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Managing Ethiopian Cities II

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By Aloysuis Bongwa

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Making Cities Work

MANAGING ETHIOPIAN CITIES II

Informality in Ethiopia: Taxing the Hard to Tax

ALOYSIUS BONGWA

Abstract

Large informal (hard to tax) sectors are an integral part of the economies of developing countries (Ethiopia included). In much of Africa, the informal, or gray economy that escapes tax collectors and government regulators, is the hidden dynamic driving economic growth. The informal economy is an important contributor to employment and production in Ethiopia but also to fiscal and regulatory evasion and, as such, is an intensely debated issue. Informality has a direct impact on public revenues and expenditure. If it is large and growing over time, policy must attempt to bring it more fully into the tax-base and/or attempt to contain its growth. Possible policy-measures will depend on the causes of its growth. If it is growing because of restrictions on entry into formal activity, then policy must address these restrictions. If, on the other hand, it is growing because of too many taxes, then policy must address the structure of taxation. Addressing these causes may transform informal into formal activity. Important questions to answer in terms of policy are: ***to what extent the informal sector should be taxed, and what instruments can be used to efficiently and effectively accomplish the task.***

All over the world several governments (including Ethiopia) have relied in the recent past, and still even rely today, on various forms of presumptive taxation, to respond to the high levels of informality. Existing presumptive tax regimes have seldom been examined thoroughly. This paper looks at the issue of presumptive taxation in the Ethiopian context and reflects on how efficient and effective the use of presumptive taxation has been. This paper argues that it is difficult to evaluate the success of special tax regimes (presumptive taxation in this case) to achieve their goals, whether those goals are increased participation in the formal tax system, obtaining some basic level of revenue from all economic agents, educating new taxpayers, or reducing compliance costs for at-risk taxpayers.

Introduction

The informal economy contributes to employment and production in Ethiopia but also to fiscal and regulatory evasion and, as such, is an intensely debated issue. Informality has a direct impact on public revenues and expenditures – the stuff of fiscal policy. If it is large and growing over time, policy must attempt to bring it more fully into the tax-base and/or attempt to contain its growth. Possible policy-measures will depend on the causes of its growth. If it is growing because of restrictions on entry into formal activity, then policy must address these restrictions. If, on the other hand, it is growing because of too many taxes, then policy must address the structure of taxation. Addressing these causes may transform informal into formal activity. As such for countries in terms of policy, important questions to answer are: to what extent the informal sector should be taxed, and what instruments can be used to efficiently and effectively accomplish the task.

Several governments across the world have relied in the recent past and still rely today on various forms of presumptive taxation[1], in which indirect methods are used for evaluating the1e\ective tax base and computing the corresponding tax liability. Basically, the effective tax base is estimated using a set of variables that are strongly correlated with it, and are easily observable, but at the same time cannot be tampered with by the taxpayers; for example, the type of occupation, labour costs, telephone and electricity bills, the number of employees, the size of the store, and so on.

While the government in many developing countries have in recent years reformed their tax systems, and while some progress has been made on the old problem of the tax-exempt status of the informal sector, there still remains a lot to be done. Ethiopia however has made great strides when it comes to taxation and the informal sector. What is debatable is whether the informal sector has in fact been growing faster than the formal sector in Ethiopia and whether the existing tax regime (presumptive taxation) has been successful in accomplishing the underlying objectives (*broadening the tax base and to increase tax revenue in an efficient, equitable and cost effective manner*) .

This paper is a contribution to the ongoing debate over the appropriate mechanisms for taxing the informal sector in developing countries with a focus on the use of presumptive taxation in the Ethiopian context and is structured as follows. After this introduction, the next section discusses the debate surrounding the definition of the informal Sector "- shadow economy, hard to tax (HTT) sector and the links of this sector to the economy of countries. This is followed by a review of the growing interest in taxing the informal sector and the various instruments (tax regimes) available to governments with a focus on the use presumptive

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[1] Strictly speaking, all taxes are presumptive, since "the conceptually pure tax base cannot be perfectly measured, and the tax authority is constrained to rely on some correlate of the concept." (Slemrod and Yitzhaki, 2002, p. 1457). However, there are cases in which the correlate is immediately found and others in which the gap to bridge is relatively large.
The word "presumptive" in English points at the legal origin of the term and means that there are reasonable presumptions about the taxable income of the taxpayer.

taxation. The following section contextualizes the issue by discussing the trends and cycles of the informal sector in Ethiopia and the use presumptive taxation in Ethiopia. This is followed by a broader look at presumptive taxation and the effectiveness of such a tax regime. The next section looks ahead and discusses the requirements for formalization. The concluding section presents the perceived effectiveness of presumptive taxes and issues for further research.

Definition of Informality and constraints

The informal sector (economy)[2] is a vague term open to a number of interpretations. In this paper we have defined informal economy as the ensemble of all unobserved economic productive activities that are driven by tax and social security evasion or by attempts to avoid compliance with certain legal standards and administrative procedures. This definition excludes marginal non taxed activities (such as domestic labour and subsistence farming) and therefore criminal activities (e.g. smuggling, trafficking, prostitution etc.), which although might exist in Ethiopia are different in nature and require different policy measures than informal activities. A clear definition of the informal sector is important as differing interpretations of the term "informal sector" could lead to significantly different estimates and conclusions. However, the issues to address here are straight-forward: What is formal and what is the informal sector? What are useful perspectives on the informal sector from a tax administration perspective? What are the implications for taxation?

To begin with, there are three main schools of thought regarding the relationship between the formal and informal economies:

The dualists: the informal economy is a separate marginal economy not directly linked to the formal economy, providing income or a safety net for the poor (ILO 1972);

- The structuralists: the informal economy is subordinated to the formal economy. In order to reduce costs, privileged capitalists seek to subordinate petty producers and traders (Castells and Portes 1989);
- The legalists: informal work arrangements are a rational response by micro-entrepreneurs to over-regulation by government bureaucracies (de Soto, 1989).

The informal sector can be usefully broken into two basic types: *below* and *above ground* informal sectors. Both may be unregistered for any or some types of tax. Underground untaxed activities include criminal activities, black market or grey activities, and tax evasion. These activities could be conducted by individuals or involve organized groups or gangs. Another possibly large underground activity is moonlighting, or individuals taking on undocumented jobs or providing services (often personal or business services) for fee typically paid in cash. Moonlighting may be conducted as an additional job or by a contractor providing added services at night or on weekends over and above formal activities. Above ground or parallel

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[2] The informal sector is increasingly being referred to as the informal economy to get away from the idea that informality is confined to a specific sector of economic activity but rather cuts across many sectors. "Informal economy" also emphasises the existence of a continuum from the informal to the formal ends of the economy and thus the interdependence between the two sides

market activities include micro/small scale unincorporated business activity that may also be outside monetary economy. Such activity is often conducted outside of any formal law (but possibly within some traditional law) or is only partially regulated, and seldom effectively taxed. It includes the majority of economic activity of the labour force in many low-income countries. It can include agricultural, forestry, fishing, mining, petty manufacturing, trading and personal and business services. While some activities may be illegal or constitute tax evasion, the bulk of them are routine or traditional subsistence or self-employment business activities.

Informal sector businesses are typically unincorporated, owner or family managed and operated with few, if any regular employees. The business may not keep books or records, and may do all exchanges for cash or barter. Only to the extent that the business has dealings with a formal sector body – bank, customs service, supplier, buyer, cooperative, etc – will a third party have some formal information on these activities.

From the tax administration perspective, the informal sector of the economy is composed of individuals and businesses for which the authorities have little or no information about their business activities. While a government may (or may not) know about the existence of an individual in a jurisdiction, official documentation of his or her business activities is often lacking. Given that information on economic activities is fundamental to assessing taxes, the informal sector poses a severe problem to the tax authorities[3].

From a taxation perspective, the underground or illegal informal activities generally reflect an *unwillingness to comply* rather than a *lack of capacity to comply* with tax laws or regulations. The above ground informal sectors often contain severe compliance capacity limitations ranging from a lack of general skills (innumeracy and illiteracy) to a lack of more specific tax compliance skills such as the ability to issue invoices, maintain transaction records and accounts, or the ability to comply with complex tax provisions

Taking the above into consideration, almost all of the literature highlights the importance of the following key factors in the establishment and growth of the informal economy:

- High intensity of legal and administrative regulations: the greater the intensity of regulations such as business registration, license and permit requirements, labour market restrictions, trade barriers, etc, the greater the incentive for flight into the informal economy. Research also suggests that law enforcement, not just the intensity of regulations, may be a key issue.
- High overall tax and social security burdens: basically, the higher the difference between the total cost of labour in the official economy and after tax earnings from work, the greater the incentive for flight

3 Typically, the more different parties have information about and an interest in these business activities; such transparency and accountability makes the accurate assessment of taxes easier or tax evasion more difficult.

operation in the informal economy.

- Lack of trust in official institutions / administrative corruption: examples of such corruption include the court system, unclear legislation and bureaucracy.
- Lack of access to formal property systems: this refers to the lack of clear property rights and title deeds and the inability to collateralise property assets. This obstructs firms' access to official financial institutions such as credit lines, insurance, etc.
- Long-term decline in civic virtue and loyalty towards public institutions, combined with a decline in tax morale.
- Broad acceptance of illicit work often sanctioned or tolerated by the state.

(Ernste, 2003, p.91; Djankov et al, 2002; De Soto, 2000)

In a comprehensive literature review, Ernste (2003) argues that since taxes affect labour-leisure choices and stimulate labour supply in the informal economy, the distorting effect of this choice is a major concern, leading to the conclusion that the bigger the difference between the total costs of labour in the official economy and the after-tax earnings from work, the greater the incentive to avoid the difference and work in the informal economy.

Why does informality matter?

Informality matters for several reasons. A good reason is that it stifles investment and undermines the overall competitiveness of the economy, because many informal enterprises are stuck in a low-productivity trap (Palmade, 2005). Being outside the regulatory and tax umbrella means that these enterprises can afford to be less productive than their competitors in the formal sector. But it also means that they are locked out of markets for finance, technology, and other resources that would enable them to close the gap.

Schneider, (2003) considers the development of the shadow economy in thirty – seven African countries[4] from 1990-2000. From this study we realize that the informal (shadow) economies in these countries have increased. On average, the size of these thirty-seven African shadow economies was 41.3% of the official GDP in 1990/2000, and increased to 43.2% in 2002/2003. This is an average increase of 0.9 percentage points over a four year period. From the results in 2002/2003, Zimbabwe, Tanzania and Nigeria (with 63.2, 60.2, and 59% respectively) had by far the largest shadow economies. At the other end of the scale, South Africa had the lowest shadow economy, with 29.5%, followed by Lesotho with 33.3% and Namibia with 33.4%

[4] For a more detailed explanation see Schneider, 2003 Shadow Economies of 145 Countries all over the World : Estimation Results over the period of 1999-2003, p15

Table 1: Shadow Economy (in % of Official GDP)

		Shadow Economy (in %of Official GDP) Using the DYMIMIC and Currency Demand Method		
No	Country	1990/2000	2001-2002	2002- 2003
1	Algeria	34,1	35,0	35,6
2	Angola	43,2	44,1	45,2
3	Benin	47,3	48,2	49,1
4	Burkina Faso	41,4	42,6	43,3
5	Cameroon	32,8	33,7	34,9
6	Congo, Dem. Rep.	48,0	48,8	49,7
7	Egypt, Arab Rep	35,1	36,0	36,9
8	Ethiopia	40,3	41,4	42,1
9	Ghana	41,9	42,7	43,6
10	Kenya	34,3	35,1	36,0
11	Lesotho	31,3	32,4	33,3
12	Mali	42,3	43,9	44,7
13	Morocco	36,4	37,1	37,9
14	Mozambique	40,3	41,3	42,4
15	Nigeria	57,9	58,6	59,4
16	South Africa	28,4	29,1	29,5
17	Zimbabwe	59,4	60,0	63,2

Source: Adapted from Schneider, 2003 Shadow Economies of 145 Countries all over the World: Estimation Results over the period of 1999-2003, p15

*** Some of the figures presented above are questionable. For Zimbabwe for obvious reasons (the collapses of the formal economy); for Mali, Zimbabwe, and the Democratic republic of Congo there is room to believe that the figures could be higher.*

There is no doubt that the informal economy forms a large part of the economies of many developing and transition countries. It comprises 42% of value added in Africa, 41% in Latin America and 35% in the transition economies of Europe and the former Soviet Union, compared with 13.5% in OECD countries. The informal economy provides employment and income for many who lose or cannot find work in the formal economy, and it includes a disproportionate number of women, young people and others from disadvantaged groups. For example, it has been estimated that informal employment accounts for 84% of women's employment in sub-Saharan Africa, (OECD, 2006).

The large informal (shadow) economy in Africa (Ethiopia included) is less an issue of tax burdens than a simple fact that the limited economy means that citizens are often unable to earn a living wage in a legitimate manner. Working in the shadow economy is often the only way of achieving a minimal standard of living (Schneider, 2005).

Interest in taxing the informal Sector

Given the current size of the informal economy and its propensity to keep increasing, there has been a growing interest in taxing the informal sector[5] in most developing countries for a number of reasons (Ayee, 2007). They include the following:

- *Revenue needs:* The introduction of neo-liberal reforms under structural adjustment programmes (SAP) with emphasis on liberalization, downsizing and changing tax policy as well as tax administration has brought to the fore the urgent practical necessity of increasing revenues, which will enable the state to deliver basic services. In fact, revenue maximization is the primary objective of tax policy. The informal sector therefore becomes the obvious avenue to be drawn into the tax net having been mostly out of it;
- *The phenomenal size and growth of informal sector:* The liberalization of economies as a result of SAP has pushed many formal businesses into the informal sector in most developing countries. Recent calculations estimate that the size of the informal sector in developing countries varies between about twenty percent in Indonesia to around sixty seven percent of GDP in Bolivia (Schneider, 2002). The informal sector is complex and heterogeneous comprising of large enterprises and small; urban firms and rural ones; visible activities as well as invisible ones; owners as well as workers; local activities as well as those that cross jurisdictional boundaries;
- *Impact on tax compliance in the formal sector:* Legitimate taxpayers in the formal sector perceive the state as being unfair in pursuing them for taxes while the informal sector continues to operate untaxed. Ignoring informal sector activities will lower compliance morale and increase the risk of generalized non compliance (Terkper, 2003). There is some evidence from Latin America suggesting that tax compliance in the formal sector is higher in countries which have a relatively small informal sector (Torgler, 2003).
- *State legitimacy:* Informalization might be indicative of the fact that operators see no value in engaging with the state in the protection of life and property, and therefore legitimacy becomes a serious concern. In order to regain legitimacy, governments are looking for ways to incorporate informal activities into formal systems. Taxation is a good route into the problem, as it enables governments to recognize informal activities without

[5] Despite the extensive debate about the definition of the term 'informal sector' we continue to use it for the purposes of this paper bearing in mind that the informal sector is heterogenous, includes a broad continuum from the 'less formal' activities that have only some of the characteristics of informality to the 'totally informal' ones that exhibit all the characteristics of informality. For a recent discussion of the definition of the informal sector see Gerxhani (2003).

legitimizing the breaking of other rules and regulations. Broadening the tax base and developing a 'culture of compliance' can achieve more than simply increasing revenues; it can be a way of re-engaging citizens with the state.

- *Demands from the informal sector:* Research shows that those within the informal sector are willing to pay taxes, specifically when these are in exchange for some legitimacy, stability and protection from arbitrary harassment from state agents (Dickovick, 2003, Baross, 1990). For many within the sector, the tax burden is not onerous, especially as they are paying informally anyway, albeit as bribes to street level bureaucrats, in order to continue operating;
- *Tax-Accountability link:* Governments that are dependent upon earned revenues such as taxes (as opposed to unearned revenues such as aid or mineral wealth) are more likely to be responsive to their citizens for various reasons. The flip side of the argument suggests that citizens who pay taxes will demand more responsive governments (Gloppen, 2002). By encouraging people within the informal sector to come within the tax net, it is thus assumed that they will start the process of a constructive engagement with the state—of gaining services and rights and becoming full citizens. In short, widening the tax net will spark off a virtuous cycle of taxation and accountability that is at the heart of consolidating democracies (Joshi and Ayee, 2006).

While there is this growing interest in taxing the informal sector, many scholars also assert that high taxation rates induce tax evasion and informality (Thomas, 1992; Schneider, 1994, 1997; Kaufmann, 1996; Johnson, 1999; Tanzi 1999, among others). High taxes reduce profit margins and thus the incentive to engage in business in the formal sector or possibly at all (see Gwartney, 1996). The relationship between the rate of taxation and the size of the informal sector is complex, however. Johnson et al. (1999) found that the US has relatively high tax rates, but a small informal sector, and that in some cases decreasing tax rates can lead to an increase in size of the informal sector.

Moreover, different types of taxes and different taxation rates have varying impacts on a firm's tax burden and on the size of the informal sector. The literature suggests that institutional aspects such as tax administration may affect the size of the informal sector at least as much as the tax rates.

Our concern in this paper, however, is with the more limited question of the extent to which "presumptive taxation" can be an effective tool to cope with what are commonly called the "hard-to-tax". While the HTT category is seldom very clearly defined – often, for example, it excludes those at the top of the power pyramid who manage to save themselves from the full fury of the taxman in accepted (or at least untouchable) ways – it appears to encompass much of the so-called "informal" ("hidden" "shadow" "underground") economy that is such a prominent feature of economic reality in many developing and transition countries (Schneider, 2003). Although much of the discussion in this paper covers the use (and abuse) of presumptive taxes in general, our specific focus is on the special simplified tax regimes that have been put into place recently in a number of transitional countries.

The use of presumptive taxation

It is the nature of the business of tax administration that the "customers" are not very willing. In all countries, some enterprises and individuals manage to avoid the full impact of the tax system. They do so in many ways. Some have sufficient political influence to remain outside of the scope of the legislation in the first place. Others, also usually at the upper end of the economic spectrum, manage to devise legal ways around the apparent intent of the law. Still others simply cheat, for example, by claiming improper deductions or under-reporting income or sales. At the extreme, some evaders may operate completely outside the scope of the formal tax system. And finally, some may simply refuse to pay their taxes. Each of these types of evasion may be dealt with in different ways.

While Benjamin Franklin may have been right that death and taxes are the only certain things in life[6], this certainty definitely does not extend to the way taxes are levied: tax systems are continuously changing as countries align their tax systems with evolving economic, political, and administrative conditions[7].

Presumptive taxation involves the use of indirect means to ascertain tax liability[8], which differ from the usual rules based on the taxpayer's accounts. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method. Broadly speaking, a presumptive income tax (P-tax for short) is a tax based on some measure of economic activity that proxy for taxable income, rather than on taxable income itself. The concept covers a wide variety of alternative means of determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation[9].

Presumptive techniques may be employed for a variety of reasons.

i. One is simplification, particularly in relation to the compliance burden on taxpayers with very low turnover (and the corresponding administrative burden of auditing such taxpayers).

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6 "In this world, nothing can be said to be certain, except death and taxes." Benjamin Franklin, 1789, in a letter to Jean-Baptiste Leroy.

7 In fact, a whole "industry" has emerged that on a daily basis scrutinizes and reports on global tax reform initiatives.

8 A useful description is provided by Ahmad & Stern: "The term presumptive taxation covers a number of procedures under which the `desired' base for taxation (direct or indirect) is not itself measured but is inferred from some simple indicators which are more easily measured than the base itself." Ehtisham Ahmad & Nicholas Stern, The Theory and Practice of Tax Reform in Developing Countries 276 (1991).

9 For further discussion and analysis of presumptive taxation, see Indira Rajamaran, Presumptive Direct Taxation: Lessons from Experience in Developing Countries, Economic and Political Weekly (forthcoming); Arye Lapidoth, The Use of Estimation for the Assessment of Taxable Business Income (1977); Kenan Bulutoglu, Presumptive Taxation, in Tax Policy Handbook 258 (Parthasarathi Shome ed., 1995); Russell Krelove and Janet Stotsky, Asset and Wealth Taxes, in id. 181; Vito Tanzi & Milka Casanegra de Jantscher, Presumptive Income Taxation: Administrative, Efficiency, and Equity Aspects (IMF Working Paper, 1987)

ii. A second is to combat tax avoidance or evasion (which works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records).
iii. Third, by providing objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of the tax burden, when normal accounts-based methods are unreliable because of problems of taxpayer compliance or administrative corruption.
iv. Fourth, rebuttable[10] presumptions can encourage taxpayers to keep proper accounts, because they subject taxpayers to a possibly higher tax burden in the absence of such accounts.
v. Fifth, presumptions of the exclusive type (see below) can be considered desirable because of their incentive effects—a taxpayer who earns more income will not have to pay more tax.
vi. Finally, presumptions that serve as minimum taxes may be justified by a combination of reasons (revenue need, fairness concerns, and political or technical difficulty in addressing certain problems directly as opposed to doing so through a minimum tax).

Turning finally, to "presumptive" regimes as such, a useful starting point is to think of four possible approaches to administrative assessment (Bulutoglu, 1995):

Systems that estimate taxpayer income on some specific basis. The estimate may be applied on an individual basis to different taxpayers (the French *forfait*, for instance) or differently for different groups of taxpayers (the Israeli *takshiv*, for example[11]). The amount assessed may be a simple lump-sum tax based on the average income of a particular trade or profession, or it may be based on a more complex calculation using information on sales, employees, assets, location, etc.

1. Systems which apply an assets tax (either generally for all businesses or as a minimum tax);
2. Systems which apply a gross receipts or turnover tax (either generally for all businesses or as a minimum tax);
3. Systems which base the tax on external indicators of income such as items of personal expenditures (e.g. on automobiles) or wealth (e.g. housing)[12].

The system used in a country should presumably be related to its policy objective – for example, to reduce evasion in general or to simplify the system for small taxpayers – as well as to the sophistication of its tax administration and the data available[13]. The table below summarizes some examples of the various forms of presumptive taxes found in a few countries.

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10 Rebuttable presumptions: The rebuttability as regards presumptive taxation involves for the taxpayer the opportunity to justify that his tax liability accrued on the basis of general taxation rules is smaller than the one calculated under the conditions of special treatment. In other words, the taxpayer can arrange the reduction of his / her tax liabilities with the tax authorities in the framework of an administrative procedure.
11 For more detailed discussion, see Thuronyi (1996, 2003).
12 The first three approaches mentioned are also widely used for local business taxation, on which see Bird (2003).
13 For a good discussion of the last two points, see Musgrave (1981).

Table 2: Presumptive Taxation in Different Countries

Country	Tax Treatment	Condition
Belgium	Small businesses: Flat rate for three years	*"Forfait"* scheme applying to small businesses based on profession for income below BF 100,00
Greece	Small businesses: Flat rate applied to purchases and receipts	1992
Spain	Small businesses: Forfait scheme for twenty-eight industries	Began in 1992
Bolivia	Other small businesses covered by a standard flat rate tax	Tax base: sales minus limited expenses
Israel	Small businesses in two sectors: Transport (no threshold) Retail and artisans (threshold of $4,000 tunover)	Tax Base: Turnover
Mexico	Small businesses and professionals (no threshold):	Tax Base: Total income
Uruguay	Small businesses and professional: all industries at a standard percentage	Tax Base: a mix of total turnover and inputs
Angola	Small businesses: all industries with turnover less than $22,000; taxed as a flat amount (un-indexed) Small businesses: all industries with turnovers less than $20,000	Tax Base: cash flow
Cameroon	Small business Sector	Tax base Turnover
Morocco	Small business service sector	Tax base; Turnover Tax Base: Flat presumptive amount Tax Base: Turnover, taxed as a fixed percentage
Ghana	Small businesses: all self-employed	Presumptive tax applied based on occupation or business

Russia	Small businesses: selected industries, indexed threshold for gross receipts and based on number of employees	Tax Base: Gross receipts or profits. If taxed on gross receipts received 6 percent, if taxed on profits, the rate is 15 percent. If eligible for the imputed tax, the base is calculated and the determined by the regional governments.
Ukraine	Small businesses: eligibility based on number of employees and level of turnover	Tax Base for unified tax: Turnover. If tax is to include VAT6 percent, if it excludes VAT, the rate is 10 percent Fixed tax, trade permit, and small enterprise tax are also available
Uganda	Small business: all industries with annual turnover approximately $38,000 US	Tax Base: Turnover, taxed as a fixed percentage

Source: Complied from: Bird and Wallace (2003) Coopers and Lybrand (1997), Rajaraman (1995), Bulutoglu (1995), Eglu and Heloo (2001), Chen and Reinkka (1999), Stotsky (1995), Shome (1995), Wallace (2002), Engelschalk (2003)

It should be noted that using presumptions improves the admissibility of a tax while lowering its accuracy. The key question that arises: to what extent the former benefit justifies the latter cost. On a related issue, some in the field believe that presumptive taxation should be considered a permanent supplement or even a replacement for the more traditional tax system. Others see it as a merely transitional phase until the tax administration is capable of collecting the normal tax without the widespread use of presumptions. No matter what system of presumptive taxation is used, there are definitely always advantages and disadvantages.

Table 3. Possible advantages and disadvantages of presumptive tax systems

Advantages	Disadvantages
Lower compliance costs	No incentive to improve bookkeeping
Tax liability more predictable	No relief in case of loss making
Less interaction with tax administration	Potential disincentive to grow
Generally lower tax burden	Risk of abuse
	Fairness concerns

Source:

Presumptive taxation raises both theoretical and practical issues of great importance. From a policy perspective, the extent to which presumptions can operate to simplify the task of administration without fundamentally changing the tax base is a key issue. From a practical perspective, the fundamental issue in presumptive taxation is the trade-off between accuracy and administrability.

The informal sector in Africa and Ethiopia

Since many African countries either don't collect data on the informal sector or they use different definitions, it is difficult to make strict comparisons within and between countries. Nonetheless, the available data clearly indicates that the informal sector represents both a significant component of gross domestic product and employment in most African countries. (Verick, 2006)

The World Bank as part of its work on benchmarking business regulations has developed a measure of the size of the informal economy. The methodology for estimating this indicator is based on the study by Schneider (2002). Using this data, Figure 1 graphs the size of the informal economy as a percentage of gross national income (GNI), which ranges from under 30 percent in South Africa, the continent's largest economy, to almost 60 percent in Nigeria, Tanzania and Zimbabwe. The average in Sub-Saharan Africa (SSA) is 42.3 percent.

Turning to the labour market, based on figures reported in ILO (2002a) the informal sector in SSA is estimated to represent around three-quarters of non-agricultural employment. According to ILO (2002c), the sector amounts to 72 percent of employment in sub-Saharan Africa, 78 percent if South Africa is excluded. Statistics reported in Chen (2001) suggest that 93 percent of new jobs created in Africa during the 1990s were in the informal sector, reflecting the impact of globalization, economic reforms and competitive pressures on the labour market in recent years.

Xaba et al. (2002) summarise the experience of a number of African countries, which shows that there has been a decline or stagnation in employment growth in the formal sector, while the informal sector on the continent has been growing in terms of both its share of output and employment. For example, informal employment in Kenya and Uganda exceeds employment in the formal sector. In terms of Southern Africa, in Zambia 43 percent of urban employment is in the informal economy, while in Mozambique evidence suggests that 30-40 percent of urban households were dependent on the informal economy in the 1990s. As also reported in Xaba et al. (ibid), 89 percent of the labour force in Ghana is employed in the informal sector.

In Ethiopia, classifying economic activities into formal and informal and measuring the extent to which the informal economy generates employment opportunities are challenging tasks. In the first national labour force survey (1999) in the country, the following definition of informal employment was used. "A person is considered to work in the informal economy when he/she is engaged in a business or enterprise that does not keep book of account, has less than 10 workers, has no business/enterprise license and works at least four hours a week." Excluding people engaged in subsistence farming and those working in private households, a quarter of all employed individuals were employed in the formal sector while nearly three-quarters of the population were employed in the informal economy in 1999. With 87 per cent and 52 per cent of the total rural and urban population involved in informal economy activities respectively, the proportion of informal economy employment is clearly higher in rural areas. This is not surprising given the fact that formal employment opportunities, education and other services that enhance the employability of people are much higher in urban areas. (Berhanu Denu, Abraham Tekeste and van der Deijl 2005. p.24)

Fransen and van Dijk, 2008, stipulate that as much as 69% of all employment in Addis Ababa and 65% of urban Ethiopia is informal. This comprises those working in informal business, which is the rather narrow definition applied by the Ethiopian Government, as well as a huge group of domestic workers, apprentices and unpaid family workers. Those could be added to the statistics offered by the Central Statistics Agency without errors of inclusion, as they are not working for informal businesses[14]

Informal businesses in Ethiopia are defined using three criteria: no book of accounts; no license; and fewer than 10 employees (World Bank 2007c). Registration is a first but not yet sufficient step towards licensing. Based on official statistics, 26% of those employed in Addis Ababa work in informal businesses, with another 4.8% reported as unpaid family work, other employees or so called domestic workers engaged in sales, machine operating, trade, clerks and official work. The sectors wholesale and retail trade, hotels and restaurants

[14] The question of measurement comes up again because Fransen and van Dijk also point out that the percentages they arrived at differ from those mentioned by the World Bank (2007c) and CSA (2005), who in their opinion erred by not excluding the 'not identified' and 'not stated' in their calculations. World Bank (2007c) also makes error of inclusion by adding self employed which can already be part of informal businesses.

and primary production activities are over 90% informal, measured as a share of employment.

Table 4: Regional distribution of informal employment in urban areas (%), 1999-2004

	1999			2003			2004		
Region	M	F	T	M	F	T	M	F	T
Tigray	4.0	7.4	6.0	4.2	7.7	5.9	5.9	7.6	6.8
Afar	1.1	1.0	1.0	0.7	0.8	0.8	0.8	0.7	0.8
Amhara	17.2	23.6	20.9	17.6	23.6	20.7	15.0	23.4	19.3
Oromiya	38.4	38.9	38.7	28.4	31.9	30.2	31.1	31.7	31.4
Somali	2.5	2.1	2.3	2.8	3.3	3.1	2.1	3.1	2.6
Benishangul-Gumuz	0.6	0.6	0.6	0.4	0.5	0.5	0.4	0.6	0.5
SNNP	12.4	12.7	12.6	13.1	13.3	13.2	12.8	14.2	13.5
Gambella	0.3	0.4	0.3	0.4	0.8	0.6	NA	NA	NA
Harari	1.0	1.0	1.0	1.1	1.2	1.1	1.1	1.2	1.2
Addis Ababa	20.8	10.7	15.0	29.7	14.8	22.1	28.3	15.3	21.7
Dire Dawa	1.7	1.7	1.7	1.6	2.0	1.8	2.5	2.2	2.3
Country Total (*Urban)	100	100	100	100	100	100	100	100	100

Source: CSA (1999) and (2004); NA – Not available

The Use of Presumptive Taxation in Ethiopia

In Ethiopia, appropriate fiscal policy measures have been introduced to encourage taxpayers through facilitating the tax collection system and its revenue generation. Measures taken so far include: income tax streamlining and closing of loopholes, improving the incentive system, strengthening tax administration, overhauling the income tax law and regulations, introducing a broad-based Value Added Tax (VAT) and tax identification numbers, and rationalizing tariff rates. (See Box Below)

Box1: Implementation of the Tax Reform Programme has helped to revamp Tax Revenue collection

In order to achieve development objectives through the PASDEP, mobilizing financial resources is indispensable. The major sustainable source of the required financial resource is domestic revenues from tax and non-tax sources. In line with this, in the past years, the Government adopted far-reaching tax reform measures including overhauling the tax laws and regulations, broaden the tax base by way of introducing the Value Added and Turn over taxes back in 2003. Parallel with the tax reform programs extensive tax administration measures have been undertaken. The tax administration measures include the implementation of a national Taxpayer Identification Number (TIN), the introduction of the presumptive tax scheme in order to address the hard to tax group, re-organizing tax collection institutions, computerizing the tax administration, and conducting comprehensive tax education to enhance taxpayers' compliance.

Since identification and registration of the tax payer is the prime function of the tax collecting institution, the introduction of TIN is expected to improve the over all revenue performance through creating data base, improving information flow, and creating essential link to all tax operations. Of all the tax reform efforts undertaken so far, substituting the previous cascading sales tax with a well designed and modern value-added tax system could be cited as significant step in the reform program and a major success. Comparative studies attested that VAT revenue productivity compared with our neighboring countries has been found to be very encouraging. Accordingly, the VAT significantly contributed to revamp recent tax revenue performance.

Tax assessment in the absence of books of account is the most challenging aspects of tax administration.

To this end, the government introduced presumptive tax assessment scheme on category "C" tax payers[15] aimed at improving equity and putting administrative simplicity. The scheme has been implemented at regional level to collect profit tax from potential taxpayers with lesser collection cost and minimized collusion. The introduction of turn over tax on those who are not eligible to VAT is intended to keep the neutrality of the tax system and argument revenue collection by

[15] Scope of schedule "C" income: Income tax shall be imposed on the taxable business income realized from entrepreneurial activity. Taxable business income: taxable business income shall be determined per tax period on the basis of the profit and loss account or income statement, which shall be drawn in compliance with the General Accepted Accounting standards, subject to the provisions of this proclamation (Proclamation No. 286/2002; Income Tax Proclamation) and the derivatives issued by the Tax Authority.

regional Governments. In the process of improving the tax system and promote service delivery, various operational programmes, systems and procedures have been introduced in taxpayers' revenue accounting. Such measures enhanced efficiency and effectiveness in the management of tax arrears and taxpayers' compliance. Above all, the tax reform agenda incorporated a comprehensive computerization programme aimed at automating all tax administration function through out the nation. To this effect, since the beginning of 2005, a tax system that handles all taxes in a single software system known as Standard Integrated Government Tax Administration System (SIGTAS) is being installed. Currently SIGTAS is implemented in Large Taxpayers' Office (LTO) and Addis Ababa Branch offices as well as regional offices of FIRA where the system is intended to administer VAT.

Source: MOFED

In Ethiopia, according to Article 68(1) and (2) of Income Tax Proclamation-No 286/2002, Standard Assessment method is used to determine the Income Tax liability of Category C taxpayers. The Standard Assessment is the fixed amount of tax determined in accordance with Council of Ministers Regulations.

The Scope of Schedule "C" Income

Income tax shall be imposed on the taxable business income realized from entrepreneurial activity. The taxable income shall be determined per tax period on the basis of the profit or loss account or an income statement, which shall be drawn in compliance with the General Accepted accounting Standards, subject to the provisions of this proclamation (Proclamation No. 286/2002) and directives issued by the tax Authorities.

The tax rate shall be determined as follows:

1) taxable income of bodies is taxable at the rate of 30%
2) taxable business income of other taxpayers shall be taxed in accordance with the following schedule (See Table 5)

In this regard, The Council of Ministers Regulations No.78/2002, Article 21 states that category "C" taxpayers (whose annual turnover estimated by the tax Authority as being up to Birr 100,000) shall pay tax in accordance with Schedule "1" and "2" attached with these Regulations. For this purpose the estimated Average Annual Profitability Rate varies in the range of 10% to 70% depending upon the nature of business service sectors. The basic amount of 100,000 is divided in to 19 divisions starting with the division of "up to Birr 10,000 and thereafter an increment of 5,000 Birr each for subsequent divisions.

Table 5: Marginal tax rate for presumptive tax on business Annual taxable income (birr) Marginal tax rate % Schedule "C"

Taxable Business Income (per Year) Threshold Presumptive Tax		Income Tax Payable
0	1800	Exempt Threshold
1,801	7,800	10
7,801	16,800	15
16,801	28,200	20
28,201	42,600	25
42,601	60,000	30
Over 60,000		35

Source: Proclamation No. 286/2002*)*

In countries (Ethiopia included) operating a presumptive tax system for small businesses, the threshold for the application of such system serves as one proxy for the definition of a small business for tax purposes. This threshold varies considerably from country to country (See table below)

Table 6: Comparative analysis of Threshold for Presumptive Turnover Taxes in Different Countries

Country	Threshold Presumptive Tax
Armenia	Turnover below AMD 30 million (US$89,000)
Brazil	Gross income not more than R$240,000 (US$103,000) for individuals and R$2,400,000 (US$1.03 million) for incorporated SMEs
Bulgaria	Turnover below BGL 75,000 (US$52,000)
Ethiopia	Turnover below Birr 100,000 (US$11,000)
Hungary	Turnover below HUF 25 million (US$120,000)
Laos	Turnover below KN 100 million (US$11,000)
Peru	Gross income below PEN 240,000 (US$71,000)
Tanzania	Turnover below TSH 20 million (US$16,000)
Russian Federation	Up to 1000 employees plus turnover below RUB 11 million (US$426,000
Zambia	Turnover below ZMK 200 million (US$50,000)

Source: International Finance Corporation. (2007) Designing a Tax System for Micro and Small Businesses. Guide for Practitioners.

A broader look at presumptive taxation

Existing presumptive tax regimes have seldom been examined thoroughly. Most do not seem to have been very successful from any perspective. The firms subject to presumptive tax regimes may prefer such regimes because it shelters them from some of the complexity of the tax system and the rapacity of some tax officials (Engelschalk, 2004). The tax administration may also prefer presumptive regimes because they no longer have to deal with troublesome small taxpayers and can concentrate on those large taxpayers that pay a very large percentage of total tax revenue.

Politicians may also prefer presumptive tax regimes because the small taxpayer community is large and vociferous and they think it either costs them little in terms of revenues or may even generate revenue.

However, those concerned with the equity, efficiency, and long-term development of sound tax systems should be less sanguine about presumptive tax regimes. Presumptive tax regimes intended in part to reduce the compliance and administrative costs of taxation may increase rather than decrease efficiency costs (Bird, 2003).

These regimes are generally not well designed and are almost never well integrated with the regular tax system. Too high an exit threshold from the presumptive system undermines the regular tax system and invites too many participants into the special regime. Too low an entry threshold may discourage small business activity and may impose tax liability on persons who should not be in the tax system. Presumptive tax regimes that define eligibility narrowly may also undermine the fairness of the overall tax system. (Bird, 2005).

Another concern is the implication of presumptive tax regimes for tax compliance. A traditional tax system relies on both enforced compliance and voluntary compliance. The educational goal of presumptive tax regimes is to bring hard-to-tax sectors into the tax net and to encourage participation in the regular tax system, thus increasing voluntary compliance. But a presumptive tax regime that does not 'graduate' its taxpayers may undermine the tax system as a whole. Instead of expanding the regular tax system, such a system may create a new generation of taxpayers who rely on presumptive tax regimes for their existence. Moreover, some so-called simplified systems are actually complicated. Although in theory more complication may or may not reduce compliance, in practice, experience tends to support the latter outcome (e.g. World Bank, 2003).

How Effective has the Presumptive Tax Regime been?

In general, presumptive income taxation has several advantages.

1. First, this type of taxation reduces tax evasion by individual entrepreneurs. Their income is no longer assessed from accounting records but from indirect indicators such as type of business activity, number of employees, etc. This approach to estimating income on which the tax is levied removes the administrative burden of financial transparency traditionally required for compliance.
2. Second, it leads to a more equitable distribution of the tax burden. It is generally accepted that wages paid by legal entities are taxed more effectively than income earned by individual entrepreneurs due to the introduction of withholding taxes at source. The presumption reduces tax evasion and hence brings more taxpayers into the tax net. As a result, the perceived fairness of the tax system increases.
3. Third, presumptive income taxation leads to simplification of taxation by reducing the compliance burden for individual entrepreneurs and the corresponding cost of enforcement by tax authorities.
4. Fourth, presumptive income taxes are a stable source of the government tax revenue due to the fact that the amount of taxes doesn't depend on actual outcomes of individual entrepreneurs' performance.

It is however difficult to evaluate the success of special tax regimes such as presumptive taxation in achieving their goals, whether those goals are increased participation in the formal tax system, obtaining some basic level of revenue from all economic agents, educating new taxpayers, or reducing compliance costs for at-risk taxpayers. Simply tracking revenues before and after the imposition of a special tax regime seldom serves to answer the question because many of these regimes yield little revenue and it is difficult to control adequately for other changes to the tax system.

In principle, a special tax regime for the HTT might be considered a success if it produced the following scenario (Bird, 2003).

A small, start-up firm is outside of the tax net. A special tax regime is instituted with the stated objective of encouraging such firms to become part of the formal sector and educating them to the point where they are able to do so. The firm stays on the simplified system for a limited period and then graduates to the regular tax system.

On the other hand, such a special regime would clearly be a failure if it encouraged entities that had previously participated in the regular tax system to move to the special regime. It would also be a failure from an educational perspective if firms stayed on the regime for year after year after year. Finally, since another aim of most special regimes is simply to increase revenues, they would also no doubt be considered failures if the long-run effect on revenues, compared to what would have happened in the absence of the regime, is negative. It seems that no existing presumptive regimes have been thoroughly examined from any of these perspectives. One reason may be is that most of them would likely fail all of these tests.

Based on the above the Ethiopian system of presumptive income taxation of individual entrepreneurs based on the standard assessment method[16] can be deemed successful in terms have captured a large number of small start-up firms which were previously outside the formal bracket. (See Addis case study below). The system also has additional advantages.

First of all, standard assessments have shown to broaden the tax base with limited disincentives to earn income. In the short-run, they can entice individual entrepreneurs into the tax net by providing incentives rewarding efficiency. Taxation based on average income allows taxpayers to retain some profit with-out being taxed. Furthermore, standard assessments are the most adequate method of taxation of small businesses like individual entrepreneurs without a legal entity. This method implies low administrative costs and less open to corruption. The estimated assessment method would make the presumption just harder to keep transparent and simple and would give a lot of room to political bargaining which would definitely not make it more equitable.

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[16] The Standard Assessment Method: Standard assessments assign lump-sum taxes to taxpayers on the basis of occupation or business activity. Standard assessments have shown to broaden the tax base with limited disincentives. Although this method is viewed as less equitable than estimated assessments it is also less open to corruption (although estimated assessments are employed as an alternative to standard assessments when taxpayers do not file or are audited).

It is important to understand that standard assessments can be a poor revenue-mobilizing method of taxation unless the fixed payments are indexed to inflation (or increased regularly) and taxpayers are moved to categories as their taxable incomes increase over time. Furthermore, standard assessments do not take into account taxpayer-specific conditions, such as family size or losses in a particular year. As a result, it can be regressive by imposing equal tax on individuals in the same category with different incomes. (World Bank)

Secondly, the facility provided in the proclamation to be able to carry losses forward takes into account taxpayer-specific conditions, such as losses in a particular year. Hence negating the negative impact this could have on risky investments. Proclamation No 286/2002 clear stipulates that:

If the determination of taxable business income results in a tax period, that loss may be set off against taxable income in the next five (5) tax periods,\earlier losses being set off before later losses.

If during a tax period the direct or indirect ownership of the share of the capital or the voting rights of a body changes more than twenty-five percent (25%), by value or by number, sub-Article (1) shall cease to apply to losses incurred by that body in that tax period and the previous tax periods.

It is also stated that a net operating loss may be carried forward and deducted only for two (2) periods of three years (Article 28 – Sub-article 3; Proclamation No.286/2002)

However, the existing system of presumptive income taxation also had several disadvantages. These are as follows.

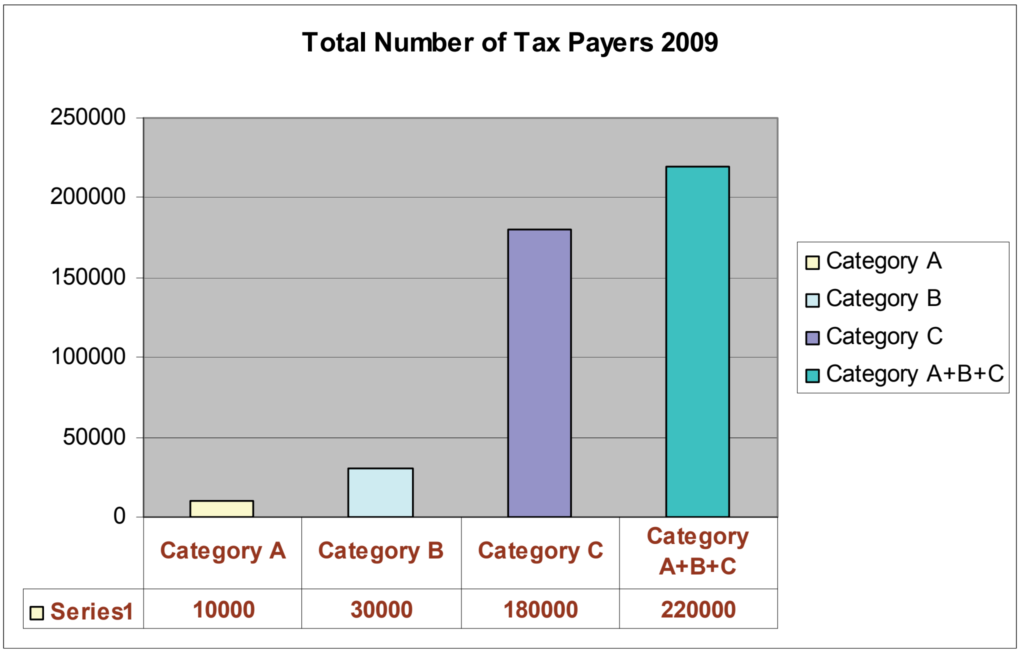
1. The fixed amount of taxes does not depend on actual outcomes of individual entrepreneurs' performance. As a result, there may be disincentives to earn income in the sense that the presumptive income taxation is an entry barrier. It may deterred people from starting a business when they think that the tax is so high that they had little chance to make a profit at all. For the same reason it may have forced people out of business who make too little profit.

2. The presumption based on the standard assessment method treated equally all individual entrepreneurs within a given category, regardless of their actual income. As a result, it can be regressive by imposing equal tax on individual entrepreneurs in the same category with different income. This leads to violation of the principle of tax equity.

These were addressed in 2002-2003. The Tax System Reform project of 2002 aimed at creating a tax system which was more supportive of private sector development, improving revenue collection, and ensuring equity and fairness of the tax system. The tax reforms that have been initiated will lay the foundations for a strengthened revenue base. Continuing efforts to improve tax administration and collection, including strengthening the large taxpayer unit which accounts for about 75 percent of several tax revenues, have resulted in tax revenues increasing from 15.3 percent of GDP in 2001/02 to an estimated 16 percent in 2002/03.

Reforms have sought to streamline and close loopholes in the income tax, make the incentive system more efficient, strengthen the collection of domestic indirect taxes through selective rate increases and broaden the tax base while relying less on border taxation. The tax reform greatly benefited from the IMF technical assistance specific measures that have been undertaken so far include:

Case study The Addis Ababa City Administration Formulation of Tax policy and Legislation



b) Introduction of Presumptive Taxation System

Collected Revenue for the Fiscal Year s 1990 – 2001 \EFY

FISCAL YEAR COLLECTED REVENUE ADDIS ABABA CITY ADMINISTRATION

	GFY	2003	2004	2005	2006	2007	2008
	EFY	1996	1997	1998	1999	2000	2001**
1	Tax	851.61	1,007.86	1,053.57	1,326.88	1,621.60	1,438.32
1.1	Direct Tax	609.39	695.72	678.20	858.57	1122.6	1001.09
1.2	Indirect Tax	242.22	312.14	375.37	468.35	499	437.23
2	Non-Tax Revenue	264.84	306.26	599.51	235.58	308.12	240.48
3	Capital Income	34.16	27.45	229.58	129.73	302.59	442.32
4	Municipal Tax	484.61	569.11	637.61	655.39	646.05	407.19
5	Others	8	0.2	0.1	0.1		
6	Toatal Revenue Collected	1,643.22	1,910.88	2,520.37	2,347.68	2,878.36	2,528.31
7	Contribution of Category C Taxpayers to the total Revenue package						

2001** Only 8 Months

In terms of administering the tax, the City of Addis Ababa has opted to have independent third parties involved thus taking away the burden of collection from the municipality and ensuring the ease of compliance by the use of third parties for the collection. (Branches of ten banks and the Ethiopian Post Office) . In total there are one hundred and thirty-nine payment points spread all over the city.See table below..

Tax Administration. Third Parties Involved Presumptive Taxation payments, Addis Ababa

Institution	Number of Outlets (Branches)	
Awash International	13	
Abysinia Bank	6	
Dasshen Bank	11	
Construction Business Bank	4	
Wogagen Bank	10	
Hebret Bank	5	
National Bank of Ethiopia	14	
Ethiopia Post Office	16	
Small Micro and Savings Enterprise	18	
Commercial Nominis	15	
Comercial Bank of Ethiopia	27	
Total Third Parties	**139**	

c) Introduction of the Value Added Tax (VAT)

d) Taxpayer Identification Number System (TIN)

e) FIRA Organization

f) Operational Programs, Systems and Procedures

g) Continued measures to liberalize the tax regime

Tax policy and Legislation

The overhaul of the tax legislations was designed to encourage capital investment and development, establish a sustainable domestic revenue base and ensure equity, fairness and consistency in the administration of the tax laws. In order to ensure that the contributions of the various stakeholders were considered, an extensive consultation process on the comprehensive tax reform measures was carried out starting early 2002.

1. The new Income tax Proclamation was introduced in July 2002 and provides

for reductions in the corporate income tax rate from 35% to 30%, the business income tax rate applicable to sole proprietors and partnerships from 40% to 35%, loss carry-forward provisions and new business income tax expenditure deductions.

2. The VAT, at the rate of 15%, was introduced on January, 1, 2003 to replace the sales tax.

3. A Turnover Tax, similar in scope to the VAT levied at the rate of 2% on goods and 10% on services and applicable to taxpayers whose annual turnover is below the VAT threshold was introduced on January 1, 2003.

4. The Excise Tax Proclamation, which has been rationalized to more accurately reflect the current business environment, was introduced on January 1, 2003. The measures include the reduction of the excise tax through the exclusion of depreciation from the computation of the cost production upon which the tax is based.

5. The enforcement powers of the tax authorities were strengthened, in accordance with international practices, which will improve taxpayer compliance.

b) Presumptive Taxation

Presumptive taxation provides the instrument to broaden the tax base and raise more revenues from the hard-to-tax group, including the large informal sector and taxpayers who understate income. The following measures have been introduced:

The standard assessment method, applicable to the City and Regional taxpayers whose annual turnover is less than Birr 100,000, to replace the estimated assessment method which was subject to inconsistent application; an advance business profits income tax on commercial imports at the rate of 3% based on C.I.F (cost, insurance and freight). A withholding tax of 2% on payments made by private limited companies, public enterprises, government agencies, non-profit organizations and private non-profit institutions to designated categories of taxpayers.

It should be noted that the disadvantages that existed before the reform and after the reforms are an inherent feature of presumption in general. It is impossible to remove all of them. In a certain degree, they can just be alleviated. At the same time, there are some additional disadvantages that are specific for the Ethiopian system of presumptive income taxation including following:

1. There is an unjustified limitation on the number of physical persons that individual entrepreneurs can employ. This limitation means that individual entrepreneurs who employ more than 10 physical persons are obliged to register as a legal entity and hence use the regular system of taxation.

However, the choice of legal status of business should be made by individual entrepreneurs themselves and shouldn't be determined by legislation. Otherwise, this limitation would lead to business split-up.

In light of the growing popularity of presumptive taxation in developing nations, it is relevant to note the existing concerns that compromise its effectiveness. Governments that recognize the limitations of presumptive taxation include provisions in their tax codes that allow taxpayers opportunity for redress. Certain areas of concern are important to government wanting to implement presumptive taxation. The World Bank has highlighted some of these areas. (See Box Below)

Box 2. Areas of Concern Presumptive taxation

Systemic Corruption (WB)

It is sometimes argued that presumptive taxation can help reduce corruption in the tax administration. However, the success of presumptive taxation in reducing corruption will depend both on the structure of the scheme and the overall administrative environment and capacity in the tax administration. A presumptive taxation scheme can in fact increase the discretionary power of tax officials and in a worst case scenario increase corrupt practices. A carefully designed presumptive taxation scheme can help reduce corruption, but can never be a substitute for much needed capacity building and administrative reforms within the tax administration.

Crude Implementation

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

Undermines Tax base

The primary goal of most governments that introduce presumptive taxation schemes is to broaden the country's tax base by preparing citizens and businesses in the informal sector to enter the formal tax net. However, presumptive taxation has proven to undermine this goal as taxpayers remain in presumptive taxation regimes indefinitely or regress from formal taxation programs to presumptive taxation schemes. This phenomenon tends to occur when sophisticated taxpayers earn above average income and recognize that standard assessments levy a lower tax burden. The result is that they either underreport income or simply pretend not to keep accurate records of income, as is prevalent in Israel, in order to remain in the presumptive regime and enjoy its benefits.

Source World Bank: http://www1.worldbank.org/publicsector/tax/presumptivedirecttaxes.html.

Policymakers, therefore, are required to prioritize and decide what the main goal of the tax system for the HTT sector should be. Design instruments obviously vary in accordance with the objective pursued. Bird[17] (2004) has developed a matrix of approaches to tax hard-to-tax taxpayers:

Dealing with Hard to Tax - HTT Sector

Objectives	Instruments	Issues
Bringing start-up firms into the tax net, enhancing taxpayer education	Some form of simplified presumptive regime	Critical to keep "presumed" level of tax liability high enough to encourage movement out; also to periodically evaluate all those in the system to ensure true eligibility.
Getting revenues from those able to pay	Alternative minimum tax (AMT) approach	AMTs are often very complicated and cumbersome for both tax administrators and taxpayers.
Increased equity in treatment of the HTT	Enforce the law	Politics is especially critical to the success of the tax administration in these cases of getting at the HTT. Lucrative businesses may be run by influential members of society who can affect the success of the tax administration.
Getting some revenue from the underground economy	Taxation via in direct taxes	May challenge the equity of the tax system and further encourage tax evasion.
Getting the HTT at low cost in the short term	Legitimize the HTT via tax exemptions and tax holidays	Although this instrument may reduce administrative costs for very difficult cases (off-shore activities) or very low yield activities (agriculture), it sets a dangerous precedent which encourages non-compliance.

Source: Bird, (2004)

[17] Is it Really so Hard to Tax the hard-to-Tax, in Alm/Martinez-Vazquez/Wallace, Taxing the Hard-to-Tax, 2004

The Road to Formalization (legal requirements for operating a business)

What, if anything, can or should policymakers do to encourage enterprise formalization? These are important questions. Some estimates suggest that over 30 percent of output and 70 percent of workers in developing countries are to some degree outside the scope of government regulation. In Africa the figures are even higher. There is much less agreement over what to do about informality. It is not necessarily harmful, either to individuals or to societies. Even relatively developed countries sustain quite large grey or shadow economies.

In Ethiopia, an informal business operator presently has three ways to formalise: becoming a legal business, becoming a co-operative and/or obtaining a formal premise. None of these are ideal. The first has high costs, but still leaves him/her without access to credit, business development services and government orders. It does not solve the main constraints that business operators mention: the market is saturated: shortage of capital (28%), limited market/ market saturation (24%) and no working premise (10%) (CSA, 2003; World Bank, ii 2007b). The second creates dependencies on the government and the third is compounded by weak land markets and high rents. In such a restrictive environment it is understandable that informality prospers. *(See Annex 2: Procedures and costs associated with setting up a business in Ethiopia and Annex 3; Evaluating the Business License)*

The bottom line is that policy makers need to understand exactly what informal sector entrepreneurs stand to gain from formalization. The benefits of formalization are and should be specific to each sector.

Conclusions

This paper has looked at the ongoing debate over the appropriate mechanisms for taxing the informal sector in developing countries with a focus on the use of presumptive taxation in the Ethiopian context.

Presumptive taxation provides taxpayers with a simplified option for tax compliance without requiring full financial transparency. While presumptive taxation can be considered as an optimal method of curbing widespread non-compliance without employing excessive government resources because it addresses the concerns of taxpayer and tax authority, caution in the implementation such a tax regime is required. The right balance between fairness and simplicity is required.

It should be noted that an ideal taxation scheme can be monitored with minimal effort, is easily measurable, and reduces reporting and bookkeeping requirements. The most drastic reform of the taxation is the introduction of a single presumptive tax. Such systems are usually based on turnover or on specific indicators (i.e. floor space, number of employees, electricity consumption). Presumptive regimes trade fairness for simplicity. Indicators are usually very crude proxies for business profitability and turnover based systems are burdensome for firms with low profit margins and generous for those with high margins. (Engelschalk, 2007)

Accordingly, constructing appropriate indicators or setting an appropriate tax rate for turnover based presumptive systems is challenging, requires extensive analysis of profit margins, and will usually be disputed by parts of the business community.

Some countries make little use of presumptive methods of taxation, given that such methods inherently involve unfairness, because they involve a departure from the normal accounting methods used to determine the tax base. Taxpayers who genuinely have no income might end up having to pay tax under a presumptive method that is not rebuttable.

On the other hand, if compliance with and administration of the income tax is so uneven that the normal rules do not lead to equal treatment of taxpayers with equal income, then presumptive methods may prove attractive. Of fundamental importance is the capacity of the tax administration to handle the particular presumptive method.

Attention must also be paid to how a particular presumptive method will work in practice. If taxpayers can hide the factors on which the presumption is based as easily as they can hide income, then the presumption will not be of much use. This is an empirical question, which also depends on the administrative capacity of the tax authorities, and the appropriate methods will therefore differ from country to country.

Another element to take into account in evaluating whether and how presumptive approaches should be used is that presumptions can involve the granting of a tax preference. Depending on how a presumption is determined and applied, it can result in a reduced burden for particular kinds of taxpayers. This is particularly the case where the presumption is elective, as in the case of the French contractual method. Thus, the purpose of the presumption can become the protection of a certain group of taxpayers (e.g., small business or farmers) rather than protection of revenue. In cases where the presumption is preferential, its application is often limited. For example, it may be available only for taxpayers with a turnover below a certain amount. In some cases, the availability of the presumptive method may depend on the legal form of business organization. For example, if all legal persons are required to keep books under the commercial code, then the use of presumptions may be restricted to physical persons.

While this approach has some justification, it has the disadvantage of discouraging incorporation in situations where the presumptive method is advantageous to the taxpayer.

It should be also mentioned that the chosen system of presumptive taxes meant designed to solve a narrow scope of problems is likely to be useless for the solution of other tasks. Therefore, the starting point in developing the system of presumptive taxation should be to identify and designate purposes and priorities to be taken into account in the framework of the tax legislation.

The international experience shows that the efficiency of application of presumptive taxation depends to a great extent on the state of the database, regulation of the accounting and calculation procedures and the quality of tax administration.

(Makedonskiy, 2005)

In the Ethiopian the use of presumptive taxation is far advanced than in most other African countries. However work still has to be done to improve certain key areas in the system. These include:

- The continued Identification and registration of small taxpayers
- Encouraging voluntary compliance
- Simple and effective determination of tax liability
- Keeping the complexity and compliance costs low for small business
- Keeping the cost of tax administration as a percentage of revenue collections low.

It is also interesting to note that in spite of being quite widespread in developing countries, presumptive taxation has received very little attention in the public finance literature. With few exceptions, the available analyses are based on collections of case studies and focus mainly on the administrative rationale for such taxes, but they lack an explicit formal model of the tax structure or the taxpayer's problem. These could be key areas for further research.

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Annex 1: Category “C” Presumptive Tax in Ethiopia

Ser. No.	Business Sectors	AAPR	Tax Free	Presumptive Tax Per Year																		
				Up to 10000	10001-15000	15001-20000	20001-25000	25001-30000	30001-35000	35001-40000	40001-45000	45001-50000	50001-55000	55001-60000	60001-65000	65001-70000	70001-75000	75001-80000	80001-85000	85001-90000	90001-95000	95001-10000
1	Fruits and Vegetables	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
2	Natural Honey, Butter & related Trades	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
3	Edible oil & its by-product	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
4	Skin &Hide Trade	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
5	Civet Trade	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
6	General Manufacturing Industries Production	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
7	General Merchandise Trade & Grocery	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
8	Sport Goods Trade	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
9	Office Cafeteria	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
10	Incense Trade	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
11	Sugar Distribution	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
12	Candy & Sweet Production	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
13	Food items	10	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1605	1680	1755	1830	1905	2000	2100
14	Salt Trade	12	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1620	1710	1800	1890	2000	2120	2240
15	Building Contractors	13	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1628	1725	1823	1920	2050	2180	2310
16	Cereal & Pulses Trade	13	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1628	1725	1823	1920	2050	2240	2380

Ser. No.	Business Sectors	AAPR	Tax Free	Presumptive Tax Per Year																		
				Up to 10000	10001-15000	15001-20000	20001-25000	25001-30000	30001-35000	35001-40000	40001-45000	45001-50000	50001-55000	55001-60000	60001-65000	65001-70000	70001-75000	75001-80000	80001-85000	85001-90000	90001-95000	95001-10000
17	Coffee Trade	14	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1635	1740	1845	1960	2100	2240	2380
18	Fabrics & Treads Trade	14	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1635	1740	1845	1960	2100	2240	2380
19	Cosmetics & Perfume Trade	14	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1635	1740	1845	1960	2100	2240	2380
20	Household Utensils Trade	14	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1635	1740	1845	1960	2100	2240	2380
21	Glass Works & Trade	14	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1635	1740	1845	1960	2100	2240	2380
22	Pepper & Spices Trade	15	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1643	1755	1868	2000	2150	2300	2450
23	Cemetery status work	15	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1643	1755	1868	2000	2150	2300	2450
24	Bed & mattress production and Trade	15	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1643	1755	1868	2000	2150	2300	2450
25	Printing press	15	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1643	1755	1868	2000	2150	2300	2450
26	Metal & building materials trade	16	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1650	1770	1890	2040	2200	2360	2520
27	Animal & animal products trade	18	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1665	1800	1940	2120	2300	2480	2660
28	Hop & malt trade	20	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1680	1830	2000	2200	2400	2600	2800
29	Barter transaction	20	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1680	1830	2000	2200	2400	2600	2800

Ser. No.	Business Sectors	AAPR	Tax Free	Presumptive Tax Per Year																			
				Up to 10000	10001-15000	15001-20000	20001-25000	25001-30000	30001-35000	35001-40000	40001-45000	45001-50000	50001-55000	55001-60000	60001-65000	65001-70000	70001-75000	75001-80000	80001-85000	85001-90000	90001-95000	95001-10000
30	Vehicles spare parts trade & workshop services	20	6000	80	180	280	380	480	630	780	930	1080	1230	1380	1530	1680	1830	2000	2200	2400	2600	2800
31	Jute trade	23	5217	110	225	340	455	615	788	960	1133	1305	1478	1650	1823	2020	2250	2480	2710	2940	3170	3400
32	Kindergarten (private)	23	5217	110	225	340	455	615	788	960	1133	1305	1478	1650	1823	2020	2250	2480	2710	2940	3170	3400
33	Shoe making & repair	23	5217	110	225	340	455	615	788	960	1133	1305	1478	1650	1823	2020	2250	2480	2710	2940	3170	3400
34	Charcoal trade	25	4800	130	255	380	518	705	893	1080	1268	1455	1643	1830	2050	2300	2550	2800	3050	3300	3550	3800
35	Construction materials production & trade	25	4800	130	255	380	518	705	893	1080	1268	1455	1643	1830	2050	2300	2550	2800	3050	3300	3550	3800
36	Laundry services	25	4800	130	255	380	518	705	893	1080	1268	1455	1643	1830	2050	2300	2550	2800	3050	3300	3550	3800
37	Hunting game services	25	4800	130	255	380	518	705	893	1080	1268	1455	1643	1830	2050	2300	2550	2800	3050	3300	3550	3800
38	Electrical & electronics goods supply	26	4615	140	270	400	555	750	945	1140	1335	1530	1725	1920	2180	2440	2700	2960	3220	3480	3740	4000
39	Hotels, bars & snakes	26	4615	140	270	400	555	750	945	1140	1335	1530	1725	1920	2180	2440	2700	2960	3220	3480	3740	4000
40	Wood & timber trade	27	4444	150	285	420	593	795	998	1200	1403	1605	1808	2040	2310	2580	2850	3120	3390	3660	3930	4200
41	Cotton trade	27	4444	150	285	420	593	795	998	1200	1403	1605	1808	2040	2310	2580	2850	3120	3390	3660	3930	4200
42	Stationeries, bookshops, books & news papers trade	29	4138	170	315	460	668	885	1103	1320	1538	1755	1990	2280	2570	2860	3150	3440	3730	4020	4310	4600

Ser. No.	Business Sectors	AAPR	Tax Free	Presumptive Tax Per Year																			
				Up to 10000	10001-15000	15001-20000	20001-25000	25001-30000	30001-35000	35001-40000	40001-45000	45001-50000	50001-55000	55001-60000	60001-65000	65001-70000	70001-75000	75001-80000	80001-85000	85001-90000	90001-95000	95001-10000
43	Gold silver smith & jewelry trade	30	4000	180	330	480	705	930	1155	1380	1605	1830	2100	2400	2700	3000	3300	3600	3900	4200	4500	4800
44	Tailoring services	30	4000	180	330	480	705	930	1155	1380	1605	1830	2100	2400	2700	3000	3300	3600	3900	4200	4500	4800
45	Souvenir, Ornaments & gift goods trade	30	4000	180	330	480	705	930	1155	1380	1605	1830	2100	2400	2700	3000	3300	3600	3900	4200	4500	4800
46	Cinema houses	30	4000	180	330	480	705	930	1155	1380	1605	1830	2100	2400	2700	3000	3300	3600	3900	4200	4500	4800
47	Commission agent for goods	30	4000	180	330	480	705	930	1155	1380	1605	1830	2100	2400	2700	3000	3300	3600	3900	4200	4500	4800
48	Barber & beauty salons	30	4000	180	330	480	705	930	1155	1380	1605	1830	2100	2400	2700	3000	3300	3600	3900	4200	4500	4800
49	Traditional clothes weaving trade	30	4000	180	330	480	705	930	1155	1380	1605	1830	2100	2400	2700	3000	3300	3600	3900	4200	4500	4800
50	Electrical lift works & repair	33	3636	210	375	570	818	1065	1313	1560	1808	2100	2430	2760	3090	3420	3750	4080	4410	4740	5205	5700
51	Health care services	34	3529	220	390	600	855	1110	1365	1620	1875	2200	2540	2880	3220	3560	3900	4240	4580	4980	5490	6000
52	Bed services	35	3429	230	405	630	893	1155	1418	1680	1950	2300	2650	3000	3350	3700	4050	4400	4750	5250	5775	6300
53	Leather clothes production, tailor & trade	35	3429	230	405	630	893	1155	1418	1680	1950	2300	2650	3000	3350	3700	4050	4400	4750	5250	5775	6300
54	Vehicles seats upholstery repair	35	3429	230	405	630	893	1155	1418	1680	1950	2300	2650	3000	3350	3700	4050	4400	4750	5250	5775	6300
55	Music & video shops	46	2609	340	615	960	1305	1650	2020	2480	2940	3400	3860	4320	4780	5460	6150	6840	7530	8220	8910	9600
56	Photograph & photocopy services	49	2449	370	683	1050	1418	1785	2230	2720	3210	3700	4190	4680	5355	6090	6825	7560	8295	9030	9765	10500

Ser. No.	Business Sectors	AAPR	Tax Free	Presumptive Tax Per Year																		
				Up to 10000	10001-15000	15001-20000	20001-25000	25001-30000	30001-35000	35001-40000	40001-45000	45001-50000	50001-55000	55001-60000	60001-65000	65001-70000	70001-75000	75001-80000	80001-85000	85001-90000	90001-95000	95001-10000
57	Tyre repair	50	2400	380	705	1080	1455	1830	2300	2800	3300	3800	4300	4800	5550	6300	7050	7800	8550	9300	10050	10800
58	Shops, cafeterias Grocery, etc.	50	2400	380	705	1080	1455	1830	2300	2800	3300	3800	4300	4800	5550	6300	7050	7800	8550	9300	10050	10800
59	Night clubs	50	2400	380	705	1080	1455	1830	2300	2800	3300	3800	4300	4800	5550	6300	7050	7800	8550	9300	10050	10800
60	Stamp sales on commission	50	2400	380	705	1080	1455	1830	2300	2800	3300	3800	4300	4800	5550	6300	7050	7800	8550	9300	10050	10800
61	Tobacco distribution on commission	50	2400	380	705	1080	1455	1830	2300	2800	3300	3800	4300	4800	5550	6300	7050	7800	8550	9300	10050	10800
62	Computers & type writer training center	50	2400	380	705	1080	1455	1830	2300	2800	3300	3800	4300	4800	5550	6300	7050	7800	8550	9300	10050	10800
63	Tailoring training center	50	2400	380	705	1080	1455	1830	2300	2800	3300	3800	4300	4800	5550	6300	7050	7800	8550	9300	10050	10800
64	Tyre sales commission agent	50	2400	380	705	1080	1455	1830	2300	2800	3300	3800	4300	4800	5550	6300	7050	7800	8550	9300	10050	10800
65	Engineering & plan drafting	60	2000	480	930	1380	1830	2400	3000	3600	4200	4800	5700	6600	7500	8400	9300	10200	11200	12400	13600	14800
66	Renting of household utensils	70	1714	630	1155	1680	2300	3000	3700	4400	5250	6300	7350	8400	9450	10500	11800	13200	14600	1600	17400	18800
67	Consultancy services	70	1714	630	1155	1680	2300	3000	3700	4400	5250	6300	7350	8400	9450	10500	11800	13200	14600	16000	17400	18800
68	Sales of paintings & drawings	70	1714	630	1155	1680	2300	3000	3700	4400	5250	6300	7350	8400	9450	10500	11800	13200	14600	16000	17400	18800

Ser. No.	Business Sectors	AAPR	Tax Free	Presumptive Tax Per Year																			
				Up to 10000	10001-15000	15001-20000	20001-25000	25001-30000	30001-35000	35001-40000	40001-45000	45001-50000	50001-55000	55001-60000	60001-65000	65001-70000	70001-75000	75001-80000	80001-85000	85001-90000	90001-95000	95001-10000
69	Transit services	70	1714	630	1155	1680	2300	3000	3700	4400	5250	6300	7350	8400	9450	10500	11800	13200	14600	16000	17400	18800

Note: AAPR stands for Average Annual Profitability Rate

ANNEX 2: This table summarizes the procedures and costs associated with setting up a business in Ethiopia.

STANDARDIZED COMPANY

Legal Form: Private Limited Company (PLC)

Minimum Capital Requirement:

City: Addis Ababa

No	Procedure	Time to complete	Cost to Complete	Comment
1	Check the company name for uniqueness	1 day	no charge	Evidence of capital deposit is not required for private limited companies. However, the memorandum of association should show that "the capital is fully paid" in cash or in kind. In practice, as long as the memorandum of association indicates that "the capital is fully paid," demonstration of actual payment is not required.
2	The applicant authenticates the memorandum and articles of association at the Office for Authentication and Registration of Documents at the Justice Ministry and pay associated fees.	3 days	no charge	The Office for Authentication and Registration of Documents serves mainly to provide notary public services. The applicants appear in person at the appointed date, with an original copy of their letter of appointment (power of attorney) and a valid identity card. Various officers check the validity of the documents, the authenticity of the signatures, and the genuineness of the identity cards. The memorandum and articles of association are readied for signature. The applicants sign the documents in front of an officer, and a stamp duty of ETB 350 is affixed to the original, and another ETB 5 stamp duty is

					affixed to the other copies.
3	Sign the documents	1 day	ETB 375	No comment	

No	Procedure	Time to complete	Cost to Complete	Comment
4	Register the memorandum and articles of association in the Commercial Register at the Ministry of Trade and Industry	3 days	ETB 85	The fees depend on the company's registered capital. If the company has a registered capital of ETB 15,000, the registration fee is ETB 15, the licensing fee is ETB 35, forms and cards cost ETB 12, and stamps cost Birr 10. If the company's registered capital is ETB 200,000, the registration fee is ETB 100, the licensing fee is ETB 200, and the costs of forms and cards and stamps remain ETB 12 and ETB 10, respectively. If an application for registration is submitted to the Ministry, it shall, upon being satisfied that the application is complete, issue a registration certificate within 5 working days of receipt of payment. This is due to civil service reforms, including customer service training, reassignment of some staff to other departments, and internal time limits, which have been implemented in the Ministry of Trade and Industry.
5	Obtain a business license with the Ministry of Trade and Industry	3 days if all documents are in place	ETB 85	No Comment
6	Register with the Inland Revenue Authority for income tax and withholding tax for employees	2 days	no charge	A newly established firm must register for income tax, payable at the end of the company's fiscal year, and pay municipal and license renewal fees and withholding taxes on their employees.
7	Make a company seal	3 days	ETB 100	Having a seal is not obligatory but is required in practice.
	TOTAL			

Source: Doing Business 2009. Country Profile for Ethiopia

Annex 3: Evaluating a Business License

	Revenue Base Definition	Valuation of Revenue Base	Fee Rate Structure
Revenue Potential	*A business license tax levied on all activities tends to generate more revenue than one on a selective base. A broader base will tend to provide more stability than a narrow base. Buoyancy depends on which activities are actually taxed, how they are valued and the revenue base structure.*	*Weighting the tax base by a measure of the business activity such as gross receipts or profitability will increase the tax base and potentially its revenue generation. With a flat rate, the yield will be severely limited by the ability to pay of the smallest/ poorest taxpayer.*	*Flat fees can be eroded by inflation and hence periodic adjustments are necessary. In contrast, advalorem rates tend to avoid the problem of erosion by inflation.*
Equity	*A business tax that covers all business activities tends to be more equitable than one levied only on a few activities. If the business license is seen as a levy for the privilege of engaging in an activity, all activities must be taxed according to the horizontal equity principle.*	*Equity is affected dramatically depending on the definition of the tax base" weight." In general, based on the ability to pay principle, the tax base weight should be a reflection of profitability or ability to pay. Businesses that genera more sales/income should be in a position better able to pay the tax. However, the weight used on the tax base can also create equity problems since a per unit flat unit tax discriminates against small firms or those with low profitability; a tax based on gross receipts discriminates against businesses that have a low ratio of net profits to sales; a tax based on property value or the number of employees may also bear no relation to profitability, while a tax based on the number of employees will discriminate against labor-intensive businesses.*	*In general, flat fees can be very inequitable since they bear no relation to income levels or profitability. A rate structure graduated according to business category or size can increase vertical equity. However, business licenses or taxes should not be used as the primary equalizing mechanism. Concepts of equity should be focused on the entire public finance system, not on a specific tax in isolation.*

	Revenue Base Definition	Valuation of Revenue Base	Fee Rate Structure
Efficiency	*If a tax is imposed only on certain activities and the tax is high, it can be economically distorting, discouraging businesses in the taxed sectors and encouraging evasion.*	*Business taxes based on gross receipts, property value or number of employees can create problems of overlap with sales taxes or VAT , property taxes and payroll taxes. This will affect the final equity of the tax system.* *Efficiency is always affected by taxation—the extent of the inefficiency depends on the rate structure and the demand and supply elasticities within the particular market. In general, a lump sum flat tax would be the most efficient since it would not tend to discourage the production decision at the margin. On the other hand, a tax on gross receipts may discourage sales at the margin.*	*See comments under "Valuation of Tax Base"*
Administration	*Broad coverage, particularly where* *this includes small businesses and the informal sector, is likely to increase the costs of administration. However, exemptions can also increase the cost of administration.*	*A lump sum flat tax is the easiest to measure and administer. The difficulties of estimating the gross income and gross receipts increase the administrative complexities. With many businesses in the informal sector, obtaining accurate information on turnover or profitability is practically impossible.*	*Flat fee structures are simple, implying low cost administration and compliance. This is importantwhen the taxing government has limited administrative and technical capacity. Graduated tariff structures do increase complexity but can increase revenues; thus the cost to revenue ratio may not increase.*
Political acceptability	*A narrow definition of tax base will reduce the scale of opposition but may encourage the intensity of those objections. A broader base will spread out the tax burden, potentially minimizing the intensity of the opposition. Perceived fairness by taxpayers will affect the* *political acceptability of the tax base definitions*	*Depends largely on the perceived fairness of the system and the extent to which the tax can be disguised in the price to the final consumer.*	*See comments under "Valuation of Tax Base"*

Source: World Bank Doing Business 2009 Ethiopia