

The Contribution and Trends of Tariff Revenue in the Ethiopian Tax Structure

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Abstract

Revenue collection from internationally traded goods is one of the core roles of Customs Administrations in many developing countries. Currently, the Ethiopian Revenues and Customs Authority (ERCA), the only government department authorized in the country to collect taxes from foreign trade, is also collecting customs duties, excise tax, value added tax (VAT), surtax, and withholding tax from imported goods to the country. These taxes provide considerable revenue to the government. The central theme of this Article is to evaluate the performance of customs duty towards its contribution to total government revenues. To achieve this objective, two important measurements of a tax revenue performance, the ratio of the tariff revenue to the total government revenues and the revenue productivity of the tax base in the study period (1959/60-2012/13), are analyzed first. Then, both the share and the trend of customs duty in the trade taxes, total taxes and total government revenues are analyzed, respectively. The trend of customs duty/GDP ratio is also included in the analyses. The findings of the analyses indicated that although its share in the government budget is significant, the effective tariff rate is much lower than the average tariff rate; its contributions to both the total tax revenues and total government revenues have also declined over time. Therefore, the identification of the responsible factors for this low performance of the tariff revenue in the country needs further investigations.

Keywords: tariff revenue, revenue productivity, government revenue, foreign trade taxes

Introduction

This Article deals with the contribution of customs tariff towards the revenue budget of the Ethiopian government. As background information, the sources of international trade taxes in Ethiopia, such as tariff revenue, excise tax, VAT/sales tax, and surtax are discussed first. Secondly, the theoretical and empirical reviews about the fiscal contribution of customs duty in the country are discussed. Thirdly, the role of customs administrations in the world in general and that of Ethiopia in particular is seen. Then, the methodology and the sources of data are explained. In the fifth part, the share and trend of tariff revenue in the total government revenues in Ethiopia is analyzed. Finally, the findings of the data analysis are presented.

Background

Revenue collection from traded goods is one of the core roles of Customs Administrations in many developing countries. Currently, the Ethiopian Revenues and Customs Authority (ERCA), the only government department authorized in the country to collect taxes from foreign trade, is also collecting customs duties, excise tax, value added tax (VAT), surtax, and withholding tax from imported goods to the country. These taxes provide considerable revenue to the government. These taxes are assigned priority levels and are calculated in a sequential order. These taxes are discussed in the following section of this Article and the discussions are supported by an example of imported goods tax determination.

Customs Duty/Tariff Revenue

The first of the five taxes levied on imported items is customs duty. The term customs duty denotes taxes imposed on goods entering or leaving the country. ERCA collects customs duty only on imported items as no tax on exports is levied, except on raw skins and hides (150%). Customs duty provides significant revenue to the government. The customs duty has six bands or group of rates which are applied to imported goods. The bands are 0%, 5%, 10%, 20%, 30% and 35% of the CIF (Cost + Insurance + Freight) value of an imported item.

Excise Tax

Excise tax is the second of the five taxes levied on imported items and it is one of the most well known forms of taxes in Ethiopia. It is a tax levied on selected goods such as luxury goods and basic goods which are demand inelastic. Moreover, excise tax is also applied to goods which are considered hazardous to health and may cause social problems. Additionally, the government uses the excise tax as a revenue-producing device.

Value Added Tax (VAT)

VAT is the third of the five taxes to be levied on imported items. In Ethiopia, VAT is levied at a flat percentage rate. With exception of the goods detailed in Article 8 of the Proclamation No. 285/2002 and goods exempted

from VAT by the Directive issued by the Ministry of Finance and Economic Development, VAT is levied on every imported item. Importers are liable to pay 15% of the sum of cost, insurance, freight, customs duty and excise tax.

Surtax

Surtax is the fourth of the five taxes imposed on imported items. It was introduced in the Ethiopian tax system on April 9, 2007. The Council of Ministers issued a regulation to levy 10% surtax on imported goods. The imposition of surtax was introduced to build the financial capacity of the government for interventions to solve the rise in the cost of living which is affecting consumers with low and medium income level. Ten percent of the sum of cost, insurance, freight, customs duty, excise tax, and VAT is the base of computation for the surtax on all goods imported into the country.

Withholding

Withholding tax is the last tax on imported items and was introduced in Ethiopia on December 30, 2001. Proclamation No. 227/2001 introduced the withholding tax. Later on, this proclamation was replaced by the Income Tax Proclamation No. 286/2002 and the Council of Ministers Income Tax Regulation No. 78/2002. The latter Proclamation has made effective a withholding tax of 3% on imported items and a 2% on payments made in return for the purchase of goods and services. Income tax is collected on the import of goods for commercial use and the collected amount is treated as a tax which is withheld and is creditable against the taxpayers' income tax liability for the year.

In conclusion, a trader who imports goods, say, with a CIF value of Birr 1,200,000, Duty Rate of 35%, and Excise Tax Rate of 100%, will pay Birr:

- Customs Duty = $1,200,000 \times 35\% = 420,000$;
 - Excise Tax = $(1,200,000 + 420,000) \times 100\% = 1,620,000$;
 - VAT = $(1,200,000 + 120,000 + 1,620,000) \times 15\% = 441,000$;
 - Surtax = $(1,200,000 + 120,000 + 1,620,000 + 441,000) \times 10\% = 338,100$; and
 - Withholding Tax = $1,200,000 \times 3\% = 36,000$.
- Total Import Taxes = $120,000 + 1,620,000 + 441,000 + 338,100 + 36,000 = \underline{2,555,100}$

Literature

The Fiscal Role of Customs Tariff

One of the objectives of levying customs tariff is to collect revenue in the form of taxes from the foreign trade. According to Carbaugh (2005: 102) "a revenue tariff is imposed for the purpose of generating tax revenues and may be placed on either exports or imports".

In underdeveloped countries such as Ethiopia, the direct and indirect domestic tax revenues are so low because of the low per capita income. In such countries the proportion of the people subject to income tax is very low and therefore income tax does not yield as much revenue as it does in developed countries. Even if the exemption limit is lowered to increase the revenue from taxation, the cost of collection and assessment will be disproportionately large and no substantial addition to revenues will be obtained. On the other hand, high rates of income tax may adversely affect incentives. The disincentive effect of taxation, it is suggested, can be largely avoided by levying indirect taxes such as customs tariff.

One major source of tax revenue, particularly in the less developed countries such as Ethiopia, is the tax revenue from international trade. According to De Wulf (1980), "In the early stages of development, internal flows of goods and income cannot be assessed and taxed because of the small and the decentralized nature of economic activity. Imports and exports, on the other hand, transit through few trade points and are readily identifiable targets of the tax administration. Hence, it is not surprising to find that the "openness" of a country greatly influences the tax burden of less developed countries, an influence that worked through increasing the relative importance of import and export taxes".

The revenue collection role of Customs Administrations is also emphasized by De Wulf and Sokol (2005: 6), when they remark that "in spite of declining tariff rates brought about by successive rounds of trade liberalization, the revenue mobilization and control functions of customs are likely to remain substantial, for several reasons: (a) the fiscal dependency on customs revenues is likely to linger for some time, in light of the difficulty many developing countries encounter in broadening their tax bases; (b) imports will probably constitute a major tax base for levying VAT, and customs is well positioned to control the goods at the time of importation; (c) customs will remain the responsible agency to ensure that goods that were imported for other than home consumption are not diverted to such consumption; and (d) assessing VAT refunds on exported goods will continue to require a high level of control over exported goods."

Keen (2003, 4), also explains that, "in Africa, more than one-third of total revenue still comes from trade taxes, whose relative importance actually increased over the 1990s. Elsewhere in the world there is a clear downward trend, but reliance still remains high: one-fifth of all revenues in Asia and the Pacific, and one-quarter in the Middle East, are from trade taxes."

Krugman and Obstfeld (2006) reveal that, before the introduction of income tax in the United States of America,

tariffs had been the major source of government of the country. Up to 1913 customs receipts constituted a considerable percentage of the total Federal revenue of the United States and fiscal needs played a significant part in tariff discussions. Since 1913 governmental revenue requirements have increased and new methods of taxation have reduced the relative importance of customs receipts. In 1922 revenue from customs duties amounted to only 8.7% of total Federal revenues; in 1932 the proportion rose to 15.5%, largely because of the decline in income tax payments in that year. By 1934 customs duties provided less than 10% of total Federal revenue (Fox, 1936).

Many countries use tariffs to improve their balance of payments positions as well. They increase their tariff rates to cut down imports generally in order to offset the decrease in exports. Todaro and Smith (2006: 634) explain the four major components of customs tariff as follows:

- i. Duties on trade are the major source of government revenue in most LDCs because they are a relatively easy form of taxation to impose and even easier to collect;
- ii. Import restrictions represent an obvious response to chronic balance of payments and debt problems;
- iii. Protection against imports is one of the most appropriate means of fostering economies of scale, positive externalities, and industrial self-reliance as well as overcoming the pervasive state of economic dependence in which most developing countries find themselves; and
- iv. By pursuing policies of import restriction, developing countries can gain greater control over their economic destinies while encouraging foreign business interests to invest in local import-substituting industries, generating high profits and thus the potential for greater saving and future growth.

According to their view, "Protection can have an important role to play in economic policy, for both economic and non-economic reasons, but it is a tool of economic policy that must be employed selectively and wisely, not as a panacea to be applied indiscriminately and without reference to both short- and long-term ramifications."

The Role of Customs Administrations in the Country's Economy

Customs administrations all over the world commonly have at least four major roles: revenue collection, trade facilitation, society protection, and compilation and dissemination of foreign trade statistics. In fact the priority and degree of their attentions to these objectives differs based on different factors such as their economic and social developments, political stands, geographical situations and the like. Most of the developing countries, for example, give due attention to the revenue collection from the international trade, mostly from imports. In contrast, as they have well-developed and diversified economies, infrastructure, better taxpayer attitude, educated tax accountants, the developed nations do not as such rely on international trade taxes.

The organizational structures of the Customs Administrations all over the world are also very much influenced by the priorities they give to the above four functions. Countries whose top priority is revenue from international trade, organize their Customs Administrations under the Ministry of Finance and also with their Tax Administrations. Those, whose top priority is trade facilitation, however, structure their customs Administrations under the Ministry of Trade/Commerce. Those who are very much concerned with the security issues such as terrorism, organize their Customs Administration along with Security, Police, Immigration, Military and other border agencies. Of course, there are some who established autonomous Customs Administrations.

Although there is no hard and fast rule, concerning how and where Customs Administrations should be structured and to which objective they need to give top priority, it is almost common event that the underdeveloped countries give top priority to the revenue function of their customs Administrations. That is why in most of them, Customs are administered under the Ministry of Finance. Adegbe (2011), for example, categorizes the organizations of the Sub-African Customs Administrations into three:

- a. Those who are a part of the civil service;
- b. Those who are given their own autonomy; and
- c. Those that are merged with the Inland Revenue Authorities.

Countries like Ethiopia also merged their Customs Administrations with their Inland Tax Authorities. This shows that revenue collection from international trade is given more weight than the security and trade facilitation objectives of the customs administrations.

As of 9th July, 2008, the previous Ministry of Revenues, the Ethiopian Customs Authority, and the Federal Inland Revenue Authority (FIRA) were merged together and formed the current Ethiopian Revenues and Customs Authority (ERCA). The objectives of ERCA are stipulated to be:

- a. To establish modern revenue assessment and collection system; and provide customers with equitable, efficient and quality services;
- b. To cause taxpayers voluntarily discharge their tax obligations;
- c. To enforce tax and customs laws by preventing and controlling contraband as well as tax frauds and evasions;
- d. To collect timely and effectively tax revenues generated by the economy; and
- e. To provide the necessary support to regions with a view to harmonizing federal and regional tax administration systems.

All these objectives of ERCA are geared towards the revenue maximization role of the Authority. Nothing is mentioned about the trade facilitation, society protection, and generation of foreign trade statistics. This also is an evidence for how much emphasis is given to the fiscal role rather than any other roles of the country's Customs Authority.

Methodology

Annual data for the period 1959/60-2012/13, fifty four years, are used to test the effect of tariff rate liberalizations on the performance of revenue tariff. The data were obtained mainly from the Ethiopian Ministry of Finance and Economic Development (MoFED), the Ethiopian Revenues and Customs Authority (ERCA), the National Bank of Ethiopia (NBE), and the Ethiopian Development Research Institute (EDRI). Although a reliable and responsible source of data is much preferable than different sources, for consistency and comparability, there is no such a complete source for the variables of this Article. Information on tariff liberalization is gathered from MoFED, tax data are collected both from MoFED and ERCA, annual average exchange rate is gathered from NBE and GDP and other macroeconomic data are obtained from EDRI. Sometimes even data from same source (organization) but at different times vary. Particularly, annual reports of ERCA and MoFED, for example, show such a discrepancy from year to year. In that case, the more recent year's reports were taken as a source.

Data Analysis and Discussions

The central theme of this Article is to evaluate the performance of customs duty towards its contribution to government revenue budget. To achieve this objective, two important measurements of a tax revenue performance, the ratio of the tariff revenue to the total government revenues and the revenue productivity of the tax base in the study period (1959/60-2012/13) are analyzed first. Then, both the share and the trend of customs duty in the total trade taxes, total tax revenues and total government revenues are analyzed, respectively. Since another important indicator of the tax revenue performance is measuring the tax in terms of Gross Domestic Product (GDP), the trend of customs duty/GDP ratio is also included in the analysis.

The Revenue Productivity of the Tax Base

The relationship between the value of imports and customs is determined by different factors. Among these, the level of tariff rates, exemptions from customs duty, smuggling and commercial frauds, bilateral agreements between trading partners, and multilateral agreements in the form of economic integration are important factors for consideration.

Since 1992/93 fiscal year, the tariff rates in Ethiopia have been revised for about four times. The revisions took place in 1993, 1996, 2000 and 2002. This list does not include the minor tariff changes that do not have significant impacts on the average tariff rate. Accordingly, the average tariff rates have been reduced from 49.96% in 1992 to 29.96%, 25%, 19.5%, and 17.5 in 1993, 1996, 2000 and 2002, respectively. The statutory tariffs are calculated based on these averages, whereas the effective tariffs indicate the ratio of the actual customs duty to the value of imports in respective years. The trends of the statutory and effective tariffs are indicated in the following Figure (1).

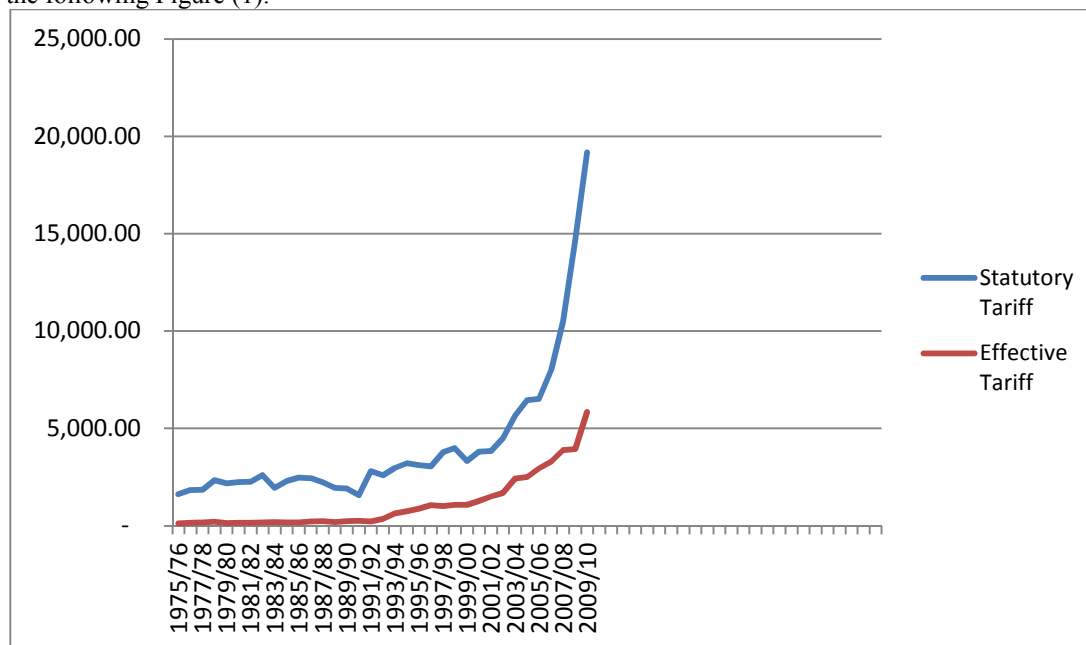


Figure 1: The Revenue Productivity of the Tax Base in Million Birr (1975/76-2012/13)
 Source: Own Computation from the NBE and MoFED Data (2014)

The above Figure (1) clearly depicts that there is huge gap between the potential (statutory) and actual (effective tariffs). Tariff revenue that could have been collected by applying the average tariff rates is not effectively collected.

The current Ethiopian government, since it has come to power in 1991, has reduced the tariff rates in about four rounds. The reductions took place in 1993, 1996, 2000, and 2002. The major reduction, amongst them, is that of 1993. During this period (1993-2002), the maximum tariff rates were reduced from 230% in 1992 to 80%, 60%, 40% and 35%, respectively. The weighted average rate was also reduced from 41.96% in 1992 to 29.96%, 25%, 19.5% and 17.5% in 1993, 1996, 2002 and 2002, respectively.

It is observable, from the above information that there is no single time when the average tariff rate is less than 17.5% in Ethiopia. However, to the contrary, there was no single time when the effective tariff rate (the ratio of actual tariff collection to the value of imports has exceeded 8% in the country. This gap shows that the productivity of the tax base in the country has been ineffective. The potential factors could be exemptions, smuggling/contraband, corruption, commercial frauds and the like. Identification of the factors needs further investigations. The following Figure (2) compares the average tariff rates with the effective tariff rates.

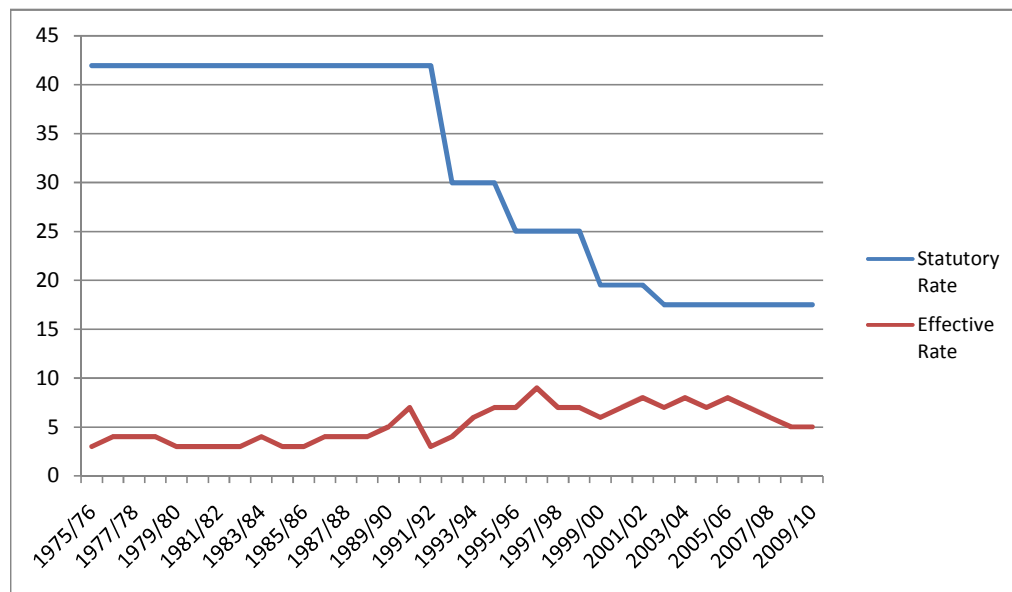


Figure 2: The Revenue Productivity of the Tax Base in Percentage (1975/76-2012/13)
 Source: Own Computation from the NBE and MoFED Data (2014)

The Share of Tariff Revenue/Customs Duty in the Total Government Revenues

In some developing countries, for example in Nigeria, oil is the major source (76% in 2006) of public revenue (Adegbe, 2011). In Ethiopia, however, tax revenues constitute the larger share. During the 1959/60-2012/13, out of the Birr 743,021 total government revenues, Birr 494,566.2 million (67%) was generated from tax sources, Birr 127,718 million (17%) from non-tax sources, and the remaining Birr 120,737 million (16%) from external grants. This is indicated in Figure 3 below.

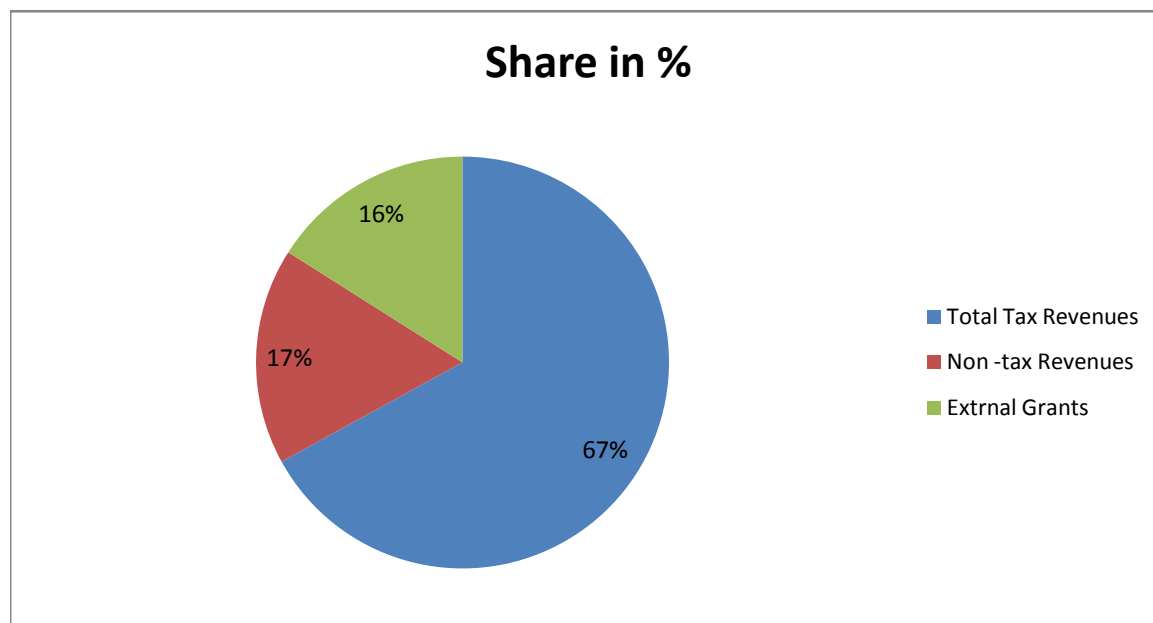


Figure 3: The Percentage Share of Tax Revenues in Total Revenues (1959/60-2012/13)

Source: Own Computations from the MoFED Data

The previous Figure (3) indicated that the highest share of the total government receipts comes from tax revenues. But it does not show whether or not this share has permanently existed for longer time. The following analysis compares the share of tax revenues with the share of non-tax revenues over time.

The amount of tax revenue mobilized during the 1959/60 fiscal year, which stood at Birr 138.5 million, has reached the level of Birr 137,192 million in the 2012/13 fiscal year. The foreign trade taxes, which comprised customs duty, excise taxes, VAT and others have increased from Birr 57.5 in 1959/60 to Birr 38,177 million in 2012/13. The trends of tax revenues and non-tax revenues are shown in Figure 4 as follows:

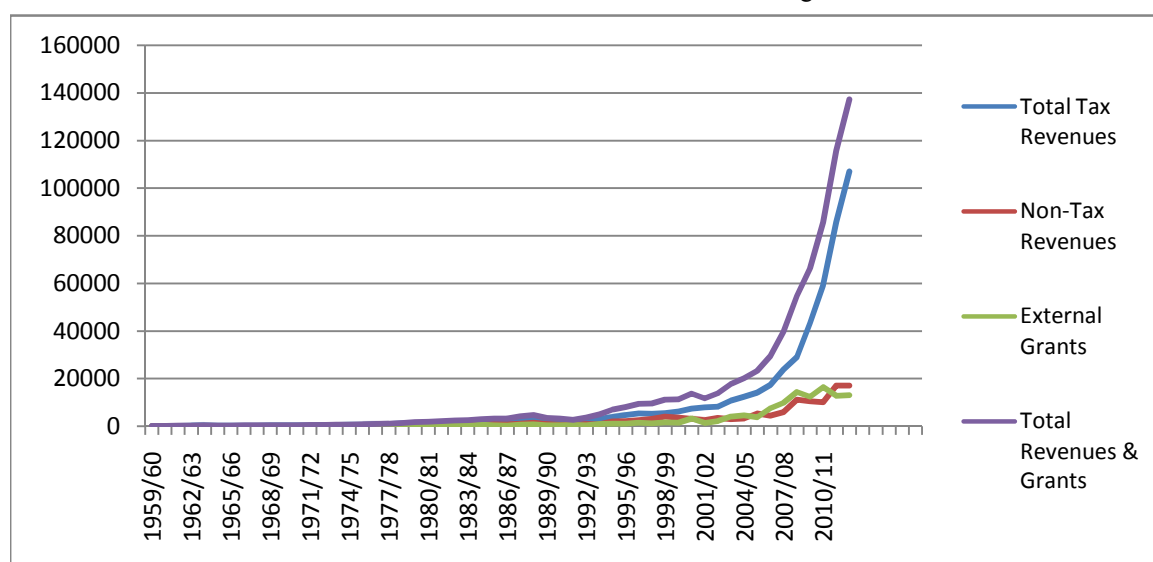


Figure 4: The Trend of Tax Revenues in the Total Government Revenues in Million Birr (1959/60-2012/13)

Source: Own Computations from the MoFED Data

The Figure 4 above indicates that the nominal amounts of both the tax and non-tax revenues have been growing over time. Particularly, since the beginning of the 2000s, the total government revenue has increased at alarming rates. This sharp increase in tax revenues can be attributed to a number of policy and administrative measures that were taken to improve domestic tax revenue collection. These included strengthening the capacity of the tax collection agencies, expanding the tax identification number system throughout the country, strengthening the Value Added Tax (VAT) system, increasing tax compliance and taking stringent legal measures against tax

evasion.

However, the data collected for the 1959/60-2012/13 period show that the trend of the percentage share of the tax revenues in the total government revenues has been declining over time. This trend is indicated in the following Figure (5).

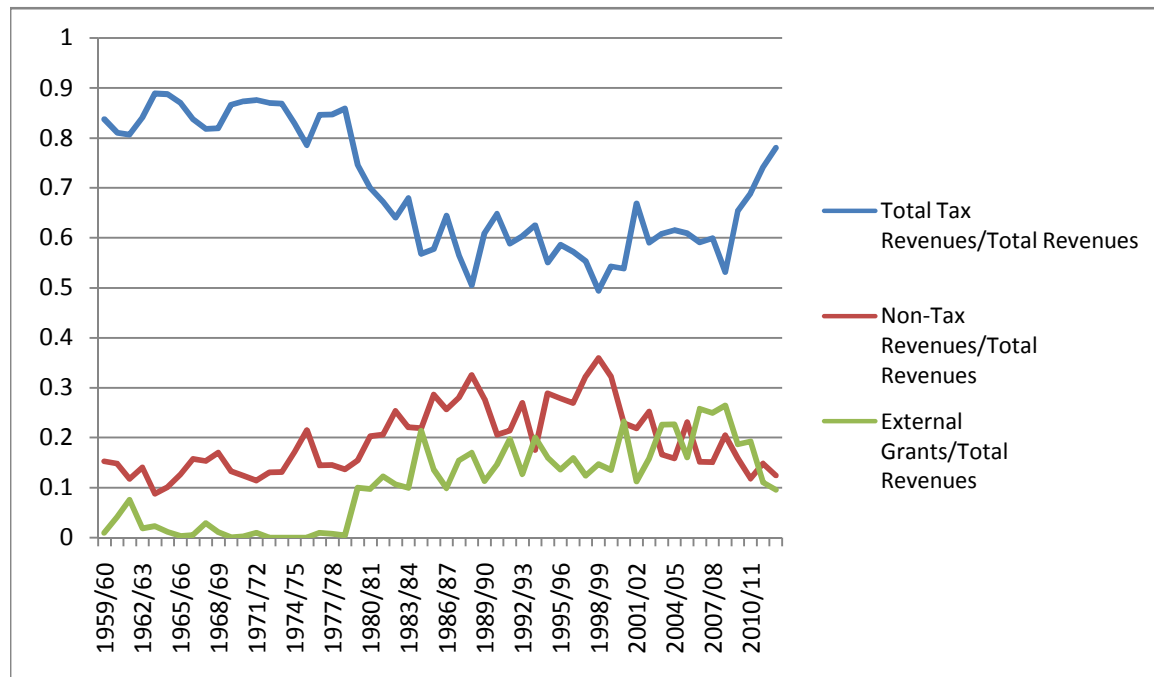


Figure 5: The Trend of the Share of Tax Revenues in the Total Government Revenues in Percentage (1959/60-2012/13)

Source: Own Computations from the MoFED Data

The above Figure (5) clearly depicts that the percentage share of tax revenues in the total government revenues has been steadily declining over time, except for the very recent years. In the 1963/64 fiscal year, the share of total taxes in the total government revenues was 89%. This share has continuously declined and reached only 49% in 1998/99 fiscal year. Between 1998/99 and 2007/08 the trend has been fluctuating. Since 2007/08, even though it has not yet reached the level of 1963/64 fiscal year, the share has been increasing over time and has reached the level of 74% in 2012/13 fiscal year. Therefore, it is worthwhile to assess the role of the foreign trade tax in general and that of customs duty in particular during the study period.

For the period between 1959/60-2012/13), the average share of foreign trade taxes was about 27% of the total revenue earned by the government. It shows that the foreign trade taxes in Ethiopia have a significant contribution to the total revenue budget of the government (see Figure 6 below).

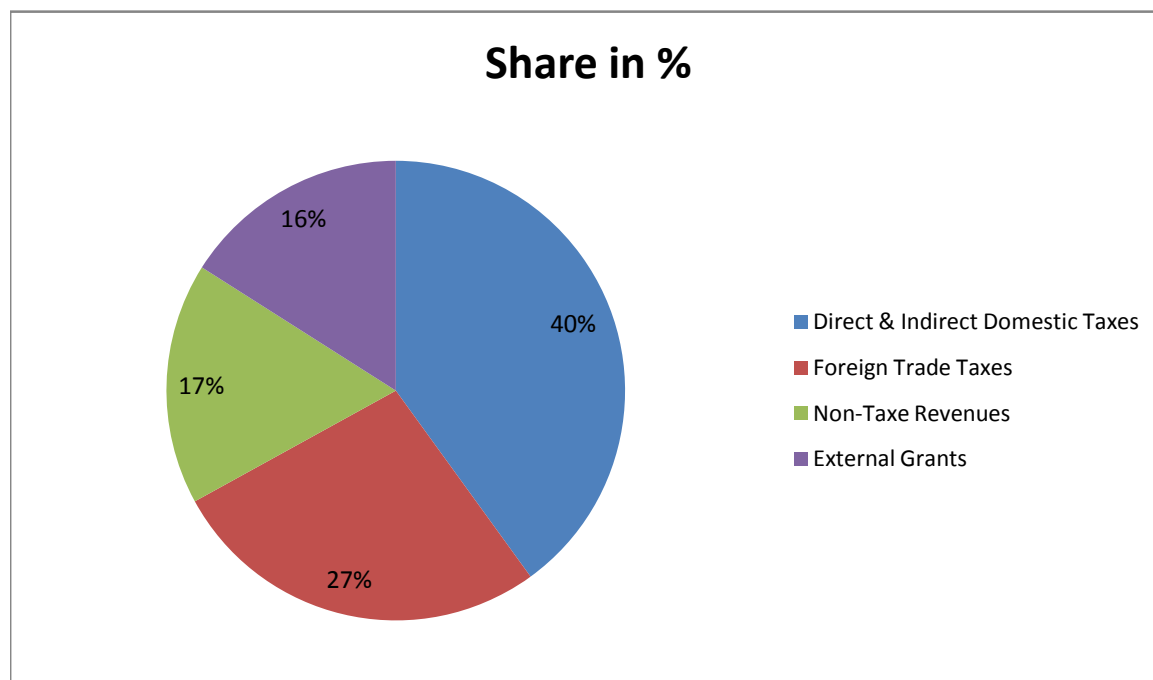


Figure 6: The Percentage Share of Foreign Trade Taxes in Total Government Revenues (1959/60-2012/13)
 Source: Own Computations from the MoFED Data

In the past fifty four years time, the average contribution of the tariff revenue/customs duty has been around 9.7% of the total government revenues and 37% of the total foreign trade taxes. This implies that the Ethiopian government highly relies on foreign trade taxes in general and on customs duty in particular. The share of customs duty in total government revenues is indicated in Figure 7 below.

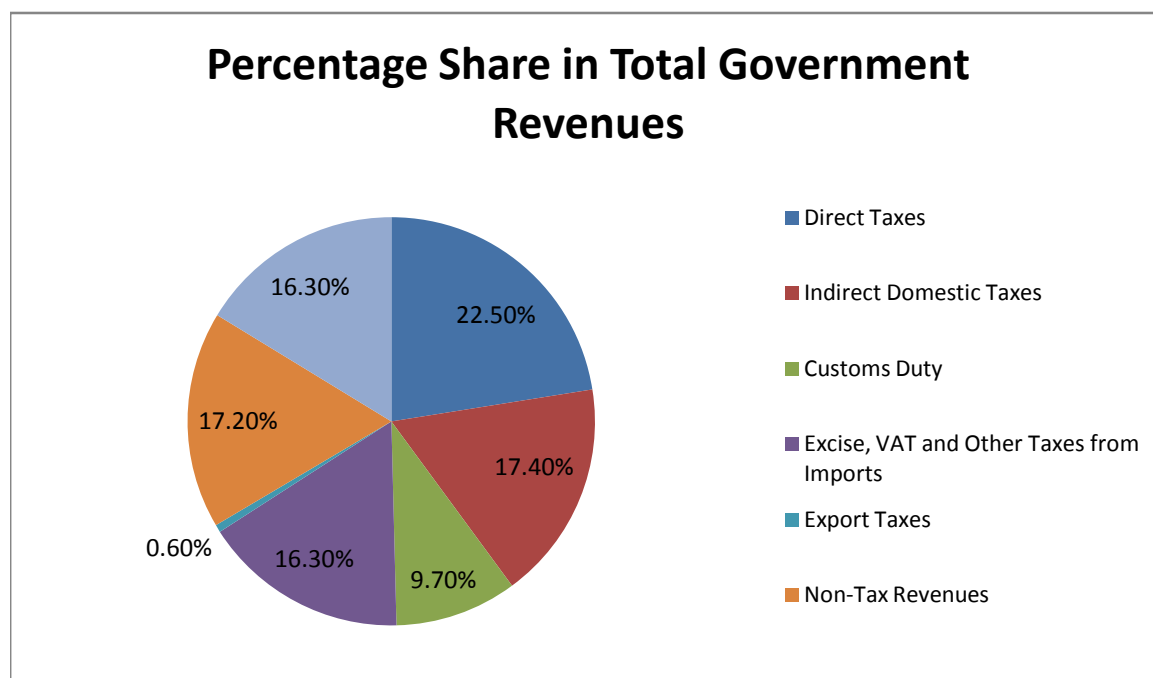


Figure 7: The Share of Tariff Revenue in the Total Government Revenues (1959/60-2012/13) Source: Own Computations from the MoFED Data

Even though the average contribution of customs duty, for the past fifty four fiscal years, is 9.7%, the share of the customs duty rate was much higher in the earlier years than the recent years. The data gathered from MoFED

for the study period reveals that the average contribution of customs duty to total government revenues has been declining over time. During the majesty era, the highest share (26%) of the tariff revenue in the total government revenues was attained in the 1965/66 fiscal year. In the military government, the highest share (16%) was recorded in the 1976/77 fiscal year. Since the current government has taken power (1991), the highest share (14%) was attained in the 2003/04 fiscal year. This shows how much the role of the tariff revenue, in the total government receipt, has steadily declined over time. The trend of the share is shown in the following Figure (8).

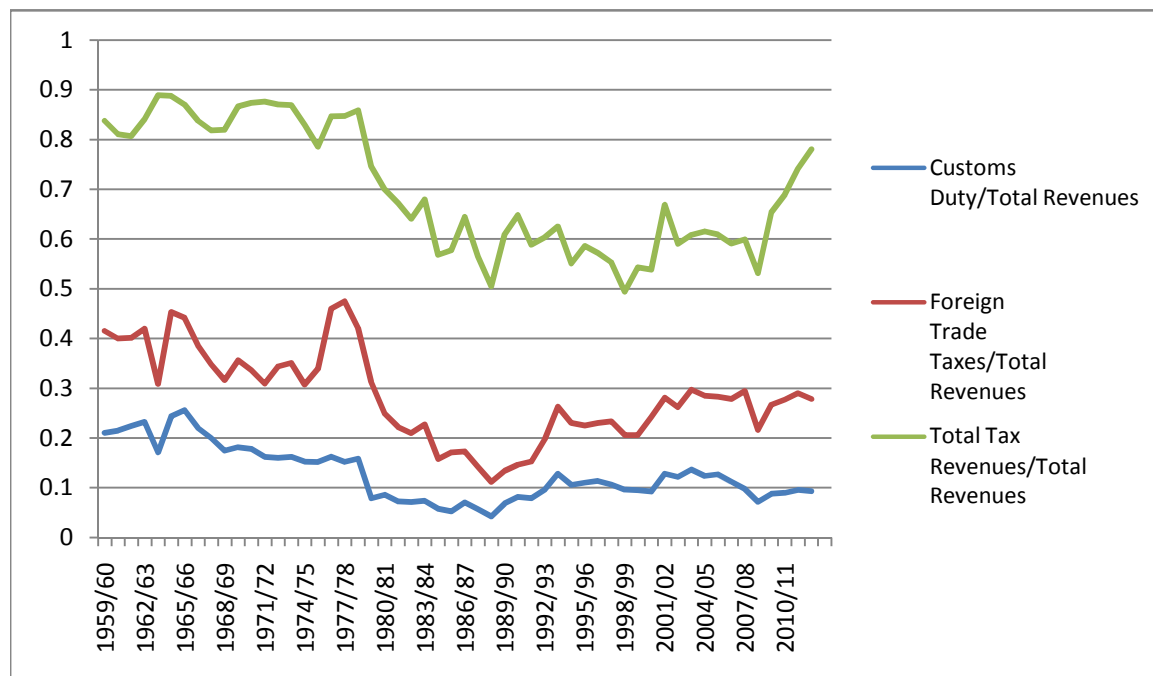


Figure 8: The Trend of the Share of the Tariff Revenue in the Total Government Revenues in Percentage (1959/60-2012/13)

Source: Own Computations from the MoFED Data

The above Figure (8) reveals also that the declining share of the customs duty is also responsible for the decline in the share of both foreign trade taxes and total taxes in the country.

The Share of Tariff Revenue/Customs Duty in the Total Foreign Trade Taxes

Amongst the sources of foreign trade taxes, the customs duty also has the lion’s share. Tariff revenue is one of the oldest taxes in Ethiopia. Over the years, customs duty has been playing significant role in the government budget and it has been a major source of revenue. In the previous five decades time, the share of the customs duty (tariff revenue) has been about 37% of the total foreign trade taxes. The share of excise taxes, VAT/sales tax, and surtax, altogether, constitutes about 61% of the total foreign trade taxes. The remaining 2% is the share of export taxes. This share of customs duty in the total foreign taxes is shown in Figure 9 below.

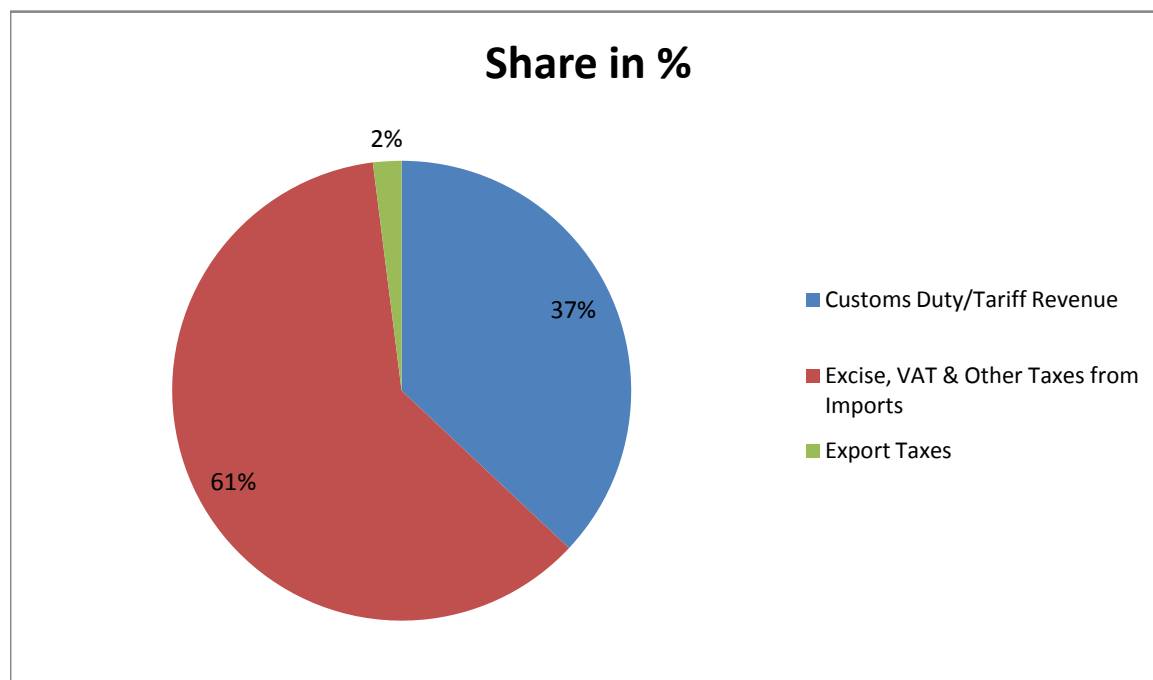


Figure 9: The Percentage Share of Customs Duty in Foreign Trade Taxes (1959/60-2012/13)

Source: Own Computations from the MoFED Data

Although export taxes were playing significant role during the majesty and the military governments in Ethiopia, they constituted an insignificant contribution during the current government. Since the 1994/95 fiscal year, except for the 1997/98 fiscal year, the export tax revenue has steadily declined. Particularly after the year 2003/04, the macroeconomic data show that there was no export tax in the country.

At the mid of 1960s, the share of customs duty in total foreign taxes has been as high as 58%. This share has steadily declined and reached only about 25% in 1979/80. Again it has revived back and reached about 56% in 1990/91 fiscal year. Since 1990/91, the share of customs duty in the total foreign trade tax has been steadily declining and since 2007/08 fiscal year it has never exceeded only 33%. The trend of the share is shown in Figure 10 below.

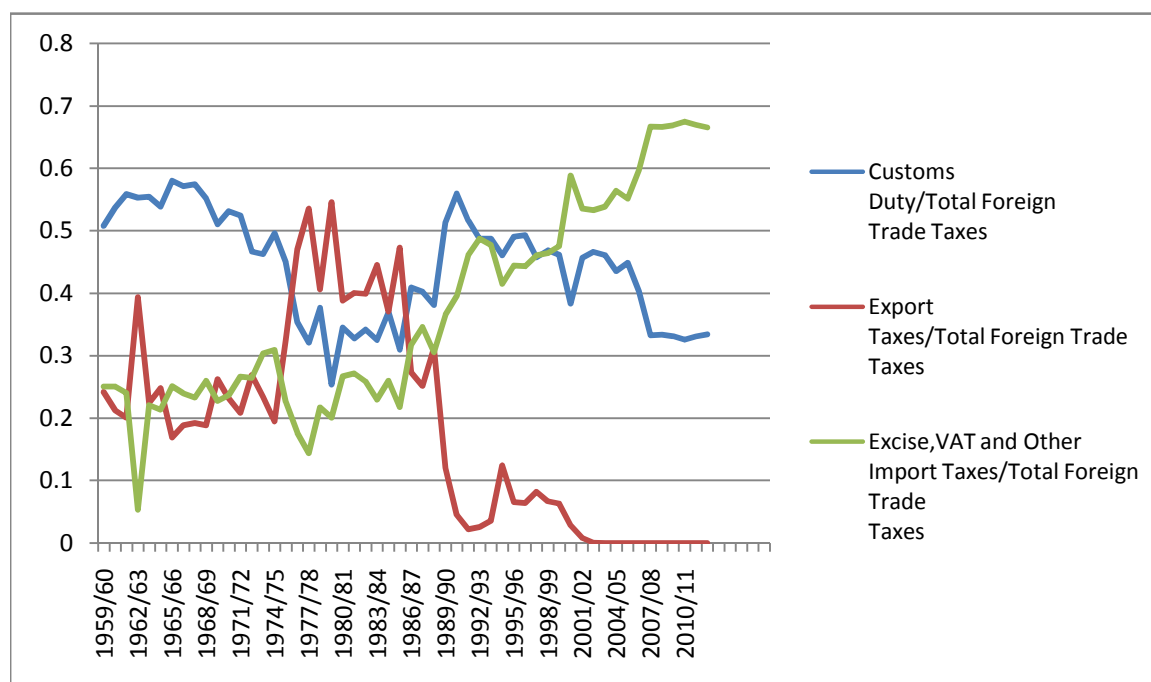


Figure 10: The Trends of Customs Duty in the Total Foreign Trade Taxes in Percent (1959/60-2012/13)
 Source: Own Computations from the MoFED Data

The Tax/GDP Ratios

Tax/GDP ratio is an important universal measure of tax performance. In Ethiopia, even if the tax receipt has the larger share in the public revenue, the Tax /GDP ratio is lower than the developing countries' average. Moreover, the Tax/GDP ratio has sharply declined from 13% in the 1983/84 fiscal year to only 6% in the 1992/93 fiscal year. Then, it has sharply increased from the 6% year to 13% in the 2003/04 fiscal year. Again, the ratio fell from the 13% to only 9% in the 2008/09 fiscal year. Since 2008/09, it is on the increasing trend, and it has reached the level of 13% in the 2012/13 fiscal year.

By the same token, the tariff revenue/GDP ratio has declined from 2% in the 1967/68 fiscal year to 1% in the 1975/76 fiscal year. Although it has increased from the 1% level to 2% in the 1976/77 fiscal year, again it suddenly fell down to 1% after only three years. Then, it has reached the level of 3% in the 2003/03 fiscal year. However, it has declined back to the 1% level in the 2012/13. These fluctuations with the total tax /GDP ratio show that the performance of tariff revenue has a significant impact on the performance of total tax revenue in the country. The trend is shown in Figure 11 below.

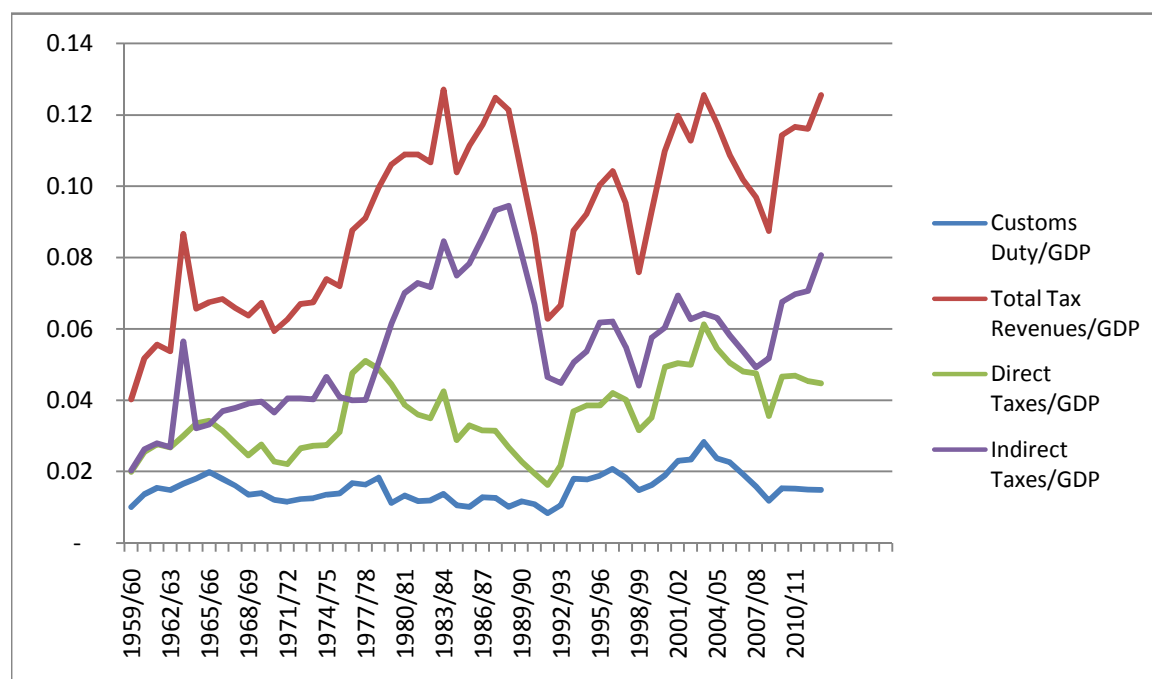


Figure 11: the Tax GDP Ratio (1959/60/2012/13)
 Source: Own Computations from the MoFED Data

Summary of Findings

The previous discussions and analyses revealed the following facts:

- i. The share of revenue tariff in the Ethiopian government's total revenue is significant. Therefore, any change in tariff policy can have influential impact on the government's revenue budget;
- ii. Although Ethiopia is categorized under the developing countries where the average customs tariff rate is high, the effective rate is much lower than average tariff rate. This indicates that the effectiveness of the tax base, in this case, the customs duty/value of imports is very low;
- iii. The performances of tariff revenue/customs duty, measured in terms of its contribution to total government budget, foreign trade taxes and its GDP ratio have declined over time.
- iv. The tariff revenue in Ethiopia has the influential power of affecting the contribution of the foreign trade taxes and total indirect taxes to the total government budget; and
- v. The low performance of tariff revenue could be one of the major factors that are lowering the country's Tax/GDP ratio, even when compared with the other Sub-Saharan African countries.

Conclusion and Recommendation

Although its share in the government budget is significant, by all measurements, including tax base effectiveness, share of tariff revenue to the total government revenue and total indirect taxes and its GDP ratio, the performance tariff revenue in Ethiopia has been declining over time. Therefore, the identification of the responsible factors for this low performance the tariff revenue needs further investigations.

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