UNIT 5

TAX THEORY AND PRACTICE

Introduction to Taxation

Key Concepts:

- **Types of Taxes:** Direct and Indirect Taxes
- **Tax Rate:** Percentage of income or economic activity that is taxed
- **Tax Base:** The level or quantity of an economic activity that is taxed
- **Tax Incidence:** How the burden of a tax is distributed among economic units
- **Impact of Tax:** Immediate burden on those who pay the tax
- **Effect of Tax:** Responses from taxpayers and the economy
- **Tax Shifting:** Passing the burden of tax to others
- **Tax Avoidance:** Legal strategies to reduce tax liability
- **Tax Evasion:** Illegal activities to avoid paying taxes

5.1 Taxes: Definition, Principles, Objectives, and Classifications

5.1.1 Definition and Terminologies in Taxation

Definition: Taxation refers to compulsory, unrequited payments made to the government. "Compulsory" means taxes are mandatory, not voluntary, and "unrequited" means there is no direct benefit received in exchange. Taxation is essential for government revenue, accounting for over 90% in peacetime.

Key Terminologies:

- **Tax Rate:** The percentage or amount of income or activity that is taxed.
- **Tax Base:** The quantity or level of the economic activity subject to tax.
- **Tax Incidence:** Who ultimately bears the burden of the tax.
- **Impact of Tax:** The initial effect of the tax on the taxpayer.
- **Effect of Tax:** How taxes influence economic behavior and the economy.

5.1.2 Objectives of Taxation

Taxes are used to:

1. Minimize income and wealth inequalities.
2. Stabilize the economy.
3. Discourage harmful consumption.
4. Provide incentives for private sector investment.
5. Reduce regional imbalances.
6. Enhance living standards.
7. Allocate resources efficiently.
8. Minimize unemployment and encourage exports.

5.1.3 Principles of Taxation

Adam Smith's principles of taxation include:

1. **Equity:** Taxpayer contribution should match their ability to pay.
2. **Certainty:** Taxes should be clear and predictable.
3. **Convenience:** Taxes should be easy to pay.
4. **Economy:** The cost of tax collection should be minimal.
5. **Fiscal Adequacy:** Taxes should generate sufficient revenue.

Modern principles include fairness, efficiency, simplicity, and flexibility.

5.1.4 Characteristics of a Good Tax System

A good tax system should be:

- Simple and understandable.
- Broad-based, covering income, property, and commodities.
- Administratively efficient.
- Balanced and equitable.
- Capable of reducing economic inequalities and promoting growth.

5.2 Approaches to Tax Equity

5.2.1 The Benefits Approach

Taxes should be based on the benefits taxpayers receive from public services. This approach links tax obligations to the advantages gained from government expenditures.

5.2.2 The Ability-to-Pay Approach

Taxes should be based on the taxpayer's ability to pay:

- **Horizontal Equity:** Individuals in similar situations should pay similar taxes.
- **Vertical Equity:** Individuals with greater ability should pay more.

Types of Taxes by Impact:

- **Progressive Tax:** Higher income means a higher percentage of income is paid in taxes.
- **Proportional Tax:** Everyone pays the same percentage of their income.
- **Regressive Tax:** Higher income results in a lower percentage of income paid in taxes.

5.3 Tax System and Structure in Ethiopia

Historical Background: Income taxation in Ethiopia began in 1944. The current tax regime is managed by the Federal Ministry of Revenues, following Proclamation No. 33/1992 and the FDRE Constitution (1995).

Tax Responsibilities:

- **Federal Government:** Levies and collects taxes on reserved revenue sources and manages the federal budget.
- **Regional Governments:** Collect taxes on state-reserved revenue sources and manage state budgets.

Ethiopia's tax system is structured to balance federal and regional tax responsibilities, with various schedules for different income sources.

Types of Tax and Tax Accounting in Ethiopia

1. Overview of Ethiopian Tax Schedules

In Ethiopia, the Tax Proclamation No. 286/2002 and Regulations No. 78/2002 classify income into five schedules:

Schedule A: Income from Employment

- **Tax Rates:** Ranges from 10% to 35%.

- **Includes:** Salary, wages, allowances, bonuses, commissions, fringe benefits, and termination payments.
- **Tax Treatment:** Tax is withheld by employers, and it's considered a final tax. Employees don't need to declare this income separately.

Schedule B: Income from Rental of Buildings

- **Taxation:** Imposed on rental income after deductions for allowable expenses.
- **Calculation:** Taxable income is the gross rental income minus allowed deductions.

Schedule C: Income from Business

- **Taxation:** Applied to business income.
- **Calculation:** Taxable income is the total business income minus allowable deductions.

Schedule D: Other Income

- **Includes:** Royalties, services rendered outside Ethiopia, casual rental income, dividends, interest income, and specified non-business capital gains.

Schedule E: Exempt Income

- **Examples:** Medical treatment costs, hardship allowances, salary for domestic servants, pension contributions, and compensation payments.

2. Indirect Taxes in Ethiopia

Value Added Tax (VAT)

- **Rate:** 15% on taxable transactions.
- **Description:** A tax on the value added at each stage of production or distribution. Vendors include VAT in the selling price and are responsible for its payment.

Turnover Tax (TOT)

- **Rate:** 2% for some services, 10% for others.
- **Description:** Imposed on businesses not registered for VAT, based on their annual turnover. It's a means to ensure fairness in taxation.

Excise Tax

- **Rate:** Ranges from 5% to 500%.
- **Description:** Applied to selected goods, including luxury items and goods harmful to health. Tax is paid on import or production.

Surtax

- **Rate:** An additional 10% on imported goods, excluding certain essential items.
- **Purpose:** To increase government revenue and control imports.

Pension Contribution

- **Rates:** Employer contributes 11%, employee contributes 7%.
- **Description:** Contributions to the Private Organizations Pension Fund based on salary.

Withholding Tax

- **Rate:** 2% on domestic transactions.
- **Description:** Deducted by entities and remitted to tax authorities monthly.

Stamp Duty

- **Description:** Tax paid by affixing stamps to certain documents. This tax is a form of revenue for the government.

Customs Duty

- **Description:** Tax on imported or exported goods. It serves as a trade barrier and helps protect domestic industries.

3. Tax Accounting

Tax accounting involves tracking and reporting financial information for tax purposes. This includes calculating income, deductions, and tax liabilities. For individuals, employers handle tax deductions. Businesses must maintain accurate financial records to determine tax obligations.

Problems Associated with Taxation in Ethiopia

1. Tax Compliance Challenges

- **Complexity:** Tax laws are complex, leading to difficulties in understanding and compliance.
- **Corruption:** Perceptions of corruption undermine trust in the tax system.
- **Cost of Compliance:** High compliance costs discourage proper reporting.
- **Tax Knowledge:** Lack of understanding about tax laws affects voluntary compliance.

2. Tax Avoidance and Evasion

- **Tax Avoidance:** Legal methods used to reduce tax liability, such as exemptions and deductions.
- **Tax Evasion:** Illegal activities, including falsifying returns or not filing taxes, rooted in high tax rates and underground economic activities.

3. System Inefficiencies

- **Workload:** Growing workload and complexity of tax legislation strain administration.
- **Non-Compliance:** Issues with taxpayer attitudes and non-compliance challenge tax collection efforts.

Unit Summary

Taxes are mandatory payments to the government used to fund public services, promote fairness, and influence economic behavior. Ethiopian taxes include various direct and indirect taxes. Direct taxes are paid directly by the taxpayer, while indirect taxes are passed on to consumers. Challenges in Ethiopia's tax system include complexity, compliance issues, and perceptions of corruption.
