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Edris Seid

2019/20 survey of the Ethiopian tax system

UKaid from the British people

MINISTRY OF FINANCE

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Preface

This report was prepared by the Institute for Fiscal Studies (IFS)'s Centre for Tax Analysis in Developing Countries (TaxDev). TaxDev aims to contribute to more effective tax policymaking in low- and middle-income countries (LMICs) through research and applied policy analysis.

The views expressed in this report are, however, those of the authors and do not necessarily reflect the views of those of the funders nor of the other individuals or institutions mentioned here, including IFS, which has no corporate views.

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1. Introduction

Over the last 15 years, the Ethiopian economy has registered growth of around 10.2% per year in real terms, making it one of the fastest-growing economies in Africa. The country's real GDP per capita also expanded by around 7.4% per year on average. This has contributed to an increase in the country's GDP per capita from US$215 in 2004 to US$602 in 2019 (measured in 2010 prices). Similarly, the poverty headcount ratio declined from 39%[1] in 2004 to 19% in 2020.

During this time, the economy has transitioned from being agriculture-led to being service-led. In 2004/05, agriculture contributed more than 52% to the country's GDP while the service and industrial sectors made up around 35% and 13% respectively. Since then, the GDP shares of the service and industrial sectors have grown relative to agriculture and in 2015/16 the service sector overtook agriculture to be the largest contributor to GDP, although agriculture still remains the country's largest employer with around two-thirds of employment being in agriculture (World Bank, 2019).

However, a number of key economic challenges remain. For example, external public debt has increased as a proportion of national income, despite rapid GDP growth, and in 2018/19 stood at around 28.2% of GDP; the balance of payments has deteriorated; and foreign exchange shortages continue to adversely impact the economy. Recognising the need to correct these macroeconomic imbalances, ease structural bottlenecks and create new growth opportunities, the new government introduced a three-year 'Homegrown Economic Reform' in 2019 that aims to address these issues by implementing a new set of comprehensive reforms.[2]

In June 2020, the government also unveiled a new 10-year development plan under the theme of 'Ethiopia: An African Beacon of Prosperity' for the years 2020/21 to 2030/31 as a successor to the Growth and Transformation Plan (which ended in 2019/20). The new Plan aims to sustain the country's GDP growth and address the main challenges the country faced under previous development plans. It has outlined six strategic pillars that will underpin Ethiopia's economic development objectives over the next decade:

1. ensuring quality economic growth;
2. improving productivity and competitiveness;
3. ensuring institutional reforms;
4. making the private sector the driving force of the economy;
5. ensuring the equitable participation of women and children;
6. building a climate-resilient and green economy.

This 'Perspective Plan' aims to achieve annual GDP growth of 10% or more over the course of the next decade. The industrial sector is expected to be the main driver of economic growth in this period, with a target of 13% growth per year underpinned by a large expansion of the manufacturing sector. It is hoped that this rapid economic growth

[1] Poverty is measured at the national poverty line. The national poverty line was ETB 7,184 per adult per year equivalent in December 2015 prices (World Bank, 2020).

[2] The Homegrown Economic Reform is aimed at ensuring that the development goals under Ethiopia's Growth and Transformation Plan II (GTP II) would be met by identifying reform areas. So, it does not replace GTP II. Details about the reform can be accessed from https://www.pmo.gov.et/initiatives/.

will bring significant improvements in living standards, with the aim of per-capita income reaching US$2,220 by 2030 – taking the country into middle-income status. The Plan also aims to reduce the poverty rate from 19% in 2020 to 7% by 2030.

However, in order to achieve these goals, Ethiopia will require sustained improvements in domestic resource mobilisation. Tax revenues will need to rise in order to fund spending plans and reduce the country's reliance on debt and international donor support. A review of the tax system provides a useful starting point for considering how such improvements could be achieved.

In this report, we provide a detailed overview of Ethiopia's current tax system and the evolution of tax revenue collections over the last 10 years. The report also highlights important changes to the structure of the tax system which have occurred over the past few years, and the associated tax revenue implications.

The report is structured as follows. Section 2 discusses the composition of tax revenue in Ethiopia, while Section 3 provides a detailed description of the structure of Ethiopia's tax system. Section 4 discusses recent tax policy reforms and the direction of reform in Ethiopia. Section 5 compares tax collections in Ethiopia with those in other sub-Saharan African (SSA) and low- and middle-income countries. We conclude the report in Section 6 by considering the implications of these findings for tax policy strategy and the potential next steps for tax reform.

2. Tax revenue in Ethiopia

2.1 Overview

The federal tax system

Ethiopia has a federal tax system, with tax powers and revenues divided between the federal government and the regional states. The power to levy and collect different taxes is allocated either 'exclusively to the federal government; exclusively to the regional states; concurrent to both the federal government and the regional states; [or is] undesignated' (FDRE Constitution, 1995 – Proclamation No. 1/1995). The details of the division of exclusive tax powers are presented in Table 2.1.

Table 2.1. Taxation power of the federal and regional governments

Federal power of taxation	State power of taxation	Concurrent powers of taxation
To levy and collect: • Custom duties, taxes and other charges on imports and exports • Income tax on employees of the federal government and international organisations • Income, profit, sales and excise taxes on enterprises owned by the federal government • Taxes on incomes and winnings from national lottery and games of chance • Taxes on income of air, rail and sea transport services • Taxes on income of houses and properties owned by the federal government • Fees and charges related to licences issued and	To levy and collect: • Income taxes on employees of the state and of private enterprises • Fees for land usufructuary rights • Incomes of private farmers and farmers incorporated in cooperative associations • Profit and sales taxes on individual traders carrying out a business within their territory • Income from transport services rendered on waters within their territory • Taxes on income derived from private houses and other properties within the state; and rent on houses and properties they own	To jointly levy and collect: • Profit, sales, excise and personal income taxes on enterprises they jointly establish • Taxes on the profits and sales of companies and on dividends due to shareholders[3] • Taxes on incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operation

[3] While the English version of the FDRE constitution is ambiguous, the Amharic version clearly states that both profit and sales taxes on companies fall under the concurrent powers of taxation.

services rendered by organs of the federal government • Taxes on monopolies • Federal stamp duties	• Profit, sales, excise and personal income taxes on income of enterprises owned by the regional states • Taxes on income derived from mining operations, and royalties and land rentals on such operations • Fees and charges relating to licences issued and services rendered by state organs • Royalty for use of forest resources	

Source: FDRE Constitution (1995) – Proclamation No. 1/1995.

Concurrent powers are assigned to the federal administration, but the resulting revenue is subject to revenue sharing according to the rules set by the House of the Federation (the higher chamber of parliament). On the other hand, revenues assigned to only one level of government can be fully used at that level, without needing to be shared.

For taxes not captured in the FDRE Constitution referenced above, flexible provisions are made. Specifically, the Constitution states that when a tax is not covered in the Constitution, then the two Houses (the House of the Federation and the House of Peoples' Representatives) shall, in a joint session, determine how taxation powers will be assigned and exercised by a two-thirds majority vote.

Tax revenues

In 2018/19, tax revenue totalled ETB 268.5 billion, of which ETB 74.2 billion was collected by the regional states and the remaining ETB 194.3 billon was collected by the federal government. This equated to a tax-to-GDP ratio of approximately 10%, which is lower than 10 years prior, and it is also significantly below the 2019/20 target of 17.2% that was outlined in the government's Growth and Transformation Plan (GTP II) in 2015 (Federal Democratic Republic of Ethiopia, 2015). There is thus a renewed and strategic focus on improving domestic revenue mobilisation under Ethiopia's new 10-year economic reform agenda, with a revised target of achieving a tax-to-GDP ratio of 18.2% by the end of the Perspective Plan in 2019/30 (FDRE Planning and Development Commission, 2020).

2.2 Revenue by tax type

Tax collections can be classified into three broad groups according to the tax base they are levied on. These include taxes on income and profits (domestic direct taxes); taxes on domestic goods and services (domestic indirect taxes); and indirect taxes on foreign trade (trade taxes). Domestic direct taxes are the most important source of tax revenue in

Ethiopia – contributing 43% (ETB 115.9 billion) of total tax collections in 2018/19.[4] Trade taxes, on the other hand, contribute 28% of total tax revenues (ETB 74.8 billion in 2018/19), while domestic indirect taxes contribute 29% (ETB 77.8 billion in 2018/19).

Table 2.2 provides a more detailed breakdown of the composition of tax revenues by individual tax type based on 2018/19 collections. Corporate income tax (CIT) is the largest component of direct taxation, followed closely by employment income tax (EIT). Together, these two taxes make up nearly three-quarters of all direct tax revenue. Personal business income tax (which is collected by regional states) is also an important element of direct taxation, and contributed 5.5% of all tax revenues in 2018/19.

Table 2.2. General government tax revenue in 2018/19 (million ETB and %)

	Revenue in million ETB	**Share of total tax revenue**
Domestic direct tax	115,858	43.2%
Employment income tax	*41,202*	*15.3%*
Rental income tax	*2,138*	*0.8%*
Corporate business income tax	*44,668*	*16.6%*
Personal business income tax	*14,738*	*5.5%*
Other domestic direct tax	*13,111*	*4.9%*
Domestic indirect tax	77,772	29.0%
VAT on local goods & services	*61,221*	*22.8%*
Excise tax on local goods	*10,055*	*3.7%*
Turnover tax (TOT)	*3,666*	*1.4%*
Other domestic indirect tax	*2,830*	*1.1%*
Trade tax	74,827	27.9%
Customs duty	*24,882*	*9.3%*
Excise on imports	*7,655*	*2.9%*
VAT on imports	*27,889*	*10.4%*
Surtax	*14,397*	*5.4%*
Other trade tax	*3*	*0.0%*
Total tax revenue	268,457	100.0%

Source: Ministry of Revenues, Ministry of Finance and authors' computation.

However, VAT is by far the largest individual contributor to overall tax collections. It comprises about 33% of total tax revenues (and almost three-fifths of all indirect tax revenues) in 2018/19. This is split between collections on domestic transactions and

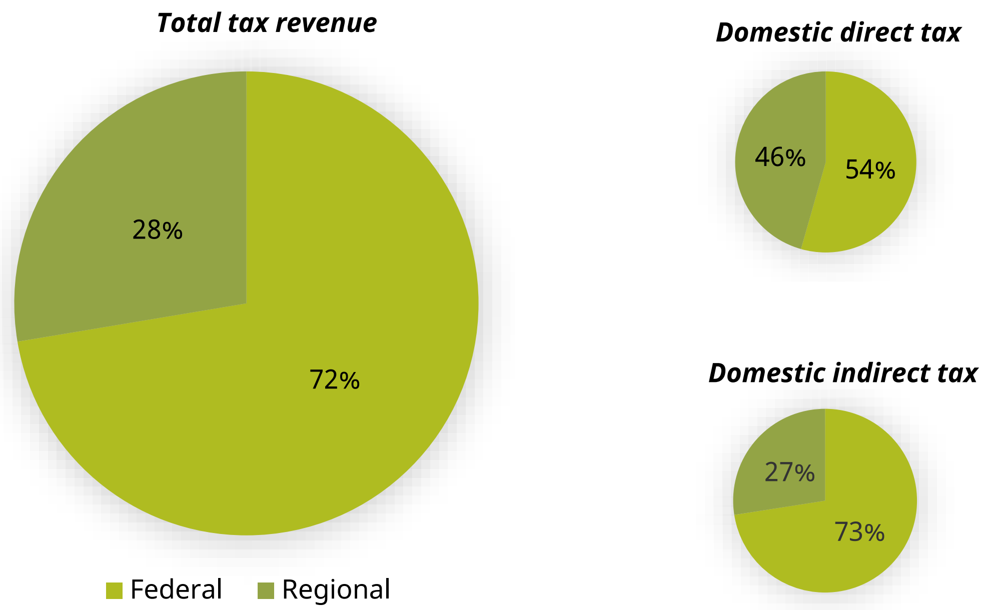
[4] In the latest Tax Revenue Performance Monitoring Report, for 2019/20, the tax revenue trends for the fiscal year 2019/20 for the federal government are reviewed and analysed. But due to reporting lags for regional tax revenue data, the general government trends are limited to 2018/19.

collections on imported goods, with VAT collections on domestic transactions contributing 23% of tax revenues and VAT on imports contributing 10%. Customs duties are the next most important indirect tax, contributing 16% of all indirect taxes and approximately 9% of total tax revenues. Other important indirect taxes include excise tax and surtax, which contributed 6.6% and 5.4% of total tax revenues, respectively, in 2018/19.

Revenues of the federal and regional governments

Despite the devolution of certain tax powers to regional governments, the federal government continues to collect the majority of tax revenue. This is illustrated in Figure 2.1, which shows the share of total tax revenues (as well as total domestic direct and indirect taxes) collected by the different levels of government. Overall, the federal government collects about 72% of general government revenues, while regional states collect only 28%.

Figure 2.1. Regional and federal government's share of total tax revenue, 2018/19



Note: In addition to the revenue divisions shown above, the federal government also collects all trade taxes for Ethiopia.

Source: Ministry of Revenues and authors' computation.

The federal government's majority share is explained primarily by collections of domestic indirect taxes (with the federal government collecting 73% of these taxes) and trade taxes (with the federal government collecting all tax revenues on trade). On the other hand, there is close to an even split on domestic direct tax revenues, with regional states contributing 46% of total collections in this category. In fact, domestic direct taxes account for 71% of regional states' tax revenue collections. These are made up largely of collections of employment income tax (58% of regions' direct tax revenues) and unincorporated business income tax collections (28% of regions' direct tax revenues).

3. The details of the Ethiopian tax system

In this section, we discuss the salient features of the various tax types in Ethiopia, categorising these according to the three overarching groups of taxes outlined in Section 2: domestic direct taxes, domestic indirect taxes and trade taxes.

3.1 Domestic direct tax

All domestic direct taxation is governed by Proclamation No. 979/2016 and Council of Ministers Regulation No. 410/2017 (introduced in 2016 and 2017). These laws provide for the taxation of income in accordance with the following five schedules:

- Schedule A: income from employment;
- Schedule B: income from the rental of buildings;
- Schedule C: income from business activities;
- Schedule D: other income;[5]
- Schedule E: exempt income.

Ethiopia operates a schedular rather than a comprehensive personal income tax system. This means different sources of personal incomes are taxed separately and subject to their own tax rate schedules, rather than being aggregated together and taxed according to the same tax schedule. A number of withholding taxes also apply, which can be offset against other income tax liabilities.

Employment income tax (Schedule A)

Employment income tax (EIT) is levied each calendar month on the employment income that tax-resident employees receive during that month. This differs from the typical approach used in other countries, which tend to instead levy income tax based on annual employee earnings. This means that employees whose incomes vary on a monthly basis may face a higher average tax rate than they would under an annual schedule.

An employee's income tax liability is calculated according to the marginal tax rate schedule shown in Table 3.1. How these thresholds compare with earnings levels in Ethiopia is not entirely clear as good data on the earnings distribution are not available. However, Figure 3.1 shows the marginal and average tax rates faced at each point on the published civil service salary scale. Some public servants such as those working as janitors and security personnel are paid at grades i–v, while skilled personnel without a college diploma (such as drivers) typically start at grade vi and a salary of ETB 2,799 per month. The marginal rate at this salary is 15% and the average tax rate is 10%. Accounting for pension contributions too increases the average tax rate to 17%. Similarly, junior staff with

[5] Here, other incomes include royalties, dividends, interest, income from games of chance, and capital gains. The applicable rate for income from royalties is 5% of the gross amount, for dividends it is 10% of the gross amount, and for interest income derived from a saving deposit with a financial institution that is a resident of Ethiopia it is 5% of the gross amount; otherwise it is 10%.

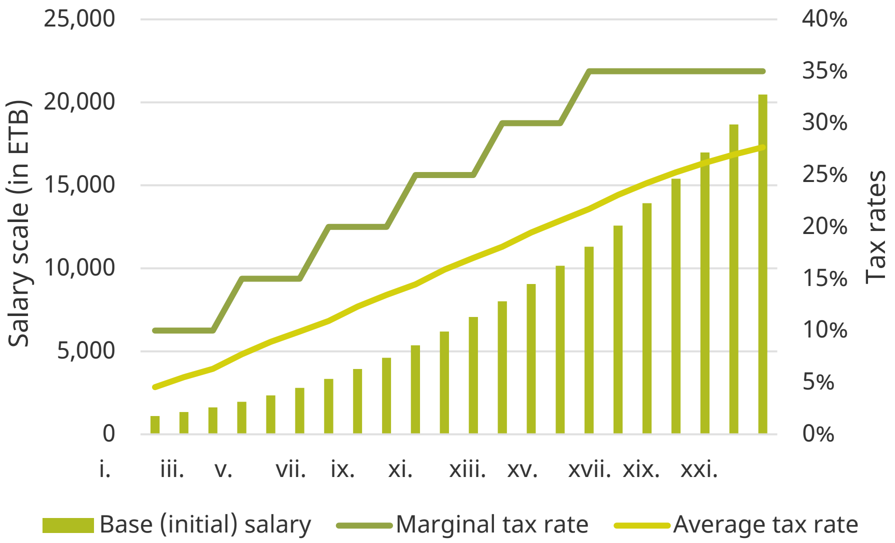
a college diploma and above six years' experience could be at salary grade x earning ETB 5,358, which has a marginal tax rate of 25% and an average tax rate of 14%.

Table 3.1. Employment income tax rates for Ethiopia (Schedule A)

Employment income (per month, ETB)	Applicable rate
0–600	0%
601–1,650	10%
1,651–3,200	15%
3,201–5,250	20%
5,251–7,800	25%
7,801–10,900	30%
Over 10,900	35%

Source: Federal Income Tax Proclamation (No. 979/2016).

Figure 3.1. Civil servants' salary scale, and marginal and average tax rates (inclusive of pension deductions)



Source: Ethiopian Civil Servants Position, Ratings, Grading and Salary Scale (Council of Ministers Regulation No. 455/2019) and authors' computation.

For tax purposes, employment income is defined to include an individual's salary, wages, allowances, bonuses, commission, gratuities, and any other remuneration received by an employee in respect of past, current and future employment. Fringe benefits are also treated as employment income.

While there are no deductible allowances for any expenditure incurred in deriving employment income, the following payments are exempt from income tax:

- an amount paid by the employer to cover actual cost of medical expenses of employees;

- transportation allowances granted under a contract employment;
- hardship allowances;
- contribution of an employer to pension, provident or other retirement fund for the benefit of an employee (provided that the monthly contribution does not exceed 15% of the monthly employment income of the employee).

Pay-As-You-Earn (PAYE) is the commonest mechanism for paying tax on employment income. Employers withhold income tax from employees' salaries, and remit it to the regional revenue authority or the Ministry of Revenues (MoR) each month on their behalf according to the schedule set out in Table 3.1.[6]

Self-employed individuals pay personal income tax according to the same schedule as employees. They are expected to file a tax declaration within 30 days of the end of every month that they earn employment income and make tax payments on the income declared at the end of every quarter (i.e. in four instalments per fiscal year). It is worth noting that since self-employed individuals have relatively volatile monthly earnings, they are more likely to face higher annual average and marginal tax rates than salaried workers.

Rental income tax (Schedule B)

Rental income tax, which falls under regional states' tax jurisdiction, is levied on a person (or a body/entity) renting out a building. The taxable rental income is the gross amount of rental income minus a range of allowable expenses necessarily incurred, including: expenses related to repairs and maintenance; depreciation of the building; furniture and equipment costs; interest expenses; and insurance premiums.[7]

Rental income tax is levied on an annual rather than monthly basis. For individual and unincorporated business landlords, the tax rates and bands are the annual equivalent of the monthly ones used in employment income tax, as shown in Table 3.2. The rental income of incorporated business entities is subject to a flat 30% rate, in line with the corporate income tax rate (see below).

[6] As indicated in Articles 83 and 84 of the income tax proclamation (No. 979/2016), an employee paying income tax via PAYE is not required to file a tax declaration unless he or she has more than one employment income source (in effect, more than one employer). In such cases, the employee is expected to file a declaration within 30 days of the end of every month and pay his or her taxes every quarter.

[7] Because of the land ownership structure in the country where the right to ownership of rural and urban land, as well as of all natural resources, is exclusively vested in the state and in the peoples of Ethiopia, the government only collects taxes on the renting of the building or the property that taxpayers own. But in both rural and urban areas, the regional states have the power to collect fees called urban land lease and rural land use fee. On top of these fees, the regional governments also collect agricultural income tax (collected from the produce of farmers). Hence there is no such thing as tax on land rent. The details of these land use fees and of agricultural income tax are provided in the section on 'Other direct taxes' below.

Table 3.2. Rental income tax rates applicable to individuals

Taxable rental income (per year, ETB)	Applicable rate
0–7,200	0%
7,201–19,800	10%
19,801–38,400	15%
38,401–63,000	20%
63,001–93,600	25%
93,601–130,800	30%
Over 130,800	35%

Source: Federal Income Tax Proclamation (No. 979/2016).

The gross amount of income derived by the taxpayer from the rental of a building in a tax year is defined to include the following:

- all income derived by the taxpayer during the fiscal year under the lease agreement, including any lease premium or similar amount;
- all payments made by the lessee in accordance with the lease agreement;
- the amount of any bond, security or similar amount that the taxpayer is entitled to retain as the result of damage to the building for the fiscal year.

If the taxpayer leases a furnished building, the gross amount of income derived by the taxpayer from the lease of the building includes any amount attributable to the lease of the furniture or the equipment.

As stated in the Council of Ministers Federal Income Tax Regulation (No. 410/2017), income derived from the lease of a business, including goods, equipment and buildings that are part of the normal operation of a business, is taxable under business income tax law, not under rental income tax law.

If the rental income tax for a fiscal year of a taxpayer who keeps records is exceeded by the deductions allowed to the taxpayer as per the income tax proclamation, then the amount of the excess is treated as a rental income loss for the year and the taxpayer is allowed to carry forward the rental income loss into the next tax year.

Business income tax (Schedule C)

Business category

The Ethiopian tax system classifies businesses into three categories – A, B and C – according to whether the business is incorporated or not, and the size of the business as measured by its turnover. Incorporated taxpayers (corporations) are classified as Category A and face the same tax rate (30%) and administrative requirements regardless of their size. For unincorporated taxpayers, these categories determine the information that firms are required to submit when reporting to the revenue authority, and whether the firm must use a cash or an accruals basis for accounting, as shown in Table 3.3. Tax rates and bands for unincorporated businesses are, as for rental income tax, the annualised equivalents of the monthly ones used for employment income tax (as shown in

Table 3.4), except for Category C taxpayers, which are subject to a special presumptive tax regime (see below).

Table 3.3. Categories of firms in Ethiopia, thresholds and reporting requirements

	Threshold for unincorporated businesses	Reporting requirements
Category A (all corporations belong to this category regardless of their turnover)	Over ETB 1 million (this threshold applies to unincorporated businesses or individual businesses)	Businesses are required to submit a balance sheet (a financial statement) and a profit and loss statement showing their gross profit and the manner in which it is computed, general and administrative expenses, depreciation, and provisions and reserves. Businesses must keep their accounts on an accruals basis and must file their returns within four months of the end of the financial year. Businesses liable for rental income tax are required to keep records of rental income received, fees and charges paid to a state or city administration in relation to the rented building, and expenditure incurred by the taxpayer in relation to the rented building, and keep a register of rental buildings showing the acquisition date, the cost of acquisition, any cost of improvement in relation to the building and the current net book value of the building.
Category B	ETB 500,000 to ETB 1 million	Businesses are required to submit a profit and loss statement that summarises the revenues and expenses of the business over the reporting period, but no balance sheet (financial statement) information is required. They can keep simplified books of accounts using cash basis accounting and must file their returns within two months of the end of the financial year, reflecting the simplified requirements. Similar to Category A taxpayers, if these businesses are liable for rental income tax, they are expected to keep records in relation to the rented building (see above under Category A for details).
Category C	Below ETB 500,000	Businesses are not required to keep books of accounts, as firms pay their taxes based on an assessment made by the MoR. However, they can pay according to the information from their own books of accounts if the MoR finds that acceptable and grants them a permission to do so. Category C taxpayers must pay their tax liability within one month of the end of the financial year (i.e. between 7 July and 6 August).

Source: Federal Income Tax Proclamation No. 979/2016; Mascagni and Molla, 2018.

Table 3.4. Business income tax rates for unincorporated or individual businesses

Taxable business income (per year, ETB)	Tax rate
0–7,200	0%
7,201–19,800	10%
19,801–38,400	15%
38,401–63,000	20%
63,001–93,600	25%
93,601–130,800	30%
Over 130,800	35%

Source: Federal Income Tax Proclamation (No. 979/2016).

It is worth noting that business income derived by non-residents with a permanent establishment in Ethiopia is subject to business income tax.

Calculation of taxable income

The process for calculating taxable income varies by taxpayer category.

a) Category C taxpayers

Category C taxpayers are currently subject to a presumptive income tax regime based on their turnover (which is placed into 19 bands), and an assumed profit margin, which varies across sectors – see Appendix Table A.1 for a snapshot of the rate structure of the presumptive taxation.[8] Turnover is first estimated at a daily level by committees set up by the regional revenue authorities for each woreda (district), and then converted into an annual equivalent and placed into the relevant band.

b) Category A and B taxpayers

For Category A and B taxpayers, the gross business income for the year is determined in accordance with the taxpayer's profit and loss or income statement for the year. Business income for a given fiscal year is defined to include the following:

- the gross amount derived by the taxpayer during the fiscal year from the conduct of a business including gross proceeds from disposal of trading stock and gross fees from the provision of services;
- any gain on the disposal of business assets (other than disposal of trading stock) made by the taxpayer during the tax year.

Any expenditure incurred by the taxpayer during the year in deriving, securing and maintaining business income can be deducted from income. This includes the cost of labour, property and equipment rental, and materials and trading stock, as well as allowances for the depreciation of both tangible and intangible assets, according to the

[8] The full rate structure of the presumptive tax for Category C taxpayers by business/sector type can be found in Council of Ministers Regulation No. 410/2017.

rates set out in Table 3.5.[9,10] Businesses are also allowed to deduct interest payments, although interest paid to foreign lenders is deductible only if the borrower has provided the tax authority with a copy of the foreign lender's letter of authorisation from the National Bank of Ethiopia that authorised the loan. In addition, businesses can deduct any losses on business assets (other than trading stock) disposed of during a year.

Table 3.5. Rates of depreciation applicable to a depreciable asset

Depreciable asset	Applicable depreciation rate
Computers, software, and data storage equipment	20%
Greenhouses	10%
Structural improvements on immovable property other than a greenhouse	5%
Any other depreciable asset	15%
Depreciable assets used in mining and petroleum development operations	25%
Preliminary expenditures for intangible businesses	25%
A business intangible with a useful life of more than 10 years	10%
For any other business intangible	100% divided by the useful life of the intangible

Note: Depreciation rates operate on a straight-line basis.

Source: Council of Ministers Regulation No. 410/2017.

Finally, charitable donations are deductible if the donations are made to Ethiopian charities and societies or made in response to a development call or an emergency call by the government to defend the sovereignty and integrity of the country.

Business income tax exemptions for investors

The Government of Ethiopia offers various investment incentives, among which are business income tax exemptions for investors involved in certain businesses and sectors including: the manufacturing sector; the agriculture sector; ICT development; electricity generation, transmission and distribution; hotel and tour service providers in non-traditional tourism destinations; industrial parks development; and pharmaceutical production in industrial parks. The investment incentives are aimed at encouraging both

[9] However, the Federal Income Tax Regulation (No. 410/2017) states that no depreciation deduction shall be allowed for the cost of a depreciable asset or business intangible acquired by a taxpayer from a related person ('transferor') when the cost of the asset or intangible had been fully depreciated by the transferor.

[10] Lease payments made for business assets held under capital goods lease agreements are deductible as business expenditure from gross business income. However, if a taxpayer does deduct lease payments for business assets, they are not able to claim a depreciation allowance for the same assets.

foreign and domestic investment, promoting technological transfer and supporting equitable distribution of investment among the regional states.

Council of Ministers Regulation No. 270/2012 lists the various businesses with income tax exemptions granted to investors. The income tax exemptions vary across sectors and locations of investments. Details of the business income tax exemptions by sector/business type and location can be found in Appendix Table A.2.

Other direct taxes (Schedule D)

Other taxable sources of income include royalties, dividends, interest income, winnings from games of chance, and gains on the disposal of investment assets. Hence, any resident who derives income from these sources (as well as any non-resident who derives income from these sources that is attributable to a permanent establishment) is liable for income tax. The tax rates applied to incomes derived from these different sources are shown in Table 3.6.

Table 3.6. Details of other direct taxes

Income source	Applicable tax rate and tax base	Details
Royalty	5% on the gross amount of the royalty	Residents of Ethiopia and non-residents who derive an Ethiopian-source royalty that is attributable to a permanent establishment of the non-resident in Ethiopia shall be liable for income tax.
Dividend	10% on the gross amount of the dividend	Residents of Ethiopia and non-residents who derive an Ethiopian-source dividend that is attributable to a permanent establishment of the non-resident in Ethiopia shall be liable for income tax.
Interest income	5% of the gross amount of interest in the case of a savings deposit with an Ethiopian financial institution; otherwise 10% of the gross amount of interest income	Residents of Ethiopia and non-residents who derive Ethiopian-source interest that is attributable to a permanent establishment of the non-resident in Ethiopia shall be liable for income tax. However, for incorporated businesses engaged in financial business deriving interest and related income, this is

		treated as part of their business income.
Game of chance	15% on the gross amount of the winnings	A person who derives income from winning at games of chance held in Ethiopia shall be liable for income tax.
Undistributed profit	10% on the gross amount of undistributed profit	Resident bodies are liable for withholding tax on the net value of undistributed profit that is not reinvested.
Repatriated profit	10% on the gross amount of repatriated profit	Non-residents conducting business in Ethiopia through a permanent establishment shall be liable for withholding tax on this profit.
Income of non-resident entertainers	10% on the gross amount of income derived from the performance (without deduction of expenses)	Non-resident entertainers (or groups of non-resident entertainers) who have derived income from participating in a performance taking place in Ethiopia shall be liable for withholding tax on this income.
Other income of non-residents	Insurance premium or royalty at 10%; dividend or interest at 10%; management or technical fee at 15%	Non-residents who have derived an Ethiopian source dividend, interest, royalty, management fee, technical fee, or insurance premium shall be liable for non-resident withholding tax at the specified rate on the gross amount of income.
Gains on disposal of investment asset	15% for disposal of an immovable asset;[11] 30% for disposal of a share or a bond	A person who derives a gain on the disposal of an immovable asset, a share or a bond (referred to as a 'taxable asset') shall be liable to pay income tax.

[11] 'Immovable asset' shall not include a building held and wholly used as a private residence for years prior to the disposal of the asset.

Casual rental income	10% on the gross amount of rental income	A person who derives casual rental from an asset in Ethiopia (including any building or movable asset) shall be liable to pay income tax.
Windfall profits	Initially specified as ‘a rate to be determined in such Directive by the Minister of the Ministry of Finance’. In 2010, a directive was issued by the Ministry of Finance (Directive No. 29/2010) to determine the amounts banks should pay in taxes on windfall incomes they got from the devaluation of the ETB against the Dollar. The rate was 75% of the windfall profits.	Windfall profit obtained from businesses prescribed in a directive to be issued by the Minister shall be liable to tax.
Rural land use fee	There is variation across the regions in the applicable rate schedule and exemptions. For example, in Oromia,[12] the rates are determined based on the landholding size. The payments are to be made annually.	The regional states have the power to levy and collect such taxes. The respective regional states issue their own proclamation for these taxes. Hence the applicable rates vary across the regional states.
Agricultural income tax	Similar to the rural land use fee, this tax is also determined based on land size. In some regions, the rates vary between rain-dependent farmers and those who farm using irrigation.	As above (‘Rural land use fee).
Urban land lease	The fee rate varies across the regional states, but the fee is determined based on land size, use and location.	This tax is also collected by the regional states (but only by municipalities).

[12] The details of Oromia’s applicable rates for agricultural income tax and rural land use fee are available at http://extwprlegs1.fao.org/docs/pdf/eth150706.pdf.

All other non-employment income	10% on the gross amount of income	A person who derives any other income in Ethiopia that is not taxable under Schedule A, B or C (or within the Schedule D income streams listed above) shall be liable to pay income tax at the specified rate.

Source: Federal Income Tax Proclamation (No. 979/2016).

Under Schedule D, there is also a withholding tax collected from domestic payments. Bodies having legal personality (apart from micro enterprises), government agencies, non-governmental organisations, non-profit organisations and other taxpayers required by law to withhold taxes shall withhold tax at the rate of 2% of the gross amount of a payment made for the following:

- the supply of goods in Ethiopia involving more than ETB 10,000 in one transaction or supply contract;
- the supply of services involving more than ETB 3,000 in one supply contract.

The withholding rate will be a flat rate of 30% if the supplier to a transaction fails to provide his or her Tax Identification Number. It is worth noting here that, similar to the withholding taxes on imports, these taxes are not final taxes in a strict sense for they will be offset against taxes due from the company or individual that the tax was withheld from.

Exempt incomes (Schedule E)

The income tax law exempts certain income sources (employment or business) from income tax payment. These include:

- any amount paid by an employer to cover the actual cost of medical treatment of an employee;
- hardship allowances given to employees;
- an allowance for transport costs granted under a contract of employment;
- travel expenses and a per diem payment (e.g. to cover accommodation and food) for employees travelling as part of their work ('a tour of duty');
- the cost of travel from and to an employee's normal place of residence if that differs from the place of employment, both at the start and end of the term of employment.

3.2 Domestic indirect tax

Value added tax (VAT) and turnover tax (TOT)

The Government of Ethiopia introduced VAT into the Ethiopian tax system in 2003 – following the ratification of the Value Added Tax Proclamation No. 285/2002. At the same time, Proclamation No. 308/2002 introduced TOT.

As shown in Table 3.7, Ethiopia operates an invoice-credit system whereby VAT-registered suppliers deduct the VAT paid on their inputs from their output VAT and remit only the net amount. VAT registration is compulsory for persons/businesses with annual turnover above ETB 1 million.[13] Businesses with turnover lower than this can voluntarily register for VAT if at least 75% of their sales are regularly made to VAT-registered businesses and they can demonstrate that they have the capacity to comply with the bookkeeping requirements of the VAT system.

Table 3.7. Key features of the TOT and VAT systems in Ethiopia

	Turnover tax	Value added tax
Legislation	Proclamation No. 308/2002	Proclamation No. 285/2002 Proclamation No. 609/2008 Proclamation No. 1157/2019 VAT Refund Directive No. 148/2019 VAT Withholding Directive No. 60/2019 Compulsory VAT Registration Threshold (Circular T/K/Q/5/161)
Registration threshold	Annual turnover up to ETB 1 million	Annual turnover above ETB 1 million
Rate structure	2% on goods sold locally and services rendered locally by contractors, grain mills, tractors and combine harvesters; 10% on other services	15%. But there are exemptions and zero rates applicable to some goods and services. Some of these were granted in the original legislation, but most exemptions since then have been granted through directives issued by the Ministry of Finance. Imports are subject to VAT, but exports are zero-rated (the destination principle).

Note: The 2% rate of TOT also applies to services provided by contractors, grain mills, tractors and combine harvesters. According to Proclamation No. 286/2002, '"Contractor" shall mean an individual who is engaged to perform services under an agreement by which the individual retains substantial authority to direct and control the manner in which the services are to be performed'.

Those businesses not registered for VAT must instead calculate and pay the turnover tax. TOT is a sales tax charged on the value of a business's annual turnover. Unlike VAT-registered firms, businesses paying TOT cannot reclaim any VAT paid on inputs. Furthermore, no businesses can reclaim any TOT paid on their input purchases.

[13] Businesses in certain sectors (such as shoe manufacturers) or businesses that are importers must register for VAT even if their turnover is below ETB 1 million. A full list of such sectors and activities is provided in the *VAT and TOT Overview Policy Study* (Federal Democratic Republic of Ethiopia MoFEC and IFS, 2017). The study reports that these sectors/activities were chosen for mandatory registration because tax officials believe that turnover is very likely to exceed the registration threshold.

VAT and TOT rates

The standard rate of VAT in Ethiopia is 15%. However, Ethiopia's tax system also applies differential VAT rates in the form of either VAT exemptions or zero rates. The majority of the existing exemptions and zero rates were included in the original Proclamation that introduced VAT in 2002. In recent years, while no additional zero rates have been introduced, the number of VAT exemptions has increased, due to the fact that the Ministry of Finance has been given the power to exempt goods and services by directive.

The major categories of goods and services subject to exemptions and zero rates are listed in Table 3.8. In addition to these, VAT exemptions have also been introduced for the supply of specific goods and services to specific types of purchasers: the supply of cotton for textile factories; the sale of finished leather from tanning factories to shoe factories; the sale of air travel by travel agencies; the marketing of pickle, wet-blue and crest products; and goods and services procured by the Ethiopian Electric and Power Company for power transmission projects.

Table 3.8. Key exemptions and zero rates set in place under Article 7(2) and Article 8 of Proclamation No. 285/2002

Exempted items	Zero-rated items
Real estate services (including the sale of a used dwelling and the rental of a dwelling)	The export of goods and services
Financial services/permits and licence fees	International transportation (and goods/services directly connected to the delivery of this service)
Sale or import of a national or foreign currency or security	Gold supplied to the National Bank of Ethiopia
Religious and other related cultural services	The supply/sale of a 'going concern' (i.e. transfer of business)
Health/medical services, educational/childcare services, books and printed materials	
Transportation services, utilities (electricity and water) and kerosene/imported cement	
Goods and services for humanitarian aid	
Mosquito nets, condoms, water treatment chemicals and prescription drugs / eye glasses	
Basic foodstuffs (e.g. milk, bread, injera, unprocessed grains, wheat flour, oil seeds; but excluding most vegetables)	
Key agricultural inputs, including fertilisers, pesticides, poultry feed and improved seeds and saplings	

Note: The lists above are not exhaustive.

Source: Federal Democratic Republic of Ethiopia MoFEC and IFS, 2017; Value Added Tax Proclamation (No. 285/2002).

The standard TOT rate is 2% on goods sold locally and services rendered locally by contractors, grain mills, tractors and combine harvesters, and 10% on other services. The

TOT exemptions that are offered seem to be aligned (to some extent) with the VAT rate structure but are more limited in scope. They include exemptions on:

- the sale or transfer of a used dwelling;
- financial services;
- the supply of national or foreign currency;
- religious or other related services;
- the provision of transport services;
- utilities (electricity and water) and kerosene;
- books and printed materials.

International and inter-regional features of the VAT system

In the context of international trade, Ethiopia's VAT operates on a destination principle, meaning imports are subject to VAT but exports are zero-rated, so exporters can request a refund of the VAT they paid on their input purchases. This is in line with best practice and ensures that Ethiopia's domestic businesses are not disadvantaged (which would be the case if imports were untaxed and exports were taxed). However, the operation of the VAT system across different regions in Ethiopia is based on the origin principle, with VAT remitted in the region in which the seller (rather than the purchaser) is registered for tax purposes. Because the same VAT rates apply across Ethiopia, this does not distort trade (which it would if different VAT rates were charged in different regions). But it means that revenues accrue to the regions where businesses are based and registered, rather than where their customers are.

VAT withholding system

Government entities and state-owned enterprises are required to withhold the VAT due on purchases. Previously, 100% of the VAT was withheld and remitted directly to the tax authorities. However, this meant that businesses conducting significant volumes of business with the government and state-owned enterprises had reduced cash flow and would often require refunds of VAT paid on purchases of inputs. As a result, amendments to the VAT law (Proclamation No. 1157/2019) introduced in 2019 reduced the withholding rate to 50%, with 50% of the VAT being transferred to the vendor, increasing their cash flow and reducing the likelihood of VAT refunds being required. Previously, government entities and state-owned enterprises were required to procure goods and services from only VAT-registered suppliers when the procurement exceeded ETB 50,000, but this threshold is now ETB 200,000.

VAT refund system

The Ministry of Revenues issued a new directive (Directive No. 148/2019) in 2019 which aims at making it quicker for taxpayers to obtain VAT refunds if the deduction for VAT paid on inputs exceeds the VAT due on outputs. The directive allows for refunds in the following circumstances:

- companies engaged in the mining sector (in oil and mineral exploration) where exploration is not successful provided that the companies could provide sufficient evidence from the Ministry of Mines and Petroleum;

- businesses engaged in the export sector that are beneficiaries of the Export Trade Duty Incentive Scheme under Proclamation No. 768/2012 are allowed a refund of the input VAT, even prior to exports taking place;
- for input VAT paid on goods and services used in condominium housing projects and Defence Foundation construction projects;
- any VAT paid on goods and services to be distributed by NGOs for emergency relief and related activities;
- those who have a National Bank of Ethiopia permit/licence to provide capital goods on lease financing can get a refund on any VAT paid on the capital good (while purchasing the good from local manufacturers or importers);
- businesses that have paid input VAT and have an output invoice from a VAT Withholding Agent.

VAT collected from capital goods transactions will also be refunded immediately.

VAT filing

Businesses registered for VAT must file taxes monthly if they have an annual turnover of ETB 70 million or higher, but can file quarterly if their turnover is below this threshold. Every business or person registered under the VAT system is required to file a VAT return with the Ministry of Revenues for each period regardless of whether tax is payable during that accounting period. They are also required to pay the tax for every accounting period by the deadline for filing the VAT return.

The TOT filing requirements vary for the different categories of taxpayers mentioned previously in the business income tax section. ‘Category B’ taxpayers are required to file and pay taxes on a quarterly basis. For ‘Category C’ taxpayers who are not required to keep records, the filing and payment period is the fiscal year.[14] Taxpayers subject to TOT are required to file a TOT return with the tax authority within one month of the end of every accounting period, and pay the tax for every accounting period by the deadline for filing the TOT return.

Excise tax

Excise tax was introduced into the Ethiopian tax system through the Excise Tax Proclamation No. 307/2002. Under this original law, the tax base for the computation of excise taxes differed for locally produced goods and imported goods. For locally produced goods, the tax base was defined as the cost of production. For imported goods, the tax base was defined as the sum of the CIF[15] value and the applicable customs duty. However, the computation and validation of the tax base for locally produced goods (i.e. the cost of production) created administrative challenges for the tax authority. The new excise tax proclamation (No. 1186/2020) issued in 2020 therefore changed the tax base for locally produced goods to the ex-factory price of the goods, albeit excluding VAT, the cost of excise stamps and the cost of returnable containers.

Proclamation No. 1186/2020 has been applied since mid-February 2020, and included additional changes to the applicable excise rates for various goods. Excise duty rates now range from 0% to 500% (of either the ex-factory price or CIF value plus customs duties),

[14] ‘Category A’ taxpayers are not eligible to be registered for TOT.

[15] Cost of product, plus insurance and freight costs.

with the tax being applied to certain demand-inelastic and luxury items, as well as to goods that are assumed to have negative externalities (e.g. fuel, alcohol, tobacco). The tax rates applied to different goods are shown in Table 3.9.

Table 3.9. Applicable excise tax rates for goods and services

Goods/Service description	Applicable rate
Fats and oils	30%, 40% and 50%
Sugar and sugar confectionery	20% and 30%
Chocolate and food preparations containing cocoa	30%
Soft drinks powder	25%
Beverages and spirits	Between 10% and 80%
Tobacco and tobacco products	20% and 30%
Salt	25%
Mineral fuels, oil and oil products	30%
Perfumes, toilet waters and beauty products	100%
Fireworks	100%
Plastic shopping bags	ETB 40 per kg
Rubber tyres	5%
Textiles and textile products produced by industries	30% on carpets 8% on all other textile products
Artificial flowers, foliage, fruits and articles made of artificial flowers, foliage and fruits	10%
Human hair and wigs	40%
Asbestos and asbestos products	20%
Natural or cultured pearls and precious or semi-precious stones	20%
Video recording or reproducing apparatus, TV broadcast receivers, cameras	10%
Motor passenger cars, station wagons, utility cars, Land Rovers, Jeeps, pickups and similar vehicles	Between 5% and 500% depending on the engine size, age and type of the vehicle

Note: For detailed excise rates, see Appendix Table A.3.

Source: Excise Tax Proclamation (No. 1186/2020).

However, certain businesses or goods are subject to excise tax exemptions. Specifically, no excise tax is charged on the following:

- excisable goods exported under customs control, including those stored in the approved (bonded) warehouse;
- imported goods that meet the conditions for import tax exemptions set out in the second import tariff schedule (see Section 3.3 below);
- denatured alcoholic products that cannot be consumed by humans;
- excisable goods supplied to entities that are exempt from excise tax by law;
- goods exempted by the Minister of the Ministry of Finance for economic, social and administrative reasons;
- excisable goods that the manufacturer has destroyed with prior permission from the Ministry of Revenues under the supervision of an Officer of the Ministry of Revenues;
- excisable goods that have been lost or destroyed through unavoidable accidents (e.g. during transit).

Excise tax deductions are also granted for excise tax paid on inputs and raw materials when excise tax is also due on a final product.

For locally produced excisable goods, excise tax payments are required to be made when the goods leave the factory and are paid by the producer. For imported goods (including petroleum products), excise taxes are required to be paid at the time of importation by the importer, unless special permits are granted under a directive issued by the Minister of Finance.

Stamp duty

Stamp duty was introduced in 1998 and is chargeable on various legal, commercial and financial instruments, as outlined in Table 3.10.

Table 3.10. Applicable stamp duty rates for legal, commercial and financial instruments

Instrument description	Applicable tax rate
Memorandum and articles of association of any business	Flat rate of: ETB 350 upon first execution ETB 100 upon any subsequent execution
Memorandum and articles of association of cooperatives	Flat rate of: ETB 35 upon first execution ETB 10 upon any subsequent execution
Award	1% of the determinable value; or ETB 35 on any undeterminable value
Bonds	1% of value of bond
Warehouse bonds	1% of value of bond
Security deeds	1% of value of security deed
Contractor agreements and memoranda thereof	A flat rate of ETB 5
Collective agreement	1% of value of collective agreement
Contract of employment	1% of salary
Lease, including sub-lease and transfer of similar rights	0.5% of the value
Notarial act	Flat rate of ETB 5
Power of attorney	Flat rate of ETB 35
Register title to property	2% of the value of the property

Source: Ethiopian Chamber of Commerce (ECC) and Ethiopian Business Development Services Network (EBDSN), 2005.

Stamp duty payments are to be made: before or at the time of the registration of businesses/cooperatives; before or at the time of the issuance of an award, notary act or property title; and at the time of signature for security deeds, bonds, agreements and contracts.

No stamp duty is required to be paid in the following cases:

- the issuance of share certificates on the register of a title of property;

- the import of goods by traders that have an import licence and when first registered in the name of the trade;
- transactions by public bodies on which the Federal Government of Ethiopia Financial Administration Proclamation No. 57/1996 applies;[16]
- documents granted exemptions from the payment of stamp duty in accordance with international agreements and conventions approved by the government;
- subject to reciprocity, the Minister may grant embassies, consulates and missions of foreign states exemption from payment of stamp duty;
- any transaction granted discretionary exemption for good cause by the Ministry of Revenues.

3.3 Trade taxes

Customs duties

Customs duties are levied on goods imported into Ethiopia, are administered and collected by the Customs Commission division of the federal MoR, and must be paid before the imported items can be released to the importers.

The tax base for customs duties is the CIF value of imports.[17] Tax rates vary across goods, which are classified using the internationally recognised Harmonised Commodity Description and Coding System (HS). Standard tax rates vary between 0% and 35%, with goods often used as raw materials or in capital investment projects typically subject to zero or low rates of duty, and goods generally used as final consumption goods typically subject to high rates of duty. Full information on the tariffs applied to different goods (by eight-digit HS code) can be found in the Ethiopian Custom Tariff Book 2017.[18]

As a member of the Common Market for Eastern and Southern Africa (COMESA) preferential trade area, Ethiopia grants preferential customs treatment for goods originating from COMESA member states – a 10% reduction in the regular customs duty rates, as shown in the second column of Table 3.11.

As well as varying across goods and countries, duty rates vary according to the use of an import. In particular, the Ethiopian government has two customs tariff schedules: the general one (i.e. ‘first schedule’), shown in Table 3.11; and a second schedule which applies exemptions or reduced rates for particular goods when imported for a specific use by certain sectors or businesses. Moreover, additional discretionary exemptions are also granted for goods imported as part of capital projects (when importers have been issued with an appropriate investment licence).

[16] This includes transfers between public bodies, transfers that form part of public expenditure and any aid in kind received by the federal government from bilateral or multilateral agreements or from other sources.

[17] The CIF value of imports is the sum of the transaction value of the goods, transportation charges and transport insurance paid. In other words, the tax base is defined as the sum of the transaction value (cost of goods), transport charges paid to transport the good from the original port of loading to the port of entry in Ethiopia, the transport insurance paid and other charges such as loading and unloading charges and port charges.

[18] Available at https://www.lawethiopia.com/index.php/volume-3/6460-custom-tariff-books.

Table 3.11. Customs duty rates

Regular customs duty rate	COMESA customs duty rate
0%	0%
5%	4.5%
10%	9%
20%	18%
30%	27%
35%	31.5%

Source: Ethiopian Customs Commission.

These preferential rates, when combined with the number of goods subject to zero or low rates under the general tariff schedule, mean that a large majority of imports are subject to either 0% or 5% duty rates.[19] In 2018/19, for example, more than 78% of imports (measured in terms of CIF value) fell into these two categories. On the other hand, goods with higher customs rates constituted a very small share. In that same year, imports with 30% and 35% duty rates made up only 8% of the total imports of the country. (See Table 3.12.)

Table 3.12. Imports and import tax revenues in 2018/19 (million ETB and %), by duty rate category

Duty rate applied	Import (CIF) value	Share of import value
0% duty rate	304,899	63%
5% duty rate	70,808	15%
10% duty rate	37,781	8%
20% duty rate	29,375	6%
30% duty rate	16,788	3%
35% duty rate	20,929	4%

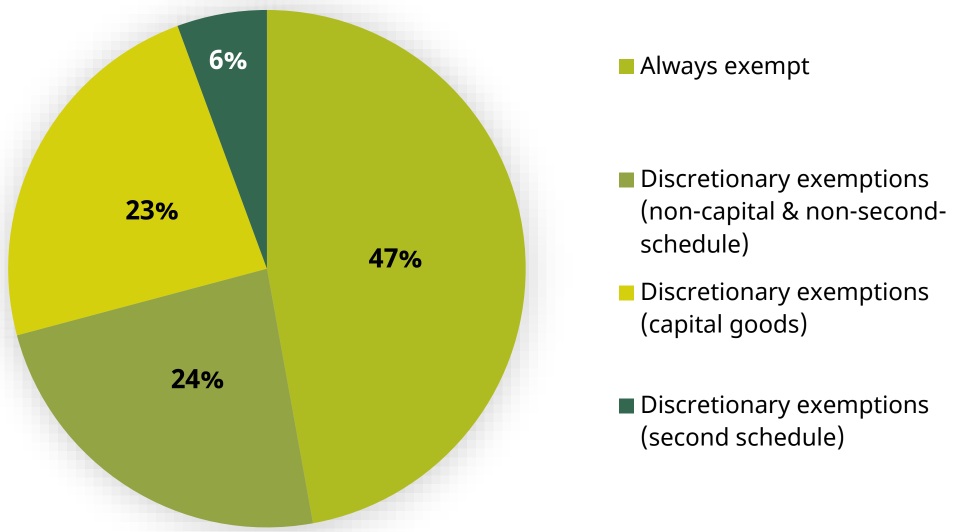
Source: Authors' computation using Ethiopian Customs Commission customs data.

Figure 3.2 shows the composition of zero-rated (duty) imports by capital, second schedule and discretionary exemptions status. The bulk of the exempted items were imported through non-discretionary exemptions (making up around 47% of total exempted imports in 2018/19, which were around ETB 304.9 billion); 24% of the exempted imports were granted non-capital and non-second-schedule discretionary exemptions; and discretionary exemptions through the second schedule and capital goods constituted around 6% and 23% respectively in 2018/19. It is also worth noting that a very small

[19] It is worth noting that the second tariff schedule was reviewed in 2019/20, and the number of customs duty exemptions offered via this channel was significantly reduced as a result. However, as second tariff schedule exemptions originally accounted for only a small portion of all exemptions granted, this is unlikely to have significantly increased the size of the customs duty tax base.

amount of the imports had discretionary exemptions through both capital goods and second schedule exemption privileges.

Figure 3.2. Composition of the exempt tax base for imported items in 2018/19, by exemption type



Source: Authors' computation using Ethiopian Customs Commission customs data.

The government also operates a set of trade duty incentive schemes targeted at supporting local exporters, such as:

- duty draw-back scheme;
- voucher scheme;
- bonded export factory scheme;
- bonded manufacturing warehouse scheme;
- bonded input supplies warehouse scheme;
- industrial zone schemes.

These schemes allow exporters to be eligible for preferential customs duty rates or allow them to claim back customs duty payments on imported raw materials used in the production of goods eventually exported. Under the duty draw-back scheme, for example, duty paid on goods imported or purchased locally by beneficiaries of the scheme is refunded to them upon fulfilment of the conditions laid down in directives issued by the Ministry of Finance. On the other hand, raw materials imported by a person who is a beneficiary of the bonded export factory scheme must be transported to the factory under the control of the customs authority without being subject to payment of duty. These raw materials must then be used solely in the production of the specified export commodity, with the commodity required to be exported within one year of receipt of such raw materials by the factory.

Surtax

Surtax was first introduced into the Ethiopian tax system in 1999 (Council of Ministers Regulation No. 59/1999) but it was abolished in 2001 (Council of Ministers Regulation No. 69/2001). Then in 2007 it was reintroduced (Council of Ministers Regulation No. 133/2007) and levied on goods imported into Ethiopia at a flat rate of 10% – albeit with significant exemptions – with the tax base being the CIF value of imported goods, plus all customs duty, excise tax and VAT payable on these goods. As with customs duties, it is collected and administered by the Customs Commission division of the federal MoR.

The original proclamation governing surtax introduced exemptions for specific goods. These included exemptions on the import of: fertilisers, petroleum and lubricants, motor vehicles for freight and passengers as well as special motor vehicles, aircraft, spacecraft, and capital (investment) goods.

Alongside these specific exemptions, the relevant tax proclamation (No. 133/2007) allows for a degree of flexibility in the granting of new surtax exemptions. First, it states that all goods imported by persons/organisations facing preferential customs duty rates are to be exempted from surtax. Thus, all goods imported by eligible importers under the second tariff schedule are automatically exempted from surtax payment. Second, the proclamation also gives discretion to the Ministry of Finance to add (or remove) exemptions and to issue directives formalising the implementation of such changes. Third, there appears to have been flexibility in the definition of capital/investment goods.[20] As a result, the following goods, which were not exempt from the surtax in 2007/08, were observed to be uniformly exempt from the surtax in 2018/19:

- various foodstuffs (e.g. groundnuts, potatoes, sugar, certain meats);
- certain other petroleum products (e.g. oil shale, tar sands, liquid paraffin);
- certain types of machinery (e.g. static converters, data processing machines, machinery for working metal, wood dryers, centrifugal pumps);
- certain medical supplies (e.g. penicillin, antibiotics);
- various iron, steel and alloy products.

Withholding tax on imports

A taxpayer under Schedule C importing goods for commercial use must make an advance payment of business income tax to the tax authority at a flat rate of 3% on the CIF value of imports. Hence, this tax is not an import tax in the strict sense, but formally part of the income tax system – as the collected amount is creditable against the income tax liability of the taxpayer for the relevant fiscal year. The taxes are paid before the imported goods are released by the Customs Commission. If the total amount of advance payment exceeds the business income tax liability of the taxpayer for the tax year, then the tax authority applies the amount of the overpayment in the following order:

- first, in payment of any other tax (other than withholding tax) owed by the taxpayer under the income tax law;
- then, in payment of tax owed by the taxpayer under any other tax law;
- then, refund the remainder, if any, to the taxpayer within 45 days of determining that the taxpayer is entitled to the refund.

[20] Capital goods are defined as machinery, equipment and their accessories needed to produce goods or render services and include workshop and laboratory machinery and equipment necessary for the same (Investment Proclamation No. 769/2012, Article 2.5 (as amended)). This definition is further expanded through a decision of the Investment Board to include Special Purpose Integrated Trucks and handling equipment destined for sector-specific purposes.

VAT and excise tax on imports

VAT and excise duties are also payable on the relevant taxable imported supplies (with the same exemptions as outlined in Section 3.2) and are collected and administered by the Customs Commission division of the MoR. Collections at customs are reported separately in revenue figures and import VAT and excise duties are included in the totals for trade taxes, rather than within domestic indirect taxes.

4. Recent reforms and trends

This section highlights recent developments in Ethiopia's tax system, focusing on key tax policy reforms and recent trends in revenues generated from different tax instruments.

4.1 Tax policy reforms

The Government of Ethiopia has introduced a series of comprehensive tax reforms especially in the last seven years. These include both tax policy and administration reforms, covering a broad range of tax types such as excise tax, federal income tax and VAT.

Tax policy reforms are usually initiated by the Ministry of Finance. In some instances, however, tax policy reform requests come from other ministries with a specific interest. In 2019, for example, the MoF granted duty-free importation of various agricultural equipment based on a request from the Ministry of Agriculture and the Agricultural Transformation Agency, which had conducted a prior study on the implications of such incentives for the modernisation of the agricultural sector.

Table 4.1 provides a list of the most recent tax policy reforms undertaken in the country. Broadly speaking, there have been several main reasons for reforms, including:

- updating tax thresholds to account for inflation (e.g. increasing income tax thresholds and VAT registration thresholds);
- enacting improvements and addressing issues identified by systematic reviews (e.g. changes to VAT filing, withholding and refund policies to reduce administrative and compliance burdens and improve cash flow);
- broadening tax bases and raising revenues (e.g. reforms to the excise tax base, the removal of some goods and importers from the second tariff schedule, and increases in excise duty rates);
- pursuing wider policy objectives (e.g. tackling pollution via increases in excise duties on older cars with large engines, supporting agricultural modernisation using import and other tax exemptions, and helping businesses and workers during the COVID-19 crisis via a range of policy and administrative changes).

Unfortunately, the fact that reforms have not been consistently costed means it is not possible to say concretely whether reforms have increased revenues – although that has been and continues to be one of the main objectives of tax policy and administration overall. Looking ahead, maintaining a database of policy costings will make it easier to assess the effect of reforms on domestic resource mobilisation.

Table 4.1. Tax policy reforms in Ethiopia

Tax type	Reform
(Federal income) tax administration reform	In **2016**, a comprehensive Federal Tax Administration Proclamation (Proclamation No. 983/2016) was issued. The new law states that implementation and enforcement of tax laws shall be the duty of the Ethiopian Revenues and Customs Authority, which became the Ministry of Revenues in 2018. The Tax Appeal Commission was also established to hear appeals against appealable decisions, to be accountable directly to the Prime Minister.
Employment income tax	The Federal Income Tax Proclamation (Proclamation No. 979/2016) was enacted in **2016**, replacing the previous Income Tax Proclamation (Proclamation No. 286/2002). Similarly, the Council of Ministers Regulation No. 410/2017 replaced the Income Tax Regulation No. 78/2002. The new law revised the income tax brackets upward. The employment income tax exemption threshold increased from ETB 150 to ETB 600 (per month), while the threshold for the top marginal income tax rate was raised from ETB 5,000 to ETB 10,900. This upward revision of tax brackets also applied to the rental income tax schedule. However, the increases did not completely undo the previous erosion of the real-terms value of thresholds set in 2002, and inflation since 2016 has started to erode the real-terms value of the new thresholds.
Unincorporated business (personal businesses) income tax	The **2016** Federal Income Tax Proclamation also introduced the same upward revision to the tax schedule for unincorporated business (personal businesses) income tax. For example, the minimum annual exempted business income was raised from ETB 1,800 to ETB 7,200. In addition, it increased the annual gross income thresholds for the various taxpayer categories. Accordingly, Category A taxpayers are those with annual gross income above ETB 1.0 million (increased from ETB 0.5 million), Category B taxpayers are those with annual gross income between ETB 0.5 million and

ETB 1.0 million (increased from between ETB 0.1 million and ETB 0.5 million) and Category C taxpayers are those with annual gross income less than ETB 0.5 million (increased from ETB 0.1 million).

The proclamation also introduced a new law requiring Category B taxpayers to keep a simplified book of account.

Business profit tax (corporate income tax)

The **2016** Federal Income Tax Proclamation (Proclamation No. 979/2016) introduced a number of changes to corporate income tax related to allowable deductibles/expenses. Specifically, the following changes were made in the new income tax reform:

- Depreciation rates for certain assets have been revised downward. For example, for computers, software and data storage equipment, the rate was reduced to 20% from 25%. Previously, all other assets had a depreciation rate of 25%. But this rate has now been reduced to 15% apart from assets used in mining and petroleum development operations.
- Previously, donations or gifts were non-deductible, but the new law allows businesses deductions when donations are made to Ethiopian charities and societies or made in response to a call for development or an emergency call by the government to defend the sovereignty and integrity of the country.
- The following are among other deductibles:
    - the cost of trading stock disposed of by the taxpayer during the year as determined in accordance with the financial reporting standard;
    - the total amount by which the taxpayer’s depreciable assets and intangible assets have declined in value during the year from use in deriving business income;
    - any loss on business assets (other than trading stock) disposed of by the taxpayer during the year.

Value added tax

In **2017**, the MoF revised the compulsory VAT registration annual turnover threshold from ETB

0.5 million to ETB 1 million (Circular T/K/Q/5/161). This came into effect in 2018.

In **2019**, the Ministry introduced an amendment to the VAT Proclamation (Proclamation No. 1157/2019), changing the required filing frequency for firms with turnover below ETB 70 million from monthly to quarterly (while for firms with turnover above that threshold, filing frequency remained monthly). The amendment to the VAT Proclamation also lowered the VAT withholding rate to 50% (from 100%).

Proclamation No. 1157/2019 also made three changes to the VAT refund policy. First, VAT paid before VAT registration was made creditable in the first accounting period after registration. Second, refunds for VAT paid on capital goods over a certain period were fast-tracked where the value of such transactions exceeded ETB 100 million in a fiscal year. Third, the tax authority now refunds the remaining amount of VAT paid on capital goods in excess of the amount credited in the accounting period within the coming month.

Excise tax

In **2020**, the MoF introduced a new Excise Tax Proclamation (Proclamation No. 1186/2020) replacing the previous proclamation which had been in place since 2003.

This reform changed the tax base for locally produced goods from the ‘production cost’ to ‘ex-factory prices’. The tax base for imported goods remained the same (i.e. CIF value plus customs duty payable).

The reform also introduced a number of administrative measures:

- any taxpayer must get a permit from the tax authority to import or locally manufacture goods that are subject to excise tax;
- the tax authority now has the power to follow up and monitor local manufacturers who produce excisable items;
- an ‘excise tax stamp’ is to be printed on the product indicating whether the excise tax has been paid.

The new law also raised the maximum applicable excise tax rate on certain imported items, mainly on old vehicles, from 100% to 500%.[21]

Some additional goods have been included in the excise tax base (which were not subject to excise previously). For example, tractors and three-wheeler motor vehicles are now subject to rates of up to 400% and 405% respectively depending on age, and human hair and wigs are now subject to 40% excise.

However, to offset the impact of the change in tax base from 'production cost' to 'ex-factory prices', excise duty rates for certain products have been reduced. For example, textile and garment products were subject to 10% before but are now subject to 8% excise tax. Similarly, powder soft drinks were taxable at 40% but are now taxed at 25%.

See Appendix Table A.3 for fuller details of the old and new rates.

Customs duty and related

In **2013**, the MoF issued a directive (Directive No. 35/2013) granting preferential customs and tax treatment for importation of raw materials for certain local manufacturers.

In **2014**, the government introduced a customs regulation (Proclamation No. 859/2014) which set out the regulations governing the customs duty and taxes on imported items. Under this customs regulation, customs duty and import taxes are payable on any imported and exported goods except those exempted by law or exemption provided by the Ministry of Finance.

In **2016**, another directive (Directive No. 45/2016) was issued by the MoF relaxing some of the strict requirements (under Directive No. 35/2013) for importers. The new directive introduced a flexible

[21] The current excise law applies different rates to imported vehicles depending on the engine size and age: larger engine sizes and older vehicles are subject to higher excise taxes. For example, a vehicle with an engine size of 1,300cc or less is subject to: a 55% excise duty if it is no more than 2 years old; a 105% excise duty if it is aged between 2 and 4 years; a 205% excise duty if it is aged between 4 and 7 years; and a 405% duty rate if it is 7 or more years old. Vehicles with engine sizes of more than 1,800cc are taxed at rates of between 100% and 500%, depending on age.

value addition requirement for importers of raw materials.

In **2017**, Ethiopia adopted the World Customs Organization's revised HS codes and tariff classification. Based on this, Ethiopia revised its own eight-digit HS codes.

In **2019**, the Ministry amended the customs and tax privileges of importers previously listed under the second schedule tariff by moving them to the first schedule, where they are to be treated under the regular customs duty and tax rates.[22]

In **2019**, the MoF granted import duty exemptions (and, where relevant, excise and surtax exemptions) to imports of agricultural machinery, irrigation equipment, and animal food development and production machinery. This reform was mainly intended to modernise and mechanise the agriculture sector. The tax exemptions also apply to local manufacturers engaged in the production of agricultural machinery and equipment.

COVID-19-related temporary tax relief and tax deferrals

The federal government has taken various policy measures in response to the COVID-19 pandemic to support taxpayers:

- Extending the VAT and TOT filing and payment deadlines. This allowed businesses to defer payment of the VAT and TOT that would otherwise have been due for a three-month period (March, April and May for the 2019/20 financial year).
- Introducing more generous loss-carry-forward arrangements so that regardless of whether businesses have used their loss-carry-forward for the past two years, they are allowed to carry any losses during the 2019/20 fiscal year forward to offset against future tax liabilities.

[22] Temporary *surtax exemptions* have been granted to importers moved from the second to the first schedule where surtax is ordinarily applied to first-schedule imports of the items in question. This is because of concerns about increases in the input costs these importers would otherwise face. But the regular customs duty rate is being applied for those items moved off the second schedule.

- Deferring pension contribution payments by private employers normally due in March, April and May 2020 to June 2020.

- Exempting rental income from tax for those landlords who gave at least two months' rental amnesty to their tenants.

- Allowing private businesses that furloughed employees and paid their full salary for two months to retain four months of employment income tax due to help pay these salary costs.

- Making COVID-19 donations deductible: Those businesses making contributions to the government's efforts to contain COVID-19 were allowed to add the cost of their contribution to their tax-deductible expenses up to the value of 20% of their taxable income (tax-deductible donations are usually capped at an amount of 10% of taxable income)

- Granting duty and tariff exemptions for those products used in the prevention of the spread of COVID-19.

- Enacting a full or partial amnesty for historical tax debts. Debts initially incurred between 2005/06 and 2014/15 have been written off entirely – meaning that the original tax owed, and any interest and penalties, are being waived. Such old debts are likely hard to collect, meaning that the revenue forgone may not be that significant, and potentially allowing administrative resources to be redeployed. For debts incurred between 2015/16 and 2018/19, the write-off is partial and conditional. In particular, the government waived interest and penalty payments if the taxpayer paid at least 25% of the original tax liability within one month of the amnesty being announced, and agreed an interest- and penalty-free payment plan of not more than 1 year for the remaining tax due. In addition, taxpayers paying the full amount within 1 month received a 10% reduction on the amount of tax due. The aim of this was to encourage taxpayers to voluntarily pay their outstanding tax debts, helping boost revenues in the short term in order to help fund COVID-19-related expenditures. The long-run effect on revenues is less clear and depends on how much of this debt (including interest and penalties) would have been collected via enforcement action.

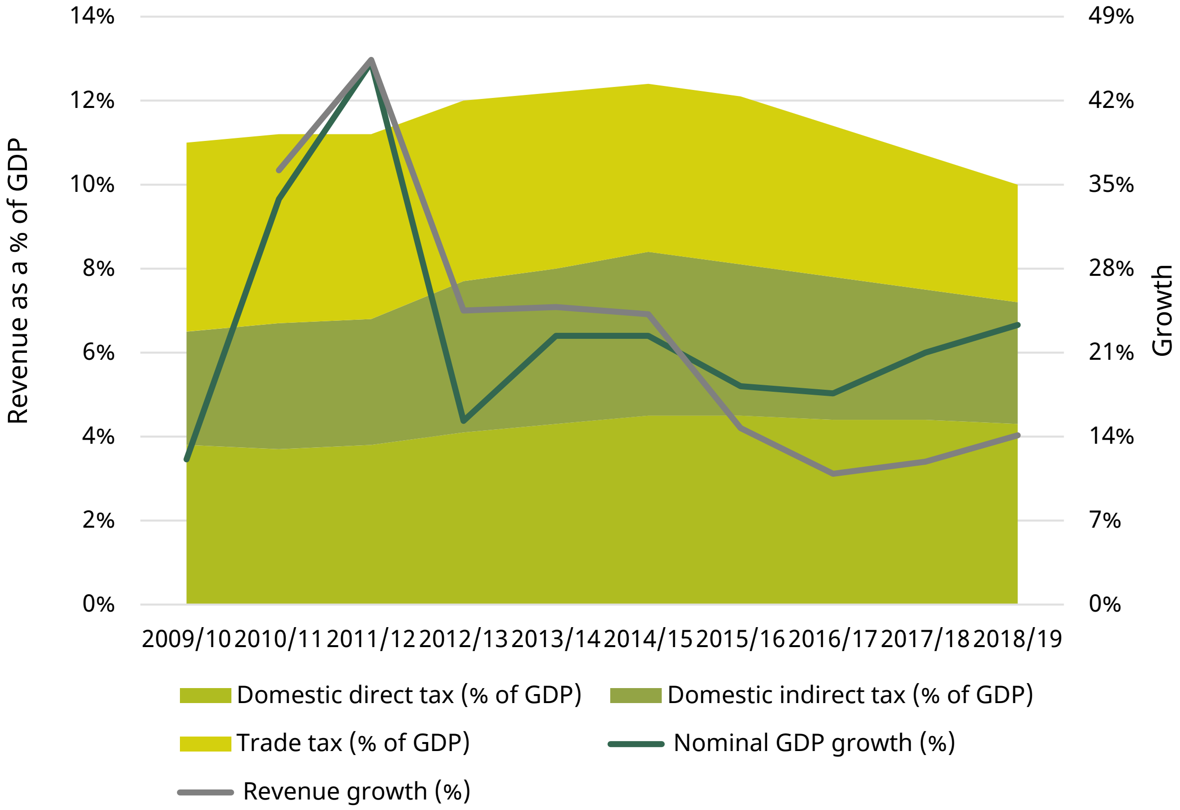
The regional states independently granted personal business income tax relief. But the measures vary from region to region. Amhara regional state, for example, granted business income exemptions for taxpayers of up to 15% (for those businesses required to close under the five-month state of emergency, such as bars and cinemas). Similarly, Oromia region took the months in which businesses were closed into consideration in the computation of annual turnover.

4.2 Recent trends in tax revenues in Ethiopia

Between 2009/10 and 2014/15, tax revenue growth slightly outpaced nominal GDP growth. However, in recent years, tax revenue performance has begun to deteriorate. While Ethiopia has still seen year-on-year increases in its tax collections in nominal terms, revenues have grown more slowly than the economy since 2015/16.

This is illustrated in Figure 4.1, which plots how tax revenues developed between 2009/10 and 2018/19. Tax revenues grew by an average of 31% per year between 2009/10 and 2014/15 compared with average annual nominal GDP growth of 28%. In contrast, between 2015/16 and 2018/19, tax revenues grew at an average rate of only 13% per year – notably lower than the average annual nominal GDP growth rate of 20%. In fact, by 2018/19, while the economy was 7.0 times larger than it had been in 2009/10, tax revenues were only 6.2 times larger. This explains the fall in the tax-to-GDP ratio from 10.9% to 10.0% over the period.

Figure 4.1. Tax revenue (% of GDP) and nominal GDP & tax revenue growth (%)



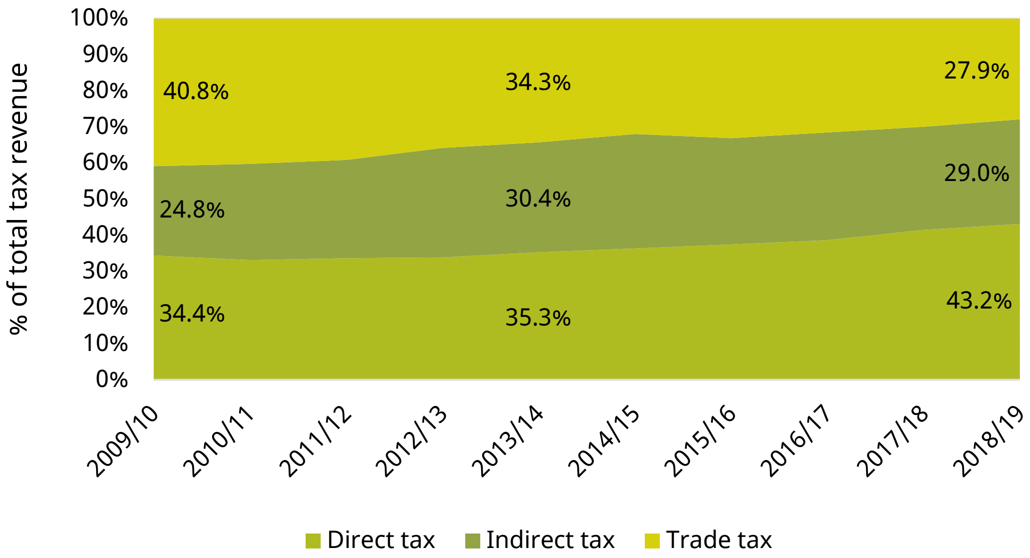
Source: Authors' computation based on data from Ministry of Revenues and National Bank of Ethiopia.

This overall trend hides some differences between tax types. Between 2009/10 and 2018/19, revenues from direct taxation increased from 3.8% of GDP to 4.3% of GDP. Domestic indirect tax revenue has seen slightly weaker growth, increasing from 2.7% of GDP to 2.9%. But in both cases, this is the result of stronger growth between 2009/10 and 2014/15 that has been partially reversed in the last few years – especially in the case of domestic indirect taxes.

Revenues from trade taxes have shown a clear decline, falling from 4.5% to 2.8% of GDP. This reduction is broadly in line with trends in imports, which have fallen from 32% of GDP to 21% of GDP between 2009/10 and 2018/19.

As a result of these changes, there has been a shift in the tax mix over this period. This is shown in more detail in Figure 4.2, which illustrates how the relative contribution of each of these three broad categories of taxes has changed over time. While taxes collected on imported goods remain an important part of the country's overall tax revenue mix, their relative importance has declined over the past decade, falling from 41% of total tax revenue in 2009/10 to 28% in 2018/19. In contrast, the contribution of domestic direct taxes has increased from 34% to 43% of overall tax revenues, while the contribution of domestic indirect taxes (including VAT) has slightly increased from 25% in 2009/10 to around 29% in 2018/19.

Figure 4.2. Tax revenue collection composition



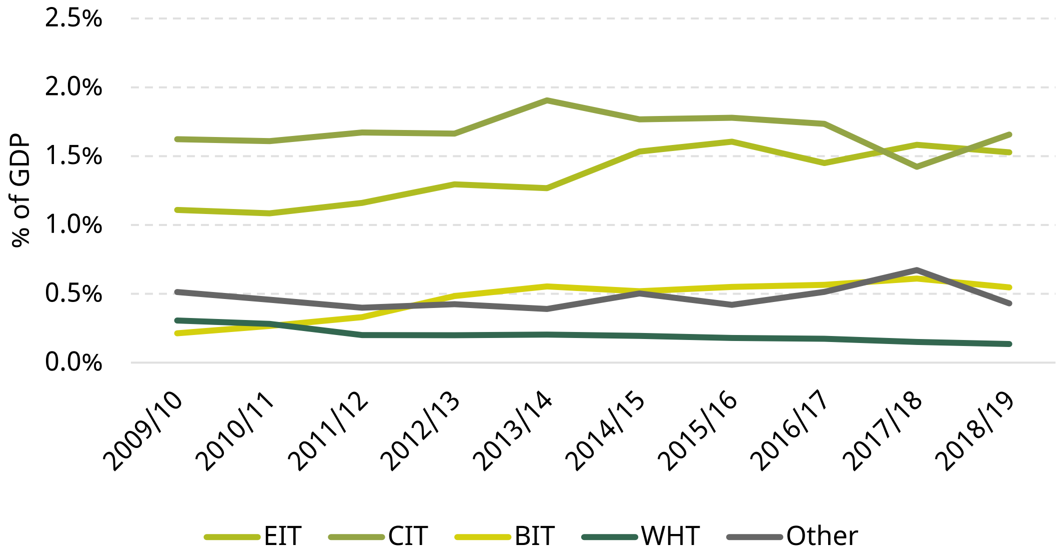
Source: Authors' computation based on data from Ministry of Revenues and National Bank of Ethiopia.

Figure 4.3 provides a disaggregated view of direct tax revenue trends in the country. Corporation income tax (CIT) and employment income tax (EIT) collections, the two main sources of revenue in this category, followed somewhat different paths over the period. Overall, CIT has remained fairly constant as a proportion of GDP, albeit with some year-to-year variation. EIT revenues, on the other hand, increased steadily as a proportion of GDP between 2009/10 and 2015/16. A reform to income taxes in 2016/17, which increased all income tax thresholds, likely contributed to the moderate decline in their revenue contribution in that year, although a full recovery was observed in the subsequent two years. Over the period as a whole, EIT collections therefore rose from 1.1% of GDP to 1.5%.

It is also interesting to note that revenues from unincorporated businesses income tax (BIT) have risen significantly, from 0.21% to 0.55% of GDP, over the period. This may reflect structural changes in the economy that have aided tax collection – such as a fall in the relative contribution of agriculture to GDP and an increase in the relative contribution of services and industry – as well as efforts by regional tax authorities to formalise businesses and enforce tax obligations.

Withholding taxes (WHT) on imports and domestic payments constituted around 0.31% of GDP in 2009/10, dropping steadily over the years to 0.14% in 2018/19.

Figure 4.3. Direct tax revenue as a % of GDP for general government

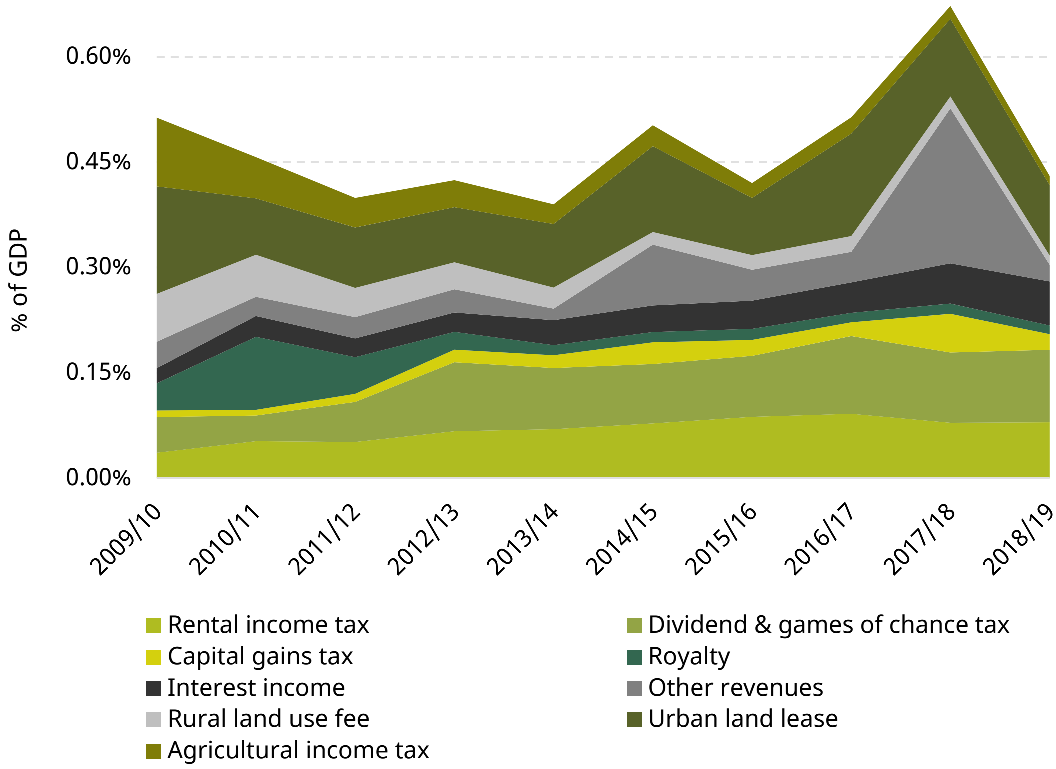


Note: 'Other' includes dividend tax, rental income, 'winnings' tax, capital gains tax, royalties, interest income, rural land use fees, urban land lease, agricultural income tax, and a few other smaller taxes.

Source: Authors' computation based on data from Ministry of Revenues and National Bank of Ethiopia.

The contribution of other direct taxes has decreased over time from 0.51% to 0.43% of GDP. However, this overall decline hides variation across individual taxes, as seen in Figure 4.4. Over this period, there was in fact an increase in revenues raised from rental income tax, interest income tax, dividend tax, taxes on winnings, and capital gains tax (as a share of GDP). This was, however, more than offset by a decline in the contribution of rural land use fees and agricultural taxes. Reductions in revenue from rural land use fees and urban land lease as a share of GDP have likely resulted in part because of taxes not being raised in line with inflation.

Figure 4.4. Changes in the composition of 'other revenues' (% of GDP)



Source: Authors' computation based on data from Ministry of Revenues and National Bank of Ethiopia.

There have also been some important trends among indirect taxes over the past decade. This is shown in Figure 4.5, which provides a disaggregated view of indirect tax revenue between 2009/10 and 2018/19. Total domestic indirect tax revenue increased substantially between 2009/10 and 2014/15, but fell back after that and is now only very slightly higher than it was in 2009/10.

While VAT revenues collected on local goods and services increased from 2.2% to 3.4% of GDP between 2009/10 and 2014/15, they fell back to 2.3% of GDP in 2018/19. Given that the statutory VAT rate remained constant over the whole period, this trend must have resulted from an increase and then a decrease in the VAT base relative to GDP. The changes in revenue occurred in spite of increases in the share of private consumption in GDP – a pattern usually associated with rises in relative VAT collections.

One factor that could have contributed to the fall in VAT revenue as a share of GDP in the most recent year is the increase in the VAT registration threshold from ETB 0.5 million to ETB 1.0 million. However, this cannot explain decreases between 2015/16 and 2017/18 (indeed, the freezing of the threshold at 0.5 million ETB in these years would have been expected to increase revenues given high inflation). Other factors that could play a role include increases in the number of VAT exemptions granted, a shift in economic activity to sectors subject to more VAT exemptions or lower compliance, or more general reductions in VAT compliance.

Figure 4.5. Domestic indirect tax revenue as a % of GDP

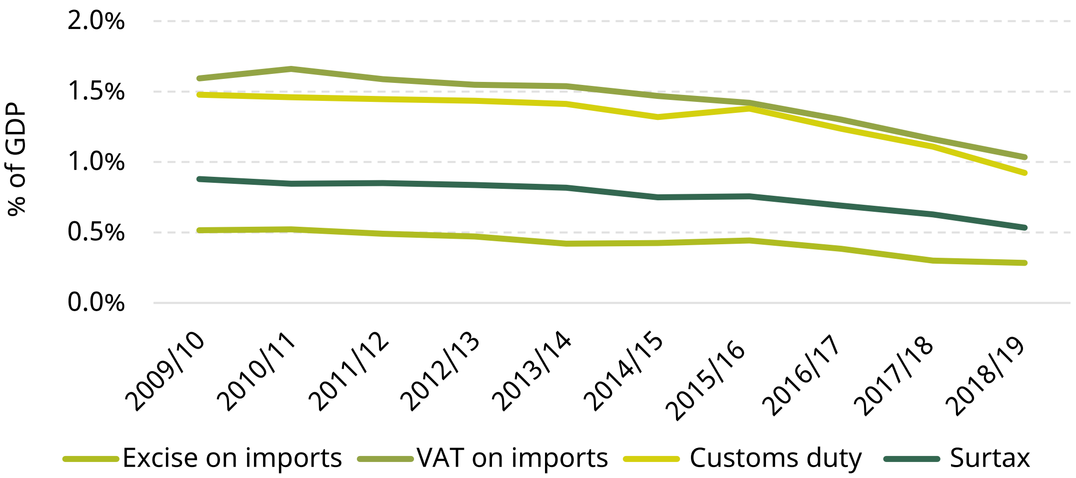
Note: 'Other domestic indirect taxes' include TOT and stamp duty.

Source: Authors' computation based on data from Ministry of Revenues and National Bank of Ethiopia.

Revenue from excise taxes on local goods has remained fairly stable as a share of GDP at around 0.3–0.4% over the period, but was slightly higher in 2018/19 (0.37% of GDP) than in 2009/10 (0.33%). Revenues from TOT and stamp duty have been consistently just over 0.2% of GDP, and reached 0.24% of GDP in 2018/19.

VAT on imports and customs duties constitute the bulk of trade tax revenue and both have fallen as a share of GDP in recent years. In 2009/10, VAT on imports and duties were equivalent to around 1.6% and 1.5% of GDP, respectively. In 2018/19, these shares had fallen to 1.0% and 0.9%, respectively. These constitute falls of 35% for import VAT and 38% for customs duty relative to GDP over the last 10 years. Surtax as a share of GDP has also exhibited a downward trend, falling from 0.9% of GDP in 2009/10 to 0.5% in 2018/19, a 39% relative decline.

Figure 4.6. Trade tax revenue as a % of GDP



Source: Authors' computation based on data from Ministry of Revenues and National Bank of Ethiopia.

5. International context

Ethiopia's tax revenues are lower than those of its regional peer countries. This is illustrated in Figure 5.1, which compares tax revenues measured as a proportion of GDP in Ethiopia with those of other countries in sub-Saharan Africa (SSA) and other lower-income countries in 2018.[23]

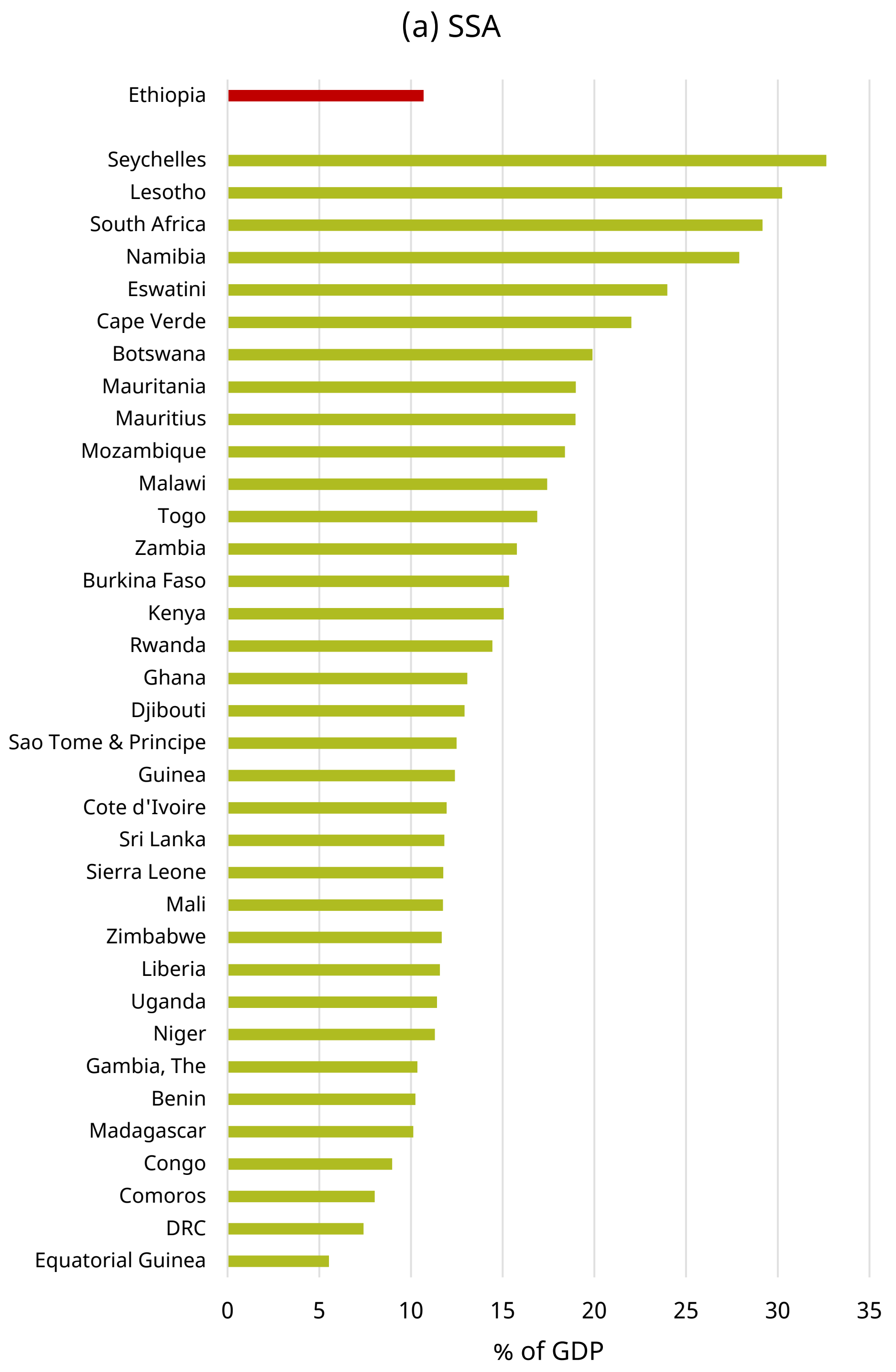
In order to make comparisons with other low-income countries, this section uses harmonised data collected in the ICTD/UNU-WIDER Government Revenue Dataset (GRD). These data cover calendar rather than fiscal years and use somewhat different definitions of tax types, so figures differ *slightly* from those used elsewhere in this report, but overall patterns and trends are very similar.

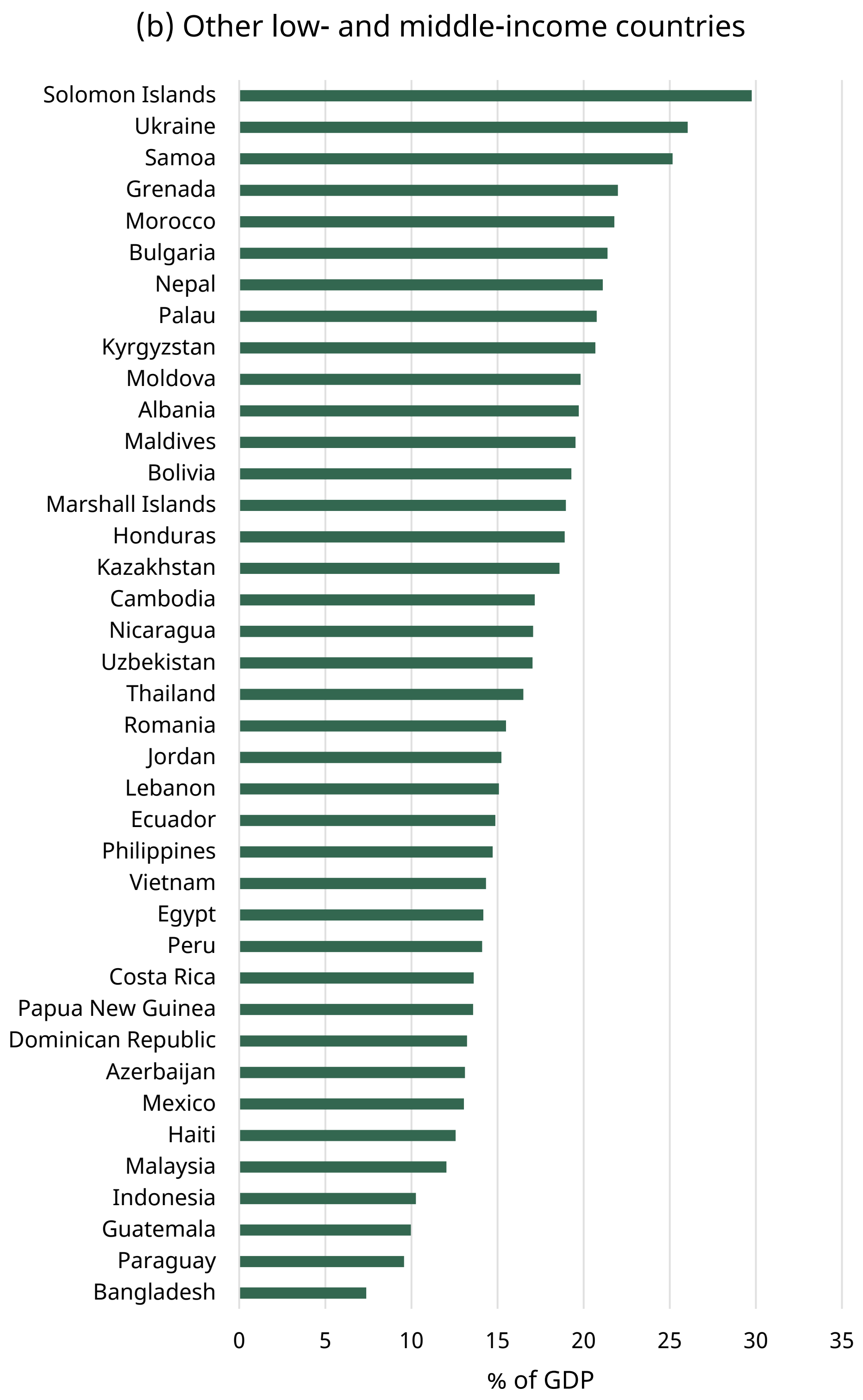
The GRD data show that Ethiopia lags notably behind most countries in both groups in terms of tax revenue mobilisation. Out of a sample of 36 countries from sub-Saharan Africa with available data in the GRD, Ethiopia ranks 29th in 2018 in terms of tax-to-GDP ratio. Among lower-income countries, it ranks 13th out of 17 low-income countries where data are available.[24] With a tax-to-GDP ratio of 10.7%, Ethiopia is also significantly below levels seen in more developed low- to middle-income countries (LMICs), such as South Africa (with a tax-to-GDP ratio of 29.2%), or advanced economies elsewhere in the world (e.g. the average tax-to-GDP ratio in OECD countries is estimated at 33.9 % for 2018; OECD, 2019).

[23] Ethiopian tax revenue data in this section are taken from the GRD in order to ensure the greatest possible comparability with other countries. There are small discrepancies between the figures in these data and the Ministry of Revenues figures because the latter reflect tax collections whereas the former attempt to implement the most consistent treatment possible for social contributions, tax refunds and VAT collected on imports, for instance.

[24] These data do not necessarily offer a representative sample.

Figure 5.1. Tax revenues in sub-Saharan Africa and other low- and middle-income countries (as a share of GDP), 2018





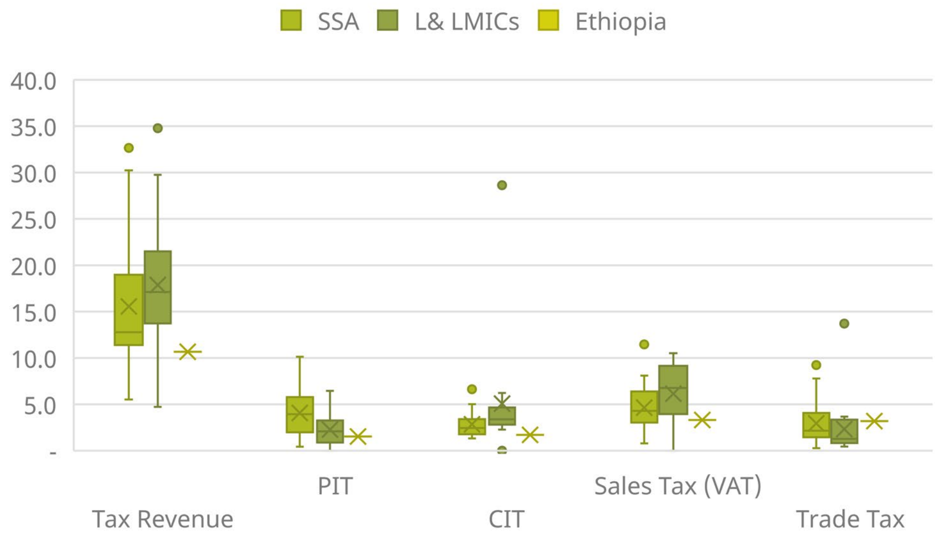
Note: Sample of countries included in figure comprises 36 countries from SSA (including Ethiopia) and 39 other LMICs.

Source: GRD and KPMG tax rates data.

It is also useful to go beyond the overall tax-to-GDP ratios to attempt to understand which components of Ethiopia's tax system might drive its relatively low yield.

Figure 5.2 plots the distribution of tax revenue yield from different components of the tax system in countries in sub-Saharan Africa and other low- and lower-middle-income countries (L&LMICs), with figures for Ethiopia alongside for comparison. In terms of corporate tax revenue, Ethiopia performs below the median for SSA, and below most low- and lower-middle-income countries in our sample (ranking 12th out of a sample of 15 SSA countries for which data were available in 2018). For personal income taxes and sales taxes, Ethiopia's revenues are also fairly low relative to other countries in these samples. While the median SSA and low- and lower-middle-income countries collected general sales tax revenue of over 4.3% and 6.8% of GDP, respectively, for Ethiopia this figure was 3.3%. Ethiopia collected personal income tax (PIT) revenues equivalent to only 1.5% of GDP in 2018; the median SSA country achieved 3.9%. However, Ethiopia did raise relatively more from trade taxes[25] when compared with many other countries in the sample – raising revenues equivalent to 3.2% of GDP compared with SSA and other low- and lower-middle-income countries' medians of 2.1% and 1.3% in trade taxes respectively.

Figure 5.2. Tax revenues in SSA and other low- and lower-middle-income countries (as a share of GDP), 2018



[25] Here, for the sake of comparability with other countries, we include only customs duties, excise duties and surtax paid on imports.

Note: Sample varies between tax revenue categories according to data availability. The line within the box shows the median value within the group while the X sign shows the mean value. For example, for SSA the median tax-to-GDP ratio in 2018 was 12.4% and the mean was 14.45%. The bottom line of the box indicates the median value for the first quarter while the upper line of the box is the median value for the fourth quarter. The dots above the bars show the outliers from each country grouping. A data point is considered an outlier if it exceeds a distance of 1.5 times the interquartile range (IQR) below the first quartile or 1.5 times the IQR above the third quartile. Hence, based on this criterion, we see that there are outliers in SSA such as Seychelles with a tax-to-GDP ratio of 32.65% and sales tax of 11.46%, while Namibia is the outlier in trade taxes (as a share of GDP).

Source: UNU-WIDER Government Revenue Dataset and Ethiopian Ministry of Revenues.

Fundamentally, two variables determine the tax revenue collected: the size of the tax base to which the tax applies, and the tax rate that is applied to this base.

The tax base is a function of a number of factors, including: the way this base is defined in tax legislation; the scale of any discretionary tax exemptions and incentives; administration factors, such as compliance and enforcement; and the size and structure of different sectors of the economy. This means that, in practice, it is extremely difficult to compare the tax base in a robust way across different countries. However, it is worth highlighting three key issues that affect the size of the tax base in Ethiopia:

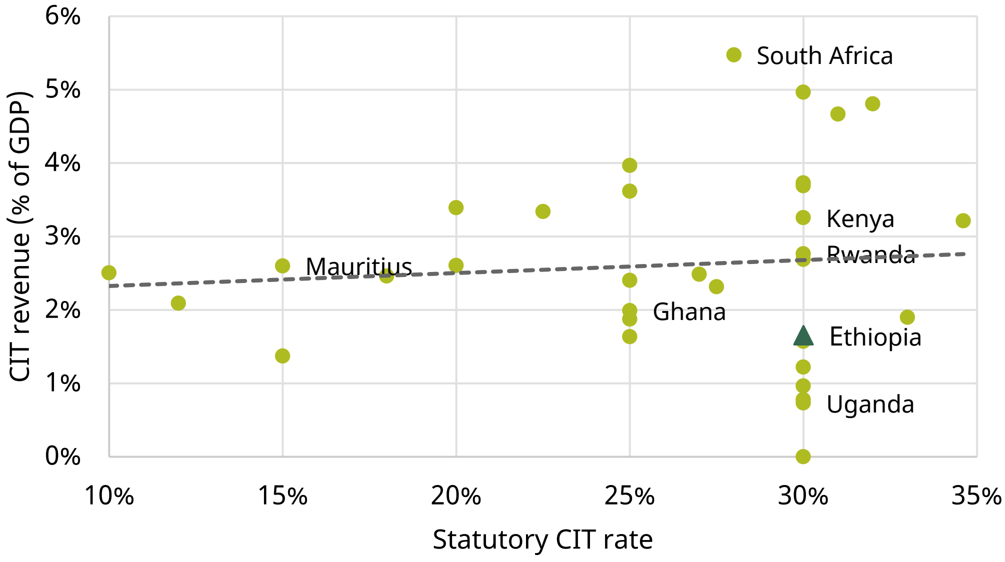
- Like most developing countries, Ethiopia has a large informal sector, comprising around 38.6% of the economy (IMF, 2013). Bringing this sector into the tax net is incredibly challenging due to a relative absence of formal record keeping (Besley and Persson, 2014). There is also a concern that the potential tax revenue collections would be fairly modest relative to the cost of collecting these revenues. Informality contributes to low tax collections, but the extent to which it explains differences with peer countries is unclear.
- Related to this, Ethiopia has been identified to have a fairly weak tax administration system with notable capacity constraints. This lowers collection efficiency and increases the compliance cost for taxpayers – with the latter potentially leading to a higher degree of tax evasion and avoidance (Abramovsky et al., 2018; Waiswa, Sebsbie and Asnakech, 2019).
- The Ethiopian government also grants an array of tax incentives for foreign investors in order to attract foreign investment, despite limited empirical evidence to support the idea that tax incentives stimulate foreign investment (Abramovsky et al., 2018).

Overall, the above factors contribute to the low level of revenue collections in Ethiopia. However, it is difficult to say to what extent these factors contribute to Ethiopia's revenues being lower than its peers'. It is true to say that Ethiopia relies on a fairly narrow tax base to raise the necessary government revenue partly because of these factors.

The second variable that determines tax revenues is the tax rate applied to the relevant tax base. Although tax rates for a given tax base may vary by individual taxpayer, tax rates are undoubtedly easier to compare across countries than tax bases. This is particularly true for taxes such as CIT and VAT, which are typically characterised by a statutory rate that applies to the majority of the tax base. Comparing Ethiopian tax rates and revenue collections with those of other countries provides suggestive evidence on whether tax policy (and tax rates specifically) can rationalise Ethiopia's relatively low tax revenue yield.

Figure 5.3 first considers statutory corporate tax revenues and rates in a sample of SSA and lower middle-income countries, showing one observation per country over the period 2016–18 according to data availability. There is considerable variation in the sample in the headline CIT rate, ranging from 10% to nearly 35%. As a percentage of GDP, CIT revenues range from zero to 5.5%. The dashed line shows a *very slight* positive association between statutory tax rates and revenues for CIT.

Figure 5.3. CIT rates and revenues across countries, 2016–18



Note: One observation per country. Sample comprises 34 countries from sub-Saharan African or in the low- and lower-middle-income country grouping. Figures for Ethiopia are for 2018/19.

Source: GRD and KPMG tax rates data.

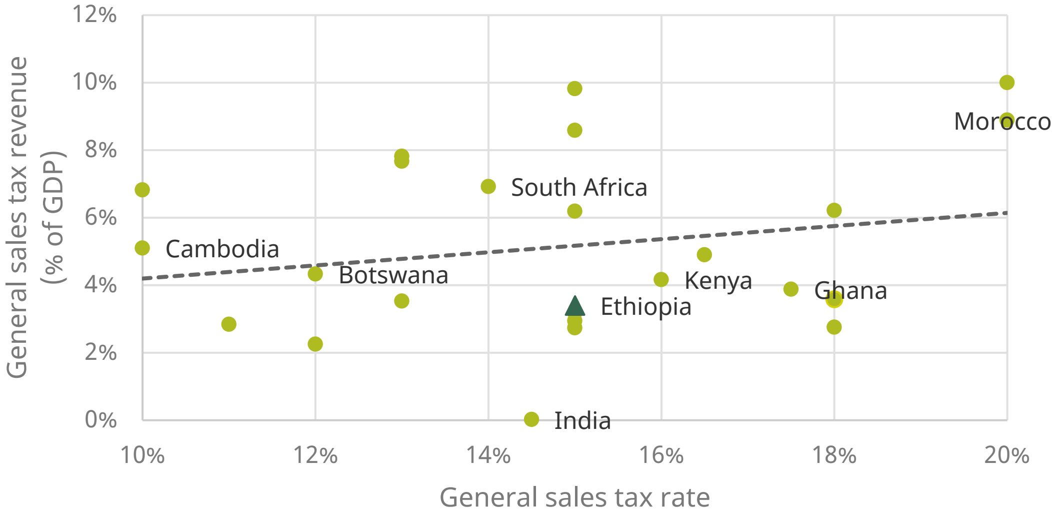
The overall pattern suggests that, given its statutory CIT rate, Ethiopia collects less CIT revenue than would be expected. Raising around 1.7% of GDP from CIT, this share is low given the high statutory rate of 30% even compared with its regional peer countries. For example, Ghana has a lower CIT statutory rate (25%), but raises the equivalent of around 2.0% of GDP. Kenya and Rwanda have similar statutory CIT rates to Ethiopia yet CIT collection in these economies is significantly higher than Ethiopia's, contributing 3.3% and 2.8% of GDP, respectively. On the other hand, Ethiopia's revenues exceed those of some comparators such as Uganda, which has the same CIT rate but collects less than 1% of GDP from CIT. These differences are likely to reflect differences in economic structures (such as the share of corporate profits in GDP), differences in policies affecting the tax base (such as rules on depreciation and other deductions, as well as the range and scale of tax incentives on offer) and differences in tax compliance.

Figure 5.4 conducts the same exercise for general sales tax revenues.[26] Here, the statutory rates range from 10% to 20%. Ethiopia falls roughly in the middle of the sample in this respect. The positive association between tax rates and tax revenues is clearer in this sample, but again Ethiopia's revenues are below what one would expect given its headline rate. Neighbouring Kenya, which has a general sales tax rate of 16% (slightly higher than

[26] The 17.5% overall rate for Ghana reflects the fact that the tax base for the National Health Insurance Levy (NHIL) and the Ghana Education Trust Fund Levy (GETFL) includes VAT.

Ethiopia’s rate of 15%), raised around 4.2% of GDP from sales taxes. Ethiopia’s relatively poor performance could be due to a range of factors, including but not limited to compliance, VAT registration requirements or the breadth of exemptions.

Figure 5.4. General sales tax rates and revenues across countries, 2016–18

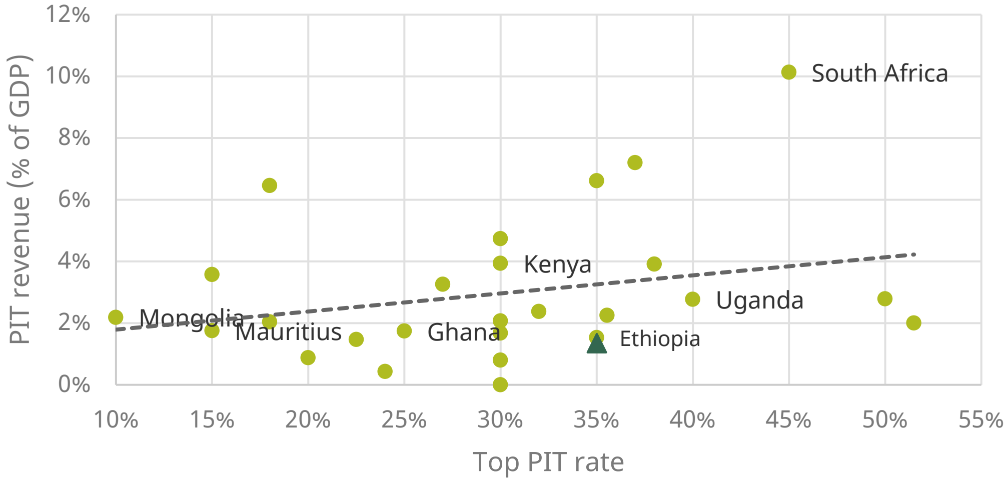


Note: One observation per country. Sample comprises 25 countries from sub-Saharan African or in the low- and lower-middle-income country grouping. Figures for Ethiopia are for 2019.

Source: GRD and KPMG tax rates data.

Finally, Figure 5.5 plots the relationship between PIT rates and revenues. PIT systems are typically characterised by a schedule of rates applying to different bands of income, making tax rate comparisons across countries more difficult. Here we use the highest marginal tax rate in each country as a proxy for average PIT rates. This does yield a weak positive association between rates and revenues: taken at face value, the trend suggests that quintupling the top rate from 10% to 50% doubles overall tax revenues. Again, though, Ethiopia falls below the overall trend line, implying it raises less PIT revenue than would be expected when compared with other countries.

Figure 5.5. Top PIT rates and PIT revenues across countries, 2016–18



Note: One observation per country. Sample comprises 27 countries from sub-Saharan African or in the low- and lower-middle-income country grouping. Figures for Ethiopia are for 2020.

Source: GRD and KPMG tax rates data.

6. Conclusions and potential next steps for tax reform

This report has provided an overview of Ethiopia's tax system and examined recent policy and revenue trends. It has also placed Ethiopia's tax revenues in an international context.

Ethiopia has a federal system where tax powers and revenues are divided between the federal and regional governments, with some exclusive to one branch and others shared between them. Overall, 72% of revenues went to the federal government in 2018/19, with the remaining 28% going to the various regional governments. The former receives all taxes on international trade and a significant majority of domestic indirect taxes. Regional governments receive almost half (46%) of domestic direct taxes, which makes up the bulk (71%) of their tax revenues.

After growing between 2009/10 and 2014/15, Ethiopia's tax-to-GDP ratio fell from 12.4% in 2014/15 to approximately 10% in 2018/19 – despite its ambitious objective of increasing the tax take to 17.2% of GDP by the end of the decade as part of GTP II. Underlying these headline trends has been a big shift in the composition of tax revenues, with domestic taxes and especially domestic direct taxes increasing in importance, and taxes on international trade decreasing in importance. Indeed, the last have fallen from 4.5% of GDP in 2009/10 to 2.8% in 2018/19, in large part driven by a fall in the ratio of imports to GDP.

This decline in the tax-to-GDP ratio means that Ethiopia raises relatively less revenue than regional peer economies such as Kenya, Rwanda and Ghana. As a result, its tax-to-GDP ratio (10%) is significantly below the average for both sub-Saharan Africa (14.4%) and other low-income countries (13%) in 2018. This reflects lower revenues from domestic direct taxes (both at the corporate and personal level) and from taxes on goods and services. Only for trade taxes did Ethiopia raise relatively more revenue – despite the large falls seen since 2009/10. Thus, Ethiopia is relatively dependent on trade taxes compared with its peers, which may pose difficulties given moves to liberalise and increase trade in Africa by reducing barriers to trade, such as high import duty rates.

The federal government has enacted reforms to most major tax types in recent years, including corporate and personal income tax, value added tax, excise taxes and customs taxes. These have broadened the tax base and increased tax revenue collection. Alongside the regional governments, the federal government has also enacted temporary changes to tax policies and administration to support businesses and households through the COVID-19 crisis.

Looking ahead, the federal government continues to consider reforms to a range of taxes given its goal of ensuring a fair and efficient tax system that raises the revenues needed to meet Ethiopia's development goals. In particular, it aims to increase the tax-to-GDP ratio to 18.2% by the end of 2029/30 – a more than 8.2 percentage point increase compared with 2018/19 – while at the same time increasing GDP per capita to US$2,220 (in constant prices) to achieve middle-income status. This would increase the real-terms resources available for spending on public investments, services and cash transfers by almost five times in little over 10 years.

Doing this will require a step change in revenue performance though. In particular, as between 2009/10 and 2014/15, domestic direct and indirect tax revenues will need to increase substantially. This is likely to require both improvements in administration and compliance, and policy reforms that broaden tax bases (such as reducing the scope of tax exemptions and incentives), given that Ethiopia's tax revenues are lower than average for its tax rates. However, increases in revenues of the scale required to meet Ethiopia's revenue targets are also likely to require at least some increases in tax rates, especially if trade liberalisation and growth in the domestic economy mean that revenues from taxes on international trade continue to decline as a proportion of GDP.

It is beyond the scope of this report to suggest specific tax reform measures. However, in determining those measures, the Ministry of Finance should have a clear long-term strategy. Such a strategy will need to take account of the existing structure of Ethiopia's tax system and revenues, and how these compare with those of other countries. It will also be important to ensure that the system and reforms to it are documented and explained in a clear and concise way. This report should therefore be updated and extended over time.

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Proclamation No. 1186/2020, 'Excise Tax Proclamation'

Appendix

Appendix Table A.1. Snapshot of the presumptive taxation rates for Category C taxpayers

	Sector/Type	Profit rates	Annual turnover in ETB																		
			1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19
			50,000	50,001–75,000	75,001–100,000	100,001–125,000	125,001–150,000	150,001–175,000	175,001–200,000	200,001–225,000	225,001–250,000	250,001–275,000	275,001–300,000	300,001–325,000	325,001–350,000	350,001–375,000	375,001–400,000	400,001–425,000	425,001–450,000	450,001–475,000	475,001–500,000
1	Cereals & pulses trade	5%	-	-	-	-	30	155	280	405	530	655	780	905	1,030	1,155	1,290	1,478	1,665	1,853	2,040
2	Edible oil & its by-product trade	10%	-	30	280	530	780	1,030	1,290	1,665	2,040	2,415	2,790	3,165	3,540	3,915	4,370	4,870	5,370	5,870	6,370
3	Hides & skin trade	10%	-	30	280	530	780	1,030	1,290	1,665	2,040	2,415	2,790	3,165	3,540	3,915	4,370	4,870	5,370	5,870	6,370
4	Textile product (yarn)	10%	-	30	280	530	780	1,030	1,290	1,665	2,040	2,415	2,790	3,165	3,540	3,915	4,370	4,870	5,370	5,870	6,370
99	Transit service	30%	780	1,665	2,790	3,915	5,370	6,870	8,370	10,095	11,970	13,845	15,720	17,790	20,040	22,290	24,540	26,790	29,250	31,875	34,500

Source: Council of Ministers Regulation No. 410/2017.

Appendix Table A.2. Business income tax exemptions by sector and location of investment

	Sector/business type	Addis Ababa and surrounding Oromia zones	In other areas
1.	Manufacturing in the food industry	Income tax exemptions for up to 3 years. But for sugar manufacturing businesses, the exemption is for 5 years.	Income tax exemptions for up to 5 years. But for sugar manufacturing businesses, the exemption is for 6 years.
2.	Beverage industry	Between 1 and 3 years depending on the type of beverage	Between 2 and 6 years depending on the type of beverage
3.	Textile and textile products industry	Between 2 and 5 years	Between 3 and 6 years
4.	Leather and leather products industry (apart from tanning of hides and skins below finished level)	Up to 5 years	Up to 6 years
5.	Wood products industry	For 2 years	For 3 years
6.	Paper and paper products industry (excluding printing business)	Between 1 and 5 years	Between 2 and 6 years
7.	Chemical and chemical products industry	Between 2 and 5 years	Between 3 and 6 years
8.	Basic pharmaceutical products and pharmaceutical preparations industry	4 and 5 years	5 and 6 years
9.	Rubber and plastic products industry	Between 1 and 4 years	Between 2 and 5 years
10.	Other non-metallic mineral products industry (excluding manufacture of cements, cement products and clay)	Between 1 and 4 years	Between 2 and 5 years
11.	Basic metals industry (excluding mining of the mineral)	Between 3 and 5 years	Between 4 and 6 years
12.	Fabricated metal products industry (excluding machinery and equipment)	Between 1 and 3 years	Between 2 and 4 years
13.	Computer, electronic and optical products industry	Between 2 and 4 years	Between 3 and 5 years
14.	Electrical products industry	Between 2 and 4 years	4 and 5 years
15.	Machinery and equipment industry	For 5 years	For 6 years
16.	Vehicles, trailers and semi-trailers industry	Between 1 and 5 years	Between 2 and 6 years

Source: Council of Ministers Regulation No. 270/2012.

Appendix Table A.3. The new and previous excise tax rates by product category

	Product category	**Old excise rate**	**New excise rate**
1.	Fats and oils	0%	The new rate ranges between 30% and 50%, depending on the exact product: • 30% – edible animal or vegetable fats and oils and their cleavage products; with content of 40g or more saturated fat per 100g, or unable to determine level of saturated fat from label • 40% – edible animal or vegetable fats and oils, partially or wholly hydrogenated, with content of 40g or more saturated fat per 100g, or more than 0.5g of trans fat per 100g, or unable to determine level of saturated fat from label • 50% – edible margarine with 40g or more saturated fat per 100g, or more than 0.5g of trans fat per 100g
2.	**Sugar and sugar confectionery**		
	Any type of sugar (in solid form) excluding molasses	33%	• 20% (including for maple sugar and maple syrup)
	Chewing gum whether or not coated	0%	• 30%
	Sugar confectionery including white chocolate	0%	• 30%
3.	Chocolate and food preparations containing cocoa	0%	• 30%
4.	**Drinks**		
	All types of soft drinks (except fruit juices)	40%	• 0%
	Powder soft drinks	40%	• 25%
	Water bottled or canned in a factory	30%	• 10% for mineral waters and aerated (sparkling) water not containing added sugar • 25% for all mineral waters and aerated (sparkling) water containing added sugar and for non-alcoholic beer

	All types of beer and stout	50%	• 40% or ETB 11 per litre, whichever is higher – all types of beer with alcohol content not exceeding 7%, with the following exceptions:
			  • 35% or ETB 9 per litre, whichever is higher – beer produced exclusively from barley grown and malted in Ethiopia
			  • 30% or ETB 8 per litre, whichever is higher – beer the local raw material content of which excluding water is at least 75% by weight of its constituents

	All types of wine	50%	• 40% for all types of wine, with the following exceptions: • 30% for wine the local raw material content of which excluding water is at least 75% by weight of its constituents
	Whisky	50%	• 80% (including for vodka, gin, rum, Geneva, fermented beverages)
	Other alcoholic drinks	100%	• 80%
5.	All types of pure alcohol	75%	• 60%
6.	**Tobacco and tobacco products**		
	Tobacco leaf	20%	• 20%
	Cigarettes, cigars, cigarillos, pipes	75%	• 30% + ETB 8 per pack (for cigarettes)
7.	Salt	30%	• 25%
8.	Fuel – super benzene, regular benzene	30%	• 30%
9.	Fireworks	0%	• 100%
10.	Plastic bags	0%	• ETB 40 per kg
11.	Rubber tyres	0%	• 5%
12.	Perfumes and toilet waters	100%	• 100%
13.	**Textiles and textile products**		
	Textile fabrics, knitted or woven of natural silk, rayon, nylon, wool or other similar materials	10%	• 8%
	Textile of any type partly or wholly made from cotton, which is grey, white, dyed or printed, in pieces of any length or width (except mosquito net and 'Abudgedid') and including blankets, bedsheets, counterpanes, towels, table cloths and similar articles	10%	• 8%
	Garments	10%	• 8%
14.	Artificial flowers, foliage and fruits, and articles made of artificial flowers, foliage and fruits	0%	• 10%
15.	Human hair and wigs	0%	• 40%
16.	Natural or cultured pearls and precious or semi-precious stones	0%	• 20%
17.	Personal adornment made of gold, silver or other materials	20%	• 0%
18.	Dish washing machines of a kind for domestic use	80%	• 0%
19.	Video decks	40%	• 10%
20.	Television and video cameras	40%	• 10%

21.	Television broadcast receivers whether or not combined with gramophone, radio, or sound receivers and reproducers	10%	• 10%
22.	**Motor passenger cars, station wagons, utility cars, Land Rovers, Jeeps, pickups, similar vehicles (including motorised caravans), whether assembled, together with their appropriate initial equipment**		
	Up to 1,300cc	30%	Rates range between 5% and 405%: • 5% – new, or completely or semi knocked down and to be assembled in Ethiopia • 55% – used, of age 1 year or more but not exceeding 2 years • 105% – used, age not exceeding 4 years • 205% – used, age not exceeding 7 years • 405% – used, age exceeding 7 years
	From 1,301cc up to 1,800cc	60%	Rates range between 60% and 460%: • 60% – new, or completely or semi knocked down and to be assembled in Ethiopia • 110% – used, of age 1 year or more but not exceeding 2 years • 160% – used, age not exceeding 4 years • 260% – used, age not exceeding 7 years • 460% – used, age exceeding 7 years
	Above 1,800cc	100%	Rates range between 100% and 500%: • 100% – new, or completely or semi knocked down and to be assembled in Ethiopia • 150% – used, of age 1 year or more but not exceeding 2 years • 200% – used, age not exceeding 4 years • 300% – used, age not exceeding 7 years • 500% – used, age exceeding 7 years
	Motor vehicles for the transport of 10 or more persons (including the driver)	0%	Rates of 100%, 200% and 400%: • 100% – used, seating capacity not exceeding 16 passengers (adults) including the driver, age not exceeding 4 years • 200% – used, seating capacity not exceeding 16 passengers (adults) including the driver, age exceeding 4 years but not exceeding 7 years • 400% – used, seating capacity not exceeding 16 passengers (adults) including the driver, age exceeding 7 years

	Three-wheeler motor vehicle	0%	Rates range between 5% and 405%: • 5% – new, or completely or semi knocked down and to be assembled by domestic industry • 55% – used, of age 1 year or more but less than 2 years • 105% – used, age 2 years or more but not exceeding 4 years • 205% – used, age exceeding 4 years but not exceeding 7 years • 405% – used, age exceeding 7 years
	Tractors (including single-axle tractors, road tractors for semi-trailers and track-laying tractors)	0%	Rates range between 0% and 400%: • 0% – new • 100% – used, age not exceeding 4 years • 200% – used, age exceeding 4 years but not exceeding 7 years • 400% – used, age exceeding 7 years
	Other vehicles with only electric motor for propulsion	0%	Rates range between 0% and 400%: • 0% – new • 50% – used, age not exceeding 2 years • 100% – used, age not exceeding 4 years • 200% – used, age not exceeding 7 years • 400% – used, age exceeding 7 years
	Motor vehicles for transport of goods, including crane lorries, mobile drilling derricks, concrete mixer lorries and the like	0%	Rates range between 0% and 400%: • 0% – new • 100% – used, age not exceeding 4 years • 200% – used, age not exceeding 7 years • 400%– used, age exceeding 7 years
	Motor cycles	0%	One of two rates: • 5% – new • 200% – used
	Trailers and semi-trailers, other vehicles not mechanically propelled, parts thereof	0%	• 200%
23.	Carpets	30%	• 30%
24.	Asbestos and asbestos products	20%	• 20%
25.	Clocks and watches	20%	• 0%
26.	Dolls and toys	20%	• 0%
27.	Carnival and festive entertainment and gambling machines	0%	• 20%
28.	Smoking pipes and cigar or cigarette holders	0%	• 20%

Source: Proclamation No. 1186/2020 and Proclamation No. 307/2002.