

TAX REFORM IN ETHIOPIA & PROGRESS TO DATE

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Abstract:

In the late 1980's and beginning of 1990's the country faced internal and external macroeconomic imbalances. With the aim of stabilizing and liberalizing the economy, the Government has undertaken Economic Reform Program since 1992/93 after the change of central planned economic system to market oriented one. As a part of ERP, the tax reform program has been undertaken. Initially, the tax reform focused on the rationalization of tax policies. Latter on the reform has included vigorously tax administration reform. In the paper complex and outdated tax law, which cannot fit with the current economic system of the country, weak tax administration and failure of tax revenue to meet government expenditure requirement are pinpointed as the bases for the tax reform. The content of the tax reform program and the status to date are also discussed. Finally, looking at the trends of real tax revenue collection and the structural changes that have been achieved after 1992/93 assessed to see the impact of tax reform. Tax policy reform generally well advanced than the tax administration reform. The achievement so far attained is positive but it needs interventions in the area of tax administration so as to reap expected output from tax policy changes.

1. Introduction

It is believed that public finance is one of the major factors that shape the course of economic development. It affects resource use and financing pattern, and together with monetary and exchange rate policies, influences the rate of inflation. Public spending and tax policies also affect the behavior of producers and consumers, and influences the distribution of wealth and income in the economy.

The fiscal and monetary policies, which have been undertaken by different political regimes in Ethiopia, have affected the course of economic development of the country. Between 1974 and

1991 the economic performance as measured by real GDP growth was 1.8 percent per annum, where as, the average population growth rate was 2.9 percent. During this period the country faced both internal and external imbalances. The overall government budget deficit including grant was on the average 7 percent of GDP. The current account deficit including grant averaged about 3.7 percent of GDP (5.2 percent of GDP excluding grant).

With the aim of stabilizing the economy, an Economic Reform Program (ERP) has been implemented in the country since 1992/93. As part of this reform program, the government has undertaken different tax policy measures.

Tax policies has played imperative role: - to raise government revenue so as to finance its expenditure; to redistribute income; to encourage the production and distribution of socially desirable goods and services and discourage those which are undesirable like cigarette, alcohol drinks etc. It also helps to maintain macroeconomic stability and encourage saving and investment. As a result, governments have adopted specific tax systems that are inline with the political and economic regimes of the country. In connection with this, in Ethiopia tax policies that were applied during the previous regime of central planning demanded a change after the economic system changed to a market oriented one. Therefore, the paper tries to address the major elements of the changes in the tax system; the progresses achieved to date and assess the impact so far observed. The objectives of this paper in details are, therefore, to highlight the major reasons for these measures and to bring to light the elements of the Tax Reform and the progress to date. Comparative analysis using key tax variables will be used to show the changes that have been exhibited in the reform period.

The scheme of the paper is as follows. In section 2 the major reasons that motivated the Government to undertake the reform will be discussed. In section 3 major tax reform measures will be highlighted. In section 4, the impact of the tax reform will be assessed. Finally, concluding remarks will be made in section 5 of the paper.

2. Bases for Tax Reform

Faced with severe macroeconomic imbalances such as falling export earnings, worsening balance of payments, mounting debts and declining economic growth, the country undertook various policy measures since 1992/93 following a major economic shift from Central Planning to Market oriented system. In the fiscal front, the aim was to expand the tax base and allow government expenditure to grow moderately so that the level of budget deficit could be reduced to a reasonable level.

Prior to the Tax reform, the Government noticed different signals indicating the need to overhaul the tax system. The major ones are: -

3. Complex and Outdated Tax Law

The tax law No. 173/53 was put into practice for more than 40 years without major changes (only with minor amendments). As a result it could not serve the current economic setup of the country and also could not go with the current world economic system of Globalization and automation. The tax system before the reform had extremely high rates and many brackets. This resulted in complex structure such that neither the tax collector nor taxpayers could easily determine the taxes owed in a particular set of circumstances. High tax rates and narrow tax base, which reinforced to each other, were the major feature of the tax system prior to the reform measures. The law did not furnish legal ground for tax administration to enforce tax collection. As a result, the tax administration could not collect tax due which have been accumulating over the years. The Government excessively relied on the refit of distorting excise and duty taxes for indirect tax revenue. These were frequently tied to the purchase of productive inputs and led to significant cascading of taxes and distortion of trade and investment decisions.

4. Weak Tax Administration

The tax administration has constrained with skilled manpower, modern equipment and work-procedure. The administration is very much week in the area of tax assessment, collection, follow up and enforcement. The administration did not even know the exact number of active taxpayers. Therefore, one key area of the reform was tax administration.

5. Failure of the Tax System to Generate Adequate Revenues for Government Expenditure

The tax revenue fail to meet government expenditure for many years. This resulted in fiscal imbalance and instability in the economy. For instance, tax revenue to GDP ratio in 1991/92 and 1992/93 was 7.8 and 10.9 percent respectively. At the same time the total expenditure of the Government (recurrent plus Capital expenditure) was at the higher side 20 percent of GDP. Therefore, generating revenue to finance government expenditure was one of the reasons for the Tax Reform.

6. The Tax Reform

Ethiopia has implemented Economic Reform Program (ERP) since 1992/93 with the support of World Bank, International Monetary Fund, foreign governments and other multilateral institutions. Since then as a part of ERP, the government has taken tax policy measures. The tax reform Program generated momentum in 1999 when the "Revenue Board" scaled up to the a level of Ministry, " Ministry of Revenue" and the reform expanded from tax policy measures to include Administrative reform.

The Government of Ethiopia is modernizing the tax and custom administration by overhauling the legislations and improving administration. The reform measures are intended to encourage trade, investment and hence development; broadening the tax base and increase Government revenues to support social programs and alleviate poverty; strengthen the enforcement capacity of the tax and customs authorities; and promoting equity in the tax system.

World Bank and International Monetary Fund publication of tax reform put the key feature of "good practice" in a reformed tax system in developing countries constitute in summary the following: -

- i. Increased reliance on a broad-based consumption tax, such as a VAT, preferably with a single rate and minimum exemptions, and a thresh hold to exclude the smaller enterprises. Excise tax should be limited to a set of products, principally petroleum products, alcohol, tobacco, and luxury items. The VAT and excises, where applicable, would be applied equally to imports as well as domestic products.
- ii. Import tariff should have a moderate to low average and, most importantly, a limited dispersion of rates,
- iii. Income tax should be characterized by (a) limited personal exemptions and deductions; (b) a moderate top marginal rate and few brackets; (c) an overall exemption limit that would exclude persons with moderate incomes from paying taxes; (d) extensive use of final withholding at source. A corporate income tax should be levied at one moderate rate, preferably the same rate as the top marginal rate of personal income tax.
- iv. Tax administration reforms should be design to enhanced the accuracy and fairness of assessment, increase the efficiency of collection, reorganize the tax and customs administrations along functional lines, and improve taxpayer registration procedures as well as collection enforcement and audit. Computerization is generally required for more effective management of taxpayers data bases, while pay incentive programs and greater autonomy for the tax authority, supported by development of specialized skills among tax officials, are intended to promote honesty and efficiency in tax administration.

The design of tax reform in Ethiopia takes into account the above key feature and its implementation status should be viewed inline with these general frameworks. The Tax reform of the country generally consists of six projects. These are: -

- i Tax Policy and Legislation Project,
- ii Tax Payer Identification (TIN) Project,
- iii Presumptive Tax Project,
- iv Value Added Tax Project,
- v Reorganization and Work Producer Development
- vi Taxpayers Education Project

Except for the first project, the other projects are dealing with the Tax Administration Reform. The contents of each project and the progress achieved to date are presented as follows: -

7. Tax Policy and Legislation Project

The project aims to overhaul the tax policies and legislations. Under this project different tax policy measures have been undertaken but the comprehensive and the last reform are Income Tax proclamation No. 286/2002, Value Added Tax proclamation No. 285/2002 and Excise Tax proclamation No. 149/1999. Before the implementation of the laws, intensive discussion was held with the Taxpayers, Regional Finance and Economic Bureaus, Academic and other relevant institutions. Moreover, for smooth implementation of VAT, manuals and procedures are developed and a new office (VAT department) opened. The major policy measures of direct and indirect taxes are as follows: -

8. Tax on Income and Profits

The maximum income tax which was 85% on employment income and 89% on business profit has been slash down consecutively after 1991 by Transitional Government of Ethiopia and latter on by Federal Democratic Republic of Ethiopia to 50%, 40% and 35% by Proclamations No. 30/1992, 107/1999 and 286/2002 respectively. Similarly, Proclamations No. 62/1992, 107/1999 and 298/2002 reduced business profit tax rate to 45%, 40% and 35% respectively. Profit tax rate on corporate enterprises (Category A taxpayers) is 30% according to the new proclamation (No. 286/2002). This shows that as compared to the high marginal rate of the Derg regime, the current tax reform, which reduced the marginal tax rate to 35%, demonstrated the Government's radical change in the tax system.

Apart from changing direct tax rates, the government has also introduced Rental tax, Urban Land Lease fee, and Capital Gain tax and interest income tax in 1993/94, 1994/95, and 1997/98 and 2000/01 respectively to broaden the tax base. But, these new taxes have not yet made a meaningful contribution to Government revenue, as their share in total tax revenue has not exceeded 2 percent in 2002/03. Their contribution to direct tax is about 6 percent in the same period. Moreover, to minimize tax evasion, the government has introduced Withholding tax in 2000/01 on import goods at the rate of 3% of the c.i.f value to be credited against the taxpayers' annual income tax liability. On local transactions, withholding tax on payments from organizations, having legal personality, government agencies, private non profit institutions and NGOs is made at the rate of 2 percent of the gross payment over Birr 10,000 and the supply of certain services of value over Birr 500 as a credit against the income tax of the recipients. To compare the marginal rates of the previous regime and the current one, business profit tax rates of the two systems are presented on the following table as an example.

Table 1 Business Profit tax system of the two governments

Proclamation No 155/1971 E.C.			Proclamation No 286/1994 E.C.		
No.	Tax bracket in Birr	Tax rate in %	No.	Tax bracket in Birr	Tax rate
1	1200 – 3000	11	1	1800 – 7800	10
2	3000 –6000	14	2	7801 – 16800	15
3	6000 – 9000	20	3	16801 – 28200	20
4	9000 – 12000	26	4	28201 – 42600	25
5	12000 – 15000	33	5	42601 – 60000	30
6	15000 – 18000	40	6	Above 60000	35
7	18000 – 21000	47			
8	21000 – 24000	54			
9	24000 – 27000	61			
10	27000 – 30000	68			
11	30000 – 33000	75			
12	33000 – 36000	82			
13	Above 36000	89			

Source: Proclamation No. 155/1971 and 286/1994 E.C.

Generally, the income tax reform of the country by and large is along the lines of 'good practice' of the tax reforms of developing countries as indicated above.

9. Commodity Tax

The reform under this category covers Sales tax/Value Added Tax, Excise tax.

Value Added Tax: - this tax replaced the sales tax. The original sales tax law was Proclamation No. 68/1993, which was amended for the last time by Proclamation No. 228/2001. Under the latest amendment, the sales tax was levied on imports and domestically produced goods at a top rate of 15% and at the lowest 5%. Many goods - primarily agricultural products and food, pharmaceutical products, and printed books were taxed at a lower 5% rate. A few specified services were taxed at 15% rate, and financial services and work contracts were taxed at the lower rate of 5%. Water electricity and medical and educational services were completely exempted. The tax paid on some goods, including raw materials embodied in the final product was credited against the output according to the law. However, no mechanism was laid down for refunding so that no taxpayer ever got refund of input tax. Moreover, no credits were given to tax paid on capital goods or other inputs in the area of distribution, warehousing, and administration. In summary, the sales tax base was very much narrow as it was limited to imports, manufactured goods and a few selected services and with many exemptions. These made the tax system unable to meet government revenue requirement to cover its expenditure. Moreover, because no credit is given to input taxes, the tax had cascading effect, distorted efficient resource allocation, and most likely impeded economic growth.

Value Added Tax (VAT) is becoming the main source of government in most of the countries who introduced VAT. It was introduced in many countries and the trend of its introduction is also increasing rapidly. Consistent to the world trend, Ethiopia introduced VAT in January 2003, replacing the sales tax. The VAT is applied at a uniform rate of 15% on most consumption goods and services with the exception of exports and exempted goods and services. The scope of exempted goods and services differs from that of the sales tax. Under the VAT, the main exempted items are sales of used dwellings, financial services, medical and educational services, electricity, kerosene, water and transportation. For detail comparison of the two tax systems, see Table 2.

Eligible Business enterprises for VAT registration are those who have annual turnover of Birr 500,000 and above. For those business enterprises whose annual turnover of taxable goods is less than the VAT registration threshold, an equalizing turnover tax is introduced at the rate of 2% for goods and 10% for services. VAT registered business enterprises are eligible

to claim input tax while non-registered are not given this opportunity. That is why the equalizing rate of turnover tax appears low.

The merits of VAT as compared with the replaced sales tax are: -

- VAT is broad based tax, which enables to raise more government revenue. This is because of the following reasons: - i) the rate is uniform and the scope of exemption is limited under VAT, ii) VAT is applied at each stage of production and distribution i.e. wherever additional value is created the tax is applied;
- VAT encourages export and investment since these activities are zero rated and exempted respectively;
- VAT is confined to consumption of goods and services so that it avoids the distorting effects of tax cascading that arises from the taxation of business inputs;
- Evasion is minimized under VAT system due to a built in checking system. The system demands each VAT registered enterprise to report its sales and purchase. One cannot hide its sales, as the sale of one is the purchase of other. The Purchaser has incentive to reveal purchases so that he can get credit on input tax;
- With a move toward globalization and regional integration; as well as the implications of loss of revenue from foreign trade, VAT is expected to take a lead as a source of revenue by minimizing the number of exempted and zero rating goods and services, and by broadening the base.

Table 2 Sales tax and Value Added Tax rate comparison

Sales Tax		Value Added Tax
Goods	Service	
15 percent tax rate applied on the value of all goods and services other than specified below.		15 percent tax rate applied on the value of all goods and services other than specified below.
5 percent on the following: - a. Live animals, meat, fish b. Fresh milk, cream and eggs c. Honey d. Vegetable, fruits, and nuts e. Cereals f. Coffee, cocoa and spices g. Milled products h. Pharmaceutical products i. Hides and skins j. Books and newspapers k. Cotton l. Sales of food in hotels and restaurants m. Sales of local food and beverages	15 percent on the following: - a. telecommunications b. garage, laundry c. tailoring, translation d. photography e. auditing, engineering f. lodging g. consultation h. cinema i. commission agents j. barber/beauty salon k. tourism l. hire of goods	Exempted Items: - a. sales/transfer of used dwelling/lease b. financial services c. religious service d. medical services and goods e. educational/child-care services f. humanitarian goods and services g. electricity, kerosene and water h. post office supplies i. transportation j. printed books k. permits and license fees l. import of gold, currency m. Fertilizer n. Bread, injera, milk
2 Birr/kg on locally sold chat	5 percent on the following: - a. Work contracts b. Financial services	
Exempted items:- a. Bread, injera b. Fertilizer c. Aviation fuel/kerosene d. Railway/marine transport e. Equipment for national defense	Exempt items: a. Water b. Electricity c. Medical services d. Educational services	Zero rate on export

Source: Proclamation No. 228/2001 and 285/2002

As mentioned above, Ethiopia introduce broad-based tax i.e. VAT in 2003 with uniform rate on all goods and services having threshold of Birr 500,000 for registration. The scope of exemption is also limited as compared to sales tax.

10. Tariff Revision

Import duties are important source of revenue to the country. It accounted about 43% of tax revenue in 2002/03. It is a preferred source of revenue as it is stable and its collection is administratively easy as compared to other types of tax revenues. Despite its importance and advantages as a source of revenue, tariffs are not considered as optimal source of

revenues because of their distortion effect on the economy when they drive a wedge between domestic and international prices and introduce inward bias on the economy. Moreover, the current international trends of globalization and regional integration demand liberalization of trade barriers.

Trade liberalization in the country started in 1993 by tariffication of quantitative restrictions and lowering of tariffs. The Government has undertaken tariff revisions six times, slashing the maximum tariff rate from 230 percent during the pre-reform period to 35 percent since January 2003. Accordingly, a weighted average tariff rate has been reduced from 41.6 percent in the pre-reform period to 17.5 percent since January 2003. The existing Tariff amendment has been worked out on the bases of the version 2002 Harmonized Commodity Classification and Coding system of World Custom Organization. A summary of tariff measures undertaken since 1993 are shown on Table 3. The Table showed that the liberalization process, by and large, deepened and the protection level of domestic economy reduced to a large extent. The tariff reduction measure with no doubt has a negative effect on Government revenue. To minimize the effect and even raise the revenue, the government has substantially reduced the exempted items and broadens the local tax bases. Moreover, by revitalizing the economy and encouraging investment and export, the government has tried to boost its foreign trade tax revenue. As a result of import boost, the foreign trade tax revenue has increased substantially.

Table 3 Tariff Measures

Descriptions	Before 1993	1 st (Aug. 1993) revision	2 nd (Jan. 1996) revision	3 rd (Dec. 1996) revision	4 th (Jan 1998) revision	5 th (Dec. 1998) revision	9 th (Jan. 2003) revision
Maximum Tariff Rate	230	80	60	50	50	40	35
Number of Items Tax Exempted	327	138	169	170	168	167	179
Weighted Average Tariff Rate	41.6	29.6	24.6	23.6	21.5	19.5	17.5
Tariff Dispersion	225	75	55	45	45	35	30
Total Number of Items	1821	5332	5294	5295	5486	5426	5608
Tariff Band	23	9	8	7	7	7	6

Source: MOFED and Ethiopian Custom Authority

As indicated in the Table above, the maximum tariff rate was substantially reduced to 17.5 percent, which is comparable with the average Sub Saharan African countries. The dispersion of the tariff rate has also continuously reduced and reached 30 percent of the current level.

11. Tax Payer Identification (TIN) Project

The project has the objective of establishing computerized database on the taxpayers to facilitate and ease the tax assessment and enforcement activities of the tax administrations. The TIN system provides the foundation for the tax administrations to independently identify taxpayers, control tax evasion, create a dependable database, and help for efficient and effective tax collection. To date, system design and pilot phase testing in ten sites of the country were completed. After the test, the national network has been established except in a few regions. Moreover, the tax administrations are in the process of providing the tax identification number to taxpayers after producing registration manuals and procedures. To utilize the technology at most, the tax administration planned to interface the system with the Custom Authority and the Commercial Banks next year. This project is believed to improve the tax collection efficiency of the tax administrations and reduce tax evasion substantially.

12. Presumptive Tax Project

In Ethiopia the taxpayers are categorized in three groups. Category A taxpayers are corporate enterprises which have annual turnover of Birr 500,000 or more. Category B are those which have annual turnover between Birr 100,000 and 500,000, and Category C taxpayers are those which have annual turnover of less than Birr 100,000. Category A and B have maintained adequate books of accounts and their income tax are subject to the statements of accounts they produced. Since Category C taxpayers do not maintain adequate accounts, it is difficult for the tax administrations to collect taxes from this group. Thus, income tax on Category C taxpayers is determined by lump sum method, which is called a "Standard Assessment".

The Standard Assessment is presumptive taxation schemes by which a fixed lump-sum tax is levied on individuals or business on the bases of i) the type, size and location of business activity or services; ii) tax exempted amount, depending on the activity; iii) average annual profitability rate of the activity. Standard assessment table or schedule has been already published for 69 categories of business activities. The schedule appears progressive with low tax burden on small merchandise traders and the highest tax burden on professional, transport and other services. The standard assessment is supposed to be implemented in 2002/03 by regional governments and city administrations but currently they are conducting survey to classify taxpayers and determine the profitability rate.

13. Reorganization and Work Producer Development

Under this project, tax administration has been reorganized and new way of service delivery has been laid down. Specifically: -

- By proclamation No. 367 and 368/2003 the Federal Inland Revenue Authority and Ethiopian Custom Authority were reestablished. The proclamations aim to enable the institutions carryout their responsibilities with well-equipped organizational set-up, trained manpower and efficient working system supported by modern information technology. The proclamation gave personnel management autonomy to the authorities, which used to be under the Civil Service Commission. This privilege is governed by directive issued by the Ministry of Revenue.
- To deliver efficient services to the large taxpayers, the administration has opened a new office called Large Tax office (LTO) in 2000/01. Moreover, additional branch offices opened in 2001/02 at Jimma and Mekela to facilitate Federal Government tax collection. Moreover, to administer VAT a new office called VAT department opened in 2003.
- Both institutions reengineered their service delivery system. Particularly, the Ethiopian Custom Authority has achieved remarkable improvements in service delivery. For instance, prior to the introduction of the new service delivery system, importers were forced to complete 74 work-processes and the process took about 59 days to clear import declaration. This long process was reduced to 10 work-processes and the processes has taken only a day. Moreover, a new window was opened to provide efficient service to exporters.
- New manuals and procedures were developed for tax assessment, auditing and tax collection.
- More than 700 fresh college and university graduates were recruited to staff the administrations with skilled manpower. They were given two months on-the-job training to familiarize them with government policies in general and the tax administrations' work practice in particular.

14. Taxpayers Education Project

Under this project intensive taxpayers' education have been undertaken using different types of media. The tax administration has transmitted education program four times a week using radio. TV broadcasting has been carried out three times a week. Moreover, information has been provided using magazines and newspapers as deemed necessary.

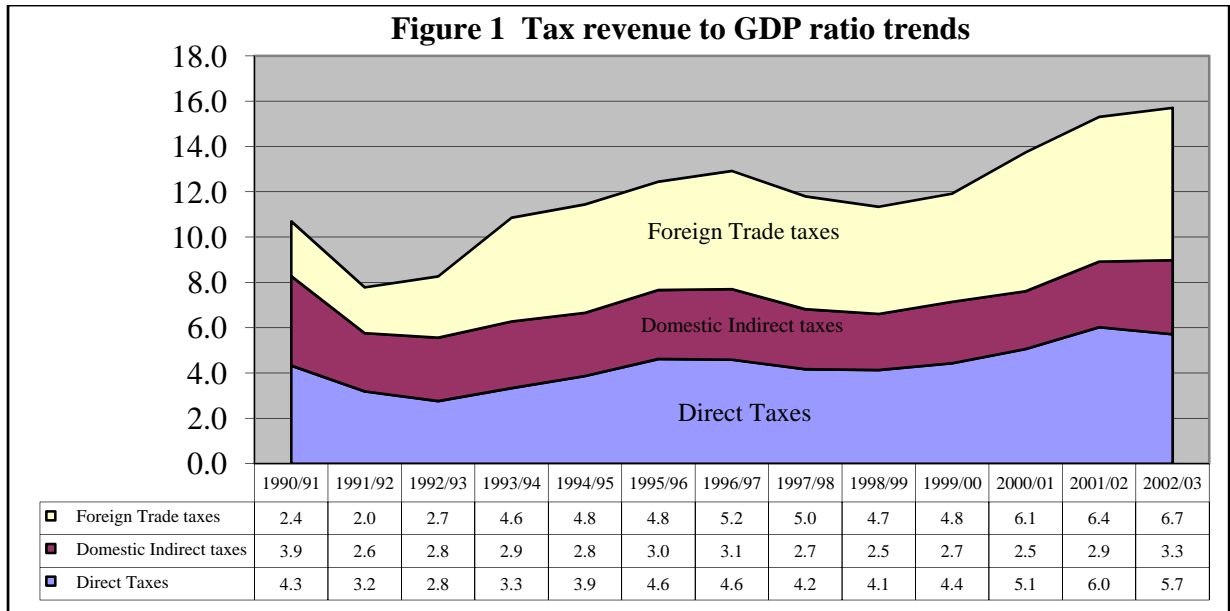
15. Evaluation of the Tax Reform

From the previous section, one can observe that some of the projects of the tax reform program have not been fully implemented. Moreover, some of the measures need time to observe their impact on the tax collection. However, one can see the trends that can indicate the likely output of the reform measures. The tax reform measures output can be measured in two ways. First, by looking at the trends of value of Government tax revenue and secondly, by looking at the changes in the structure of the tax revenue. Moreover, though the VAT has been implemented for one and a quarter year, comparative analysis of VAT income with the sales tax income will be made to evaluate the VAT project.

16. Tax Revenue Collection Performance

Tax revenue as a share of GDP, which was at its lowest level of 7.8 % in 1991/92, has shown an increasing trend and reached to the level of 12.9% in 1996/97. Then the performance slowed down until 1999/2000 owing to the poor performance of the agricultural sector on account of drought during the period and due to the war between Ethiopia and Eritrea. After 1999/2000, taxes revenue as a share of GDP has shown a vivid improvement. Over the years under review, the most notable improvement was registered in foreign trade tax to GDP ratio. Next to foreign trade tax, direct tax performed well in terms of revenue generation. Indirect tax to GDP ratio has depicted almost a constant trend.

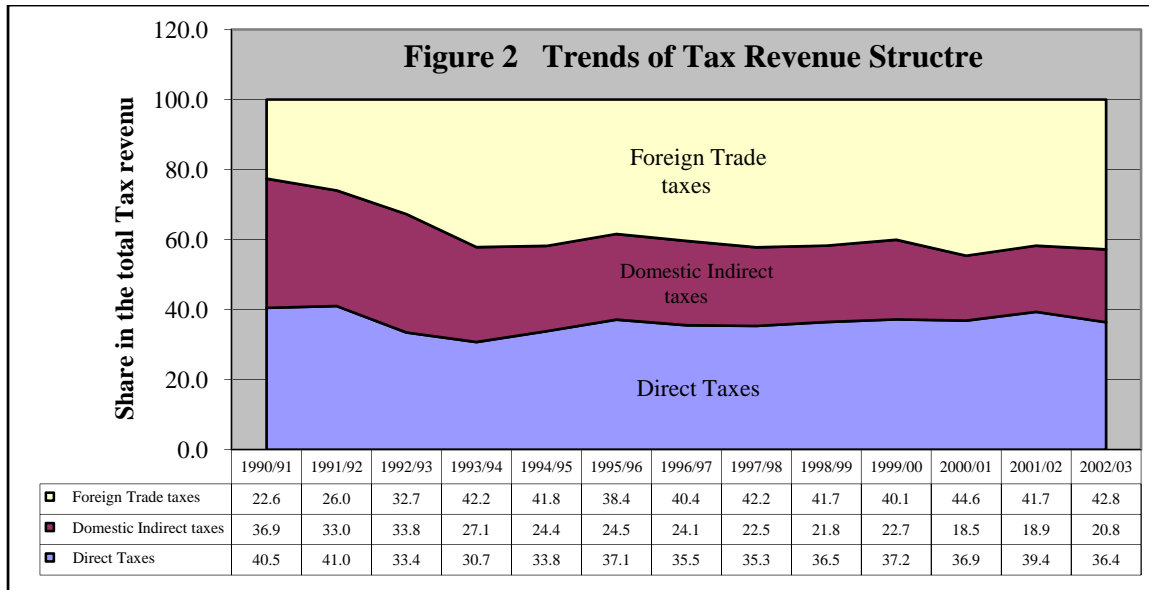
Generally, except the domestic indirect tax, tax revenue to GDP ratio has shown upward trends over the years since 1990/91.



Source: MOFED (The data attached as annex)

17. Tax Revenue Structure

Similar to tax revenue to GDP ratio trends, the structure of tax revenue after 1992/93 has been biased towards foreign trade tax as shown in Figure 2. The share of direct tax has slightly declined during the periods under consideration. The share of indirect tax has dropped over the years drastically from about 36.9 percent in 1990/91 to 20.8 percent in 2002/03. The transaction of goods and services has increased with economic growth and indirect tax revenue is expected to increase. Contrary to this, the decline in the share of indirect tax from tax revenue has been experienced in the reform period. After the introduction of VAT in January 2003, the share of indirect taxes is expected to increase, as VAT is considered broad based and helps to minimize tax evasion to some extent.



Source: MOFED (The data attached as Annex)

In the reform period, foreign trade tax revenue has become the dominant source of government revenue. Its share in tax revenue has increased from 22.6 percent in the 1990/91 to 42.8 percent in 2002/03.

This increase in the share of foreign trade tax is surprising given that the Government has reduced the maximum and average tariffs rates from 230 and 41.6 percent to 35 and 17.5 percent respectively, and removed export taxes. This is undesirable trend as it looks. With the further liberalization of external trade and the force of Globalization and Regional Integration, government revenue from external trade will be declined substantially. Thus, taking into account these factors, the structure of the tax revenue has to be shifted towards domestic taxes than foreign trade taxes. For this unexpected trend, the following factors are considered as the main reasons: -

- During the previous regime, some commodities were banned and tariffs were excessively high so that imports were suppressed a lot. However, after liberalization of foreign trade, and with better supply of foreign exchange, imports have increased significantly (on the average it increased by 25 percent since 1992/93). Moreover, transfer of quantitative control to tariffication, reduction of exempted goods and controls on illegal imports contributed to the increase in foreign trade tax revenue.
- Due to devaluation of Birr and its subsequent depreciation of the Birr, value of imports has increased considerably so that the Birr value of government revenue from import duties and tax has increased,

- The weakness of the tax administrations in collecting domestic taxes relative to foreign trade tax collection contributed a lot to the structural change in the tax revenue. This is because that collection of foreign trade tax is easy as it is collected at entry point where as domestic tax collection is very difficult with the existence of large number taxpayers in the informal sector and weak tax administrations lacking integrated computerized system, skill manpower etc.

Though the revenue generated from external trade is relatively high indicated by its share in GDP and in the total tax income, the trend is not desirable considering the impact of globalization and regional integration. The revenue from external trade is not a dependable source of Government revenue as it will decline with the intensification of external trade liberalization and force of Globalization and Regional Economic Integration. Aware these facts, in the long run it is expected that revenue function will be shifted to domestic tax as the ongoing tax administration reform is completed and the expected positive result is realized.

18. Value Added Tax Performance

After the introduction of VAT, revenue collection has shown growing trends as compared with the replaced sales tax. Before January 2003, average monthly sales tax collection was about Birr 181.15 million (Birr70.1 million on domestic goods and services and Birr 111.05 million on imported goods) between the period 1999/00 and January 2003. After the introduction of VAT a total of Birr 3.93 billion has been collected within 14 months, which is equivalent to a monthly collection of Birr 271.0 million. This indicates a 50 percent growth in VAT collection as compared with that of sales taxes.

The impact of VAT on tax revenue is also shown in the structure of tax. Although it is too early to assess the structural impact of VAT on tax revenue, the last 14 months performance indicates some changes in the structure of tax revenue. The contribution of VAT on domestic goods and services in the total tax revenue, which the sales tax contribution was about 12.6 and 13.5 percent in 1999/00 and 2000/01 respectively, has slightly increased to about 14.9 percent within 14 months after January 2003, where as the contribution of VAT on foreign trade has substantially increased to 27 percent. For details see the following Table. The contribution of VAT to tax revenue from domestic source is by far lower than that of foreign trade. This might be associated with administrative difficulty to collect the tax from the domestic economy and the existence of illegal practices on VAT. VAT collection from imported goods is easy since it is collected at entry point.

Table 4 Federal Government Tax Revenue Structure (% of the Total Tax Revenue)

	1999/00	2000/01	June 2002 - January 2003	February 2003 - March 2004
<i>Tax Revenue</i>	100.0	100.0	100.0	100.0
Direct Taxes	26.3	28.3	31.1	17.3
Domestic Indirect taxes	18.8	19.6	20.9	20.4
Excise tax	5.2	5.4	5.2	4.8
<i>Sales Tax</i>	12.6	13.5	14.8	0.0
<i>VAT & TOT</i>	0.0	0.0	0.0	14.9
Others	1.0	0.7	0.8	0.6
<i>Foreign Trade taxes</i>	54.9	52.0	48.0	62.3
Customs duties	21.1	23.0	22.6	28.0
Excise tax	4.7	4.9	3.0	7.0
<i>Sales Tax</i>	19.0	22.2	20.8	0.0
<i>VAT</i>	0.0	0.0	0.0	27.1
Export tax & Sur Tax	10.2	1.9	1.6	0.2

Source: MOR

Although it appears the tax collection from VAT has shown some progress relative to the sales tax it replaced, it is relatively very small as compared to the potential that has to be collected if the tax administrations are strong enough to control illegal practices. In principle, VAT is collected from consumption of goods and services. So, the maximum potential that can be collected from consumption expenditure is VAT rate multiplied by consumption expenditure of a particular year. Total consumption expenditure in 2001/02 was about Birr 55.6 billion. Thus, at this level of consumption expenditure and taking into account inaccessible consumption level for tax and the exempted consumption, one can imagine the potential of revenue from VAT is substantially high as compared to the current level of collection.

Problems that are observed during the implementation of VAT related with external and internal factors.

The external problem associated with the illegal practices of the taxpayers:

Even though intensive education program has been provided by the tax administration, the following illegal practices are observed: -

- Some VAT registered business enterprises have collected the tax with illegal invoice and retain the tax for themselves,
- Some eligible business entities have not yet registered for VAT,
- Some VAT registered business enterprises offer customers an option to pay or not to pay VAT,
- Some do not declare the tax they collected as per the law, and etc

The weakness of tax administration highly attributed to the above illegal practices: -

The tax administration is weak in the area of auditing, follow-up and enforcement. Recently in March 2004, the VAT Department of the Federal Inland Revenue Authority has computerized its tax system. As a result, VAT registration, assessment and follow up is supported by computerized system. However, the department is highly constrained by skilled manpower limitation specially auditors. For instance, the department could not force taxpayers to declare tax every month as per the law. In Addis Ababa, out of the total 5998 VAT registered enterprises, on the average about 80 percent have declared each month of which about 15 percent are nil fillers. That is about 20 percent of the registered do not appear for declaration and the number of nil fillers is substantially high. These show that the young VAT department is not yet strong enough to control illegal practices on VAT.

19. Conclusion

In the late 1980's and beginning of 1990's the country faced internal and external macroeconomic imbalances. With the aim of stabilizing and liberalizing the economy, the Government has undertaken Economic Reform Program (ERP) since 1992/93 after the change of centrally planned economic system to market oriented system. As a part of ERP, tax reform program has been undertaken. Initially, the tax reform focused on the rationalization of tax policies. Latter on the reform included vigorously tax administration reform. Complex and outdated tax law, weak tax administration and failure of tax revenue to meet government expenditure requirement were major constraints.

The conclusion is that the tax reform program is not yet completed, particularly the administrative reform part. The tax policy reform is well advanced. The most progress that has been achieved in the tax policy changes are: - elimination of export taxes and excess wage and profit taxes, reduction of tariffs, introduction of appropriate broad-based consumption tax (VAT) and excise tax. The assessment of the reform indicates that the trend is positive predominantly in the foreign trade. The reform has not yet brought about a significant change in the domestic revenue, which is largely explained by the weakness of the tax administration.

Thus, critical area of interventions in the area of tax administration should be further escalated. The ongoing projects, which aim to raise the efficiency of the tax administration, are promising but lag behind the policy changes and hence needs close follow-up to speed up their implementation.

20.

Annex 1 Trends of Tax Revenue

Tax type and GDP/Year	1990/9 1	1991/9 2	1992/9 3	1993/9 4	1994/9 5	1995/9 6	1996/9 7	1997/9 8	1998/9 9	1999/0 0	2000/0 1	2001/0 2	2002/0 3
Tax Revenue (million Birr)	2053	1618	2206	3076	3879	4724	5359	5292	5536	6343	7451	7926	8949
Direct Taxes	831	664	738	945	1312	1754	1904	1869	2018	2360	2746	3119	3255
Domestic Indirect taxes	758	535	746	834	945	1156	1292	1189	1208	1442	1381	1498	1863
Foreign Trade taxes	464	420	722	1297	1622	1814	2164	2234	2310	2541	3324	3308	3831
GDP at CMP(million Birr)	19195	20792	26671	28329	33885	37938	41465	44840	48803	53190	54211	51761	57077
Structure of Tax Revenue (%)													
Tax Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Direct Taxes	40.5	41.0	33.4	30.7	33.8	37.1	35.5	35.3	36.5	37.2	36.9	39.4	36.4
Domestic Indirect taxes	36.9	33.0	33.8	27.1	24.4	24.5	24.1	22.5	21.8	22.7	18.5	18.9	20.8
Foreign Trade taxes	22.6	26.0	32.7	42.2	41.8	38.4	40.4	42.2	41.7	40.1	44.6	41.7	42.8
TAX to GDP Ratio (%)													
Tax Revenue	10.7	7.8	8.3	10.9	11.4	12.5	12.9	11.8	11.3	11.9	13.7	15.3	15.7
Direct Taxes	4.3	3.2	2.8	3.3	3.9	4.6	4.6	4.2	4.1	4.4	5.1	6.0	5.7
Domestic Indirect taxes	3.9	2.6	2.8	2.9	2.8	3.0	3.1	2.7	2.5	2.7	2.5	2.9	3.3
Foreign Trade taxes	2.4	2.0	2.7	4.6	4.8	4.8	5.2	5.0	4.7	4.8	6.1	6.4	6.7

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