



## The Corporate Tax Burden in Ethiopia: Evidence from Anonymised Tax Returns

Summary of Working Paper 48 by Giulia Mascagni and Andualem Mengistu

### Why the corporate tax burden?

Many low income countries face the challenge of increasing tax revenue dramatically while minimising distortions in the economy that may discourage investment and, more generally, economic growth. In this context, corporations have to contribute to the public purse but their tax burden should still allow them to prosper. Despite the importance of this topic, very little evidence is available so far on the corporate tax burden in many low-income countries, including Ethiopia.

This paper fills this gap by calculating and analysing effective tax rates (ETRs) across Ethiopian corporations. ETRs are broadly defined as the ratio of taxes to income paid by a firm and represent the tax burden on firms. ETRs differ from statutory tax rates (those defined in the law) because firms can benefit from a range of legal provisions and other practices, such as aggressive tax planning, to reduce their tax burden. Therefore, despite a flat statutory rate, ETRs can vary across firms depending on size and sectors, amongst other firm-level characteristics.

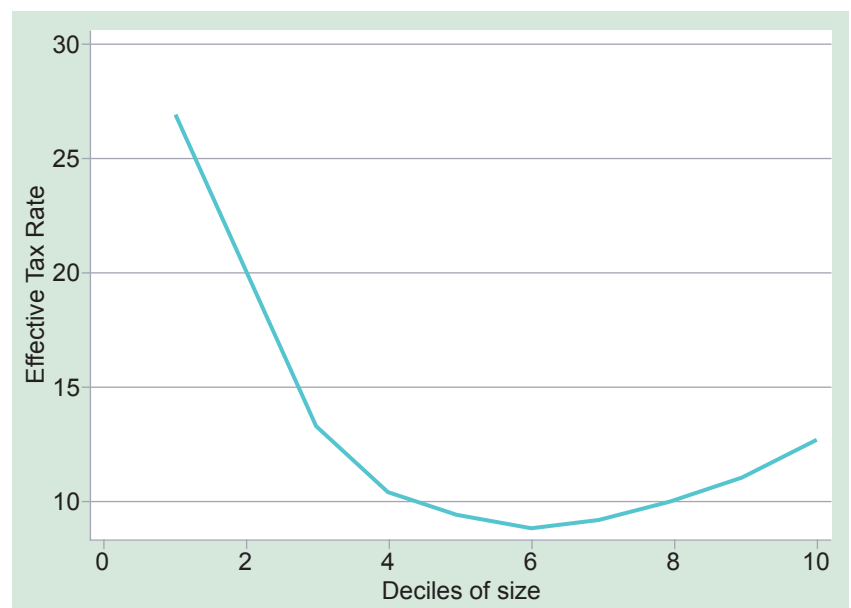
### Using anonymised tax returns

We measure effective tax rates based on firm-level data from anonymised tax

returns. This data has recently become available in African countries, thanks to the modernisation of revenue administrations and the digitalisation of taxpayer records. However, it is still underused for research purposes. To the best of our knowledge, this paper is the first attempt to use administrative data from anonymised returns to analyse ETRs in Africa.

Thanks to a collaborative relationship with the Ethiopian Revenue and Customs Authority, we obtained data from corporate tax returns over eight years, from 2006/07 until 2013/14, for a total of about 92,000 observations. ➤

“ In Ethiopia it is middle-sized firms that actually face the lowest tax burden of all. ”



## Do small businesses pay more?

The short answer to this question is yes, small firms bear the highest burden, but the largest firms face a relatively high burden too.

Our results show evidence of a U-shaped relation between tax burden and size: while small firms bear the highest burden, the largest firms still pay more than middle-sized firms. The association between size and the tax burden is relatively large in magnitude and statistically significant, even when other relevant firm-level variables are included in the regression analysis.

Our interpretation of this U-shaped relation is that both small and large firms face constraints in minimising their taxes, but these constraints are fundamentally different. On the one hand, small firms do not have the capacity and resources to fully exploit the tax system and therefore, they lose out. This is likely due to high compliance costs, since relatively small firms are required to file complex books of accounts under current Ethiopian law. On the other hand, large firms are highly visible and under great scrutiny by the tax authority, since 90% of revenue comes from the largest 10% of corporations. Therefore, they too face limits in the extent to which they can apply aggressive tax-minimising strategies.

We argue that these differences in tax burden between large and small firms are mainly due to their use of business expenses to reduce taxable income. Although this interpretation is somewhat speculative, it is supported by available data on firms' deductions and by our knowledge of the Ethiopian tax system. We show that the expense to turnover ratio closely mirrors the U-shaped size-ETR relation. Business expenses are less visible to the revenue authority and harder to monitor. This is particularly true for the category "other expenses", which in the Ethiopian case accounts for about 20% of the total.

Importantly, our result is in contrast with previous evidence on the tax burden in

Africa, which showed that middle-sized firms are "squeezed" by a high tax burden. With better data and a simple methodology, we show that the opposite is true in Ethiopia.

## Only 60% of registered corporations are liable to paying tax

Furthermore, the data shows that every year, on average, one third of the firms that declare positive turnover report losses. Moreover, over 20 per cent filed nil declarations, reporting zero turnovers and therefore implying zero tax. These figures, taken together, suggest that over 40 per cent of declarations yield no taxable income and no tax revenue. This situation is more common in the agricultural sector, but it occurs throughout the economy. While this may be the genuine picture of a difficult business environment in Ethiopia, it may also be indicative of tax evasion.

## What can policymakers do?

The most important element emerging from this paper is the relatively high tax burden experienced by small corporations. We argue that this is largely the result of high compliance costs: due to strict reporting requirements, small firms end up paying relatively more. Policymakers can address this issue by making sure that small firms can benefit from less stringent reporting requirements than they currently face, since they cannot comply with complex tax systems. This situation is related to the erosion of all thresholds in the Ethiopian tax system, due to high inflation in the past decade and a lack of revision of the tax system to take it into account. Regarding expenses, the Ethiopian Revenue and Customs Authority may need to step up efforts to collect data on firms' deductions, and use it more extensively for audit purposes.

Furthermore, the tax authority may need to investigate nil-filers to understand whether this behaviour hides non-compliance, if it is related to problems in the tax registry, or if it is indeed genuine.

## Further reading

Mascagni, Giulia and Mengistu, Andualem (2016), *The Corporate Tax Burden in Ethiopia: Evidence from Anonymised Tax Returns*, ICTD Working Paper 48. Brighton: September

## Credits

This paper was written by **Giulia Mascagni**, Research Fellow at the Institute of Development Studies and Research Director of the International Centre for Tax and Development in Brighton, UK; and **Andualem Mengistu**, Senior Researcher at the Ethiopian Development Research Institute (EDRI) in Addis Ababa, Ethiopia.

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