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Turnover-Based Presumptive Taxation and Taxpayers Perceptions in Ethiopia

Summary of ATAP Working Paper 7 by Abis Getachew

Why turnover-based presumptive taxation?

The Ethiopian economy is cash-based and dominated by a large number of micro and small businesses. Hence, taxing this sector assists in raising government revenue and increasing the number of taxpaying firms. Turnover-based presumptive taxation provides a regime that simplifies the tax rules for small taxpayers and helps introduce them to the standard tax regime.

Principles of presumptive taxation

As presumptive taxation is designed to introduce taxpayers to the standard regime and eventually transition them in that direction, it is important that the system adheres to basic tax principles. One of the most important among those basic tax principles is fairness. The American Institute of Certified Public Accountants separates tax fairness into seven different dimensions, which this study used to analyse public perceptions of the tax system. Those dimensions are:

1. ***Exchange fairness*** refers to the adequacy of public goods and services provision to citizens in the long run.
2. ***Procedural fairness*** is a measure to assess the representation of taxpayers in the estimation process.
3. ***Horizontal fairness*** refers to the principle that taxpayers in similar situation should be treated similarly and should pay similar taxes.
4. ***Vertical fairness*** refers to sharing the overall tax burden based on taxpayers' ability to pay.
5. ***Time-related fairness*** means that the total tax liable is suitable over the long term and is not overly distorted by fluctuations in income and wealth over time.
6. ***Inter-group fairness*** is the form of fairness that means no group within society receives unjustified special treatment.
7. ***Compliance fairness*** is a fairness dimension that measures whether all taxpayers in the system pay their tax dues on time and in the correct manner.

This study examined the perceptions of 'Category C' taxpayers (those small taxpayers included in the turnover-based presumptive taxation regime) along these different dimensions of tax fairness.

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Practical challenges and taxpayer perceptions

The sample respondents of Category C taxpayers reported negative perceptions on the dimensions of exchange fairness, procedural fairness, horizontal fairness, time-related fairness and compliance fairness. On the other hand, sample respondents reported positive perceptions of vertical fairness and inter-group fairness.

One important factor leading to poor fairness perceptions was the late reassessment of daily sales that took place in 2017. Although daily sales estimations for presumptive taxpayers are supposed to be reassessed every three years, there was a six-year gap following the 2011 assessment. This extended reassessment delay led to an unanticipated and sharp increase in the estimation of daily sales for presumptive taxpayers. To avoid the negative perceptions associated with this steep increase, tax officials should emphasize the importance of continuous assessment at least every three years.

Another important factor leading to negative perceptions was the large number of business activities and turnover bands within the presumptive regime, leading to an overly-complicated tax rating and adjustment system. Complicated regimes are not only difficult for taxpayers to understand, but also place a high administrative burden on their compliance. Ideally, tax officials should strive for greater simplicity in the design of the turnover-based presumptive tax regime.

Finally, the law currently includes the option for Category C businesses to keep proper records to inform their assessment, but does not provide any incentives for businesses to do so. A turnover-based presumptive tax system can only smooth the transition to a standard system when sufficient incentives for full compliance are in place. For instance, as in the case of Tanzania, the presumptive system should ideally reduce tax dues for those businesses that keep full records of their sales and expenses.

A way forward

The Ethiopian revenue authority should reassess daily sales estimations for Category C taxpayers at least every three years. Frequent reassessments will help small taxpayers to get used to the system, and to be less surprised at increases to their dues. Additionally, frequent reassessments lessen the possibility of surprise chaos amongst firms and the community in general.

The second action to consider is the lesson learnt from Tanzania. Micro businesses that keep full records of their transactions should be allowed to pay less than those that do not. Since one of the main objectives of presumptive taxation is to slowly transition taxpayers into the standard system, it is important to motivate small businesses to keep proper books and records.

The third recommendation is that the government should moderate its expectations about the amount of revenue that can be generated from city or sub-city administrations. High expectations may influence assessment teams to inflate daily sales estimations to reach the revenue collection targets for the sub-city that were pre-set by the government. Category C businesses have small marginal profits, and the government should not expect to collect meaningful levels of revenue from them.

Assessment teams should also be representative of all stakeholders in the business community. In practice, full representation has not been achieved. Assessment teams are made up primarily of staff from the revenue collection authority, and a single individual is responsible for assessing the daily sales estimation for a single business premise. As laid out in the presumptive taxation Directive 123/2009, assessment teams should be representative of all stakeholders, and all members of the team should be involved in the estimation process. Tax officials should seek to fully comply with the directive, as current practice undermines the system's credibility for taxpayers and has led to protests and boycotts in the past.

Further reading

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Credits

Abis Getachew is a Research Assistant at the Policy Study Institute, the former Ethiopian Development Research Institute. He is a BA graduate in Economics from Addis Ababa University and holds his BA Honours and MCOM from the University of South Africa. Abis has been involved in different macroeconomic policy-related researches in Ethiopia, with a particular focus on taxation, monetary policy, labour market and economic growth.

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