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Tax Policy Reforms, Trends and Composition of Tax Revenue in Ethiopia

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Abstract
Taxation is a vital fiscal policy instrument indispensable for the development of both developed and developing countries. However, in Ethiopia the resource mobilization effort through tax collection is low though tax policy reforms are done in various periods. Hence, the major objective of this study is to analyze the tax policy reforms, trends and composition of tax revenue in Ethiopia using the data covering 40 years (1974/75-2013/14). Descriptive analysis method was used to address the objective. The finding of the study indicates that most of the tax policy reforms are concentrated on tax legislation and the pace of institutional reform is slow. In addition, the amount of tax revenue collected is characterized by cyclical trends and it is highly dependent on foreign trade taxes. Therefore, the tax system of the country fails to generate adequate revenue commensurate with the growth of the economy. Hence, the institutional reform should be dynamic to improve the tax mobilization effort. Similarly, the government should strength its effort towards direct taxes to raise adequate revenue emanated from the economy as the tax revenue sources from foreign trade is unpredictable provided the volatile nature of the international market situation.
Keywords: Tax revenue; tax policy reforms, composition of tax revenue, Ethiopia

1. Introduction

The major aim of most governments of developed and developing countries is to stimulate and guide their economic and social development. One of the most important policy upon which most scholars agreed is that, the use of fiscal policies to mobilize their own internal resource, and thereby to meet their financial needs. Among these, the most important instrument used to mobilize resources is the implementation of effective tax policy (Wawire, 2011).

It is believed that the ability to mobilize tax revenue emanated from the economy is highly variable across the world. Legal reforms, institutional reforms, and the composition of tax revenue can play significant role in the tax revenue performance of a particular country. Teera and Hudson (2004) also state that effective tax policy always has been an important instrument for augmenting revenue to finance essential expenditure on the goods and services provided by the government mainly for the attainment of optimal allocation of resources and to ensure sustainable economic growth. Likewise, Ethiopia follows a developmental state in which the government has an active role in the economy and conducts different tax reforms. However, the tax revenue performance is not as such satisfactory in developing countries. In a similar fashion, the tax revenue mobilized in Ethiopia is very low. Even if the country has made both institutional and legal reforms, the tax to GDP ratio of the country remains very low. According to the report issued by MoFED in (2013), it is asserted that the country could collect only 11.7% and 11.6% of GDP in the year 2010/11 and 2011/12 respectively and this is still well below the average for SSA (17%) and LIC (13%). Analyzing the tax policy reforms, tax revenue trends and its sources of composition (direct, indirect, trade tax etc) is essential since it may bequeath an input for the country's policy interventions. Therefore, this study tried to analyze the tax policy reforms, trends and composition of tax revenue in Ethiopia.

2. Methodology of the study

In order to address the stated objective, the study employed descriptive research design that deals with analyzing the tax reforms, trends and composition of tax revenue in Ethiopia. This study used secondary type of data. Particularly, it used a time series data, which covers a period of 40 years (1974/75-2013/14). The data were collected from different government agencies such as Ministry of Finance and Economic Development (MOFED), Central Statistical Agency (CSA) and National Bank of Ethiopia (NBE) annual published and unpublished reports. The researchers also collected data from World Bank database development indicators websites. Moreover, due to non-availability of time series data on the informal sector (underground economy) in governmental organizations, the researcher also collected data from research papers conducted by Delessa (2015). Because the stated objective does not involve establishing relationship and exploring new things; instead simply it describes the tax policy reforms, trends, and composition of tax revenue using percentages, average, growth rate and nominal values. Therefore, descriptive analysis method was appropriate.

3. Analysis and discussions of the study

This section focused on descriptive analysis of the tax policy reforms, trends and composition of tax revenue in Ethiopia. It has three main sections. The first section deals with describing the tax policy reforms conducted during the Derg regime and post 1991. The second section evaluates trends of tax revenue in terms of total amount and its share to GDP. The final section analyzes the composition of tax revenue in both periods.

3.1. Tax Policy Reforms

3.1.1. Tax Policy Reforms during the Derg Regime

When the Derg regime came to power in 1974/75, the overall economy had been changed towards socialism in which the economy was distorted by excessive intervention of the government. As part of it, the government had changed the existing tax system to some extent. As it is asserted by Fanuthun (2001) the tax policy was designed mainly to reduce income inequality to that end the income tax rate at some period reached 89% of the taxable income. Such high levels of tax rates coupled with relatively small tax bases and heavily rely on few tax instruments resulted in severe distortion in the economy and failed mobilized sufficient revenue ultimately.

During this regime land tax, rental income tax and the tithe were revoked. The health and educational taxes were also canceled, and the remaining tax types were extensively amended and restructured. Thus, the income tax proclamation No. 173/1961 has been amended by proclamation No. 255/1967. Accordingly, employment income tax rate was ranged from 10% up to 85%, tax bracket had been reduced and tax exempted income raised to Birr 50. Furthermore, business income tax rate for incorporated bodies had been increased to 50% and that of unincorporated one to 89%. In addition, land use fee was first introduced during this regime. The agricultural income tax that was first introduced in 1967 by proclamation No. 255/1967, was replaced by proclamation No.77/1976 and subsequently amended by proclamation No. 152/1978, with high rate varied from 10% to 89% (Misrak, 2014).

In the case of indirect taxes, excise tax and customs duties were in effect during this regime. During 1976, the militant government has conducted customs duties with respect of classification of the schedules and commodities. During this regime not only the direct taxes, but also the indirect ones have a high tax rate. Among the indirect taxes, the customs duty has reached a maximum rate of 230% (Ibid). Therefore, the overall tax policy of the Derg regime was characterized by narrow tax bases together with high excessive tax rates and such policy distorted incentive to work and invest which is against the design of good tax policy.

3.1.2. Tax policy Reform Post 1991/92

Following the downfall of the Derg regime in 1991/1992, with the view of stabilizing the economy, an economic reform program has been implemented in the country. The economic structure has changed towards market orientation. As part of it, the government pursued different tax reforms. As it is noted by Demirew (2004), the driving forces of the reform constitute; the existence of complex and outdated tax laws because the tax proclamation No. 173/53 has been put in to practice for more than 40 years without fundamental changes. In addition, the tax system of the previous regime was characterized by excessive high tax rates, too many tax brackets and narrow tax bases, weak tax administration and the overall tax system distorts incentive to work and invest.

As a result, the transitional government of the country issued proclamation No. 7/1992, which ensures the establishment of the regional government with legislative, exclusive and judicial powers. In addition to this, the tax reform has conducted with the aim of rationalization of the tax rates, reduction of tax brackets, broadening tax bases, and restructuring the tax administration system. According to Misrak (2014), Fanthun (2001), MoFED (2014), the major tax reform pursued by the transitional government includes the following:

- The pervious income proclamation No. 173/53 was amended by proclamation No. 30/1992. In this law, the personal income tax rate was reduced from 89% to 50% latter to 40%, and the minimum taxable personal income exempted increased from 50 to 120 birr, and the number of tax base bracket was reduced from eleven to six.
- The maximum business income tax rate for unincorporated and incorporated was also reduced to 45% and 40% respectively.
- With regard to broadening the tax base mining income was introduced by proclamation No. 53/1993 with 45% rate for large scale mining and 35% for small scale mining, capital gain tax was newly introduced by this proclamation on shares, bonds and urban house at the rate of 15% with respect to gain on shares and 30% that of urban lessees.
- Rental income was reintroduced with rates of 10% to 45% and up to 1200 birr exemptions.
- With regard to indirect taxes, the first customs duties revision was initiated in 1993. In view of liberalizing the foreign trade, therefore, the first customs revision reduced the maximum duty rate from 230% to 80%. The government also abolished taxes and duties levied on exported of goods most of the specific taxes were converted to advolrem.

Although following these reforms and other some improvement has been observed in the tax revenue performance in terms of annual growth in 1990's, its performance was hardly changed. Despite of the various measures taken to rationalize the tax system, still the shares of tax revenue to GDP remained low, it depends upon indirect taxes, particularly trade taxes and most direct taxes was emanated from government owned public enterprises; while contribution from the private sector was minimal. On the contrary, the government expenditure has been shifted from defense to social and infrastructural outlays, which demands a huge resource. Thus, the failure of the effort of the government to mobilize adequate domestic resources called for further reforms in policy, administration and institutional reforms (MoFED, 2014).

Accordingly, in view of streamlining the objective of tax policy, the government adopted a rigorous tax reform in the last decades, especially in 2002/03, which focuses on reduction of tax rates, removing unproductive taxes, broadening the tax bases and improving and modernization revenue collection. The overall objective and principles of these tax policy and administration reform situated on the following basic issues (MoFED, 2014 & Fanthun, 2001).

- A shift from reliance on high tax rates to broader tax bases.
- Switching from taxation of production to taxation of consumption
- Shifting from international trade taxes to domestic transactions
- Diverging the burden of taxation from poor to rich
- Restricting of investment incentives

The tax reform consisted of six projects of tax policy and legislation project, taxpayer identification (TIN), presumptive tax project, value added tax project, building efficiency and effectiveness of revenue administration and taxpayer education projects (Ibid).

Tax policy and legislation project: For the purpose of ensuring modern and efficient legal framework in the tax policy of the nation, wide range of proclamation and regulation was issued. The income tax proclamation No 286/2002, VAT proclamation 285/02, excise tax proclamation No 307/2007, turnover tax proclamation No. 308/2002, and customs proclamation No 662 /2009 were among them.

The fundamental changes of the income tax proclamation 286/02 constitutes, broadening the concept of income to taxing income generated in cash and in kind, the maximum tax rate on incorporated business income, rental income and employment income was reduced to 35%. The incorporated bodies' rate was also reduced to a flat rate of 30%. In addition, the minimum annual income tax exempted was raised from 1200 to 1800, in the case of business rental and (unincorporated) and employment income to 150 on monthly basis.

In addition to this, the government also introduced withholding taxes to generate revenue by withholding at sources with minimal of administrative resources. This system was introduced by proclamation No. 227/01, to withhold on imported and locally produced goods. According to this proclamation the government introduced withholding taxes 5% of the sum of CIF (cost, insurance and freight) on imported goods and local transaction on gross earnings. However, later on by proclamation No. 286/02 the rate was reduced to 3% of CIF value, for imported goods and 2% local transactions on gross amount of the payments.

With regard to tariff liberalization the country has also made customs reform and administration so as to facilitate international trade and create a conducive environment for foreign investment, thereby to boost the economic growth and development. As noted by Delessa (2014) the customs reform and modernization was oriented towards rationalization of tariff rate, reduction and simplification of document requirements. The government conducted six times a tariff reduction between 1993 and 2003, as a result the maximum tariff rate was reduced to 35% in 2003 (Demeriew, 2004). Moreover, with the view of having legal framework, which is compatible with the increasing growing of international trade and encourage trade and investment, the government issued customs proclamation No 622/2009.

Taxpayer registration: the government introduces unique tax identification numbers to each taxpayer. This enhances the tax administration to independently identify taxpayers, control evasion and create a dependable database for efficient and effective tax collection (MoFED, 2014).

VAT project: one of principal objective of the tax reform program is to avoid inefficient and unproductive taxes. In this regard, VAT was introduced by proclamation No. 285/02 and kept in effect on January 2003 by replacing the previous sales taxes. VAT was introduced to broaden the tax base as it enables to tax value added created at each stage of production, and distribution. It also minimizes the damage that may be caused by attempts to avoid and evade taxes and helps to ascertain the profit of obtained by taxpayers. In addition, it also encourages saving and investment as it is a consumption tax and does not attempt to tax capital. Replacement of the sales tax by VAT also oriented to enhance economic growth and to improve the tax to GDP ratio. This tax was introduced at flat rate of 15% and zero rates for exported goods and exemptions of capital goods and basic necessities. To complete the coverage of tax and to collect taxes from these which is infeasible to comply with VAT registration, the government introduced TOT taxes at the rate of 2% for good and 10% for services.

Presumptive taxation project: This project was introduced to generate taxes from the taxpayer, which are intensive to use accounts for their transaction. In addition it also enables raise more revenue from these who fails to declare their income or understate their income. Accordingly, the previous estimated assessment method was changed to standard assessment method by proclamation No. 227/01 and later on by promotion No. 286/02.

Tax Administration and Institutional Reform: Most of the reform taken was mainly focused on policy reforms. However, change in tax policy alone cannot be achieved the desired outcomes without effective tax administration. To this end, the government also conducted a tax administration reforms to improve the effectiveness and efficiency of tax operations, to change the behavior of the taxpayer and to raise the compliance level of the taxpayers. Accordingly, the Federal Inland Revenue Authority (FIRA) and Customs Authority (CUA) were established in 2003.

In addition to this in the year 2008, the former three institutions ministry of revenue, FIRA and CUA merged, which leads to the establishment of Ethiopian Revenue and Customs Authority (ERCA). ERCA was established with the objective maintaining modern revenue assessment and collection system, to collect timely and infectively tax revenues generated by the economy and to provide support to regions with a view of harmonizing federal and regional tax administration systems. This shows that the focuses given to the institutional reform was a recent phenomenon.

Generally the overall tax policy and administration reforms conducted in the last two decades was geared towards broadening the tax bases, decreasing the tax rate and restructuring the tax administration system in view of financing the ever-growing needs of government expenditure. Most of the tax reforms were concentrated in tax law; the pace of institutional reform was slow. However, the tax revenue amount is very lag behind even the sub-Saharan countries average.

3.2. Trends of Total Tax Revenue

3.2.1. Trends of Tax Revenue during the Derg Regime

The trend of tax revenue during the Derg regime was characterized by ups and downs. It lacks sustainable growth over the whole periods. The trends of total tax revenue and its growth is depicted in the following table.

Table 4.1: Trends of Tax Revenue in Million of Birr (1974/75-1990/91)

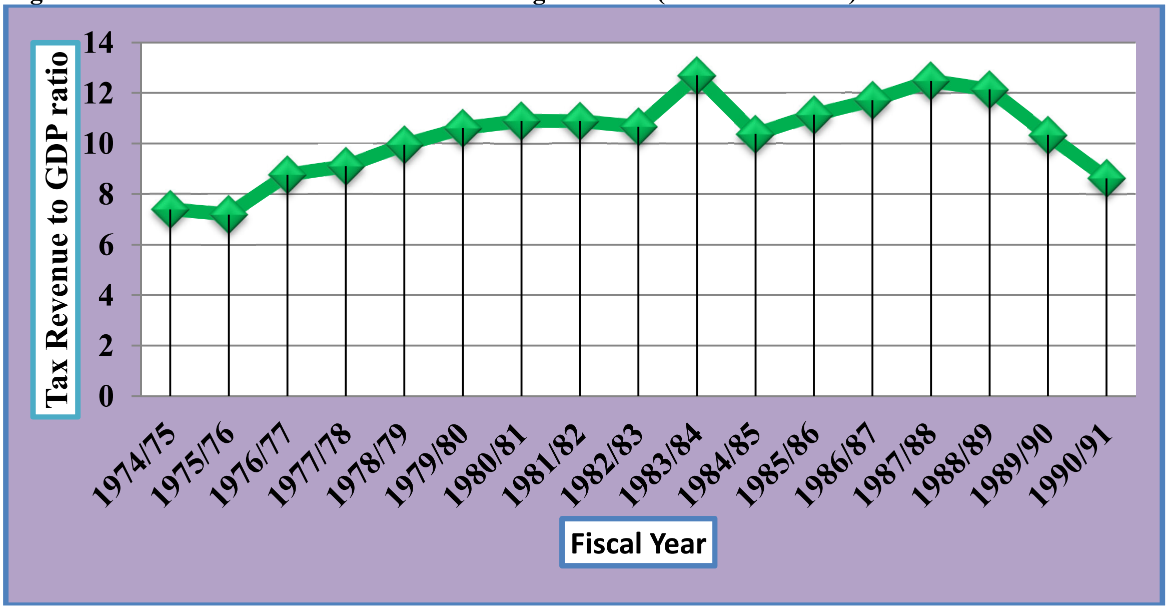
Year	Total Tax Revenue	Growth rate
1974/75	589.7	_
1975/76	613.4	4.02
1976/77	855.9	39.54
1977/78	938.8	9.68
1978/79	1,146.9	22.16
1979/80	1,298.2	13.19
1980/81	1,361.9	4.9
1981/82	1,436.4	5.47
1982/83	1,558.1	8.47
1983/84	1,731.4	11.13
1984/85	1,677.5	-3.11
1985/86	1,876.1	11.84
1986/87	2,092.2	11.52
1987/88	2,317.4	10.76
1988/89	2,371	2.31
1989/90	2,159.2	-8.93
1990/91	2,053.4	-4.9

***Source**: MoFED (2015)*

The above table asserts that the amount of tax revenue collected shows an increasing trend up to 1983/84. It increases from 589.6 million Birr in 1974/75 to 1.73 billion Birr in 1983/84 by showing an average growth rate of 13.17%. The highest growth rate of the tax revenue was achieved in 1976/77, which has shown 39.54% growth rate. However, in 1984/85 the total tax revenue was declines to 1.67 billion Birr due to unfavorable economic situation created in the country especially, because of the wide spread of severe famine in most parts of the country worsened the economy thereby the performance of tax revenue. Starting from 1985/86, the amount of tax revenue collected comes to the increasing trend up to 1988/89. It increases from 1.87 billion birr in 1985/86 to 2.37 billion birr in 1988/89 by showing average growth rate of 9.10%, which is less than the previous period's average growth rate. After 1988/89, it continuously declines up to the fall down of the regime. It is surprisingly that in the whole 17 years, the amount of total tax revenue collected increases from 586.7 million birr to 2.05 billion birr which is only 3.5 times of the initial period performance. In other words, it takes 17 years to triple the performance of tax revenue.

Therefore, tax revenue lacks a sustainable growth rate to meet the government financial needs. This is due to the fact that, as the period was characterized socialist economy together with the high political instability and continuous civil war; it was difficult to maintain good tax system. Not only the total tax revenue collected had variable trend but also the tax to GDP ratio did not show significant improvement during the whole periods.

Figure 4.1 Trends of Tax Revenue as Percentage of GDP (1974/75-1990/91)



Source*: Authors computation based on MoFED 2015 data*

As it is indicated in the figure 4.1 above the tax to GDP ratio during the derg regime was characterized cyclical trends. It varies between 8% and 12.70% of GDP except the beginning of two years in which the tax to GDP ratio is below 8%. The country achieved the highest tax to GDP ratio in 1983/84, which was 12.7% of the GDP, goes to the government in the form of tax revenue. Like that of the total tax revenue trend, the tax to GDP during this regime showed an increasing trend up to 1983/84, then declined during the famine period from its peak of 12.70% in 1983/84 to 10% in 1984/85. However, after the shock of 1984/85 it starts to rise up to 1987/88 from 10% to 12.47%. After 1987/88, it continuously declined up to the fall down of the regime. Therefore, the tax to GDP ratio of the country during the whole period of 17 years had ups and downs trend. Generally, the tax system failed to bring the sustainable growth rate.

3.2.2. Trends of Tax Revenue during the Post 1991/92

In the post 1991, the trend for tax revenue collected can be examined by decomposing in to three Periods. As MoFED (2014) reported in the 1991/92 up to 2000/01, the overall nature of tax policy reforms was oriented towards rationalization of the previous excessive tax rate, a modification of the tax base brackets, and ensuring the establishment of fiscal federalism.

The second period from 2002/03 up to 2007/08 following the diverting of the government expenditure towards poverty alleviating programs and ensuring the sustainable economic growth, rigorous tax policy and institutional reforms were undertaken to modernize the tax administration and thereby to efficiently and effectively collect tax generated from the economy. The third period was from 2008/09-2013/14 in which the country introduced business processing reengineering (BPR), and consequently, completely new institutional reform was conducted which establishes the ERCA and tax administration harmonization with A.A city revenue office and overall the country launched a growth and transformation plan (GTP) with the view of achieving the vision of middle income countries.

Unlike the Derg regime, the total tax revenue collected increased through the whole period, except in 1997/98. It takes very few periods, on average 5-6 years, to triple a performance of a given year. The table 4.2 below asserts that during 1991/92 the total amount of total tax revenue collected was 1.62 billion Birr, and steadily increased up to 1996/97, though it has a cyclical growth rate. During these years, the total tax revenue of the government increased on the average by 23% each year. The amount of total tax revenue collected in 1996/97 was 5.36 billion Birr, which is 3.5 times the revenue collected in 1991/92. In other words, it takes almost five year to triple the performance of the beginning period, which is faster than that of tax performance during the Derg regime, which takes almost 17 years to triple the tax revenue collected in the initial period. However, in 1997/98 it declines to 5.29 billion Birr from the previous year of 5.36 billion Birr. Starting from 1998/99 up to 2001/02 the tax revenue collected turned back to its upward trend by showing 10.55% growth rate each year. Comparing to the previous period of 1991/92-1996/97, the growth rate was lower, which is almost one third of it. This is due to the fact that the country faces border conflict with Eretria which adversely affect the economy and thereby the fiscal system.

Table 4.2: Trends of Tax Revenue in Billion of Birr (1991/92-2013/14)

Year	Total Tax Revenue	Growth Rate
1991/92	1.62	_
1992/93	2.21	36.42
1993/94	3.08	39.37
1994/95	3.88	25.97
1995/96	4.72	21.65
1996/97	5.36	13.56
1997/98	5.29	-1.31
1998/99	5.53	4.54
1999/00	6.13	10.85
2000/01	7.39	20.55
2001/02	7.86	6.36
2002/03	8.19	4.20
2003/04	10.77	31.50
2004/05	12.04	11.79
2005/06	13.91	15.53
2006/07	16.29	17.11
2007/08	22.65	39.04
2008/09	28.09	24.02
2009/10	38.82	38.20
2010/11	58.98	51.93
2011/12	85.74	45.37
2012/13	107.01	24.81
2013/14	133.12	24.40

***Source**: MoFED (2015)*

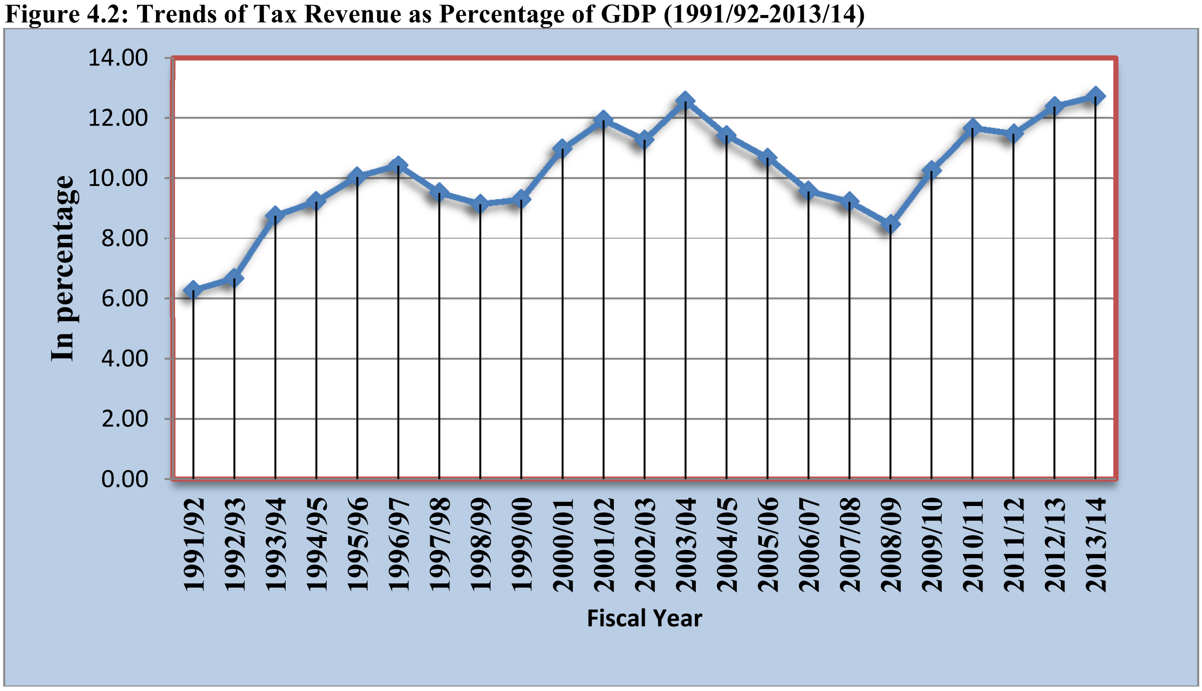
After the comprehensive reform of 2002/03 which constitutes modernization of the tax law by broadening its base, the trends of tax revenue has increased from 8.19 billion in 2002/03 to 28.09 billion in 2008/09 by showing an average growth rate of 17.92% of each year. Comparing to the previous period of 1998/99 to 2002/03 the growth rate was better even though still it is below the growth rate achieved in the first five starting period of the regime.

The third period in which the country launches a growth and transformational plan and institutional reform which establishes ERCA in the federal case, the tax revenue performance is tremendously increased from 28.09 billion Birr in 2008/09 to 133.32 billion Birr in 2013/14. That is the tax revenue collected in 2008/09 was raised by more than forth fold in 2013/14. The amount of total tax collected increased on average by 34.79% each year, which is higher than the previous periods.

This is due to the fact that, as MoFED (2014) reported that during this period due attention was given to modernization of the tax administration. These includes: strengthening the capacities of intuitions through recruiting skilled human power, and implementation of modern tax information such as excessive implementation of Biometric TIN, expansion of sales register machine, introduction of electronic filing (E-filling) for large tax payer, expansion of standards integrated governmental administration (SIGTAS) to regional tax authorities, automation and service improvement in customs areas, and strengthened of tax enforcements etc. Therefore, the overall trend of total tax revenue has upward trend except the 1997/98.

Even though the performance of tax revenue collected in terms of nominal amount shows upward trend for the past 23 years, the growth of tax revenue was lagging behind the growth of the economy. The tax to GDP ratio trend was not only very low, but also characterized by cyclical natures and it is depicted by the following figure.

Figure 4.2: Trends of Tax Revenue as Percentage of GDP (1991/92-2013/14)



Source*: Author computation based on MoFED 2015 data*

As pinpointed in the figure above 4.2 except in three periods the overall performance of tax revenue to GDP ratio was below 12%. In the first period of transitional government (1991/92 -1992/93) was below 8% of GDP, and showed an upward trend up to 1996/97 reached around 10% of GDP but declined during the Ethio-Eritrean Border conflict. Following the introduction of VAT in Jan 2003 and other reforms conducted in 2002/03, the tax to GDP ratio shows an improvement with a value of 12.5% in the year 2003/04 which was higher than the previous period performances.

Nevertheless, in the subsequent years the tax to GDP ratio startd to decline continuously up to 2008/09. On the contrary, the economy of the country continued to score double-digit economic growth. This indicates that there is a limitation in the capacity of the tax authority to collect the tax revenue generated from the economy. However, it started to recover in 2009/10 from previous shocks. This is due to the fact that there were effective reinforcement measures taken on the tax administration. Thus, the reform and modernization conducted in the year 2008/09 such as the emergence of ERCA and full implementation of business processing re-engineering (BPR), has contributed to the improvement of the tax to GDP ratio of the country.

Not only in the year 2009/10, but also in consecutive year up to 2013/14, the tax to GDP ratio continues to raise and highest tax to GDP ratio was achieved in 2013/14 (12.7%). Especially in the period of Growth and Transformation Plan (GTP) of 2012/13 and 2013/14 the country achieved above 12% tax to GDP ratio. This improvement was achieved since focus was given to effective tax administration, taxpayer education to improve voluntary compliance and strengthen of enforcement of the tax laws. However, comparing the GTP plan of the country 15-17 percent of GDP by the year 2014/15, the performance was very low and it is difficult to achieve it within one year.

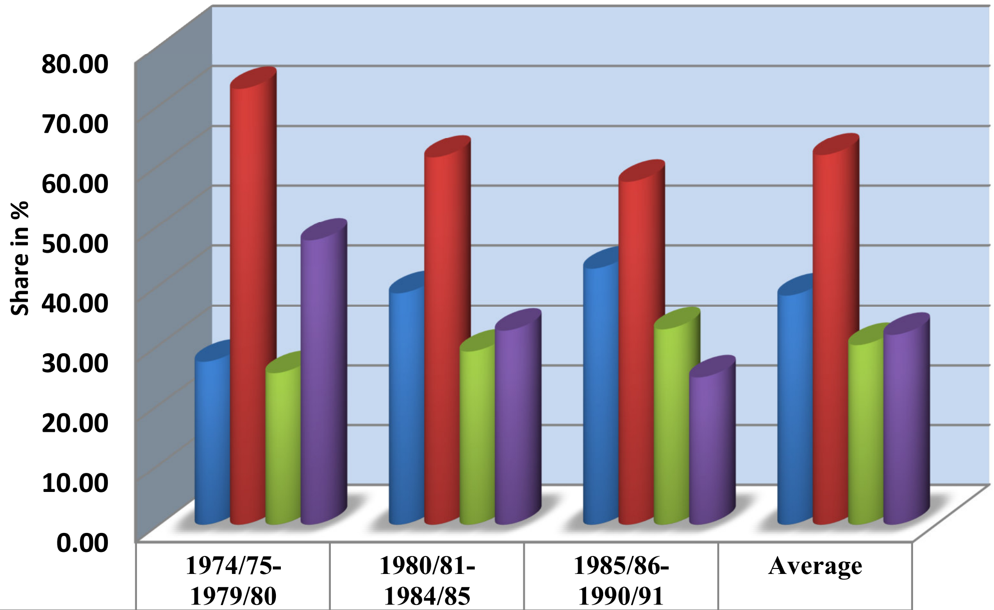
To sum up, in the whole period of post 1991 the trends of tax to GDP ratio of the country is not satisfactory. On average in 23 years, the government collected only 10.16% of the economy (GDP) and less than that of the average tax revenue to GDP ratio of the Derg regime (10.34%). The maximum value which is achieved in 2013/14 (12.7%) is as equal as the highest value of tax to GDP ratio during the Derg regime achieved in 1983/84 (12.70%). Moreover, it is also well below comparing to the GTP plan of the country. In addition, it is lower than the average of Sub-Saharan African countries and neighboring countries such as Kenya, Uganda, Rwanda and Tanzania.

3.3. Tax Revenue Composition (1974/75-2013/14)

3.3.1. Tax Revenue Composition during the Derg Regime

Even though there is still conflicting argument which tax type should raise the most, as depicted in the figure below during the Derg regime, indirect taxes have the lion's share of the total tax revenue of the government. It accounted on average 61.7% of the total tax revenue. While the remaining 38.3% of the total tax revenue are generated from direct taxes.

Figure 4.3 Tax Revenue Composition (1974/75-1990/91)



	1974/75-1979/80	1980/81-1984/85	1985/86-1990/91	Average
Direct tax	27.22	38.68	42.76	38.30
Indirect tax	72.78	61.32	57.24	61.70
Domestic indirect tax	25.33	28.92	32.62	30.00
Trade tax	47.44	32.39	24.62	31.70

***Source**: Authors computation based on MOFED 2015 data*

The figure 4.3 above reveals that, in the first six years (1974/75-1979/80), 72.78% of the total tax revenue was collected from indirect taxes, while the rest 27.22% generated from direct taxes. Among the indirect taxes, trade taxes have a lion share with 47.44% of the total taxes. However, in the next two periods, the shares of direct taxes increased to 38.6% and 42.76% of the total tax revenue respectively. On the contrary, the shares of indirect taxes decreased to 61.3% and 57.24% respectively in the same period. The cause of the fall in the share of indirect taxes was due to a continuous decline in the share of the trade taxes, even though the domestic indirect taxes increased their contribution to the total taxes. This is due to the fact that trade taxes are highly sensitive not only to domestic economy situations but also highly vulnerable to international market situations. On average from the year 1974/75-1990/91 like most developing countries, indirect taxes have a lion share with 61.70% of the total tax, while direct tax contribute only 38.30% of the total tax. On the other hand, domestic indirect taxes and trade taxes have almost the same share of contribution, which is 30% and 31.7% respectively.

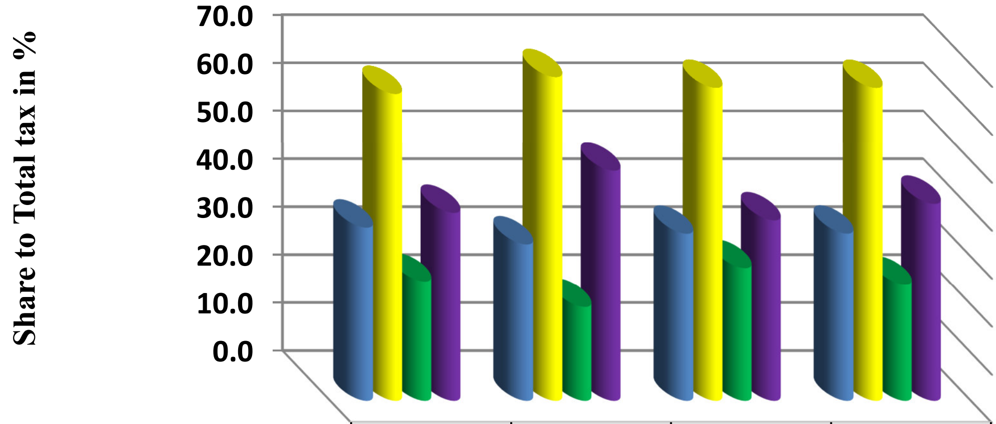
Therefore, the tax revenue composition during this regime was dominated by indirect taxes. However, high reliance on indirect taxes has its own unfavorable effect on the society. These taxes by their nature have regressive effect and thereby adversely affect lower-income section of the society. This widens the income and wealth inequalities.

3.3.2. Total Tax Revenue Composition Post 1991/92

One of the objectives for tax policy reforms conducted in the post 1991/92 was to divert the burden of taxation from poor to rich. In other words, to balance the revenue of the government generated from direct and indirect taxes. This is due to the fact that indirect taxes have regressive nature, which adversely affects the low income section of the society. Despite of the tax reforms conducted to generate more revenue from direct taxes, still the indirect taxes dominate the composition of tax revenue during post 1991/92. On average, 65.2% of the total tax revenue was generated from indirect taxes for the past 23 years. While the amount of revenue collected from direct taxes constitutes only 34.8% of the total tax revenue. Comparing to the average of the Derg regime the share of indirect tax increased by 3.5%, implying the country depends more on indirect taxes. On the other hand, the share of revenue collected from direct tax is less than the average of the Derg regime. This asserts that the government is highly relying on trade taxes to generate revenue from indirect taxes.

One of the objectives of tax reforms conducted in 2002/03 was to switch from taxation of international trade to domestic taxation. However, the share of trade taxes increased from 39.1% in (1991/92 - 2001/02) to 47.9% during the reform periods of (2002/03-07/08). On the contrary, the revenue collected from domestic indirect taxes and direct taxes declined to 32.6% and 19.5% respectively. Even after the institutional reform conducted in 2008/09, the revenue collected from indirect taxes and domestic indirect taxes increased to 34.8% and 27.6%, still trade taxes dominated the composition of the tax revenue of the government.

Figure 4.4: Tax Revenue Composition (1991/92-2013/14)



	1991/92-2001/2	2002/03-07/08	2008/09-13/14	Average
Direct tax	36.1	32.6	34.8	34.8
Indirect Tax	63.9	67.4	65.2	65.2
Domestic Indirect tax	24.8	19.5	27.6	24.2
Trade Tax	39.1	47.9	37.6	41.0

***Source**: Author computation based on MOFED 2015 data*

Generally, the composition of tax revenue during the 1991/92-2013/14 was dominated by indirect taxes. Among the indirect taxes, the major contribution to total tax revenue of the country comes from trade taxes. However, relying on trade tax is not favorable, provided that the country on the way to shift towards trade liberalization, with the view of joining the world trade organization (WTO) and its performance not only depends up on domestic economy but also it is highly vulnerable to international market situations. This indicates that the sustainability of such sources of revenue to the government is uncertain in the future. In addition, despite of tax reforms conducted, the tax authority fails to bring shifting of taxation from trade taxes to domestic taxes. This implies that the tax policy reform conducted in the post 1991/92 to balance the revenue of the government generated from direct and indirect taxes and divert the burden of taxation from poor to rich is not working as required.

4. Conclusion

The tax system of the country during the Derg regime is characterized by excessive high tax rate and narrow tax bases, which fails to generate adequate tax revenue to the government. Furthermore, the tax to GDP ratio is very low. Even if the tax revenue composition incorporates both direct and indirect taxes the lion share of revenue was generated from indirect taxes. The existence of unstable political environment together with high tax rate and narrow tax bases resulted in low performance of tax revenue mobilization effort of the country during the regime.

Similarly, after the downfall of the Derg regime, in the last two decades the government conducted tax policy reforms aimed at rationalization of the tax rate, broadening the tax base, removing unproductive taxes, tariff liberalization and to some extent institutional reforms. Most of these reforms are concentrated on tax legislation; the pace of institutional reform was slow. Though various tax policy reforms had been done, the tax revenue mobilization effort of the country was very low comparing to the average SSA and neighboring countries. Still the government relies on foreign trade taxes. However, these taxes are characterized by a high cyclical trend together with vulnerability of this revenue to the international market situation and the view of the country to join the world trade organization might question the sustainability of this revenue in the future. Therefore, the government should strength its effort towards direct taxes to raise adequate revenue emanated from the economy given that tax revenue sources from trade is unpredictable given the volatile nature of the international market situation.

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