

# The 2016-Income Tax Reforms of Ethiopia: Drivers, Major Legislative Changes, and Constraints<sup>⓵</sup>

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## Abstract

*This article investigated Ethiopia's 2016 income tax reform in terms of its drivers, actors involved in the process, major legislative changes and constraints that may impede its intended goals. It employed a qualitative research methodology, by which it gathered relevant data from key informant interviews, and document review. Legal analysis and description of issues are used as methods of analysis and discussion of the findings. The article identified the drivers of the reforms as addressing changes in the economy, enhancing revenue mobilization, improving efficiency and equity, and addressing gaps in previous income tax legislations. In the reform process, the Ministry of Finance had the upper hand position, though; practically the International Monetary Fund had a significant stamp in the course of the process. However, the participation of other key national actors, including the*

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*Ministry of Revenues and the Ethiopian Chamber of Commerce was minimal. The reform has introduced major legislative changes, including the introduction of Schedule 'E' and new tax bases; taxation of residual income; and consolidation of tax administration laws. The article also discussed constraints that may impede the goals of the reforms, including the absence of impact assessment of the 2016 reforms; inflation; poor tax administration; lack of meaningful stakeholder participation; and low tax-to-GDP ratio. Finally, suggestions are made for undertaking impact assessment of the 2016 income tax reforms; redesigning the income tax system to be responsive to inflation; modernizing the tax administration; and enhancing meaningful stakeholders' participation.*

**Keywords:** *Income tax; reforms; legislative changes; tax administration; MoF; IMF.*

## **Introduction**

Tax reform, as the name suggests, is the process of changing the tax system of a nation including the way taxes are levied, collected and managed in a defined jurisdiction.<sup>1</sup> The reform may be manifested through a redefinition of taxable units, or revision of tax rates, tax bases, and assessment or collection methods.<sup>2</sup> The most important policy objectives of tax reforms are to boost government revenue, restore efficiency, maintain fairness, improve compliance and simplify the tax system.<sup>3</sup> The need to modernize the tax administration is also another reason for taking the reforms.<sup>4</sup> Nevertheless,

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<sup>1</sup> Sumedh Rao, *Tax Reform: Topic Guide*, University of Birmingham, (2014), p. 6.

<sup>2</sup> *Id.*

<sup>3</sup> Organization for Economic Cooperation and Development (OECD), *Fundamental Reform of Personal Income Tax*, OECD Policy Studies, (2006), p. 31.

<sup>4</sup> Wilson E. Herbert et al., *Tax Reforms and Nigeria's Economic Stability*, *International Journal of Applied Economics, Finance and Accounting*, Vol. 3: No. 2, (2018), p. 75.

achieving these objectives has never been easy because of the trade-off among two or more of these objectives. For instance, the trade-off between efficiency and equity has been the prevailing challenge facing tax policy makers every time they consider reforming the tax system.<sup>5</sup>

In relation to tax reforms, the influence of international financial institutions such as the International Monetary Fund (IMF) and the World Bank (WB) cannot also be underestimated. For instance, most African countries undergone in sweeping tax reforms in the 1980s due to the Structural Adjustment Programs introduced, mainly by the IMF and the WB.<sup>6</sup> The objectives that were set by these countries with the recommendation of IMF were improving the tax-to GDP ratio and economic efficiency; broadening the tax base; enhancing equity of the tax system; encouraging self-assessment; boosting administrative efficiency; and encouraging saving and investment.<sup>7</sup> Unlike most African countries, Ethiopia was not part of this trend. This was attributable to the tense relation the country had with the west due to its anti-capitalist ideology that it was following during that time.

In fact, the landmark tax reform of Ethiopia took place from 1942-1944, five decades prior to the African sweeping tax reforms of the 1980s. The pre-1941 era was mainly characterized by traditional system of taxation although a few modern taxes had already begun to be introduced a little bit earlier.<sup>8</sup> The

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<sup>5</sup> Jorge Martinez-Vazquez, *Successful Tax Reforms in the Recent International Experience: Lessons in Political Economy and the Nuts and Bolts of Increasing Country Tax Revenue Effort*, Revised in 2022, Asian Development Bank (ADB), (2022), p. 26.

<sup>6</sup> Odd-Helge Fjeldstad and Lise Rakner, *Taxation and Tax Reforms in Developing Countries: Illustrations from Sub-Saharan Africa*, Chr. Michelson Institute, (2003), p.1.

<sup>7</sup> Jean K. Thisen, *Tax Reforms in Selected African Countries*, Economic Commission for Africa, 2003.

<sup>8</sup> Taddese Lencho, *Towards Legislative History of Modern Taxes in Ethiopia (1941-2008)*, Journal of Ethiopian Law, Vol. 25, No. 2, 2012, P. 104-108.

introduction of “excise and consumption” taxes in 1931, the “entertainment tax” in 1932 and the income tax in 1934 were some examples.<sup>9</sup> However, it was only after 1942 that extensive introduction of various tax laws were observed.<sup>10</sup> The 1942 tax reform was transformative for it introduced a cash-based payment system replacing the in-kind system and published tax laws avoiding arbitrary tax impositions.<sup>11</sup> The major taxes introduced during this time include land tax, income tax, excise tax, wholesaler’s sales tax, customs duties, education tax and health tax. After the comprehensive reform of 1941-44, fragmented reforms were common until the *Dergue* regime took power following the 1974 Revolution. The Revolution had a big impact on the country’s income tax regime, including the removal of tax on income from agricultural activities and rental of lands and buildings from the income tax schedules.<sup>12</sup>

However, it was in 2002 that Ethiopia undertook the most sweeping tax reforms which were part of a larger liberalization policy of the Ethiopian People’s Revolutionary Democratic Front (EPRDF) - led government.<sup>13</sup> The reform was comprehensive not only because it completely changed the existing income tax, and excise tax and somehow customs duties; but it also introduced new taxes such as the value-added tax and turnover tax.<sup>14</sup>

Despite bringing a lot of improvements, the 2002 income tax reform could not be free of limitations. Some of the shortcomings were the fragmentation

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<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*, p. 120.

<sup>13</sup> Alemayehu Geda and Abebe Shimeles., *Taxes and Tax Reform in Ethiopia; 1990-2003*, Research Paper, UNU-WIDER, United Nations University (UNU), (2005).

<sup>14</sup> Misganaw Gasahw, *Ethiopian Tax System*, in Misganaw Gasahw (ed.), *Ethiopian Tax Law: A Text Book*, Ethiopian Law School’ s Association (ELSA), Addis Ababa, June 2022

of the tax rules; complexity of the tax laws; prevalence of delegation rules; absence of adequate administrative rules, including assessment rules and valuation rules for fringe benefits; narrow tax base; etc.<sup>15</sup> In addition to these gaps, there appears to be a growing need to make the tax provisions conform to the changing circumstances such as the need to conform tax brackets to the increasing inflation, and socio-economic needs of the country.<sup>16</sup> As the economy grew up, the old rules also could not enable to collect sufficient revenue. Moreover, there was a need to improve the tax administration towards making it more efficient and effective.<sup>17</sup> Derived by such factors, the government undertaken income tax and tax administration reforms in 2016.

Though six years have passed since the 2016 reforms, no study has made an examination of this reform. While the real impact is yet to be empirically studied, this research aims to play its part by investigating the drivers, process and actors of the reforms; major legislative changes it introduced; and some of the notable constraints that may impede its intended goals.<sup>18</sup> To this end, the research employed a qualitative research methodology, by which it used key informant interviews (KII), and document review as data collection tools.

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<sup>15</sup> Taddese Lencho, The Ethiopian Tax System: Excesses and Gaps, *Michigan State Journal of International Law*, Issue: 20, No. 2, (2012), pp. 365-369.

<sup>16</sup> ገቢ ለልማት መጽሕፍት፣ ስለተሻሻሉት የገቢ ግብር እና ታክስ አስተዳደር አዋጆች፣ ልዩ እትም፣ መስከረም 2009 ዓ.ም.።

<sup>17</sup> *Id.*

<sup>18</sup> Though, Ethiopia's current form of government grants both the federal and regional governments with their own power of income taxation, practically, the federal government takes the lead in initiating and enforcing income tax reforms. The regional governments usually play a passive role as they simply adopt the reforms enforced by the federal government, and copy paste and rename the federal tax laws as regional laws to exercise their taxing powers. As a result, the regional income tax laws are almost similar, in content and form, to federal income tax laws. Thus, to avoid redundancy in discussing the 2016 income tax reforms, this paper limits its discussion to the federal income tax reforms and legislations. However, its discussions and findings are relevant to understand the contexts of regional income tax laws too.

Accordingly, KIIs were held with top officials of the Ministry of Finance (MoF), Ministry of Revenues (MoR), Ministry of Mines, and the Ethiopian Chamber of Commerce and Sectoral Association, and selected tax officers at the MoR. The relevant existing bodies of literature on income tax reforms in Ethiopia and income tax legislations were also reviewed to analyze the core issues of the research. Finally, the research used legal analysis and description of issues as method of analysis and presentation of findings.

The article discusses the findings of the research in five sections. The first section is dedicated to make a general overview of the income tax reform of Ethiopia in historical contexts of pre-2016 trends. Section two discussed the drivers that pushed the government to undertake the 2016 income tax reforms, together with hinting the goals intended to be achieved through the reforms. As a follow-up, section three discussed the process and major actors involved in the initiation and design of the reforms. Section four discussed the major legislative changes resulted from the 2016 income tax reforms. Section five is dedicated to point out and discuss some of the notable constraints against the realization of the intended goals of the reforms. Finally, the article winds up with concluding remarks.

## **1. Income Tax Reforms in Ethiopia: An Overview**

Tax collection is rooted in the long history of Ethiopia though land and its production value had long been the primary focus and taxes were dealt with in traditional forms. With the introduction of new economic plan and increasing revenue needs in the post-liberation period, Ethiopia introduced modern tax system that transform the tax system into cash-based payment system and published tax laws avoiding arbitrary tax impositions.<sup>19</sup> The country enacted its first modern income tax law in 1944 through the Personal and Business

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<sup>19</sup> Taddese, *supra* note 8, p. 104-108.

Income Tax Proclamation No. 60/1944.<sup>20</sup> This law has a distinctive place in the history of income tax system for it established a schedular system, which has remained as the basic structure of income taxation to this day.<sup>21</sup> The Proclamation defined income as ‘every income earned or unearned, accruing from or received’ and came up with three Schedules: Schedule ‘A’ for taxing personal incomes derived from employment and other sources in non-business context, while Schedules ‘B’ and ‘C’ for business incomes on the basis of fixed and presumptive taxes.

The 1944 income tax law was replaced by Proclamation No. 107/1949 which defined income more broadly as ‘every sort of income earned or unearned, whether in the form of gains, profits or rents, salaries, wages or compensation for personal services of whatever kind’.<sup>22</sup> This Proclamation was again replaced by the Income Tax Decree of 1956, which kept Schedule ‘A’ unchanged, but narrowed down the scope of Schedule ‘B’ to the taxation of income derived from ‘rent of lands and buildings used other than for agricultural produce, cattle breeding purposes’.<sup>23</sup> It also brought the taxation of businesses to Schedule ‘C’ and classified the taxpayers into two groups: business and small business.<sup>24</sup>

The 1956 income tax decree was replaced in 1961 by Income Tax Proclamation No. 173/1961.<sup>25</sup> Some consider this legislation as a better known income tax law in modern income tax history of Ethiopia as it

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<sup>20</sup> Personal and Business Income Tax Proclamation No. 60/1944, *Negarit Gazeta*, (1944).

<sup>21</sup> Taddese, *supra* note 8, p. 115.

<sup>22</sup> Proclamation to Provide for the Payment of Tax by All Individuals and Businesses No. 107/ 1949, *Negarit Gazeta*, (1949).

<sup>23</sup> Income Tax Decree No. 19/1956, *Negarit Gazeta*, (1956).

<sup>24</sup> *Id.*, Arts. 40, 41, 43, 44, and 69.

<sup>25</sup> Income Tax Proclamation No. 173/1961, *Negarit Gazeta*, (1961).

remained in force, fully or partly, for more than 40 years (i.e. until 2002).<sup>26</sup> In 1962, a regulation was issued to supplement this proclamation, and the regulation among other things classified business income taxpayers into Category 'A', 'B' and 'C', for the first time.<sup>27</sup> Moreover, the Proclamation underwent many amendments, which also contributed to its long survival.<sup>28</sup> One of these was the Income Tax Proclamation No 255/1967,<sup>29</sup> which introduced Schedule 'D' to bring agricultural income into the main income tax system for the first time.<sup>30</sup> In the late 1970s, Schedule 'D' has been used to levy tax on different incomes, other than agricultural income, such as royalty, income from technical services, income from games of chance winnings, and dividend.<sup>31</sup>

Following the 1974 Revolution, which overthrown Emperor Haile Selassie's government, the *Dergue* regime assumed power. The latter nationalized all means of production (including land, housing, farms and industry) adopting Socialism as its ideology. The *Dergue*, although introduced no new legal framework or income tax structure, changed two of the income tax Schedules of the 1961 Income Tax Proclamation. Accordingly, Schedule 'B' (income from rental of lands and buildings) and Schedule 'D' (tax on income from agricultural activities) were removed and the rates for Schedules 'A' and 'C' were changed.<sup>32</sup> In addition, taxes on agricultural income and rural land were

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<sup>26</sup> Taddese, *supra* note 8, P. 119.

<sup>27</sup> Income Tax Legal Notice No. 258/1962, *Negarit Gazeta*, (1962).

<sup>28</sup> Taddese, *supra* note 8, P. 119.

<sup>29</sup> Income Tax Proclamation No. 255/1967, *Negarit Gazeta*, (1967).

<sup>30</sup> Taddese, *supra* note 8, P. 119.

<sup>31</sup> *Id.*, P. 121.

<sup>32</sup> *Id.*, P. 120-121.



replaced with a rural land-use fee and a new tax on income from agricultural activities was enacted in 1976.<sup>33</sup>

The piecemeal revision of the 1961 income tax law had continued in the 1990s even after EPRDF assumed power and made shifts of economic policy. We can mention the Income Tax (Amendment) Proclamation No. 62/ 1993,<sup>34</sup> and Income Tax Amendment Proclamation No. 107/1994.<sup>35</sup> The most notable developments of the 1990s in the area of income taxation were the reintroduction of ‘income taxes on rental of buildings’ and the reduction of tax rates both for individuals and companies as part of encouraging the private sector.<sup>36</sup>

The repetitive piecemeal revision of the 1961 income tax laws (from 1960s to late 1990s) has resulted in complex system of rate structures and income brackets.<sup>37</sup> This became one of the major reasons why the Ethiopian Government undertook what might justifiably be called ‘comprehensive’ income tax reforms culminating with the passing of income tax laws in 2002.<sup>38</sup> The Income Tax Proclamation No. 286/2002 put an end to the incremental approach to revision of income tax laws and repealed all previous income tax laws in force up to that time, except the autonomous income tax regimes in the agriculture, mining and petroleum operation sector.<sup>39</sup> This Proclamation brought many fundamental changes to the then income tax system, including bringing the scattered pieces of income tax legislations in a

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<sup>33</sup> Rural Land Use Fee and Agricultural Activities Income Tax Proclamation No. 77/ 1976, *Negarit Gazeta*, (1976).

<sup>34</sup> Income Tax (Amendment) Proclamation No. 62/ 1993, *Negarit Gazeta*, (1993).

<sup>35</sup> Income Tax Amendment Proclamation No. 107/1994, *Negarit Gazeta*, (1994).

<sup>36</sup> Taddese, *supra* note 8, P. 122.

<sup>37</sup> *Id.*, P. 123.

<sup>38</sup> *Id.*, P. 124.

<sup>39</sup> Income Tax Proclamation No. 286/2002, Federal *Negarit Gazeta*, (2002), Arts. 118-119.

single body of law; adoption of ‘residence rule’ to assume income tax jurisdiction; created uniform income tax rates and brackets for Schedules ‘A’, ‘B’ and ‘C’; and introduced tax avoidance and modern income tax accounting rules to the tax system.<sup>40</sup> The income tax laws resulted from the 2002 reforms served for about 14 years until they got replaced with income tax laws resulted from the latest income tax reforms of Ethiopia, the 2016 income tax reforms.

To sum up this section, it is true that Ethiopia’s income tax system underwent several reforms since the 1940s. The reforms from 1940’s to 2002 were largely fragmented, while the 2002 reform was the country’s first comprehensive and inclusive income tax reform.<sup>41</sup> If we see these reforms from the perspective of their goals; the income tax reforms of the imperial period were aimed at enhancing revenue and encouraging productivity, while the *Dergue* era reforms were undertaken to demote private investment and empower the government in the economy.<sup>42</sup> The post-*Dergue* period coincided with a free economic policy, and the main tax reform goals of this period were broadening the tax base, strengthening the enforcement capacity of the tax and customs authorities and promoting equity in the tax system.<sup>43</sup> However, through all these changes the effectiveness and productivity of Ethiopia’s income tax reforms remain questionable due to lack of institutionalized practices, limited role of professionals, lack of adequate

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<sup>40</sup> Taddese, *supra* note 8, PP. 123-124.

<sup>41</sup> Of course, a fragmented and gradual income tax reform has also continued from 2002 to 2016. See *supra* note p 50.

<sup>42</sup> *Id.*

<sup>43</sup> Misganaw Gashaw, Tax Reform Discourse and Its Implication on Development: Evidence from the VAT Introduction in Ethiopia, *Mekelle University Law Journal*, Vol: 3 No. 1, (2015), pp. 23-24.

studies and consultation with stakeholders and prominent role of international actors.<sup>44</sup>

## 2. The 2016-Income Tax Reforms of Ethiopia: Drivers

Public policy reforms are designed to achieve defined goals and present solutions to defined problems.<sup>45</sup> In this regard, tax reforms are no exception. Tax reforms can be motivated by several concerns, most commonly, the desire to generate adequate revenue with a minimum of economic distortion, build up an efficient and fair tax system and improve the feasibility and administrability of the tax system.<sup>46</sup> Tax reforms are also used to advance a wide range of policy objectives such as adjusting macroeconomic problems, structural disparities, fiscal imbalances, and balance of payments disequilibria.<sup>47</sup> Moreover, the influence of developed countries, intergovernmental organizations, and international tax experts has been a common driver of post-World War II tax reforms in developing countries.<sup>48</sup>

Ethiopia's post-*Dergue* tax reforms are no exception to the above pattern and tax has been associated with external factors especially the influence of the IMF and the World Bank.<sup>49</sup> The complex and out-dated tax laws, failure of

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<sup>44</sup> *Id.*

<sup>45</sup> Christoph Knill and Jale Tosun, Policy Making, In Daniele Caramani (ed.), *Comparative Politics*, Oxford University Press, (2008), pp. 495-519.

<sup>46</sup> Theresa Stattel and Anton Kamenov, Tax Policy Reform Primer, research report produced for review by the United States Agency for International Development (USAID), (2022), p. 4.

<sup>47</sup> Victor Barros *et al*, Drivers of the Tax Effort: Evidence from a Large Panel, REM – Research in Economics and Mathematics, (2021).

<sup>48</sup> Leyla Ates, Domestic Political Legitimacy of Tax Reform in Developing Countries: A Case Study of Turkey, *Wisconsin International Law Journal*, Vol. 30, No. 3, (2013).

<sup>49</sup> Misganaw, *supra* note 43; Feleku Ayenachew, Challenges of Tax Reform In Ethiopia Revenue And Custom Authority (ERCA), Msc Thesis, St.Mary's University College, (2012).

the tax system to generate adequate revenue and weak tax administration are also the common and major factors that necessitated tax reforms.<sup>50</sup> Building on this, this section discussed the drivers of the 2016-Income Tax Reforms of Ethiopia. Examining government documents and interviewing higher officials at the MoF and MoR, the authors have been able to grasp that the 2016 reforms had four major drivers, which are discussed one by one as follows.

## **2.1. Changes in the Economy**

Tax policy is a major component of any country's economic governance framework, and fiscal instruments are important to manage economic growth.<sup>51</sup> Thus, reforms on direct taxes (such as income taxes) can be used as essential instruments to influence the micro and macro aspects of the economy.<sup>52</sup> As such, in Ethiopia too, tax reforms have long been considered along with economic changes. For instance, the change of the economic policy from a centrally planned economy to a semi-market oriented economic system is one of the major internal driving factors for the post-1991 tax reforms.<sup>53</sup> Among other things, the increasing public spending and recurring

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<sup>50</sup> Ethiopian Economic Association (EEA), Proceeding of the Second International Conference on the Ethiopian Economy, Volume III, (2005).

<sup>51</sup> Jason Lakin, The Politics of Tax Reform in Low- and Middle-income Countries A literature Review, International Budget Partnership, (2020).

<sup>52</sup> Ian Preston, Political Economy of Taxation: Needs And Drivers For Tax Reforms, In Savina Princen (ed), *Political Economy of Tax Reforms*, European Commission Workshop Proceedings, (2016).

<sup>53</sup> Belayneh Asmare, Economy wide Impact of Direct Tax Reform in Ethiopia: A Recursive Dynamic Computable General Equilibrium Analysis, MSc Thesis, Addis Ababa University, (2018).

budget deficit have necessitated the country's comprehensive tax reforms of 2002.<sup>54</sup>

After the enactment of the Income Tax Proclamation No. 979/2016,<sup>55</sup> and Tax Administration Proclamation No. 983/2016,<sup>56</sup> *Gebi le-Limat*, a magazine published by the Ministry of Revenues, held an extensive interview with Ato Wassihun Abate, the then Director of the Legal Service Directorate of the Ministry of Finance and Economic Cooperation (MoFEC), now, Ministry of Finance,<sup>57</sup> where he thoroughly discussed the drivers and goals of the 2016 tax reforms, and the main changes it introduced. Part of this interview, as quoted below, is telling that changes in the economy were also the main driver of the 2016 income tax reforms.

"... በነዚህ ዓመታት ውስጥ የአገራችን ኢኮኖሚ በአማካይ 11 በመቶ እያደገ ነው። ስለዚህ ይህ የገቢ ግብር አዋጅ በወቅቱ የነበረው ኢኮኖሚ መምራት በሚያስችል መልኩ ቢሆንም አሁን ባለበት ደረጃ ግን ከኢኮኖሚው ጋር የተጣጣመና ኢኮኖሚውን መምራትና መደገፍ የሚያስችል አይደለም። ስለዚህ አዋጁ የአገራችን ኢኮኖሚ እድገት ከደረሰበት ደረጃ ጋር የተጣጣመ እንዲሆን ለማድረግ ነው። ... የዛሬ 14 ዓመት የነበረው የገንዘብ የመግዛት አቅም ዛሬ ካለው አቅም ጋር ሲወዳደር በከፍተኛ ደረጃ የተለየ ነው። ስለዚህ በአዋጁ ውስጥ በገንዘብ መልክ የተቀመጡ የማስከፊያ

<sup>54</sup> Demirew Getachew, *Tax Reform in Ethiopia and Progress to Date*, Ethiopian Economic Association Sound International Conference on the Ethiopian Economy, Addis Ababa, (2004).

<sup>55</sup> Federal Income Tax Proclamation No. 979/2016, Federal *Negarit Gazzeta*, (2016) [hereinafter Income Tax Proclamation No. 979/2016].

<sup>56</sup> Federal Tax Administration Proclamation No. 983/2016, Federal *Negarit Gazzeta*, (2016) [hereinafter Tax Administration Proclamation No. 983/2016].

<sup>57</sup> ገቢ ለልማት መጽሔት፣ “ስለተሻሻሉት የገቢ ግብር እና ታክስ አስተዳደር አዋጆች ልዩ ቃለ-ምልልስ ከገንዘብና ኢኮኖሚ ትብብር ሚኒስቴር የሕግ አገልግሎት ዳይሬክተር አቶ ዋሲሁን አባተ ጋር”፣ ልዩ እትም፣ መስከረም 2009 ዓ.ም [here in after *Gebi le-Limat*]. The authors are highly indebted to this interview.

ምጣኔዎችና የገቢ መጠኖች አሁን ካለው የገንዘብ የመግዛት አቅም ጋር ተጣጥሞ እንድሄድ ለማድረግ ነው።”<sup>58</sup>

This shows government’s continuing use of tax and fiscal policy to influence and manage the economy. In other words, tax reform is needed because the existing tax laws could not capture developments including the 11% economic growth and changes in purchasing power, among others.

In an interview with the authors, Mesfin Gulilat, a Director of the Research and Development Directorate at MoR, also shares this economic justification. According to him, the 2016 income tax reform was required to bring an income tax legislation keeping pace with the economic growth, attracting foreign direct investment, and encouraging the private sector.<sup>59</sup>

## **2.2. Enhancing Revenue Mobilization**

Many agreed that adequate domestic revenue mobilization is critical for the healthy financing of public expenditure and fiscal crisis is the mother of tax reforms in most developing countries.<sup>60</sup> Thus, most African countries, including Ethiopia, undertaken tax reforms to mobilize revenues, particularly, with declining external assistance, capital inflows, and trade following the global financial and economic crisis. According to Tadele, who assessed the percentage change in tax revenue due to the percentage change in the base (usually GDP) in Ethiopia from 1974 to 2010, the ability of the Ethiopian tax structure to generate revenues during economic growth has been low and non-

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<sup>58</sup> *Id.*

<sup>59</sup> Interview with Mesfin Gulilat, Director, Research and Development Directorate of Ministry of Revenues, (June 23, 2022).

<sup>60</sup> Richard M. Bird, Improving Tax Administration in Developing Countries, *Journal of Tax Administration*, Vol:1, No. 1, (2015).

buoyant.<sup>61</sup> Scholars in the field and donor organizations have long recommended the country to mobilize domestic revenue by broadening the tax base, bringing new taxpayers into the tax net, reducing tax exemptions, and improving the tax administration.<sup>62</sup>

Since the 1940s, governments in Ethiopia have made numerous efforts to reform and modernize the tax system with the primary goal of raising sufficient revenue.<sup>63</sup> However, despite a nominal increase in tax collection, efforts could not bring the required result. According to the National Bank of Ethiopia (NBE) report of 2015/16, the tax to GDP ratio in Ethiopia was 13.5%, which was far less than the average value of sub-Saharan countries (16%).<sup>64</sup> It had become apparent that the government cannot achieve its plan to increase revenue from taxation to 17 % of GDP by 2020 (the end of GTP II). The IMF's 2016-Country Report also calls for additional tax reform if the country has to improve its tax performance and collect corresponding to the underlying economic conditions.<sup>65</sup> As a result, the country's persistent fiscal imbalance and budget deficits was one of the factors that made the 2016 income tax reform necessary.<sup>66</sup>

### **2.3. Improving Efficiency and Equity in the Income Tax System**

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<sup>61</sup> Tadele Bayu, Analysis of Tax Buoyancy and Its Determinants in Ethiopia: Cointegration Approach, *Journal of Economics and Sustainable Development*, Vol:6, No.3, (2015).

<sup>62</sup> Alemayehu and Abebe, *supra* note 13.

<sup>63</sup> Takele Abdisa, Macroeconomic Impact of Tax Reform in Ethiopia, *Journal of Economics and Sustainable Development*, Vol: 9, No.19, (2018).

<sup>64</sup> *Id.*

<sup>65</sup> Belayneh, *supra* note 53.

<sup>66</sup> Gebi le-Limat, *supra* note 57.

Enhancing the efficiency and equitability of the income tax system was also the driver of the 2016 income tax reforms of Ethiopia.<sup>67</sup> This goes in agreement with the general goal to ensure that the tax system is fair and efficient, which are used as the two most important criteria to build a good tax system.

In order to attain efficiency in the tax system, tax reforms are aimed at minimizing the cost of complying with the tax laws (by taxpayers and tax authorities) and distortions in the economy caused by the tax. For example, tax reforms introduce legislation that promotes compliance, criminalizes evasion, limits loopholes that invite tax planning, simplifies requirements and procedures, etc. Another often stated reform objective is that tax laws are designed in a way not to inhibit people from deciding to do something because of the tax. When it comes to equity, although there are several criteria, reforms attempt to ensure that taxes are imposed based on the taxpayers' ability to pay and the benefits they receive from government services. As the latter requirement is more practical than legal, tax laws try to ensure that people with equal income pay equal taxes and people with higher income pay tax on a greater percentage of their income. Beyond ensuring efficiency and equity in the system, tax reforms are expected to resolve the possible trade-off between the two competing considerations.<sup>68</sup>

There are empirical evidences showing how the Ethiopian tax system is severely starving both efficiency and equity criteria, as well as how the tax system is performing in managing the two competing concerns is far from

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<sup>67</sup> *Id.*

<sup>68</sup> This trade-off is central to income tax policy, where the key issue is whether the distortionary impact of raising taxes off the benefits of having more resources to redistribute.



clear.<sup>69</sup> From an efficiency perspective, slow structural transformation (dominance of subsistence agriculture), poverty (low per capita income), low savings rates, the large size of the informal sector (40% of GDP), low level of monetization of the economy, and macro-economic problems (such as inflation, unemployment, low volume of exports, low FDI share), poor tax culture and low compliance are commonly mentioned as constraints.<sup>70</sup> There are also concerns about equity, where studies indicated that income tax practices have a negligible role on the overall income distribution and poverty reduction.<sup>71</sup> This is because income taxes, though designed progressive may easily turn regressive if the tax brackets are not regularly adjusted to keep up with inflation.

In this regard, the thresholds set for personal income tax under the 2002 income tax laws were not been updated for 14 years and were dramatically eroded by inflation. Most strikingly, the exempt threshold (1,800 Birr annual income) was well below the poverty line (3,781 Birr in 2010/11) and the lowest government wage (5040 Birr until 2022).<sup>72</sup> This means that the poor were still liable to pay income taxes. Evidences show that 1 in 4 households in

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<sup>69</sup>See for instance, Wollela Abehodie and Odd-Helge Fjeldstad, Business People's Views of Paying Taxes in Ethiopia, ICTD Working Paper 43 January 2016; Workneh Ayenew, Determinants of Tax Revenue in Ethiopia: Johansen Co-Integration Approach, *International Journal of Business, Economics and Management*, Vol: 3, No. 6, pp. 69-84.

<sup>70</sup>See for instance, Minyichel Baye and Degefe Duressa, Factors Affecting Tax Revenue In Ethiopia, Volume 8, Issue 4, 2020; Daniel Bayera, Tax revenue Determinants and Tax Efforts in Ethiopia from 2000-2019: ARDL Approach, *International Journal of Public Administration and Management Research*, Vol: 7, No. 2, (2021), pp. 1-18; Tahir Desta *et al*, Factors Affecting Tax Revenue in Ethiopia: Autoregressive Distributed Lag Approach, Research Square, 04 Apr. 2022.

<sup>71</sup>Kalle Hirvonen *et al*, Linking Taxation and Social Protection: Evidence on Redistribution and Poverty Reduction in Ethiopia, UNU-WIDER Working Paper 2016/111, (2016), P. 3.

<sup>72</sup>*Id.*, P. 8.

Ethiopia were made poorer by the tax system, which is known as fiscal impoverishment.<sup>73</sup> Thus, it is not surprising to see that responding to the increasing concerns about the equity and appropriateness of the income tax structure is mentioned as one of the driving factors for the 2016 income tax reforms.<sup>74</sup>

## **2.4. Gaps in the Existed Income Tax Laws**

Legal reforms are generally recommended as old laws become obsolete to capture changes as a society and the economy evolves. Tax laws in general and income tax laws, in particular, are the most complex and dynamic areas of law that deals with domestic and international persons and transactions. There is thus a need to be flexible so as to permit the adequate handling of new situations when they arise without compromising the certainty and predictability of the system.<sup>75</sup> This is made possible through *de novo* tax design and/or the reform of existing tax laws.

Compatible with this notion, the legislative gaps under the 2002 enacted income tax laws was one of the driving factors to initiate Ethiopia's 2016 income tax reforms.<sup>76</sup> In an interview with the authors, Ato Boshe, a Legal Advisor to the Minister in MoF, further explained that the 14 years old income tax laws had caused serious implementation problems and came to be obsolete to support new developments in the national and global economy.<sup>77</sup> For instance, the laws failed to tax some income sources, which not only

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<sup>73</sup> World Bank Group, Ethiopia Poverty Assessment, Washington DC, (2015).

<sup>74</sup> Gebi le-Limat interview with Wassihun, *supra* note 57.

<sup>75</sup> Alexander V. Demin, Certainty and Uncertainty in Tax Law: Do Opposites Attract? *Laws*, Vol: 9, No. 30, (2020).

<sup>76</sup> Gebi le-Limat interview with Wassihun, *supra* note 57.

<sup>77</sup> Interview with Boshe, Legal Advisor, Ministry of Finance, (June 17, 2022).

narrowed the tax base but also become a source of inequity.<sup>78</sup> Tax rates and tax brackets were also needed to be updated in light of the economic development of the country.<sup>79</sup> Moreover, as the income tax laws were found scattered in the different legislations, the system was open to inconsistencies and contradictions making them difficult to enforce.<sup>80</sup> This is why, one of the purposes of the 2016 reform was to consolidate and fill gaps of the pre-existing tax laws.

### **3. The Process and Actors Involved in the 2016-Income Tax Reforms**

The process and the actors involved in decision-making are crucial agendas in tax reform projects. As far as its nature is concerned, it is apparent that the 2016 tax reform is part of the post 2002 incremental tax reform practice in the country. Given the absence of changes for almost 15 years in response to socioeconomic developments in the country, the government had faced several questions from taxpayers and pressures from the IMF and other international organizations. Thus, the Council of Ministers decided to amend the Income Tax Proclamation No 286/2002 and organized a committee for draft preparation. The Committee was headed by the Ministry of Finance and comprised people from Ministry of Revenue, Ministry of Justice, Ministry of Trade and Industry, and Ministry of Labour and Social Affairs. It was closely supported by independent consultants and technical assistants from IMF. It was the draft by the committee that went through the normal legislative process in the country and finally ratified by the parliament.

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<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> Interview with Mesfin, *supra* note 59.

The first question that one can logically raise is what were the roles of the MoF and other concerned government departments in the initiation and formulation of the 2016 income tax reforms. The same question can be raised with respect to the different private and professional associations such as the Ethiopian Chamber of Commerce and Sectoral Associations, the Ethiopian Workers Association, the Ethiopian Employers Federation, the Ethiopian Bankers Association, the Ethiopian Economic Association, the Ethiopian Lawyers Association, etc.

Various state and non-state actors participate and played a role in the 2016 tax reform.<sup>81</sup> In Ethiopia, the MoF is the key institution with the power to formulate fiscal policy, initiate reform, and follow up the proper implementation of the same.<sup>82</sup> Thus, it is expected to take the leading role in the initiation and design of the 2016 income tax reforms, and in fact it played a pivotal role. However, the international actors, particularly, the IMF had a big impact in shaping the course of the reforms. The IMF and international experts were ostensible in developing and implementing tax reforms in developing countries including Ethiopia.<sup>83</sup> Ethiopia has been under the Extended Credit Facility (ECF) and Extended Fund Facility (EFF), which provide financial assistance to countries with protracted balance of payment and revenue mobilization problems.<sup>84</sup> In response to Ethiopia's request for technical assistance to restructure the tax system and increase revenue in 2010, IMF has strongly recommended government authorities to, among others, reduce corporate tax rates (from the current 30% to 25%) and drop the

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<sup>81</sup> Interview with Boshe, *supra* note 77.

<sup>82</sup> Definition of Powers and Duties of the Executive Organs Proclamation No.1263/2021, Federal *Negarit Gazzeta*, (2021), Art 26.

<sup>83</sup> Misganaw, *supra* note 43.

<sup>84</sup> IMF Communications Department, *IMF Executive Board Approves US\$2.9 Billion ECF and EFF Arrangements for Ethiopia*, Press Release No. 19/486, December 20, 2019.

10% dividend tax.<sup>85</sup> Although such specific recommendations cannot be directly counted in the 2016 income tax reform, the general income tax reform is motivated by the IMF's recommendation. This is later made clear under the 2016 IMF country report on Ethiopia, which underlined the need for tax reform is necessary to overcome the problem of revenue mobilization and support the development agenda in the country.<sup>86</sup> And of course, the government of Ethiopia adopts IMF recommendations in its recent tax reform on income tax and tax administration at the same time.<sup>87</sup> The main features of income tax reform such as adjusting tax bracket, increasing the schedules (from four to five), elevating exempted threshold (to Birr 600 monthly and Birr 7200 annual income) and simplifying tax laws are the aftermaths of the IMF recommendations.<sup>88</sup>

Regarding the role and involvement of experts, the IMF, as part of its technical support, sent Professor Lee Burns of the University of Sydney to draft the income tax law in Ethiopia.<sup>89</sup> Professor Lee has worked on tax reforms in over 30 developing countries for decades as part of the technical assistance programs of international organizations, particularly the IMF and World Bank.<sup>90</sup> He has provided assistance on the design and drafting of the recent income tax and tax administration laws in Ethiopia with the same assignment from the IMF. The influence of IMF and the broad involvement of foreign scholars demonstrate external significances to undertake the reform. This can be more problematic when tax reforms are carried out before

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<sup>85</sup> Bruh Yihunbelay, Ethiopia: IMF Recommends Tax Cuts for Ethiopia, *Addis Fortune*, (Mar. 30, 2010).

<sup>86</sup> IMF, Federal Democratic Republic of Ethiopia (FDRE), Article IV Consultation: IMF Country Report No. 16/322, (2016).

<sup>87</sup> Belayneh, *supra* note 53.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

home-works remained up in the air. This goes to the institutional framework, where organizational problems and lack of human, material, technological and financial resources are commonly raised.<sup>91</sup>

Thus, although there is a claim that MoF is the one initiating the reforms,<sup>92</sup> the interviews and the evidences produced above say otherwise. The informant from the MoR, on this point, further stated that from the very outset, MoF was and is not in a position to undertake a nationwide tax reforms; it lacks organizational structure and manpower necessary to lead the country's tax system and undertake reforms when necessary.<sup>93</sup> Most of the tax reforms are project-based and run on the technical and financial support of the IMF and WB. The MoF had controlled the monitoring of the whole process of initiation and study, legal drafting, presented to the Council of Ministers for discussion and to the HoPR for approval. Thus, what is clear is that a committee composed of experts and officials from the MoF, and MoR, was established to facilitate the process and to provide comments, if any.<sup>94</sup>

At the final point, the bill was commented on by tax practitioners, scholars, and representatives of the business community.<sup>95</sup> However, stakeholders (government departments, private and professional associations and the general tax-paying public) were not adequately engaged in the development of both the income tax proclamation and regulation. The absence of adequate representation (for example, of the employees and the business community) and expert opinion would frustrate the implementation of the income tax reforms. For instance, when the 2017 reassessment results of the average

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<sup>91</sup> Misganaw *supra* note 43.

<sup>92</sup> *Id.*

<sup>93</sup> Interview with Mesfin, *supra* note 59.

<sup>94</sup> *Id.*; Interview with Boshe, *supra* note 77.

<sup>95</sup> *Id.*

daily sale of category ‘C’ were announced, they produced a tremendous uproar from taxpayers, and lack of advance consultation with the taxpayers or their representatives about the process was one of the main contributing factors.<sup>96</sup> In an interview with the authors, the Senior Policy Analyst at the Ethiopian Chamber of Commerce and Sectoral Associations, Teklewengel Kasaye, explained that although the chamber of commerce was invited to the discussion on the draft income tax laws, many of the comments the chamber suggested are not included in the final bill.<sup>97</sup> Of course, one of the lacunas in this regard is that there is no national law or policy that defines the stakeholders and their roles and responsibilities in tax reform projects. So, at least on article, it is possible to understand that the MoF assumes a disproportionately greatest responsibility in the initiation, design and legislating tax reforms.

#### **4. Major Legislative Changes of the 2016 Income Tax Reforms**

The 2016 tax reforms have resulted in Income Tax Proclamation No. 979/2016,<sup>98</sup> Income Tax Regulation No. 410/2017,<sup>99</sup> Tax Administration Proclamation No. 983/2016,<sup>100</sup> and Tax Administration Regulation No. 407/2017.<sup>101</sup> Though this reform has brought several legislative changes, this section is dedicated to pointing out only the major ones. In addition, even if

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<sup>96</sup> Amanuel Mekonnen *et al.*, Where the Gap Lay: Presumptive Income Tax Assessment for Small and Micro Enterprises in Addis Ababa City Administration, ICTD Working Paper 94, 2019.

<sup>97</sup> Interview with Teklewengel Kasaye, Senior Research and Policy Analyst, Ethiopian Chamber of Commerce and Sectoral Association, (June 29, 2022).

<sup>98</sup> Income Tax Proclamation No. 979/2016, *supra* note 55.

<sup>99</sup> Federal Income Tax Regulation No. 410/2017, Federal *NegaritGazeta*, (2017) [here in after Income Tax Regulation No. 410/2017], as amended by the Federal Income Tax Regulation (Amendment) No. 485/2021, Federal *Negarit Gazeta*, (2021).

<sup>100</sup> Tax Administration Proclamation No. 983/2016, *supra* note 56.

<sup>101</sup> Federal Tax Administration Regulation No. 407/2017, Federal *Negarit Gazeta*, (2017).

several directives are issued by the MoF following the reform, the discussion focused at changes made at the Proclamation and Regulation level. The discussions are structured into three sub-sections: new introductions; the changes and improvements made on the pre-existed prescriptions; and the changes in the income tax administration.

#### **4.1. New Introductions to the Income Tax System**

The repealed income tax proclamation was criticized for failing to capture income sources that are not explicitly or implicitly mentioned in the individual income tax schedules.<sup>102</sup> No provision focused on the taxation of residual income. To curb this limitation, the new income tax proclamation, under Art 63 obliges any person who derives any income that is not taxable under Schedules ‘A’, ‘B’, ‘C’, or other provisions of Schedule ‘D’ to pay income tax at the rate of 15% on the gross amount of the income.<sup>103</sup>

The new income tax proclamation also introduced a tax on new income sources thereby widening the tax base. Income from international air transportation business of non-residents; Ethiopian source dividend, interest, royalty, management fee, technical fee, or insurance premium derived by non-residents; income received by non-resident entertainers; repatriated profit; undistributed profit;<sup>104</sup> and foreign currency exchange gains<sup>105</sup> are among the new tax bases.

The introduction of Schedule ‘E’ is another new development that increases the number of existing schedules to five. This Schedule is dedicated to list

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<sup>102</sup> Taddese Lencho, *The Ethiopian Income Tax System: Policy, Design and Practice*, PhD dissertation, University of Alabama, (2014), p. 265.

<sup>103</sup> Income tax Proclamation No. 976/2016, *supra* note 55, Art 63.

<sup>104</sup> See *id.*, Arts 50-53 and 60-63.

<sup>105</sup> Income Tax Regulation No. 410/2017, *supra* note 99, Art 44.



down incomes that are exempted from taxation under Schedules ‘A’, ‘B’, ‘C’, and ‘D’.<sup>106</sup> The incomes listed in the Schedule or those treated as exempted, do not make the tax base of any schedule, hence, not part of the gross income.<sup>107</sup> Thus, an income that neither falls in the exemption list nor satisfies the conditions for exemption under Schedule ‘E’ should be regarded as part of gross income. For instance, when it states “a contribution made by an employer to employee’s pension not exceeding 15% of the monthly employment income of the employee is exempted”, it is also saying that a contribution beyond this threshold is a taxable income.

It is not common to design a separate income tax schedule just to list down exempt income sources. The official at the MoR explained to the authors that Schedule ‘E’ is introduced with the premise that the consolidation of exempted income sources under a single schedule will enable taxpayers to easily understand the tax laws/ensuring simplicity.<sup>108</sup> However, one may argue that stating the applicable exemptions under each schedule rather is more easily understandable than collecting the exemptions of all income tax schedules in a single basket.

The other new introduction is the treatment of micro-enterprises as individual taxpayers, to determine the applicable tax rate and duty to keep books of accounts.<sup>109</sup> Accordingly, even if micro enterprises are by definition ‘body’ under Schedule ‘C’, in assessing their income tax liability, the applicable rate is not the 30% flat rate applicable to ‘body’ taxpayers, but the progressive rate applicable to individual taxpayers. The new law intends to encourage the

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<sup>106</sup>Income Tax Proclamation No. 979/2016, *supra* note 55, Art 65; See also *id.*, Art. 54.

<sup>107</sup> See *id.*, Arts 12 (2), 15 (4), 21 (2) and 64 (1) (b).

<sup>108</sup>Interview with Mesfin, *supra* note 59.

<sup>109</sup>Income Tax Proclamation No. 979/2016, *supra* note 55, Art. 19 (3); Income Tax Regulation No. 410/2017, *supra* note 99, Art 48

enterprises' business growth by exempting them from the 30 % flat rate. Since the enterprises are regarded as individual taxpayers, the type of books of accounts that shall be kept by them varies depending on their annual turnover. Such positive and differential treatment of the micro-enterprises is a good move as it helps these enterprises reduce their compliance cost by allowing them to use simplified bookkeeping and also encourages their business growth by exempting them from the 30 % flat rate.<sup>110</sup>

#### **4.2. Major Amendments on the Previous Income Tax Provisions**

Both the repealed and current income tax proclamations provided seven tax brackets for taxpayers of Schedule 'A' and individual taxpayers of Schedules 'B' and 'C'. The first bracket being the floor exemption, the remaining six brackets constitute taxable amounts to be charged with tax rates ranging from 10% to 35%. What is changed under the current Proclamation is that it came up with increased thresholds of exempted amounts. Accordingly, the floor exemption of employment income tax increased from birr 150 to 600; and for individual taxpayers of Schedules 'B' and 'C' from birr 1,800 to 7,200.<sup>111</sup> When it comes to the remaining six brackets, the current income tax Proclamation showed a substantial increase in the amounts in the brackets compared to its predecessor. For example, under Schedule 'A', the 10% tax bracket increased from birr 151-650 to birr 601-1,650; the 15% tax bracket increased from birr 651-1400 to birr 1,651-3,200.<sup>112</sup> For individual taxpayers of Schedules 'B' and 'C', the 10% tax bracket increased from birr 1,801-

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<sup>110</sup> Belete Addis, Characterization of Taxable Units and Tax Bases under the Income Tax Schedule 'C' of the Federal Income Tax Proclamation of Ethiopia: A Commentary, *Bahir Dar University Journal of Law*, Vol: 10, No. 1, (2019), pp. 93-94.

<sup>111</sup> Compare Income Tax Proclamation No. 286/2002, *supra* note 39, Arts 11, 15 (b) and 19 (2) (b) with the Income Tax Proclamation No. 979/2016, *supra* note 55, Arts 11, 14 (2) and 19 (2).

<sup>112</sup> Compare the repealed Proclamation, Art 11 with the current Proclamation, Art 11.

7,801 to birr 7,201-19,800; the 15% tax bracket increased from birr 7,801-16,800 to birr 19,801-38,400.<sup>113</sup> The increase in amounts in the tax brackets could be taken as progress made by the income tax reform of 2016. The amounts in the tax brackets on which tax rates are applied are increased from the previous ones.

The current income tax laws made no significant change when it comes to tax rates. However, Schedules ‘C’ and ‘D’ have introduced some noticeable changes. Under the repealed income tax system, mining and petroleum operations were taxed at a harsh flat rate of 35%.<sup>114</sup> Now, this rate is reduced to 25%,<sup>115</sup> which is intentionally made to encourage investors to engage in the sectors.<sup>116</sup> Previously, income from interest was a subject of taxation under three distinct situations.<sup>117</sup> Now, the new proclamation defines the term ‘interest’,<sup>118</sup> which was not the case previously, and broadens its reach by imposing a tax on interest from any source, even on loans between individuals. It also imposes a lower rate on income from deposits to encourage deposits and it favors deposits made in resident financial

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<sup>113</sup> Compare the repealed Proclamation, Arts 15 (b) and 19 (2) (b) with the current Proclamation, Arts 14 (2) and 19 (2).

<sup>114</sup> The Petroleum Operations Income Tax Proclamation No. 296/1986, *Negarit Gazeta*, (1986); the Mining Income Tax Proclamation No. 53/1993, *Negarit Gazeta*, (1993); and the Mining Income Tax (Amendment) Proclamation No. 23/1996, Federal *Negarit Gazeta*, (1996).

<sup>115</sup> Income Tax Proclamation No. 979/2016, *supra* note 55, Art 37 (3).

<sup>116</sup> Interview with a Senior Tax Expert, Ministry of Mining, (June 22, 2022).

<sup>117</sup> Interest accruing from deposit accounts taxable at the rate of 5% under Schedule ‘D’; interest paid to non-resident financial institutions recognized by the National Bank of Ethiopia as lending institutions taxable at the rate of 10%; and interest received by a Schedule ‘C’ taxpayer, such as banks and other financial institutions, from loans to others as part of its business taxable under Schedule ‘C’ as business income. See Income Tax Proclamation No. 286/2002, *supra* note 39, Art. 36; Income Tax Regulation No. 78/2002, Federal *Negarit Gazeta*, (2002), Art 10.

<sup>118</sup> Income Tax Proclamation No. 979/2016, *supra* note 55, Art.2 (16).

institutions. Interest from saving deposits is taxable at 5% (if deposited with a resident financial institution), Schedule ‘C’ taxpayers pay business income tax from their interest income while for other forms of interest the rate is 10%.<sup>119</sup>

Fringe or in-kind benefits are among the types of income sources that have been included both in the repealed and the existing income tax proclamations. However, they were not taxed during the enforcement period of the repealed proclamation of 2002 due to a lack of valuation rules and administrative limitations. The Council of Ministers failed to provide valuation mechanisms in the income tax regulation of that time although the income tax proclamation of 2002 mandated it to do so. The new change that the income tax reform of 2016 brought regarding fringe benefits is that the income tax regulation incorporated valuation rules for fringe benefits.<sup>120</sup> Thus, the introduction of detailed valuation rules for fringe benefits is one big step to broaden the tax base, raise more tax revenues, and ensure tax equity.

Another change under the current income tax proclamation is that it expands the scope of Schedule ‘C’ to include income from mining and petroleum operations. Though these operations were subjected to separate income tax regimes for a long time, the current income tax proclamation merges them with the other business income sources under Schedule ‘C’. It is important to note that though they share the provisions of Schedule ‘C’ with other business activities subject to Schedule ‘C’, there are also special rules concerning definitions, deductions, and tax rates applicable only to mining and petroleum operations.<sup>121</sup> The repealed independent mining and petroleum income taxes proclamation was criticized for its separate existence and high tax rate. Now,

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<sup>119</sup> *Id.*, Art. 56.

<sup>120</sup> Income Tax Regulation No. 410/2017, *supra* note 99, Arts 7-19.

<sup>121</sup> Income Tax Proclamation No. 979/2016, *supra* note 55, Arts 36 – 44.

these problems are solved by the consolidation of the separate regime with and reduction of the tax rate by the new income tax proclamation.

The repealed income tax laws were containing inconsistent provisions, contradictory versions between the Amharic version and the English Version, highly complex even for an academician, and lacking clarity on many parts. If we compare the current income tax laws with these, it is fair to say simplicity and clarity are one of the milestone accomplishments of the laws resulted from the 2016 income tax reforms. The new income tax proclamation has substantially reduced the problem by providing clearer, simple, and less complex legal provisions. For instance, compared with its predecessor, the new income tax proclamation came up with clear and detailed definitional provisions for income sources subject to Schedule 'D', which ease the characterization of taxable units and tax bases. For instance, the repealed income tax laws had no definition of 'dividend', hence, it was mandatory to cross-refer to the commercial code which in turn created several challenges.<sup>122</sup> The current Proclamation avoided this problem by providing a comprehensive definition of 'dividend', under Art 2 (6), which provides illustrative lists of distributions that will be considered as 'dividends' and also enable capturing 'fictitious dividends'. In addition, regarding taxation of 'royalty', the current Proclamation under Art 2 (20) came up with a relatively comprehensive list of assets whose exploitation results in the payment of royalties. For instance, it adds assets that were not included under Art 31 of the repealed income tax proclamation<sup>123</sup> but are widely used owing to the advancement of technology such as visual images or sounds or both transmitted by satellite, cable, optic fiber, or similar technology in connection with television, radio, or internet broadcasting. In addition, the new definition

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<sup>122</sup> Taddese, *supra* note 110.

<sup>123</sup> Income Tax Proclamation No. 286/2002, *supra* note 39, Art 31(5).

of royalty includes the supply of services rendered as per Article 2(20) (F) of the current proclamation. The current Proclamation also attempts to define ‘games of chance’<sup>124</sup> for the purpose of taxation of income from games of chance, which was not the case under the repealed income tax laws.

Changes are also made concerning taxation of ‘capital gains’. The current income tax proclamation classifies assets subject to capital gains taxation into two classes: Class ‘A’ comprising immovable assets and Class ‘B’ refereeing to shares and bonds and any interest in these.<sup>125</sup> By doing so, it widens the scope of assets subject to capital gains tax by adding bonds and any interest in shares or bonds, as well immovable assets other than building. Previously, buildings and shares of companies were the only assets subjected to this tax.<sup>126</sup> The income tax regulation also introduces inflation adjustment in computing the costs of the taxable assets, namely immovable assets, shares, and bonds.<sup>127</sup>

In terms of non-residents taxation, both the repealed and the current income tax Proclamation are inclusive of non-residents with respect to their Ethiopian source income.<sup>128</sup> However, the repealed proclamation had only one prescription about while the current proclamation came up with far clearer and expanded prescriptions. It has emerged with separate provisions regarding taxation of non-residents; Arts 51-53 and 62 of the Proclamation are exclusively dedicated to taxing non-residents. In addition to these provisions exclusively precluded for non-residents taxation, it is clear that non-residents derived ‘Ethiopian source’ employment income, rental income

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<sup>124</sup> Income Tax Proclamation No. 979/2016, *supra* note 55, Art 57 (4).

<sup>125</sup> *Id.*, Art. 59 (2) & (7); Income Tax Regulation No. 410/2017, *supra* note 99, Art 3.

<sup>126</sup> Proclamation No. 286/2002, *supra* note 39, Art. 37 (1).

<sup>127</sup> Income Tax Regulation No. 410/2017, *supra* note 99, Art. 56.

<sup>128</sup> Income Tax Proclamation No. 979/2016, *supra* note 55, Art 7 (2); Income Tax Proclamation No. 286/2002, *supra* note 39, Art 3 (2).

from buildings, business income, income from games of chance, income from the casual rental of asset, gains on disposal of certain investment asset, and other income are subject to taxation in Ethiopia.<sup>129</sup>

Regarding the rules of permanent establishment, the current proclamation has an improved and more detailed definition than its predecessor. For instance, while the repealed proclamation used the whole idea of permanent establishment as a definitional element of a resident taxpayer, the new proclamation considered the place of effective management as one alternative criterion to define a resident taxpayer of Ethiopia.<sup>130</sup> New business conducting manners that were not recognized as constituting permanent establishment by the repealed proclamation, such as furnishing of services, are introduced by the new proclamation.<sup>131</sup> This is an indication that the Ethiopian income tax proclamation has shifted from the OECD model to the UN model. The UN model tax treaty is known for favouring the source country principle. But, unlike the repealed proclamation, the OECD and UN model conventions, the new proclamation fails to mention those activities that do not constitute a permanent establishment.

The other major changes introduced by the income tax proclamation are the explicit inclusion and definition of important tax (accounting) concepts. These are acquisition of an asset, cost of an asset, consideration of an asset and net-book value of an asset, and disposal of an asset.<sup>132</sup> These concepts were not defined and explained in the former tax rules despite their relevance to calculate the taxpayer's taxable business income. The new proclamation, however, has provided detailed definitions and explanations for these

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<sup>129</sup> See *id.*, Arts 10 (1), 13 (1), 18 (1), 57 (1), 58 (1), 59 (1), and 63.

<sup>130</sup> *Id.*, Art 5(5); Income Tax Proclamation No. 286/2002, *supra* note 39, Art 5(4).

<sup>131</sup> *Id.*, Art 4(1) (2) and (3).

<sup>132</sup> *Id.*, Art 66-71.

concepts, thus making tax assessment less difficult than the previous one.<sup>133</sup> Stipulating what kinds of transactions constitute disposal, what kind of expenses are considered as a cost, and which payments are treated as consideration (income derived from the disposal of an asset) has important significance, including understanding the tax to be imposed on a gain derived from the disposal of business assets.

One important deviation of the new proclamation from the repealed one is the rules of deduction of taxable assets and business assets. The new proclamation unlike the repealed one differentiates assets as business assets and taxable assets and applies differing rules on how to deduct the loss incurred while disposing of the two things.<sup>134</sup> Concerning depreciation deduction, the new income tax regulation has modified the categories of depreciable assets and the existing straight line depreciation rates, introduced new diminishing value depreciation rates, and a 100% accelerated depreciation rate for category “B” taxpayers.<sup>135</sup>

Regarding the deductibility of interest expense, the new proclamation differs from the repealed one in the following aspects:<sup>136</sup> First, it allows a deduction only if the taxpayer has used the loan that gave rise to interest to earn the business income. Second, it denies a deduction for an interest that is paid to a related person. Third, it allows a deduction for interest beyond 2% of the rate between the National Bank of Ethiopia (NBE) and commercial Banks if the

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<sup>133</sup> *Gebi le-Limat*, *supra* note 57.

<sup>134</sup> Income Tax Proclamation No. 979/2016, *supra* note 55, Arts 21(3), (4) ((A and B) and 59 (3).

<sup>135</sup> Income Tax Regulation No. 410/2017, *supra* note 99, Arts 39-41.

<sup>136</sup> Compare Income Tax Proclamation No. 286/2002, *supra* note, Art 21(1)(e); Income Tax Regulation No. 78/2002, Art 10 with the Income Tax Proclamation No. 979/2016, *supra* note 55, Art 23.



lenders are financial institutions recognized by NBE and foreign Banks allowed to lend in Ethiopia.

### **4.3. Changes in the Income Tax Administration**

One of the most important changes introduced by the income tax reform of 2016 is the enactment, for the first time, of a tax administration proclamation dealing exclusively with administrative matters. A lot of changes are introduced due to the adoption of this proclamation. The most important change that came up with it is the consolidation/refinement of duplicated procedural provisions that were scattered among the numerous tax laws into a single document. Previously, similar procedural provisions were included in various tax proclamations and regulations. Now, they are merged into a single accessible legal document. The new tax administration proclamation, besides avoiding the scattered and duplicated procedural rules, has brought a lot of changes to the previous procedural rules.

It has also improved the ambiguity of former laws by including provisions for advance rulings, their legal status, their effect, and the procedure of making them.<sup>137</sup> The new income tax proclamation has solved the complexity and unclear nature of the former tax proclamation and regulation by defining important words and concepts which were previously unknown making the tax assessment process very tiresome and vague.

Institutionalization of the dispute settlement process was another achievement brought about by the new laws. The tax complaint committee which was formed as a simple ad-hoc committee is now upgraded into a permanent department within the tax authority composing professional dispute

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<sup>137</sup> Tax Administration Proclamation No. 983/2016, *supra* note 56, Arts 68-76.

settlers.<sup>138</sup> Appeal right to the higher courts is also made clear and undisputed process.<sup>139</sup> Unlike the previous laws, the new income tax law has made it clear to which level of court appeal can be lodged, and provided detailed rules on the appeal procedures, on organs responsible for entertaining the appeals, the time span to give decisions on appeals, the composition of the tax complaint hearing department. The law has made a great reform on the organization and working procedures of the Tax Appeal Commission and it has enabled it to be constituted by qualified personnel. The changes the reforms have brought regarding tax dispute settlement are among the most welcomed by the business community.<sup>140</sup>

The income tax reform of 2016 has also brought more taxpayer rights than the repealed ones as it introduced some taxpayer rights such as the right to get tax amnesty for calamities, the right to get an administrative ruling, etc. The advance payment mechanism is also another system that is introduced by the new income tax laws. Previously, there was no mechanism or procedure to make an advance payment. The new income tax proclamation, however, has provided the right to make advance payments and detailed procedures on how to effect the payment.

The new income tax proclamation has also introduced more general anti-tax avoidance rules that were absent in the previous income tax legislation. The only general rule available in the repealed proclamation was the transfer pricing rule. Even this rule was not detailed to prevent or at least reduce transfer mispricing activities. The new proclamation has provided more

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<sup>138</sup> *Id.*, Arts 51-60.

<sup>139</sup> *Id.*

<sup>140</sup> Interview with Teklewengel, *supra* note 97.

detailed and elaborate rules on transfer pricing and included two more provisions known as “income splitting” and “tax-avoidance schemes”.<sup>141</sup>

## **5. Constraints to the Success of the 2016 Income Tax Reforms**

In the preceding sections, discussions made regarding the drivers of the 2016 income tax reforms, and the main legislative changes, largely improvements it introduced. In this section, a discussion is made on selected constraints that may impede the reforms from meeting its intended goals. It is crucial to note that in no way the authors are saying these are the only constraints, but a highlight of some notable ones requiring serious attention. Most of the constraints discussed below are not new to Ethiopia’s income tax system or resulted from the 2016 income tax reforms, but continuing impediments.

First, though it has been over six years since the 2016 reforms have touched the ground, its impact is not yet studied. Have a scientific assessment of the pros and cons of the reforms as well as the real impacts it created, positive or negative, is a big milestone to decide what to do in the tax system. Doing so was specially expected from the MoF, as it is the principal responsible organ when it comes to tax reforms. But, so far, it has done nothing in this regard and it appears that it has no plan to do so.<sup>142</sup> The Ministry has also no guiding framework to assess the effectiveness and impacts of such reforms. Not only the MoF, but also the MoR has made no assessment of the reforms, except some piece meal studies about certain issues/aspects of tax.<sup>143</sup> Without studying the real impact, it is hard to tell the practical success stories of the reforms and the shortcomings to heal.

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<sup>141</sup> Income Tax Proclamation No. 979/2016, *supra* note 55, Arts 78-80.

<sup>142</sup> Interview with Boshe, *supra* note 77.

<sup>143</sup> Interview with Mesfin, *supra* note 59.

The other related problem related with the MoF is its structural lacuna for income tax reforms [tax reforms for that matter]. Despite the fact that the MoF is at the top tier for the design of the country's income tax system and its reform, its organizational structure is short of resembling it. The Ministry has no separate department and experts for tax research. It is also not active enough in updating/reforming the tax system/laws when the circumstances demand.<sup>144</sup> Thus, when planning for making positive changes in the tax system of the country, the utmost attention should be given to reforming the MoF itself. Specially, it should have a separate department for tax reforms and tax research, staffed with best minds who are allowed to have the expertise autonomy.

Thirdly, inflation is one of the main constraints that have been posing a big challenge to the tax system of the country. For instance, one of the drivers of the 2016 income tax reforms was to make the tax brackets responsive to the changes in the purchasing power of Birr, and the progress in the economy.<sup>145</sup> And in fact changes are introduced by increasing the thresholds for floor exemption and tax brackets.<sup>146</sup> However, the changes resulted from the reform are too insignificant compared to the existing cost of living, which is also a position the MoR shares.<sup>147</sup>

One of the mitigating solutions in this regard is to make timely update of the threshold of floor exemptions and tax brackets considering significant changes in cost of living. To do so, further reform of the whole income tax system may be proposed, but, making such reforms every five years is costly for a least developed country, like Ethiopia. Also making frequent reforms

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<sup>144</sup> *Id.*; Interview with Boshe, *supra* note 77.

<sup>145</sup> *Gebi le-Limat* interview with Wassihun, *supra* note 57.

<sup>146</sup> See discussion *supra* section 4.2, first paragraph.

<sup>147</sup> Interview with Mesfin, *supra* note 59.

can go against the basic canons of taxation, certainty. However, the authors believe that making adjustments of floor exemptions and tax brackets should not require a holistic reform of the income tax system, nor the income tax proclamation. Making a timely amendment of few relevant provisions of the income tax schedules can be sufficient. The tax laws as they currently appear have no indications for the possibility of making such changes and this need to be rectified. In answering when to update, two big considerations should be taken into account; a significant change of cost of living and the principle of certainty, the determination of which falls outside the expertise of the authors. But, for instance, in fixing the frequency of the update, we can start from related prescriptions of the income tax laws. For example, the Income Tax Proclamation prescribed a change of the annual gross income thresholds to categorize income taxpayers as category 'A', 'B' and 'C', at least within five years.<sup>148</sup> In addition, the daily sales estimation that used to determine the tax liability of category 'C' taxpayers is required to be revised/updated, at least every three years.<sup>149</sup> These stipulations are made to make the thresholds reflect the changes in the economy, and a change of these thresholds do not require amendment of the entire income tax laws or system. It is important to have similar stipulation for periodical update of floor exemption, tax brackets and tax rates considering the change in the economy. Tax laws should be dynamic or responsive to economic changes, of course, without forgetting other basic economic polices/tools that can better fight inflation.

The fourth main constraint that is impeding the realization of the intended goals of the 2016 income tax reforms is the problems with the tax administration. Despite a lot of improvements have made on the tax

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<sup>148</sup> Income Tax Proclamation No. 979/2016, *supra* note 55, Art 3 (3).

<sup>149</sup> Income Tax Regulation No. 410/2017, *supra* note 99, Art 49 (3).

administration laws,<sup>150</sup> the tax administration institution is still one is weak. In the context of Ethiopia, this concerns the MoR [and the revenue authorities at various level], as it is the principal organ to administer the tax laws of the country.<sup>151</sup> The Ministry is strangled with serious challenges such as poor [tax] information collection system, absence of efficient system to follow-up the activities and revenues of the taxpayers (due to which taxpayers are paying less than what they should have), and not well equipped to tax e-commerce.<sup>152</sup> This is also impacting the tax compliance rate. To the extent there is poor tax administration and weak data recording, the level of tax compliance will be also low.<sup>153</sup>

For Teklewengel, a senior policy analyst at the Ethiopian Chamber of Commerce and Sectoral Associations, as long as the tax administration continues to be bureaucratic, dependent on manual operation which require physical meeting of the taxpayer and the administration and not replaced with e-tax, the reform is far from being complete for the business community.<sup>154</sup> He also raised the problem with tax audit where the revenues authorities at various levels have poor culture of timely/immediate auditing of the books of accounts of taxpayers when they are provided with.<sup>155</sup> The authorities collect the tax based on what is stated in the books of accounts, and then after years they will audit the books and require taxpayers to pay accumulated tax. According to him, tax auditing should be undertaken timely, when the books are presented and related to this there is a need to ensure the country-wide application of the already started accounting system of IFRS (as it will

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<sup>150</sup> See discussion *supra*, section 4.3.

<sup>151</sup> Tax Administration Proclamation No. 983/2016, *supra* note 56, Art 5.

<sup>152</sup> Interview with Mesfin, *supra* note 59.

<sup>153</sup> *Id.*

<sup>154</sup> Interview with Teklewengel, *supra* note 97.

<sup>155</sup> *Id.*

contribute to alleviate the problems associated with the books of account record).<sup>156</sup> The way the average daily revenue estimation is being administered is also too manual, unfair, and highly susceptible for corruption/abuse which is negatively affecting the small businesses/category ‘C’ taxpayers.<sup>157</sup>

The tax administration lacuna is also reflected with taxation of fringe benefits. Though the reform has come up with detailed prescriptions of taxation of fringe benefits, these benefits are not taxed as prescribed. The MoR Research and Development Director raised two basic reasons for this.<sup>158</sup> The first relates with lack of administrative capacity and established system to trace fringe benefits employers provided for employees, as well as to make valuation of the benefits in monetary terms. The second relates to fringe benefits provided to higher government officials. If the benefits are valued in monetary terms, they will highly exceed their monthly salary in that if asked to pay taxes on the fringe benefits, their salary will not be enough.<sup>159</sup> The authors found the second reason not convincing not to tax the fringe benefits payable to higher government officials, as they are easily traceable. What is rather more worrisome is that gaining such excessive fringe benefits, these officials are not taxed enough as the amount of tax liability from fringe benefits is capped at 10% of the monthly salary of the employee.<sup>160</sup> Thus, what should be in order is the need to revisit this prescription for the sake of vertical equity.

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<sup>156</sup> *Id.*

<sup>157</sup> *Id.*

<sup>158</sup> Interview with Mesfin, *supra* note 59.

<sup>159</sup> *Id.*

<sup>160</sup> Income Tax Regulation No. 410/2017, *supra* note 99, Art 19.

Moreover, due to weak tax administration, taxation of ‘other income’ under Article 63 of the Income Tax Proclamation is a rare practice, if not absent. Though bringing residual income sources to the income tax net and thereby widening the tax base was one of the drivers of the reform, the implementation seems not to meet this objective. Officials and tax officers at the MoR revealed that no source has collected as ‘other income’ since the reform, at least to their knowledge, and they also believe that the low level revenue authorities may not have even the know-how about it.<sup>161</sup> The MoR may take this as an indication in that there is a need for intensive awareness creation about Art 63 of the Proclamation to its officers at various levels.

In conclusion, unless there is a strong institution to implement the substantive prescriptions, making income tax reforms now and then would make no meaningful impact. The problems in the tax administration, among other things, necessities for digitalizing the tax administration, staffing the tax administration institutions with officers equipped with the knowledge and skill required for efficient tax administration.

The fifth problem is lack of meaningful stakeholder representation/participation during tax reforms and/or enactment of tax laws. Though the representative of chamber of commerce and sectorial associations were invited to take part in the 2016 reform process by providing their comments on the draft income tax laws, the recommendations/opinions were not incorporated.<sup>162</sup> This makes the participation merely symbolic. Unless the voices of the business community are given place or reflected in the final

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<sup>161</sup> Interview with Mesfin, *supra* note 59. Interview with Thsegaye Bitew, Tax Education Officer, Ministry of Revenues, Bahir Dar Branch (July 2, 2022); Interview with Getaneh Dagnaw, Tax Assessment Officer, Ministry of Revenues, Bahir Dar Branch (July 2, 2022); and Interview with Yilkal Garde, Legal Officer, Ministry of Revenues, Bahir Dar Branch (July 2, 2022).

<sup>162</sup> Interview with Teklewengel, *supra* note 97.



legislations, it is hard to say they are represented, and the potential consequence is continuing non-compliance and confrontational relation between the taxpayers and the revenue authority.

Finally, we may raise the low tax-to GDP ratio as another continuing concern of Ethiopia's income tax system. Even if the amount of revenue from income tax increases from year to year, it is very low compared to the amount of revenue the economy generates, as the tax-GDP ratio of the country is below 10% which is low even in the standards of the sub-Saharan African countries.<sup>163</sup> This is tempting to conclude that the reform has failed in one of its objective, i.e., enhancing the income taxation so as to improve the status of the revenue from income tax to support the economy, as its contribution to the economy of the country was seen as minimal at the time.<sup>164</sup> This is the reflection of the tax administration's failure to collect all taxes as prescribed. Thus, solving the tax administration challenges discussed above is the key to make a positive change in this regard.

### **Concluding Remarks**

This research article tried to examine the 2016 income tax reforms of Ethiopia, in terms of its drivers, actors' involved in the process, major legislative changes it introduced and some constraints that may shadow the reforms intended successes. In this regard, the main drivers the reforms are identified as changes in the economy, enhancing revenue mobilization efforts, building up efficient and equitable tax reform, and addressing gaps in previous income tax legislations. In the reform process, several actors have

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<sup>163</sup>World Bank, Tax revenue (% of GDP): Ethiopia, (2020), <https://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS?locations=ET> (accessed Nov. 22. 2021).

<sup>164</sup> *Gebi le-Limat* interview with Wassihun, *supra* note 57.

taken part, though; the role of MoF and IMF is very noticeable, while other relevant national actors had a negligible involvement.

The tax laws resulting from the reforms have introduced many legislative changes, including the introduction of Schedule 'E' (to list exempt incomes); detailed regulation of non-residents and fringe benefits taxation; addition of new income tax bases; explicit taxation of residual income sources; increment of the thresholds for floor exemption and tax brackets; and several improvements of in procedural matters that includes consolidation of the administration laws, introduction of advance ruling, institutionalization tax complaint hearing committee, and detailed prescription for the Tax Appeal Commission.

However, there are also several constraints that need serious attention and solution if we wish to see the realization of the goals of the reforms. In this regard, the article highlighted the absence of impact assessment of the 2016 income tax reforms; the institutional lacunas at MoF to handle issues of tax reforms; lack of prescription under the tax laws to make the tax system responsive to inflation; the much troubled, bureaucratic, and weak revenue authority; lack of meaningful stakeholder participation; and low tax-to GDP ratio.

Based on the findings, the authors forwarded the following recommendations:

- The MoF should undertake scientific impact assessment of the 2016 income tax reforms, as soon as possible. The Ministry should also establish a separate department for tax research and reforms, and staffed with the best minds on the subject matter;

- The tax laws should be devised to have a system of periodical update of the floor exemption, tax brackets and tax rates considering the change in the economy [without a need to wait another income tax reform];
- The government should take action to improve the tax administration system and capacity of the MoR [and its subordinate revenue authorities], including digitalizing the administration, staffing with qualified officers, employing objective criteria for average daily revenue assessment, timely tax auditing, and design effective system of data management/recording or tax information.
- The government should opt for meaningful participation of stakeholders in reforming the tax system or enactment of tax laws than the accustomed symbolic forums; and
- Exploiting the abundant inputs forwarded by previous studies and qualified experts, the government should devise tenable tools so as to improve the tax-GDP ratio of the country.

