Tax Expenditure Report for 2018/19 FY

Ministry of Finance

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Contents

Introduction

The Ethiopian tax system provides for many tax and duty concessions aimed at enhancing the socio-economic development of the country. Specifically, tax and duty concessions intend to enhance the development of selected priority sectors, regions, economic activities or groups of beneficiaries and to increasethe affordabilityof certain commodities. Tax and duty concessions in Ethiopia take various forms including: exemptions and reduced rates of customs duty; income tax exemptions (tax holidays), extended loss carry-forward, and reduced rates of income tax for mining and petroleum operations; and exemptions from VAT, excise duties, and surtax, among others. While tax and duty concessions intend to realize the government's socio-economic development objectives, they also result in reduction of tax liabilities for taxpayers and, hence, in the government's revenues.

The reduction (or loss) of government revenue due to different tax and duty concessions is considered as 'tax expenditure'[1]. Tax expenditures are like public expenditures; in some circumstances they could be used as alternatives to direct transfers from the government. However, unlike public expenditures, which are subject to thorough scrutiny, monitoring and controlling, tax expenditures usually remain unevaluated. This practice is likely to compromise the transparency of the country's financial governance and the proper allocation of public funds. This is one of the reasons for the need to measure and report tax expenditures periodically and take correction measures, where required.

Tax and other related legislation in Ethiopia does not provide for the requirement to estimate and periodically report tax expenditures. Nonetheless, it is good practice to provide public accountability for all public expenditures, including those undertaken through the tax system. This is the first official tax expenditure report prepared in Ethiopia, with the objectives of serving as a point of reference in further scrutinizing the efficiency of tax expenditure items granted under different tax and non-tax laws; and

[1] The definition of tax expenditures in Ethiopia is provided in the latter section

establishing the practice of periodically measuring and reporting tax expenditures and enhancing transparency in Ethiopia's financial governance. The report also aims at serving as a common reference to all interested in the subject.

Tax concession decisions should be viewed as a trade-off between their costs and benefits. Cost -benefit analysis of tax concessions is beyond the scope of this report, but will remain under review by the Government. The report focuses on estimating tax expenditures (tax revenues foregone).The report includes tax expenditures by tax type: custom duty, VAT, excise taxes, surtax and income tax. All taxes are covered in this report; however, relatively detailed discussion is provided for tax expenditures on international trade taxes and duties for these have better quality data than domestic taxes.

The report covers a three-year period (2016/17 to 2018/19), based on three years' import data obtained from Customs Commission. In addition, the report uses past studies on tax expenditure estimation in Ethiopia including World Bank Group (WBG)(2017a), WBG (2018a), WBG (2019) and IMF(2018).

The report is organized in five parts. The first part presents the definition of tax expenditures and the benchmark tax system. This is followed by a discussion of the methods and assumptions in estimating tax expenditures in Ethiopia in part two. Part three presents tax expenditure estimates. Finally, recommendations and conclusion are presented in parts four and five respectively

Part I: Definitions of the Benchmark Tax System and Tax Expenditures

The Benchmark Tax System includes the standard rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax administration, and international fiscal obligations(see for example, Kraan (2004 as cited in OECD 2010), Krelove et al (2012), CRC Sogema(2013)).

Tax Expenditures (TE)[2]: are provisions of tax laws, regulations or practices that reduce or postpone tax liability for a selected population of taxpayers relative to a benchmark tax structure. They represent revenue forgone compared to revenue collections under the benchmark system and are applied based on provisions in the tax legislation.Any deviation from the benchmark tax system is treated as part of tax expenditures. In Ethiopia, tax expenditures may take the form of exemptions, deductions, allowances, and reduced rates under such tax legislation as income tax, VAT, turnover tax (ToT), custom duty, surtax, and excise taxes.

Different tax and non-tax laws provide the basis for defining the benchmark tax system and tax expenditures in Ethiopia. Laws governing the granting and administration of tax expenditures in Ethiopia include:

- Investment Proclamation 769/2012 (as amended by proclamation 849/ 2014) and investment incentives and investment areas reserved for domestic investors Council of Ministers Regulations 270/1012 and 312/2014;
- Mining Proclamation 678/2010 (as amended by Proclamation 816/2014), and Petroleum Operations Proclamation 295/1986;
- Cooperative Societies Proclamation 147/1999;

[22]Tax expenditure exists when: it implies a reduction of tax revenue (tax liability); it results in deviations from a standard/benchmark tax structure in a given country; it targets a particular group of taxpayers or economic activity; and/or it could be replaced by direct spending (WBG 2017a).

- ERCA (MoR) directive 79/2013 governing the tax and duty relief given to charities and societies established in accordance with Charities and Societies Proclamation 621/2009;
- Export trade duty incentive proclamation 768/2012 and ERCA's (MoR) directive 86/2013;
- Customs Proclamation 859/2014, the Council of Ministers Customs Tariff Regulations (as amended), and MoF (MoFEC)'s directives 35/2005;
- Councils of Ministers Import Surtax Regulations No. 133/2007;
- Income Tax Proclamation 979/2016 and Council of Ministers Regulations 410/2017 and directives issued by MoF (MoFEC) and MoR (ERCA);
- Value Added Tax Proclamation 285/2002 (as amended) and Council of Ministers Regulations 79/2002 and different directives issued by MoR (ERCA) and MoF (MoFEC);
- Turnover Tax Proclamation 308/2002 (as amended) and related directives; and
- Excise Tax Proclamation 307/2002 (as amended).

The following subsections present the definition of the benchmark tax system under each of the relevant tax regimes in Ethiopia.

1.1. Income taxation

The benchmark tax under both personal or individual and company income tax is assumed to include the following:

- the tax unit is the individual (physical person) and company or body (legal person);
- taxis imposed on a calendar year or fiscal year basis (and monthly for employment income tax);
- income tax rates are taken as given (10% to 35% for individuals and 30% for bodies);

- taxable business income is gross income reduced by allowable costs of earning income;
- the regular rates of taxes under schedule D income;
- residents are taxed on worldwide income, non-residents on income sourced from Ethiopia;
- exemptions provided for persons subject to diplomatic privileges on a reciprocal basis (under international obligations);
- exemption of Ethiopian Birr (ETB) 650 per month from employment income tax and ETB 7200 per annum from business profit tax and building rental income tax by individuals;
- taxation of micro (category C) taxpayers under a separate presumptive regime;
- exemption of the following:
    - income of persons employed for domestic duties;
    - transport allowances and similar other allowances (reimbursable business expenses);
    - maintenance or child support;
    - gifts and inheritance;
    - income of non-profit activity; and
    - pension benefits.

1.2. Value Added Tax and Turnover Tax

The benchmark VAT (ToT) structure in Ethiopia is suggested to include the following:

- the tax unit is a registered person;
- the tax is imposed on a calendar month basis and quarterly for relatively small VAT registered taxpayers;
- tax rates are 15% and zero rate on exports;
- financial services are exempted (administrative difficulty justifies their exemption);

- registration threshold is ETB 1 million (annual turnover) (facilitating administration justifies the exclusion of businesses with annual turnover below the registration threshold);
- turnover tax for those with annual turnover less than ETB 1 million (tax rates 2% for goods and 10% for services (with some exceptions)).
- destination based taxation of cross border transactions;
- reliefs under international obligations (including diplomatic privileges);
- exemption of the following goods and services:
    - import or supply of books;
    - supply or import of national or foreign currency (except for that used for numismatic purposes), and of securities;
    - rendering by religious organizations of religious or church related services;
    - supplies by the post office authorized under the Ethiopian Postal Services Proclamation, other than services rendered for a fee or commission;
    - permits and license fees;
    - public transport;
    - travel agents (in respect of the services in selling air tickets);
    - prescribed drugs and medical services

1.3. Customs duty

Customs duty has five bands of positive rates chargeable at Cost, Insurance and Freight (CIF) value of imported items. The rates are: 5%, 10%, 20%, 30%, and 35%. In addition, there are import duty free items.[3] WBG(2017a) classifies imported goods into three categories as:

- Items imported for public use, raw materials that are imported for productive purposes such as agricultural inputs, capital goods, and semi-finished goods. Rates are 0 (duty free) to 20%.

[3] WBG (2017a) considers customs duty free items as zero rated making the total number of duty rates six.

- Consumer goods imported for personal use and for non-productive purposes (rates are in the range 20% to 35%).
- Luxury goods and goods that can be produced locally (30% to 35%)

The benchmark customs duty structure includes:

- Duty is charged on all imported goods except reliefs granted under international obligations; the benchmark customs duty structure includes also privileges granted on goods originating from COMESA member states.
- Import duty exemptions (import duty free) and import duty rates (ranging between 5 and 35 percent) as under the first tariff schedule are part of the benchmark duty structure.
- Alternatively, to deal with data quality issues, 30 percent duty rate is assumed to apply to all duty chargeable imported items excluding those that are duty free (as under the first tariff schedule) and that are chargeable at 35 percent.

1.4. Excise Taxation

Excise taxes are imposed on 19 selected items. It is imposed on both imports and local production. Production cost, and the sum of cost, insurance and freight (CIF) value and duty paid are the bases for excise tax on local production and imports respectively. Excisable items include sugar, salt, beverages (alcoholic and nonalcoholic), petroleum and petroleum products, tobacco and tobacco products, automobiles, and textile and textile products, among others. Excise taxes are imposed at rates ranging from 10 to 100 percent; these are considered as the benchmark rate structure. Excise tax exemptions granted by the MoF as per the provisions of the excise tax legislation are beyond the benchmark tax system.

1.5 Surtax

Surtax is levied on goods imported into Ethiopia. It is chargeable at 10 percent onthe aggregate CIF value, custom duty, VAT and excise tax payable on imported goods. The benchmark surtax system includes the 10 percent rate structure and exemptions granted on duty free imports (as under the first tariff schedule) and those under international agreements.

Deviations from the above described benchmark tax and duty structures are considered as tax expenditures.

Part II: Assumptions and Methods

There are assumptions made in the identification of the benchmark tax system, tax expenditures and estimation procedures. Some of the assumptions are made to simplify the calculations.

The main assumptions in the identification of the benchmark tax system include: the benchmark tax system in Ethiopia is defined to include the standard rate structure, accounting conventions, deductibility of compulsory payments, provisions to facilitate tax administration, and international fiscal obligations. Based on this,tax expenditure (TE) is defined to include all deviations from the benchmark tax system reflecting the above features.

TEsare calculated using the revenue forgone method[4,5] which calculates the tax that would have been payable if tax concessions were removed, and economic behavior and revenues from other taxes remained unchanged. In other words, TE estimation does not consider the second-round effects (positive and negative) of removing tax expenditures on other tax bases, and of changing taxpayers' behavior. The estimation of TEs in this report is, therefore, based upon a comparison of the existing legislation and the legislation without the tax concession in question.[6]

[4] The revenue foregone method is most commonly used method (IMF 2012).
[5] Details about the methods used under each tax type are provided in appendix 1.
[6] It is an ex-post measure of the cost of a particular relief. This method estimates tax expenditures one at a time. It does not account for the change from removal of one provision resulting in increased use of other provisions, lowering tax revenue elsewhere. In addition, this method does not consider the removal of tax expenditures that may result in some taxpayers changing behavior (IMF 2012).

Data from ASYCUDA++ and eCMS of Customs Commission were used to estimate revenue foregone through exemptions and reduced rates under different taxes and duties on imports. The dataset contains, among others, taxes and duties assessed and collected, tax and duty rates applied, CIF values, HS codes, a seven-digit Customs Procedure Codes (CPCs)[7], and description of imported items. The import data were merged with statutory tariff rates 2012 (first schedule tariff rates). In merging the two datasets, some observations were found to be unmatched. For example, from the 2018/19data, about 1000 observations were found to be unmatched. This may reduce the reliability of data obtained from Customs Commission; it also suggests the importance of exercising caution in examining the estimates.

Part III: Tax Expenditure Estimates

As noted earlier, in estimating tax revenue foregone due to concessions on border taxes, three years' transaction level import data from Customs Commission were used.

Table 1 shows the breakdown of tax expenditures on border taxes among revenue sources and total tax and duty revenue foregone as a share of GDP. Total tax and duty revenue foregone on international trade as a share of GDP shows a declining trend overtime. In 2017/18, tax revenue foregone on border taxes as a share of GDP was estimated at about 4.37 percent. The ratio declined to 2.74 percent of GDP in 2018/19. Past studies including WBG (2017a), WBG (2018a) and WBG (2019) also documented varying estimates of tax expenditures on border taxes and duties and all taxes (in some circumstances). In particular, WBG (2017a) reports a fluctuating border tax expenditure to GDP ratio over time, but a decline in the ratio from 2015 to 2016. The average tax expenditure (including revenue foregone on withholding taxes) as a share of GDP for the period 2012 to 2016 estimated to be about 4.4 percent (WBG 2017a). The comparison, however, should be with caution because there are differences in the

[7] The last three digits in CPCs (additional procedure codes (APC)) show the institutions importing the goods and applicable taxes as per the relevant legislation.

approaches followed in this report and those in WBG (2017a). The differences are in terms of the types of tax expenditure items included and estimation of revenue foregone due to reduced duty rates.[8]

In addition, Table 1 provides tax and duty revenue foregone estimates, under reduced duty rates, using a standardized duty rate of 30 percent. Under this scenario, total border tax and duty revenue foregone as a share of GDP is estimated to be nearly 3.81 percent in 2018/19; this is a decline from 5.61 percent in 2017/18.

Overtime, a declining trend in tax expenditures on border taxes is noted. This declining trend could be explained in part by the decrease in the volume and value of imports which, in turn, appeared to be because of a foreign exchange shortage. For example, as import data obtained from Customs Commission reveal, the volume and value of imports declined from 2017/18 to 2018/19 by about 12 percent and 7.7 percent respectively.[9] The decline is also as a result of the government becoming stricter in granting additional exemptions and incentives. For example, MoF used to give tariff exemptions on quarterly basis, however this has stopped since 201718 as learnt from tax policy directorate.

[8] WBG (2017a) uses 35 percent as the standard rate and estimates duty revenue foregone due to reduced rates on that basis.
[9] Between 2017/18 and 2018/19, CIF value of imports declined from ETB 465 billion to ETB 429 billion. Similarly, quantity of imported items declined from 13.8 billion KGs to 12.1 billion KGs.

Table 1: Overview of tax expenditure (revenue foregone)* on border taxes

	2016/17				2017/18				2018/19			
Description (amounts in Million ETB)	Revenue Foregone	%age share in total	%age share in GDP	%age share in GDP**	Revenue Foregone	%age share in total	%age share in GDP	%age share in GDP**	Revenue Foregone	%age share in total	%age share in GDP	%age share in GDP**
Import Duty Exemption***	27,400.00	26.39%	1.50%	1.50%	22,500.00	23.37%	1.02%	1.02%	15,800	21.39%	0.59%	0.59%
Import Duty Reduced rates*^	1,840.00	1.77%	0.10%	1.51%	1,993.00	2.07%	0.09%	1.33%	3,100	4.20%	0.11%	1.18%
VAT Exemption (Import)	46,074.16	44.37%	2.51%	2.51%	45,800.00	47.56%	2.08%	2.08%	36,800	49.82%	1.36%	1.36%
Excise Tax Exemption (Imports)	4,721.02	4.55%	0.26%	0.26%	5,210.00	5.41%	0.24%	0.24%	2,920	3.95%	0.11%	0.11%
Import Surtax Exemption	23,800.03	22.92%	1.30%	1.30%	20,791.00	21.59%	0.94%	0.94%	15,240	20.63%	0.57%	0.57%
Total	103,835.21	100.00%	5.67%	7.07%	96,294.00	100.00%	4.37%	5.61%	73,860	100.00%	2.74%	3.81%
GDP at current market prices	1,832,554				2,202,373				2,696,223			

Notes: *Revenue foregone is estimated as the difference between revenue assessed (including recalculated revenue to be collected) and revenue actually collected.
** figures under these represent revenue foregone as a share of GDP using 30 percent as a standard rate for the estimation of revenue foregone due to duty reduced rates
*** The data on duty rate applied on palm oil for 2016/17 is blank in the dataset; and the duty to be paid and duty paid for this is reported to be zero. On the other hand, data for 2018/19 shows data for duty to be paid; this is determined by applying 30 percent on the CIF value of palm oil.
*^Revenue foregone through duty reduced rates is estimated using the statutory rates (5 to 35%) as under the 2012 first tariff schedule.
*^^ This includes recalculated VAT revenue foregone by applying 15% on CIF value plus duty assessed and excise tax assessed. The recalculation is done for those imports for which VAT assessed and VAT collected were reported to be zero while the goods are VATable.
Source: Ministry of Finance, Customs Commission and own estimates

Due to limited data available, this report does not attempt to estimate tax expenditures on domestic taxes. However, according to past studies, tax expenditure on business income tax (tax holidays) and domestic VAT were estimated to be lower than that of international trade taxes. Specifically, apart from estimating border tax expenditure, WBG (2019) attempted to estimate tax expenditure on business income tax (tax holidays)[10]. According to this study, tax expenditure on business income tax (tax holidays) as a share of GDP ranged from 0.24 percent to 0.6 percent from 2012 to 2015.

WBG (2018a) estimated tax expenditure on domestic VAT; as a share of GDP, domestic VAT expenditures in Ethiopia averaged 1.9 percent over the period 2005/06 through 2015/16 (WBG 2018a). WBG(2019), building on WBG (2018a), also reported domestic VAT expenditure as a share of GDP ranging from 1.12 percent (2012) to 1.61 percent (2016); the average share in GDP being 1.57 percent (WBG 2019). IMF's (2018) estimates of business income tax (tax holidays) revenue foregone were found to be in the range of 0.1 percent and 0.16 percent of GDP over the period 2014 to 2016.

While this report does not estimate revenue foregone on domestic taxes, assuming IMF (2018), WBG (2018a) and WBG's (2019) estimates of tax revenue foregone on business income tax and domestic VAT would hold, the total tax expenditure for 2018/19 is highlighted in Table 2.

Table 2: Tax Expenditure Estimates for 2018/19

Descriptions	**Tax expenditure Estimates (in million ETB)**	**Share in GDP**
Duty exemption	15,800	0.59%
Import duty rate reduction	3,100	0.11%
VAT exemption (imports)	36,800	1.36%
Excise tax exemption (imports)	2,920	0.11%
Surtax exemption	15,240	0.57%
Total tax expenditure on border taxes	73,860	2.74%

[10] In estimating tax expenditure on business profit tax (tax holiday) WBG (2019) employed mainly Large and Medium Manufacturing (LMM) Enterprises Survey and past studies such as IMF (2018).

TE Business income tax (tax holidays) (IMF estimates; average for 2014 to 2016)		0.13%
TE Business income tax (tax holidays) (WBG estimates; average for 2012 to 2016)		0.4%
Domestic VAT expenditure (WBG estimates)		1.9%(1.57%)*
Total tax expenditure (with IMF's estimated TE BIT) **		4.77%(4.44%)^*
Total tax expenditure (with WBG's estimated TE BIT)**		5.04%(4.71%)^*

Notes: * 1.9% is the average Domestic VAT expenditure for the period 2005/06 to 2015/16 (WBG 2018a) and 1.57% is estimated average Domestic VAT expenditure for the period 2012 to 2016 (calculated based on WBG 2019)

**total estimated tax expenditure for 2018/19 does not include domestic excise, turnover tax and personal income taxes, reduced rate (for the extractive industry), and loss carry forward, among others.

^* figures in parenthesis are based on average Domestic VAT tax expenditure of 1.57% of GDP.

Source: Customs Commission, Ministry of Finance, WBG (2018a), WBG (2019),IMF(2018), and own estimations

Considering first tax expenditures that include IMF's estimates for business income tax, we see that the overall revenues foregone make up around 4.44 percent to 4.77percent of GDP. Secondly, using WBG's estimates of domestic tax expenditures, the total revenue foregone is estimated to be in the range of 4.71 percent to 5.04 percent (Table 2). However, caution should be exercised in using these estimates because, in particular, business income tax figures used to produce these numbers have data limitations, as reported by the IMF (2018) and WBG (2019).Similarly, revenue foregone from duty reduced rates suffers from data quality problems and the estimates may be on the low side.

Examining the above estimates in comparison with experiences in neighboring countries can be useful. However, it should be noted that each country defines its benchmark tax system differently and includes a different basket of estimates. For example, Kenya tax expenditures on corporate income tax and VAT were estimated to be about 5 percent of GDP (WBG 2017b). WBG (2018b) also estimated revenue foregone in Uganda across major tax types to be in the range of 4.5 through 5.6 percent of GDP in 2016/17. In Rwanda, TE as a share of GDP, in 2017/18, is reported to be 4.6 percent.[11]

[11] This is reported on www.minecofin.gov.rw › fileadmin › templates › documents › Data_Reports

Among duty and taxes considered, VAT accounts for the largest share of total tax expenditures in Ethiopia. For example, for 2018/19, among trade taxes, VAT accounts for nearly 50 percent followed by import duty exemptions and surtax exemptions. The trend is consistent between the periods considered in this report. The revenue foregone under the excise tax regime is about 4 percent of total revenue foregone on border taxes in 2018/19.

Although IMF and WBG's estimates are relatively old, they both indicate that business income tax expenditure as a share of GDP absorbs the smallest share in total tax expenditures in Ethiopia.

The subsequent sections provide further details on revenue foregone under VAT, custom duty, surtax and excise taxes in turn.

3.1. Value Added Tax

In Ethiopia, VAT is chargeable at the standard rate of 15 percent and zero rate on mainly exports. The benchmark tax system includes 15 percent standard rate and zero rate on exports. Exemption of such items as prescription drugs, books and those to meet international obligations, among others, is treated as part of the benchmark tax system. Deviations from the benchmark tax system are treated as part of tax expenditures under VAT. Considering only border taxes, VAT revenue foregone on imports in 2018/19 is estimated to be about 1.36 percent of GDP. In addition, past studies estimate the average VAT revenue foregone on domestic taxes to be in the range of 1.57 percent and 1.9 percent of GDP.

Of the total VAT revenue foregone on imported goods, the largest share is absorbed by capital goods for investment by the private sector with about 21 percent. This is followed by imported goods by public enterprises accounting for about 13 percent of total VAT revenue foregone. Reliefs from duties and taxes including scanning fees (through special decisions by MoF) account for about 12 percent (Table 3). Adding to this VAT revenue foregone due to special reliefs and exemptions (without scanning fees) by MoF would increase the share to about 20 percent. This reveals that estimated VAT revenue foregone due to MoF's special reliefs is nearly as high as that on capital assets for private investment.

Capital goods for investment by public sector represent about 8 percent of VAT revenue foregone on imports. Exemption of agricultural inputs also accounts for a good share of the total VAT revenue foregone in 2018/19 Fiscal Year (FY) (Table 3).

Table 3: VAT revenue foregone by Customs Procedures Code as a share of total (2018/19)

Descriptions	**VAT revenue foregone as a share of total**
Capital goods for investment by private sector	20.95%[12]
Goods for public enterprises which are fully or partially owned by government	13.29%
Relief from duties and taxes including scanning fees (special decision of MoF)	11.66%
Capital Goods for investment by public sector	8.37%
Relief from duties and taxes under special exemption (without including scanning fees)	7.93%
Agricultural inputs	7.07%
Relief from duties and taxes for the Somali, Oromia and Afar regional states and other regional states and others	3.18%
Goods for private sector	2.25%
Relief goods imported by Government or NGO	2.25%
Goods for government budgetary institutions	1.88%
Goods for USAID activities or for the projects and programs financed by US	0.36%
Others	20.84%
Total	100.01%

Source: Import data from Customs Commission and own estimations

[12] VAT expenditure arising from exemption of imported capital goods should be viewed with caution. This is, because, as IMF (2019) noted developing economies usually use VAT exemptions for capital goods (inputs), as an alternative policy to providing input tax credit or refunds. These should not be considered tax expenditures, to the extent that they do not produce tax cascading along the value chain. This suggests that VAT revenue foregone on exempted capital goods arises only when these capital inputs are used in exempt supplies or services, and by those who are not registered for VAT, among others. This, in turn, indicates the need to separate out VAT revenue foregone on capital goods from the total (reported in table 3), which was found to be difficult due to limited data availability.

A further look at VAT revenue foregone by type of goods reveals that nuclear reactors, boilers, machinery, and mechanical appliances account for the largest share (about 21 percent) in VAT revenue foregone in 2018/19(Table 4). This is followed by mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes at about 15 percent. Aircraft parts and accessories are the third largest contributors to VAT revenue foregone in 2018/19, accounting for about 10 percent.

Exemption of food items to enhance affordability is also the other source of VAT revenue foregone. Food items including rice and beans and cereals as a whole, account for about 8 percent. Exemption of animal or vegetable fats and oils also represents about 6 percent of the total VAT revenue foregone on imports. Vehicles and spare parts account for about 3 percent; similarly, exemption of agricultural inputs such as fertilizer also contributes for about 5 percent of the total VAT revenue foregone at the border (Table 4).

Table 4: VAT revenue foregone 2018/19 (by type of goods imported-customs code)

Descriptions (amounts of million ETB)	**Harmonized Customs Codes (Chapters)**	**VAT Revenue foregone as a share of total**
Nuclear reactors , boilers, machinery, and mechanical appliances; parts thereof	Chapter 84	21.25%
Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes	Chapter 27	14.78%
Aircraft, spacecraft and parts thereof	Chapter 88	9.86%
Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers and parts and accessories of such articles	Chapter 85	8.89%
Cereals (including wheat, rice, maize, oats),	Chapter 10	7.93%
Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes	Chapter 15	6.28%
Base metals and articles of base metal (Iron and steel and articles thereon, Copper and articles thereof, Nickel and articles thereof, Aluminum and articles thereof)	Chapters 72-76	6.20%
Fertilizers	Chapter 31	4.57%
Vehicles other than railway or tramway rolling -stock, and parts and accessories thereof	Chapter 87	3.15%
Sugars and sugar confectionery	Chapter 17	2.83%
Others		14.27%
Total		100.00%

Source: Import data from Customs Commission and own estimation

3.2 Customs duty and surtaxes

As presented in Part II, we consider the benchmark system to be duty tariff rates under the first schedule. This means the following tariff rates and exemptions under the first schedule are considered as the benchmark structure: duty free, 5%, 10%, 20%, 30%, and 35%.Duty exemptions granted under international obligations are also considered as part of the benchmark tax system.

Custom duty exemptions and reduced rates(estimated at 0.7 percent of GDP) absorb the second largest share of border taxes revenue foregone in Ethiopia following VAT. Of the total import duty revenue foregone on exemptions, capital goods imported by private investors represent the largest share at about 31 percent. This is consistent with the trend under the VAT regime.

The second largest duty revenue foregone (on exemptions) is accounted by special reliefs (including scanning fees) granted by MoF. Adding to this duty revenue foregone due to special reliefs (without including scanning fees) granted by MoF makes these reliefs the largest contributors to duty revenue foregone in Ethiopia. For example, in 2018/19, these two special reliefs granted by MoF account for about 40 percent of the total import duty revenue foregone (on duty exemptions). Duty revenue foregone on capital goods for investment in the public sector also has a good share in total duty revenue foregone (Table 5).

Similarly, of the total duty revenue foregone due to reduced rates about 75 percent is absorbed by imports of raw materials and other items by manufacturing firms.

Table 5: Duty revenue foregone by customs procedure codes (2018/19)

Descriptions (amounts in million ETB)	Reduced Rates	%age Share in total	Duty Exemption	%age Share in total
Capital goods for investment by private sector			4,870.00	30.82%
Relief from duties and taxes including scanning fees (special decision of MoF)			3,780.00	23.92%
Relief from duties and taxes under special exemption	10.40	0.34%	2,420.00	15.32%
Capital Goods for investment by the public sector		0.00%	1,880.00	11.90%
Relief from duties and taxes for selected regional states		0.00%	1,070.00	6.77%
Goods for duty free shops			376.00	2.38%
Goods for private sector[13]	345.00	11.13%	264.00	1.67%
Goods for private sector exempted from withholding taxes (Manufacturing firms)	2,330.00	75.16%	0.12	
Agricultural inputs	268.00	8.65%		
Goods for government budgetary institutions	1.40	0.05%		
Goods for public enterprises which are fully or partially own by the government	0.39	0.01%		
Others	145.20	4.68%	1,139.88	7.21%
Total duty revenue foregone	3,100.39	100%	15,800.00	100.00%

Source: Customs Commission Data and own estimation

In terms of specific imported products, such items as animal or vegetable oils account for the largest share of duty revenue foregone (on exemptions) in 2018/19. This is followed by nuclear reactors, boilers, machinery, and mechanical appliances and related parts; electrical machinery and equipment and parts thereof; and vehicles and parts at respectively 17 percent, 15 percent and 6 percent of duty revenue foregone due to exemptions(Table 6).

[13] As per interviews with an official at Customs Commission these are mainly due to duty free privileges granted to such countries as Sudan through the Preferential Trade Agreement (PTA). Ethiopia signed PTA with Sudan. The agreement entered into force in February 6, 2003. The provision of the preferential treatment is applicable to all industrial and agricultural products originating from both countries (https://addischamber.com/ethiopia-and-sudan-preferential-free-trade-agreement-pta/).

Table 6: Import duty revenue foregone due to exemptions (by major items)(2018/19)

Description (amounts in million ETB)	Duty Revenue foregone	%age share in total
Animal or vegetable fats and oils; prepared edible fats; animal or vegetable waxes	3,430	21.71%
Nuclear reactors, boilers, machinery, and mechanical appliances and related parts	2,660	16.84%
Electrical machinery and equipment and parts thereof; sound and television image recorders and reproducers and related parts and accessories	2,350	14.87%
Iron, steel and articles of iron and steel	1,107	7.01%
Vehicles related parts and accessories	1,010	6.39%
Preparations of cereals, flour, starch or milk, pastrycooks' products	381	2.41%
Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus, and related parts and accessories	374	2.37%
Textile and textile products	361	2.29%
Furniture, bedding, mattresses, mattress supports, cushions and similar stuffed furnishings; lamps and lighting fittings etc	305	1.93%
Cereals	272	1.72%
Sugars and sugar confectionery	261	1.65%
Edible vegetables and certain roots and tubers	214	1.35%
Plastics and related articles	212	1.34%
Mineral fuels, mineral oils and products;	159	1.01%
Beverages, spirits and vinegar	143	0.91%
Aluminum and related articles	142	0.90%
Articles of stone, plaster, cement, asbestos, mica or similar materials	112	0.71%
Others	2,307	14.60%
Total	15,800	100.00%

Source: Data from Customs Commission and own estimates

Surtax is chargeable at 10 percent on the aggregate CIF value, custom duty, VAT and excise tax payable on imported goods. It is imposed on all goods except exemptions[14] as specified in the schedule attached to the import surtax Council of Ministers' Regulations 133/2007. As noted earlier the benchmark surtax system is assumed to

[14]The following are exempted from surtax: goods imported by persons or organizations exempted from customs duty by law or by agreement entered into by the Government; fertilizers, petroleum and lubricants, motor vehicles for freight and passengers, and special purpose motor vehicles; aircraft, spacecraft, and parts thereof; and capital (investment goods).

include 10 percent and duty-free imports as specified in the first tariff schedule. Surtax expenditures, therefore, include all exemptions, except those granted under international obligations and duty free imports as under first tariff schedule (2012). Exemptions under the surtax regime are the third largest contributors to total revenue foregone on imports (estimated at about 0.57 percent of GDP).

Of surtax revenue foregone in the year 2018/19, special reliefs granted by the MoF, capital goods for both private and public investments and imports by manufacturing businesses absorb over 86 percent.

Table 7: Surtax revenue foregone by goods and or customs procedure codes (2018/19)

Descriptions	Surtax exemption revenue forgone as a share of total
Capital goods for investment by private sector	33.55%
Relief from duties and taxes including scanning fees (special decision of MoF)	16.23%
Capital Goods for investment by public sector	14.14%
Goods for private sector exempted from withholding taxes	11.71%
Relief from duties and taxes under special exemption	10.43%
Relief from duties and taxes only for the Somali, Oromia and Afar regional states and other regional states and others	3.75%
Goods for private sector	1.17%
Agricultural inputs	1.07%
Equipment and supplies for aircrafts engaged in international flights	0.09%
Goods for government budgetary institutions	0.01%
Others	7.84%
Total	100.00%

Source: Data from Customs Commission and own estimation

3.3 Excise taxes on imports

Excise tax is imposed on imports and local production of a few selected goods. The benchmark tax system includes rates ranging from 10 percent to 100 percent; and imposition of the tax on all selected excisable goods, including tobacco and tobacco products, petroleum and petroleum products, automobiles, and alcoholic beverages, among others. All exemptions except those granted under international obligations are, therefore, considered as part of excise tax expenditures. Excise tax foregone on imports accounts for about 0.11 percent of GDP in 2018/19. This is the smallest of all taxes and duties imposed on imports and the share fluctuates over the period considered in the report (Table 1). The relatively small share of excise tax on the total revenue foregone on border taxes may be because the tax applies to relatively few items.

Of the total excise tax revenue foregone on imported goods, about 50 percent is due to exemption of sugar. This is followed by excise tax revenue foregone on exemption of vehicles (about 22 percent). Other items such as alcoholic beverages, perfume and tobacco and tobacco products together account for about 28 percent of the total excise tax revenue foregone on imports in 2018/19 (Table 8).

Table 8: Excise tax revenue foregone by major products – 2018/19

Excisable items	**Excise revenue foregone (in million ETB)**	**Share in total excise tax foregone**
Sugar (Chapter 17)	1,420	48.63%
Vehicles	634	21.71%
Alcoholic beverages	264	9.04%
Perfume	249	8.53%
Tobacco and tobacco products	218	7.47%
TV, video camera	11	0.37%
Others	124	44.28%
Total	2,920	100.00%

Source: Import data from Customs Commission and own estimations

3.4 Rationale for tax expenditures

It is vital to consider the context and rationale for each tax expenditure item rather than examining the estimates in isolation.

The main rationales for tax expenditures in Ethiopia include the following:

- Supporting national development plans and economic growth objectives. Duty and tax exemptions and preferential rates (duty rates) are provided to priority sectors (including manufacturing, agriculture, ICT, tourism, and others) sectors on a range of items including raw materials (intermediate goods), capital goods, spare parts, construction materials, and motor vehicles;

- Exemptions from customs duties to Government agencies, non-governmental agencies and citizens on such items as capital goods and machineries, together with a selected list of items are exempted and/or rated preferentially to meet social and development objectives. Further, a range of economic sectors and products are being exempted from taxes and duties on imports in order to achieve social and development objectives. This also includes exemptions as being granted by the MoF on VAT and Excise areas;
- Attracting investment to Ethiopia, which in turn, is expected to generate other economic benefits in terms of increasing and speeding up the flow of capital, technology/knowledge transfer, employment creation, local production and overall development of the country;
- Ensuring the equitable distribution of investments among regions within the country;
- Reducing the burden of taxes on certain goods and improving affordability; and
- Targeting development and competitiveness of priority sectors/activities (manufacturing, exporters).

Part IV Recommendations for future tax expenditure reporting

Since this is the first tax expenditure report, in the process of undertaking the estimation, a number of challenges were encountered. This section provides a summary of recommendations for developing the methodology for future tax expenditure estimation and reporting exercises. Recommendations include:

- Future tax expenditure reports should be expanded to include domestic VAT and then income taxes using recent data;
- VAT exemption of capital goods to taxpayers who use them directly and are entitled to claim VAT credits or refunds do not represent VAT expenditure. Future estimates should estimate and report VAT expenditures arising from exemption of capital goods imported (or used) by taxpayers who are not entitled for input tax credits or refunds (or capital goods VAT exemptions that cause tax cascades);
- Work should be done to identify and fill data gaps in the estimation of tax expenditure by enforcing the requirement for taxpayers to submit returns periodically even when they are benefiting from tax holidays;
- In the case of personal income tax exemptions, where feasible, encourage employers of tax exempt individuals to file returns including a declaration of the employment income and employment income tax that would otherwise have been applicable if the privilege of income tax exemption were not there;
- The existing tax declaration forms and the tax administration databases and/or IT systems should be reviewed and adjusted to accommodate the filing requirement imposed on taxpayers who are under tax exemptions including tax holidays;
- Tax expenditure measurement and reporting should be planned and resourced sufficiently to provide for incrementally more detailed and accurate estimates over time; and
- Improving the quality of import tax and duty revenue data should be considered; periodic reconciliation of revenue data on the system and officially available import tax and duty revenue data can be helpful.

Part V. Conclusions

This report attempted to provide estimates of tax and duty revenue foregone due to various concessions granted through relevant legislation. In Ethiopia, tax and duty concessions take various forms including allowances, deductions, exemptions, reduced rates, and loss carry forward, among others. The report attempted to estimate revenue foregone mainly on border taxes, namely import duty, surtax, and import VAT and excise taxes. The report employed three years (2016/17-2018/19) transaction level import data.

The report estimated revenue foregone under each import tax and duty regime using revenue foregone method. In addition to estimating the revenue foregone under international trade tax and duty regimes, based on past studies, this report highlighted the overall tax and duty revenue foregone in Ethiopia.

Estimated revenue foregone as a share of GDP depicts a declining trend overtime owing its explanation in part from the decline in the volume and value of imports. For example, estimated revenue foregone (on imports) as a share of GDP declined from 4.37 percent in 2017/18 to 2.74 percent in 2018/19. More specifically, revenue foregone due to import duty exemption declined from 1.02 percent (2017/18) to 0.59 percent of GDP (2018/19). Similarly, VAT and surtax revenue foregone as a share of GDP decreased from 2.08 percent and 0.94 percent (2017/18) to 1.36 percent and 0.57 percent (2018/19) respectively. This decrease in tax expenditure is also as a result of the government becoming stricter in granting additional exemptions and incentives. For example, ministry of finance used to give tariff exemptions on quarterly basis, however this has stopped since 201718.

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Appendix 1. Methods and procedures in estimating tax expenditures on border taxes

As noted in the discussion earlier in estimating border taxes expenditures, this report employed data obtained from Customs Commission. The Dataset contains detailed individual importer transaction level data. Specifically for each imported item in the three years period, the dataset contains information about customs office, registration number, CPC, HSCode, Item description, item commercial name, country of origin and consignment, net weight, CIF value, applicable duty rate, duty to be collected, duty collected, applicable excise rate, excise tax to be collected, excise tax collected, VAT to be collected, VAT collected, Surtax to be collected, Surtax collected, withholding tax to be collected, withholding tax collected, total taxes to be collected and total taxes collected.

In estimating tax revenue foregone under each international trade tax, the following procedures are used.

Custom Duty

In identifying items to be included in duty exemption and duty reduced rate categories the following were followed:

- Items with zero duty rate applied, zero duty paid and duty to be paid (assessed)greater than zero are considered as items exempted from import duty;
- Items with zero duty rate (as per the dataset from customs commission), and zero duty to be paid and duty paid are treated as items taxed at zero rate; these are included in estimating TE due to duty reduced rates to the extent that they are chargeable with positive Tariff rates as under the first schedule;
- Items with nonzero duty rates (applied) less than tariff rates as under the first schedule are included in the estimation of import duty foregone due to reduced rates.

To estimate revenue foregone under each, the following steps were taken:

1. ***Revenue foregone due to import duty exemption***

DutyExemp = Dutytobepaid – Dutypaid,

IfDutytobepaid>0; Dutypaid=0&Dutyrateapplied=0; DutyTariff>0[15]

Where:

DutyExemp	*= amount of import duty exemption revenue foregone*
Dutytobepaid	*= amount of duty to be paid (as per the dataset, in which the standard rate in tariff schedule is applied to CIF value)*
Dutypaid	*= amount of duty paid (as per the dataset)*
Dutyrateapplied	*= import duty rates applied (as per the dataset obtained from Customs Commission)*
DutyTariff	*=Duty tariff rate as under the first tariff schedule*

2. ***Revenue foregone due to reduced duty rates (including zero rated imports)***

2.1. DutyZeroRates = EstDutytobepaidzero – Dutypaid,
If Dutytobepaid = 0; Dutypaid=0; DutyTariff>0

Where:

DutyZeroRates	*= amount of duty foregone due to duty zero rating*
EstDutytobepaidzero	*= estimated duty to be collected on zero rated items (applying Duty Tariff rate as under the first tariff schedule)*

[15] In the estimation the condition that Duty Tariff Rate (as under Schedule one Tariff 2012) greater than zero was not used. This is because while the duty rate for edible oil is 30 percent in schedule one, in the dataset edible oil is zero rated.

Dutypaid	*= amount of duty paid as per the dataset from Customs Commission*
DutyTariff	*Duty tariff rate as under the first tariff schedule*

2.2. EstDutytobepaidzero = CIFValue * DutyTariff

DutyZeroRates = EstDutytobepaidzero – Dutypaid

If Dutytobepaid = 0; Dutypaid = 0; DutyTariff> 0

Where:

CIFValue = sum of Cost, Insurance, Freight value

2.3. DutyNONZeroRates = EstDutytobepaidNONzero – Dutypaid,
If Dutytobepaid> 0; Dutypaid> 0; DutyTariff> 0

***2.4. EstDutytobepaidNONzero*= CIFValue *DutyTariff,**
If Dutytobepaid> 0; Dutypaid> 0; DutyTariff> 0

2.5. DutyReduRatesTE= *DutyNONZeroRates + DutyZeroRates*

In estimating the revenue foregone due to reduced rates, following the approach used in WBG (2017a), this report, alternatively employed a standard duty rate of 30 percent[16] instead of tariff rates as under the first schedule.

Value Added Tax

Under VAT there are no reduced rates. All taxable items are chargeable at 15 percent. Concessions granted are mainly exemptions. To estimate VAT revenue foregone due to

[16] WBG (2017a) used 35 percent instead of 30 percent

exemptions we take the difference between VAT to be paid (assessed) and VAT paid as per the dataset obtained from Customs Commission. For those items with zero value for VAT to be paid (assessed) and VAT paid we estimated VAT to be paid applying15 percent on the sum of CIF value, amount of duty to be paid and amount of excise tax to be paid.

- ***VATExemptTE = VATtobepaid – VATpaid, if VATtobepaid>0***

Where:

VATExemptTE	*= amount of VAT foregone due to exemption where VAT paid is greater than 0*
VATtobepaid	*=amount of VAT to be paid (assessed) as per the dataset from Customs Commission*
VATpaid	*=amount of VAT paid as per the dataset from Customs Commission*

- ***VATtobepaidonexemp= 15%*(CIFValue+Dutytobepaid+Excisetobepaid),***
  If VATtobepaid=0; VATpaid=0[17]

Where:

VATtobepaidonexemp	*=amount of VAT to be paid if the tax was charged at 15% on the items that have (in the dataset) zero VAT assessed and paid;*
CIFValue	*= sum of cost, insurance and freight values*
Dutytobepaid	*=amount of duty to be paid (assessed) as per the dataset obtained from Customs Commission*
Excisetobepaid	*=amount of excise tax to be paid (assessed) as per the dataset obtained from Customs Commission*

[17] Items considered as part of the benchmark VAT system have been removed from the dataset

- ***TotVATExemptTE= VATExemptTE + VATtobepaidonexemp***

Where:

TotVATExemptTE	*=total amount of import VAT foregone due to exemptions*

Excise Tax

Similar to VAT, concessions under excise tax regime mainly take the form of exemption. To estimate revenue foregone from excise tax exemptions on imported goods we consider the amount of excise tax to be paid, excise tax paid, and excise tax rates applied among others.

- ***ExciseExemptTE=Excisetobepaid-Excisepaid; If Excisetobepaid>0***

Where:

ExciseExemptTE	*=amount of excise tax revenue foregone*
Excisetobepaid	*=amount of excise tax to be paid as per the dataset;*
Excisepaid	*=amount of excise tax paid*

- ***Excisetobepaidestimated= ExciseTaxRate*(CIFValue+Dutytobepaid);***
  If ExciseRate=0; Excisetobepaid=0; ExciseTaxRate>0

Where:

Excisetobepaidestimated	*=estimated amount of excise tax to be paid for those items that have zero reported excise tax to be paid as per the dataset from Customs Commission;*
ExciseTaxRate	*=standard rates as per the legislation;*
CIFValue	*=sum of cost, insurance and freight values;*
Dutytobepaid	*=amount of duty to be paid as per the dataset from Customs Commission;*

ExciseRate =*excise tax rates applied as per the dataset obtained from Customs Commission*

- ***TotalexciseTE* = *ExciseExemptTE + Excisetobepaidestimated***

Where:

TotalexciseTE =*amount of total excise tax revenue foregone*

Import surtax

Surtax is charged on imports at 10 percent. Surtax exemptions are the main sources of surtax revenue foregone. In estimating the revenue foregone under the surtax regime, we consider the amount of surtax to be paid, surtax paid and the standard surtax rate of 10 percent.

- ***SurtaxexemptTE = Surtaxtobepaid – Surtaxpaid, if Surtaxtobepaid>0***

Where

SurtaxexemptTE = *amount of surtax foregone due to exemptions and as per Customs Commission data, surtax to be paid is greater than zero*

Surtaxtobepaid =*amount of surtax to be paid as per the data from Customs Commission*

Surtaxpaid =*amount of surtax paid as per the dataset;*

- ***SurTaxtobepaidExp=0.1(CIFValue+Dutytobepaid+Excisetobepaid+VATtobe paid); If Surtaxtobepaid=0; SurTaxRate=10%(or 0.1); DutyTaxRate>0***

Where:

SurTaxtobepaidExp =*amount of re-estimated surtax to be collected when surtax to be collected as per the data set is found to be zero while the standard surtax rate is 10%;*

CIFValue	*=sum of cost, insurance and freight values;*
Dutytobepaid	*=amount of duty to be paid;*
Excisetobepaid	*=amount of excise tax to be paid;*
VATtobepaid	*=amount of VAT to be paid;*
Surtaxtobepaid	*=amount of surtax to be paid;*
SurTaxRate	*=the standard surtax rate of 10%*
DutyTaxRate	*=Duty Tariff Rate as under 2012 first tariff schedule*

- ***TotalSurTaxTE = SurtaxexemptTE +SurTaxtobepaidExp***

Where

TotalSurTaxTE =amount of estimated total surtax revenue foregone