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COVID-19
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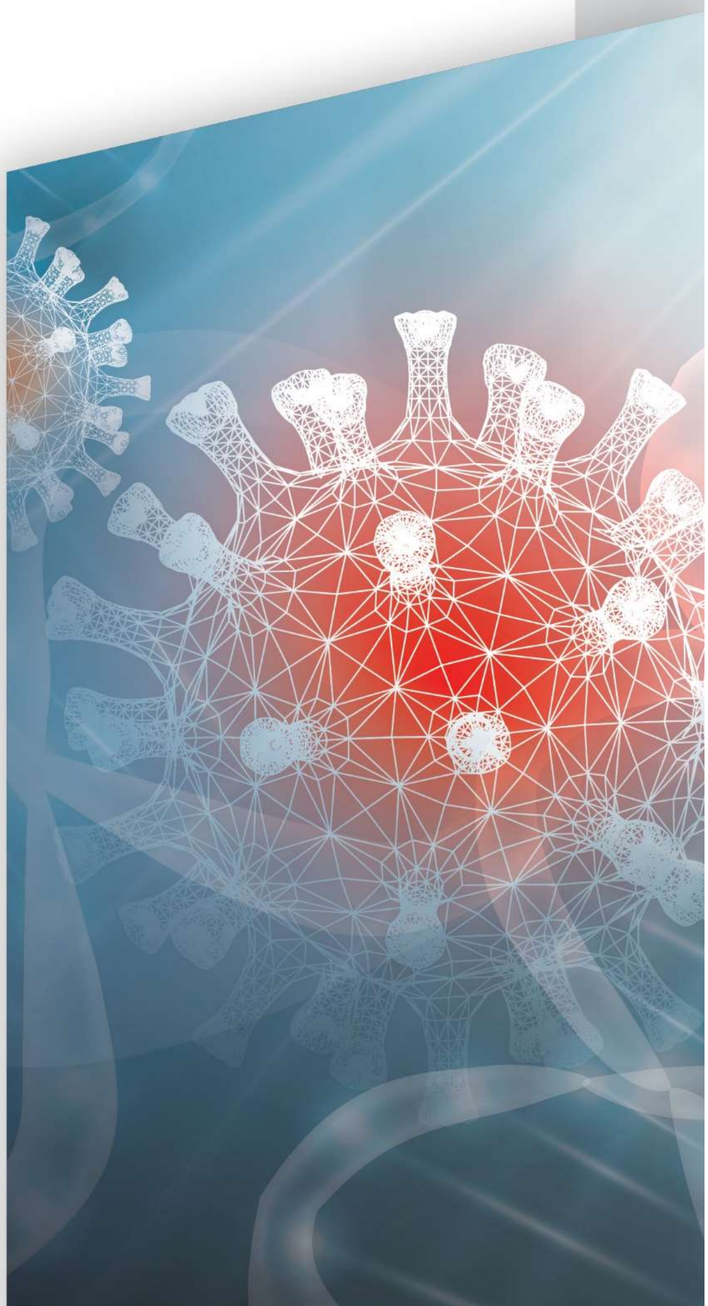

ECA

MARCH 2022

An Assessment of the Direct Tax Regime in Ethiopia

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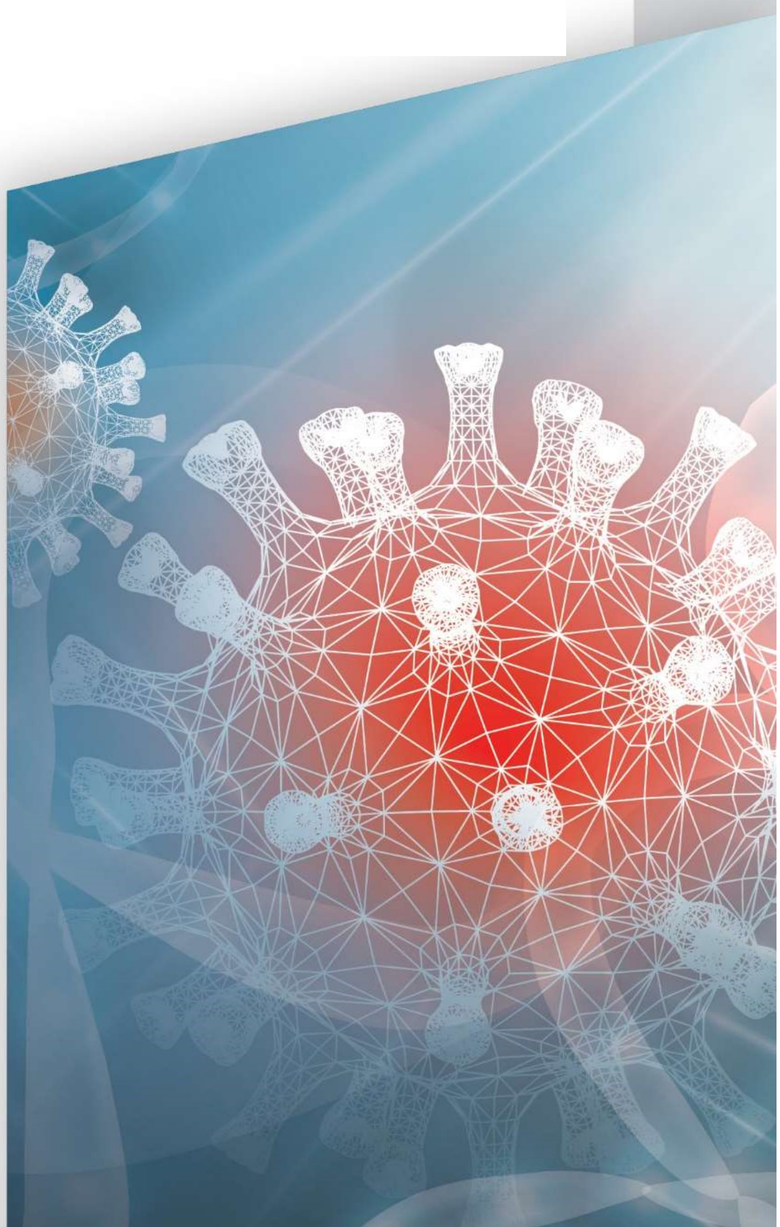

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About the COVID-19 Response and Recovery project

This paper is an output from the project "Response and Recovery: Mobilising financial resources for development in the time of COVID-19", which is co-ordinated by the Debt and Development Finance Branch of UNCTAD and jointly implemented with ECA, ECLAC and ESCAP. This project is one of the five UN Development Account short-term projects launched in May 2020 in response to the COVID-19 crisis.

In this work, a framework to assess external debt and financial sustainability and public sector sustainability through the lens of the achievement of the Sustainable Development Goals (SDGs) is presented. The approach differs in some key areas from the International Monetary Fund's (IMF) Debt Sustainability Analysis (DSA), placing the external constraints and the resulting possible growth rate at centre stage. This in turn provides information on the fiscal space available to policy makers with which to achieve the SDGs through public investment.

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Contents

I DIRECT TAX REVIEW

All income taxation in Ethiopia is governed by proclamation No. 979/2016, Council of Ministers Regulation No. 410/2017, and the amendment issued on October 4, 2021. Laws promulgated by regional governments govern other direct taxes such as property tax. This paper reviews the personal income tax, business income taxes, and property tax in Ethiopia using the framework developed by UNECA (2021) and in light of peer countries' and global best practices. Based on identified gaps in the review, we propose changes to the tax law and sketch their associated revenue gains and losses.

1.1. Tax system

Before we delve into the details of the personal, business, and property taxes in Ethiopia, we define two critical concepts that anchor our discussion.

(A) Global versus scheduler tax system

In general, personal tax liability is calculated in two ways: global and scheduler systems1. In the global system, income from all sources is pooled, and a uniform tax rate is applied2. On the other hand, different income sources are taxed separately (at different rates) in a scheduler tax system. The two systems have different advantages and disadvantages. The global system ensures better horizontal equity and tax progressivity. However, it is challenging to administer, especially in developing countries where third-party reporting is limited. A scheduler system treats each income source separately and therefore lacks horizontal equity, and taxes are less progressive. On the other hand, it is easier to administer. The reason is that, in the scheduler system, withholdings from the source will be final as the tax rate does not depend on the aggregate income of the person.

(B) Territoriality versus worldwide principle

In a territorial tax system, residents and non-resident taxpayers are taxed based on their income generated in the country's territory. On the other hand, in a worldwide principle, residents are taxed based on their worldwide income, and non-residents are taxed based on their income generated in the territory of the country. A territorial system is likely to lead to loss of corporate tax base through legal tax avoidance, for example, through transfer pricing. The worldwide principle helps reduce the loss of tax base, although it is by no means a flawless method and is difficult to administer. In recent years most developed countries have moved to a territorial principle for corporate taxation[3]. Whereas they still keep the system of taxation of worldwide

[1] Le et al (2016).
[2] Note that a pure global system is rarely, if ever, implemented.
[3] Japan and the United Kingdom adopted a territorial system in 2009. In 2017, the U.S. moved to a predominantly territorial system.

income for resident individuals.

In Ethiopia, tax is applied on the worldwide income of resident individuals and companies and the income of non-residents (including both individuals and any legal entity) earned in Ethiopia.

1.2. Personal Income Tax

The personal income tax in Ethiopia follows a scheduler-type system, with each income stream taxed separately. The following are identified schedules in the income tax proclamation[4] and regulation[5].

Schedule A: income from employment
Schedule B: income from the rental of buildings
Schedule C: income from business activities
Schedule D: other income
Schedule E: exempt income.

Schedule D includes royalties, dividends, interest income, income from games of chance, and gains on disposal of certain investment assets (capital gain).

1.2.1 Employment Income Tax (Schedule A)

(A) Bases and exemptions
The tax base for employment income tax in Ethiopia includes the following:
(i) Salary, wages, allowance, bonus, commission, gratuity, or other remuneration received by an employee in respect of a past, current, or future employment; (ii) the value of fringe benefits received by an employee in respect of a past, current, or future employment; (iii) an amount received by an employee on termination of employment, whether paid voluntarily, under an agreement, or as a result of legal proceedings, including any compensation for redundancy or loss of employment, or a golden handshake payment. Details about the fringe benefits can be found in the regulation[6].

The proclamation and regulation provide a detailed list of exempt incomes from employment income tax. However, to avoid erosion of the tax base, the maximum allowable exemption under each category is specified as a share of the employee's gross income from employment[7]. Among the exemptions are medical expenses covered by the employer, transportation allowance, per diem and travel expenses related to work, employer's contribution to pensions and provident funds, etc.

[4] Federal Income Tax Proclamation, Proclamation No. 979/2016.
[5] Council of Ministers Regulation No.410 /2017.
[6] Council of Ministers Regulation No.410 /2017.
[7] As we will not simulate any changes to these allowable exemptions, in this document, we did not include the complete list of allowable fringe benefits and associated share in gross income.

(B) Rate structure

The employment income tax in Ethiopia is based on a withholding tax regime as a final payment. In addition, tax is levied each calendar month on the income received during that month. As a result, individuals whose income or employment condition varies throughout the year will face higher employment income tax. Therefore, the employment tax system in the country lacks horizontal equity.

There are six income brackets for employment tax purposes. The income brackets and applicable tax rates are shown in Table 1. The number of bands is 7, which is slightly higher than the African average (5 bands on average)[8]. On the other hand, the tax rates are in line with some peer countries (Rwanda and Tanzania) and at the higher end of those applied in most peer countries. For instance, income under $2,571 is taxed at 10 per cent in Kenya[9]. Similarly, in Nigeria, income even above $7,805 is taxed at 24 per cent[10].

Part of the reason for the high tax rate at a relatively low-income level is the absence of tax bracket adjustment for inflation. The brackets were set in 2016 when the law came into effect and have not changed since then. Due to the high inflation rate in the country since the promulgation of the tax proclamation, the bracket creep has put a large tax burden on low-income individuals. Partly due to fear of loss of base erosion and partly due to administrative difficulty, indexation of personal income tax is not common in most African countries[11]. Therefore, the practice of no indexation in Ethiopia is in line with the experience of peer countries.

Table 1: Employment income tax rates in Ethiopia

Employment Income in Birr (per month)	Annual equivalent	USD annual equivalent[12]	Tax Rate
0 –600	0-7,200	0-150	0%
601-1,650	7,201-19,800	151-413	10%
1,651-3,200	19,801-38,400	414-792	15%
3,201-5,250	38,401-63,000	793-1313	20%
5,251-7,800	63,001-93,600	1314-1950	25%
7,801-10,900	93601-130,800	1951-2725	30%
Over 10,900	Over 130,800	Over 2725	35%

Source: Federal Income Tax Proclamation No. 979. 2016

[8] https://cdn.odi.org/media/documents/ODI-EITD_WP-JAN2022.pdf
[9] https://taxsummaries.pwc.com/kenya/individual/taxes-on-personal-income
[10] https://taxsummaries.pwc.com/nigeria/individual/taxes-on-personal-income
[11] Lennart Flood and Michele Savini (2014).
[12] Note that we have used 48 Birr per USD as the exchange rate based on the rate prevailing on December 3,2021.

1.2.2 Rental Income Tax (schedule B)

(A) Bases and exemptions

For rental tax income purposes, the taxable income is the gross amount of income derived by the taxpayer from the rental of a building reduced by the total amount of deductions allowed to the taxpayer for the year. Land is not included in the rental income because there is no private land ownership.

The gross income includes all payments made by the lessee to the lessor. These include rental payments in the lease agreement and improvements to the property made by the lessee for which the lessee does not receive compensation from the lessor. If the owner rents out a furnished building, the proceeds from the furniture are also included in the gross income for rental income tax purposes.

Allowable deductions depend on whether the taxpayer keeps books of accounts. Those who keep books of accounts can deduct all documented expenditures necessary for deriving the rental income. These include the cost of the lease of land on which the building is situated; repairs and maintenance; depreciation of the building, furniture, and equipment; interest and insurance premiums; and fees and charges, but not tax levied by a State or City Administration in respect of the land or buildings leased. Those that do not keep a book of accounts can deduct any fees and charges, except tax, levied by the government and an amount equal to 50 per cent of the gross income as an allowance for repairs, maintenance, and depreciation[13].

(B) Rate structure

For individual and unincorporated businesses, rental income tax follows the same progressive structure that applies to annual values of employment income (see Table 2). For incorporated businesses, rental income is taxed at the same rate as corporate profit (30 per cent).

Table 2: Rental income tax rates in Ethiopia

Taxable Rental Income (per year) Birr	Tax Rate
0 -7,200	0%
7,201-19,800	10%
19,801-38,400	15%
38,401-63,000	20%
63,001-93,600	25%
93,601-130,800	30%
Over 130,800	35%

Source: Federal Income Tax Proclamation No. 979. 2016

[13] These are taxpayers below the 500,00 birr annual turnover threshold.

The above discussion applies to income derived from renting buildings by those that rent out the building for an extended period. On the other hand, a person who derives income from the casual rental of an asset in Ethiopia (including any land, building, or movable asset) shall be liable for income tax at the rate of 15 per cent of the gross amount of the rental income.

1.2.3 Other Income Tax (Schedule D)

(A) Bases and exemptions

i. Dividend income

Taxable dividend income includes the distribution of profits by a body to a member.

- *In respect of a membership interest on a partial reduction in the capital of the body to the extent that the amount returned exceeds the amount by which the nominal value of the membership interest was reduced.*
- *On redemption or cancellation of a membership interest, including on liquidation of a company or termination of a partnership, to the extent that the amount returned exceeds the nominal value of the membership interest.*
- *The amount of any loan, payment for an asset or services, the value of any asset or services provided, or any debt obligation released by a body to, or in favor of, a member or a related person of a member to the extent that the transaction is, in substance, a distribution of profits;*

In terms of administration, the firm that issues the dividend withholds the tax from residents and non-residents.

ii. Interest income

Interest income means a periodic or lump sum amount, however, described as consideration for the use of money or being given time to pay and includes a discount, premium, or other functionally equivalent amounts. In terms of administration, tax on interest income is withheld by the financial institution or issuer of the financial asset for residents and non-residents of Ethiopia. The withholding is final for individuals.

iii. Capital gains income

In the Ethiopian tax law, a capital gain is defined as the difference between the value of the taxable asset and the cost of the asset at the time of disposal[14]. The cost of the asset includes the following.

- *The cost of the asset at the time of acquisition.*
- *Any taxable income included in the asset.*

[14] Disposal means a sale, exchange, or gift of the asset.

- *Adjustment for inflation[15].*

If a share that a non-resident person transfers is related directly or indirectly to an asset in Ethiopia, such a share shall be treated as having been transferred in Ethiopia. The tax law does not treat the transfer of a business asset between two resident companies as disposal of an asset if the transfer is conducted as part of a reorganization. In the law, the cost basis for the acquisition of the asset is the value of the asset at the time of reorganization. This part of the law creates a significant tax loophole and increases the administration cost.

The tax proclamation allows to indefinitely carry forward losses from the disposal of capital assets. However, the loss carry forward is available

- *to offset gains on disposal of a taxable asset of the same class until the losses are fully exhausted.*
- *unless the loss is recognized by a related person to offset a gain.*

iv. Income from royalties

Income from royalties, in the Ethiopian tax law, includes a periodic or lump sum payment for the

- *the use of, or the right to use any copyright of literary, artistic, or scientific work, including cinematography, films and tapes for radio, television, or internet broadcasting;*
- *the receipt of, or right to receive, visual images or sounds, or both, transmitted by satellite, cable, optic fiber, or similar technology in connection with television, radio, or internet broadcasting;*
- *the use of, or the right to use any patent, invention, trademark, design or model, plan, secret formula or process, or other like asset or right;*
- *the use of, or the right to use any industrial, commercial, or scientific equipment; and*
- *the use of, or the right to use any information concerning the industrial, commercial, or scientific experience.*

v. Income from games of chance

In the Ethiopian tax law, games of chance mean a game whose outcome depends primarily on chance rather than the skill of the participant, including a lottery or

[15] Council of Ministers Regulation No.410 /2017 only included inflation adjustment for class A assets. The amendment issued on October 4, 2021, included class B assets in the inflation adjustment. Application of inflation adjustment for capitals held for longer periods is in line with the partial exclusion of such gains in most countries.

tombola. The law does not allow any deduction for any loss incurred by the person from games of chance.

vi. *Windfall profit*

In the Ethiopian tax law, windfall profit refers to any unearned, unexpected, or other non-recurring gains. The law gives significant latitude to the Minister of Finance to determine

- *A given income as a windfall;*
- *the amount of income to be considered as a windfall profit;*
- *businesses that are subject to tax levied on windfall profit;*
- *the date on which such tax shall become effective;*
- *how the tax is assessed and factors that need to be taken into consideration; and*
- *prescribe different amounts to be considered as windfall profit and rates for different types of businesses.*

vii. *Tax on undistributed profit*

Undistributed profit tax is levied on the after-tax profit of a business that is not distributed as a dividend nor invested. i.e., the tax is levied on retained earnings not invested by the firm. This raises the question of what constitutes an investment. Unfortunately, the law does not specify what investments are.

viii. *Tax on repatriated profit*

The repatriated profit of a body for a tax year is calculated with the following formula: A + (B - C) – D, where: "A" is the total cost of assets, net of liabilities, of the permanent establishment at the commencement of the tax year; "B" is the net profit of the permanent establishment for the tax year calculated following financial reporting standards; "C" is the business income tax payable on the taxable income of the permanent establishment for the tax year; and "D" is the total cost of assets, net of liabilities, of the permanent establishment at the end of the tax year.

(B) Rate structure

Table 3: Other income tax rates in Ethiopia

Income Source	Residents	Non-residents
Dividend	10% of the gross amount of the dividend	10% of the gross amount of the Ethiopian source dividend is attributable to a permanent establishment of the non-resident in Ethiopia
Interest	5% on savings deposit with a financial institution	5% on savings deposit with an Ethiopian resident financial

	10% of the gross amount of interest on any other interest income	institution 10% of the gross amount of interest on any other interest income
Capital gains	15% on class A asset 30% on class B asset[16]	15% on class A asset of a resident company 30% on class B asset of Ethiopian source
Royalties	5% of the gross amount of royalty	5% on the gross amount of the royalty that the entity received from an Ethiopian source.
Games of chance	15% of the gross amount of winnings at games of chance held in Ethiopia[17]	15% of the gross amount of winnings at games of chance held in Ethiopia
Windfall profit	To be determined by the Minister[18]	To be determined by the Minister
Undistributed profit	10% on the undistributed net profit of a body in a tax year to the extent that it is not reinvested	10% on the undistributed net profit of a body in a tax year to the extent that it is not reinvested
Repatriated profit		A non-resident body conducting business in Ethiopia through a permanent establishment shall be liable for tax at the rate of 10% on the repatriated profit of the permanent establishment.
Non-resident entertainers		10% on the gross income derived from the performance in Ethiopia without deduction of expenditures.
Other income of non-residents[19]		for an insurance premium or royalty, 5% withhold tax on the gross amount of the premium or royalty for a dividend or interest, 10% withhold tax on the gross amount of the dividend or interest

Source: Federal Income Tax Proclamation No. 979. 2016

[16] Class A assets are immovable assets, and class B assets are bonds and shares.
[17] Although not clearly specified in the law, in practice, the tax is treated as a final withholding tax at the source.
[18] The Minister here refers to the Minister of Finance.
[19] These are incomes derived by non-residents from Ethiopian sources. But the non-resident does not have a permanent establishment in Ethiopia.

Comments on schedule D taxes

- *The tax rate on interest income is at the lower end by global and peer country standards. For instance, the average tax on interest income in OECD countries is 27 per cent. Similarly, the tax on interest rates in Kenya ranges between 15 and 25 per cent. It is 15% in Rwanda.*
- *The inflation adjustment on capital gains is intended to make sure that only real income is taxed. The law does not specify the length of time the asset should be held to qualify for inflation adjustment. A similar logic would imply that inflation adjustment should be included for business income (profit), interest income, and dividends. However, such adjustment is not included in the tax law as far as we know.*
- *The tax rate on royalties, as border withholding, is at the lower end of the global practice and the experience in peer countries. For instance, the tax rate on royalties on non-residents in Kenya is 20 per cent and 15 per cent in Rwanda. In the USA, income from royalties is treated as ordinary income, and similarly, in the U.K. tax rate on Royalty income is 20 per cent[20].*
- *The tax on games of chance is rather low, given the current expansion of sports betting in the country and its associated social ills. Peer countries such as Kenya have a 20 per cent withholding tax, and OECD countries such as the USA treat these winnings as ordinary income and impose a much higher tax rate than is the case in Ethiopia.*
- *Given the broad definition of a windfall profit, any tax on it is bound to be contentious. Giving such extensive latitude to one Minister may create uncertainty. It is probably better to involve the house of representatives to reduce uncertainty.*
- *Undistributed profit tax: the tax inherently introduces a bias toward issuing dividends rather than withholding by a firm that can then be used for further growth. It would also be beneficial to consider the costs of administration vis-à-vis the tax yield.*
-

1.3. Business income tax (Schedule C)

The proclamation governing business income tax in Ethiopia is the income tax proclamation no. 979/2016, which came into effect in July 2016. It replaced the income tax proclamation no. 286/2002 and related amendments.

In subsequent sub-sections, we will review the income tax law using the framework paper by UNECA (2021).

[20] A guide to taxation in Rwanda, Pwc.

1.3.1 Accounting and Taxable Income

There are two ways of accounting: the accrual method and the cash method. According to the cash method, income/expense (transaction) is recorded when payment is received or paid out. On the other hand, in the accruals method, income/expense (transaction) is recorded when goods and services are supplied, or an invoice is issued rather than at the time the corresponding cash payment is received[21].

Ethiopia's income tax proclamation does not include specific requirements on using cash or accrual accounting methods. It leaves it open as to who should be using cash or accrual accounting. The major arguments for and against the use of one over the other relate to information accuracy and ease of administration (See Gnanarajah and Keightley, 2015; Goncharov and Jacob, 2014). Hence, the research team concluded that the need to delve further into the topic is not significant enough.

The taxable income is based on the profit and loss statement of the taxpayer. Deductible expenditures include: (i) any expenditure that a taxpayer incurred to generate the business income, (ii)the cost of trading stocks disposed of, (iii) the amount by which the value of the depreciable assets and business intangibles have declined from use in deriving business income, (iv) a loss on disposal of a business asset, and (v) other expenditure allowed in the proclamation.
Some of the deductible expenses are potential areas for investigation. The deductible expenses will be treated item by item in the subsequent discussion.

1.3.2 Business Entities

A taxpayer is a person (both legal and natural persons) liable for paying taxes under the proclamation. Residents and non-resident individuals and bodies are required to pay taxes. Residents can be individuals, bodies incorporated or with a place of effective management in Ethiopia, and federal, regional, and city governments in Ethiopia. A non-resident could be liable for taxes relating to a business conducted on a permanent establishment in Ethiopia; disposals of goods or merchandise through a permanent establishment; and any other business conducted by the non-resident through a permanent establishment (See FDRE, 2016).

Taxpayers in Ethiopia are categorized into A, B, and C based on their annual gross income and whether they are individuals or bodies.

- *Category 'A' taxpayers are all bodies and individuals with an annual gross income of 1,000,000 ETB or more.*

[21] Tax policy handbook (1995).

- *Category 'B' taxpayers are individuals with an annual gross income between 500,000 and 1,000,000 ETB.*
- *Category 'C' taxpayers are individuals with an annual gross income of less than 500,000 ETB.*

1.3.3 Jurisdictional basis

The income tax proclamation applies to the worldwide income of residents. Non-residents are also liable for taxes on Ethiopian source income[22]. There is a lack of clarity regarding what definition of worldwide income applies for taxation purposes. For example, it does not specify if residents are liable for dividends not repatriated. For residents, Ethiopian source business income refers to all the business income of residents, excluding residents' incomes from a permanent establishment outside of Ethiopia. Foreign income is any income that is not Ethiopian source income.

For non-residents, Ethiopian source incomes are income from a business conducted on a permanent establishment in Ethiopia; income from disposals of goods or merchandise through a permanent establishment; and income from any other business conducted by the non-resident through a permanent establishment (See FDRE, 2016).

There are two points worth discussing regarding the worldwide versus territorial taxation systems. First, the adopted system will impact the tax revenue of the home country. Second, it has implications for attracting multinational investment in an increasingly globalized world to the home country (See Matheson et al., 2013). Countries transition to the territorial system to attract multinational investment and increase the flow of dividends to the home country (See Liu, 2020).
In Ethiopia, the law does not state when the liability arises on foreign income of residents' companies, which is not the case in other countries. Usually, the tax liability on foreign income arises when the taxpayer repatriates his/her income. In a worldwide income tax system, foreign income detection and enforcement of the tax rule are difficult. Despite the implementation challenges, the current system is favorable for mobilizing more revenue. Hence, we have not considered modifications to the existing system as a revenue-enhancing reform idea.

1.3.4 Rate structure

As described in section 1.1, the income tax proclamation provides the taxation of income in schedules. Schedule A refers to income from employment; schedule B deals

[22] Non-residents with a P.E. are taxed on a net basis, whereas non-residents without a P.E. are taxed on a gross basis.

with income from renting buildings; schedule C is about business income; schedule D refers to other income, and schedule E refers to exempt income. This section will review the rate structure of schedule C.

The business income tax payable by a taxpayer depends on whether the taxpayer is an individual or a body, as was the case for rental income tax.

I. *The rate of business income tax applicable to a body is 30 per cent.*
II. *The rates of business income tax applicable to an individual are:*

Table 4: Business income tax rates in Ethiopia, unincorporated businesses

Taxable Income (Per Year in Birr)	Income Tax Rate
0-7,200	0%
7,201-19,800	10%
19,801-38,400	15%
38,401-63,000	20%
63,001-93,600	25%
93,601-130,800	30%
Over 130,8000	35%

Source: (FDRE, 2016)

The above rates are applied to the taxable business income, which is defined as total business income less total deductions allowed for the year.

Category 'A' taxpayers are required to keep books of accounts as per the financial reporting standards for business income tax purposes. Specifically, they are required to keep business assets and liabilities showing the acquisition date, the cost of acquisition, the cost of improvement, and the current book value of the assets. In addition, they should keep all records of daily income and expenditure related to the business, the sales and purchase of goods and services with names and TINs, invoices containing their TIN, and any other relevant documents.

Category 'B' taxpayers are required to keep daily income and expenditure. In addition, they are required to keep records of purchase and sales of trading stocks, a salary and wages register, and any other document that is relevant for determining tax liabilities. They are required to keep the information for business income tax.

Category 'C' taxpayers may keep a record of gross income and shall keep such other records as required. Category 'C' taxpayers are liable to presumptive income tax as the information is not enough to determine their tax liabilities.

1.3.5 Base and Exemptions

Ethiopia has been following the developmental state model and has an industrial policy aimed at the economic transformation of the country. One of the policy instruments that policymakers have used extensively was/is tax exemptions.

The Ethiopian Investment laws entitle investors engaged in selected sectors to income tax exemptions (See FDRE, 2012). Specifically, investors engaged in manufacturing, agribusiness, generation, transmission and supply of electrical energy, and ICT are entitled to income tax exemptions for a period ranging between 1 and 9 years, depending on the specific activity and the location of the investor.

In addition to the general incentive based on the sector and location of investment, there are additional incentives. An investor is entitled to an income tax deduction of 30 per cent for additional three consecutive years if they 1) expand or upgrade an existing enterprise, increasing by at least 50 per cent the production or service capacity; or 2) introduce a new production or service line by at least 100 per cent of an existing enterprise. Finally, investors who export at least 60 per cent of their products or services, or supply these to an exporter, will be exempted from the payment of income tax for an additional two years.

According to Mascagni and Mengistu (2019), the average effective corporate tax rate is 11 per cent compared to a 30 per cent statutory rate. While tax exemption is one of the potential explaining factors, we did not find studies explaining these differences. Nonetheless, we are not going to pursue these further as Ethiopia does not prepare tax expenditure data.

1.3.6 Interest Expenditure

When we define taxable income in section 1.1, we have deferred discussion regarding allowable deductions to subsequent sections. One of the allowable deductions according to the Ethiopian tax law is interest expense incurred on debt by the taxpayers to generate proceeds and benefits to the business. While the law limits the interest paid or payable by limiting allowable financial institutions that can provide credit, it does not limit the level of debt for domestic firms. There is a thin capitalization rule for a foreign-controlled resident company operating in the non-financial sector, limiting the deduction on interest paid during the tax year if the average debt to equity is more than two to one. However, the applicability of the rule does not extend to Ethiopian-controlled companies.

1.3.7 Depreciation

Another deduction that is allowed in the proclamation relates to the depreciable asset or business intangibles. Taxpayers are required to calculate the amount of deductibles for deprecation according to the income tax regulation. Businesses can choose between the straight line or diminishing value methods as long as they apply the same method in the financial accounts and use the same method for all depreciable assets. Notwithstanding the above statement, businesses should only use straight-line methods for business intangibles and a structural improvement of immovable property. Table 5 below presents the applicable depreciation rate for the straight-line method.

Table 5: Depreciation rates in the Ethiopian tax system

Depreciable Asset	Straight-line Rate
Computers, software, and data storage equipment	20%
Greenhouses	10%
Structural improvement on immovable property other than a greenhouse	5%
Any other depreciable asset	15%
Depreciable asset used in mining and petroleum development operations	25%

If the taxpayer did not use the depreciable asset or business intangibles for the whole year or partially used for other purposes, the deductions should be calculated as a proportion for which the asset or intangible is used for deriving business income.

1.3.8 Loss carryforward and backward

The Ethiopian tax law allows for loss carryforward if the taxpayers' books of account are audited and accepted by the authority. If the taxpayer has submitted the loss after an external audit and the tax authority fails to respond to the claim by the due date for filing the declaration for the following tax year, the taxpayer can carry the loss forward. However, the Authority can amend the assessment later on to serve the taxpayer with the amendment. Taxpayers can also carry loss backward for losses incurred in the final year of performance of a long-term contract, and it cannot carry the loss forward – e.g. because the business will cease operations.

1.4. PROPERTY TAX

Property tax refers to a tax on properties owned by a natural or legal person(s). The tax is usually levied on the values of land, buildings, and other immovable properties. In Ethiopia, property taxes, especially taxes imposed on land value, have played a significant role in revenue mobilization for a long time. However, the heterogeneity in the land tenure system in the country for a long time means the tax varied across the country.

In 1974, the Derg nationalized land and established a relatively uniform land tenure system. Subsequently, it issued proclamations No. 77/1976 and No. 152/1978 to systematize the tax on rural land use and proclamations No. 80/1976 and No. 161/1979 to govern taxes on urban land. The laws governing rural land use set a price per land area based on the ownership of the land. The cheapest rate was assigned for land use by government-owned agricultural organizations, and the highest was assigned to land owned by ordinary farmers. On the other hand, the urban land-use laws set a price on the land by type of land (grade of land)[23]. It also sets a "roof" tax based on the estimated annual rental value of urban houses.

In the constitution that came into effect in 1995, the right to ownership of rural land, urban land, and all natural resources is exclusively vested in the state and the people of Ethiopia. Therefore, land can not be included in the property tax regime. Instead, several regional governments mobilize revenue by leasing urban land. However, urban land, especially in big cities, is finite. As a result, raising revenue through the lease system is not sustainable[24]. A more sustainable (buoyant) tax system imposes a tax on the value of buildings and land improvements.

Regional governments in Ethiopia, including Addis Ababa city, impose a property tax on buildings. The property tax is presumably based on the annual rental value of buildings. However, the current property tax system -known as "roof tax" - is outdated, with very low rates and poor enforcement mechanisms. In particular, new buildings are not assessed, and the value of properties that are already registered is not updated.

[23] Yohanes Mesfin and Sisay Bogale (2009).
[24] Tom Goodfellow (2014) taxing property in a neo-developmental state: the politics of urban land value capture in Rwanda and Ethiopia.

II PROPOSED REFORMS

In this section, we propose a few reforms to the direct tax system in Ethiopia and highlight their revenue implications. Note that the figures presented are based on readily available data. Further refining of the underlying data would improve the accuracy of the estimated revenue gain or loss.

2.1 Increase the tax rate on interest income

As we showed in section 1.1.5, the tax rate on interest rate in Ethiopia is at a lower end of the practice elsewhere. Below, we highlight the revenue implications of raising the interest rate to 10 per cent in alignment with the tax imposed on other financial instruments. Table 4 shows that increasing the tax rate on interest income earned from deposits in financial institutions leads to an increase in tax revenue of 0.77 per cent of total tax revenue or 0.08 per cent of GDP. In comparison, as we will show in section 2.4, doubling the basic allowance for employment income tax will lower tax revenue by 0.07 per cent of GDP. Therefore, the combination of the two proposed policies will increase the progressivity of the personal income tax, improve the welfare of low-income households, and it is revenue neutral.

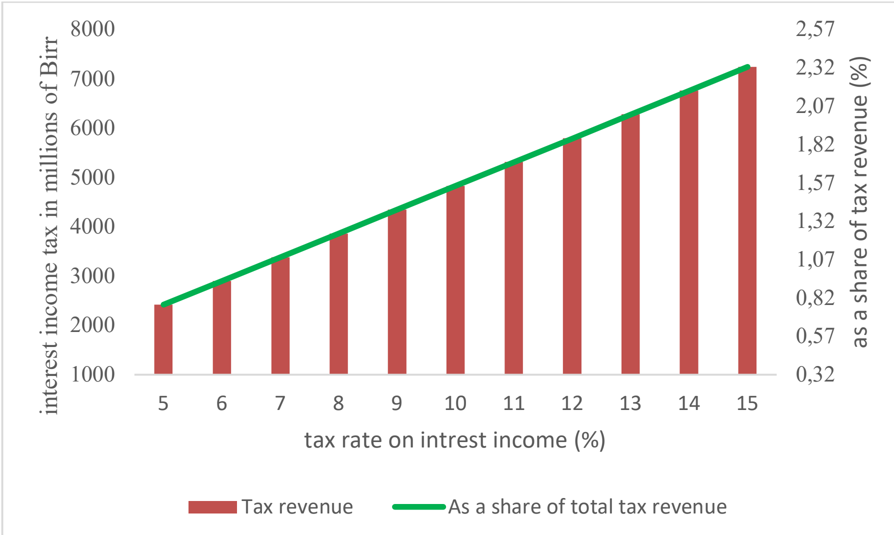
Table 6: The impact of raising the tax rate on deposit interest to 10% in 2019/20

Instrument	Amount [25]	Interest income[26]	Tax at 5%	Tax at 10%	Increase revenue as a share of total tax (%)[27]	Increase as a share of GDP (%)
Savings deposit	589,174	41,242.18	2062.11	4124.22	0.66	0.06
Time deposit	87,886	7,030.88	351.54	703.10	0.11	0.02
Total	**677,060**	**48,273.06**	**2,413.63**	**4827.32**	**0.77**	**0.08**

A more complete picture of the revenue implication of tax changes is provided in Figure 1. Suppose the tax rate increases to 15 per cent instead of the 10 per cent proposed above. Then, tax revenue will increase by 1.3 per cent or 0.14 per cent of GDP.

[25] In millions of Birr.
[26] In millions of Birr.
[27] The denominator is the total tax revenue of the General government (i.e., the combined tax revenues of Federal, regional, and municipal governments).

Fig 1: Tax revenue from interest income under different tax rates



Source: National Bank of Ethiopia and authors' calculations[28]

2.2 Alternative minimum tax

In developing countries, tax evasion is rampant. In this regard, Ethiopia is not an exception. For instance, a study conducted in 2017 shows that taxpayers increase their tax payments by 33 per cent when they receive a letter from the tax authority[29].

It is shown in the literature that third-party information and withholdings increase tax compliance[30]. However, when third-party information is not complete and/or when the enforcement capacity of the tax authority is weak, third-party information does not lead to the desired enhanced revenue[31].

One alternative policy countries follow that is effective is levying a minimum tax based on firms' turnover. We show below that an alternative minimum tax in Ethiopia would raise significant revenue from business income taxpayers. The revenue implication of an alternative minimum tax is estimated under the following assumptions.

- *A 1.5 per cent turnover tax is levied on the turnover of the firm if the turnover tax is higher than the profit tax the firm declares;*

[28] NBE annual report 2019/20.
[29] Shimeles et al. (2017).
[30] Kleven et al. (2011).
[31] Carrillo et al. (2017).

- *The turnover tax is levied on larger firms. Three scenarios are included in Table 4 regarding the threshold (turnover greater than 10 million, greater than 15 million, and greater than 20 million Birr).*

Table 4 shows that the revenue collected from category A and B firms will increase by more than 5 per cent if the alternative minimum tax is applied. Note, however, that firms may reduce their turnover due to the introduction of a turnover-based tax. Therefore, this policy is only effective if the Ministry of Revenue has more reliable information on revenue rather than profits.

Table 7: Revenue mobilization implications of an alternative minimum tax in Ethiopia[32]

	Actual revenue collected	Revenue-based on each threshold		
		>10 million	>15 million	>20 million
2016	32,849.1	34,525.1	34,479.0	34,439.3
2017	39,097.7	41,327.3	41,278.3	41,240.2
	Increment in revenue mobilization as a share of baseline revenue (%)			
2016		5.1	5.0	4.8
2017		5.7	5.6	5.5

In 2019/20, the government mobilized ETB 64.6 billion from profit income tax. If an alternative minimum tax was introduced, revenue would have increased to ETB 67.9 billion Birr. In other words, revenue would have increased by 0.1 per cent of GDP. However, the alternative minimum tax is controversial. First, it imposes taxes on firms that incur a loss for genuine economic reasons. Second, it imposes taxes on firms engaged in such sectors as the manufacturing sector that tend to incur a loss at the initial stage of business operation. Finally, unless the threshold is adjusted for inflation, eventually, all businesses would be faced with the administrative burden of such a tax. If adopted, the alternative minimum tax should incorporate features limiting the impact of the complications mentioned above.

2.3 Introduce property tax at regional levels

Following the rapid urbanization in the country and the significant flow of capital to the real estate sector, there is a substantial rise in the price of properties in Ethiopian cities. As in most developing countries, property tax is an underutilized revenue source in Ethiopia. Revenue from rural land use fees and urban land lease fees raises 0.08 per cent of GDP as of 2019/20[33]. In contrast, OECD countries raise 2 per cent of GDP, and developing countries, in general, mobilize 0.6 per cent of GDP from property

[32] Note that the revenues are in millions of Birr.
[33] Authors' estimation based on data from the Ministry of Finance.

tax[34,35].

Recognizing the revenue potential of a property tax, in 1996, the government conducted a census of formal and informal properties in Addis Ababa. Under the new valuation, existing "roof" taxes would have to increase by 75 per cent. Also, the inclusion of new property would have entailed significant revenue mobilization. However, due to popular resistance, the government was forced to downscale the new bill to only a quarter of the estimated value. Despite the artificial reduction, the city government collected ETB 50 million Birr in 1999, a considerable increase from the ETB 4 million Birr collection before the survey due to the capture of new buildings[36].

The large gap in revenue from property tax in Ethiopia and other developing countries suggests that leveraging the tax potential of urban dwellings and commercial properties will significantly enhance the revenue mobilization effort of the government.

This section outlines the revenue potential of a property tax levied on buildings, with certain caveats. Estimating the revenue potential of a property tax requires an updated list of properties and their values (either rental or capital values). Unfortunately, as far as we know, such data currently does not exist in the country. Therefore, we follow Kiflu and Tewodros and base our estimation on the Ethiopian Socioeconomic Survey (ESS 2015/16)[37]. The ESS data contains information on 4,954 households, and it is nationally representative. It also has information on house characteristics and ownership conditions, which are critical to analyzing the revenue impact of a property tax. A summary of statistics based on the ESS 2015/16 data shows that 48 per cent of households in urban areas live in privately owned houses, while 42 per cent of households live in rented houses and 9 per cent live in rent-free houses (see Table A.1 in the appendix).

The revenue impact of a property tax is estimated using the modified version of the ETHTAX model developed at the Institute for Fiscal Studies (IFS) to analyze the tax-benefit system of Ethiopia[38]. Under an assumption that a **2 per cent tax** is levied on the annual rental value of a house, the resulting revenue gain is **0.6 per cent (0.33 per cent from owner-occupied and 0.27 per cent from rented buildings)** of total tax revenue (0.06 per cent of GDP) compared to the baseline. Using 2019/20 data, this amounts to **ETB 2.2 billion** Birr **($73 million**). Note that this number should be considered a lower limit for a couple of reasons. First, there is a known bias that surveys under-represent upper-income households, and therefore, houses with higher

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[34] https://data.oecd.org/tax/tax-on-property.htm
[35] https://www.lincolninst.edu/sites/default/files/pubfiles/1256_Bahl%20Final.pdf
[36] Goodfellow (2015).
[37] Note that the summary statistics and revenue impact estimations are from the unpublished working paper by Tewodros M. Gebrewolde and Kiflu G. Molla.
[38] see Abramovsky et al. (2018).

values do not enter the simulation. Second, households in the survey understate the values of their houses and rental value to escape taxation.

2.4 Inflation adjustment (adjustment for "bracket creep")

Inflation has three effects on real income tax liability. First, inflation erodes amounts expressed in national currency in the proclamation (bracket creep). Second, there is a collection lag. Collection lag is the difference between the time income is received and paid. Third, the tax base is distorted because inflation erodes the historical cost of the taxpayer's assets and liabilities[39].

The first effect (bracket creep) arises because as inflation increases, more and more of the person's real income becomes subject to a higher marginal tax rate. The second effect (collection lag) arises because taxpayers that are not subject to withholding pay their taxes with a periodic lag. For instance, a company that submits its tax return in July gets to keep all the profit between June of the previous year and June of the current year. As a result, by the time the tax is submitted, the real value of the tax paid is lower than when it was earned. The third effect (tax base distortion) arises in business taxation, in which the cost basis of capital is not adjusted to reflect the impact of inflation on the cost of capital, thereby overstating the profit of businesses.

The three effects of inflation affect the three types of income taxpayers (employees, sole proprietors, and incorporated businesses) differently. Since the tax on employees is withheld immediately, they do not benefit from the collection lag, and instead, they suffer from bracket creep. Sole proprietors benefit from the collection lag[40]. However, they are affected by bracket creep and tax base distortions. Incorporated businesses are not affected by bracket creep (because their tax rate is flat). Instead, they benefit from collection lag and suffer from tax base distortions.

Due to its impact on low-income earners, countries usually address the bracket creep effect. Generally, countries follow three ways of adjusting tax brackets for inflation. First, the most cumbersome way is to change the law (proclamation) periodically. Second, some countries follow a discretionary approach. For example, in South Africa and the U.S., tax authorities publish new tax brackets every year. The third method embeds an automatic adjustment to the bracket based on the inflation rate.

In this section, we first provide practical examples of how the tax bracket creep effect works in Ethiopia. We then provide the revenue impact of adjusting the tax brackets for inflation.

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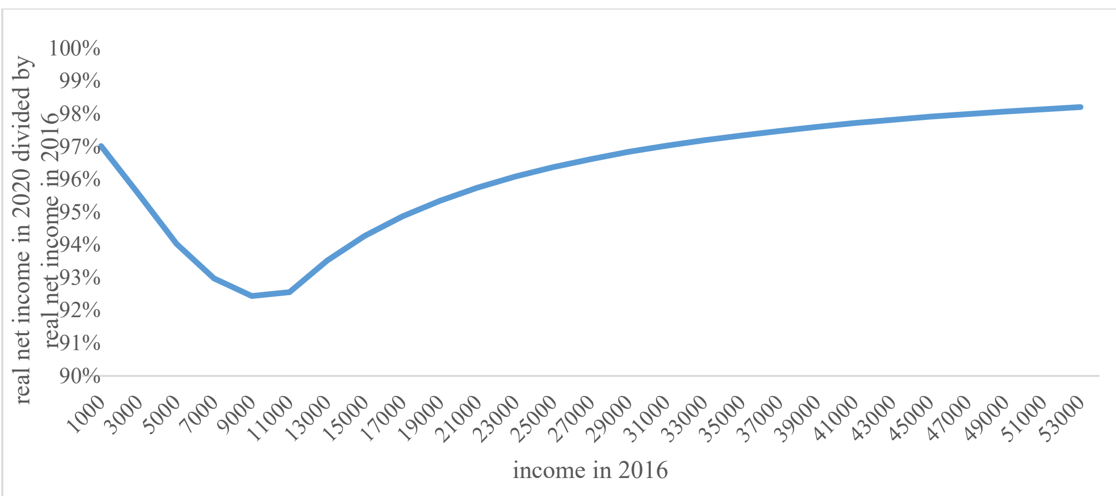
[39] Thuronyi, V. T. (1996).

[40] Individuals that are subject to rental income tax are affected in a similar fashion as sole proprietors.

Example 1: Let's compare two individuals, A and B. Individual A earned 4,000 Birr per month, and individual B earned 20,000 Birr in 2016. Individual A will pay 498 Birr tax and receive 3,502 Birr net pay[41]. Similarly, individual B will pay 5,500 Birr in tax and takes home 14,500 Birr. Now, suppose the income of both individuals increases at the inflation rate. Therefore, individual A's income, tax, and net pay in 2020 would be 7,000 Birr, 1,185 Birr, and 5,815, respectively. Similarly, individual B's income, tax, and net income would be 35,000 Birr, 10,750 Birr, and 24,250 Birr. In real terms, the net income of individual A in 2020 is 3,323 Birr which is 95 per cent of her real net income in 2016. Individual B's real net income in 2020 is 13,875 Birr, which is 96 per cent of her real income in 2016.

The above illustration demonstrates three crucial aspects of bracket creep. First, the real income of all households decreases due to the tax structure even if their nominal income increases at the inflation rate. Second, the decrease is particularly significant for those earning between 5,000 Birr and 25,000 Birr. Third, the impact of indexation on revenue depends on the income distribution in the country. If there are sufficient high-income earners, indexation will not lead to significant revenue losses.
Figure 2 provides the impact of bracket creep for wider income distribution. Note that the y-axis is the result of dividing the real net income in 2020 by the real net income in 2016 of the person that earned the income indicated in the x-axis in 2016.

Fig 2: Ratio of real net income after and before inflation for each income group



We highlight the revenue implications of a proposed bracket adjustment in the following. But first, we want to point out a caveat. A precise simulation of the impact of a bracket adjustment requires data on the earnings distribution of public and private sector employees for the year of simulation. Unfortunately, we do not have access to

[41] We abstract away from the issue of social security tax for illustrative purposes.

such data. Instead, we provide illustrative figures based on the following. First, we use the 2015/16 household consumption expenditure survey of the Central Statistics Agency (CSA) (HICE 2015/16). Second, we proxy employment income by household expenditure from an employment income source, i.e., we abstract away from savings. Third, we assume that income increases at the rate of inflation.

Table 8: tax revenue from PAYE with no adjustment for inflation (in Billon Birr)

Bracket	Tax rate	Tax in 2015/16 (in billons of Birr)	Tax in 2019/20 with no adjustment for inflation (in billons of Birr)
0-600	0	0	0
601-1650	10	0.44	0.25
1651-3200	15	2.47	1.49
3201-5250	20	4.80	4.78
5250-7800	25	4.61	8.07
7800-10900	30	3.43	9.15
>10900	35	3.59	21.42
Total revenue		**19.34**	**45.15**

Source: Analysis based on HICE 2015/16

We then consider the following adjustments:

Scenario 1: Adjust only the first bracket. Specifically, double the basic allowance from 600 Birr to 1,200 Birr per month. In this scenario, all other aspects of the current tax bracket are kept the same.

Scenario 2: Adjust the first two brackets. Bracket 1 ranges between 0 and 1,200, and bracket 2 ranges between 1,200-2,890. The rest are kept as is.

The results in Table 5 show that a measure such as doubling the basic allowance from 600 Birr to 1,200 Birr that significantly improves the welfare of low-income workers will not have a significant revenue impact.

Table 9: The revenue implication of adjusting the tax bracket for PAYE

Scenarios	Tax revenue from PAYE (billion Birr)	As a share of the baseline (%)	Revenue loss as a share of GDP (%)
Baseline	45.15	100	---
Scenario 1	42.92	95	0.07
Scenario 2	40.10	89	0.15%

Source: Analysis based on HICE 2015/16

2.5 Introducing interest expense deduction restriction rule (Thin capitalization rule)

Burns and Krever (1998) argue that limiting the deductibility of interest expense may be desirable for the following reasons.

- *To prevent taxpayers from exploiting the full deductibility of interest in periods of high inflation.*

In an inflationary environment, interest expenses may, in fact, be repayment of part of the principal. Therefore, taxpayers may exploit the full deductibility of interest expenses in a period of high inflation. Over the last decade, inflation has been high in Ethiopia, which is an environment that encourages debt financing of investment.

- *To prevent taxpayers, particularly foreign taxpayers, from exploiting different tax rates on interest and dividends.*

There are several cases in which tax treatment of interest expense creates a debt bias in capital financing. First, if households lend the money directly to companies, the interest is deducted from the company's income as an expense. Households pay income tax on the interest once. If interest and dividends are taxed at the ordinary income rate, then the only distortion is that equity is taxed twice, whereas a loan is taxed once. If, on the other hand, interest income is taxed at a lower rate than personal income and dividends, the system further increases the incentive to finance by borrowing.

- *To prevent taxpayers from exploiting differences in the treatment of interest and capital gains.*

In general, interest is deductible as incurred, while income is recognized as derived. For instance, if a business borrows money to acquire an investment asset, the interest expense is deducted from income every year (a reduction equivalent to the ordinary income tax rate), whereas the capital gain is taxed at a later date when the asset is disposed of. This intertemporal difference in the taxation of interest and capital gain is one potential distortion. If the capital gain is taxed at a lower rate and/or if there is an inflation adjustment, then it further increases the incentive to finance through debt. Several countries (e.g., U.S., U.K., etc.) restrict interest expenses deductible to 30 per cent of taxable income before interest deductions and capital allowance. Limiting the amount of interest expense deductible can help Ethiopia generate additional revenue.

We have based our analysis for this section on large and medium taxpayers in Ethiopia. We estimate the average ratio of interest expenses to adjusted taxable income and limit the deduction of interest for those taxpayers that have interest expenses above 30 per cent. The adjusted taxable income is net income before interest, depreciation, and amortization expenses are deducted.

Interest expenses, as in actual and as a share of adjusted taxable income, have increased over the years[42]. As of 2019, the share of interest expense was 35 per cent of adjusted taxable income. The percentage of taxpayers claiming interest expenses over 30 per cent has increased and reached 18 per cent of all taxpayers (large and medium taxpayers) by 2019 (Table 10).

Table 10: Interest expense for large and medium taxpayers as a share of adjusted taxable income

Year	Interest expenses (% of Adjusted Taxable Income)	Percentage of taxpayers with interest expense (% of adjusted taxable income) above 30%
2008	16%	12%
2009	14%	10%
2010	14%	10%
2011	14%	10%
2012	14%	10%
2013	15%	11%
2014	15%	12%
2015	16%	12%
2016	23%	14%
2017	28%	16%
2018	32%	17%
2019	35%	18%

Source: Ministry of Revenue and Authors' calculations

In Ethiopia, like many developing countries, large taxpayers contribute a large share of the tax revenue (See Mascagni and Mengistu, 2019). Hence, the Ministry of Revenue has a dedicated large taxpayers office in Addis Ababa. If we disaggregate the data into large and medium taxpayers, we can see that there is no distinct pattern for medium taxpayers[43].

Table 11: Interest expense for large and medium taxpayers as a share of adjusted taxable income

Year	Medium Taxpayers		Large Taxpayers	
	Interest expenses (% of Adjusted Taxable Income)	Percentage of taxpayers with interest expense (% of adjusted taxable income) above 30%	Interest expenses (% of Adjusted Taxable Income)	Percentage of taxpayers with interest expense (% of adjusted taxable income) above 30%
2008	15%	12%	16%	15%

[42] Adjusted taxable income is defined as earnings before interest, depreciation, and amortization (EBITDA).
[43] A taxpayer is designated as a large taxpayer based on the turnover and the sector (see Mascagni and Molla, 2018).

2009	16%	9%	13%	11%
2010	15%	9%	14%	12%
2011	14%	10%	14%	12%
2012	14%	10%	14%	13%
2013	15%	10%	15%	15%
2014	14%	11%	15%	17%
2015	18%	12%	16%	16%
2016	23%	13%	24%	17%
2017	25%	15%	29%	19%
2018	24%	16%	33%	20%
2019	45%	17%	34%	25%

Source: Ministry of Revenue and Authors' calculations

The next question is how much revenue can the government generate by limiting interest expense deduction.

Simulated Scenario 1: Focusing on large and medium taxpayers, we simulate the revenue implication of limiting the allowable deductible interest expense to 30 per cent of adjusted taxable income[44].

Implementing the above policy option in 2019 could have generated an additional 0.32 per cent of GDP or 3.23 per cent of tax revenue (Table 12). For accurate revenue impact, we must exclude foreign-controlled businesses from our analysis, which are subjected to the thin capitalization rule. However, we have also not included individual-owned businesses, which would have pushed the additional tax revenue higher.

Table 12: Return on limiting deductible interest expense

Year	Interest expense pre-restrictions (Million ETB)	Interest expense post-restrictions (Million ETB)	Tax income applying a 30 per cent rate on the difference (Million ETB)	GDP @ current market price (Million ETB)	Tax revenue (Million ETB)	Additional tax income (% of GDP)	Additional tax income (% of Tax Revenue)
	A	B	C=0.3*(A-B)	D	E	F=C/D* 100	G=C/E* 100
2016	54,930	40,612	4,295.20	1,568,097.45	133,118.26	0.27%	3.23%
2017	69,853	43,525	7,898.30	1,832,785.96	90,519.68	0.43%	4.15%
2018	75,916	53,308	6,782.32	2,200,120.59	235,229.48	0.31%	2.88%
2019	72,812	43,913	8,669.66	2,690,751.35	268,457.41	0.32%	3.23%

Source: Ministry of Revenue and Authors' calculation

[44] According to the OECD database, 30 per cent is the most common practice.

Focusing on medium taxpayers only, we re-estimate the revenue implication of limiting the maximum allowable interest expense deduction to 30 per cent of adjusted taxable income (see Table 13 below). Implementing the above policy option in 2019 could have generated only 0.03 per cent of GDP or 0.25 per cent of tax revenue.

The results show that most of the gain in revenue will result from including a larger share of the taxable income of firms in the LTO into the tax bracket. The contribution of medium taxpayers is very limited. For accurate revenue impact, we exclude foreign-controlled businesses from our analysis, which are subjected to a thin capitalization rule.

Table 13: Return on limiting interest expense deductible for medium tax payers

Year	Interest expense pre-restrictions (Million ETB)	Interest expense post-restrictions (Million ETB)	Tax income applying a 30 per cent rate on the difference (Million ETB)	GDP @ current market price (Million ETB)	Tax revenue (Million ETB)	Additional tax income (% of GDP)	Additional tax income (% of Tax Revenue)
	A	B	C=0.3*(A-B)	D	E	F=C/D*100	G=C/E*100
2016	3,924.62	2,887.12	311.25	1,568,097.45	133,118.26	0.02%	0.23%
2017	4,989.16	3,192.11	539.12	1,832,785.96	90,519.68	0.03%	0.60%
2018	5,652.74	3,589.18	619.07	2,200,120.59	235,229.48	0.03%	0.26%
2019	8,320.32	6,055.18	679.54	2,690,751.35	268,457.41	0.03%	0.25%

Source: Ministry of Revenue and Authors' calculations

III CONCLUSION

In conclusion, the study has assessed the prevailing direct tax system in Ethiopia. Moreover, the study has identified opportunities and challenges that the system is currently facing to maximize its revenue collection potential. The following table has summarized some of the potential areas that the Federal Democratic Republic of Ethiopia could consider when reforming its direct tax system in order to enhance its domestic resource mobilization.

Table 14: Summary of some suggested tax reforms

Reform	Description of Reform	Rationale
Increase the tax rate on interest income	We suggest raising the interest income from the current 5 per cent to a 10 per cent (flat) rate.	The rationale for raising the interest income tax is to align it with the treatment of other capital income, such as the tax rate on dividends. Doing so, we believe, will contribute to making the tax system more neutral.
Alternative minimum tax	The reform suggests an alternative 1.5% turnover tax of business income tax if the profit tax is lower than 1.5% of the revenue.	Studies show a significant level of tax evasion in the country. A turnover-based alternative minimum turnover tax could provide a mechanism to deal with tax evasion.
Introduce property tax at regional levels	Introducing a property tax equivalent to 2% of the annual rental value of housing units.	The country is mobilizing limited resources from property taxation, and it is the most easily achievable.
Inflation adjustment	We suggest doubling the tax-free amount for employment income from 600 ETB to 1200 ETB per month. A second scenario suggests doubling the tax-free amount and adjusting the amount subject to the lowest rate	Ethiopia is a country with high inflation. The tax brackets have not been adjusted to match the inflation observed. As a result, a bracket creep has been reducing the disposable income of households. The reform aims to address the gap.

	to be 1200 to 2890 ETB per month.	
Introducing interest expense deduction restriction rule	We suggest limiting the maximum deductible interest expense to 30 per cent of the adjusted taxable income. The adjusted taxable income is net income before interest, depreciation, and amortization expenses are deducted.	There is no limit on the interest expense deductible, which has resulted in large interest expense deductions, eroding the tax base.

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Appendix A

Table A.1 Summary Statistics on housing based on ESS 2015/16 data

	National	Urban areas
Private Ownership	0.77	0.48
Rented house	0.16	0.42
Rent free house	0.06	0.09
Number of Rooms	1.90	2.22
HH owns another house	0.08	0.07
HH with House/Car Rental Inc.	0.04	0.13
Income from House/Car Rental	853.35	13430.73
HH is a House Renter	0.17	0.42
House Rent Paid	6972.86	7637.08