L.L.B. Thesis

THE RIGHT OF TAX PAYERS UNDER THE INCOME TAX PROCLAMATION NO. 286/2002, CASE ORIENTED

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CHAPTER ONE

1. HISTORICAL BACKGROUND OF TAXATION

The first Known system of taxation was in Ancient Egypt around 3000 BC-2800 BC in the first dynasty of the old kingdom. Early taxation is also described in the bible. In Genesis (chapter 47, Verse 24-the new international Version), it states. "But when the crop comes in, give a fifth of it to pharaoh. The other four-fifths you may keep as seed for the fields as food for yourselves and your house holds and your children." Joseph was telling the people of Egypt how to divide ether crop, providing a portion to the pharaoh[1].

In the ancient civilizations of Palestine, Egypt, Assyria and Babylonia, individual property rights did not exist. The king was sole owner of every thing in his domain, including the bodies of his subjects. Thus, instead of taxing individuals to support the government, the king could simply forced them to work for him. Ancient kings earned income in the form of food from their lands and precious metals from their mines. If this income did not meet the king's demands, he might lead his armies into neighboring countries to confiscate their property. The conquered peoples might also be required to make payment to the conqueror in acknowledgment of their property. The conquered peoples might also be required to make payment to the conqueror in acknowledgment of their submission to his power. In societies that operated without money, the ruler taxed farmers by requiring that they turn over some proportion of their crops to the state. Poll taxes were a major source of revenue in Egypt under the Ptolemaic dynasty (323BC-30BC)

The government of ancient Athens, Greece, relied on publicly owned silver mines, tribute from Conquered countries, a few customs, duties, and voluntary contributions from citizens for revenue. It levied poll taxes

only on slaves and aliens (non-citizens)and made failure to pay a capital crime.

In the early years of the Roman republics all Roman citizens paid a poll tax. However, Roman Military victories in so much foreign tribute that the government exempted citizens from this tax in the second century BC, after the Punic wars between Rome and carthage More than hundred years later, Emperor Augustus introduced land and inheritance taxes. The succeeding emperors raised rates and found an increasing number of things to tax, including wheat and salt.

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

Under the system of feudalism that dominated in Western Europe beginning in about the 11th century, Kings, nobles and church rulers all collected taxes. Kings derived income from their lands, from import and export duties, and from the various feudal duties and services owed by their vassals. For the most part, church officials and nobles were granted exemption from royal taxes, so the burden of taxation fell heavily on the peasantry. When king John of England tried to increase his income by a series of heavy scutage (payments that knights made in lieu of military service), the feudal nobility refused to pay. In 1215 they forced the king to sign the magnacarta, a document in which he agreed to collect scutage only with the “common consent” of his barons- thus, limiting the kings power to tax [2].

The Roman Catholic Church was a major tax collector during the middle Ages. One of the most important sources of the church revenue was the tithe, a compulsory payment of one–tenth of a persons harvest and livestock. The church also collected various fees, fines, and tolls, and required clergy members, such as bishops and archbishops, to make payments to the papacy in Rome.

An important development toward the end of the feudal period was the dramatic growth in the number and population of towns and cities. These urban centers collected revenues using taxes on property as well as sales taxes uncertain items[3].

Over a period of time, feudalism faded and strong centralized states emerged in Europe. During the 16th and 17th centuries, these taxes levied heavily on revenues generated by kings own estates and by taxes on land. In England, the power of parliament grew steadily because the kings and queens had to convene it frequently to obtain money. In 1689 the English Bill of rights guaranteed that the king could not tax without parliament's consent.

By the 18th century England started imposing various taxes on transactions. Taxes on imported goods (tariffs) assumed great importance, as did on a wide variety of commodities, including sugar, meat, chocolate, alcohol, coffee, candles and soap. As times passed, people become dissatisfied with this system of public finance for several reasons. First, although the English government levied some taxes on commodities consumed only by the rich-window glass for example which was a great luxury fell mostly on the poor. In addition tax systems did not generate as much revenue as the governing classes wanted. Finally, economists and political leaders began realizing that by reducing trade, tariffs created economic losses for society.

In the late 19th and early 20th centuries, concerns about both fairness and the ability of tax systems to generate sufficient revenue led governments to enact income taxes. In 1799 Britain enacted the first national income tax, to finance the Napoleonic wars. The governments discontinued the tax when the war ended in 1815, but revived it in 1842. The first progressive income tax- which imposed a greater tax burden on people with higher incomes- was introduced in Prussian in 1853. Other countries introduced progressive income taxation in subsequent decade, including Britain in 1907, the United States in 1913, and France in 1917. Although income taxes generated little revenue at first, today they play a major role in all modern tax systems[4].

Though it is very difficult to get reliable documentary evidence as to when exactly taxation was introduced, it is believed that history of Ethiopia taxation comes together with the establishment of the government. Taxation was a source of government revenue from early Axumite kingdom in Ethiopia, around 500AD. Earlier day's people used to contribute from their cattle and agricultural product to the governors of the state. The kind of traditional tax system continued for several centuries smoothly until it was replaced by the modern tax system in the 20th century. Evidences indicate that in the third quarter of 19th century also taxes were paid in kind and in money. Payment in kind included various forms such as salt, honey, butter, grain, livestock (cows, oxen etc), horses and mules, etc.

Taxes during the period 1855-1868 consist of direct and indirect taxes. Direct taxes included land tax (Gibr), Tithe (Asrat) provincial administrative taxes, tax for appointees and appointment, tax on livestock, tax for maintenance, tax on honey etc. Artisans and salt producer also taxed. During periods of war peasant were asked to pay even more than two times a year.

The history of taxation in Ethiopia can be conveniently arranged into the following periods.

Ethiopia's tax system dates back to ancient times, in Axumite Kingdom. In the kingdom of Axumite there was a practice of traditional taxation. The traditional taxation had provided for taxes on crops, livestock and livestock products such as wool, butter and milk. The tax on wool was particularly levied on main areas of the country. Hunting taxes were imposed, especially, on elephant hunters in the form of ivory taxes. Another type of taxation in traditional taxation system was the compulsory hospitality in which the peasantry was legally obliged to feed house officials and other travelers through the countryside. Thus, one can infer from the above points that taxation in traditional Ethiopia had been excessively burdensome and arbitrary[5].

During medieval period, there had been different obligations that were considered to be taxes in Ethiopia as indicated in different written documents. This was evident during 15th century AD. At the time of Emperor Zerayacob that the first tax system introduced. The tax system was set for those people engaged in livestock production[6].

Emperor Tewodros was also able to levy taxes in the parts of the country he controlled, and his officials, not less remarkably, kept detailed tax records. Emperor Tewodros, friend, the British consul Walter Plowden, wrote "The taxes are numerous but varied according to the traditional customs of each village." The people pay a certain portion in kind to the Ras or other great chief and some times a regular tax in money. Besides this, they must furnish oxen to plough the king's land. Their immediate governor then takes his share of every kind of grain and feeds a certain number to demand oxen, sheep, goats, mules, butter, honey and every other requisite for subsistence.

The first important reform carried out by Emperor Menilk II towards the end of the 19th country resulted in the establishment of a fixed tithe rather than the undefined and essentially arbitrary system of agriculture taxes.

Taxes during the Hailesellessie Regime (1942-1974), was statutory bases for all the tax proclamations during this period were (a) the 1955 revised constitution of Ethiopia and (b) the power being given to the minister of finance. The emperor has the right to initiate legislation and to originate other resolutions and to proclaim all laws on the other hand article 88 of the revised constitution states that ..... all laws dully approved by both chambers of parliament shall be forwarded to the emperor through the prime minister by the presidents of the chambers of disputes and of the senate. In the event that such law shall receive the approval and signature of the emperor, it shall be published by the minister in the Negarit Gazetata, with recital of the affixing of the signature and the great seal of the emperor. All imperial decrees and all ministerial decrees and orders shall be published in Negarit gazetta[7].

During the Derge regime, taxes were similar to those imposed during the Halisellassie regime except that the proclamations, of the previous proclamations or regulations or decrees in the coverage of tax bases and the tax rates owing to the need to raise more revenue to support war efforts and to finance the ever growing public sector and needs of the society for public goods and services. The taxes that were in effect at that regime were income tax (personal, business, rental and agricultural), urban land rent tax, rural land use fee, excise tax, transaction tax, sales tax, customs duty and stamp duty.

The present government of Ethiopia replaced the personal income tax law amendments made in 1976 in 1978 by the proclamation No.30 1992 and further by the income tax amendment proclamation No-107 of 1994. The

main features of these laws monthly income of up to birr 120 is exempted from paying personal income tax, and the rates were revised downwards from 10% to 85% range to 10% range This law was further amended by proclamation No. 286/2002[8].

1.1. Definition of Income Tax

Tax, charge, monetary, imposed by the government on persons, entities, property to yield public revenue. Most broadly, the term embraces all governmental impositions on the person, property, privileges, occupations, and enjoyment of the people, and includes duties, imposts, and excises. Although a tax is often thought of as being pecuniary in nature, it is not necessarily payable only in money[9].

Income Tax – A tax on an individual's or entities net income. The federal income tax-governed by the internal Revenue Code – is the federal government's primary source of revenue and many states have income taxes as well[10].

Income - The money that a person, a region, a country, earns from work, from investing money, from business, etc[11].

Income, money received over a certain period, especially, as payment for work or as interest on investments: a family with two incomes (eg. When the husband and wife both do paid work) Tax is payable on all income over the specified amount[12].

Bhatia, defines the term tax as "a compulsory levy and those who are taxed have to pay the sums irrespective of any corresponding return of services or goods by the government[13].

Tax may be defined as a compulsory contribution (levy) payable by an economic unit to a government without exception of direct and equivalent

return from the government for the contribution made. From this definition, it may be noted that tax:

- Is not a voluntary contribution but is a mandatory contribution. A person on whom the tax is imposed cannot refuse to pay it. Refusal to pay tax can lead to punishment by law. The contribution can be financial (money) or non financial such as grains and corvee. Corvee is a type of annual tax that is payable or labour by the serf or villein for the monarch, vassal, overlord or lord of the manor.

- Is contributed by an economic unit which is also called an assesses or a tax payer. An assesses is a person (an individual, a body or an association) who is liable to pay tax according to the rules and regulations prescribed by low.

- Is contributed to a central government, state government or a functional equivalent of a state such as tributes and secessionist movements.
- Is contributed without expectation of direct and equivalent return for the contribution made. This means, there is no direct relationship between the compulsory contribution to a government and the amount of the service received from the government for the compulsory contribution made. Rather, the benefits of government expenditures may go to any one irrespective of the taxes paid. Thus, a compulsory contribution in order to be tax, the absence of quid pro quo is must. This means, without equivalent return from the government[14].

Tax may also be defined as a pecuniary (financial) burden imposed on assesses by government. Tax is a liability to an assesses but a major source of revenue to a government. Divide N. Hyman also defined tax as "a compulsory or unrequited payment to a government associated with

certain activities." The revenue collected through taxation is used to purchase the inputs necessary to produce government supplied goods and services, to redistribute purchasing power among citizens, and too many other operation[15].

Throughout history, people have debated on the amount and kinds of taxes that a government should impose, as well as on how it should distribute the burden of those taxes across society. Unpopular taxes have caused public protests, riots, and even revolutions. For instance in Ethiopia there was the Gojjam peasant rebellion, in 1968. The immediate cause of the rebellion was the introduction of a new agricultural income tax, which peasants opposed. In political campaigns, candidates, views on taxation may partly determine their popularity with voters.

Although countries differ considerably in the amount of taxes they collect, yet the most important source of revenue for modern government remains to be tax. The remainder of government revenue comes from charging fees for services, borrowing and from other related sources.

Governments may raise or lower taxes to achieve social and economic objectives, or to achieve political popularity with certain groups. Some economists consider taxation an important tool for maintaining the stability of a country's economy. This is because taxation can redistribute a society's wealth by imposing a heavier tax burden on one group in order to fund services for another.

As we can understand from a close reading of the definitional article of the income tax proclamation, this definition has not imposed limitation on the source of the economic benefit or gain so as to be considered as income[16].

According to the proclamation, income could be derived form whatever source whether in Ethiopia or abroad. The whole definition aspect of the

concepts of taxation, it would be better to see how the concept is treated under the Ethiopian legal system. Lack of sequence and clarity, going back to previous law of taxation seems logical for a clear understanding of the point in discussion.

The new Ethiopian income tax proclamation defines taxable income as the amount of income subject to tax deduction of the necessary expenses and other deductible items followed under the proclamation and regulation. Different scholars defined taxation from the view point of economic and legal philosophy, level of socioeconomic development and policy considerations of their government at different time. The over all concept of taxation from the above different assertion classified can be as follows:

- Taxation is a subject that was necessitated by the coming into existence of the government for its continuous existence and operation.
- Be it compulsory or unpleasant subject, it is one of the most important source of revenue for the government, and it is one of the means that established institutionalized world government.
- It is a subject that has defined formula based on three elements: tax base, tax rate and identification of legal tax payers.
- It is a subject that presupposes a private ownership for its existence as a subject to operate.

Proponents/expounders of taxation argue that taxation of business is justified on the grounds that the commercial activity involves use of publicly established and maintained economic infrastructure and that businesses are in effect charged for use. Compulsory taxation of individuals, such as tax, is argued to be justified on similar grounds, including territorial sovereignty, and the social contact[17].

1.2. Characteristics of a Good Tax System

Characteristics of a good tax system may be formulated from various objectives, principles or canons of a tax system. Discussion in the previous sections clearly indicates that these also form an integral part of its features. Similarly additional features may be searched in the issues associated with its administration, effects, kinds, forms and timing etc. However, in this connection it is helpful to keep the following points in mind.

1.2.1. To consider a tax system in isolation from other items of public revenue, or from public expenditure, is an incomplete and unrealistic attempt. Taxation is only one part of the total budget of the government. Its effects are always intermixed with those of non-tax and expenditure parts of the public budget. Thus, within the overall framework of the total revenue, effects of taxation depend upon its structure, tax rates, and so on. Equally important is the consideration as to what is being done on the expenditure side of the budget, since that influences the attitude and reactions of the tax payers.

Formulation of characteristics of a good tax system by considering its effects does not imply that the non-tax items or the public expenditure can be ignored. This is done only for the sake of clarity of analysis and understanding. Any choice is bound to harbor several conflicts and contradictions, necessitating an adjustment. Further it is being implicitly assumed that taxation forms a major portion of the public revenue, and that the expenditure side of the budget is being administered in an optimum manner or at least it is not working against the objectives of the tax system.

1.2.2. A tax system has many dimensions. We should look into its volume, composition, rates, coverage, timings of collection, mode of collection and so on in order to grasp its effects in their totality. Alternative sets of these tax-features represent alternative tax systems with distinctive effects. Each system has its corresponding merits and demerits in terms of social and economic effects. Normally, it is rather difficult to evolve a tax system which is the best or ideal in every respect.

1.2.3. It is nearly impossible to choose a theoretically best system. For example, we cannot quantify the theoretical concepts of marginal utility and disutility and use them in practice. Similarly, in theory many tax proposals may appear very convincing, but it may not be possible to implement them. Further, it is generally assumed that the administrative machinery is efficient and honest. In real life, this may not be true. In addition, every government also faces several administrative, political and other difficulties. In theory it is assumed that a government has an absolute right over the property of all its subjects; but in practice it is not a right which can be exercised fully and without limits. Some taxes, though theoretically sound, may involve a heavy cost of collection. In some countries, there may be long drawn legal procedures preventing the government from changing its tax policy quickly and easily. In actual practice, the government has to think of these various problems while working out the best possible tax system in the country. It will generally settle for a compromise between these conflicting considerations and will end up with a sub-optional tax system. If the government fails to make a correct assessment

of effects of alternative tax-measures, it will be all the more difficult for it to achieve an ideal tax system.

1.2.4. The attitude of the tax payers is an important variable in determines the contents of a good tax system. Normally each taxpayer desires to be free from a tax burden but does not mind if the tax burden is borne by others. If this is not so, he feels discriminated against. It is essential that a good tax system should appear equitable to the tax payers similarly, over all burden of the tax system is of equal importance. In addition, the altitude of tax payers is also influenced by a host of other factors like prevalent political situation, natural calamities like floods and droughts, economic situations like prosperity or depression.

1.2.5. It is a well known fact that changes in a tax system can be brought about only slowly and in stages. Even if it is decided to have an entirely new tax system the authorities cannot suddenly disrupt the existing one. They have to gear their tax machinery to new system.

On account of the above mentioned limitations, the authorities cannot hope to satisfy all the objects or considerations, and have to be satisfied with a compromise between them. Still, in a good tax system should run in harmony with important national objectives and if possible should assist the society in achieving them. Such dynamism of the tax system is all the more relevant for a developing economy, where the structure and rates of taxes have to be constantly reviewed. We may also say that the interests of the administrative machinery, the economy, the state and individual tax payers can be in conflict with each other and a

good tax system tries to accommodate them all in the best manner[18].

A good tax system recognizes that the tax payer has some basic rights. He is expected to pay his taxes but not undergo harassment. With this end in view, tax laws should be simple in language and the tax liability should be determinable with certainty. The mode and timings payment should suit the convenience of the tax payer to the extent possible. At the same time, a tax system should be equitable as between different tax payers. It should be progressive so as to levy an equitable burden on all.

Developed free market economies are subject to cyclical fluctuations. A good tax system should be flexible enough to counteract them. In developing countries, on the other hand, the main problem is not that of cyclical fluctuations, but that of unleashing the forces of economic growth and productivity. For this all possible sources of savings and capital accumulation should be exploited. In the private sector, the tax system should encourage the consumers to go in for durable consumption goods. This will reduce their expenditure on consumption items over time and release larger amounts for savings. Within the economy, the demand for luxuries should be reduced while the consumption and production of the health giving and efficiency-producing should be encouraged[19].

1.3. <u>Purpose and Effect of Taxation</u>

Funds provided by taxation have been used by states and their functional equivalents throughout history to carry out many functions. Some of these include expenditures on war, the enforcement of law and public order, protection of property economic infrastructure (roads, legal tender, enforcement of contracts, etc), public works, social engineering, and the operation of government itself. Most modern governments also

use taxes to fund welfare and public services. These services can include education systems, health care, systems, and pensions for the elderly, unemployment benefits, and public transportation. Energy, water and waste management systems are also common public utilities. Colonial and modern states have also used cash taxes to draw or force reluctant subsistence producers into cash economies:

Governments use different kinds of taxes and vary the tax rates. This is done to distribute the tax burden among individuals or classes of the population involved in taxable activities, such as business, or to redistribute resources between individuals or classes in the population. Historically, the nobility were supported by taxes on the poor; modern social security systems are intended to support the poor, the disabled, or the retired by taxes on those who are still working. In addition, taxes are applied to fund military aid, to influence the macroeconomic performance of the economy[20].

A country's tax system is often a reflection of its communal values of those in power. To create a system of taxation, a nation must make choices regarding the distribution of the tax burden, who will pay taxes and how much they will pay and how the taxes collected will be spent. In democratic nations were the public elects those in charge of establishing the tax system, these choices reflect the type of community which the public wishes to create. In countries where the public does not have a significant amount of influence over the system of taxation, that system may be more of a reflection on the values of those in power.

The resource collected from the public through taxation is always greater than the amount which can be used by the government. The difference is called compliance cost, and includes for example the labor cost and the other expenses incurred in complying with the tax laws and rules. Some economists argue that all taxation creates market distortion and

results in economic inefficiency. They have therefore, sought to identify the kind of tax system that would minimize this distortion. Also, one of every government's most fundamental duties is to administer possession and use of land in the geographic area over which it is sovereign, and it is considered economically efficient for government to recover for public purposes the additional value it creates by providing this unique service.

Taxation has four main purposes or effects: Revenue, Redistribution, Reprising and Representation. The main purpose is revenue taxes raise money to spend on roads, schools and hospitals, and on more indirect government functions like good regulation or justice systems. This is the most widely known function.

A second is redistribution. Normally, this means transferring wealth from the richer sections of society to poorer sections, and this function is widely accepted in most democracies although the extent to which this should happen is always controversial.

A third purpose of taxation is reprising. Taxes are levied to address externalities tobacco is taxed, for example, to discourage smoking, and many people advocate policies such as implementing a carbon tax.

A fourth, consequential effect of taxation in its historical setting has been representation. The American revolutionary slogan "no taxation without representation" implied this: rulers tax citizens, and citizens demand accountability from their rulers as the other part of this bargain. Several studies have shown that direct taxation (such as income tax) generates the greatest degree of accountability and better governance while indirect taxation tends to have smaller effects[21].

1.4 Approaches to Taxation

Approaches to taxation, also called theories of taxation, deals with the justification for imposing tax as duty in a given country. These approaches, the benefit received approach, and the ability to pay approach.[22]

1.4.1. The cost of service approach states that the basis for taxation should be the cost incurred by a government to provide services for the individual taxpayers. In other words, tax payers should be taxed based on the cost, incurred by the government on different services for the benefit of the individual taxpayers. Each tax payer has to pay the tax equal to the cost of service to him. It means, the higher the cost, the higher it should be the tax rate and vice versa. Viewing it from other angle, the citizens are not entitled to any benefits from the government and if they do receive any benefit, they must pay the cost thereof. By adopting this approach, the government gives up its basic perspective and welfare functions. Its only job is to recover the cost of service. The government is not concerned with the problem of income distribution.

1.4.2. Limitation of this approach

a) It is unrealistic

It is difficult to measure the cost of services incurred by a government to each individual taxpayer. For instance, it is possible to determine (estimate) by a government the 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 taxpayer. Moreover, it is not possible, in most cases, to have a conceptual clarity of the cost measures. If, for instance, certain state services are being produced inefficiently at higher costs, the inefficiency is passed on to the tax-payers (consumers).

b) It may violate equity principle

If cost is taxed as the basis of taxation, it may violate equity principle. This is because if the poor members of the society receive more service from the government, then they are going to be taxed more thereby violated equity principle.

c) It is not in accordance with the character of a tax one of the basic characteristics of tax is that it is a compulsory payment. It has to be distinguished from the price which the government might be changing for a good or a service. However, according to this theory (approach), the payment of a tax is in return of the cost of service.

d) It is not fair in a welfare state

If cost is taken as a basis of taxation, the government may not perform various functions which may be vary much desirable for the welfare of the country as a whole such as free education and medical facilities.

1.4.3. Benefit Received Approach

This theory proceeds on the assumption that there is basically an exchange or contractual relationship between taxpayers and the government. The government provides certain goods and services to the members of society and these members contribute to the cost of this supplier in proportion to the benefits received. According to this theory, the burden of taxation should be divided among the people in proportion to the benefits received from the government. The persons (an individual or group of individuals) receiving equal benefits, protection, hospitals, education, roads, irrigation, etc., from the government should pay equal amount as taxes and those who receive greater benefits should pay more as taxes than those getting less benefits.[23]

1.5. Effects of Taxation

Taxes have both micro and macro economic effects in a modern economy. The economic effects of taxation may be good as well as bad. Due to heavy imposition of tax, the ability of the taxpayer may be affected adversely or he may be reluctant to work more since his additional income is taxed more. This, in turn, may affect production adversely. Taxation also affects the allocation of resources and may change the composition and direction of production and income of the community. Such changes caused by different taxes have far-reaching effects on the economic welfare of the society. Therefore, the government should not keep only the revenue consideration in mind but the economic effects of taxation should also be considered. In modern context, the effects of taxation on production, distribution of income and economic stabilization is analyses as follows.[24]

A) Effects of Taxation on Production

Taxation has adverse effect on production, taxation negatively affects production in an economy by affecting the ability and willingness to work, save and invest. For instance, imposition of higher to reduces the purchasing, power of the poor section of the community. When the tax burden falls upon the poor, it curbs the consumption of necessaries and comforts which lowers the standard of living and ability to work of poor people. Imposition of higher tax also reduces income and savings. This, in turn, effects investment and capital formation in the economy as the ability to invest depends on the resources available for investment i.e., savings.

B) Effects of Taxation on Distribution of Income

An important objective of taxation in most governments is to reduce the inequalities of the income and wealth and to bring about an equal society. Income generated in society if not distributed properly will create inequality in the distribution of

income and wealth. It will give rise to the creation of two classes, i.e., the class of the rich and the class of the poor. The gap between rich and poor will lead to class conflict which may prove disastrous to the society. Every government in the world tries to bridge this gap by imposing higher taxes on the richer section of the society and the proceeds realized from such taxes are distributed among the poorer section of the society by way of providing social amenities to them. The use of taxation to reduce income and wealth inequalities between the rich and the poor has its own limitation. For instance, the use of progressive tax system may have adverse effect on production and economic growth. This is because as the burden of the taxes increases, the individual's interest to work, save and invest will decrease. Progressive taxation may also aggravate tax evasion.

C) Effects of Taxation on Stabilization of Economy

A normal rise in price is a sign of healthy economy. However, problem arises whenever abnormal price fluctuations are there in the economy. These fluctuations may result in economic instability and taxation can be used as a tool to stabilize the economy, i.e., to control abnormal rise in price (inflationary pressure) and falling prices (deflationary pressure). During inflation period, the government may increase tax rates and impose additional taxes to reduce the excess or abnormal demand. The decrease in abnormal demand leads to price declines so that economic stability will be created in the economy. On the other hand, the government may reduce existing tax rates and remove some existing taxes during deflation period in order to increase demand and encourage business activities, which can lead to economic stability.

1.6. Conceptual Constraints on Tax Assignment

A) Tax Exporting

Some taxes imposed by sub-national governments are 'exported' that is they are borne by residents of other jurisdiction. The best example of exported taxes are, taxes on business that cannot be shifted to consumers or to labor and thus are borne by owners of business, many of whom may be non-residents. Tax exporting is generally undesirable because it imposes unfair burdens on non-residents and it also cheapens the provision of public services in the taxing jurisdiction, encouraging over consumption.[25]

An important exception involves taxation that is related to compensate for costs imposed on sub-national governments levying the taxes or on their citizens. In this case, export taxes to users are appropriate. As to Mclure "under such circumstances, tax exporting is consistent with fairness and economic neutrality, as defined by the benefit principle." According to Bird and Vallancort "tax exporting breaks the critical link between local spending decisions and the taxes borne by local residents."[26] Thus, they suggest, care should be taken to prevent substantial governments from exporting their tax burdens, for example, by limiting access to the taxation of business.

B) Locational Distortion

If benefits of free markets are to be realized sub-national governments should not impose taxes that distort the location of economic activity. The need to avoid distortions in the geographic location of economic activity places another important constraint on the assignment.[27]

Decentralizing tax assignment as pointed out by Boadway et al. can interfere with the efficiency of the economic union in two ways. First, uncoordinated taxation is likely to lead to distortions in markets. For

resources which are mobile across states, especially capital and tradable goods. Second, if sub-national governments engage in socially wasteful beggar they neighbor policies to attract resources to their own states, the result will simply be inefficient low taxes (or high subsidies) on mobile factors. But, on the other hand, it is argued that agreements (through coordination) between jurisdiction to fix tax rates (or the imposition of uniform rates by a higher level of government) represent a form of centralization that encourages over expansion of the public sector and inefficiency. Competition among sub-national governments, it is argued, both prevents excess taxation of business and impedes inefficiency in government.[28] It is believed, however, benefit taxation by sub-national governments does not distort the allocation of resources; indeed, it contributes to an economic allocation of resources.

1.7. Alternative Methods of Tax Assignment

The literature on tax assignment deals with several different tax assignment techniques. Possible techniques of tax assignment include independent legislation and administration by sub-national governments, surcharges on the tax base of a higher level of government, and tax sharing. Mclure noted that these techniques differ in the level of fiscal independence they provide sub-national governments, their ease of compliance and administration, the fairness and neutrality they are likely to produce, and the degree of inter jurisdictional redistribution they can provide.

a) Independent sub-national legislation and administration

This technique provides sub-national governments with the greatest sovereignty. Under this approach sub-national governments choose the taxes they levy, define the tax base, set the tax rate and administer the taxes. This is essentially the situation in the United States, where neither the constitution nor federal laws imposes important restrictions on the tax policy of sub-national governments.[29]

Many argued, inconsistent sub-national laws and administrative practices raise the costs of compliance and administration and create inequity. Mclure, however, suggested that

> "Within limits, these problems can and should be tolerated in the interest of gaining the benefits of decentralized government. But serious complexities, inequities, and distortions can and should be avoided. This objective can be achieved, without greatly compromising the fiscal autonomy of sub-national governments, through intergovernmental compacts among sub-national governments or the imposition of uniform ground rules by a higher level government."

He forwarded, as an example, rules for the definition and division of the corporate income tax base, and employment of sub-national surcharge on national taxes as an alternative.

b) Sub-national surcharge

It is considered to be an ideal system for many countries. Under this approach a higher level of government defines the tax base and collects both its own tax and surcharges set by sub-national governments. This approach ideally avoids are problems of complexity, inequities, tax exporting, and vocational distortions inherent in sub-national choice of tax bases and administration of taxes. It is agreed that sub-national surcharges appear to be the most appropriate means of providing sub-national governments with own marginal revenues in many countries, especially developing countries and in transition, where administrative resources are scarce.[30]

c) Tax Sharing

In this approach, one level of government collects the revenues from a tax and shares it with one or more other levels of government. In tax sharing sub-national governments have essentially no control over the

choice of taxes, tax bases, tax rates, or tax administrations.[31] This approach severely restricts fiscal autonomy of sub-national governments.

1.8 Tax Assignment Responsibility and Practices

The purpose of tax assignment is to provide sub-national governments with revenues that they control and thus to decentralize the control of public spending. For decentralization to be viable, sub-national governments must have their own revenues that are adequate to cover their recurrent expenditure. To define the term own revenues here, it connotes revenues that sub-national government can affect by their own action, especially by changing tax rates, but also by imposing new taxes or repealing old ones, by changing the tax base and varying tax administrative effort.

The most important issue in a federal system is the allocation of expenditure and tax function to various levels of governments. It is argued that assigning responsibility for spending must precede assigning responsibility for taxation because tax assignment is generally guided by spending requirements at different levels and cannot be determined in advance.[32]

The decentralization of the tax should be done together with decentralization of expenditure or the regions will depend on grants from federal level. If regional governments are not responsible for generating, at least some of their revenue they will have little interest to give local service in cost effective way. In the same way, if regional governments are assigned more revenues than their requirements of expenditure, they will have incentive to reduce taxes or increase public sector wage.

In contrast, the timing of responsibilities assignment, i.e., expenditure assignment is first and the revenue assignment come after is inclusive.

For example, many Latin American countries assigned revenues to sub-national government and put transfer in place before transferring the functional competencies from the central government to sub-national governments. This approach resulted in weak sub-national government and fiscally overburdened central government, which in many cases continued to take on most expenditure responsibilities with fewer resources.

When we come to some practices of tax assignment from literature, for instance, Bird noted that despite variations in the historical, social and cultural evolution of the society, the arrangement of intergovernmental financial system in many countries reveals certain broad patterns, such as the existence of in adequate own resources, of sub-national governments to finance the expenditure functions and the lack of sub-national sovereignty to levy taxes that are capable of yielding enough revenue to satisfy local needs.

Sub-national governments do not have adequate level of own revenue sources. The revenue which is under direct control of local governments is invariably less than their expenditure needs. Striking variations appear in the size and capacity of sub-national governments in all countries. This variation includes big differences in terms of revenue sources across sub-national units in almost every country.[33] Additionally, sub-national revenues are not adequately responsive to changing needs and sub-national governments; lack the legal authority to levy some taxes that yield. Enough revenue to meet their needs. For instance, income and property taxes are usually seen as major sources of revenue for sub-national governments. However, since it is costly and difficult to administer well, the collection of property tax is problematic in most developing countries. Even well administered local property tax

cannot finance major social expenditures such as education and health except perhaps in the richest communities.

Further more, taxes that expand with economic activity and spending needs is entirely assigned to central governments in many countries.[34]

In terms of revenue shares high income countries are more decentralized than others, Shah noted that in developing and transition economies centralization of taxing power is much more seen than would be based on economic considerations. In some countries such as Mexico and Pakistan, as he noted national government raises more than 90% of consolidated public sector revenues.

Sub-national governments in sub-Saharan countries have the lowest level of revenue shares compared to other regions of the world. This creates a variety of problems. The first problem is that there is a significant vertical imbalance between expenditures and revenues at all levels of government, with consequent implications for autonomy, efficiency and accountability. The second problem is that the present system results in considerable costs of administration, costs of compliance and costs arising from tax induced inefficiencies in the allocation of scarce resources.

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CHAPTER TWO

2. Tax Policy

Tax policy is inevitably a contentious subject. Oliver Wendell Holmes famously declared that "taxes are what we pay for civilized society," a lofty sentiment indeed, and perhaps one that is widely shared. But most taxpayers nonetheless seem to feel that the cause of civilization might be still further advanced if its price were distributed somewhat differently, usually in any direction but theirs. Senator Russel Long, a veteran tax legislator, summed it up this way: "Tax reform means, do not tax you, do not tax me, tax that fellow behind the tree." Moral and ethical principles are frequently invoked in tax reform debates, with advocates strenuously asserting the importance of "fairness" and "equity" in taxation Remarkably enough, that adherence to these moral principles usually necessitates" taxing the fellow behind the tree.[1]

Fairness in taxation is undoubtedly important to all citizens, and certainly no branch of government seeks an inequitable distribution of tax burdens. Meaningful discussion of tax reform must begin with recognition, however, that there is wide disagreement about the meaning of "fairness" or "equity". It must also begin with a recognition that the search for better tax policy always involves the balancing of competing principles, of which equity or fairness is one but never the only one. This balancing is no easy task, but constructive public discourse can be advanced by an awareness that tax policy does involve trade offs, and that policy-makers, and the citizens that they represent, must make choices among competing goals.[2]

Economists have been grappling with the problem of taxation at least since the time of Adam Smith's Wealth of Nations (1776), and certain

perspectives have gradually evolved during the past two centuries of attempts to systematize the analysis of the tax policy. Perhaps the most important perspective that economists bring that public policies, including tax policy, should be evaluated in terms of their impact on economic welfare, that is, the economic well-being of those who bear their burden, but some methods of raising revenue cause more harm than others. To quote another famous justice of the supreme court, John Marshall, "The power to tax involves the power to destroy." As Justice Marshall saw clearly, taxes affect behavior. An industry, an occupational category, the economy of a region, and even the economy of an entire state can be hampered, discouraged, even destroyed by taxation because taxes create economic incentives that generally tend to discourage the taxed activity. These incentives sometimes work in a very direct and obvious fashion, as, for example, when taxes on particular items of consumption such as luxury goods, tobacco products, or alcohol cause consumers to reduce their purchases of taxed commodities-or to obtain those commodities from untaxed sources such as out-of-state suppliers.

Sometimes the incentives are much less direct, as, for example, when taxes on energy cause an increase in the cost of production for certain industries, whose outputs then become more costly, resulting-perhaps through several further stages in the production process in higher prices for goods or services purchased by households. The adjustment of economic behavior in response to tax and other fiscal incentives may occur rapidly in some cases and quite slowly in other cases, but at whatever rate they proceed and however indirect they may be, the responses of producers and consumers to changes in tax policy play a crucial role in determining the ultimate impact of tax policy both on the allocation of resources in the economy and on the economic incidence of taxes, that is, the distribution of the real burden of the tax system.[3]

2.1. Objectives of Taxation

There is a good deal of overlapping interaction between subject matter covered by principle / canon of taxation, features of a good tax system and objectives of taxation. None of these can be discussed without bringing in the others. However, it may be emphasized that the focus of "objectives of taxation" is upon what is sought to be achieved through it, principles of taxation are the rules to be observed in formulating tax structure; while features of a good tax system amount to a broad description of a tax system devised in conformity with forgoing principles.[4]

Objectives of tax system in any economy are intimately connected with the overall economic and non-economic policies of the government, the non-tax components of its fiscal policy and institutional and other circumstances faced by the economy. Therefore, objectives of a tax system differ significantly between developed and developing countries. Further some of these objectives can be contradictory and the tax system must resolve this problem in the best possible manner. Also a tax system, by itself, cannot be expected to achieve all the goals fully. It has to fit in the overall framework of policies and measures of the government.

A. *Objective of Taxation in a developed country*

The problem of a developed country are materially different from those of a developing one. A developed country does not have to worry about accelerating its rate of economic growth. It has adequate capacity to save and invest. Similarly, in spite of the fact that it may have very wide inequalities of income and wealth, the problem of distributive justice is not an urgent one. Generally, the incidence of absolute poverty is very low in a developed country. The main problem facing a developed market

economy is that of instability of income and employment and the tax system is directed to attack it.

In this connection, the general prescription as provided by Keynesian and Lerner's theories is that taxation should be used to generate anti cyclic changes which means higher change in total expenditure and demand in the economy. They should be pushed up to counteract depression and reduced during boom periods. Keynes had concentrated his attention upon the state of a chronic depression which was to be cured by increasing effective demand. Hence, his remedy was to reduce taxation coupled with a deficit budgeting and to encourage expenditure in private sector. More specifically, his approach implied reducing tax liability of those tax payers who have high marginal propensity to consume. Similarly, Lerner's remedy of compensatory fiscal finance advocates a reduction in taxation during depression and an increase in it during boom. Also taxation in the field of customs duties should be adjusted to bring about desired changes in the balance of trade of the country. Care should, however, be taken to use these duties only if the demand and supply of the export and import items are appropriately elastic.[5]

B. Objective of Taxation in developing countries

The primary objectives are not related to instability of income and employment. Instead such countries face a number of problems connected with economic growth on the one hand and removal of poverty and inequalities on the other. In such countries, there are additional problems of chronic unemployment and regional disparities also. They may start with a view that such an economy must try to come out of its vicious circle of poverty and that the governments and public sector have to play an active role in this task. It may be noted that the problem of

growth, by itself, covers numerous aspects and the tax system may be designed to help the economy in more than one ways.

Thus, a developing country faces the problem of insufficient savings and capital accumulation. There is a need to promote specific products to fill both the supply and demand gaps. Social overheads have to be created and maintained, and key and basic industries must be developed to provide a foundation for the industrialization of the economy. Removal of regional disparities necessitates the promotion of agricultural and industrial development in back ward areas of the country. There is also a continuous need to restrict unnecessary imports and promote import substitution and exports.[6]

Equity and resource mobilization considerations also dictate that the tax burden should be evenly distributed as between sectors and as between individuals. As between individuals, taxation should be highly progressive. Progressive taxation means the higher the income more tax to pay. It should not be burdensome for the honest taxpayer and favorable to the tax evader. Given this fact, we should emphasise that the rates of direct taxation should be moderate. It is widely believed that tax measures are capable of influencing saving, investment decisions of the household and corporate sectors. As a matter of detail, various exemptions, differential rate schedules, rebates and other provisions can be incorporated to affect economic activities of the decision makers along specific lines. Tax measures can be so designed that they appropriately influence relative profitability of various investments, and otherwise affect consumption and production patterns.[7]

It is not an easy task to introduce an optimum tax structure in an developing country. There is an inevitable conflict between defined policies and the ability to execute them. Various characteristics and

institutions of an economy may come in the way of adapting an ideal system such as the paucity of data, level of education, cultural patterns etc. A tax system has to be politically acceptable and in conformity with administrative capabilities of the authorities. Moreover, several taxes tend to work at cross purposes. A system of capital gains discourages building up of specific capital assets. This also poses its own problems in devising an efficient and optimal tax structure. These days, it is generally believed that indirect taxation should not be used for influencing resource allocation. It would only distort investment priorities, make the tax system quite complex and encourage tax evasion. It is now believed that VAT is an ideal form of indirect tax. It avoids almost all drawbacks of indirect taxation and can be improved through selective exemptions and rate differentials.[8]

In developing economies, while making an effort at resource mobilization, the state is obliged to rely heavily on indirect taxation for collecting adequate revenue. The base for direct taxes is generally quite narrow and cannot be considered adequate for fiscal needs. In developed economies, however, no such generalization is possible. In their case while some economics rely more on direct taxes, others collect more revenue from indirect taxes.[9]

2.2. Principles of Taxation

Principles of taxation refer to the appropriate criteria to be employed in developing (devising) and evaluating a good tax structure/system of a country. Tax authorities must follow certain code of conduct in the form of principles of taxation while determining the type and amount of tax. Adam Smith, who was perhaps the first writer to attempt a general statement of the principles of taxation and most other economists believe that a tax system should be based on the following principles of taxation to be the good tax system.[10]

1. ***The Principle of Equity / fairness***

This principle states that similarly situated tax payers should be taxed similarly. This principle takes two forms: horizontal equity and vertical equity. Horizontal equity states that taxpayers in equal position of income and those with equal ability to pay should pay the same amount of tax. For instance, if two persons both have income of say, Br. 2,000 each, horizontal equity requires the two persons to pay the same amount of tax regardless of their positions. On the other hand, vertical equity implies that tax payers with greater ability to pay should pay more amount of tax. This in other words means taxpayers in unlike circumstances should be treated differently. There is no ground to levy the same amount of tax on two persons earning different amount of incomes: one earning Br. 2,000 and the other person earning Br. 3,000. This is essence of vertical equity. The progressive tax rate structure is founded on the vertical equity premise.[11]

2. ***The principle of Certainty***

Certainty principle states that taxes should not be arbitrary and based on relationship rather it should be based on statutory bases. Therefore, taxes not to be arbitrary and not to be based on relationship, a tax law should specify:

- how the amount of tax that due is determined,
- how tax is to be paid (the method of payment), and
- when the tax is to be paid (period of payment).

A certain tax ensures a stable source of government tax revenues through tax planning.

3. ***Principle of Simplicity***

Simplicity principle states that as complex tax system may result in error (due to failure to understand the tax laws), tax

evasion (violation of tax laws) and disrespect for the system, tax laws should be simple and clear to be understood by the taxpayer and they should not be confronted with accounting, administrative or other difficulties.[12]

4. ***Principle of Convenience***

Also called convenient for payment principle, states that taxes should be due at a time and in a manner which is most likely convenient for taxpayers. In other words, the period of tax payment should be appropriate for the taxpayers and tax must be collected but not through unnecessary harassment by the tax authority on the taxpayers. The government of Ethiopia collects employment income tax from taxpayers (employees) at source, i.e., when the payroll is due. Similarly, the best time for the collection of land tax should be the time of harvest.

5. ***Efficiency / Economy of Collection***

Efficiency principle states that the costs to collect taxes should be kept as minimum as possible for both the government and taxpayers. Governments incur administrative costs such as costs for hiring tax collectors together tax revenues, data entry clerks to process tax returns, auditors to inspect questionable returns, lawyers to handle disputes, and accountants to track the flow of money. Taxpayers also incur cost of taxation to comply with tax system such as costs to workers, costs for record keeping, and noncompliance costs for appeal. Therefore, efficiency theory implies that government administrative costs and taxpayers cost of taxation should be as low as possible.[13]

6. ***Neutrality Principle***

Neutrality principle states that a tax system should be free from bias.

- incomes of tax payers from different sources should be taxed without partiality;
- the decisions of taxpayers to undertake transactions should not significantly be affected by the tax system;
- the tax system should not create any inflationary or deflationary effects in the economy (or taxation should not create distortion on economy); and
- the government should not collect too much tax just to finance its operations or should not collect too little tax just to favor taxpayers.

7. ***Economic growth / Buoyancy principle***

The principle of economic growth states that a tax system should not impede or reduce the productive capacity of a economy by over-taxing. For instance, a tax system should not significantly affect international competitiveness, investment, and production like labor supply. Viewing the concept from the other angle, a tax system should be in line with the economic growth policy of a country and should have an inherent tendency to increase along with an increase in National Income. A tax system should not work against the economic goals and policies of the government. Economic growth principle highly reflects the theory of neutrality.[14]

8. ***Transparency and Visibility Principle***

This principle implies that tax payers should know that a tax exists, why tax exists, and how tax is imposed on them. When taxpayers are aware of a tax and the change in their liabilities

that result from specific transactions or events, they can compute the true cost of the transaction and identify who ultimately pays the tax.

9. Appropriate government revenue principle

The appropriate government revenue principle implies that taxes should be predictable by government, meaning, a tax system should enable a government to predict (determine) how much tax revenues will likely be collected and when so as to undertake its budgeting and appropriation process accurately.[15]

10. Minimum Tax gap principle

A tax system should be structured to minimize tax gap/ non-compliance. Tax gap exists if the actual tax owed (tax imposed) is not the same as the tax voluntarily paid by taxpayers.[16]

2.3. Direct & Indirect Taxes

2.3.1. Direct Tax

Economists usually classify taxes into direct and Indirect taxes.

According to Dalton, direct taxes are those taxes which are paid entirely by those persons on whom they are imposed. In other words, the immediate money burden is upon the man who pays the tax to the authority. Direct taxes are those taxes which cannot be shifted to others. To quote J.S. Mill, "A direct tax is demanded from the very persons who, it is intended, desired, should pay it." Thus, if a tax is intended to be paid by the persons on whom it is imposed, it is a direct tax.

A.R. Prest, an authority on public Finance, defines direct taxes as those taxes which are based on the receipts of income. Income tax, tax on profits, capital gains tax, property or wealth-tax are direct taxes.[17]

Direct taxes such as income-taxes on property, capital gains, etc. are just and equitable because they are based on the principle of progression. Higher incomes are taxed more heavily and lower incomes slightly. The larger the income the higher is the rate of tax and vice versa. Direct taxes are taxed according to the "ability to pay" of the taxpayers. Ability to pay is interpreted as the money income of the assesses. It means, any person having a flow of income is expected to pay tax. Taxes at high rate are paid by the richer section of society and lower are paid by the poorer sections of society.

Direct taxes satisfy the canon of certainty. Direct taxes involve certainty about the rates of taxes, which are widely publicized. In other words, the taxpayer is certain as to how much he is expected to pay, and similarly the state is certain as to how much, it have to receive income from direct taxes. There is also certainty about the time of payment and manner of payment. Therefore, taxpayers can plan their own budgets and other economic activities in advance because they know with certainty their tax liabilities.

As stated above, direct taxes are progressive in nature; rich people are subjected to higher rates of taxation, while an employee who earns less than 150 Birr per month are exempted from paying tax. Rates of taxes increase as the levels of income of persons rise. As they fall heavily on the rich, they take away a large part of their income by way of income and property taxes. The revenue so called is used for providing social amenities like, food, clothing and housing facilities to the poor people. The real income of the poor rises and that of the rich falls. Hence, direct taxes help to reduce inequalities in incomes and wealth.[18]

Direct taxes are also satisfying the canon of elasticity. Elasticity in direct taxes implies that more revenue is collected by the government by simply

raising the rates of taxation. In other words, revenue of government may be increasing the incomes of the people. Therefore, the income of government from direct taxes may increase with the increase in the incomes of the people.

Direct taxes are unpopular because they are required to pay in one lump sum which is inconvenient to the taxpayer. Direct taxes are generally not shifted; they are painful to the tax payer. Hence, such taxes are unpopular and are generally opposed by the taxpayers as they have to be borne by the assesses themselves. As stated above, direct taxes are certain and taxpayers know the rate of tax they have to pay. Therefore, awareness of tax liability tempts the taxpayer to evade tax. It is a fact that the people in the higher income groups do not reveal their full income. They do not hesitate to fill up false returns, concealing a considerable part of their incomes. Black money is generated on a large scale and a parallel economy is established which is injurious to economic development. Hence, it is found that direct tax can wholly or partly be evaded, if the tax payer decides to become dishonest.[19]

Direct taxes are found to be arbitrary because there is no logical or scientific principle to determine the degree of progression in taxation. Rates of income-tax and other direct taxes determined according to the whims of tax authority. It is likely to underestimate or overestimate the taxable capacity of the people.[20]

2.3.2. <u>Types of Direct Taxes</u>

- Tax on income from employment/personal tax
- Business Profit Tax
- Tax on Income from Rental of Buildings
- Tax on interest Income on Deposits
- Dividend Income Tax

- Tax on Income from Royalties
- Tax on Income from games of chance
- Tax on gain of transfer of certain investment property
- Tax on income from rental of property
- Rendering of Technical Services outside Ethiopia, and
- Land Use Tax

2.3.3. <u>Indirect Tax</u>

Indirect tax is a tax the burden of which may not necessarily be borne by the assesses. Indirect taxes can be shifted or passed on to other persons. Indirect taxes on commodities are custom duties, excise duties, sales tax etc. According to John Stuart Mill, "Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another." Thus, if it is intended that the amount of tax should be collected from other persons by those on whom it is imposed, such a tax in an indirect tax.

Indirect taxes are imposed when the income is spent i.e. on goods purchased. According to Bastable, taxes levied on occasional and particular events are direct. According to professional Shirras, taxes which affect the income and property of persons through their consumption may be called as indirect taxes. Indirect taxes are taxes on expenditure. All taxes on commodities and services other than personal services are treated as indirect taxes.

Indirect taxes can be made progressive by imposing heavy taxes on luxurious and exempting articles of common consumption from the tax net. Sales tax, are also collected by traders, manufacturers and sellers from individual buyers and then paid in lump sum to the tax authorities. Indirect taxes are regressive in nature, as they fall more heavily upon the

poor than upon the rich. The real burden on the poor is more, since their incomes are low.

Direct and indirect taxes may be compared on the basis of distribution effects. Direct taxes are regarded as superior to indirect taxes as an instrument of fiscal policy to reduce inequalities. Direct taxes reduce inequalities of income and wealth, as they are progressive in nature. Rich persons are subjected to higher rates of taxation and poor are exempted from tax obligations. However, they fall more on the rich persons than on the poor. On the other hand, indirect taxes are included in the price of the commodity, so they cannot be evaded. Secondly, articles of common consumption are subjected to higher rates of taxation, hence they are generally regressive in nature as the burden of indirect taxation falls more heavily on the poor than on the rich. Therefore, indirect taxes are generally not suitable from the point of view of removing inequalities of income and wealth.[21]

2.3.4. Types of Indirect Taxes

- Turnover Tax
- Excise Tax
- Value Add Tax, and
- Customs Duty

2.4. Assessment of Income Tax

2.4.1 Meaning of Assessment

The word assessment has never been defined in the income tax legislation. In spite of this, you can understand that by assessment what is meant is the determination of the tax liability of the taxpayer when you read the provisions of the income tax proclamation. In other words, assessment may be understood as the whole procedure for ascertaining and imposing liability upon the taxpayer and the machinery for

enforcement thereof. Assessment involves the process by which the tax authority determines the tax liability of the taxpayer and it includes all the mode of imposition from the inspection to the collection of the tax.[22]

2.4.2. ***Methods of Tax Assessment in Ethiopia***

The determination (assessment) of business income subject to tax depends on the choice of the taxpayers' accounting methods. However, the Tax Authorities are empowered to notify accounting methods to be followed by the taxpayers and the taxpayers are required to follow regularly the accounting methods recognized by the tax authority. Where taxpayers do not follow accounting methods notified by the tax authority, the Tax Authority may reject the books of accounts and may compute the tax liability based on estimation. Section of proclamation 286/2002 tells that taxable profits of businesses are computed either in accrual basis, cash basis or percentage of completion methods.[23]

2.4.3. ***Accrual Basis Method***

As per Art. 53 (3) of proclamation No. 286/2002, companies (share and private limited) are required for tax purposes to employ actual basis, of accounting. If the accounts are kept on actual basis, revenues are accounted for when they are earned, i.e., when the title passes to the buyer for the sale of goods or services are performed to customers irrespective of cash receipts, and expenses are accounted for when they are incurred irrespective of cash disbursements. Thus, taxpayers using the accrual method of accounting generally report taxable income in the year it is earned and computed.[24]

2.4.4. ***Cash Basis Method***

All businesses other than companies can select and employ either cash basis or accrual basis but not both. Based on the cash basis concept, a record is kept of actual receipts and actual payments entries are made

only when money is actually collected or disbursed. If the profit of a business is accounted for in cash basis, the taxable profit is the difference between the receipts (revenues) and the disbursements (expenses) for the period in question.[25]

There are two popularly known types of assessment, which differ from one another in the degree of participation required from the taxpayer or tax administrator in determining tax liability. These are official (government) assessment and self-assessment. Under the official assessment, it is the tax authority which finally determines the tax liability whereas the payer's role is confined to presentation of information and document. Self-assessment, on the other hand, invites for high participation from taxpayer to determine the tax due. In this case, the taxpayer prepares necessary documents and statement of accounts and then calculates his own tax liability. The tax authority investigates only when there is suspicion for fraudulent acts to willfully suppress taxes payable.

2.4.5. *Assessment procedure (Identification of the Taxpayer)*

The first task of the tax authority is to identify the persons or the bodies which bear the burden of taxation before imposing any tax on them. This identification of the real taxpayer would smoothen the relation of the authority and the taxpayers. In other words, if the real taxpayer is identified, the tax officials would have reasons to enforce upon the taxpayer any tax law to ensure the collection of the tax from the taxpayer.[26]

2.4.6. *Basis of Assessment*

The rules of taxation naturally have an authoritarian character, but tax laws do not grant the taxing authority a privileged position nor deprive

the taxpayer a means of defense against arbitrary taxation. The tax law stipulates bases for the tax assessment so that the tax officials could not employ other methods of assessment other than stated in the appropriate schedule. This is to curtail the power of the tax officials in assessing tax and not to abuse power. This is clearly reflected under the Income Tax Law under consideration (see Art. 40 of the Income Tax Proclamation).

When we come to basis of assessment, there are two methods of assessment. These are assessment on the basis of accounts and assessment by estimation. The income tax law imposes an obligation on certain taxpayers in accordance with their category of income or form of organization. The current Income Tax Law categorizes those Taxpayers under schedule C and B into three groups as provided Art. 2 (16) and 48 of the proclamation and Art. 18 of the regulation. These categories are category 'A', category 'B' and category 'C'. Category 'A' includes any company incorporated under the law of Ethiopia or in a foreign country, any other business having an annual turnover of Birr. 500,000 (five hundred thousand Birr) or more. Category 'B' include any business having an annual turnover of birr 100,000 (one hundred thousand birr). Category 'C' includes any business whose annual turnover is estimated by the tax authority as being up to birr 100,000 (one hundred thousand birr).

Art. 78/2002 Of the regulation requires category 'A' and 'B' taxpayers to maintain books of accounts which are expected to show gross profit and the manner in which it is computed, general and administrative expenses, depreciation, provisions of profit and loss statements. If, on the other hand, category 'C' taxpayer maintains books of accounts acceptable to tax authority, he shall pay on the basis of such books of accounts. If the records and accounts maintained by the taxpayers are considered satisfactory by the tax authority, tax shall be assessed on the

basis of the records and books of account. Here, you have to bear in mind that whenever the tax authority finds that the accounts are not satisfactory, the authority does not assess the on the basis of the account.[27]

The second basis of assessment of income tax is assessment by estimation. For different reasons, the taxpayers may be subjected to taxation on the basis of estimation. Though it is not defined by the relevant laws, its dictionary meaning refers to judgment or approximate calculation. The main point during estimation is that the tax officials must assess the tax liability in a fair and equitable manner. In other words, they must not assess the tax liability arbitrarily and they must not have the intention to punish the taxpayers; rather they should estimate the tax in good faith. In order to achieve this goal, they must assess the tax in accordance with the available evidence and the circumstantial evidence that is associated with the thing to be assessed.

The tax authority employs different mechanisms to get necessary information as to the actual activities of a certain business. It is empowered to send inspectors to the place of business or practice of the taxpayer to check same or any vouchers, stocks or other material items of the taxpayers, and to require any 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.

In addition, for the purpose of assessment by estimation, the tax authority uses purchases, sales or services, income information obtained from third party like National Bank and Customs Authority for foreign

transaction, public enterprises and government organizations and wholesaler.[28]

2.5. Power of Taxation

By citing Art. 95 of the constitution, the Federal Government and the states shall share revenue taking into consideration the federal arrangement. The major sources of revenue for all governments are taxes. Hence, sharing of revenue will be meaningful between the federal government and regional states when the power of levying and collecting taxes has been given both to the regional states and the Federal Government. Therefore, the constitution has carefully regulated power of taxation of the Federal Government and the states under Arts. 96,97,98 and 99 of the same constitution. These constitutional provision have regulated the exclusive power of taxation of the Federal government, the exclusive power of taxation of the regional states, concurrent power taxation and undesignated power of taxation.[29]

In any case, each regional state government must formally devolve adequate decision making authority and control over resources to zonal, woreda and kebele administrations in order to promote democratic decentralization and get government closer to people. The constitution of the FDRE has empowered, the sub-national states in Ethiopia to finance number of tax sources. Similar to the case of federal government, these sources of revenue for states are related either to the functions of the states under the constitution or things which solely belong to the ownership of states. Hence, fees for land usufruct rights, fees and charges relating to licenses issued and services rendered by state organs and taxes on income transport services on water bodies within their territory are regarded as the functional assignment of taxing powers to the states. On the basis of ownership, states own tax powers over income from their properties and profit, sales, excise and personal taxes on

income of their properties and profit, sales, excise and personal taxes on income of their enterprises.[30]

Additionally, it seems on the basis of administrative efficiency and convenience of tax collection that incomes of private farmers and farmers associated in cooperatives, profit and sales on individual trades and taxes from mining and royalties and land rentals on mining operations are assigned to the states.

With regard to the productivity of revenue sources, the tax sources of regional states in Ethiopia are concluded as being unproductive and limited in variety. For example, though there is devolution of revenue powers upon states, these resources are inadequate to finance extensive social, economic and cultural responsibilities, and as a result, there is a great discrepancy between the devolution of spending responsibilities and revenue powers of states. And there has not been meaningful integration and coordination between these units of government functioning at the grass roots partly because the very concept of revenue powers of states and its structure is not well conceived and developed in Ethiopia.

2.6. Concurrent Jurisdiction of Taxation

Concurrent power of taxation is a third category under the FDRE constitution. I refer to area of jurisdiction exercised by both the federal and state governments. These are matters which are not allocated exclusively either to the Federal Government or to the states. The state legislative could make laws as equally as the House of people's representatives. Most constitution do have concurrent list of powers.

Art. 98 of the FDRE constitution, provides that the Federal and state governments jointly levy and collect taxes from tax bases which belong to

the two unit of government together. This provision is construed as both units of government should act together starting from legislating the tax laws to administering and collecting the tax revenues. However, this way of interpretation is undoubtly non-practical as long as it would give rise to the question how two units of government make law jointly. Apart from this, it is smooth to say that the law enacted by one tier of government which is confined to joint tax jurisdiction should get approval from another layer of government to be effective.

On the other hand, taking the wording of Article 98 is clear; it is too far to interpret it as if it follows the levy and collection of taxes from the joint tax sources by both the federal and state governments, per laws enacted by each tier of governments independently. The prohibition against dissociate levy and collect by each government with respect to their own laws on the joint sources of revenue is suggested in the discussion of article 100 of the draft constitution, which is the current art. 98 of the FDRE constitution. The discussion in the constitutional Assembly underlines that there should be a consensus through negotiation on the question which level of government should levy and collect taxes from joint tax jurisdiction on behalf of the other layer.[31] Of course, this assertion seems settling the potential conflict, but the question left here is that what if the two levels of governments could not reach an agreement?

The phrase "jointly levy and collect" reveals that the constitution has taken as each level of government cannot unilaterally levy and collect taxes falling under Art. 98. Even they cannot modify the rate of taxes falling under the same provision unless the joint session of the house of people's representative and the state council at hand is conducted.

When we come to the provisions of the constitution, sub-art 1 of article 98 states "The federal Government and the states shall jointly levy and collect ---- taxes on enterprises they jointly establish."[32] This means, if these two levels of governments owned enterprises jointly, they are empowered to levy and collect revenue sources derived there by. In the discussion of constitutional assembly the constituents underline that each units of government should receive revenue from what their ownership extends to which on the other hand reflects an equal access to benefits from matters of joint ownership.

Sub art, 3 states that "The federal government and the states shall jointly levy and collect taxes on incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operations." This implies that in our country both the Federal Government and the States jointly own taxes on natural resources confirming the provision of Art. 40(3) of the document. The fact that all natural resources belong to the state and the people of Ethiopia, presupposes the nations-nationalities and peoples of Ethiopia should partake in sharing the national cake.[33]

The constitutional assembly reasoned out that the rationale of categorizing of taxes on profits of companies and dividends of share holders under the joint taxation jurisdiction as it was thought that when private economic activities grow in the near future, they will be productive and increasing sources of revenue for both limits of governments.

Under the FDRE constitution neither the federal government nor the states have the power to apportion the proceeds from taxes displayed under Art. 98. It is the house of federation which determines division of revenues received from the joint federal and states tax resources per Art.

62 (7) of the same constitution. This type of apportionment as between the two levels of government is said to be tax-sharing. It is an approach whereby both the federal government and the states jointly levy and collect certain taxes and share the proceeds between themselves. Hence, we can deduce that tax sharing become exist at the time of revenue for certain taxes are shared between the federal government and the states.

In spite of Art. 62 (7) of the constitution which prescribes for the tax sharing approach, the formula for the distribution of proceeds as between the federal government and states that the money from the jointly owned revenue sources is not yet settled procedure in our country. This is why currently the sharing is made on ad-hoc basis. The two levels of governments are said to have equal share in the proceeds from direct taxation, while the revenue arising from indirect taxes is to be apportioned between them in the 37% ratio in favor of the Federal Government. This approach which is sound from the practical point of view represents a tax sharing arrangement in contrast to the tax power distribution formula stated in the constitution. It takes the taxes in question out of the field of joint jurisdiction and puts them in the exclusive federal sphere of taxation. Additionally, the practice deviates from the constitutional prescriptions as long as the federal government is said to be performing the administration of the taxes in question.[34] As such it may well be seen as a violation of the constitutional fiscal design. The above problem is resulted due to their concurrent involvement in the collection of the same tax is bound to become an extremely cumbersome and grossly inefficient administrative exercise, requiring a highly costly coordination.

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CHAPTER THREE

3. Presumptive Taxation in Ethiopia

The dictionary meaning of the term "Presumptive" is having a reasonable basis or grounds for belief or acceptance. Accordingly, presumptive taxation is the application of indirect means to ascertain tax liability and is different from the usual provisions and rules of Income Tax Proclamations. That is, a presumptive income tax is a tax based on some measure of economic activity that surrogates for taxable income, rather than on taxable income itself.[1]

Presumptive income taxation is employed primarily in economics where 'hard-to-tax' taxpayers comprise the majority of the population and administrative resources are scarce. In these countries, most taxpayers lack the financial transparency that allows for effective taxation by the government. The result is that governments estimate or presume the appropriate income on which taxes should be levied. In developed countries, the transition from presumptive to actual income based taxation paralleled the shift from agricultural to industrial economics.[2]

In developing countries, however, presumptive taxation may still be the most appropriate method of tax administration for specific groups of taxpayers. The economic transition from agriculture to industry has not occurred to the same degree as in industrialized nations. Most tax laws are written as if they had, assuming tax is assessed on well-defined measures of income and well documented in transparent accounting records. The reality is that most taxpayers do not possess the administrative resources to maintain accurate books or navigate complex tax codes.[3]

Presumptive taxation is considered an optimal method of reduction of widespread non-compliance without employing excessive government resources because it addresses the concerns of both taxpayer and tax authority. It provides taxpayers with a simplified option for tax compliance without requiring full financial transparency and it offers a streamlined method for moving from the informal to formal sector. Income is no longer assessed from accounting records but from indicators such as the value of a farmer's land, gross turnover of a small and medium enterprises or signs of individual wealth. The approach to estimating income on which tax is levied removes the administrative burden of financial transparency traditionally required for compliance.[4]

Tax administrations are quite aware of the burden tax compliance places on individuals and businesses. However, non-compliance amounts to a lack of funds for the public service programs of governments and there by for national developments. As a result, authorities spend a disproportionate amount of time tracking down non-compliant small and medium enterprises. Governments often introduce presumptive taxation method for providing incentives to citizens and businesses to enter the formal tax net and increase the countries tax base. Presumptive taxation also offers two additional benefits to both governments and taxpayers: it allows the government to tax its citizens in a more equitable manner while regarding efficient businesses with financial incentives.[5]

In light of the growing popularity of presumptive taxation in developing nations, it is relevant to note the existing concerns that compromise its effectiveness. Governments that recognize the limitations of presumptive taxation include provisions in their tax codes that allow taxpayers opportunity for redress. It is sometimes argued that presumptive taxation can help reduce corruption in the tax administration. The success of presumptive taxation in reducing corruption will depend both

on the structure of the scheme and the overall administrative environment and capacity in the tax administration. A presumptive taxation scheme can in fact increase the discretionary power of tax officials and in a worst-case scenario increase corrupt practices. A carefully designed presumptive taxation scheme can help reduce corruption, but can never be a substitute for much needed capacity building and administrative reforms within the tax administration.[6]

Despite its steam lined requirements, presumptive taxation is not always effective because governments do not have sound tax administration systems in place at the federal, state, or local levels to implement schemes as envisioned by policy makers. Countries in early stages of economic development tend to employ crude methods of estimating income because they lack sufficiently qualified resources to analyze the profitability of various economic activities and to define the indexes for effectively calculating presumptive incomes. As a result, small businesses in particular are routinely taxed unfairly and inffficientyly.[7]

The primary goal of the government in introducing presumptive taxation schemes is to broaden the countries tax base by preparing citizens and businesses in the informal sector to enter the formal tax net. Presumptive taxation has proven to undermine this goal as tax payers remain in presumptive taxation regimes indefinitely or regress from formal taxation programs to presumptive taxation schemes. Attention must be given to how a particular presumptive method will work in practice. If taxpayers can hide the factors on which the presumption is based as easily as they hide income, then presumption will not be much use. This question depends on the administrative capacity of the tax authorities, and the methods used. In Ethiopia tax authorities are continuously working on the methods of presumptive taxation for developing effective new methods and rate schedule.[8]

3.1. Payment of Tax and Collection Enforcement

The ultimate obligation of any taxpayer is payment of tax which is due to the tax authority. Failure to make a timely payment results in the imposition of interest and late payment penalty. The interest is to be calculated from the date the tax is due to the date it is paid. The interest rate is twenty five percent (25%) plus the prevailing interest rate of t he Commercial Bank during the time. Thus, if Ato 'A' failed to pay a tax in the year 2005 and if in that year the interest of the commercial Bank was 6% Ato 'A' will be obliged to pay an interest of 31 percent.[9]

On the other hand, if a person pays tax in excess of his liability, the tax authority shall set-off the excess with other tax liabilities of the taxpayer. If still, these remains excess, the authority is duty-bound to refund the remainder to that person within 90 days. If the excess is not refunded within the 90 days time limit, he will be entitled at an interest of 25% plus the prevailing interest rate of the Commercial Banks.[10]

The request of refund shall be instituted within three years from the time the notification assessment was served to the taxpayer or from the date the tax or interest was paid. The tax authority shall make a decision in writing to the applicant. If the applicant taxpayer is not satisfied with the decision of the tax authority he can take his case to the Tax appeal commission.[11]

When we come to the enforcement aspect, as per Art.77 of the proclamation of 286/2002, if the taxpayer is not willing to pay the tax due, the authority will have the right to seize or attach the property of the former. Such seizure may be made on any other person who owes many or property to the taxpayer. However, such seizure shall extend only to property possessed and obligations existing at the time the seizure are made. Future goods or obligations cannot be seized.[12]

During seizure, the tax authority has the right to request police officer to be present. It has also the right to sell the property seized at public auction or in any other manner that it has approved. But the sale cannot be effected before 10 days after seizure except that the commodities (goods) seized are perishable. If the goods seized are perishable, the authority can sell it after a reasonable period having regard to the nature of the goods.[13]

The authority can make seizure on employee's remuneration or other property of a person with respect to any unpaid tax only after notifying such person in writing of its intention to make such seizure. The notice shall be given to the taxpayer not less than thirty (30) days before the day of the seizure. However, if the authority makes a finding that the collection of tax is in jeopardy, a demand for immediate payment of such tax may be made without regard to the thirty days (30) notification period. The tax authority cannot seize properties that are not liable to attachment as per the 1965 civil procedure code and other legislation and amount of employee's remuneration that is less than Birr 150 (one hundred birr). For example, wearing-apparels, bed and beddings, cooking utensils, necessary foodstuff, seeds and the like are not to be attached by virtue of Art. 404 of the civil procedure code.[14]

As per Art. 78 of the income tax proclamation, a person in possession of property subject to the seizure and on which a seizure has been mode, is duty-bound to surrender such property on the demand of the tax authority. If a person fails or refuses to surrender such property, he 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.[15]

In addition to this personal liability, 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. On the other hand, a person in possession of property who surrenders or makes payment in accordance with the above mentioned requirement should be discharged from any obligation or liability to the delinquent taxpayer or to any other person arising from such surrender or payment.[16]

3.2. Rewards and Administrative Penalties

Income tax proclamation No. 286/2002 (under Art. 84 and 85) authorizes the tax authority to give rewards for persons that provided a verifiable and objective information of tax evasion through concealment, under reporting, fraud or any other improper means also for taxpayers and officers for outstanding performance and discharge of duties.

On the other hand, taxpayers are subject to the following penalties for failure to live up to the requirement of the income tax law:

a) Penalty for late filing or non-filing
b) Penalty for understatement
c) Penalty for late payment
d) Penalty for failure to keep proper records
e) Penalty for failure to withhold tax
f) Penalty for failure to meet TIN requirements

In order to understand the specific penalties under each of the above heading, you have to refer Arts. 86-93 of the Income Tax Proclamation No. 286/2002.[17]

3.3. Criminal offences /Tax offences/

The Income Tax Laws of any country are known to create tax offences. These tax offences are created in order to ensure the proper implementation of such laws. In this regard Barry Goldwater, “the income tax created more criminals than any other single act of

government." Though criminal offences are the subject of the criminal law, since tax offences have been provided under section IX of the Income Tax Proclamation, it is indicated in the relevant provisions of this proclamation. Pursuant to articles 95-102 of same proclamation, various kinds of tax offences are created and their respected penalties are provided. These tax offences, as they are violations of criminal law of Ethiopia, are made to be charged, prosecuted and appealed in accordance with Ethiopian Criminal Procedure Code. Tax evasions, making false or misleading statements, obstruction of tax administration, offences by tax authority employees, unauthorized tax collection and aiding or betting.[18]

3.4. Rights of Taxpayers under the Ethiopian Law of Income Tax

As a taxpayer has a right to expect the department of revenue to honor its mission and uphold rights every time to clear and concise explanation, basis of assessment of additional taxes, interests and penalties. The right to know, and to be served a written notice about the income of tax assessment.[19]

Upon receipt of a tax assessment notification, the taxpayer, in principle, is duty-bound to settle accounts with the authority within one month. If, however, he is not in accord with the assessment of the authority two options are available to the taxpayer. The first option open to him is an administrative means. The administrative remedy may be sought from an organ called a review committee established by virtue of the Art. 104 of the proclamation. According to Art. 104 of the proclamation, members of the review committee are to be appointed by the Minister of Revenue or the competent authority of the regional governments, upon the recommendation of the head of the tax authority. When the taxpayer opts for administrative means, he is required to file an application for a review

of assessment by this committee. Within ten days of the receipt of assessment notification. In this case, the review committee examines the validity of the taxpayer's claim. The investigation process may involve going into the files of the taxpayer, and inspection of the premises where activities are carried on. If the findings of the committee warrant revision of the assessment, it will be performed accordingly, and the new assessment will be served on the taxpayer afresh. (Art. 105 of proclamation No. 286/2002).[20]

The other alternative remedy provided under Art. 112 of the above-cited proclamation is judicial remedy. This stems from the right to appeal against the assessment made by the tax authority. However, in order to exercise this right, the taxpayer is obliged to fulfill two important preconditions. The first is related to the time within which an appeal must made which runs just one month from the date of decision of the review committee if the taxpayer has resorted to administrative remedy. The second important precondition is to deposit fifty percent of the disputed amount of money with the tax authority. In the absence of either of the preconditions, the taxpayer cannot exercise his right of appeal. In this case, in the case where the tax buyer is barred from lodging appeal, the assessment of the tax authority will be final, conclusive and executor by courts of law.[21]

The appeal remedy can safely be divided into quasi-judicial and judicial per se remedies. The quasi-judicial remedy is the tax appeal commission which is established at the federal, regional, zonal, and woreda levels. By virtue of Art.115 of the proclamation, the appeal commission is empowered to confirm, reduce or annul any assessment appeared against based on factual grounds and the relevant provisions of the law. Besides, it is authorized to make consequential orders thereon as may seem just and necessary for the final disposition of the manner. The

burden of proving facts before the commission (tribunal) lies on the person objecting to the assessment or decision of the tax authority.[22]

The other judicial per se remedy is available to both the taxpayer and the tax authority alike. Both parties have the right to lodge their appeal to the competent regular court whenever they are dissatisfied with the decision of the commission. The appellate court can, however, entertain only issues of law. The court is precluded from going into the merits of the case, and is required to send back the case to the tribunal having rectified only what is considered legally erroneous in the decision. If still the parties are distinguished by the decision of the court they can appeal to next court of appeal within 30 days of the decision of the lower court. However, in both cases, the appeal of the taxpayer is acceptable by the court if and only if he has paid the tax liability determined by the Appeal Commission.[23]

3.5 Cases of Appeal

Case One

Appellant	Ato Akmel Kiyar
Respondent	Tax Authority
Trade type	different Commodities

Appellant was asked to pay 130 birr per day for 365 days, without taking into consideration, Sundays and public holidays into account. The appellant forward his claim to the appeal commission to deduct the holidays and Sundays of daily payment.

Decision by the appeal commission

The commission reduced the days from 365 to 300 days, and reduced to the payment from birr 130 to birr 90 per day. Considering the penalty, adjust according to the birr 90 and 300 working days in a year.

Comment

Income tax proclamation No. 286/2002 art 4 states, every person getting income has to pay income tax. On the process of argument of the parties, the commission passed a decision on the side of the appellant. However, the decision given has no legal ground and hurts the taxpayer.

Case Annexed

Case Two

Appellant	Ato Berhe Bogato
Respondent	Tax Authority
Trade Type	Leather Shoe Seller

Memorandum of Appeal

Appellant was paying birr 112 per day for the last consecutive years. Now, he is asked to pay 400 birr per day by the assessment committee.

Decision of the Appeal Committee

After they heard the argument of the parties, the appeal committee passed a decision. The place of the business is on the road side. It is at the center of the market. Paying birr 400 per day is not too much

for such business, but they lowered the payment from birr 400 to 300 birr.

Opinion

The decision is partially correct, but lowering the payment from birr 400 to birr 300 has no legal ground. He has to approve the respondent's claimed. Such decision create loophole among taxpayers. All taxpayers have to pay according to their income. It is unfair decisions, tax payers start claiming to get unlawful reduction of taxes.

Case Annexed

Case Three

Appellant	W/ro Medhin Woldu
Respondent	Tax Authority
Trade type	General importer and tea (breakfast) house

Memorandum of Appeal

Appellant complained that to pay birr 300 is too much for him/his business is not category 'B' but it is on category 'C'. He has never worked as a general importer

Decision of the Appeal Committee

As general importer there is no evidence. His business is not under category 'B' but it is category 'C'. He is not expected to have a book. His payment readjusted from birr 300 to birr 210.

Opinion

The decision rendered looks as just and rational, however, it is improper to state about alcohol as there is no phrase from the parties, while, in the decision they stressed about alcohol, it is not clear from where they mentioned it.

Case Annexed

Endnotes of Chapter Three

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Conclusion and Recommendation

A. Conclusion

On this senior paper I have tried to show some of the problems on both sides, on the side of taxpayers and tax authority. The tax assessment committees have no concrete knowledge of accounting and the taxpayers are not fair enough to pay their taxes. They must understand that the tax they pay is for the use of public at large. Both of them should not spend their time in going to appeal commission and regular courts.

As Ethiopia follows a free market policy, the design of the tax system should be as neutral as possible so as to minimize interference in the allocation process. The tax system should have simple and transparent administration procedures so that it is clear and it is not being enforced as designed.

In settling conflicting cases between the tax authority and taxpayers, there is a judicial decision is made according to law, whereas administrative decision to administrative policy. To elaborate it, a judge attempts to find what is the most expedient and desirable solution in the public interest.

The tax authority has to give tax process is to give continuous training and capacity building to his tax collectors and tax assessment committee. If there are obstacles in the proclamation No. 286/2002 and regulation No. 78/2002 on income tax he has to try to amend them and make fair and equity between taxpayers and tax authority.

A. Recommendation

Ethiopia at present is encouraging foreign and local investors. The tax proclamation No. 286/2002 and regulation 78/2002 are newly introduced. The Federal and Regional tax authorities have to work closely in order to give smooth and equity administration.

It would be advantageous to take fast measures to enhance revenue of the Federal and Regional governments. Efficiency and accountability of the tax assessment is unquestionable. The tax authority has to give priority to have skilled manpower and give attractive salaries compared to other civil servants.

As I have seen in the attached cases, the tax authority is not effective and transparent in his tax assessment and tax collection staffs.

The regional governments should adequately share revenue sources, consistent with the income tax in a centralized system. To improve fiscal autonomy of both regional and local governments the capacity of the revenue collecting authorities at all levels should be strengthened by implementing the on going tax reform program properly and effectively. To make regions beneficiary from the joint revenue source, the Federal In land revenue authority should collect taxes effectively in time.

The power given to different body to issue directives that is the ministry of revenue and the ministry of finance and economic development has some problems to implement it, which directives in practice. Therefore, Art. 26 of the Regulation No. 78/220 should be amended and the power to issue directives should be given to the ministry of finance and Economic development.

I hereby declare that this paper is my original work and I take full responsibility for any failure to observe the conventional rules of citation.

Name ____________________

Signed ______________

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Introduction

One of the mechanisms in which countries raise revenue to finance government spending on the goods and services that most of us demand is taxation. As compared to the developing countries, the developed countries have been able to generate substantial revenue through imposing of taxes. One of the reasons for this has been the efficient tax system operating in the developed countries unlike the developing economies which are characterized by weak policy and the low development of the formal sectors.

Any government to stand as government should generate revenue. Without taxation we should not talk of progress of a country. One of the most important tax base is taxation from income because income tax is an important source of revenue.

The income tax law imposes obligations both on the tax payer and the tax machineries. To facilitate such obligations, the new income tax law of Ethiopia has in cooperated different kinds of mechanisms. The objective of the paper is therefore, to show the problems of this new income tax law with respect to the rights of the taxpayer, the constitutional principle of judicial power and the severity of the penalties to be imposed in case of failure to comply with the tax law.

The tax Authority, as one of the executive body, to perform its duty as provided by the law should properly understand the tax policy of the country, principles of taxation and the governing tax law. As a result, the tax authority must strictly make its service transparent and accountable so as to help to correct the employees who commit mistakes in the assessment of income tax on taxpayer books of account and records.

This paper has three chapters. The first chapter deals with, historical background, definition, characteristics of a good tax, purpose and effect, and approaches of taxation.

Chapter two, deals with, tax revenue policy, objectives, principles, direct and indirect, assessment, power of taxation, and concurrent jurisdiction of taxation.

Chapter three deals with, presumption of tax, right of taxpayer and three cases which are interpreted. The last part of this paper is devoted to conclusion; recommendation and bibliography.

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