall submit with the first VAT return after the tax comes into force an inventory of all qualifying goods on hand at the beginning of the first day on which the

Proclamation comes into force, supported by documentary evidence of the payment of sales tax.

10. A disallowance of a credit for sales tax imposed before the date, on which the Proclamation comes into force, shall not be treated as a disallowance for purposes of Article 4, Sub-Article (5) of the Proclamation.

11. Where a contract is concluded between two or more parties before the proclamation comes into force, and no provision relating to tax is made in the contract, the supplier shall recover from the recipient, tax due on any taxable transaction made under the contract and made after the date on which the proclamation comes into operation.

12. Where a contract concluded after the date on which the proclamation comes into operation does not included a provision relation to tax, the contract price shall be deemed to include tax and the supplier under the contract shall account for the tax due,

13. Subject to sub-article (16) of this Article, if in connection with a supply of goods or services,

    a) title to goods passes, delivery of goods in made or services are rendered after the date on which the Proclamation comes into force; and

    b) payment is received or an invoice issued within nine months before that date,

    for the proposes of determining the accounting period in which the supply occurs or a tax credit is allowable, the payment is treated as having been made or the invoice is treated as having been issued on the date on which the proclamation came into forces.

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

15. If goods are leased under an agreement that provides for periodic payments or if services subject to sales tax were rendered during a period that began before end ended after the Proclamation came into force, VAT is imposed on the consideration for the services rendered after the proclamation came into force, except that to the extent the consideration for the services rendered before the proclamation came into force is paid more than four months after the proclamation came into force, the consideration is treated as consideration for the rendition of services on the day after the end of that four month period.

16. Notwithstanding Sub-article (13) of this Article, if construction, manufacture or extension of building or civil engineering work is performed under a written agreement executed before the proclamation came into force and the property is made available to the recipient after that date, VAT is imposed only on the value of work performed after that date if the value of

the work on the day before the proclamation came into force is determined in a manner a0proved by the Authority and is submitted to the Authority by the end of the supplier's first VAT period after VAT comes into force.

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

CHAPTER TWO

Exemptions

Dwellings (Article-19):

1.A "dwelling," defined in Article 8, Sub-Article (1) (b) of the proclamation, includes that area surrounding or appurtenant to the dwelling that is necessary for its enjoyment, but not farmland adjacent to a dwelling. The land surrounding a dwelling compels, including the driveway, paths, gardens and lands-caped grounds for the use and enjoyment of residents is part of the dwelling.

2.A registered person who purchases a new or used property for lease s a dwelling id denied tax credits for tax on any costs attributable to the exempt lease of the dwelling.

1. If an employer provides a dwelling to an employee as a fringe benefit, the exemption for the supply under Article 8, Sub-Article (2) (a) of the proclamation takes priority over Article 4, Sub-Article (3) of the proclamation treating fringe benefits provided to employees as supplies by the employer in the course or furtherance of a taxable activity. The employer under Article 21 of the Proclamation is denied tax credits for tax on costs attributable to the exempt fringe benefit.

2. A sale of a parking space that is part of the dwelling to the purchaser of a dwelling, or the lease of a parking space as part of a lease of a dwelling is exempt from tax.

Financial Services (Article-20):

1.Financial services as defined in these regulation are exempt from tax under Article 8, Sub-Article (2)) (b) of the proclamation, whether provided for explicit or implicit fees.

2.The financial services exempt from tax include the following:

a) granting, negotiating, or dealing with loans, credit, credit guarantees, or any security for money, including management of loans, credit, or credit guarantees by the grantor; or

b) Transactions concerning money (including the exchange of currency), deposit, savings, and current accounts, payments, transfers, debts,

cheques, or negotiable instruments, other than debt collection and factoring; or

a) provision of credit under a hire purchase agreement or sale of goods, but only if the credit is provided for a separate charge, and the separate charge is disclosed to the recipient of the goods; or

b) to the extent provided in this regulation, provision, or transfer of ownership, of an insurance policy, or the provision of reinsurance in respect of any such policy: or

c) provision, or transfer of ownership, of an interest, of an interest in a scheme whereby provision is made for the payment or granting of by a benefit fund, provident fund, pension fund, retirement annuity fund, or preservation fund; or

d) the arranging of any of the services in (a) to (d) or

e) provision of intermediation services by a buy-aid society or medical-aid fund;

3.For purposes of these regulations, the following definitions apply;

a) "cheque" includes a postal order, a money order, a traveler's cheque, or any order or authorization whether in writing, by electronic means, or otherwise) to a financial institution to credit or debit any account;

b) "currency" means any bank note or other currency of any country, other than when used as a collector's piece, investment article, item of numismatic interest, or otherwise than as a medium of exchange;

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

b) "merchant's discount" means a charge made to merchants for accepting a credit o debit card as payment for the supply of goods or services, or a similar charge made by a buying organization.

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

3. Financial services that are listed as exempt under these regulations are exempt, whether rendered by a registered bank or financial institution or by any other person.

4.Some services are not exempt under Article 8, Sub-Article (2) (b) of the proclamation, whether or not they are rendered in connection with an

exempt financial service, They include, but are not limited to the following:

a) Legal, accounting and record package services, actuarial, notary, and tax agency services (including advisory services) when rendered to a supplier of financial services or to a customer of that supplier of financial services;

b) Safe custody for cash, documents or other items;

c) Data processing and payroll services;

d) Debt collection services;

e) Management services, such as management of a superannuating fund;

f) Trustee, financial; advisory, and estate planning services, and

g) Leases, licenses, and similar arrangements relation to property other than a financial instrument.

5. For purposes of Article 20, Sub-Article (6) of these Regulations, accounting and record package services include a financial clearing system that may be part of the settlement process, the posting of financial transactions to customer's accounts the maintenance of customer's accounts, and the rendering of services ancillary to the services just described.

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

7. Zero-rated exports of financial services include:

a) financial services rendered in connection with an export of goods;

b) financial intermediation service rendered in connection with a loan to an unregistered, non-resident person to finance the export of goods; and

c) fees imposed by an Ethiopian bank on banking services rendered to a non-resident who is outside Ethiopia when the banking services are rendered, if they do not come within the exceptions in Article 35 of these Regulations.

8. If an exempt or zero-rated financial service is incidental to a main supply, or if such a financial service is the main service, the rules in Article 5 of the proclamation on mixed supplies apply.

9. Financial institutions and others providers of financial services that make both taxable (including zero-rated exports) and exempt supplies may claim tax credits under Article 21, Sub-Article (2) of the proclamation only on purchases (including rentals) and imports used in making taxable transactions.

10. The provisions under Article 21, Sub-article (2) of the Proclamation on the allocation of tax credits between exempt and taxable transactions do not apply (and full tax credits are allowed) to a registered person who derives more than 90 percent of the person's total supplies in an accounting period from taxable transactions (article 21, Sub-Article (3) of the Proclamation). For this purpose, when calculation g the value of the taxable and total supplies, the supplier should use gross figures for supplies other than intermediation services and use net interest amounts (interest income less interest expense) for financial intermediation services.

11. The Value Added tax Directive to be issued by the Minister of Revenue may give the Authority discretion to determine the allocation of tax credits between taxable and exempt supplies on bases that the Authority considers reasonable.

12. Regardless of method used to allocate tax credits under Article 21 of the Proclamation, the registered person must retain records to substantiate the method used. The authority may require financial service providers to submit statistical data on various product lines.

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

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

15. Services covered in riders to exempt insurance policies that are not incidental to the insurance coverage are taxable to the extent that the independent supply of those services would be taxable.

16. The Authority shall have the sole discretion to determine whether a non-insurance rider is incidental to the main insurance policy.

17. The premium on an insurance policy is exempt only if the premium is charged on a policy issued by a person who is licensed to issue such policies under the Insurance proclamation.

18. Commission and other fees earned by brokers/agents who provide insurance coverage for their customers do not come within the exemption for insurance as a financial service.

19. An insurance policy does not include insurance cover on a warranty in respect of the quality, or performance of tangible property.

Supply or import of securities (Article-21):

1. The exemption for securities under Article 8, Sub-Article (2) (c) of the proclamation covers:

   a) transactions relating to the issuance, transfer, or receipt of, or any dealing with shares, stocks, bonds, treasury bills, or other debt or equity securities, other than Custody services:

b) transactions relating to financial derivatives, forward contracts, options, or similar arrangements, and

c) transactions relating to the creation, issue, transfer, assignment or receipt of, or dealing with, an option or warrant relating to securities included in (a).

2. The underwriting of the issuance of securities generally is exempt from tax. However, the exemption for underwriting services does not extend to other services obtained in connection with an underwriting, such as advertising and printing costs, accounting, legal, and adviser's fees.

3. The exemption for securities or for financial services does not include management or administrative services provided to a business whose principal activity is investing funds for shareholders, members, or other persons.

4. For purposes of this Article,

a) "currency" means any banknote or other currency of any country, other than when used as a collector's piece, investment article, or otherwise than as a medium of exchange;

b) "debt security" means any interest in or right to be paid money that is, or is to be, owing by any person, but does not include a cheque or an interest or right that is a lease, license or other similar arrangement in respect of immovable property; and

c) "equity security" means any interest in or right to a share n the capital of a juristic person or the interest in a close corporation of a member thereof.

Import of gold for National Bank of Ethiopia (Article-22):

The exemption for the import of gold to be transferred to the National Bank of Ethiopia under Article 8, Sub-article (2) (d) of the proclamation applies to imports by or for the National Bank, regardless of the level of purity of the gold or the form in which it is imported.

Religious or Church-related Services (Article-23):

1. The supply of religious or church-related services by a religious organization is exempt under Article 8, Sub-Article (2) (e) of the Proclamation. generally, services rendered by a religious organization that are integral to the practice of that religion come within the exemption.

2. The activities of a religious organization that compete with the private sector or that are not integral to the practice of the religion do not come within the exemption, If the value of these taxable supplies exceed the threshold under Article 16 of the Proclamation, the religious organization must register.

3. Article 8, sub-Article (2) (p) of the proclamation exempts books and other printed material. This exemption for books applies to supplies of books or other printed material by a religious organization.

4. Te donation in kind or money (such as church plate donations) or services are not subject to tax if there is no direct link between the payment and any benefit received by the donor.

5. A receipt by a religious organization from a business in not a supply for consideration if the receipt merely entitles the transferor to be mentioned in a brochure or program, but if a religious organization receives payment when it sells space in a brochure of program, the receipt is a supply for consideration that does not come within the exemption for religious or church-related services.

6. A religious organization that operates taxable activities through a development commission or similar entity or through a division or branch may apply for or be required to separately-register one or more of the commissions, divisions, or branches as provided under the Value Added tax Minister of revenue Directive.

Medical Services and Prescription Drugs (Article-24):

1. Article 8, sub-Article (2) (f) of the proclamation exempts the rendering of medical services, and the import and supply of prescription drugs specified in the directives issued by the Minister of Health Medical services are exempt, whether provided with or without charge and whether paid by the patient of resident or any third party, if the medical services meet two conditions:
   a) they are rendered in a qualified medical facility or by a qualified medical practitioner, or both, and
   b) they qualify as exempt medical services in this Article of the Regulations.

2. To be exempt, medical services must be rendered at a qualified medical facility. For purpose of this Article, a qualified medical facility includes the offices of a qualified medical practitioner, a hospital, maternity home, or clinic.
3. A qualified medical service is exempt if a qualified medical practitioner provides it. A qualified medical practitioner includes a doctor, healer, dresser, health officer, physical therapist, and other health care provider who is required to register and registered with the Ministry of Health.
4. To qualify for the exemption, medical services must consist of qualified services (including meals and accommodations) in a qualified medical facility, and must involve the rendering of medical services by a qualified medical practitioner. Medical services involve the diagnosis, treatment, prevention, or amelioration of a disease, including the promotion of mental health.
5. For purposes of sub-Article (1) of this Article, services that qualify as exempt medical services include the services provided to a resident or patient by a qualified medical practitioner in a qualified facility, as well as meals and accommodations, nursing and personal care, and assistance with daily living activities to meet the needs of the resident or patient.

6. For purposes of Sub-Article (1) of this article, exempt medical services include the following:

   a) medicines and drugs that are issued in a hospital or clinic for which there is no separate charge;

   b) laboratory, X-ray, or other diagnostic service;

   c) medical devices as defined in Sub-Article (7) of this Article that are provided as part of the supply of qualified medical services;

   d) the use of operating rooms, case rooms, or anesthetic facilities, including necessary equipment or supplies;

   e) the use of radiotherapy, physiotherapy, or occupational therapy facilities in rendering exempt medical services;

   f) accommodation and meals (except in a restaurant or cafeteria available to persons other than patients or residents) provided to patients or residents in the course of receiving exempt medical service;

   g) services rendered by the medical facility staff (including orderlies or technicians) in connection with exempt medical services;

   h) dental, periodontal, and endodental services rendered in connection with a disease, trauma, or congenital deformity, but not for general dentistry or for cosmetic reasons; and

   i) psychoanalytic services.

7. For purposes of Sub-Article (6) (c) if this Article, medical devices means devices that are supplied to a resident or patient in a qualified medical facility, supplied to a qualified medical facility, or supplied on prescription in connection with the rendition of qualified medical services, including: -

   a) a respiratory or heart monitor, dialysis machine, or feeding utensil for use by an individual with a disability;

   b) a medical or surgical prosthesis or orthopedic aid provided as part of the rendition of qualified medical services; and

   c) medical or surgical equipment supplied to a qualified medical facility, or the sale or rental of such equipment to a patient or resident.

Education Services (Article-25):

1. Article 8, Sub-Article (2) (g) of the Proclamation exempts education services rendered by educational institutions, and childcare services at pre-school institutions. Qualified charges for education services are exempt if the services meet two conditions:

   a) they are specified in these regulations; and

   b) they are provided to students by a qualified educational institution.

2. To qualify for the exemption, the services must be provided to students by an accredited:

   a) Pre-primary, primary, or secondary school;

b) technical college or university; or

c) institution established to promote adult education, vocational training, technical education, or education or training of physically or mentally handicapped persons.

3. An educational institution in (2) is qualified, whether it is a private school operating on a for-profit basis, or a non-profit organization, church, or charity, or a department of government.

4.An educational institution in Sub-Article (2) is a qualified institution only if the institution is accredited or is being evaluated for accreditation by the accrediting agency at the time the services are rendered.

5. The following categories o services qualify as exempt education services:

a) course of instruction provided to students at a qualified education institution;

b) qualified meal plans, and other associated goods or services provided in kind as part of the education program of a qualified provider of education services;

c) instruction in, or the administration of examinations, if provided by the educational institution: and

d) instruction or tutoring related to a qualified course.

6. School bus transportation to and from pre-primary, primary, or secondary schools is an exempt education service if it is provided by the school authority, not if provided by a private company under contract with the school authority.

7. Qualified charges for exempt education services include:

a) charges for tuition, facilities, and curriculum related activities and instruction;

b) compulsory levies for facilities are part of a supply of exempt education services;

c) student council fees, athletic fees, and other mandatory fees related to course registration;

d) charges for reports, library services, identity cards, record keeping and other administrative services provided by the educational institution and directly related to the supply of education courses:

e) charges for course materials, the rental of curriculum-related goods by the supplier of the education (e.g., the rental of musical instruments), field trips directly related to the curriculum if not predominantly recreational: and

f) student accommodations (including hostels) supplied by the supplier of the education.

8. Qualified facility charges include charges for buildings, grounds, libraries, and computer, science and other laboratories.

9. The exemption for education services does not cover the following education courses:

    a) course in sports, games, video recording or photography or other hobbies or recreational pursuits, unless they are part of a degree-or diploma-granting program;

    b) course, such as picture framing, cooking, and personal investment, that are designed to improver knowledge for personal purposes; and

    c) music lessons that are not part of a school curriculum.

10. Religious workers receiving education are treated as students for purposes of this Article of the regulations.

11. In addition to services exempt under (4), exempt education services rendered by a pre-primary, primary, or secondary school include-

    a) basic instruction, including special education courses;

    b) fees or charges for a pre-school or after-school program operated by the school;

    c) charges for the use of school musical instruments or sports equipment;

    d) services rendered by students or their teachers as part of the instructional; program; and

    e) charges for students to attend a school play, dance, field trip, or other school-sanctioned activity primary for the students.

12. Exempt education services rendered by a university of technical college include courses, including correspondence courses, that qualify for credit toward a degree or diploma, whether or not the student is pursuing a degree or diploma program.

13.The education exemption for adult education, vocational training, technical education, and education or training of physically or mentally handicapped persons includes charges for:

    a) adult education courses leading to a degree or diploma or courses that are likely to enhance employment-related skills of the students enrolled in the courses;

    b) courses of study at a vocational school that develop or enhance a student's occupational skills;

    c) courses leading to, or to maintain or upgrade, a professional or trade accreditation or designation recognized by the appropriate government accrediting agency; and

    d) a certificate or examination in a course or program for accreditation or designation.

14. Courses enhance employment-related skills if the course objectives specify those skills that students will acquire, and there is a reasonable expectation that thee skills taught will be used by the students in their employment,

businesses, professions, or trades, rather than for recreational, hobby, artistic, or cultural purposes.

15. The exemption for education services does not include;
    a) the rental of facilities by an educational institution to an outside group;
    b) the sale of admission to school athletic events open to the general public;
    c) commissions and other fees received from the placement of coin-operated machines on the institution's property; and
    d) the sale of non-course material, such as items containing the school logo.

Supplies of Humanitarian Aid, and Imports of Goods for Rehabilitation after Natural Disasters, Industrial Accidents, and Catastrophes (Article-26):

1. The exemption for supplies of humanitarian aid under article 8,Sub-article (2) (h) of the proclamation applies to goods imported or purchased locally by organizations registered as humanitarian organizations, for such purposes.
2. The exemption under article 8, Sub-article (2)(h) of the Proclamation covers the import of goods or purchase of goods locally in connection with an announcement or declaration of a natural disaster, industrial accident, or catastrophe by the Disaster prevention and Rehabilitation commission.

Water (Article-27):

A supply of water is exempt from tax under Article 8, sub-Article (2) (i) of the proclamation, unless it is processed in a factory.

Imports Exempt by Law or Agreement (Article-28):

1. Article 8, Sub-Article (2) (j) of the proclamation exempts imports of goods by the government, organizations, institutions or projects only to the extent that they are exempt from duties and other import taxes by law or by agreement.
2. An exemption by law covers an exemption for certain imports granted by a Proclamation, granted by a regulation or directive.
3. An exemption by agreement covers tax exemptions for the government enters into certain import of goods only of the agreement or the agreement is entered into with permission granted by the government.
4. The exemption by agreement includes an exemption provided under;
    a) a technical assistance or humanitarian assistance agreement entered into between the Government of any country;
    b) the Diplomatic Immunities and Privileges Registrations,
    c) an international convention having the force of law in Ethiopia;
    d) any other multilateral agreement to which Ethiopia is a party;

Transport (Article-29):

1. The exemption for transport services under Article 8, sub-Article (2) (1) of the Proclamation is a broad exemption covering the charges imposed for the transport of passengers or freight by any mode of transport.
2. If a transaction involving the international transport of goods or passengers qualifies for exemption under Article 8, Sub-Article (2) (1) of the proclamation, Article 8, sub-Article (4) treats the transaction as zero-rated.

Permits and Licenses (Article-30):

1. The exemption for permits and license fees under Article 8, Bus-Article (2) (m) of the proclamation is limited to fees charged for permits and licenses issued by a government agency.
2. The exemption in (1) does not apply to licenses of intangibles and other licenses or permits, such as the right to use property, granted by private parties.

Imports Exempt under Schedule 2"B" of Customs Tariffs Regulations (Article-31):

The exemption granted under Article 8, Sub-Article (2) (n) of the Proclamation for imports of goods exempt under Schedule 2 of the Customs Tariffs Regulations is limited to the exemptions granted under part (B) of Schedule 2 of Customs Tariffs Regulations and under Directives issued pursuant to those Regulations.

Workshops for Disabled (Article-32):

1. The exemption under Article 8, Sub-Article (2) (0) of the proclamation applies to goods sold and services rendered by workshops employing physically or mentally disabled individuals.
2. To qualify for the exemption under Sub-Article above more than 60 per cent of the workshop's employees must be disabled, The 60 per cent threshold is measured by the number of disabled and total employees in the previous 12 months, except that if the workshop has been in existence for less than 12 months, then the threshold is measured for the number of months the workshop has been in existence.

Books and other Printed Materials (Article-33):

1. The exemption under Article 8, Sub-Article (2) (p) of the proclamation applies to a printed book or an update of a book. The exemption applies to a bound or unbound printed version of scripture of any religion.
2. The exemption for books generally does not apply to an audio recording that is a spoken reading of a printed book, except that the exemption under Article 8, Sub-article (2) (p) of the Proclamation applies to import and supplies of talking books (on cassettes or other forms of recording) specifically designed for the blind or severely handicapped.

CHAPTER THREE

Supplies Subject to Zero Tax Rate

Substantiation of Zero Rating (Article-34):

Where a registered person has applied the rate of zero percent to a supply under these regulations, the registered person shall obtain and retain such documentary proof acceptable to the Authority substantiation the person's entitlement to apply the zero rates to the supply.

Export of Goods or Services (Article-35):

1. In this Article

   a) "export country" means any country other than Ethiopia and includes any place which is not situated in Ethiopia, but does not include any specific country or territory that the Minister of Finance and Economic Development may by directive designate as one that is not an export country;

   b) "exported from Ethiopia" in relation to any movable goods supplied by any registered person under a sale or credit agreement, means

      1. consigned or delivered by the registered person to the recipient at an address in an export country as evidence by documentary proof acceptable to the Authority; or

      2. delivered by the registered person to the owner or charter of any foreign-going aircraft when such aircraft is going to a destination in an export country and such goods are for use or consumption in such aircraft, as the case may be;

2. The following supplies are zero-rated exports within Article7, Sub-Article 7, Sub-Article, (2), (a) of the Proclamation:

   a) a supply for goods where the supplier has entered the goods for export, pursuant to the customs Proclamation, and the goods have been exported from Ethiopia by the supplier;

   b) a supply for goods where the authority is satisfied that the goods have been exported from Ethiopia by the supplier;

   c) a supply of goods where the goods are not situated in Ethiopia at the time of supply and are not to be entered into Ethiopia for home consumption pursuant to the Customs Proclamation by the supplier of the goods;

   d) a supply of services directly in respect of

      i. movable property situated outside Ethiopia at the time the services are rendered;

      ii. goods temporarily imported into Ethiopia under chapter 5 of the Customs Proclamation: or

      iii. supply of goods referred to in (a) or (b) of the definition of "exported from Ethiopia".

   e) a supply of goods in the course of repairing, renovating, modifying, or treating any goods to which Sub-Article (2) (d) (ii) of this Article applies and the goods supplied

i. are worked into, affixed to, attached to, or otherwise form part of those other goods; or

ii. being consumable goods, become unusable or worthless as a direct result of being used in that repair, renovation, modification, or treatment process;

f) a supply of services directly in connection with land, or any improvement thereto, situated outside Ethiopia;

g) a supply of services to a non-resident person who is not a registered person comprising the arranging for the person of a amply of goods referred to in (a) and (b) of the definition of "exported from Ethiopia",

h) a supply of services physically rendered else where than in Ethiopia;

i) a supply of service to a non-resident person who is outside Ethiopia at the time the services are supplied, other than a supply of services;

i. directly in connection with immovable property situated in Ethiopia

ii. directly in connection with movable property situated in Ethiopia at the time the services are supplied unless the movable property is exported from Ethiopia subsequent to the supply of services;

iii. comprising the refraining from undertaking any taxable activity in Ethiopia; or

iv.. comprising the tolerating of another person undertaking any taxable activity in Ethiopia;

j) a supply of services comprising-

i. the filing, prosecution, granting, maintenance, transfer, assignment, licensing, or enforcement of intellectual property rights for use outside Ethiopia;

ii. incidental services necessary for the supply of services referred to in (i) above; or

iii. the acceptance by any person of an obligation to refrain from pursuing or exercising in whole or part, intellectual property rights for use outside Ethiopia;

3. To obtain zero rating for the export of goods and related services under this Article, the exporter, at the port of exit, must identify the goods and present documentary proof required y the Authority.

4. Zero-rating for exports under Article 7, Sub-Article (2) (a) of the proclamation doen not apply to any export of goods which have been or will be re-imported to Ethiopia by the supplier for export.

5. A supply of tangible personal property (including natural resources, but not including spirits, beer or tobacco) made by a registered person to a registered recipient who will export the goods in zero-rated, if all of the following conditions are met:

   a) the recipient exports the property as soon after the goods are delivered to the recipient as is reasonable having regard to the acts of each situation, including the type of goods involved and, where applicable, the normal business practice of the recipient;

   b) the recipient has not acquired the goods for consumption, use or supply in Ethiopia before exportation;

   c) the goods must not be further processed, transformed or altered in Ethiopia, except to the extent reasonably necessary or incidental to its transportation, after delivery and before its exportation; and

   d) the supplier must maintain evidence satisfactory to the Authority of exportation of the goods by the recipient.

6. For purposes of sub-article (5), -

   a) the recipient must intend to export the goods and must in fact export the goods;

   b) a supply to a recipient who intends to sell to a registered person who will export the goods is not treated as a supply to a recipient who will export the goods;

   c) processing, transformation, or alteration includes preparation, handling or other activity that causes a physical or chemical change in the property other than natural growth, but generally doen not include services such as inventory-taking, refrigeration, warehousing, export packing or repacking, export labeling, export crating, loading or unloading; and

   d) evidence of exportation can be satisfied with documents satisfactory to the Authority, such as an export certificate from, the recipient of the goods in a form acceptable to the Authority.

International Transport of Goods or Passengers (Article-36):

1. In this Article-

   a) "ancillary transport services" means stevedoring services, lashing and securing services, cargo inspection services, preparation of customs documentation, container handling services, and storage of transported goods or goods to be transported;

   b) foreign-going aircraft" means any aircraft engaged in the transportation for reward of passengers or goods wholly or mainly

on flights between airports in Ethiopia and airports in export countries or between airports in export countries;

c) "International transport services" means:

1. the services, other than ancillary transport services, of transporting passengers or goods by land, water, or air.

i) from a place outside Ethiopia to another place outside Ethiopia where the transport or part of the transport is across the territory of Ethiopia;

ii) from a place outside Ethiopia to a place in Ethiopia; or

iii) from a place in Ethiopia to a place outside Ethiopia;

2. the services of transporting passengers from a place in Ethiopia is to another place in Ethiopia to the extent that the transport is by aircraft and constitutes "international carriage" as defined in Article 8 of the Convention on International Civil Aviation.

3. the services, including any ancillary transport services, of transporting goods from a place in Ethiopia to another place in Ethiopia to the extent that those services are supplied by the same supplier as part of the supply of services to which (a)of this definition applies; or

4. the services of insuring or the arranging of the insurance or the arranging of the transport of passengers of goods to which (a) to(c) of this definition applies:

2. The following supplies are zero-rated supplies within Article7, sub -Article (2)(b) of the Proclamation

(a) a supply of the goods under a rental agreement, or agreement for chartering, where the goods are used exclusively in an export country;

(b) a supply of goods delivered to the owner or chatterer of a foreign-going aircraft when the aircraft is flying to a destination in an export country and the goods are to be used international transport services;

(c) a supply of international transport services;

(d) a supply of services directly in respect of the repair, maintenance, cleaning or reconditioning of a foreign-going aircraft;

(e) a supply services directly to a non-resident person not being a registered person, otherwise than through an agent or other person;

i) comprising the handing, pilotage, salvage,or towage of any foreign-going aircraft while situated in Ethiopia; or

ii) provided in connection with the operation or management of any foreign-going aircraft;

(f) a supply of services to a non-resident person who is not a registered person comprising the arranging for the person of-

(i) a supply of services to which sub-Article (2)(d) or (e) of this Article applies; or

(ii) the transport of goods, including ancillary transport services, within Ethiopia;

(g) a supply of services comprising the repair, maintenance, cleaning, or reconditioning of a railway train operated by a non-resident person who is not a registered person.

Supply of Gold to the National Band of Ethiopia (Article-37):

A supply of gold to the National Band of Ethiopia is zero-rated under Article 7,Sub-Article (2)(c) of the proclamation, and the import of gold to be transferred to the National Bank exempt under Article 8, Sub-Article (2)(d) of the proclamation.

Transfer of a Going Concern (Article-38):

1. The transfer of all or portion of a taxable activity as a going concern is a supply in the course or furtherance of the taxable activity under Article 4, Sub-Article (9) of the Proclamation. If the transfer meets the requirement of Article 4, Sub-Article (10) and Article 7, Sub-Article (2) (d) of the proclamation, the transfer can b zero-rated, In appropriate cases described in Article 4, Sub-Article (11), a portion or the entire transfer that is zero-rated to the supplier may be treated as a taxable transaction to the person acquiring the going concern.
2. To obtain zero-rating, the parties must comply with the following requirements:

   a) The transfer can be of a going concern between registered persons;

   a) A notice of the transfer must be submitted in writing and signed by the transferor and transferee;

   b) The notice must be furnished to the Authority within 21 days after the transfer takes place; and

   c) The notice must include the essential details of the supply.

1. A going concern is an income-producing activity capable of separate operation that is in fact operational and capable of being carried on without interruption after the transfer, but not a dormant or prospective business.
2. A transfer can be of a gong concern even if the transferred business in not profitable, or is being transferred to a liquidator, receiver, trustee in bankruptcy, or other persons appointed upon the insolvency of registered person.
3. The transfer is zero-rated only if it takes place on or after the effective date of the VAT.
4. A transfer of a going concern comes within the zero rating of Article 7, Sub-Article (2) (d) of the proclamation if the transfer is to a person with no previous interest in the business, or is a transfer of an existing business

involving only a change of legal entity or form of doing business, such as from a partnership to an incorporated company.

5. It is not necessary for the transferee to operate the particular income-producing activity acquired, so long as it is capable of separate operation.

6. The supply of farmland alone is not a supply of a going concern if it can be separately operated.

7. Unless the transferor and transferee both are registered persons and both sign and file in a timely manner to treat the transfer as a supply of a going concern as required under Article 7, sub-Article (2) (d) of the Proclamation, the transfer is not zero-rated, even if in fact it is a transfer of a going concern.

8. The 21-day period within which the notice must be filed is determined under the time of supply rules in Article 11 of the proclamation.

9. If the transferee previously was not a registered person, the supply can qualify for zero rating only if the transferee is registered by the date the transfer takes place.

10. If the parties file the required notice and the transfer does not qualify as a zero-rated supply of a going concern under Article7, Sub-article (2) (d) of the proclamation, the consideration charged for the supply is treated as being exclusive of VAT, the transfer is subject to tax, and the transferee can claim a tax credit to the extent allowable under the proclamation.

11. The notice to the Authority required under this Article must include a compete list of the assets transferred, the market value of each asset transferred, the nature of the business conducted by the transferor and the business to be conducted by the transferee with the acquired assets, and the length of time the transferor's business has been operated with the assets transferred, The authority may require additional information from the transferor or transferee, or both.

12. If the transferor cancels its registrations as part of the transfer of a going concern, then goods not transferred as part of the going concern generally constitute a supply of the goods by the transferor at their market values, except that this rule does not apply to goods for which the transferor has not been allowed a tax credit under Article 21 of the proclamation.

13. The transferor and transferee, upon written application signed by both, may request a transfer of taxpayer identification number and certificate of registration, and the Authority has the sole discretion to grant or deny the request.

14. If the application under (7) is approved, -

    a) the transferor must transfer VAT records to the transferee, and the transferee must retain those records for the time required for the retention of records under Article 37 of the Proclamation; and

    b) both parties are legally obliged to pay any VAT liability incurred while the transferor owned the business.

Directives (Article-39):

The Minister of Revenue may issue directive for the proper implementation of these Regulations.

Effective Date (Article-40):

These Regulations shall come into force as of the date the Proclamation comes into force

Done at Addis Ababa this 31 st day of December 2002.