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**ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES**

**CHALLENGES OF ENFORCING VALUE ADDED TAX
LAW IN ETHIOPIA**

**BY
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**CHALLENGES OF ENFORCING VALUE ADDED TAX
LAW IN ETHIOPIA**

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for the Masters of Law (LL.M) in Business Law Stream**

Approval Sheet by the Board of Examiners

Challenges of Enforcing Value Added Tax Law in Ethiopia

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Declaration

Awet Halefom, hereby declare that this research paper is original and has never been presented in any other institution. To the best of my knowledge and belief, I also declare that any information used has been duly acknowledged.

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Acronyms

CRM	Cash Register Machine
DTE	Developing and Transitional Economics
ERCA	Ethiopian Revenue and Custom Authority
EU	European Union
FAD	Fiscal Affairs Department
GATT	General Agreement on Trades and Tariffs
GDP	Gross Domestic Products
GST	General Sales Tax
IMF	International Monetary Fund
ITD	International Tax Dialog
MoFED	Ministry of Finance and Economic Development
NBE	National Bank of Ethiopia
NOFTA	No One Size Fits All
OECD	Organization for Economic Cooperation and Development
PNC	Public Sector, Non-profit and Charitable activities
PSM	Point of Sale Machine
TOT	Turnover Tax
UK	United Kingdom
USAID	United States Aid for International Development
USD	United States Dollar
VAT	Value Added Tax
WTO	World Trade Organization

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Abstract

The spread of value added tax around the world is unmatched by that of any other tax in modern times. The expansion particularly with the least developed countries indicates a heavy reliance on the hope that this form of tax will solve the problem of raising revenue while fostering growth in the context of a highly competitive global economy. The most potential gains linked with the adoption of VAT are revenue and ease of enforcement. Ethiopia, as part of this expansion, came with this type of tax in 2002 which has rescinded and replaced the sales and excise tax proclamation No 68/1993 (as amended). Even if enforcement problem is not a new fangled problem for developing countries, the policy alternative of value added tax in exemptions, rates and thresholds in the one hand and the stakeholders which include the enforcing body, the taxpayers and consumers on the other hand have their own impact on enforcement. The Ethiopian value added tax opts single rate, some exemptions and a threshold of 500,000 from other alternatives. These alternatives are also in one or another way influence the compliance by the taxpayers and other stakeholders. This paper finds that comparing to the African and OECD member countries the Ethiopian value added tax seems well towards the enforcement which has fifteen percent rate, limited exemptions and high threshold which is 500,000. However, the means of accommodation those businesses below the threshold; the limited capacity and the problems related to estimation and registration of the enforcing body and lack of awareness, sales register machine problems and fraudulent act of taxpayers are the challenges entangled with the enforcement of value added tax in Ethiopia.

Key words: Value Added Tax, Enforcement, Taxpayers

Chapter One

Research Proposal of the Study

1.1 Introduction

“Value added tax is a broad based tax levied on commodity sale up to and including, at least, the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs except perhaps on capital goods that due on output.”¹ The spread of this tax around the world is unmatched by that of any other tax in modern times. The expansion particularly with the least developed countries indicates a heavy reliance on the hope that this form of tax will solve the problem of raising revenue while fostering growth in the context of a highly competitive global economy.² In Africa the spread of VAT has been visible in sub-Saharan Africa, some 90% of the least of developed countries in this region currently have VAT regime in place.

Ethiopia, as part of this expansion, came with this type of tax in 2002 which has rescinded and replaced the sales and excise tax proclamation No 68/1993 (as a mended) and which has come into force on January 1st 2003 after 6 months of its enactment. This tax is a consumption tax which is levied and paid as value added tax at rate of 15% of the value of every taxable transaction by a registered person, every import of goods in Ethiopia for a person registered in Ethiopia for VAT or any resident legal person by a non resident person who is not registered for VAT in Ethiopia.

The most potential gains linked with the adoption of a VAT rests on three things.³ These are:

Firstly, VAT will impose on successive value addition so that even if it is distorted in single point of sale, it can be arranged in the next stage and does not distort the complete gain. However, sale tax or similar other taxes are vulnerable to evasion and avoidance

¹ Liam Ebrill, Michael Keen, Jean Paul Bodin, and Victoria Summers, *The Modern VAT*, (2001) P. 2

² Allison Christians, *Global Trends and Constraints on Tax Policy in the Least Developed Countries*, Legal Studies Research Paper Series No.1086, Wisconsin Law School, (2009).

³ Ebrill et al, *Supra* note 1, P.6. Christians, *supra* note 2, p.16, Carl Shoup, *The Value Added Tax and Developing Countries*, *The World Bank Research Observer*, Vol.3, No.2 (July 1988), P.140.

because revenue is completely lost if for some reason the tax is not properly imposed as the single point of sale.

Secondly, its ease of administration, which indicates that adoption of VAT, is often seen as central element in a program of modernizing tax administration developing the use of methods of self assessment whose generalization is expected ultimately to ease administration and compliance in relation to other taxes on the area.

Thirdly, the VAT is introduced as a part of a package of trade liberalization compensating for the revenue loss from the reduction of tariffs as a result of membership to the world trade organization.

Within the Ethiopian context, the first two principles are adopted in the preamble of the VAT proclamation. The last is not part of the preamble may be because of the time difference of the enactment of the proclamation and the WTO accession negotiation, but since Ethiopia is in the process to accede this will be used to substitute reduction of tariffs in the future.

1.2. Background of the Study

The Ethiopian Custom and Revenue Authority is the concerned government body for the enforcement of value added tax. To bring modern tax collection mechanism and the effective enforcement of VAT and other taxes and to attain its objective the authority made different arrangements starting from merging the Federal Inland Revenue Authority and Ethiopia Custom which were formerly under Ministry of Revenue since year 2008 extended to introduction of the new Business Process Re-engineering to facilitate its activities as it is indicated at the authority website www.ERCA.gov.et. Besides, the main purpose of introducing the value added tax as it is indicated in the preamble of the VAT proclamations is its ease of enforcement. Albeit of such changes, it is not uncommon to hear and read in magazines and other mass medias on the issue of VAT in general. Besides, the issue of VAT was part of the regular prime minister interview with journalists and the members of parliament. The point is that in fact enforcement problems is not a new-fangled thing in developing countries, but VAT issues becomes a usual issue

in our country. To add some, practically the researcher observes that there is a shift of consumers, particularly in food and beverages, from registered entities to non-registered entities. These and other background information initiate me to conduct a research on the topic “challenges of enforcing VAT law in Ethiopia.”

1.3 Statement of the Problem

Analysis of the data organized by MoFED of the country (as published in the Quarterly reports of the NBE) on Ethiopia government finance during the last one and half decades, shows that the domestic as well as on import indirect taxes shows some increment but with insignificant number which is not as expected as the first. If domestic indirect taxes (TOT/VAT and excise (before replaced) takes as an example before and after the enactment of the VAT proclamation i.e. 2003, the following are the results in terms of GDP 1988/99(11.3%), 1999/2000(14.1%), 2000/2001(12.8%), 2001/02(13.7%), 2002/03(15.2%), 2003/04 (15.7%), 2004/05 (15.7%), 2005/06(16%), 2006/07(16.3%), 2007/08(15%). This is even small compared with other sub-Saharan Africa countries.

Besides, in spite of ease administration, above 400 persons are imprisoned because of VAT related matters which have its own implication on the simplicity of enforcement indicated in the introduction or other matters. The above revenue share also shows the total increment is insignificant. Besides, the background information is another indicator of challenge of enforcement of VAT. These all, revenue, imprisonment and purpose of introducing the VAT and the background information imply that there are challenges for the enforcement of the value added tax law and the enforcement of VAT is not as intended as the introduction. Following this, there are two possible causes of such challenges. The first possibility lies on the law it self that its positions are not with conditions of Ethiopian taxpayers and other stake holders and hence it became a challenge and/or the second possibility is that positions of the law are best but the challenges of enforcement rests on stake holders, which consist of the authority, taxpayers or consumers. In other words, which one is/are the possible challenges of enforcement of VAT? Position of the VAT law taken on rate, exemption and threshold or/and stakeholders consists of the taxpayers, the enforcing body and consumers? In this research, “position of the law” refers rate, exemption and threshold of the VAT.

Coming to the value added tax law, it opts one rate (15%) instead of multiple rates, exempts some goods and services for whatever reason and put 500,000 birr as minimum threshold instead of zero threshold through the invoice credit method of compliance of for taxpayers from other alternatives. Consequently, in this regard the researcher addresses the following questions:-

- Does the positions taken in the proclamation (single rate, 500,000 minimum threshold and exemption) challenge the enforcement of the law, if so how and which position?
- If the above answer is in the affirmative, how the ‘position of the law’ affects the compliance by the taxpayers?

If the answer goes to the negative, the questions shifts to the stakeholders (the authority, taxpayers and customers), and hence the questions to be addressed are

- What are the real challenges for the enforcement of the law within the stake holders?
- What are the possible cause of these challenges and how the law can address these challenges, if any?

1.4 Research Method and Methodology

To achieve the research, I have used qualitative as well as quantitative method of data gathering. The qualitative data includes the primary like interviews and secondary information like books and the like. All the interviews made are semi-structured questions which are more developed during the interview. To collect the quantitative data closed and open ended type questionnaire were developed.

To answer the two big issues therefore, the researcher used both primary and secondary data. The primary data include questionnaire, interviews and personal observations where as the secondary data includes books, articles, senior thesis, magazines, reports released on the subject matters, and practices of other countries is utilized as the case may be.

To get the primary data of the research, the researcher take Addis Ababa as a center of the study. This is because of the fact that, even if the proclamation is applicable to all regions of the country, most problems and issues on VAT arises in Addis Ababa, which

covers the largest revenue collected and hence the researcher presumed that identifying the challenges and solutions of enforcement in Addis Ababa can be used as a means to other regions. Besides, it is not possible to assess the challenges within the country as a result of time and space limitation.

Questionnaire: the authority consists of two branches⁴ and one head office in Addis Ababa and within these branches and head office there are inspection, investigation, prosecution and other officers. However, inspection officers are selected to this purpose because their daily activities make them to contact taxpayers and know the challenges. Therefore, 20 questionnaires are distributed to inspection officers with equal proportions of the branches and the head office.

With regard to taxpayers, 120 questionnaires are distributed with equal proportion of the two districts to randomly selected taxpayers. Consequently, 140 questionnaires are distributed and analyzed accordingly.

Interviews: Interviews was made with higher officials of the Ethiopian Revenue and Custom Authority and some officials of the Addis Ababa Revenue Authority to identify the real challenges to enforce the VAT law. Besides, 20 randomly selected customers are interviewed, and some taxpayers too. All the interviews made with officials, consumers as well as taxpayers are semi structured type interviews.

Direct personal observations: the other method of data gathering employed is direct personal observation around ‘Piazza’ and ‘Merkato’ to observe practical problems and challenges personally. This is conducted in collaboration to the inspection officers of the authority during their inspections.

⁴ The eastern branch of the Ethiopian Revenue and Custom Authority holds Akaki Kaliti, Yeka, Bole, Arada and Nifas Silk Lafto sub cities and the western branch of the authority includes, Lideta, Addis-city, Kirkos, Kolfe-keranio and Gulele sub cities.

1.5 Objective of the Study

The research will have the following general as well as specific objectives.

1.5.1 General objective. This research assess and analyze whether the challenges of enforcement falls with the law itself or/and with problems of stakeholders.

1.5.2 Specific objectives:

Specifically the study attempt to:

- Assess position of the law taken on exemption, tax rate, minimum threshold and its impact on enforcement;
- identify the general problems linked to stakeholders on the enforcement process;
- Investigate the challenges within the enforcement body it self, taxpayers or consumers.
- The possible cause of these challenges of stake holders
- Show the connection of the above main problems to one another.

1.6 Significance of the Study

The final result of the research paper can:

- Contribute to the academic community and practitioners involved in the subject area try to make more research on the issue;
- Be used as a data to know the problems or the relationship of the law with enforcement and the role of stake holder;
- Used as an input to the enforcement body to identify the real problems and to set a solution on the subject matter.

1.7 Scope of the Study

The scope of the study is limited with answering the two big questions to see the challenges within the law it self related to exemptions, thresholds and rates and stake holders problems with respect to enforcement only. No other justification or issues related with value added tax will be covered of enforcement. For instance, in case of exemptions whether exemption to NGO's, or foods is justifiable or not, or the trend or

other way will not be part of the study rather how these exemptions affect enforcement in general will be discussed.

As to the scope of space, the study on stakeholders is destined to Addis Ababa city so that no other regions case or no interview, observation will be made and no questionnaire will be distributed to regions rather it will be limited to the two branches and the head office in Addis Ababa as to the matters of inspection, taxpayers or customers.

1.8 Limitation of the study

The limitations that are encountered by the researcher are:

- There are limited books and other printed material on the area
- Access of internet is also another limitation because the university access on internet is limited with few rooms and chairs which is not proportional with the number of post as well as under graduate students.
- The amount funded from the faculty is not enough to cover all the costs of the research and have its own contribution on the collection and gathering of necessary information.
- Although every research has its own limitation, making any research requires honesty. During the questionnaire distribution, some taxpayers back the questionnaire without filling the questions there in. Some officials are also not willing full to make interviews. The library of the Ethiopian revenue and custom authority was not opened during and till the end of this paper and hence some information couldn't be available. However, the direct or indirect reflection of such limitations may be envisaged when reading the part or entire part of the thesis.

1.9 Organization of the Study

The thesis is categorized into five chapters. The first (current) chapter is devoted to the research proposal which includes introduction, background of the study, statement of the problem, scope of the study, objective of the study, significance of the study, research methodology and limitation of the study.

The second chapter of the thesis is exclusively concerned with general overview of value added tax with particular emphasis reviewing literatures concerning the concept of VAT, the distinguishing characteristics of VAT vis-à-vis sales and turn over tax, the nature of VAT as indirect tax taking the legal and economic point of view, the main advantages of VAT from the taxes it replaced, and types of VAT by means of calculation and the treatment of capital goods.

Under the third chapter, the comparative policy alternatives on rates, exemptions and thresholds taken from literatures and practices of the OECD as developed tax system and African countries as less developed tax system is examined to find best alternatives and practices of enforcement. These practices and alternatives are also compared with Ethiopian value added tax positions on rates, exemptions and thresholds.

The fourth chapter of the thesis is concerned with analysis of the data gathered through questionnaire, interviews and personal observations from the taxpayers, inspection officers and higher officials of the ERCA and Addis Ababa revenue authority.

The last and the fifth chapter of the thesis are conclusions and recommendations. In this chapter, based on the data and information analyzed in the fourth chapter, the researcher provides how the law and respective stakeholders challenge the enforcement of the value added tax. In this chapter, the writer has also suggested possible solutions and measures that should be taken to avoid or minimize the challenges of enforcement.

Chapter Two

General Overview of Value Added Tax

2.1. Concepts of Value Added Tax

The term value added is an economic concept unrelated to the familiar accounting and tax laws and it is defined as the increase in the value of goods and services brought about by whatever a business does to them between the time of sale.⁵ In relation to the value added tax there are some definitions in different literatures,

*“VAT is a broad based tax levied on commodity sales up to and including, at least, the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs-except perhaps on capital goods- against that due on outputs.”*⁶

*“A broad based tax levied at multiple stage of production (and distribution) with crucially taxes on inputs credited against taxes on output.”*⁷

Up on these definitions, we can take some common features of value added tax. The first is that VAT is tax on consumption paid ultimately by final consumer. Although the name of the tax imply the value added as a base of the tax, it is usually intended as a tax on consumption⁸ because firms have a mechanism of offsetting the tax they have paid against the tax they charge on their sales of goods and services. To take an example, firm A sells its output for a price of \$150 to firm B, firm B also sell its outputs for \$450 to final consumers. Assuming that there is a VAT rate of 15%, Firm A will charge firm B \$10, remitting \$10 to the government considering no material inputs. Firm B will charge final consumers 480 remitting tax \$20 by creating \$10 to the tax charged on its inputs. Secondly, in principle the tax is levied on a broad base in the sense that it is all inclusive

⁵ In contrast to this concept, most business taxes involve profit, asset or net worth measures with a purpose of comparing similar business. James W.Haughey, “The Economic Logic of the Single Business Tax”, *Wayne Law Review*, Vol.22, No.4 (1976), p.1019.

⁶ Ebrill et al, supra note 1, P.2.

⁷ International tax dialog (ITD), *The Value Added Tax Experiences and Issues prepared for the ITD conference in the VAT*, from (March 15-16, 2005), P.8. available at, <http://www.rotman.utoronto.ca/iib> accessed on April 18, 2010.

⁸ However, it does not mean that it will be collected directly from the end consumers who bear the brunt of it nor from these companies which sell to end-users but from all these companies which intervene to provide them with goods and services. See François Rouet, *VAT and Book Policy* (1999), p.9.

though it depends on circumstance of a country. Thirdly, the burden of the tax falls in the consumers, not on the businesses because of refunding mechanisms. Lastly, the collection mechanism goes in successive process. Within this speculation, the VAT observed in practice considerable diversity regarding the base of tax⁹ the credit mechanism available for business¹⁰ and the name it self. Scholars also differ whether this tax can be classify as turn over tax (TOT), sales tax or an income tax, or to none of them which is mainly arise from the debates of their proponents and opponents of VAT.¹¹

Some scholars conclude that, as to the majority or weight of academicians, VAT is a species of sales tax and this argument goes up to the inclusion of the general TOT, the VAT and the single stage tax to be regarded as three methods of collection of sale taxes.¹²

Some authorities also juxtaposed this tax with retail sale tax and TOT in the sense that VAT is merely complicated methods of collection and a sophisticated variation of the TOT that it is levied at each successive stage of production, however, they are not desired to hide their difference with VAT¹³ which is distributed with a series consequential flows vis-à-vis retail sale tax and VAT employed the concept of value added which allow credit for taxes previously paid that avoids cascading¹⁴ compared to TOT.¹⁵

The researcher believes that the value added tax might come to the spotlight by substituting the sale tax or turn over tax, depending on the tax policy of a country, and it

⁹ Some countries do not levy VAT on services, for instance, Pakistan and some also limited to the manufacturing stage (Bangladesh and Botswana), in this case see Ebrill et al, supra note 1,p.2 and International tax dialog, supra note 7, P.7.

¹⁰ Some countries like China do not grant credit for capital goods which is common in most countries. Id,P.2.

¹¹ The name value added tax is not a universal term. The term exists in two English forms; “value added tax” and “value-added tax”. Both represent a translation of the original French term “taxe sur la valeur ajoutée”. See David Williams, in the Law Design and Drafting, Victor Thuronyi, (ed), vol.1 (1996), p.4 The tax with a similar purpose and objective is called in some countries goods and services tax (e.g. Australia), a general sale tax (Canada), single business tax based on accounting (the Michigan state in USA). On this matter see Ebrill et al, supra note 1, p.2, W. Haughey, supra note 5, p.2. But such designation has no economic importance.

¹² Clara K. Sullivan, *the Tax on Value Added* (1965), p.3 and Lock, Ras and Hamilton, “The Michigan value Added Tax, *National Tax Journal*, Vol.8 (1995), p.369.

¹³ Sijbren Cnossen, “A VAT Primer for Lawyers, Economists and Accountants,” *Tax Notes International*, Vol.55 No. 4 (July 27, 2009), p.322.

¹⁴ Cascading arises when tax is charged both on an input in to some process and on the output of that some process which leads to tax on tax. See also the topic 2.3.2 on neutrality.

¹⁵ Mark A. Bloomfield, Charles E. Maclure, *the VAT: Key to Deficit Reduction*, American Institute for Public Policy Research (1987), p.23 and Lock et al, supra note 12, p. 334.

might have similarity with sales tax or turnover tax but VAT is not a TOT nor sale tax as Richard Miller quoted “VAT is neither a gorilla nor a chimpanzee but rather a genus like primates.”¹⁶

Historically, the base of the VAT was derived from Thomas S.Adams and William Von Siemens writings from account of the individual firm in order to eliminate the multiple taxations of items entering in to cost of sales which characterize the general TOT.¹⁷ Two approaches are indicated for the development of the concept of the value added tax.¹⁸ The first approach signifies as a method of collecting a sale tax viewed as a tax on the value of a product collected from business enterprises selling it and expected to be shifted forward to purchases by means of an increase in prices equal to the amount of tax where as the second approach formulated based on the benefit principle of taxation.¹⁹

Throughout the 20thc from its origin, the VAT passes different stages. Up to 1950, it was perceived as undesirable because it discriminates consumers by influencing their decisions through different rates and hence income tax favored over this. In 1950 and 1960, the VAT comes parallel with the income tax where as from 1970’s on wards, it began to be preferred over income tax with a single rate and comprehensive base.²⁰

Adoption of the VAT within a country began in 1920s in France but such tax is not compatible with above characteristics of VAT. With this definition, it was introduced in 1948 in France.²¹ Currently, there are over 140 countries with VAT and it is more likely that VAT will distribute over because practically it is hardly conceived to repeal once it is introduced.²² The main reason for the rapid expansion and success of VAT are two folds. Firstly, the early adoption of VAT in the European Union and the perceived success of

¹⁶Richard Miller Bird, *The Value Added Tax by Developing and Transitional Countries: lessons and questions*, Prepared for the First Global ITD Conference on VAT, Rome (March 15-16, 2005), p.10. available at <http://www.rotman.utoronto.ca/iib> accessed on April 18, 2010.

¹⁷ Sullivan, supra note 12, P.3. The idea of VAT originates in the writing of German business men, where as the invoice credit method was suggested by Adams see Ebrill et al, supra note 1, p.4.

¹⁸ Sullivan, supra note 12, p.3.

¹⁹ Stephen F. Weston, *Principle of Justice in Taxation* (2009), P.162. The benefit theory is an economic concept which assumes that a tax is a payment for services rendered by the state to the individual.

²⁰ Sullivan, supra note 12, p.15.

²¹ Ebrill et al, supra note 1, p.4. Even before 1948, there were instances limited crediting by section and to items physically incorporated output in Greece, Argentina and Philippines

²² There are few countries that repealed there VAT laws after its introduction like Ghana and Grenada in spite of revival of the laws later on after different arrangements. See Christians, supra note 2, p.8.

the VAT and secondly the key role played by the IMF in the spreading of the word to the developing countries first to the Latin America and then around the world.²³

Within the Ethiopian context, the value added tax comes after replacing the sales tax proclamation in 2003. Considering the above characteristics, the VAT is a consumption tax²⁴ and levied on successive stages with a tax credit mechanism.²⁵ According to article 20 of the VAT proclamation, the amount of tax to be calculated is the difference between the amounts of tax charged on taxable transactions and the amount of tax creditable. In short, the VAT within the Ethiopian perspective has the following impression. A consumption tax levied and paid as value added tax at a rate of 15% of the value of every taxable transactions by a registered person, every import of goods, other than an exempt import, and an import service rendered in Ethiopia for a person registered in Ethiopia for VAT or any resident legal person by a non resident person who is not registered for VAT in Ethiopia.²⁶ Throughout the research VAT implies the credit invoice method VAT which is common throughout the world and a term utilized by the Ethiopian VAT proclamation unless expressed otherwise.

2.2 Broad Issues with a VAT System

2.2.1 Value Added Tax as a Consumption Tax

A consumption tax is a tax on spending rather than income in the sense that it is levied only on income that is spent on consumer goods and services.²⁷ It is not a direct tax on consumption but on indirect multistage transaction tax. It is indirect because it taxes

²³ Bird, supra note 16, pp. 19-20.

²⁴ The preamble says 'the tax enhances saving and investment as it is a consumption tax and does not tax capital.' See Value Added Proclamation No.285/2002, Federal Negarit Gazette, 8th Year, No. 33, July, 2002, preamble.

²⁵ Ibid. Art 20 and 21, these articles provides the availability of credit. Under the proclamation there is no limitation to take credit whether you are wholesaler, retailer or distributor so long as it is entitled to such credit. A taxable person can be an individual, firm, Company, as long as such a person is required to be registered for VAT.

²⁶ VAT proclamation, supra note 24, Art 7(1) (a) (c) cumulative with Art 22 (1) (2).

²⁷ Marina Sentsova, VAT and, Direct Taxes: How to Distinguish, in M.Lang, P.Megz and E.Alhager, *Value Added Tax and Direct Taxes: Similarity and Difference* (2009), p.186.

transaction in lieu of directly taxing consumption, and because it collects the taxes from suppliers rather than from consumers.²⁸

I) Forms of Consumption Taxes

There is no black and white approach to forms of all the consumption taxes. There are different forms of consumption taxes like flat tax and a personal expenditure,²⁹ sales tax and the VAT.³⁰ For purpose of this research the sales tax, TOT and value added tax with credit invoice method are taken for comparisons.

II) Equivalences of Consumption Taxes

From purely economic perspective, the VAT, the sale tax, the flax tax and other methods of calculating the VAT are perceived to be equivalent.³¹ In most consumption taxes certain necessities are exempted from tax or take preference and some sectors like financial services are difficult to tax.³²

III) Differences between Consumption Taxes

To start with the sales tax versus the VAT, the main difference between VAT and the sales tax are directly or indirectly related to the two critical features that characterize the design of the credit method VAT.³³ Firstly, the VAT is collected at each stage of production process, while the sale tax is collected only at the time of the final sale to the

²⁸ Id. P.292.

²⁹ A flat tax is a consumption tax that allows registered business to deduct wages from value added as calculated under the direct subtraction method, but that taxes these wages at the level of individual wage earners where as a person expenditure tax taxes on goods and services at the level of the tax paying individual by subtracting saving (including loan repayments and purchase of stocks, bonds) from aggregate incomings both calculated on a cash flow basis. See Cnossen, supra note 13, pp.320-321.

³⁰ In many forms of consumption tax literatures, the VAT is refereed to invoice credit VAT and consequently, a direct subtraction method and addition method tax considered as other forms of consumption, although in principle the direct subtraction method tax, the addition method tax and even the flat tax also can be considered variants of value added taxation. See Cnossen, supra note 13, p.320 on footnote 2 and its accompanying text.

³¹ See infra note 119 and its accompanying text.

³² Malcolm Gills, Peter Mieszkowski, and George R. Zodrow, "Indirect Consumption Taxes: Common Issues and Differences among the Alternative Approaches", *Tax Law Review*, Vol.51 (1995), p.757.

Comparing the consumption taxes in Ethiopia, particularly the replaced sales tax and the VAT gives the following similarity: both taxes are consumption taxes, the exemption or zero rating of exports in both taxes, except those necessity consumption at rate of 5% and those of exempted, in both taxes the standard rate is 15%.

³³ George R. Zodrow, The Sales Tax, The VAT, and Taxes in Between or, is the Only Good NRST A "VAT In Drag?", *National Tax Journal*, Vol.LII, No. 3, p. 431.

consumer hence it clearly much easier to collect the bulk of tax revenue from large scale manufactures and wholesalers rather than focusing all collection efforts at the retail level. Secondly, with respect to method of collection under the VAT, the firm charges tax on all of its sales but receive a credit for taxes paid by its suppliers provided that such taxes appear on the firm invoice. Consequently, the possible advantages of the credit invoice VAT over sale tax can be summarized as follows.

Firstly, the VAT is self-enforcing³⁴ in sense that it creates for the purchasing firm to ensure that the selling firm pays it's taxes or at least it supplies an invoice for the purchasing firm that states it has paid its taxes.

Secondly, it discourages evasion as it creates a paper trail that facilitate audit. Tax authorities can cross check claims for tax credits made by firms against taxes paid by their suppliers.³⁵ This is so because in firms in the early stages of production withhold taxes which is the determinant for evasion that whether any one other than taxpayer withhold or report the tax to the concerned authority.

Thirdly, eliminating business purchases from the tax base is achieved straight forward fashion under the VAT.³⁶ The invoice credit approach provides an effective means of ensuring that the VAT is not applied to business inputs. Firms received tax credits for all purchase of such inputs including all intermediate goods and capital goods.³⁷ That application of the final purchase of consumption goods makes it to be a consumption tax.

Fourthly, the sale tax is more vulnerable for evasion of goods that can be used both as business inputs for formal consumption.³⁸ This is so because under VAT, in order to evade, firms should make such claims to the tax authority but under the sale tax as firms

³⁴ Id. 432.

³⁵ Gale, William G, and Janet Holt Zblatt, *The Role of Administration Factors in Tax Reform: Simplicity, Compliance and Enforcement* (1999), p. 37.

³⁶ Gills et al, supra note 32, p. 756.

³⁷ This elimination of business purchase can be achieved as long as there are no new pretrial exemptions. If there are exemptions, credit mechanism will not apply because if firm A sold its goods to B and B also sold to exempted firm C and firm C sold to form D, in this case the inputs will not credited in firm C and firm D will start to tax without credit which possibly can create cascading. Out of this, the VAT avoids the troublesome problem of cascading which give rise to a serious distortion of both production and consumption decision. See Zodrow, supra note 33, p. 432, Ebrill et al, supra note 1, p.23.

³⁸ Zodrow, supra note 33, p.433.

can evade tax by making false claims to the seller of dual use goods who have a clear incentive to avoid scrutinizing such claims carefully in order to increase sales. In other words, it may be psychologically easier for purchaser to make a false statement to a vendor than to make a false return to the tax authority.³⁹

Lastly, there is less incentive and thus less political pressure for tax exemptions because an exempt firm loses the ability to pass forward to its purchasers the tax credits associated with its input purchase and tax exemption as the retail level apply only to the value added tax.⁴⁰ This is raised from the sole reason that on exemption tax is not charged on outputs at the same time tax paid on inputs cannot be reclaimed contrary to zero rating in which case there is credit for input but no tax for output.

Despite such positive advantages of the VAT, there are counter defenses against VAT. To cite some; the distribution process under the VAT implies more transaction subject to tax hence there is a mere opportunity for tax fraud but the sale tax impose rate on the final retailer. Besides, firms can always create false invoices for their purchase which really contravene the self-enforcing character of the value added tax.⁴¹

The difference between the value added tax and turn over tax can be summarized as follows. The TOT is levied as a percentage of sales not just value added.⁴² Comparing to VAT, three main defects can be mentioned from the TOT. Firstly, the cumulative cascade system of the TOT causes market deformation since that tax incidence increases proportionally to the length of the productive and distribution chain whereas under the VAT, the total accumulated tax, down through the retailer, is the same for every dollar of retail price, no matter how the value added that makes up this dollar are distributed among the

³⁹ Ibid.

⁴⁰ Ibid.

⁴¹ Id.p.434. In Ethiopia, under the present VAT and its previously replaced sales tax, there are some differences. For instance, comparing to the previous tax there is tax over tax, with possible exceptions in exemptions, there was no credit mechanisms for tax paid for inputs and the VAT imposes on the whole production distribution process but the sale tax was imposed in limited sectors that is producers, importers and services.

⁴² For example, the miller would pay tax on sales to the bakery, and the bakery would pay tax on its sales to the wholesaler and so on. Hence, the value added by the miller would thus be taxed several times but the retailer's activity only once. This puts pressure on the economic system to reduce activity at the earlier stage see, Shoup, supra note 3, p.140.

stages of production and distribution.⁴³ This idea have its own implication on equity that the rich consumer is taxed less severely than the poor consumer because the poor buys more of retailed goods while the later supermarket types of goods.

The other difference is that TOT encourages vertical mergers between business firms.⁴⁴ If the miller and the bakery merge in to one, in miller, baker and wholesaler sequence, the total revenue from the TOT decrease because of the elimination of one stage or turn over of production where as in the VAT system, the value of milling and the value of baking are still each taxed just once with the only difference taxing from one firm not from two.

Besides, the TOT has a difficulty of exempting exports because it has been levied several times on the constituents of the exported commodity but under the VAT the tax credit method can simply alleviate such problem.⁴⁵ To generalize, the supreme court of the New Zealand put the following with regarded to GST and the TOT comparison:

“GST has been likened to a TOT (the outputs are the turnover) but to provision for offsetting deduction (or credit) for the GST content of input costs...[D]iffering from other form of consumption tax, GST is a multi stage tax imposed on the value added at every stage of the business activity by which goods or services reach the ultimate consumer. It is a tax on final consumption because it is the sum of the value added by firms at each stage of supply chain that consumers ultimately purchase and consume. Registered person produce taxable supplies effectively operate as tax collectors on belong of the government and as such are themselves subject to GST’s.”⁴⁶

⁴³ Ibid.

⁴⁴ Ibid.

⁴⁵ Ibid.

⁴⁶ Glen harrow holding ltd versus commissioner of Inland Revenue cited in Rebeca Miller, “Echoes of Source and Residue in VAT Jurisdiction”, Sydney Law School Legal Studies Research Paper No. 09/44 (June 2009), available at <http://ssrn.com/abstract=1416495> .p 13. In the Ethiopian tax system, the TOT has the following features. The Turnover Tax would be payable on goods sold and services rendered by persons not registered for Value Added Tax. The rate of Turnover Tax is 2% on goods sold locally; where as for services rendered locally: 2% on contractors, grain mills, tractors and combine-harvesters and 10% on others. The base of computation of the Turnover Tax is the gross receipts in respect of goods supplied or services rendered. A person who sells goods and services has the obligation to collect the Turnover Tax from the buyer and transfer it to the Tax Authority. Hence, the seller is principally accountable for the payment of the tax. See Turn Over Tax Proclamation No.308/2002, Art.4-6.

2.2.2 Dealing with Regressivity of VAT

Progressivity of a tax is very closely connected with the question of equity and the redistributive function of taxes. The concept of regressivity versus progressivity can be explained in terms of the proportion of taxes paid relative to income or effective tax rates. Accordingly, if effective tax rates for higher income groups are greater than those for low income groups, the tax system is considered to be progressive, if the opposite is true then the tax system is regressive, if effective tax rates are equal for all income groups then the tax system is called proportional.⁴⁷

A widely point of view is that a tax system should not impose a tax burden on the poorest number of society. Related to this view, the value added tax is criticized and considered unfair to lower income individuals and families followed by the syllogism that ‘consumption tax are regressive, a value added tax is consumption tax consequently, a value added tax is regressive so that burdensome to the poor.’⁴⁸ In relation to this, Alan Tait in his book stated that since the VAT is a broad based tax levied on essentials, it is a regressive tax.⁴⁹ Besides, the study conducted by the OECD finds that consumption taxes and especially VAT are somewhat regressive when related to income.⁵⁰ As a result of such view on the regressivity of VAT, different laws whether proposed or enacted have special rules to alter the distributional burden and thus alleviate its regressivity by providing reduced rate, exemptions and zero rating to food, medicines and the like which commonly known as rate differentials and the reimbursement system.⁵¹ However, the principle of rate differentiation is criticized based on the point that it is poorly targeted because all consumers benefit from exemption or rate preference for particular commodity and the size of the benefit increase with the increment of income although

⁴⁷Geove N. Carlson and Melanie K. Patrick, “Addressing the Regressivity of Value Added Tax”, *National Tax Journal*, Vol.42, No.3 (1989), p.340.

⁴⁸Id., p.339. See also *Value Added Tax, Administrative and Policy Issues*, Alan D Tait (ed.) (1991), p.5.

⁴⁹Alan D. Tait, *Value Added Tax: International Practice and Problems* (1988), p.214.

⁵⁰OECD, *Taxing consumption* (1988), p.123. However, experts in value added tax like Michael Kean pointed out that assessing based on income is not the best way to assess. Pressing welfare ultimately depends on consumption. Thus, higher income households are not necessarily better of households, rather it is the manner in which tax liability varies with consumption that matters for assessing the distribution implication of tax not how it working with income. See Ebrill et al, supra note 1, pp.106-107.

⁵¹Carlson et al, supra note 47, p.340.

less than proportional if the commodity is consumed disproportionately by the poor.⁵² Thus, by exempting necessities, the taxes paid by middle and upper income groups are reduced while lower groups still pay tax on their purchase of other taxable commodities. Similar with this conclusion, the OECD study concludes “it has been suggested that in recent years the consumption patterns of different income groups have converged and if this is so, applying multi-rate would be less important for increasing progressivity.”⁵³ It can also lead to lost of quite high revenue in providing tax relief for poor which in turn implies for relatively high tax rates exposed for evasion.

As to reimbursement mechanism of addressing regressivity, the concept refers to a single tax rate to be imposed on a broadly define base, and eligible individuals and families will then receive reimbursement for the tax paid on some threshold level of consumption deemed to represent a minimal standard of living.⁵⁴ The primary attraction of this approach is that it avoids the problem of launching multiple rate alternatives comparing its cost. In terms of revenue forgone, because of its target to relief appropriate persons, such an approach would add more to the progressivity of a tax system.⁵⁵

The multiple rate and reimbursement mechanisms are presumably taken to answer unresolved issue of regressivity of VAT. However, out of these two approaches, within the VAT system, there is another scenario on regressivity versus progressivity VAT i.e. annual income verses individual income controversy.⁵⁶

The life cycle theory of consumption and saving argues that individuals go through three main phases of consumption and saving over their lives.⁵⁷ In the first phase, individuals borrow to fund consumption early in life when earning is relatively low. In the second phase, which covers the prime earning years, individuals save in order to retire debt

⁵² Gills et al, supra note 32, p.735. This poor target criticism is to mean “low and moderate income groups do not purchase only items that may be treated as necessities for tax purposes such as food and medical, they purchase taxable goods and services as well. Besides, middle and upper income groups also purchase necessities. See Carlson et al. supra note 47, p.345.

⁵³ OECD, supra note 50, p.123.

⁵⁴ Carlson, supra note 47, p.345.

⁵⁵ Edith Brashares, Janet F. Speyrer and George M.Carlos, “Prons and Cons of Alternative Approach to the Taxation of Consumption”, *National Tax Journal*, Vol. 47 (1980), p.73.

⁵⁶ Gills et al supra note 32, p.739.

⁵⁷ Ibid.

accumulated during their youth and to fund retirement consumption. In the third phase of the life cycle, retirees consume primarily by drawing down the assets accumulated during the second phase. During this phase, individuals who are quite wealthy and enjoy high level of consumption nevertheless can have relatively low annual income. Under the life cycle theory, some measure of the level of life time income assumed to be the basis for individual decision about consumption and saving and is thus appropriate indicator of current ability to pay taxes.⁵⁸

Considering the three levels of life on consumption and saving, it will give the following results if we take annual income as measure of regressivity. In the first and third phase of the life cycle i.e. youth and the retirement years, which is expressed with low annual income, it implies that there is high consumption tax relative to annual income where as during the second phase, a period of prime earning and saving year, relatively high annual income, but the tax paid will be low relative to annual income.⁵⁹ In general, the point of the life cycle approach is that the distribution of the tax burden is a better measure relative to consumption than income because, for example, some people who are poor in terms of their life time income may be over served in some particular period to have relatively high current income by whatever reasons. So, it is wrong to regard such household as rich and to interpret the low ratio of consumption tax payments to income for this household as indicative of regressivity.⁶⁰

The second argument that supports the life cycle theory is permanent income hypothesis which holds that individuals whose income tends to fluctuate from year to year, base their consumption decisions on measure of permanent income rather than annual income.⁶¹ Accordingly, individuals with a temporary downturn in income pay a relatively large consumption tax and similarly, an individual with a temporary high level of income tends to have a relatively low level of consumption and consumption tax.

All in all, proponents of the life cycle and permanent income hypothesis argue that the idea that consumption based tax like VAT are inherently regressive is overstate based on

⁵⁸ Id. p.739.

⁵⁹ Ibid.

⁶⁰ Ebrill et al, supra note 1, p.107.

⁶¹ Gills et al, supra note 32, P.740

the annual income hypothesis, rather several studies have argued that consumption based taxes are proportionally or even progressive in the presence of exemptions designed to reduce the tax burden on the poor.⁶²

2.2.3 VAT as an Indirect Tax

The controversy between direct and indirect taxes is universal.⁶³ According to John Stuart Mill, the distinction between direct versus indirect taxes should be based on- whether the person who actually pay the money over the tax collecting authority suffers a corresponding reduction in his income. Then if he does, in the traditional language, impact and incidence are on the same person and the tax is direct, if not and if the burden is shifted and the real income of some one else is affected it implies that impact and incidence are on different people then the tax is indirect.⁶⁴ The essence of this theory consists in a taxpayer having an opportunity to shift the burden of the tax to other persons so called tax bearers. This shifting theory is classically applicable to indirect taxes and hence in these taxes, the tax burden is shifted from the taxpayer on the tax bearer.⁶⁵ This theory is also applicable to direct taxes, considering this facts, it does not serve as a criteria to distinguish between indirect taxes, including value added tax from direct taxes.⁶⁶ The distinction between direct taxes and indirect taxes particularly value added tax can be analyzed from the legal and economic point of view.⁶⁷ This economic and legal characteristics allowing value added tax and direct taxes to be distinguished are caused by the fact that each taxes has an economic substance, based on the norms of the law establishing these laws.

⁶² Ibid.

⁶³ The differentiation between direct and indirect (including VAT) has its own consequence on trade because indirect taxes are considered as obstacle to international trade by the WTO. See the agreement on subsidy countervailing measures, annex 1 foot note 58 of the WTO on the definition of direct and indirect taxes.

⁶⁴ J.S.Mill, Principles of Political Economics, Book V Chapter III as cited in Alan Schenk and Oliver Oldman, *Value Added Tax: Comparative Approach* (2007), p.5.

⁶⁵ Sentsova, supra note 27, p.189.

⁶⁶ Ibid. Under certain circumstances, direct taxes may partially shifted to the consumer through the price mechanisms.

⁶⁷ Ibid.

a) Economic Point of View

The economic relation in value added tax payments includes three subjects that is the state, the taxpayer and the tax bearer.⁶⁸ From the economic point of view, therefore, these three parties are included. In this matter, the economic relation and tax-legal relation in value added tax payments are not identical i.e. the economic relation include the three parties while the legal relation regulates the state and the taxpayer, where as in direct taxes the economic relation and tax-legal relation are always identical.⁶⁹

Within the economic point of view, the differentiation between direct and value added tax can be made based on consumption tax theory; accordingly, indirect taxes are taxes on consumption and direct taxes are taxes on income – because in their calculation, a person ability to pay is estimated by the calculation of his/her income but in indirect taxes like VAT, the actual ability of the taxpayer is estimated by the kinds and amounts of his/her expense.⁷⁰ Under this method of ability to pay principle, irrespective of the taxpayer that is legally bound to face the levy, and irrespective of the phenomena of shifting the tax burden, a tax is usually considered to be direct if it directly impinges on income or wealth, while it is considered indirect if it impinges on income or wealth indirectly.⁷¹ Besides, drawn from the analysis of general agreement on trade and tariffs, article 1 and article 3, it could be say that while direct taxes are imposed on the taxpayer, indirect taxes are more directly levied up on products.

Moreover, from economic point of view, the distinction between direct and value added tax is quite explained with the method of levy.⁷² Therefore, direct taxes are levied periodically by means of nominal lists of taxpayers and based on certain criteria where as indirect taxes are paid usually from the purchase of goods under the rate tariff established for such taxes. In addition, direct taxes are personal taxes (subjective) which mean the person who bears the tax is known while indirect taxes are objective ones.

⁶⁸ Joachim English, VAT/GST and Direct Taxes in Different Purposes in M. Lang et al supra note 27, p.16.

⁶⁹ Ibid.

⁷⁰ Sentsova, supra note 27, p.192.

⁷¹ Oldman et al, supra note 64, p.6.

⁷² Sentsova, supra note 27, p.192.

Tax deductions can be also another difference in both axes. If we take, as an example, the deductions under the value added tax and deductions under the personal income tax, the deductions under personal income taxes are actually fiscal incentives on the following basis.⁷³ First, deductions under value added tax are provided for all taxpayer without any exception but the deductions under the personal income tax are fiscal incentives as they are not available for every body but for certain category of taxpayers. Secondly, the tax deductions under the income tax are fiscal incentives because they give certain advantage to one category of taxpayers compared to others.

b) Legal Point of View

The obvious distinction between value added tax and direct taxes is found in their legal expression on the basis of their taxable object. The economic object of value added tax is the value added which represents the difference between the costs of the realized goods or services. This economic object of VAT does not find any standard definition in legislation of VAT laws.⁷⁴

The other important means of difference could also found in the technique and legal design of the taxation element. It is clear that the norms of law of VAT should reflect the economic essence of VAT in its characteristics through logically interconnected elements of taxation established in the law.⁷⁵ A tax law analysis shows that the economic nature of VAT and direct taxes is expressed in various ways. In VAT the economic nature is expressed implicitly and in direct taxes, on the contrary, explicitly in the sense that first of all, in VAT, economic aspects of the direct tax shifting mechanism are not defined. The economic aspect of the direct tax is transformed in the rules of law which aggregately define the order of the tax calculation by legal provisions, namely, by the rights and duties of the taxpayer on the offset of the entering tax by the invoice calculation method and so on.⁷⁶ Unlike VAT, therefore, the legal regime of direct taxes calculation does not hide its economic essence through legal provisions. With respect to

⁷³ English, supra note 68, p.2.

⁷⁴ Sentsova, supra note 27, p.194.

⁷⁵ Ibid.

⁷⁶ Ibid.

technique of taxation, VAT has very complex documentation requirement like invoice and allocation of books.⁷⁷

Furthermore, legal distinction between direct and indirect taxes can sometimes be put down as “in direct taxes the principle of the country of origin applies and for indirect taxes country of destination applies” according the report of working party of the WTO.⁷⁸

2.3 Purpose of VAT Compared to Sales, TOT or Other Taxes It Replaced

2.3.1 Revenue

Developed and developing countries around the world embraced VAT as a major revenue mechanisms, especially over the past two decades. Particularly, its spread in the least developed countries indicates a heavy reliance on the hope that the value added will solve the problem of raising revenue while fostering growth with the context of highly competitive global economy.⁷⁹ In fact, the VAT is the second only to the individual income tax in its ability to raise revenue in most OECD member countries, and in some it raises more revenue than the income tax.⁸⁰

The conventional conclusion that can be drawn is that if VAT can be administered adequately, it offers the best way for a country to makeup revenue losses from trade liberalization, though such conclusion appear to hold more convincingly for more developed countries than for the least developed countries in which trade taxes are generally more important and alternative tax bases less accessible.⁸¹ Some researchers also concluded that “there is some evidence that the presence of VAT has been associated with the higher ratio of general government revenue and grants to GDP.”⁸² This study also stated that this relationship seems stronger the higher GDP per capita and the lower

⁷⁷ Id. p.194.

⁷⁸ Boarder tax adjustments, report of working party adopted on 2 Dec/ 1970 L (3464) GATT BISD 18th Sept. /185/97, as cited in Sentsova, supra note 27, p.195.

⁷⁹ Christians, supra note 2, pp.15-16.

⁸⁰ Reuven S. Avi-Yonah “The Three Goals of Taxation”, *Tax Law Review*, Vol.3 (2006-2007), p.5. Some recent studies also questioned the capability of VAT to replace revenue from trade liberalization especially in low income countries. See Thomas Baunsgaard and Michael Kean, “Tax Revenue and (Or?) Trade Liberalization”, IMF Working Paper WP/05/112 (2005), P.10.

⁸¹ Ibid.

⁸² International tax dialog supra note 3, p.11. Moreover, the VAT has been successful in raising revenue even in developing countries with weak administration, which are largely unable to collect the personal income tax from the majority of the population. See Avi-Yonah, supra note 80, p.8.

share of agriculture in GDP though the latter relation may simply effect the common exclusion of most agricultural activity from VAT. Similarly, the study suggested that although the revenue impact of VAT seems smaller the higher the import ratio, this may be simply reflection of the fact that other taxes may be equally effective in such countries.⁸³ On the other hand, more revenue can be collected from an existing VAT if foreign trade becomes important to a country.

Other things being equal, the average economic cost of collecting revenue is less with VAT because the base of VAT is invariably broader than other taxes it replaced. Even if increasing the rate of an existing VAT will neither necessarily increase revenues proportionally nor be costless, it is nonetheless often the economically most sensible way to expand revenue share in developing and transitional countries.⁸⁴

Of course, a definitive answer with respect to VAT's revenue is more difficult to come by single assertions. The above conventional conclusion that VAT is the most economically desirable and administratively effective way in which to collect a given share of the national income holds the capacity to administer can create more complexities and costs for both taxpayers and the tax administration.⁸⁵ Additionally, when the tax is being eroded in such ways, government hard pressed for revenues have sometimes been driven to discretionary and unpredictable enforcement efforts, collecting more where they can and keeping it when they get it whether they should do so or not.⁸⁶ Alternatively, governments sometimes resort to introducing still more legislative changes to close the very gaps that previous political and administrative decisions have opened. There may be also other problems in addition to the poor tax design in reducing revenue gain from VAT:⁸⁷ a gap between the institutional requirements for good VAT administration and the practical institutions in a country. As it is always cited, VAT is basically self-enforced tax but there are some prior conditions that should be fulfilled before such principle is

⁸³ Ibid.

⁸⁴ Ibid.

⁸⁵ Bird, supra note 16, p.7.

⁸⁶ Ebrill et al, supra note 1, p.6.

⁸⁷ Richard M. Bird and Pierre-Pascale Gendron, "Is the VAT the Best Way to Impose a General Consumption Tax in Developing Countries", International Studies Program Working Paper 06-18, May (2006), p.15.

implemented. Experts stated that⁸⁸ the conditions include a simple, clear and stable tax laws; adequate service and support to taxpayers in complying with tax obligations; effective collection enforcement, reasonable audit coverage, and strict application of penalties. Since many countries with VAT do not satisfy all of these conditions, VAT actually implemented is often a very different tax than VAT as set out in the law.

The extent to which deviations from good VAT practice used to reward political supporters or as instruments of industrial policy is another problem.⁸⁹ In the economics and political environments of many developing and transitional countries, such policies attractive almost certainly ensure that they are unlikely to have good results in revenue or any other terms.

Within the framework of VAT legislations, the rates, exemptions and base of the law are also other determinant factors to the reduction or increment of revenue from VAT. The emerging conventional wisdom based on practice and numerous country case studies suggests that a single VAT rate, with very few exemptions and a broad base is superior to a VAT with multiple rates and many exemptions which reduce its base and compliance administration.⁹⁰

As Tait pointed out, administrative and compliance costs rise dramatically as the number of rates increase.⁹¹ Thus, rate differentiation, through higher costs, may adversely affect revenue. Besides, single rate is almost always revenue superior to multiple rates with little rate depression. Consequently, it may be that it is dispersion of rates rather the number of rates perse that may adversely affect revenue.⁹²

The money machine character of introducing VAT remains open to interpretation and question as recently underlined by some who question the capability of VAT to replace

⁸⁸ Victor Thuronyi, *Comparative Tax Law* cited in Richard M. Bird, et al. supra note 83, p.17. Thuronyi also noted that “while there are differences in VAT from one country to another, compared with the income tax VAT laws are remarkably similar”.

⁸⁹ M. Bird et al, supra note 87, p.18.

⁹⁰ Ibid

⁹¹ Some useful reviews on the problem of VAT refunds is discussed in Graham Harrison and Russell Krelove, “VAT Refunds: A Review of Country Experience”, IMF Working Paper Wp05/218 (2005), p.15

⁹² M. Bird et al, supra note 87, p.19.

revenue for trade liberalization in some developing and transitional economics.⁹³ Perhaps the most important point emerging from these studies is the extreme variation across countries in the revenue performance of VAT, reflecting a wide range of factors including differences in VAT design, difference in economic environment and different characteristics in different economics. The IMF study in 2001 noted a number of empirical regularities with respect to trade, country size and government size and its relation on revenue.⁹⁴ Accordingly, countries that have implemented a VAT have relatively higher per capita GDP levels and rely less on international trade. Both income and openness are positively correlated with the ratio of taxes to GDP. A relatively high ratio of trade to GDP is conducive to VAT revenue performance presumably due to the relative ease of collecting VAT at the point of import and economics for which international trade is important tend to have highest tax yields whether or not they operate a VAT. Consequently, very small economies may have characterized that facilitate tax enforcement such as social structure and remoteness.

Another data⁹⁵ also suggest that there is no obvious variation between the level of economic development and the importance of VAT revenues and that there is also no clear relation between the level of economic development and VAT productivity or efficiency. On the other hand, there does seem to be definite correlation VAT productivity and VAT share of GDP.

There is also a relation between the revenue collection of VAT and its legal framework. Initially VAT legislations, in most DTE, were usually close to standard international models in part because it was often been drafted in whole or in part with the participation of international experts.⁹⁶ As time goes, however, most countries VAT have tended to become more complex in structure and some substantial changes from the initial one particularly the structure of VAT becomes littered with privilege and exemptions that

⁹³ Ebrill et al, supra note 1, p.141.

⁹⁴ M. Bird et al, supra note 87, p.20.

⁹⁵ World Bank lessons of tax reforms, cited in Zeljko Bogetic and Fareed Hassen, "Determinants Value Added Tax Revenue: A Cross Section Analysis", World Bank Policy Research Working Paper Wps1203 (1993), p.2. An inspection of sample of 49 countries, according these experts, found that first, the use of more than one rate doesn't help to raise more revenue, secondly, though multiple rates offer greater opportunity to fit the VAT various social and political ends, rate differentiation raises administrative and compliance costs which undermine the VAT performance. Id. P.3.

⁹⁶ Tait, supra note 49, p.160.

minimize its revenue impact and make it difficult to manage, requiring frequent tune-ups to keep the revenue coming in.⁹⁷ Once concessions enter the system they are often subsequently enlarged through political lobbying and other means. Such concessions, therefore, decrease revenue of VAT.

2.3.2 Neutrality

From certain point of view, discrimination is the opposite of neutrality as there is always one factor that is treated more or less favorably than others and with discrimination against somebody or something.⁹⁸

The neutrality of VAT can be broadly divided in to external as well as internal neutrality and the later neutrality can further divided in to legal, competitive and economic neutrality.⁹⁹ The legal neutrality of the VAT is expressed when there is a relation between tax burden and the ratio of the consumption of the taxpayer.¹⁰⁰ Competitive neutrality on the other hand refers to the situation that the tax burden is not depending on the rate of vertical or horizontal integration. In this situation, when the tax rate is set as a percentage of the sale price enterprises do not have any reason for integration for taxation purposes and hence competition is not distorted. Economic neutrality of VAT on the other hand refers that the tax will not distort economic decisions among products or methods of production or between present and future consumption. The economic neutrality of VAT can be sensed that a flat tax rate on the labor and capital cost income in every business does not change the relative price of any input or output.¹⁰¹ To illustrate with an example¹⁰² assumed that a perfectly functioning economy, there a two percent VAT is imposed. The products are all increased by two percent. Ultimately, the imposition of the

⁹⁷ Bogetic et al, supra note 95, p.4. See also Borbala Kolozs, *Neutrality in VAT*, in M. Lang et al., supra note 27, p.201.

⁹⁸ Ibid.

⁹⁹ Ibid.

¹⁰⁰ The VAT has to be set as a percentage of the sale price otherwise the tax burden would not be proportional. Moreover, the tax burden could not have been identified for the identical good produced by producer with a different integration and therefore the tax value burden could be different. Id. P.202.

¹⁰¹ W.Haughey, supra note 5, p.1019.

¹⁰² This illustration assumes a perfectly functioning market economy with no taxes. Besides, if each firm combines factors of production (labor, land and capital) in the most efficient manner, resources are bid in their most productive use. Payments to these factors in a competitive market are approximately equal to each factor's contribution to the market value. Each firm's value added can be thought of proportional on each firm's use of the factors of production. Id., p.1020.

tax increases the prices of all commodities by two percent but it has no other effect on the economy. Relative prices are unchanged, no commodity costs relatively more or less than it did before the tax was imposed. Since the relative price of outputs and inputs are unchanged, the relative output of each good and the relative income of every person is unchanged. No alternation in any economic decision has been caused by the imposition of the tax. This is what economic neutrality mean.¹⁰³

The neutrality of value added tax is also expressed in non-discriminatory application to labor intensive industries or capital intensive industries because it is applicable in both cases.¹⁰⁴ Besides, since the value added can be levied on all forms of business organization, it does not discriminate against any particular enterprise. One additional neutrality aspect of the value added tax is stressed that since the base of that tax is value added, taxes paid at earlier stages in the production distribution process are not pyramided throughout the economy.¹⁰⁵

The VAT enjoys the reputation of being the most neutral form of taxation in theory. The neutrality argument is valid however, only if the ideal type of VAT is enacted that if the tax is comprehensive in coverage and applied at a single rate.¹⁰⁶ In actual practice, adherence to the idea of neutrality in the VAT has been sacrificed in order to accommodate other worthwhile public policy concerns. As to the comprehensive base for instance, there are some items that are very difficult to include, at least for the consumption variety of the tax.¹⁰⁷ Accordingly, basic necessities, small business and financial services are exempted in many countries.

The single tax rate ideal has been also sacrificed to practical necessary in several value added tax enactments. The case for granting preferential VAT treatment, either by tax

¹⁰³ Some authors also stipulated that a VAT that is introduced in a revenue neutral manner would have no impact in the aggregate price level, since the aggregate demand in this case is uncharged but this conclusion will not hold if the tax switch elicits a supply response to a lower degree of distortion. See Howell zee, H, value added tax, cited in Hiranya Mokhopadhyay, "Cascading, Revenue Neutrality and the VAT: Some Theoretical Results", National Institute of Public Finance and Policy Working Papers No.97/3, (April 1997), p. 2.

¹⁰⁴ W.Haughey, supra note 5, p.1023.

¹⁰⁵ Ibid.

¹⁰⁶ Gerald, "Value Added Tax: Its Concepts and Effects", *Cincinnati Law Review* Vol.39 (1970), p.340.

¹⁰⁷ The issue of exemption and zero rating is discussed in chapter three topic 3.2 and 3.1.2 respectively.

exemption or the use of a multiple rate structure, rests on familiar arguments. Indeed, a major policy concern in any form of taxation involves the preferential tax treatment accorded to certain businesses and individuals.¹⁰⁸ The same pressure and public concerns are likely to apply in the case of VAT there by resulting in a preferential tax treatment may be designed in to a value added tax for certain sectors of the economy.

Although there are significant policy argument for such concessions and varying rates, these deviations from a uniform rate some what contradict the theory of the strict economic neutrality. Despite such argument, it is a well known fact that the value added tax replaced inefficient, cascading and badly administered taxes.¹⁰⁹ As discussed in the above, the neutrality of VAT may be reduced because of preferential treatment and multiple rates but the value added tax is more neutral than the taxes it replaces. Besides, providing few exemptions and little zero rating VAT can make VAT non-distortable. Besides, in practice it is difficult to find a complete neutral VAT, even other tax, in this world.

2.3.3 Efficiency

If consumption taxes only taxes consumption and taxing it compressively, it is possible to achieve efficiency. Taxes are going to be say efficient if they eliminate tax related distortions in decisions to work, save and invest.¹¹⁰ As it is discussed above, the VAT avoids cascading effect of tax by providing credits to inputs.

The efficiency of value added tax in terms of collection can be analyzed vis-à-vis urbanization, trade openness, real GDP per capita and measures of political instability and the fluidity of political participations, agricultural share of GDP.¹¹¹ It has positive relation with the first measurements but it is negatively related with agriculture share

¹⁰⁸ W.Leland, supra note 106, p.340.

¹⁰⁹ Tait, Supra note 49, pp. 6-7.

¹¹⁰ Malcolm Gills, Peter Mieszkoloski, and George R. Zodiow, "Indirect Consumption Taxes: Common Issues and Differences among the Alternative Approaches", *Tax Law Review*, Vol.51 (1995), p. 767.

¹¹¹ J. A.Zenman, And Y. Jinjark, "The Collection Efficiency of the Value Added Tax, Theory and International Evidence", *the Journal of International Trade and Economic Environment*, Vol.17, No.3 (2008), p.392.

GDP. That means as the share of agriculture to GDP increase the collection efficiency of VAT decreases.¹¹²

Besides, Stiglitz cautioned that the welfare gains from a switch to the VAT are questionable in the presence of large informal sector and Baunsgaard and Keen found that revenue recovery for trade liberalization has been very weak in low income countries.¹¹³

One of the advantages of VAT is that this tax is collected throughout the production chain, giving it a practical advantage. In other words, it is stated that the VAT is associated with easier enforcement as it allows the enforcing authority to compare reported sales of each intermediate product with reported purchases of producers using the intermediate product as on inputs in a vertical production chain. This gives efficiency to the value added tax. In general, it is shown that greater political instability and polarization tends to reduce VAT efficiency in addition to less urbanization, less trade openness and higher share of agriculture, reduce the collection efficiency of VAT.¹¹⁴

Liam Ebrill et al, identifies that “it is difficult to quantify the impact on economic efficiency of adopting VAT.” They goes on to say that production efficiency is acquired through the exclusion of inputs from the tax base and out of this the efficiency of VAT can be identify by looking indirectly the low efficiency costs raising revenue by VAT which gives government with a VAT raises more total revenue than those without.¹¹⁵

2.4. Types of VAT by means of calculation

Once a legislature defines the value added tax base, it must further define and determine whether the taxpayer shall calculate the value added tax based on the factor of production

¹¹² The most important explanatory variables are urbanization and real GDP per capita. See M.Bird et al., supra note 87, p.16.

¹¹³ Baunsgaard et al, supra note 80, p.20 and see also On Selective Indirect Tax Reform in Developing Countries, cited in Zenman et al, supra note 111, p.392.

¹¹⁴ Zenman et al, supra note 111, p.293.

¹¹⁵ Ebrill et al, supra note 1, p.27. They also discussed that “cross to a more efficient tax instrument will lead an increase in the tax GDP ratio. While a lower marginal efficiency cost of raising revenue can be expected to lead to more revenue being collected”

(Additive method)¹¹⁶ or based on the persons sales and purchases (credit invoice method)¹¹⁷ or subtracting purchases from sales and applied the tax rate (subtractive method).¹¹⁸ In spite of such classification of methods i.e. indirectly crediting the tax on purchases against the tax on sales under the credit invoice VAT, directly by subtracting purchases from sales and applying the difference under the direct subtraction method and directly by taxing aggregate labor income and capital income jointly at the business level under the addition method, the same total tax can be collected in all these systems in theory.¹¹⁹

The equivalence of the various methods of calculation can be illustrated by the following example assume that the sale of desk and its process. The primary producer(p) sells the wood to the furniture manufacturer(m) with 400 Birr with no purchases and also sale to wholesaler(w) of desk with 1,200 birr with previous 400 purchase from p and the wholesaler sold with 1,400 Birr with 1,200 previous purchase. Then assumed that each stage purchases the whole output of the previous stage and the primary producer has zero inputs and the primary producer has zero inputs for simplicity and 10% rate. According to the invoice credit method, in ‘P’ there is no previous input we get 40 Birr by multiplying the sale with 10% rate. In 10% of 1,200 gives us 120 but there was 40 birr

¹¹⁶ The addition method VAT requires taxable entities to calculate tax liability by adding the cost of the firm’s economic factors production plus a measure of profit for VAT purpose, and multiplying the total by the tax rate. See Schenk et al, supra note 64, p.43. This Addition method has never been adopted as a national tax in any Jurisdiction but the Michigan state even if arguable, has such method of calculation. See *Itai Grinberg, Where Credit is Due: Advantages of the Credit Invoice Method for a Partial Replacement VAT*, Prepared for the American Tax Policy Institute conference, Washington DC, February 18-19, 2009, p.2 available at www.americantaxpolicyinstitute.org/pdf accessed on April 16, 2010

¹¹⁷ This method is particularly distinguished with its invoice method and this is the most common method applied with VAT countries. See infra note 121 and accompanying text.

¹¹⁸ The subtractive method is related to the Japanese VAT system. Under the Japanese system, goods taxed on taxable sale is calculated in the same way as the credit invoice method but taxpayers are allowed to subtract from their VAT liability an amount of input credit that is calculated from aggregate accounts based on the total purchases from domestic entities instead of subtracting the amount of tax paid on each individual transaction with a registered trader similarly with credit method VAT. See Schenk et al supra note 112, p. 42. See also details on subtractive method infra note 136 and its accompanying text.

¹¹⁹ It is worth mentioning here, Ato Lidetu Ayalew complain during the parliament last session in June 2010, asked to Prime Minister Melese Zenawi on his report that: the VAT paid practically is not as the concept of the value added tax, because he says” customers are taxed not the value added but the totality of their sale” this researcher believes that this is raised because of the misunderstanding of the means of calculation of VAT. Ato Lidetu was talking, I think, according the subtraction method which taxes only the value added directly but it similar with credit invoice method, applicable in Ethiopia, which indirectly taxes the difference.

input tax, it gives 80 birr. In 'W' 10% of 1,400 gives us 140 but subtracting the 120 birr of its inputs gives 20 birr. The total tax is 40 +80+ 20 equals 140.

In the subtraction method, the formula is tax on sales minus purchase and multiplying by the rate. Consequently there will be 40 birr tax from P, 80 from M and 20 from W with a total of 140 birr. In the addition method, the value inputs increases by the value of labor and capital, and assume that the value added in 'p' 400 birr accounts 380 from wage and 20 from capital income; then in 'M' 800, 750 from wage and 50 from capital income and in 'W' 200, 190 from wage and 10 from capital income, then 10% of individual wages and 10 of capital income in 'P' gives 40, in 'M' 80 and in 'W' 20, with a total of 140 birr. This implies the equivalence of the systems.

2.4.1 Credit Invoice Method VAT

In a credit invoice method VAT, registered business assess tax in taxable goods and services each time they supply such a good or service to either a business or a consumer. In this case, registered traders are permitted to reduce the amount of VAT they are liable to remit to the government by a credit equal to the amount of VAT paid to other registered traders.¹²⁰ In credit invoice method, the amount of VAT credit available to a registered trade to offset VAT liability is determined based on printed invoices received by a purchasing registered trader from a selling registered trader.¹²¹ In order to obtain the tax credit, an entity will want to be sure that the suppliers invoice is correct.

The method of using invoices makes this VAT system self-enforcing in two senses. Firstly, registered traders demand invoice requirement in order to claim input credits that reduce their own VAT liability and secondly, in time of subsequent claim, VAT invoices create a paper trail that give tax authorities an independent source of information about the selling firm sales which help authorities to enforce VAT.¹²² The availability of input

¹²⁰ Cnossen, supra note 13, p. 321.

¹²¹ This invoice contains the amount of VAT collected on a given sale, and VAT registration numbers of the buyer and seller, and so on. See VAT proclamation, supra note 24, Art 22.

¹²² Grinberg, supra note 116, p.5.

credits can imply that a registered trader with more input credits than VAT liability can obtain a refund for VAT paid in excess of inputs credits.¹²³

The credit invoice method has the advantage from other methods by which the failure to collect tax at any point prior to the retail level will not result in less net tax revenue to the government because the reduced tax at a pre-retail stage will be offset by a correspondingly reduced tax credit.¹²⁴ Hence there is no reason at the pre-retail stage not to apply the VAT since a credit will be obtained any way.

Under this credit method VAT, tax is not chargeable or payable until the goods are sold or services are rendered i.e. the tax is separately stated on invoices, payable at the time of sale, and the taxpayer receives a credit against his VAT liability for VAT it has paid on purchases during the reporting period, the tax does not become build in to the price of product as it proceeds through the stages of production and distribution.¹²⁵ Therefore, the tax component in each goods or services can be precisely determined under this credit method VAT.

Under the credit invoice method, VAT liability and VAT credits are not matched for individual item sold, notwithstanding that this VAT system is referred as transaction based tax, because the tax is assessed on each individual transaction subject to the VAT. So it can be precisely described as a transaction based accounts verified VAT because while the tax is assessed on each individual transaction, tax remittance to the authority is calculated and audited based on accounts.¹²⁶

2.4.2 Additive Method VAT

With an additive method VAT, a taxpayer totals for each accounting period the respective amounts attributable to the factors of production which added value to its taxable goods

¹²³ This can be particularly happen in Zero rated goods and/or services which allows the registered business for input credit but not VAT liability because of the Zero rate; for example export items are zero rated in Ethiopia VAT law see on this issue chapter three on zero rate topic 3.1.2

¹²⁴ Peter Chio and Joel G. Siepel, "What the Value Added Tax is all about", *The Tax Magazine*, Vol.67, No.1 (January,1989), p.340.

¹²⁵ "Evaluation of an Additive Method Value Added Tax for Use in the USA", *Tax Lawyer*, Vol.30, No.3, (1976-1977), p.568.

¹²⁶ Grinberg, supra note 116, p.6.

and services, wages, certain interest and rent expense and profit.¹²⁷ To clarify with an example, if a manufacturer had 20,000 in wages, 1,000 in interest and 4,000 in rent includable in the VAT rate, it would have a VAT liability of 3,000 because aggregating the tax base and multiplying by ten percent gives 3,000. In theory, in the same tax base a VAT calculated under the additive and credit method is equal but practically when VAT calculated by the additive method, tax is levied as the value added whether the goods produced are sold or remain in inventory.¹²⁸

Under additive method, a vertically integrated manufacturer may obtain a competitive advantage over the non-integrated business.¹²⁹ This solely because, for example, at the manufacturing level, the additive method tax imposed on the higher profit would increase the sale price of the product to the wholesaler. This sales price to the wholesaler also includes VAT imposed at prior stages of production and distribution. This cost element in the goods purchased will at least carry an interest factor with it.

There are some drawbacks particularly attributed to this method of VAT.¹³⁰ One of the difficulties in this method is zero-rating of goods and services.¹³¹ To illustrate, if a processor of zero rated food purchases paper products to package its food, the processor should receive a credit against VAT liability for the VAT element in the cost of paper purchased hence the processor cannot compute with accuracy the VAT components in the price of this paper. The other problem of this additive method compared to invoice credit VAT is that it may cause revenue loss because this method is based on the value added at a particular stage and does not have mechanism by which lost revenue at an earlier stage may be recouped.¹³²

¹²⁷ Supra note 125, p.567

¹²⁸ This method leads to the acceleration of VAT liability because prior to sale a firm adds value through the employment of labor or expenditure of funds for rent and interest. See supra note 125, p. 568

¹²⁹ This will not happen in credit invoice method since one factor in the additive VAT base, profit, would not arise until the wholesale division sold the goods. See Ibid, p. 572

¹³⁰ Ibid.

¹³¹ Such difficulty of granting exemption or zero rating by type of product or service really contravenes the political, economic or social achievements through zero rating or exemptions. Chapter three of this research devoted on such issues.

¹³² Victor Thuronyi in M.Bird, supra note 88, p.18. See also "Should the United Sate Adopt the Value Added Tax? a Survey of The Policy Considerations the Data Base", *Tax Lawyer*, Vol.26, No.2 (1972), p.45.

Besides, the additive method may have disadvantage on companies which maintain large inventories goods like steel and auto industries, oil exploration, construction industry which probably would prefer the credit than additive in contrast to companies with quick turn over of goods and services which could not suffer such disadvantages.¹³³

There are also special problems related with additive methods like the issue of multiple taxation of single item, for instance, a chain of lenders with same property,¹³⁴ definitional problems with compensation and profit.¹³⁵

2.4.3 Subtraction Method VAT

The general design features of subtraction method VAT are somewhat less well specified than those of a credit invoice method VAT and this method particularly distinguished by the absence of credits.¹³⁶ In contrast to credit invoice method, which is generally perceived on a tax-exclusive basis, the subtraction method is thought of on a tax-inclusive basis.¹³⁷

As discussed earlier, in principle, the credit invoice method and subtraction method VAT are nearly identical i.e. both are multi-stage taxes but the key substantive difference between these two systems is the subtractive method does not impose an invoice credit requirement.¹³⁸

In a credit invoice method VAT, no VAT is collected on exempt supplies; similarly a registered trader will not receive input credits for inputs associated with provision of supplies. In subtraction method VAT, revenues from the sale of exempt supplies are excluded from the registered trader's VAT base. For this reason, exemption in a credit-invoice method VAT can be characterized as input taxation.¹³⁹

¹³³ Ibid. This is so because the taxable person does not have VAT element in its raw materials work in process, or finished goods inventories but in the additive method there will be a VAT element in the cost of raw materials, work in process and finished goods inventories.

¹³⁴ Sullivan, supra note 12, p.7.

¹³⁵ Supra note 125, p.580.

¹³⁶ Grinberg, supra note 116, p.7.

¹³⁷ Ibid.

¹³⁸ David Weisbach, "Ironing out the Flat Tax", *Stanford Law Review*, Vol.52 (2000), p.599.

¹³⁹ Grinberg, supra note 116, p.14.

In contrast, exemption in an open subtraction method VAT will not result in the denial of deductions associated with the exempt good or service. Thus, while exemptions of an intermediate-stage good or service in a subtraction method VAT reduces total tax collected in the value chain, exemption of an intermediate stage good or service in a credit-invoice method VAT increase total tax collected in the value chain.¹⁴⁰

Advocates of this method VAT may claim that this VAT more likely to be imposed on a broad base, and avoid exemptions because it is entity based, however, under the credit invoice method VAT, too, providers of intermediate good prefer their sales to be fully taxed to get input tax and to avoid expensiveness of goods to the final consumers. Besides, although there are good policy arguments in favor of minimizing exemptions generally no country has removed all exemptions from its VAT.¹⁴¹ Conventional analysis highlight that a credit invoice method VAT, as distinct from a subtraction method VAT, provides flexibility to impose preferential tax rates on specific goods or services. In contrast, without an invoice requirement, a subtraction method VAT cannot feasibly be administered with multiple tax rates.¹⁴² If we take grape grower sold grape to the winemaker and the winemaker sold to the retailer and if there is preferential rate in the process, the tax authority must know not only what part of the retailer sales consisted of grapes but also what part of the retailer's sales consisted of wine and the tax rate paid one each of these inputs.¹⁴³ In the absence of an invoice requirement the necessary information could not available.

With regard to exemptions, a small business exemption is problematic in an open subtraction method VAT because purchases from exempt small business can still be deducted by registered traders.¹⁴⁴ Without an invoice requirement, a small business exemptions creates the potential for firms to, among other abuses, avoid VAT liability on inputs by purchasing from business below the small business threshold, to convert non

¹⁴⁰ In credit invoice method, in case when there is an exempt good or business, this exemption will not lead to reduction of revenue because there will not a credit for the exempted good or business, in spite of cascading effect, there will be an increase in revenue .

¹⁴¹ David Williams, *Value Added Tax in Tax Law Design and Drafting* Vol.1 (1996), Victor Thuronyi (ed.) P. 58.

¹⁴² U.S. General Accounting Office, *Tax Credit and Subtraction Method of Calculating a Value Added Tax*, June 1989, available at <http://archive.gao.gov/dzst7/138940.pdf> accessed on April 16, 2010.

¹⁴³ Ibid. See also Grinberg, supra note 116, p. 19.

¹⁴⁴ Jack M. Mintz, *The Business Transfer Tax as Consumption Tax*, cited in Grin Berg, supra note 79, p.29.

deductible salary expenses in to deductible service costs by housing their employees in separate legal entities, and to avoid VAT collection on sales by organizing their activities in a series of small enterprises.¹⁴⁵

With respect to the WTO rules, a subtraction method VAT might be challenged as a direct tax under WTO rules in the sense that the imposition of custom duty at the subtraction method VAT rate on imports might be challenged as violating WTO rules and the boarder adjustments provided for exported goods under a subtraction method VAT might be challenged as being excessive.¹⁴⁶

The 1970 GATT working party on boarder tax adjustment concluded that a credit invoice method VAT was equivalent to a retail sales tax levied directly on products, and thus was boarder adjustable.¹⁴⁷ Unlike to credit invoice method, a subtraction method VAT may not formally be treated as a tax imposed on sales to consumers through fractioned collection. Besides, the subtraction method VAT could be characterized as tax on an entity, rather than on products, collecting tax on imports at the boarder in the context of a subtraction method VAT might be susceptible to challenge as a lot impermissible custom duty less favorable than that accorded products of domestic origin in contrast to the in lieu of domestic taxation portion of a credit invoice method value added tax.¹⁴⁸

With respect to negative value added,¹⁴⁹ the possibility of improper claims in open subtraction method VAT makes immediate refundability of negative taxable value added a significant revenue risk. Without invoices to allow for audit and ensure of setting tax revenue, the abuse potential implicit in being able to demand a check from the fisc by claiming to have negative taxable value added is great.¹⁵⁰ Although refund fraud exists in the credit invoice method VAT, the invoice requirement empirically has provided a reasonably adequate requirement mechanism because it helps authorities to check it out.

¹⁴⁵ Bloomfield et al, supra note 15, pp.117-120.

¹⁴⁶ Under the GATT rules, a boarded tax adjustments applied to a direct tax is prohibited trade subsidy, GATT, 1947, Article III Para.49,.

¹⁴⁷ Report of the working party, boarder tax adjustments cited in Grinberg supra note 116, p.33.

¹⁴⁸ Ibid.

¹⁴⁹ Negative tax arises whenever taxed inputs exceed taxable supplies with this respect exporters generally have negative taxable value added because they are generally zero-rated. A more detail analysis is done in chapter three.

¹⁵⁰ Weisbach, supra note 138, p.599.

In addition to the above, credit invoice method VAT may be more likely to be imposed in a manner that avoids double taxation and double non-taxation of cross border services than subtraction method value added tax's.¹⁵¹

2.5 Types of Value Added Tax

Value added taxes are of three types. The crucial difference among them is the treatment of capital assets.¹⁵²

2.5.1 Gross Product VAT

Under this approach, the business is not permitted to deduct the cost of the depreciation on capital goods purchased from other firms in calculating its tax liability. Purchases of goods and services from other firms that are entirely used up in the current year that is purchases on current account can be deducted.¹⁵³ To illustrate with example, assume a firm has only gross receipts of 125,000; 10,000 purchases of machine and a 25,000 purchases of materials and supplies, three transactions in the course of its taxable year. For this firm, the gross product VAT base will be 100,000 (125,000 in gross receipts less 25,000 in purchases on current account). No deduction is permitted for the 10,000 machine since this is purchase of capital. Of the three types value added tax bases, the gross product version places the heaviest tax liability on capital goods and therefore may influence firms to minimize the use of capital assets.¹⁵⁴

2.5.2. Income Type VAT

Under this type of tax, the cost of a capital asset is not deducted when it is purchased.¹⁵⁵ The income type tax base does, however, permit the firm to deduct the amount of depreciation that occurs in a given year on its capital assets. Under this type VAT,

¹⁵¹ Grinberg, *supra* notes 116, p.35.

¹⁵² Ernest S., "The Best of Both: Where VAT and Tax Integration Converge", *Value Added Tax Executive*, Vol.42 (1990), p.42.

¹⁵³ Richard W. Lindholm, "The Value Added Tax-Rebuttal of Negative View" *Tax Executive*, Vol.86 (1969-1970), p.85.

¹⁵⁴ *Ibid*, p. 87.

¹⁵⁵ Richard W. Lindholm, "The Origin of Value Added Tax" the *Journal of Corporation Law*, Vol.6 (1990-1991), p.11.

depreciation is allowed on all capital assets whether old or new.¹⁵⁶ If we take three transactions in the above an item for depreciation of its purchased machine is added if we assume 1,000 for the year then the income type value added tax base would be 99,000 (124,000 gross receipts from sales less 25,000 for purchases for materials and supplies less 1000 for depreciation of the machine during the year.)

The income type value added tax is complicated by the fact that it involves the depreciation of capital equipment computation of depreciation is complex under this VAT because it requires separation of purchases and sales of both capital and current goods, therefore more difficult to administer than others. Because of the treatment of depreciation allowances is one of the more arbitrary elements of the income tax, there are some oppositions to the income type VAT.¹⁵⁷

2.5.3. Consumption Type of VAT

The consumption type of VAT provides the most nearly neutral treatment of capital assets.¹⁵⁸ Under this tax base, a firm that purchases a capital asset may deduct, in the year of purchase, the full value of this purchase. In contrast to the income type value added tax, where depreciation is deducted year by year, the consumption value added approach permits no adjustments for depreciation since to do so- after allowing deduction of full value in the year of purchase, would amount to deducting the price of the capital good twice. The name consumption by it self signifies for the situation that the VAT represented by the capital equipment is not subject to tax until later years, as the equipment is being consumed in the process of production.¹⁵⁹

The significant different centers on the time path for the value added. Under the consumption type tax (where the purchase is deducted in the year of acquisition), the value added is small during the first year but larger each of the following years if the

¹⁵⁶ Ibid. See also, supra note 152, p.42.

¹⁵⁷ Ibid.

¹⁵⁸ Id. p.12.

¹⁵⁹ Id. In effect, the intermediate tax rebate granted to users of capital equipment imposes the tax only once on gross proceeds of the sales of the goods and services produced by the capital equipment.

income type VAT applied.¹⁶⁰ Besides under the consumption type, the tax deduction is restricted to new purchases of plant and equipment.

The consumption VAT is preferable over others. One of the most important advantage is that it is easier to apply a very practical concern for matters of tax administration. Unlike the income type base, there would be far easier to apply a very practical concern for matters of tax administration.¹⁶¹ Besides, according to the above discussion, it can be concluded that the consumption type VAT would be advantageous to new and growing firms because capital expenditures will be deducted in the year of purchases.

¹⁶⁰ Christian, *supra* note 152, p.43.

¹⁶¹ Unlike the income type base, there would be no need to distinguish between intermediate and capital goods with the consumption VAT, the tax credit would be allowed on all business purchases, so there in no need to account for each such item, either by the business firm or by the government. *Ibid*, p.44.

Conclusion

Value added tax is an indirect consumption tax levied at a multi stage production and distribution. Compared to the sales tax, value added tax has the following advantages. It is self enforcing; it discourages evasion as it creates a paper trail that facilitate audit; it eliminates business purchases from the tax base; and provide less incentive and thus less political pressure for tax exemptions. The other consumption tax, TOT, has the following problems. TOT creates cascading, encourages vertical mergers between business firms and the TOT has a difficulty of exempting exports because it has been levied several times on the constituents of the exported commodity.

Coming to the regressivity of VAT, the value added tax is criticized and considered unfair to lower income individuals and families. As a result of such view, different laws whether proposed or enacted have special rules to alter the distributional burden like multiple rate, exemption and zero rating commonly known as a rate differentials and the reimbursement system. However, out of these two systems, there is another scenario on regressivity versus progressivity VAT i.e. annual income verses individual income controversy. The life cycle theory of consumption and saving argues that individuals go through three main phases of consumption and saving over their lives and in these stages consumption and saving differed accordingly. as a result, it adopts, distribution of the tax burden is effectively measured relative to consumption than income.

The distinction between value added tax and indirect taxes particularly value added tax can be analyzed from the legal and economic point of view. From the economic point of view, the common means of difference are method of levy, actual purpose of tax deductions and its direct and indirect impact on income.

From the legal point of view, in VAT the economic nature is expressed implicitly and in direct taxes, on the contrary, explicitly. Furthermore, legal distinction between direct and indirect taxes can sometimes be put down “in direct taxes the principle of the country of origin applies and for indirect taxes country of destination applies.”

Comparing to taxes it replaced like the TOT and sales tax, the VAT have best record in revenue, neutrality and efficiency.

Within the revenue, in the literatures it is indicated that the presence of VAT has been associated with the higher ratio of general government revenue and grants to GDP. The emerging conventional wisdom based on practice and numerous country case studies suggests that a single VAT rate, with very few exemptions and a broad base is superior to a VAT with multiple rates and many exemptions which reduce its base and compliance administration.

The neutrality of VAT can be broadly divided in to external as well as internal neutrality and the later neutrality can further divided in to legal, competitive and economic neutrality. Its application to labor or capital intensive industries and its levy on all forms of business organization is another expression of neutrality of VAT. The neutrality argument is valid however, only if the ideal type of VAT is enacted that if the tax broad based and applied at a single rate. Nonetheless, even in the absence of such facts, the value added tax is more neutral than the taxes it replaces.

Value added tax is more efficient than other taxes since it eliminates tax related distortions in decisions to work, save and invest and collection cost is low.

Based on of method calculation, VAT can be calculated based on the factor of production (Additive method) or based on the person's sales and purchases (credit invoice method) or subtracting purchases from sales and applied the tax rate (subtractive method). However, the same total tax can be collected in all these systems in theory.

Up on the treatment of capital assets value added taxes can be grouped as gross product, consumption and income type VAT. Under the gross product VAT, the cost of a capital asset is not deducted when it is purchased. The income type tax base does, however, permit the firm to deduct the amount of depreciation that occurs in a given year on its capital assets. The consumption value added approach permits no adjustments for depreciation since to do so- after allowing deduction of full value in the year of purchase, would amount to deducting the price of the capital good twice.

Chapter Three

Comparative Value Added Tax Policy Issues on Rates, Thresholds, and Exemptions and their Impact on Enforcement

As to the design of VAT laws, there is a principle of NOFTA which means no one size fits all.¹⁶² This solely arises because the context within which they must be answered tax design differs significantly from country to country and indeed over time within any one country. It is only to be expected that different tax designs may be best for different countries. The features of VAT like the single rate or multiple rate, exemptions or broad based, the minimum threshold or inclusiveness of every business that may be universally desirable in some sense may nonetheless either not attainable or indeed neither essential nor desirable in the context of a particular country at a particular time. However, this does not mean that there are no acceptable principles. Though they are theoretical, there are some practices and theoretical foundations for the ease enforcement of value added tax. At least the single rate or multiple, broad based or full of exemptions, minimum threshold or otherwise options have their own particular effects on enforcement of a VAT system.

In this chapter the researcher will try to analyze these available options with their drawbacks or positive sides vis-à-vis acceptable practices and theories.

3.1 Rate of Value Added Tax

3.1.1 Multiple Vs Single Rate Approach

Rate of value added tax in a country may opt to have one single rate or other rates out of the standard rate. Multiple rates refer the existence of additional rate whether below or above the standard rate where as single rate refers the adoption of one rate out of zero-rate. There are some justifications towards the approach of adopting multiple rates. One of the common justifications towards the implementation of one more reduced rate out of the standard rate is, traditionally the poorest households are presumed to spend high

¹⁶² Bird, supra note 16, P.11.

proportion of their income on essential goods and services.¹⁶³ This means, the poor would suffer more from VAT, example food, hence reduced VAT rates will minimize the supposed regressivity of the tax and achieve some level of redistribution to the poorest households.¹⁶⁴

The other possible reason towards the multiple rates approach could be that taxation on labor intensive services would encourage consumers to adopt inefficient methods of self supply and to reduce the extent of tax evasion. One study on the member of EU countries suggests that reduced rates applied to carefully targeted sector may provide some benefits, for instance, when the locally supplied services sector employs many low skilled workers and this might shift do- it- yourself work or eliminate it the shadow economy to the formal sector.¹⁶⁵

However, the regressivity of value added tax and applying multiple rates as a means of solution is not acceptable in different literatures.¹⁶⁶ If we take food as an example of taxing at a reduced rate as a solution of course, the poor expend most of their income on food and we may think of taxing food less than others or zero-rate or subsidize it but the result gained as such is very limited.¹⁶⁷

¹⁶³ Alan Charlet and Jeffrey Owens, "An International Perspective on VAT", *Tax Notes International*, Vol.59, No.12, (September 20, 2010), P.949.

¹⁶⁴ This is supported by the efficiency grounds that with the inverse elasticity rule implying that in elastically demanded goods should be subject to particularly high tax rates. Some researches conducted in this matter estimated that poor South African house holds spends most of their income (61%) on food, where as high income households spend 15%. See, Delfin S. Go, Marna Kearney, Sherman Robinson, and Karen Theirilder, *An Analysis of South Africa Value Added Tax*, World Bank Research Working Paper No.3671, (2005), p.10. Because of the equity issue, many countries have specific higher rate for luxury goods probably, e.g. Algeria, Chile, Tunisia and Turkey with a rate between 20 and 110%, 50 and 85%, 10 up to 700% and 7.40% respectively. See Charlet et al, supra note 163, P.949.

¹⁶⁵ Study on Reduced VAT Applied to Goods and Services Tax in The Member States of the European Union, final report, Copenhagen economics, 2007, p.9 available at ec.europa.eu/taxation.../vat/howvat.../studyreducedVAT.pdf. accessed on 2 may 2010.

¹⁶⁶ Whether VAT is regressive or not or the possible problems of multiple rates is addressed on topic number 1.3 in chapter two.

¹⁶⁷ In one country Fiscal Affairs Department of the IMF estimated that for every 500 in VAT revenue for gone as a result of zero-rating food, less than \$ 15 accrued to the poorest, 30% of the population while about \$45 benefited the richest 30% of population. See Ebrill et al, supra note 1, P.76. Besides the real burden of the VAT tax may not fall entirely on consumers but its impact may be passed to suppliers of factors through lower prices received by producers. Ibid. In 2009, France adopt the VAT rate from 19.6 to 5.5 for supplies of restaurants on the assumption that restaurants will reduce price substantially and improve compliance but the price for restaurant service decrease only by 1.1 percent in July, 0.2% in august and 0.1 in September. And more recently, a survey reported that the reduced VAT rate granted in

This is the fact that albeit the proportion of their income that the rich spends on food may be relatively low, the amount of food they consume may be very large. Thus, much of the money forgone by the reduced rate will actually benefit the rich. There are also other possible problems related to multiple rate approach. When a tax design employs a multiple rates, the problem of definitions and demarcations among the differentiated goods can be ambiguous and sometimes arbitrary and therefore, subject to manipulation.¹⁶⁸ Besides, what was necessary today with a low elasticity demand could tomorrow become one of relatively indifferent choice which, in this case distort consumer and producer choices. Using the general equilibrium model it has been shown that rate differentiation leads to reduction in the welfare gains of adopting VAT.¹⁶⁹

The approach confirming multiple rates can have also a great impact on compliance costs. Compliance costs are minimized if a tax is as simple as possible i.e. single rate, minimum borderline, minimum special exemptions.¹⁷⁰ A comprehensive review of GST in selected OECD countries stresses that “overall compliance costs, like administrative costs can be reduced by imposing a single rate and by increasing the threshold for registration.”¹⁷¹ There is also a growing consensus among developed countries that employing reduced rates other than the standard rate are not an effective way to assist or compensate the poor by consumption patterns of low and high income groups have converged because, as Cnossen stressed, the rich spend twice as much on food than the poor because they buy more expensive food eat out more often and tend to throw food away more easily and hence reduction of rates gives more advantage to rich members of

Germany to the hotel industry as a part of tax cut for 2010 has not been passed on the consumers and prices seem to have remained the same. See Charlet et al, supra note 163, p.950

¹⁶⁸ Glenn P. Jenkins, *Value Added Taxation: The Policy Issues*, Harvard Institute For International Development (1994), P.15. The multiple rates approach invites for protracted legal disputes. For example, different rates for eats and light trucks, confectionery and food, restaurant meals and ready to eat snacks can encourage purposeful reclassification the applicable tax rate there on at every stage of production, distribution and sale is high.

¹⁶⁹ Charles Ballard, John Shoven and John Whalley, *The Welfare Cost of Distortion in the US Tax System: a General Equilibrium Approach* cited in Jenkins, supra note 168, P.15.

¹⁷⁰ Stanford, Godwin and W. Hard Wick, Administration and Compliance Costs of Taxation cited in Jeft Pope, “Compliance Costs of the Goods and Services Tax: Major Issues”, *Economic Papers: A Journal of Applied Economics and Policy*, Vol.18, Issue 2(1999), P. 671.

¹⁷¹ Studies disclosed that an implementation of a unique VAT rate can reduce business compliance costs by at least 20% and up to 30% and this can lead to an increase of growth by 0.1% to 0.7%. See Charlet supra note 2, P. 949. See Also Cnossen, *Administrative and Compliance Costs of VAT*, cited In Pope, p.607.

the society.¹⁷² These above arguments lowered the traditional justifications towards multiple rates based on equity matters. Therefore, at this time the approach is towards the single VAT approach. On this matter, the EU study concludes that moving towards a more uniform VAT rate structure has considerable advantage that a single rate can improve economic efficiency, reduce compliance costs and smooth function of the market.¹⁷³

If we believe that providing multiple rates has the above different problems and single rate VAT is better to avoid the problems of multiple rate approach, the next question could be ‘is there an alternative solution provided to address equity and distribution matters to the poor.’ The most commonly cited tool to avoid the rate differentiation is the income tax adjustments. It is often called that increasing the VAT rate while reducing the income tax rate combining a broad based VAT with a steeply progressive income tax avoids, to some extent, negative effects on the poor.¹⁷⁴

It is important to mention some examples in this matter. The 2010 New Zealand new reform of VAT for an increase of rate from 12.5 to 15% announces for decreasing personal income tax rate from 12.5 to 10.5% and the top rate from 38 percent to 33 percent, the corporate income tax changed from 30% to 28%.¹⁷⁵ The decision of the UK government during the 1979 reform to increase the VAT rate from 8% to 15% brings the cutting of the basic rate of the income tax from 33% to 30% and the top rate from 83% to 60%.¹⁷⁶ This approach considers the progressiveness of the whole tax system not the distributional impact of VAT in isolation. However, the problem is, though for developed countries with a well functioning income tax this approach is possible to apply, many

¹⁷² Ibid. For further clarification on this issue see the regressivity of VAT in chapter two topic 2.2.2. Applying a single rate VAT to all items except export simplifies both compliance and administrative costs because it simplifies taxpayers’ books and invoices and eliminates the need to open separate records for purchases and sales depending on the rate to be applied. Ebrill, supra note 1, p.78.

¹⁷³ Copenhagen economics, supra note 165. This view is in support of the idea that a broad base with a single standard rate would enable significant revenue to be used while decreasing tax administration for governments and compliance costs for business. Besides, VAT should not used as a tool for manipulating social behaviors. See Charlet, supra note 163, p.949.

¹⁷⁴ Ibid.

¹⁷⁵ See the website of the New Zealand revenue authority i.e. www.itd.gov.nz/news-updates/campaign-budget-2010.html?id.=Homepage accessed on April 17, 2010.

¹⁷⁶ See Neil Warren, *The UK Experience with VAT*, cited in Charlet, supra note 163, P. 952.

developing countries do not have well functioning income taxes and the case for differentiation may thus be stronger.¹⁷⁷

Besides, other social policy mechanisms like the expenditure polices in areas such as education and health may be more successful to meet equity purpose.¹⁷⁸ It should be noted that the mere existence of one single rate does not lead to find another solutions out of the VAT law. Within the VAT law, with a single standard rate, other mechanisms are also available like exemptions and zero-rating so that the importance of rate differentiation issue should not be overstated.

The matter of single VAT rate should not be taken only with matter of enforcement. Where there is differentiation of rates, above the equity matters, the possible revenue that can be collected will be decreased whether by evasion or other means to meet this little equity matters is the point. In reality, as Tait expressed in his book, even if there is reduced rate, it might not benefit the final consumers. Traders faced with recouping certain amount of VAT from consumers. They adjust their prices inline with the market regardless of the tax rate prescribed i.e. given multiple rates traders will arrange their price what the market will bear and items with low VAT could end up by cross subsidizing the higher rated items.¹⁷⁹

Lastly, it is interesting that applying the theoretical rule of using single rate should be carefully taken. The taxpayer's nature of compliance, efficient tax administration and sufficient means of control should be considered. As it is noted in the introduction of this chapter, the economic ideal discussed above might not be workable. Deviation from the economic theory may be needed to receive public support for the existing system. The existence of reduced rate in addition to the standard rate although it distorts the economy, it may render a standard rate to be more acceptable for taxpayers. The zero rating or reduced rate of food may be acceptable in a society and may lead to acceptance to the whole society on the VAT system. Therefore, the point is practical circumstance of a

¹⁷⁷ Shahabuddin, Hussien, "The Equity Impact of the VAT in Bangladesh", *IMF Staff Papers*, Vol.42 (1995), p.420.

¹⁷⁸ Ebrill et al, supra note 1, P.741.

¹⁷⁹Tait, supra note 49, P.42.

country should be taken beside to the above theoretical foundations against the approach of multiple rates and in favor of the single rate approach.

3.1.2 The Principle of Zero-Rating and its Justification

In addition to the standard rate of VAT, it is normal practice of states to have a zero rate of tax.¹⁸⁰ In many literatures, when argue for a single rate, most of them assume zero-rating and not considered it as multiple rates with the standard rate.

There are two views on the term itself.¹⁸¹ The first view is that zero-rate refers to exemption with credit, because, on the one hand a tax rate of zero percent is nonsense and on the other hand it is not a rate of tax and no tax is collected. The second view argue that the effect of zero rate is approximately the same as that of a very low positive rate of tax and that is why, they argue, a tax with progressive rate schedules, provide a zero rate at the bottom bracket. And further, zero-rating makes a supply taxable in technical sense and therefore achieves the objective of bringing these transactions within the operation of the VAT credit for input tax which an exemption does not.

Zero-rating of goods or services means that while no VAT is due on the supply, the supplier remains entitled to claim a tax offset for input tax incurred in making that supply and therefore, may be eligible for a refund of input tax paid.¹⁸² Zero-rating of goods and services may be grouped to domestic goods and services consumed domestically and export goods and services consumed abroad. Accordingly, zero-rating an export is not a tax preference because a destination based VAT for cross boarder transactions simply reflects that exports are consumed outside the jurisdictional reach of the national VAT and therefore, should only taxed in the jurisdiction of consumption.¹⁸³ Besides, within international area, zero-rating supply of international transport is widely cited with the

¹⁸⁰ It is stated that there is inconsistency in the use to the hyphen, Zero-rating and zero rating. David Williams, *Value Added Tax in Tax Law Design and Drafting* Vol. 1 IMF (1996), Victor Thuronyi (ed.) P.50 at the foot note.

¹⁸¹ Id. P.50-51.

¹⁸² Id. P. 50. See also Itai Grinberg, *supra* note 116, p.21. See Also Shoup, *supra* note 3, P.145.

¹⁸³ Id. P.22.

justification of protecting international transport business based in the state from odd competition from other states.¹⁸⁴

One of the frequent justifications cited for zero-rating of domestic consumptions is where there is an affirmative desire to consistently remove all tax from a specific good or service.¹⁸⁵ Within this spectrum, the supply of monetary supplies to the national bank and the sale or transfer of an on going business is often cited.¹⁸⁶ The former is justified based on the idea that “failure to protect the national bank from a charge to VAT on all supplies of gold to it may result in taxing the national reserves”. The later is rationalized based on the fact that the sale will involve no VAT or loss of VAT. To illustrate with an example, if A sell his business activity to another taxable person, B, since B is a registered person he will claim back his input credits later on. Here at first look it seems for revenue but in the long run there is no revenue, therefore, zero-rated.

There may be some considerations influencing the choice between zero-rating and exemptions.¹⁸⁷ The first is the desirability of freeing users of specific goods or services completely from value added tax, as with zero rating, or only partially, as with exemptions and the second is the advantage of excluding certain firms from the registration and filing of returns. These considerations have their own impact on the enforcement. A firm which is exempted is not required to register but a firm which transacts zero-rating is required to register and claim tax credits.

The arguments against zero-rating are still stacked on the compliance cost and enforcement. As pope indicated “there is no compliance costs research that supports the proposition that zero-rating food from a GST leads to lower compliance costs to a country over all.”¹⁸⁸ Zero-rating for distributive reasons is not advisable in countries already facing many difficulties with VAT refunds because there are some problems peculiar to zero-rating system particularly to zero-rating of exports such as false export documentation with respect to actual production sold domestically, falsification of

¹⁸⁴ Bloomfield et al, supra note 15, pp.74-75.

¹⁸⁵ Williams, supra note 180, P.51

¹⁸⁶ Id. P.52.

¹⁸⁷ Glenn, supra note 168, P.12.

¹⁸⁸ Pope, supra note 170, p.67.

invoices, production and purchase records, and misreporting of prices which are used to claim excess credits to be refunded.¹⁸⁹ These problems added with poor auditing system and enforcement mechanisms in developing countries could be burdensome.

3.1.3 Some Practices from OECD Member Countries and African Countries

The researcher take some practices of OECD and African countries based on the assumption that the OECD member countries are more developed in their tax system and to the contrary African countries are less developed in their tax system in which Ethiopian is part of them. It is difficult to analyze and compare every member state of the OECD and African countries. So that the general comparison between the OECD (as developed tax system) and African countries specifically Ethiopia (as less developed) is taken.

I. Rates of VAT in OECD Member Countries

These developed countries can be grouped into countries that have introduced a VAT based on the French and then European mode and countries that implemented a different VAT.¹⁹⁰ The first group of countries generally applies several reduced rates and hence the tax basis subject to standard rate is some how limited; the second group takes a broader base at the standard rate.¹⁹¹ The OECD tax data base¹⁹² gives the following table in totally of ratio of these countries in 2010.

Table 3.1 OECD countries rate distribution

Average rate	One rate	Two rate	Three rate	Four rates	Five rates	Six rates
18.0	7	7	11	1	-	2

¹⁸⁹ Ebrill et al, supra note 1, P.158. Some solutions are of course recommended by the FAD. To cite some distinguish between refund claimants with history of compliance, using pre-refund audits for high risk refund claims, post refund claims for claims of lesser risks and so on. See FAD cited in Id, P. 161.

¹⁹⁰ Charlet et al, supra note 163, P.944.

¹⁹¹ Ibid. From these groups New Zealand is the most cited countries with low exceptions that it has a broad based VAT with a low single rate (12.5), few exceptions and exemptions and this country takes the highest revenue ratio from the OECD member countries. See Stephen Buydens, *Consumption Tax Trends*, 2008, cited in Charlet , supra note 163, P. 945.

¹⁹² OECD tax database available at www.OECD.org starting from 1976 up to 2010 accessed on September 15, 2010.

Source: from OECD tax data base. Note that the number of tax rate excludes zero rate of export.

Within the OECD member countries, there are major differences within the standard rate starting from 5 percent in Japan to 25 percent in Denmark, Hungary and Sweden. The majority of these member countries, 24 out of 30, have a standard rate between 15 percent and 25 percent with whole average of 18.0. With the exception of Japan and Chile, all OECD member countries have one or more reduced rates or domestic zero rate (A zero rate without a zero rate of export).

In these countries, it seems to the contrary that almost all (by the way if we include domestic zero rate as a rate, two countries have only one rate) have two or more than two rates. Even as discussed earlier, one reduced rate may be fair to account depending on a country circumstances but in the OECD member countries, countries which have more than three rates, excluding the domestic zero-rate, amounts 14 members.

In the OECD member countries, the reduced rates and zero rating of goods and services in general contain all the following categories.¹⁹³ Basic essentials such as medical and hospital care, food and water supplies; certain activities considered traditionally to be vitalities, public transport, postal services and public television, activities considered socially desirable such as charitable services, culture and sport and certain sectors that are exempt for VAT for historical or practical reasons like insurance and financial services. It is disclosed that most OECD countries grant food with lower rate, zero rate or exemption.

II. Rates of VAT in African Countries

The rates of African countries below refer to the rates during 2006. The researcher couldn't find the most recent data but the researcher believes that a major difference might not occur with the present rates because change of rates is not a simple issue and hence the researcher takes the 2006 rates of African countries as a means of comparison.

¹⁹³ *Consumption Tax Trends: VAT/GST and Excise Rates; Trends and Administration* (2008), P.39.

Table 3.2 VAT rate in African countries

Country	Date of VAT introduced	Standard rates at introduction	Current standard rates	Current other positive rate
Algeria	1997	13.0	17.0	7.0
Benin	1991	18.0	18.0	
Botswana	2002	10.0	10.0	
Burkina Faso	1993	15.0	18.0	
Cameroon	1999	18.7	19.3	
Cape Verde	2004	15.0	15.0	
Central Africa republic	2001	18.0	18.0	
Chad	2000	18.0	18.0	
Congo republic	1997	18.0	18.9	
Côte d'Ivoire	1960	8.0	18.0	5.0
Egypt	1991	10.0	10.0	5.0,20.0
Equatorial Guineas	2005	15.0	15.0	
Ethiopia	2003	15.0	15.0	
Gabon	1995	18.0	18.0	
Ghana	1998	10.0	12.5	
Guinea	1996	18.0	18.0	
Kenya	1990	17.0	16.0	14.0
Lesotho	1996	14.0	14.0	5.0,15.0
Madagascar	1994	20.0	18.0	
Malawi	1989	35.0	17.5	
Mali	1991	14.0	5.0	
Mauritius	1998	10.0	15.0	7.0,10.0
Morocco	1986	19.0	20.0	
Mozambique	1999	17.0	17.0	
Namibia	2000	15.0	15.0	
Niger	1986	12.0	19.0	
Nigeria	1994	5.0	5.0	
Rwanda	2001	15.0	18.0	

Senegal	1961	20.0	18.0	
South Africa	1991	10.0	14.0	
Sudan	2000	10.0	10.0	
Tanzania	1998	20.0	20.0	
Togo	1995	18.0	20.0	
Tunisia	1988	17.0	18.0	
Uganda	1996	17.0	18.0	6.0,10.0
Zambia	1993	20.0	17.5	
Zimbabwe	2003	15.0	15.0	

Source: This table is derived from IMF's VAT data base VAT rates for member countries which in turn draw information from the internal Bureau of fiscal Documentation (IBFD), Africa Tax system (Amsterdam), and this researcher derive it from, Richard Krever (ed.), VAT in Africa (2007), P.3.

To compare with OECD member countries, the following data can be derived from the above table.

Table 3.3 Rate distribution in African countries

One rate	Two rates	Three rates	Four rate	Five rate	Average
30	3	3	-	-	16.0

Contrary to OECD member countries, almost all African countries have one single rate and there are only three countries with two rates and three countries with three rates compared to nine and eleven, respectively, in OECD countries. All African countries which introduce their VAT system after 2000 have one single rate with the exception of Lesotho. The average rate in African countries is 16.0 which is less than 18.0 of the OECD member countries. The VAT rate of African countries that introduce VAT after 2000 is above 15%.

From the above analysis, it can be concluded that African countries (developing) have generally chosen to adopt a single rate VAT system while OECD member countries (developed tax system) favored multi-rate system. What could be the reason? Why those countries, which are center of researches for efficient and well functioned VAT with the

principle of single rate, broad based and few exception tax and a good capacity to attain distributive issues through other tax system, adopt the multiple rate VAT while those African countries with less alternative for equity matters through other tax system, adopt a single rate system?

In fact, it might be said that “the preference among developing countries for single rate VAT system in large measure from their relatively weak enforcement capabilities.”¹⁹⁴

Can we say that the burden of the tax in African countries is lesser than the developed countries? The researcher query for further research

3.1.4 VAT Rates in the Ethiopia VAT Proclamation

Similarly with most African countries, the Ethiopia value added proclamation opted to levy a single rate at 15 percent.¹⁹⁵ This means, unlike few African countries and most of the OECD countries, the Ethiopian VAT tax law choose to impose a single rate. At least theoretically, it is possible to say with this matter only that neutral efficient tax is adopted. It will not distort the production or distribution or the preference of consumers consumption, although whether it is well-done or not is going to be analyzed in the next chapter.

Besides, there are very limited zero-rating goods and services in the VAT proclamation.¹⁹⁶

- The export of goods sand services.
- The rendering of transportation or other services directly connected with international transport of goods or passenger, as well as the supply of lubricants and other consumable technical supplies taken on board for consumption during international flights.
- The supply of gold to the national bank of Ethiopia and
- Transfer of an on going business.

¹⁹⁴ Ibid.

¹⁹⁵ VAT Proclamation, supra note 24, Art 7(1).

¹⁹⁶ Id. Art 7(2(a)-d), the possible justifications of these zero- rated goods and services is discussed above at note 180 and it's accompanying text.

Strictly speaking, it is difficult to say the Ethiopian value added tax grants zero-rating because the four transactions indicated in the proclamation are by their special objective and nature obvious not to be taxed. To clarify, export could not be taxed under destination principle; international transport because of competition as well, supply of gold to the national bank will be taxing of the national reserve and taxing of ongoing business will be nonsense. In addition, the VAT proclamation does not zero-rate commodities that are commonly freed even in the developed nations. Food is a prominent example. Most OECD member countries tax food at reduced rate or zero rate or exemption based on different justifications.

3.2 Exemptions

It is not uncommon to find, when introducing VAT, exceptions to the breadth of the potential scope of operation of VAT. The standard way of dealing with this is to exempt certain forms of supply that are otherwise within the scope of VAT from liability to VAT. Listing of those supplies that are subject to VAT is also another option. In principle, broad policy considerations including of ease of administration, the revenue level produced by VAT compared with other taxes, the tradeoff between the rate structure of VAT and the base on which those rates are levied, fairness and economic neutrality of VAT, all echoed for minimal use of exemptions. Despite strong arguments for minimizing exemptions, no state has succeeded in removing all exemptions from its laws.¹⁹⁷ Political and social consideration of a particular state may be used to introduce or preserve exemptions. The following subtopic therefore discusses the most common exempted goods and services with their justifications.

¹⁹⁷ New Zealand is the most successful in attaining broad base VAT, but in this country there are some exemptions still maintained like financial services, specific supplies by non-profit bodies, certain supplies of accommodation and land, and supplies of gold and fine metals. See Williams, *supra* note 180, P.40.

3.2.1 Common Place Exemptions and their Justifications

As Ebrill et al noted, there is a consensus to except some goods and services like public sector, real-estate, financial services and some non-profit and charitable organizations on different grounds¹⁹⁸ which will be discussed in turn.

A. Financial Services

Financial services cannot be considered meritorious goods nor are they consumed largely by low income groups warranting exemption on grounds of progressivity. The fact remains behind the exemption or otherwise of financial sectors is administrative difficulty embodying these sector to the value added tax base. The primary debate in the financial sector is what constitutes value added in these sectors, i.e. how to determine the tax base.¹⁹⁹ Charges for services often do not reveal their full price except for specific services such as the provision of safe deposit. The charges for many services are reflected in the interest rates charged on loans and paid to depositors. Thus, the difficulty lies essentially in distinguishing a tax upon the financial services from a tax upon the return of the capital.²⁰⁰ Taxation of the full amount of interest charged would amount to taxing the depositors for the use of capital in addition to the value of services rendered by the financial institution.

Besides, difficulty arises for services charged in the margin between the return paid to lenders and that charged to borrowers.²⁰¹ The aggregate value added created can be

¹⁹⁸Ebrill et al, supra note 1, p.91, but they stated that there is no consensus on the alternative of taxing these goods like zero rating or reduced rate away states.

¹⁹⁹Glenn, supra note 168, p.24.

²⁰⁰ Ibid.

²⁰¹ Alan Schenk and Howell Zee, *Financial Services and the Value Added Tax in Taxing the Financial Sector: Concepts, Issues and Practices*, Howell H.Zee(ed.)(2004), pp. 61-63. The function of financial intermediation can be divided into four distinct types:

- 1) intermediation between suppliers and users of financial capital (deposit taking intermediation);
- 2) intermediation between persons with different exposures and/or tastes for risk (risk intermediation);
- 3) intermediation between persons with exposure to similar risks (the insurance function); and
- 4) intermediation between buyers and sellers of commodities, currencies, and/or debt and equity securities (brokerage services). See Tim Edgar, "Exempt Treatment of Financial Intermediation Services under a Value-Added Tax: An Assessment of Alternatives", *Canadian Tax Journal*, Vol. 49, No.5 (2001), p.1137.

This intermediation process might not be problematic if it is to the final consumers. The problem is when there is another registered firm. In Ebrill et al the following example is used. Assume that a bank pays its depositors 5 percent and charged its borrowers 15 percent. The value added is 10 in this case, but if the borrower is a registered firm, the question of how much to be creditable arises. Here also a standard rate may be imagined, and then if the rate is 12 percent the value added provided to the borrower is $15 - 12 = 3$ of

identified to the extent that the financial services are used by registered firms but it needs further to allocate the aggregate value added between the two sides of the transaction. This margin based income comes not only from the acceptance of deposits and the granting of credit but also includes trading in equities, debts and other instruments, as well as a foreign exchange transactions.²⁰² A unique and identifiable margin relating to an individual transaction between a single borrower and a single lender might be hypothetically conceivable but practically it is not workable.

The difficulty of taxing financial services is not measuring the value added tax created or considerations received by the service provider.²⁰³ This information is already generated as a result of the service providers accounting and reporting obligation. However, quantifying the consideration on transaction by transaction basis is no straight forward which is necessary for the purpose of drawing upon invoice recording, the services supplied and giving the recipients of the services the right to deduct the corresponding tax as input tax.

With respect to invoice credit method specifically, the operational requirement cannot readily satisfied in the financial institutions because the invoice credit method works by charging tax at each level in a chain of transactions which is then invoiced to the individual purchasers.²⁰⁴ In financial institutions, the only services directly observable values in the framework of the transactions are transfer of funds and the gross interest and therefore no base to apply the tax in a way that is comparable to other transactions. Some recent technological changes like internet banking causes mix of activities and relationship more complex which is not easier to measure them.²⁰⁵

the loan, and the remaining 12-5=7 percent is value added provided to the lender. The problem however is identifying a pure interest rate. This leads to exemption of financial intermediation. See also Tait, *supra* note 49, p. 92.

²⁰² Arthur Kerrigan, *the Elusiveness of Neutrality: Why Is It so Difficult to Apply VAT To Financial Services?* 2010, Munich personal Repec Archive paper number 22748, available at <http://mpra.ub.uni-muenchen.de/22748/>, p.2 accessed on May 23, 2010.

²⁰³ *Ibid.*

²⁰⁴ *Ibid.*

²⁰⁵ *Ibid.*

B. Taxing Real Property

Real estate is tangible: it consists of land, land improvement, building and building improvements. In principle, there is no reason to treat durable consumption goods such as housing differently from non-durable consumption goods and services. In practice however, the appropriate and equitable treatment of housing and housing services remains one of the most difficult areas in VAT practices.²⁰⁶ The most difficult aspect, one that unsurprisingly, as yet no country in the world has dared to tackle is the taxation of the inputted consumption services provided by owner-occupying housing.

Of course, it is clear that there are also serious administrative problems in taxing such services since it could be difficult to establish a fair tax based in the absence of market transaction.²⁰⁷ Most of the time, real estate services are self-supplied and so have no observable market value. This poses no particular difficulty for services used as business inputs because the tax that the enterprise should charge itself on those services would in any event carry an exactly offsetting credit.²⁰⁸ But in owner-occupied housing, it is problematic to tax since it involves final consumption on which one would like the tax to stick.

Nonetheless, it is not misleading to say that the dominant treatment of real estate around the world is to exempt not only services from owner occupation but also the commercial leasing or of residential property, presumably in order to avoid distorting choice between house ownership and renting based on the distributional grounds as home ownership is correlated with income.²⁰⁹

Generally all the means of exemption area revolve around the real estate is justified in four grounds.²¹⁰ First, contrary all housing rent, a segment owner occupied housing in the absence of regular market transaction creates difficulty to administration. Second, the same real estate can be used for the production of goods and services by taxable firms or

²⁰⁶ Sijebn Cnossen, *VAT Treatment of Immovable Property in Victor Thuronyi* (Ed.), Tax Law Design and Drafting, Vol.1, (1996), p.4.

²⁰⁷ Robert Conrad, *Real Estate and the VAT*, In Value Added Taxation in Developing Countries, (ed.) by Malcolm Gills, Carl Shoup, and Gerardo Sicat, cited in Ebrill et al, supra note 1, p.96.

²⁰⁸ Ebrill et al, supra note 1, p.98.

²⁰⁹ Glenn, supra note 168, p.25.

²¹⁰ Ibid p. 25-26 and Ebrill et al, supra note 1, p.99.

for financial transactions. Third, real estate is used for consumption and investment and hence VAT distinguish between the two i.e. it taxes consumption. Lastly, the construction industry by its very nature presents special difficulties primarily because it produces goods (buildings) for both capital and consumption purpose.

C. Public Sector, and Non- Profit and Charitable Activities

The output of the public sector, non-profit and charitable activities (here after PNC) is often treated as final consumption by the organization itself rather than consumption by the ultimate final consumers. The activities of the PNC sector can be grouped into the redistribution of income and wealth, the provision public goods and services, and the provisions of other goods and services which are similar to those goods and services by the private sector.²¹¹ Redistribution involves the transfer of among different segments of the population using taxation, grants, subsidies, and so on in which such transfers do not constitute supplies nor do they create value added. As to the public goods and services provisions since they supply to the population in general, it is usually impossible to identify individual transactions to individual consumers. Pure public goods share non-rivalry and non-excludability as characteristics.²¹² Examples include national defense, street lighting, environmental protection, and so on. The PNC sector provides goods and services that are similar to those provided by the private sector.

In the public sector wise, it usually impossible to identify individual transaction to individual consumers, to the extent that public goods and services are provided to the population in general. Health care and education are generally exempt since, although it is feasible to measure consumption and charge prices for such services, whether provided

²¹¹ M. Aujean, Petter Jenkins Satya Poddar, "A New Approach to Public Sector Bodies", *International VAT Monitor*, Vol.10, No.4 (1999), p.144.

²¹²Pierre-Pascal Gendron, Value-Added Tax Treatment of Public Sector Bodies and Non-Profit Organizations: A Developing Country Perspective, International tax program Paper 0514, July 2005 available at http://www.rotman.utoronto.ca/iib_p.4-5. accessed on June 21, 2010. Quasi public goods are either not completely non-excludable or may be subject to congestion. Examples include streets and highways, police and fire protection, libraries and museums, preventive medicine, and sewage disposal. Health care and education are special types of quasi-public goods called merit goods. It is important to note at this point that supplies in the education and health sectors are predominantly exempt.

by public agencies or otherwise it is generally considered socially undesirable to do so, presumably on externality grounds or more importantly for distributional reasons.²¹³

The most commonly cited justifications in favor of exempting PNC include the following.²¹⁴ First, in the case of merit goods though it is feasible to exclude users, measure consumption, or charge a price that reflects the full value of the supply, it is usually deemed socially desirable not to do so helped with possibilities of positive externalities. Second, the exempt treatment of many outputs of the PNC sector achieves distributional objectives. A prominent example is the sale of education and health services at prices below market value. This is closely related to the first rationale so far as low-income members of society could be unfairly deprived of, certain merit goods should be priced at their market value. This exemption supports the activity in addition to the grant or subsidy necessary to makeup the difference between market value and user contribution. Finally, it is hard to tax the output of the sector for compliance and administrative reasons so it is preferable to sacrifice taxing household consumption and instead collect some VAT revenue on inputs used by registered traders along the supply chain.

3.2.2 Problems with Exemptions

As discussed above, there may be practical as well as technical reasons that necessitate VAT exemptions like the impossibility, inefficiency, inequitable of taxing some consumptions or any other policy that may be warrant to exemptions. However, there are some particular problems related to VAT exemptions which can directly or indirectly affect enforcement of VAT Laws. Distortions of inputs choices, incentive to self supply,

²¹³ Ebrill, supra note 1, p.92. They added that, the reason for public sector exemption is it is hard to tax output that is given away other than by taking inputs its production; in education it is a significant component of national income and basic educational services are commonly delivered at zero or subsidized prices and in health there may again be externalities from some kind of health care that warrant some degree of subsidization. See id., pp.92-95.

²¹⁴ Gendron, supra note 212, pp.5-6. Supporting these justifications FAD (Fiscal Affairs Department of the IMF) recommends that certain services, principally health, education, and non-fee financial services, be exempt from VAT for policy and practical reasons. Ebrill et al, supra note 1, p. 65.

revenue effects, compliance costs and further distortions due to partially exempt traders are some of them.²¹⁵

Exemption may result reduction of VAT burden if the person supplied is a consumer and is not relieving the supply of a business. Nonetheless, if the person supplied is a taxable person, exemption results in an increase in the burden of VAT on a supply. The person making the exempt supply will probably have had to pay VAT on some part of the supplies made it and will therefore have to pass some VAT on the business as part of its price. If the supply is subject to tax, the input VAT can be recovered but this cannot be recovered if it is exempted.²¹⁶ Besides, this problem of cascading provides an incentive to self supply taxable goods and services rather than purchase taxable goods or services because both activities give rise to irrevocable input tax.²¹⁷ The extent to which such effects of self supply are a matter of concern varies with circumstances for instance, the extent to which it affects choices depends on the degree of substitutability of self-supplied goods and their pre-tax price relative to those of purchased goods.²¹⁸

Exemption-creep is also the other possible problem of exemption.²¹⁹ This refers that once any activity or product is exempted from VAT, it often seems almost impossible to subject it to tax in the future. Moreover, since any exemption involves drawing lines between what is exempted and what is not exempted, there is a possible pressure from near substitutes or competitors to extend.²²⁰ Within this spectrum, possible complication could be raised also in firms that provide both taxable and exempted goods and services. In this case, administratively, taxpayers can possibly evade tax by misplacing taxable goods in to exempted goods.

²¹⁵ Ebrill et al summarizes these effects of exemptions. See Ebrill et al, supra note 1, p.85-89.

²¹⁶ Williams, supra note 180, p.40. This distortionary consequence of exemption can spread far beyond the sectors most directly affected, Ebrill supra note 1, p.86

²¹⁷ Id. P.44

²¹⁸ Id. P.87

²¹⁹ Ibid.

²²⁰ Exemptions may take various forms: Sectoral exemptions, there should exemption by firm size. Besides, particular item may be excluded or exempted from VAT for different reasons like as specific product, with in specific purchases or as specific uses, and in this case such division complicates the administration of VAT.

Within the international arena too, “firms using inputs that are exempt have an incentive to import these inputs which will be zero-rated rather than exempted in the country of export instead of purchasing tax-laden items from exempt domestic producers.”²²¹

3.2.3 Prospects with Exemption Systems

The common place exemptions discussed earlier are not the inherent nature of VAT. As time and technological change grow up, mechanisms to include in a VAT system become visible.

To come up with the problems of real estate regarding VAT, the stock VAT or S-VAT is proposed by Conard.²²² Under the S-VAT, the first purchaser of either old or new real estate after the VAT is introduced pays VAT on the entire capital value of the sale. In effect this onetime payment is a prepayment of all future taxes regardless of whether future use is for consumption or investment. Taxable firms receive credit on purchase but not on a sale.²²³ Nontaxable purchasers pay the tax, and nontaxable sellers receive as refund the taxes paid by the purchaser. When the property is resold at some future date, the seller will be able to demand and receive from purchasers the sale price of the property as part of the remaining balance of the prepaid taxes.

With respect to PNC, different solutions are practiced in different countries. To cite some; exemption with rebates (compensating public bodies for input VAT paid to make exempt or non-taxable supplies)²²⁴, reduced exemptions (permit some degree of departure

²²¹ Ebrill et al, supra note 1, p.88.

²²² Robert Conard, *The VAT and real-estate in value added Taxation in developing countries*, (ed.), Gills, Shoup and Sicat cited in Glenn, supra note 168, p.26.

²²³ Id. The allocation of residential property between owners and renters would not affect. Renters still pay the value added tax over the period of the lease; technically repaying the owner for prepayment, but still the issues of self-construction remain unresolved in this system.

²²⁴ Several European countries, mostly EU members, have rebate systems that compensate public bodies for input VAT paid to make exempt or non-taxable supplies with two exceptions: Activities of public sector bodies engaged in their role as public authorities in which case, bodies and their activities are non-taxable activities and public sector bodies in education and health are exempt. Gendron, supra note 212, p.17. In the Canadian system however, all supplies made by PNC sector are within the scope of VAT, with some services taxable, some are exempt and some are zero-rated. The system grants rebates tax paid on inputs used to make exempt supplies. Id. P.15.

from a pure exemption system)²²⁵, New Zealand system (all activities of public bodies and non-profit organizations are within the scope of the VAT with few exemptions)²²⁶ and full taxation.²²⁷

Despite its complexity, different alternatives are provided for taxing financial services in different literatures and countries. The possible methods to be discussed do not apply equally to all types of financial services which include:²²⁸ deposits, borrowing and leading; purchase, sale and issuance of financial securities; Insurance; brokerage and other agent services and advisory, management and data processing.

Some of the alternatives that could and are applying to financial services are account based method or addition method (calculated as the sum of wages and profits),²²⁹ cash flow taxation (all cash in flows from financial transactions are treated as taxable sales on which VAT must be remitted to the tax authorities and all cash outflows by financial institutions are treated as taxed purchases with entitlement for input VAT credit),²³⁰ modified reverse charging (a registered business collects the VAT on both input and output side of its business)²³¹ and zero-rating.²³²

²²⁵ This might be done for example, by bring goods and services that are otherwise outside the scope of VAT into the scope of the tax or by converting exempt goods and services into taxable or zero-rated goods and services.

²²⁶ Andrew J. Maples, *The Zero Rating of Financial Services and Introduction of Reverse Charging in New Zealand (At Last!)*, cited in Pierre-Pascal Gendron, "Value Added Tax Treatment of Financial Services: A Developing Country Perspective", international tax program paper 0606 (2006) available at <http://www.rotman.utoronto.ca/iib>, p.18 accessed on April 18, 2010.

²²⁷ Aujean et al, supra note 211, p.148.

²²⁸ Satya Poddar, *Consumption Taxes: the Role of Value Added Tax, in Taxation of Financial Intermediations Theory and Practice for Emerging Economics*, Patrick Honahan (ed.), cited in Gendron, p.4.

²²⁹ Israel currently taxes financial services and non- life insurance using this method. Quebec can also be cited. See Schenk et al, supra note 201, p.63.

²³⁰ Literatures discussed that this method seems the conceptual correct way to apply the VAT to margin services, but it is complex and has not yet been adopted any where. See Satya Poddar and Morley English, "Taxation of Financial Services under Value Added Tax: Applying the Cash Flow Method", *National Tax Journal*, Vol.50 (1997), P. 90-94.

²³¹ Howell Zee, "A New Approach to Financial Intermediation Services under Value Added Tax", *National Tax Journal*, Vol.58, No.1 (2005), p.16.

²³² New Zealand allows zero-rating of financial services supplied between registered businesses or by a financial intermediary to a registered business with the limitations that final consumers are taken out of the VAT net and all revenue front taxation of inputs under the exemption system is lost. Edgar, supra note 201, P.1156.

3.2.4 Exemptions within the OECD Members and African Countries

A. OECD Member Countries

In fact, it is difficult to gather all the exemptions within the OECD member countries rather it is important to know that there are standard exemptions common to almost all countries and there are country specific exemptions within the OECD member countries. A recent OECD publication sets out the following standard exceptions within these countries: non- commercial activities of non-profit making organizations, sporting services, human blood, tissue and organs; dental care, cultural services; financial services; betting, lotteries and gambling, supply of land and building, certain fund raising events are among the standard exemptions.²³³

Every OECD member countries are also departed from these common exemptions with their own policy objectives: To cite some; Portugal exempts agriculture, Belgium and Greece exempt legal services, Greece also exempt author rights and artist services, many country like Korea, Netherlands, United Kingdom, Italy exempt burials, Australia exempts specific basic foods and cars for use by people with disabilities, Finland exempts certain transactions by blind people, and Japan does the same for certain kinds of equipment for the physically handicapped people and so on.²³⁴

From among the OECD member countries, New Zealand is at the other extreme that not only does not grant any non-standard exemptions but also it actually subject to the VAT almost all of the standard exemptions.²³⁵

B. African Countries

Still it is very difficult to put all exempted goods and services of all African countries, but it is better to see what is best for developing countries like Africa countries within the previous common place exemptions.

²³³ OECD Tax Policy Studies, *Recent Tax Policy Trends and Reforms in OECD Countries* (2008), P.27.

²³⁴ Id. P.28

²³⁵ Richard M. Bird and Pierre-Pascal Gendron, *VAT Revisited: A New Look at the Value Added Tax in Developing and Transitional Countries* (2005), p.91. New Zealand has an almost perfectly neutral VAT system, owing to a single uniform tax rate and virtual absence of exemptions. See *Tax and Economy: a Comparative Assessment of OECD Countries*, OECD Tax Policy Studies No.6 (2001), p.62.

The difficult administrative environment in most developing countries suggests that the only possible approach to tax real property is likely to be some form of VAT prepayment.²³⁶ This approach too may be thought by some to be either unworkable or undesirable owing to the possible financial problems due to liquidity constraints when faced with large upfront tax demands.

With the stage of development in developing countries, it seems likely that they are best advised to leave aside issues as complex as the taxation of financial services as far as possible and to concentrate on essential aspect of VAT design and implementation. Essentially only two approaches of taxing financial service seem feasible in most developing countries; exemption and reduced exemption.²³⁷ Edgar makes a detailed argument in support of the exemption system on the basis of what he sees on serious deficiencies and difficulties with both the major alternative of zero-rating and cash flow taxation. Besides, making financial services fully taxable will not necessarily increase VAT revenues and may even reduce them.²³⁸ The hybrid system²³⁹ might be real alternative in the context of developing with advantage of reducing self supply, import bias and keeping the VAT chain intact.

3.2.5 Exemptions in the Ethiopia VAT Law

The Ethiopia VAT law listed down twelve general commodities which are exempted from the VAT.²⁴⁰ Five others goods and service are added later to the domain of VAT

²³⁶ Id., P.56.

²³⁷ Edgar, supra note 201, P.1144.

²³⁸ Id. P.1156.

²³⁹ M.Bird et al, supra note 235, p.56. The hybrid holds the rule that subject all fees and commissions to VAT and subject all margin services to VAT using the separate tax rates and taxing gross interest methods.

²⁴⁰ VAT Proclamation, supra note 24, Article 8 in collaboration with circular references available at <http://www.erca.gov.et> lists down the following exemptions: The sale of dwelling used for at least two years and the lease of a dwelling; the rendering of Financial services; the Supply or import of national or foreign currency (except for that used for numismatic purposes) and or securities; the import of gold to be transferred to the National Bank of Ethiopia; the rendering by religious organizations of religious or church related services; the rendering of educational services provided by educational institutions as well as child care services of children at pre-school institutions; the supplies of electricity, kerosene and water (except for those supplies of water bottled by a factory); supplies by the post office authorized under the Ethiopian postal proclamation, other than services rendered for a fee or commission; the provision of transport, Permits and license fees; the supply of goods or services by a workshop employing disabled individuals if more than 60 percent of the employees are disabled, supply of books; supply of food grain e.g. Teff, Wheat, Maize, Sorghum and other cereal: animal skin or hides sold to shoe factories by a leather factory after the

exemption by circular reference according to Art 8(4) which gives power to the MoFED to issue directive. These goods and services listed down in the proclamation and added by circular reference can be grouped into four major categories of justifications though different alternatives are reminded in different countries as discussed in the previous sub topic. These justifications include, hard to tax principle, inefficiency to tax, equity matter and exemption for incentive. The hard to tax principle incorporates the sales or transfer of used dwelling, or the lease of a dwelling and financial services. The regulation under Article 19 illustrates what the first exemptions are. With regard to financial services the regulation stipulate services considered as exempted, zero rated and taxable financial services.²⁴¹ The later two, the zero- rated and taxable financial services, are difficult to considered as the ordinary activities of the financial services, that the zero- rated financial services are related with export connected services which are juxtaposed with zero- rating principle of export in the proclamation where as taxable financial services are services goes side by side with the financial sector but not pure financial services. Therefore, it is possible to say the financial services are exempted in general.

As to the inefficiency, exemption related with national bank, religious services, humanitarian aid, supplies by the post office, permits and license fees, education and medicine can be grouped because they are economically in advisable to do so or because there is no net revenue gain from doing so, or they are administratively costly.

Exemptions related to transport, electricity, kerosene, water are related to equity justification because they are related to distributional effect of the tax. Lastly, imports of

tanning process is done and the supply or import of fuel gas. The last three exempted goods are later included by MoFED through circular references.

²⁴¹Value Added Tax Regulation No.79/2002, Federal Negarit Gazette, 9th year, No.19, Art 20. Financial services at zero rating includes financial services rendered in connection with an export of goods, financial intermediation services rendered in connection with a loan to an unregistered, non-resident person to finance the export of goods; and fees imposed by an Ethiopian bank on banking services rendered to a non-resident who is outside Ethiopia when the banking services are rendered. See article 20(9) of the above regulation. The regulation provides the following as taxable: Legal, accounting and record package services, actuarial, notary, and tax agency services(including advisory services) when rendered to a supplier of financial services or to a customer of that supplier of financial services; safe custody for cash, documents or other items; data processing and payroll services; debt collection or factoring services; Management services, such as management of a superannuating fund; Trustee, financial advisory, and estate planning services, and Leases, licenses, and similar arrangements relating to property other than a financial instrument. See VAT proclamation, supra note 24, Article 20(6).

goods according to tariff regulation, books and other printed materials, supply of goods and services by a workshop employing disabled individuals may be grouped into incentive justification. The inclusion of all the above transaction into one of the justifications does not mean that their justification is acceptable.

3.2.6 Thresholds

A threshold is a type of exemption that excludes certain businesses from collecting and remitting VAT and from being able to claim input tax credits for VAT paid on purchases. Traders with annual sales above the threshold level are required to register with the concerned body and collect and remit the VAT. Consequently, the possible questions are where to set the threshold and how to accommodate the minnows of the tax system (small business).

3.2.6.1 Considerations in Setting Thresholds

I. Revenue and Size of Firms

One of the rationales for deciding whether to set high threshold or low threshold is the amount of revenue to be collected from firms with high turnover which are commonly few or firms with low turnover but huge in numbers. Some empirical evidence suggests that a relatively small proportion of firms account for a large proportion of potential VAT revenue.²⁴² For example, in the United Kingdom the millions smallest registered businesses pay only about 7% of total VAT revenue although they constitute 76% of those registered for VAT. Besides, in Mexico, almost 90% of VAT revenue is collected from 10% of the registered traders.²⁴³ This relatively small contribution to aggregate national VAT revenue by the smallest businesses considering the relatively significant costs of administration and compliance compared to large firms signifies for a high registration threshold of value added tax. Even if a little revenue is lost by increasing the threshold, the point is that such revenue loss could be recouped because the administrator will be able to concentrate its efforts on the large firms.

²⁴² Ebrill et al, supra note 1, P.117.

²⁴³ Tait, supra note 49, P.117.

II. Compliance Costs

“If it were not for the costs of administering a VAT (incurred by authorities) and complying with it (incurred by taxpayers) the best threshold would be zero: this would maximize revenue (at any given rate) also minimizing distortion of competition between firms of different size”.²⁴⁴

Keen and Mintz, present a model of optimal threshold with the consideration of administrative and compliance costs, tax rates of VATs, the ratio of the value added to the products and the distribution of the products.²⁴⁵ Accordingly, if the threshold is too high, the number of firms bearing tax burden decreases and therefore tax revenue shrinks, where as when the threshold is too low, administrative and compliance costs increase.

The lowering or increment of threshold has its own impact upon the tax evasion of firms through the compliance costs.²⁴⁶ When the threshold is very low, small firms with high compliance costs are tempted to evade the tax. On the other hand, those firms above the threshold are likely to opt for tax evasion when the threshold is set too high because as the number of firms under the threshold increase, those firms above the threshold feel easy to underreport the production and evade the tax as the firms under the threshold do not have to file.

Compliance costs research conducted in OECD countries implies that a well-functioning VAT involves administrative cost of \$500 per registrant with a compliance cost of around \$500.²⁴⁷ Within this, a threshold exempts certain categories of businesses from the VAT and creates compliance risks by making distinctions between traders. Traders with sales

²⁴⁴ Ebrill et al, Supra note 1, P.117.

²⁴⁵ Micheal Keen, and Jack Mintz, *The Optimal Threshold for Value Added Tax*, 1998, cited in Sangheon Kim, *Optimal Threshold for a VAT in The Presence of Tax Evasion*, 2003, P.6 available at cpe.ucsd.edu/assets/002/6976.pdf. accessed on September 23,2010,. Besides, it is stated that the compliance costs of VAT are regressive that the lower the threshold, the greater the number of small business in the VAT net and the higher become the gross compliance costs.

²⁴⁶ Ibid.

²⁴⁷ *Sijibren Cnossen, Administrative and Compliance Costs of VAT: a Review of the Evidence*, cited in Ebrill et al, supra note 1, p.119. Two studies conducted in UK, put down that, compliance costs for the smallest business, as a percentage of taxable turnover, are 1.94%, more than 600 times to 0.03% for the largest business. See Cedric Stanford et al. *Administrative and compliance cost of taxation*, 1989, cited in Williams, J Turnier, “Accommodating to the Small Business Problem Under a VAT”, *Tax Law Review*, Vol.47(1993-1994), P.964.

slightly above the threshold may have an incentive to underreport sales activities to avoid being required to collect and remit VAT. But unlike other VAT preferences, which have reverse relation with an increment, a threshold possibly decrease administrative costs and compliance burdens since threshold reduce the number of business in a system, the number of returns a tax administrative processes and the number of businesses subject to audit.

III. Distortion Effects and Thresholds

Providing a threshold to accommodate the small business can create cascading so that competition unfairness and splitting of a business into small enterprises.²⁴⁸ Exemption creates competitive advantages to these businesses below the threshold over businesses above the threshold, which incur the compliance costs and either absorb them or add them and the VAT to their prices.²⁴⁹ On the other hand, the enormous differential in compliance costs between large and small businesses destroys the pre-tax neutrality among them. The loss of neutrality is more serious in industries which add large amounts of value than industries where below the threshold.²⁵⁰ For example, assume that a business below threshold uses nothing other than labor as an input competes against business above the threshold. Assuming that prior to imposition of VAT both parties charged the same amount for their services and imposition of 15% VAT, then the former will find that he must bear the burden of the VAT or confront such change that his services will be 15% more expensive than those of the latter business.

Nonetheless, in the other extreme, providing a threshold avoids creating a competitive disadvantage for small business which incur compliance costs that greatly exceed those of their larger competitors when measured as a percentage of turnover because it is conventional sense that compliance costs are relatively more burdensome for small

²⁴⁸ Ebrill, supra note 1, pp.120-121.

²⁴⁹ Turner, supra note 247, P.972.

²⁵⁰ Id. "But if the below threshold business sold products at retail that had been previously subject to VAT, his above threshold competitor would not face significant disadvantage. For example, assume that a below threshold retailer person purchased goods at wholesale that has been subject to VAT at 15% and resold them twice their cost. Because the small business would not have a VAT input credit available in his purchases, his price advantage over his fully taxed competitor would be reduced by this amount. This result would be that a similarly situated taxable person would be forced to bear the VAT burden equal to a 7.5% or would have to sell his goods at a price 5% over the selling price of his exempted competitor." See Ibid P.972 at the footnote.

businesses whatever or wherever the threshold is set.²⁵¹ Besides, the distortionary effect of providing thresholds should not overstate because it is common practice of countries to permit voluntary registration.²⁵² The problem of distortion is not limited lowering the threshold, even in case when the threshold becomes high, since revenue should be maintained, rates should be increased, and therefore this in turn intensifies the distortion among the two groups of firms.²⁵³

In addition to the above, the other potential problem of setting a threshold whether high or low is the danger of splitting of firms to small enterprise to attain the advantage of below threshold, which aggravate tax avoidance.²⁵⁴ The distortionary problem of providing a threshold depends also on the tax treatment of businesses below the threshold which is discussed below.

Out of the above three considerations, there are also some important issues to be considered in designing a threshold system which have their own impact on enforcement. The first is the issue of taxable sales or total sales in setting a threshold.²⁵⁵ The total turnover taxable goods and services supplied by the person over a set of period is the usual measure of business activity in determining a threshold.²⁵⁶ The second issue is setting single threshold or two categories of thresholds for sale of goods and services or others.²⁵⁷ A provision setting more than one threshold needs to provide a definition for these who make both kinds of supplied which in turn complicated administrations of VAT.

²⁵¹ Bird, supra note 162, p.10.

²⁵² See voluntary registration on infra note 101 and its accompanying text. This voluntary registration is particularly important to zero-rating goods and services which enable them to reclaim tax paid on their inputs.

²⁵³ Ebrill, supra note 1, p.121.

²⁵⁴ Id. To cumber such problem, the Ethiopia Value Added Proclamation provide a solution by stipulating mandatory provision for branches to be registered in the name of main branch for such purpose and provide the option of aggregation of the value of taxable transactions of related persons by the authority. See VAT proclamation, supra note 24, Art 16(4) and Art 16(7).

²⁵⁵ John. P. Due, "some Unresolved Issues in Design and Implementation of Value Added Taxes", *National Tax Journal* Vol. 43, No.4 (1990), p. 384. Taxable sales not include exemptions or sales out of the VAT, whereas a total sale considers all sale types.

²⁵⁶ Williams, supra note 180, P. 15.

²⁵⁷ For example, Ireland exempts vendors of service with turnover under \$ 15,000 and vendors of goods with turnover under 30,000 where as Greece exempts vendors of services with turnover under 250,000 and vendors of goods with turnover under 1,000,000 see Tait, supra note 49, P.125.

3.2.6.2 Possible Accommodation Mechanisms of Small Businesses in VAT

Different mechanisms are applied in different countries to accommodate the special problems related with small firms.²⁵⁸

The first is exemption or special schemes for small businesses.²⁵⁹ This system can be implemented by providing minimum threshold, taxing small business at a lower effective tax rate, exempting sales by retailers but imposed a VAT in purchase by retailers at high rate and negotiations.²⁶⁰

The second is a compliance cost sharing.²⁶¹ Germany exempts taxpayers with gross annual turnover below \$20,000 and allows businesses with annual turnover below \$60,000 to retain part of net VAT otherwise due to compensate them for the added compliance burden businesses with turnover between \$20,000 and \$29,500 may reduce VAT they are required to remit by 80%. This is phased out at the rate of 1% for each additional \$500; with no retention allowed when annual turn over exceeds \$60,000. This is a share of cost by the government and seen as government subsidy for such economic activities.

Thirdly, providing voluntary registration,²⁶² such speculation allows those operating just below the threshold level to avoid any competitive disadvantage compared with other operators who are required to be registered.²⁶³ However, such privilege should be taken with great caution because traders may utilize the situation to evade the positive net tax.

²⁵⁸ A broad discussion is held on Tait, supra note 49, p.118-138, and see also, Turnier, supra note 247, P.970.

²⁵⁹ Tait, supra note 18, P.118

²⁶⁰ Id. P.118-124

²⁶¹ Id. P.124. A compliance cost sharing enhances the goal of achieving economic neutrality by minimizing the disparity in compliance burden between large and small business but it could not remove administrative and compliance cost of the VAT system. See William. J. Turnier, "Designing an Efficient Value Added Tax", *Tax Law Review*, Vol.37 (1984), p. 461.

²⁶² Williams, supra note 180, P.17.

²⁶³ Small businesses may opt to register particularly in credit invoice method countries. Firstly, businesses that have high turnover with taxed inputs but not reached the threshold, may want to attract customers who claims credit for their purchase, secondly, businesses with more inputs than output VAT opts to register to get refund particularly those not at end of the chain of the commerce. See, Turnier, supra note 261, p.459.

Fourthly, the means of treatment of small businesses below the thresholds through other taxes is another decisive means of accommodating small business problem under VAT.²⁶⁴ These businesses below the threshold are commonly subject to turnover tax in different countries.

3.2.6.3 Practices in OECD member countries and African Countries

There is gap between developing countries and developed countries.

Table 3.4 Threshold distribution between OECD member countries and African countries

	No threshold	Single threshold	Two threshold	Three threshold
OECD countries	9	8	10	1
African countries	1	28	8	1

Source:- thresholds of the OECD member countries is taken from OECD 2004, 2004a as cited in Richard M. Bird and Pierre-Pascal Gendron, VAT Revisited: A New Look at the Value Added Tax in Developing and Transitional Countries, International Tax Program, USAID, 2005

- Thresholds of the African countries are drawn from data prepared by the fiscal affairs department of the IMF, which in turn drawn from international bureau of fiscal documentation publication IMF country documents and IMF staff estimates.
- The most recent data available
- All the calculation of home dollar versus US dollar is taken from Jan- May, 2006 to African countries and 2004 in OECD member countries

The variation is far wider across the OECD member countries with a VAT compared with African countries, and from OECD countries the lowest is zero and highest is about 252,660 USD in Japan where as in African countries the lowest is zero with highest rate 97,543 USD.²⁶⁵

There is also a significant variant on the form that thresholds take and in the extent and nature of related measures. Most of the OECD member countries provide more than one

²⁶⁴ Ebrill, supra note 1, P. 121.

²⁶⁵ Nine countries include, Belgium, Italy, Korea, Mexico, Netherlands, Portugal, Spain, Sweden and Turkey have zero threshold where as from the African countries Nigeria is the only country with zero threshold. Japan takes the highest threshold where as Mauritius leads the highest threshold with commerce and manufacture level VAT from the African countries.

threshold. From the African countries, almost two third of these countries take one threshold. It seems these African countries are near to the acceptable economic theory with single threshold for administrative and compliance costs purpose. Differentiation also goes to treatment of goods and services. The most common variant, service and goods, involves a lower threshold for services than for other activities.²⁶⁶

Among the OECD member countries, some of them provide a difference on threshold to non-profit organization which is normally more than other traders. For example Austria priced 100,000 for non profit while 22,000 for other activities, Canada, 50,000 for non-profit while 19,082 for other business activities.

The other common output of these countries with zero-threshold is that they apply simplified schemes notably, as Ebrill et al noted, presumptive tax based on the firm's characteristics or with reduced reporting requirements for small business possibly to reduce compliance as well as administrative burden.²⁶⁷ Notably, Austria provides obligatory registration to firms above 7500 but they are subject to VAT if they exceed 22,000. Several rationales may be suggested to keep low threshold notably if there is a good administration which rests on information and this will be advantageous to include as large a share of economic activity in the tax base as possible. However, this seems difficult to set in African countries which have low administrative capacity and it is advisable to adopt single and high thresholds.

3.2.6.4 Thresholds in the Ethiopian VAT Law

To start with policy consideration, the proclamation adopts the total value of taxable transaction instead of total sales.²⁶⁸ The VAT proclamation under Article 16 provides voluntary as well as obligatory registration to persons. Accordingly, with mandatory registration, a person made total taxable transactions exceed 500,000 birr at the end of

²⁶⁶ For example France provides 76,300 for goods where as 27,000 minimum thresholds for services, Ireland 25,000 for services and 51,000 for other activities. From the African countries Gabon holds 112 for services whereas 149 for other activities.

²⁶⁷ Ebrill, supra note 1, p.116, Belgium provide an alternative to small businesses below 500,000 need not issue invoices and only to register if they exceeds 5,500, Korea and Italy, simplified scheme for small business, in Portugal there is an effective exemption of Euro 12,470 for those under the simplified regime and a standard exemption Euro 9,975 for taxpayers who do not have to keep standard accounting records.

²⁶⁸ VAT proclamation, supra note 24, article 16(1) (a) (b), used the phrase 'taxable transaction' which gives such impression.

any period of twelve calendar months or at the beginning of any period of twelve calendars based on reasonable ground estimation is duty bound to register. Within this spectrum, under the Ethiopian VAT system, there is obligatory sectoral registrations without considering the 500,000 threshold.²⁶⁹ The main rationale of providing obligatory registration of such sectors is that persons in these sectors are presumed to make taxable transactions above the thresholds because of the nature of the business. Besides to the above, the objective of avoiding competition unfairness could be another reason.

The position with voluntary registration is also provided with great limitation that a person may voluntarily apply for registration, if he/she regularly supply or render at least 75% of his goods and services to registered person. Possibly, this limitation avoids the fraudulent activities of persons with no taxable output but desired to register simply to get refund. The proclamation provides no difference among businesses, as discussed above, like non-profit organizations, services and goods, since there is one threshold.

The threshold can be analyzed comparatively with other African and OECD member countries with Ethiopia 57,573 US dollars.

Table 3.5 Comparison of VAT thresholds between Ethiopian VAT, and African and OECD member countries

	Below 57,573	Above 57,573
African countries	31	7
OECD	23	5

To formulate this, almost in number, not economically, Ethiopia puts in the fair threshold theoretically.²⁷⁰ Compared with New-Zealand, the country with best VAT laws, the Ethiopia threshold (57,573 USD) exceeds the New Zealand (20,963 USD). From these points atlas it is possible to say that the Ethiopian threshold is not low.

²⁶⁹ These sectors which are duty bound to register without considering the minimum threshold are nine in number. These transactions are: jewelry, electronics specially TVs, refrigerators, DVD, VCD etc. , flour factories, importers, shoe factories, contractors above 10 level, computer and computer spare parts, leather and leather products, plastic and plastic products. Person who involve in these activities are required to register without considering the threshold criteria. See **ሰተጨማሪ እሴት ታክስ ስለመመዘን የወጣ መመሪያ ቁጥር 25/2001 የኢትዮጵያ ገቢዎችና ጉምሩክ ባለሥልጣን፣ ነሐሴ 2001 ዓ.ም፣ አዲስ አበባ, article 4.**

²⁷⁰ It is out of the research to calculate in economic formula.

The low the threshold, there is high possibility for weak VAT.²⁷¹ From the African countries Ghana and Uganda can be cited as example in which case, the low level of threshold is cited as one reason for the failure of their value added taxes.²⁷²

²⁷¹ Ebrill, supra note 1, p.113.

²⁷² Terkper, Seth A, VAT in Ghana; Why it Failed, cited in Ebrill, supra note 1, pp.113-114.

Conclusion

In this chapter, the alternative approaches on rates, exemption and threshold of value added tax is discussed. Coming to the single versus multiple rates approach, the multiple rates approach has some deficiencies. The most commonly cited problems are: it is poorly targeted and it increase administrative and compliance cost. To alleviate the equity problem of the single rate approach, arrangement through the direct taxes, expenditure policies and the VAT it self thorough exemptions and thresholds is often proposed. Comparing to OECD member countries, most African countries have single rates. The Ethiopian value added tax also hold the approach of single rates which expected to avoid the deficiencies of the multiple rate approach in the above. The fifteen percent rate is also lower than the average African and OECD member countries which are 16 and 18 respectively.

Within the exemption system, the common place exemptions, the problem and prospect of exemptions are discussed. The most common exemptions include financial services, real property and public and non profit organization based on administrative, equity, efficiency and hard to tax grounds. In spite of such grounds, as time goes up there are some prospects in these sectors like the stock VAT in real properties; exemption with rebates and reduced exemptions and the like in PNC; and cash flow taxation, account based method, zero rating and the like in financial services. This shows that exemption is not an inherent part of VAT. There are some common problems of exempting goods and services under VAT. Distortions of inputs choices, incentive to self supply, revenue effects, compliance costs and further distortions, due to partially exempt traders, are some of them. Though avoiding exemptions and broadening the VAT base advised, according to the data, no country succeeds in avoiding exemption from it system. The justification in the above seems grounded in the Ethiopian exemption system. It seems that the exemptions in the value added tax proclamations neared the above theoretical justifications of exemptions.

In setting threshold, a legislature needs to consider revenue and size of firms, compliance costs of traders and means of accommodation traders below the threshold. Empirical evidence suggests that a relatively small proportion of firms account for a large

proportion of potential VAT revenue. This relatively small contribution to aggregate national VAT revenue by the smallest businesses considering the relatively significant costs of administration and compliance compared to large firms signifies for a high registration threshold of value added tax. Setting high threshold also imply that the number of firms bearing tax burden decreases and therefore tax revenue shrinks, where as when the threshold is too low, administrative and compliance cost increases. The means of accommodation of firms below the threshold needs special consideration since providing a threshold to accommodate the small business can create cascading so that competition unfairness and splitting of a business into small enterprises.

Coming to the practice of African as well as the OECD member countries, the data shows that the range of thresholds exceeds in OECD member countries compared to African countries. Besides, few African countries have zero threshold compared to OECD member countries. The Ethiopian value added proclamation sets 500,000 as a threshold. There is no additional threshold based on transactions or sectors as it is shown in other countries. The amount of threshold is, relatively, higher than OECD and African countries which is expected, theoretically, to ease enforcement. The legislature opt turn over tax with a principal of two percent rate as a means of accommodation to those traders below the threshold.

Chapter Four

Data Analysis of Challenges of Enforcing Value Added Tax Law: Position of the Law on Exemptions, Rates and Thresholds vis-à-vis Stake Holders

4.1 General

So far the researcher tried to show the conceptual definitions and descriptions of VAT and different alternatives for value added tax positions. And now the focus of this chapter is to analyze the different data gathered and to show the results obtained during the research. Accordingly, qualitative as well as quantitative data gathered, questionnaire distributed to the taxpayers (persons registered for VAT) and inspection officers of the Ethiopian Revenue and Custom Authority (hereafter ERCA), and the two branches in Addis Ababa i.e. eastern and western branches of the ERCA. Interviews also conducted with higher officials of the ERCA and the Addis Ababa Revenue authority. Besides, personal observation also held by the researcher two times with inspection officers around Merkato and Piazza. Interviews also made with 20 consumers and some taxpayers.

As to the proposal, it was intended to distribute a total of 140 questionnaire with that 20 for inspection officers and 120 for taxpayers. As a result, I have been able to gather 20 out of 20 (100%) respondents (inspection officers), 95 out of 120 (79.16%) respondents (taxpayers) and therefore the sum total 115 out of 140 (82.14%) is collected.

During the distribution of questionnaire to taxpayers, consideration is given to different sectors, time for registration (short or longtime VAT registration) size of firms and nature of registration (compulsory in sector and threshold wide). There was a great challenge during the distribution of the questionnaire that unwillingness and carelessness from respondents while filing the questionnaire in which 15 of the questionnaire back blanked and 10 of them are totally lost. It is also important to remember so long as the main objective of this research is to find the real challenges of enforcing value added tax, any specific challenge raised within the Addis Ababa VAT registrants could all more or less relevant to other enforcement body outside Addis Ababa.

Besides, the researcher tried to include those very relevant and great points with respect to challenges of enforcement because there are uncountable challenges as observed practically.

The data presentation is related firstly, by describing the general issues discussed in the previous chapter and what was left to be addressed in this chapter and secondly, presenting the data and finally discussing and analyzing the tables and other qualitative data's. Hence the challenges occurred in enforcing VAT are summarized in the following broad categories of challenges. The law as challenge (rate, threshold and exemptions), the taxpayers as challenge (lack of awareness, sale register machine, common means of evading tax) and the tax authorities as challenges (registration and estimation problems, capacity of the authority, inspection officer's related problems) but first it is important to start with the structure of the VAT administration and the number of taxpayers.

4.1.1 Structure of the VAT Administration

Before the replacement of the sales tax by the value added tax, revenue sources are assigned in three categories by the nature of taxpayer not by the type of tax. The federal government has the power to levy and collect sales taxes on imports and federal owned enterprises. States are empowered to levy and collect sales tax on individual traders within their territory and on regionally owned enterprises. Both the federal and state government possesses concurrent power to levy and collect sales taxes on jointly owned enterprises and private enterprises. The sharing of VAT revenues follows this pattern. The value added tax was decided to be administered by the federal government and the federal government entrusted the power to administer and collect the VAT.²⁷³

²⁷³The value added tax was not determined by the constitution to which government it assigned because it is new tax. Though there are controversies in this issue, it is not doubtful that it replaces the sales tax which was previously determined by the constitution which government it collects and on what base. Whatever the reason and argument on the constitutionality, the joint session of the two houses decide the VAT to be administered by the federal government, FDRE house of peoples representative minute, vol.3, April 3, 1994 E.C (Amharic). See also for more details on federal VAT issues, Gizachew Sileshi, the Problems of VAT in Federal System: the Option Taken in Ethiopia, and the Constitutional Issues Related to it, unpublished, AAU, faculty of law, 2006.

The ERCA delegates its power of administering VAT to regions to collect and administer VAT on sole proprietors considering that it is their own.²⁷⁴ This power of delegation emanates from Art 6 of the ERCA establishment proclamation. The main reasons of the delegation are²⁷⁵ first, the possible evasions that can be created during VAT payment in the sense that sole proprietors are payers of income tax to states. If these taxpayers became federal VAT payers, there is high possibility of fraud in the middle. Secondly, the capacity of the ERCA to administer VAT throughout the country; the federal Revenue and Custom Authority is not expected to administer and collect every outcome of the value added tax throughout the country considering the capacity of the authority. The inherent nature of delegation is that the federal authority can take the power it delegates to the regional authorities and city administrations. Notwithstanding such fact, the letter of delegation declared that “as the capacity of the state/city administration improves, those VAT payers to the federal government destined in states will be transferred to the regions or city administration.”²⁷⁶ This seemingly implies that in the future it is expected such a power transfer not the cancellation of the delegation.

The delegation power is not without restriction. According to the directive of ERCA,²⁷⁷ the ERCA and its branch offices shall keep records showing the name of taxpayers and to which state/city administration or federal government the taxpayer belongs. After receiving segregated paid tax from its branches, the authority categorize the VAT’s spend, according taxpayers to each state and federal government and aggregate it.²⁷⁸ It will be sent to the entitled states within twenty days after the end of each month accompanied by a letter informing the details and five percent of the revenue of each state shall be retained by the authority for the purpose of refund for taxpayers.²⁷⁹

²⁷⁴ See letter on the delegation at the annex

²⁷⁵ Interview with Ato Mokonnen Ayele, Civil Cases Affairs Coordinator, at the ERCA, in November 2, 2010.

²⁷⁶ Letter supra note 2, at the annex

²⁷⁷ የኢትዮጵያ ፌዴራላዊ ዲሞክራሲያዊ ሪፐብሊክ የገቢዎ ሚኒስቴር ከክልል ግብር ካዮች የሚሰበሰብ ተጨማሪ እሴት ታክስ (VAT) የቅድመ ክፍያ (With holding) እና የጋራ ገቢዎች ለክልሎች ፈሰስ ስለሚደረግበት አሰራር የወጣ መመሪያ ቁጥር 22/2001፤ የኢትዮጵያ ገቢዎችና ጉምሩክ ባለሥልጣን፤ ነሐሴ 2001 ዓ.ም፤ አዲስ አበባ article 4(3)

²⁷⁸ Id. Art, 5(2).

²⁷⁹ Id. Art, 4(1) and Art, 5(2).

4.1.2 Number of VAT Payers in Ethiopia

The following table provides the number of taxpayers of VAT in Ethiopia with the respective tax authorities.

Table 4.1 Number of Taxpayers by respective tax Authority from date 01-01-2003 to date 04-11-2010.

No	Tax authority	Number of taxpayers
1	Addis Ababa City Administration Revenue Authority	20,770
2	Afar National Regional Government Finance and Economic Development Bureau	224
3	Amhara National Regional State Revenue authority	1,194
4	Benshangul Gumuz National Regional State Revenue Authority	921
5	DireDawa City Administration Revenue Authority	452
6	Ethiopian Revenue and Custom Authority	24,699
7	Gambella Peoples National Regional State Revenue Authority	1
8	Harari Revenue Authority	13
9	Oromia National Regional Government Revenue Bureau	6,162
10	SNNPR State Tax Administration Authority	1,897
11	Somali Regional State Revenue Bureau	279
12	Tigray Regional State Revenue Authority	1504
	Total	58,116

Source- from the ERCA data base

From the above table, it is possible to draw that most of the VAT registrants are found in Addis Ababa, 20,770, without considering those traders destined in Addis Ababa registered under the ERCA. It is also stated that most revenue is collected from the Addis Ababa taxpayers.²⁸⁰

²⁸⁰ Interview with Ato Eshetu W/semayat, Directorate Director of prosecutors of ERCA, at the ERCA, in 27 Oct. 2010. To the question why the revenue authority concentrates its strict enforcement in Addis Ababa he stated that above 90% of revenue is collected from Addis Ababa taxpayers. The researcher could not get accessible data on contribution share of revenue of VAT of each regional states and city administrations.

4.2 The Law as a Challenge of Enforcing Value Added Tax

As it is already outlined in the proposal, the law as a challenge of enforcement is concerned with VAT rate, threshold and exemptions for purpose of this research unless otherwise indicated incidentally. In chapter three of this research, the different alternatives on rates, exemptions and thresholds are discussed in theoretical manner. Here the researcher focuses the practical implication on the Ethiopian context vis-à-vis the theoretical view points in chapter three.

4.2.1 Rate of Value Added Tax

As it is discussed in chapter three, there are two alternatives in rate of value added taxes.²⁸¹ The first issue relates multiple versus single rate where as the other is range of rate. With respect to multiple rate versus single rate issue, single rate is better for enforcement purposes which the former creates a scope for misclassification fraud and give rise to refund entitlements which in turn creates opportunities for fraudulent abuse. The Ethiopian value added tax opts for single rate to all transactions with the exceptions of exports. This is theoretically at least expected to simplify enforcement of the VAT.

The second issue is the level /degree of value added tax. Theoretically, several frauds become more attractive to evasion the higher is the rate of VAT.²⁸² This may be because of the attractive value of the rate in the sense that as the amount of rate increase, the amount you collect and pay to the government increase which in turn inspires evasion. Concerning high or low rate, comparing to African countries, average of 16 VAT rate, the Ethiopian seems fair with simple mathematical comparison, at least theoretically, with 15% rate as it is discussed in chapter three table 3.3.

The replaced sales tax had employed different rates for different items. For example, five percent was levied on some foods and necessities such as pharmaceutical products, books and cotton. The new VAT goes for single rate with some exemptions and zero-rate of exports. The sales tax is replaced with VAT and TOT in which case the latter is presumed

²⁸¹See chapter three topic number 3.1

²⁸²Michael Keen and Stephen Smith, "VAT Fraud and Evasion: What Do We Know, and What Can be Done?" International Monetary Fund working paper 07/31 (2007), p.11.

to be an equalizing rate of VAT. The point needed to be answered practically in this chapter is what the practice claims on the other alternatives i.e. multiple rate, high or lower rate of 15% or any other in this issue. The following table gives us the clue on this issue.

Table 4.2 Responses of inspection officers and taxpayers on VAT rate and number of consumers

Proposition	Options	Percent	Total
1. Which of the following do taxpayers complain about VAT rate?	VAT rate is high	5 (25%)	20(100%)
	VAT and TOT rates are not proportional	5(25%)	
	VAT rate is high and VAT and TOT rates are not proportional	9(45%)	
	Adopting single rate	0(0%)	
	No complain	1(5%)	
	Others	0(0%)	
2. In what manner does the law became a challenge of enforcement if position of the law is included in answering question number one?	VAT rate is high	7(8.75%)	80(100%)
	High registration threshold	3(3.75%)	
	Adopting one rate	2(2.5%)	
	Adopting several exemptions	0(0%)	
	The doesn't exempt exempted that should be exempted	10(12.5%)	
	VAT rate is high and high registration threshold	40(50%)	
	VAT rate is high, high registration threshold, not exempted that should be exempted	20(25%)	
	Others	6(7.5%)	
3. How do you see the number of customers before and after registration of VAT?	Decrease	60(63.1%)	95(100%)
	No change	30(31.5%)	
	No answer	5(5.26%)	

Note: the first question is for inspection officers and the second and third questions are for taxpayers. See questionnaires at the annex

In this table there are two respondents that are the inspection officers' responses (the first question) towards taxpayers' attitude on rate of the VAT during their inspection and the taxpayers thinking towards the law on rates (the second and third questions in the above table). Accordingly, from the 20 inspection officers', 5(25%) of them says VAT rate is high, 5(25%) responds VAT and TOT rates are not proportional, 9(45%) of them encircled both VAT rate is high and VAT and rates of TOT are not proportional. Out of them, 1 (5%) respondent say no complain and no one take the option of adopting single rate and others (0%). Surprisingly, no respondent circled the importance of multiple rates. Taking all 13(70%) respondents say VAT rate is high and 13(70%) pronounces VAT and TOT rates are not proportional.

With respect to taxpayers response, 7(8.75%) says VAT rate is high, 2(2.5%) circle adopting one rate option, 40(50%) of them responded VAT rate is high and high registration threshold and 20(25%) of them choose three of them i.e. VAT rate high, high registration threshold, some taxable commodities should have been freed. Aggregating the taxpayers only on tax rates, it furnish the result that 67 (83.75%)²⁸³ favor VAT rate is high.

To know the shift of consumers from those traders that are registered to those traders that are not required to register, taxpayers are asked concerning the number of consumers before and after VAT registration. 60(63%) of them supports the idea that the number of consumers decreases, 30(31.57%) takes there is no change and 5(5.26%) puts no answer. In this situation, two things need to be considered in deciding whether the numbers of consumers are declining or not. First, purchasers who are registered of VAT are happy to buy from a registered trader than non-registered trader because of the input credit mechanism. Second, the mandatory registration provided for nine sectors²⁸⁴ should be taken in to consideration in deciding the number of consumers in the above question that buyers are not expected to shift to other similar businesses because all businesses are duty bound to register unless otherwise it is taken that consumption in these sectors is

²⁸³It is cumulative of respondents on 'VAT rate is high' 7(8.75%); 'VAT rate is high and high registration threshold' 40(50%); 'VAT rate is high, high registration threshold, not exempted that should be exempted' 20(25%) take note that the 80 persons are those take the position of the law as a challenge in Question no.1, see questionnaires at the annex

²⁸⁴ Directive, supra note 269, article 4.

diminished. Those who responded that VAT rate is high are asked how high VAT rate is obstacle to the enforcement of VAT.²⁸⁵ They put their reasons as follows:

- The high rate of VAT does not consider the ability to pay of the society which results simulated as well as fraudulent sale, shift of consumers to the non-registered traders and reduction of consumers in businesses joined to the VAT web.
- It creates competition unfairness with unregistered trader²⁸⁶ which results fearing of registration of these traders below the threshold.

These views are also uttered during taxpayers' conference prepared by the Addis Ababa chamber of commerce, in which case taxpayers raise the competition unfairness existed as a result of the disproportional rate of VAT and TOT.²⁸⁷

Similar reasons also elucidated by the inspection officers to the question 'what are the possible reasons of taxpayers of such complain':

- VAT and TOT rates are not proportional
- The rate of VAT should be decreased as a result taxpayers can register voluntarily
- Competition unfairness between the registered and non-registered taxpayers
- The tax rate is not necessary on food related items.

Following this, it is important to see the ground of business communities complain on the proportionality of VAT and TOT rate, competition unfairness, and others outlined above. To begin with, rate complains of taxpayers have two folds. First, the rate is too low to be an equalizing rate of the VAT and second, TOT taxpayers can evade simply the tax because of the lessen compliance cost requirement.²⁸⁸ It is true that a 2% is an

²⁸⁵This questions mainly avoids the bias that taxpayers are not expected to be happy with tax related issues

²⁸⁶This covers two issues. First, there are businesses that are above the threshold but not registered in the same sector. Second, there is computational problem even with TOT taxpayer

²⁸⁷በግብርና እና ታክስ የሚታዩ ችግሮችን አስመልክቶ ለመንግስትና ለግሉ ዘርፍ ምክክር መድረክ የተዘጋጀ ማስታወሻ /ረቂቅ/፣ ሐምሌ 2002፣ አዲስ አበባ ንግድና ዘርፍ ማህበራት ምክር ቤት፣ አዲስ አበባ፣ ያልታተመ ገፅ-10-12.

²⁸⁸The Turnover Tax would be payable on goods sold and services rendered by persons not registered for Value Added Tax. The rate of Turnover Tax is 2% on goods sold locally; for services rendered locally: 2% on contractors, grain mills, tractors and combine-harvesters; 10% on others. Turnover Tax Proclamation, supra note 46, Art.4. The main advantage of TOT taxpayer is that, they are not forced to have record, except those above 100,000 and below the 500,000 according article 9 of TOT proclamation, and receipts they can sale their goods and services lesser than others considering the lower rate, and the tax enforcement is strict in VAT registrants and lastly, the reporting is more frequent in VAT than in TOT. See article 10 of the TOT proclamation and article of the VAT proclamation.

equalizing rate of the VAT rate with the assumption that VAT registrants have the advantage of getting credit for input tax. This is emanated from the logic that through the intermediate process, VAT registrants get input credit opposing the tax over tax effect of TOT. However, is that the fact?

In fact, the two percent rate is an equalizing rate adopted by the legislature.²⁸⁹ TOT payers are presumed to be small traders and consequently they are not assumed to be manufactures, producers, wholesalers or importers rather they are usually retailers. Considering such fact, the possibility of occurring intermediate process is less or none. This reasoning obliges us to oppose the advantage of VAT registrants of getting input credit compared to TOT which is less persuasive because there is less otherwise no possibility of intermediate process in the TOT taxpayers. There are also some considerations that should be taken in deciding the competitive effect to those taxpayers below and above the threshold. Comparing to the VAT registrants, TOT payers have low compliance costs regarding the recording, reporting and others. Considering these facts, TOT payers may be more competitive than VAT registrants within the same sector.

In the other extreme, all VAT registrants do not procure credit for their inputs. The high-flying situations are inputs from exempted goods or services and inputs from firms that are below the threshold. The later aggravates the issue. In this case, two firms, one VAT registered and other TOT payer, take alone with 15% and 2% rate respectively, are not in equal footing. For instance, in butchery businesses²⁹⁰ that are registered of VAT do not compete with non-registrants in the market. This is mainly due to the fact that VAT registrants cannot claim input credit from transactions with traders below the threshold but they have to compete with the two percent equalizing rate.

Disproportionality of these rates normally leads to a loss or win in auction bidding and shifting of consumers to non- registrants, which are the common problems complained by VAT taxpayers. Most taxpayers agreed that the disproportional rates as well as the high

²⁸⁹ With the purpose of such fact, after the sales tax is rescinded by VAT, the Ethiopian legislature come out with an equalizing tax, TOT, with the purpose of accommodating small business below the threshold perhaps because of the reason that they have no capacity to fulfill the VAT requirements like recording, reporting and others considerations of compliance costs.

²⁹⁰ Butchery business and construction businesses commonly raises the issue of refunding which is one of the challenges to be discussed later on. See supra note 287, P.12.

rate of the VAT are the main causes that lead to simulated contracts and contracts without VAT. Generally, the disproportionality of VAT and TOT rates and the high rates of VAT are the dominant issues of the respondents which the former creates competition unfairness whereas the latter inspires taxpayers to transact without VAT or to make simulated contracts.

4.2.2 Exemptions in the Value Added Tax Law

Within the exemption, in chapter three it is discussed that different justifications are provided for exemptions in VAT.²⁹¹ Exemptions may be a way of dealing with distributional objectives and a means of circumventing a variety of technical defaulting or any other purpose. In Ethiopia, lists of eighteen items which more or less are related to the technical as well as distributional effects are exempted from value added tax. Most important items like Injera, milk, bread, kerosene, education, health and so on are already exempted through the proclamation or through later interpretations.²⁹² The social impact of such exemptions needs another research. The point here is that how the numbers of exemptions in the VAT proclamation affect the enforcement of the VAT law in Ethiopia. Specifically, whether the common problems of exemptions discussed in chapter three like definitional problems, mixed sales of exempted and non-exempted goods and services, the refund problem and the sufficiency or insufficiency of VAT exemptions, are also the problems of the Ethiopian VAT system.

²⁹¹The justifications for exemptions can be summarized as administrative convenience (manageable traders to be registered), cost effectiveness (compliance and collection cost of traders), social and welfare considerations (treating consumption of low income households) and technical challenge (financial and insurance sectors). See the discussion in chapter three topic 3.2 and its accompanying texts.

²⁹²The MoFED can grant exemptions considering a case by case analysis as to Art 8(4) of the VAT proclamation. Injera, bread, milk and some other necessities were not expressly listed in the proclamation but later through letters or directives of the MoFED that are exempted.

Table 4.3 taxpayers' and inspection officers' response on exemption and problems attached to it

No	Proposition	Options	Percent	Total
1	If your answer to No.5 is exemptions are various, what are the possible challenges created as result of this?	No input tax credit It complicates book keeping Opens for fraud Others	4(100%) 0(0%) 0(0%) 0(0%)	4(100%)
2	Which of the following do you think taxpayers complain about exemptions during your inspection?	Some commodities should have been exempted No input tax credit Some commodities should have been freed and no input tax credit Complicates book keeping No complain Others	10(50%) 5(25%) 5(25%) 0(0%) 0(0%) 0(0%)	20(100%)
3	Is there a way that taxpayers used the law as a means of evasion during your inspection?	Yes No	11(55%) 9(45%)	20(100%)

Note: the first question is for taxpayers and the next two for inspection officers

From this table, from 80 taxpayers(the first question),²⁹³ 4 of them select numerous exemptions as a challenge and to the question of possible challenges 4(100%) of them select no input tax credit, no taxpayer choose for complication of book keeping, opens for fraud and others.

Inspection officers are also asked what the taxpayers complains about exemption and 10(50%) responds some commodities should have been exempted, 5(25%) for no input tax credit, 0(0%) for complicates book keeping, no complain and others. 5(25%) of them selects both some commodities should have been freed and no input tax credit. Cross analysis of the first three options in question number 2 in the above table gives that 15(75%) choose for some commodities should have been exempted and 10(50%) adopt no input tax credit. These inspection officers are also asked whether taxpayers used the law as a means of evasion with the purpose of knowing definitional problem and mixed sales problem and consequently,11(55%) of the taxpayers respond in the affirmative and

²⁹³Eighty persons refer to the number of taxpayers who include the law as a challenge in their option as indicated in table 4.2.

9(45%) respond to the negative. These respondents are also asked to outline the means and few of them say the mixed sale of taxable goods to the exempted goods in some businesses but most of them described their reasons that have no relation with intended problems of the law.²⁹⁴

Those taxpayers choose the option ‘some commodities should have been exempted other than those mentioned in the proclamation’ are also asked what goods and/or services should have been exempted and how it accelerates enforcement. They stated that traditional foods and some drinks should be exempted²⁹⁵ and their justification is a matter of equity that the low income society will be happy and then it can possibly help in exposing frauds of taxpayers.

Coming to the refund process, most officials interviewed agreed that there is an issue of input tax credit as a challenge but this input tax credit problem is not commonly emanated from the commodities or sectors exemption listed in the VAT proclamation rather it is the problem related to the absence of input tax in transactions from traders below the threshold.²⁹⁶ This may imply that the exemptions listed down in the proclamation are not serious problems and they are few in number considering the inherent input tax credit problems occur in exemptions.

Possible challenges of exemptions also include the definitional demarcation between those exempted and not exempted as well as mixing of exempted and taxable commodities problem. With this regard, the questionnaire distributed to the taxpayers as well as to the inspection officers does not give comprehensive data in this affair. The interviewed officials stated there are some problems related to exemptions in this

²⁹⁴Some of the reasons mentioned by the taxpayers are hiding their business not to register, not issuing VAT invoice, the claim that they are below the threshold, which are in one or another reason in the threshold area. These challenges are discussed in topic 4.3.3 of this chapter below.

²⁹⁵According to them, the traditional food includes foods which are usually eaten by the low income group like ‘Shiro’ and drinks like tea and milk.

²⁹⁶Interview with Ato Mengsteab Teklu, inspection officers coordinator of the Ethiopian Revenue custom authority, at ERCA, in November, 02, 2010 and interview with Ato Abebe G/yohannes senior officer of tax collection and assessment of the Addis Ababa Revenue authority, at the Addis Ababa revenue authority, 14 October, 2010. Ato Abebe in his interview cited, an example of butchery business and construction businesses which raise this issue at the time of registration and there after. See also, supra note 287, p.11. This will be addressed more on the chapter four topic 4.2.3.

matter.²⁹⁷ The first is the problem of distinguishing the limit of those exempted goods and sectors in the proclamation. The most cited problem as an example is bread and bread processed products, milk and milk products. Bread, injera and milk are exempted under the Ethiopian VAT law.²⁹⁸ Then the problem is that there is a misunderstanding among the taxpayers that ‘since bread and milk are exempted, products from the processes of milk and breads with additional inputs are exempted’. However, all of these interviewed officials agreed that they are not a decisive challenges of the VAT and these problems are not intentional but because of lack of awareness.

The second problem is the issue of shifting taxable commodities to exempted commodities in time of sale particularly in supermarkets. For instance ‘injera’ is exempted consequently those firms which hold ‘injera’ and other goods in their business mix these together and shifts those goods as an exempted by the pretext of ‘Injera’. They are collecting the tax but did not forward to the authority. This is due to the lack of awareness of the consumers on VAT invoice to be discussed later on. This problem is an intentional fraud made by some traders, but it is stated that “this is not a major challenge of the VAT enforcement too.”²⁹⁹

Thirdly, there is lack of awareness on the sectoral exemptions such as education and health.³⁰⁰ The problem in these sectors is that the business community in these sectors perceives that it is not only the education or health that is exempted but also the related businesses of education and health. For example, cafeteria services, construction of building for such services and others. Those all circumstances are not intentionally emanated to evade tax but as a result of lack of awareness on what the exemption of health and education extend in these sectors. Whether definitional problems of

²⁹⁷Ibid. Besides, interview with Ato Yohannes, officer of tax operations in Addis Ababa Revenue authority, broadcasted thorough FM 96.3, in Thursday 21, October 2010, at 11:30 AM in revenue program of this radio.

²⁹⁸Circular reference of the MoFED by አመ3/16/28/889 and አመ3/16/28/1 exempts milk, bread and Injera

²⁹⁹Ato Mengesteab, Interview supra note 296.

³⁰⁰Ato Yohannes, supra note 297. Education and health are exempted under Art 8(2) (f) (g) of the VAT Proclamation.

exemptions are a challenge during litigation are also asked to some prosecutors of the ERCA, and they stated that exemption related definitions are not challenges.³⁰¹

The last issue of exemption is the problems of food related matters. Comparing to the replaced sale tax with 15% and 5% rates, the VAT proclamation subject processed foods and drinks to the tax net with the exception of ‘Injera’, bread and milk. It is remembered that the issue of VAT on food was an election agenda with the issue of inflationary effect and income of the society.³⁰² What shows the data in this matter? As it is discussed above, 15(75%) of the inspection officers opt the ‘some commodities should have been exempted’ other than those mentioned in the proclamation as complaint of taxpayers and the common thing cited by both of the inspection officers and taxpayers is food and some drinks. The reason outlined by taxpayers during tax rate questions was that it is unfair to put such rate on food and they suggest that it is better to exempt foods usually consumed by the low income groups to faster enforcement by means of voluntary compliance and include as far as possible taxable commodities to the tax base to balance the loss of revenue.

With the purpose of knowing the perception of consumers towards exemption of food, 20 consumers were interviewed during their consumption in cafeterias and restaurants and stated unanimously that “VAT on food is unfair” and they stated that they start shifting to non-registered business on this matter. In table 5.2, it is discussed that there is a decrease in consumers, however; taxpayers interviewed in these sectors responded that, despite the decrease of consumers might be the result of such problem, the main problem that bothered them is the disproportionality of VAT and TOT rates.³⁰³ The researcher asked whether the number of cases prosecuted by the ERCA on VAT outweigh on the food

³⁰¹Ato Eshetu, Interview, *supra* note 280 and Interview with Ato Fisha Alemayehu, senior prosecution officer of the ERCA, at the ERCA, in October 26, 2010, , Interview with Ato Yohannes Woldesiliasie, higher prosecutor of the ERCA, at the ERCA, in October 26, 2010 but they cite some other challenges like problem related in sole proprietors, evidences in manager versus workers.

³⁰²Whether VAT on food is inflationary or not needs economic research on this matter, but it is undeniable fact that starting from 2003/04 up to 2007/08, the inflation of food increase high but whether it is because of VAT or not is another issue. See, Annual report on Macro Economic Development, EFY 2000/2007/08, Dec, 2008, MoFED, Addis Ababa, Ethiopia available at www.mofed.gov.et and retrieved at October 29, 2010.

³⁰³Still it is doubtful that whether the increment of price is a result of the VAT rate, though it has its own contribution, because the researcher observe that VAT registrants change their price completely after registration comparing before registration.

related sectors than others and it is sated that the number of cases outweigh in this sectors than others but the reason is not related with exemption rather it is a matter of time in the sense that the ERCA begins the implementation of VAT in this sector.³⁰⁴

In deciding whether food should be totally exempted or apply with reduced rate, some important considerations need to be answered. The first is can't the government compensate the loss of revenue from food exemption in the sector if exemption is made? Second, is the increment of price emanated from the imposition of VAT because taxpayers usually make substantial change of price after they become registered of VAT? Third, is it the VAT exemption the only alternative since there are other mechanisms like increasing the salary of workers or/and decreasing the income tax rate? Fourth could the exemption of food really benefits the poor since there are another mechanisms like the expenditure of the government on education, health and other sectors which substantially affect the poor? Fifth, is really the revenue from this sector substantial to other sectors because, as it will be discussed later on there are taxable sectors which are not yet addressed by the authority?³⁰⁵ Sixth, is collection capacity of the authority really high in which case it will benefit the society through other mechanisms? These and other questions need to be addressed before decision is made. Some of these questions are economical matters; others are out of the VAT schemes which are out of the scope of the paper.

However, the researcher doubt that there are mechanisms that can bring the equity issue raised above because those scholars that oppose for the exemption of food are based on other alternative that is adjusting direct taxes to benefit the poor which is made in countries like New Zealand. However, developing countries like Ethiopia have collection problem even in direct taxes and they are not expected to bring distributional equity through this mechanism. Besides, the researcher doubts the revenue loss argument from the exemption of food because there are goods and services which are capable of generating revenue to compensate the revenue forgone. At this time, there are some

³⁰⁴The ERCA first starts enforcement in the food sector like the introduction of cash register or other and as time goes it extended to other sectors. Ato Eshetu, supra note 280.

³⁰⁵The MoFED also exempted different goods based on development or other grounds which can substantially erode the system.

traders that are not yet registered like boutiques, mobile centers, legal services and the like. Regarding challenges of enforcement, the reasons outlined are a matter of equity and they have no ground on how they facilitate enforcement against the theoretical view point that exemptions should be limited.

Generally, the exemptions are not basic challenges to the enforcement of the value added tax. However, the equity matter needs a further research.

4.2.3 Thresholds of Value Added Tax

It is already discussed that the size of firm's, compliance costs and the means of accommodations businesses below the threshold should take into account in setting a threshold.³⁰⁶ In terms of enforcement, the high the threshold may ease administration in terms of saving costs. Besides, the revenue forgone by setting high threshold may be small vis-à-vis the cost of administration. The Ethiopian value added tax put a high threshold comparing to African countries and even the OECD member countries with 500,000 birr as it is shown in table 3.4. This is expected to ease enforcement. However, is this real in the field? Let's see the following stake holders' response in this matter.

Table 4.4 Response of taxpayers and inspection officers towards the threshold

	Proposition	Options	Percent	Total
1	Which of the following do you think that taxpayers complain about threshold?	Competitional unfairness with the unregistered businesses Decrease number of consumers We should not have been registered All We should have been register No complain Others	6(30%) 4(20%) 2(10%) 7(35%) 0(0%) 1(5%) 0(0%)	20(100%)
2	If your answer for number 5 is high threshold, what	Competitional unfairness with the unregistered business VAT and TOT rate are not	5(7.92%) 3(4.76%)	63(100%) ³⁰⁷

³⁰⁶See chapter three topic 3.2.6.1

³⁰⁷ 63 refers to the taxpayers that response to the high threshold from 80 persons in table 4.2 who include the law as a challenge of enforcement.

	are/is the problem created as a result of this?	proportional Shift of consumers to the unregistered All	0(0%) 55(87.3)	
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Note: the first response is from inspection officers while the next are from taxpayers

From the table above, out of 63 taxpayer respondents (question number two), 60(95%) responses for competitiveness of the threshold in the sense that the taxpayers below the threshold get competitive advantage over the registered ones. 58(92%) of them respond for the disproportionality of the VAT and TOT rates and 55(87.3%) reply that there is a shift of consumers to the unregistered traders.

Likewise, from the inspection officers (question number 1), 13(65%) choose to complain of taxpayers on unfair competition, 11(55%) of them favor a decrease of consumers in the registered businesses, 9(45%) choose the alternative that they should not have been registered, no one complains for registration and 1(5%) of the inspection officers disfavor a complain on thresholds. Cumulative results of these respondents give that competitiveness is the common problem of the threshold.³⁰⁸ Besides, the disproportionality of VAT and TOT rate, goes side by side with the above,³⁰⁹ is another challenge of the threshold.

In addition to those closed questions, taxpayers were asked whether they are happy with VAT law and what reasons call for their unhappiness if any. Their reason rotates around the fairness issue; unequal treatment of the law to all taxpayers. Inspection officers also asked how the taxpayers utilize the law to evade tax and they respond that taxpayers hide their business not to register. Related to this, it is also important to note that no taxpayer

³⁰⁸During the seminar of the Addis Ababa chamber of commerce unfairness was the other main issue complained by the taxpayers. See supra note 287, p. 12

³⁰⁹The reader needs to understand that competitiveness and rate difference of VAT and TOT are two different things. Because, the former may imply that the threshold is unnecessary and the second requires balancing the two rates. Competitiveness is not only created because of rate but also the obligation of book account, reporting, cash register machine and others.

claim to register voluntary which imply unfair means of accommodation traders below the threshold.³¹⁰

The competitiveness unfairness of those traders is raised because of two conditions. The first is from those traders which should have been registered but not yet registered and the second is those traders below the threshold with TOT but sold similar commodities. The former is going to be discussed under registration and estimation problems under topic 4.4.1 below. The latter creates two competitiveness problems on the one side there is shift of consumers to those below the threshold and out of the shift of consumers and the issue of auction bidding is the other.

Some of the consequences of the unfairness are; first, traders are not volunteer to register for VAT which some times expressed with high corruption in the registration process and second, traders which are already in the hand of VAT make their better effort to be out of the VAT for instance splitting their business or closing their business and alter with another business name.³¹¹

To avoid or at least decrease the problems above, different options available within this area. The first option is that the threshold will be done zero and all traders will be VAT registered. The main problem with this option is, to benefit those businesses above the threshold it generates another unfairness on the small business in which not only the compliance cost is more but also this compliance cost cannot fully passed on the consumer as these small businesses do not have the sufficient market power. Secondly, experience shows that zero threshold is not advisable particularly for developing countries.³¹² Thirdly, if zero threshold is opted, do the ERCA and the respective state

³¹⁰This imply that no taxpayer complain against the 75% requirement of the law for voluntary registration. During the distribution of the questionnaires the researcher observe that when traders asked whether they are VAT registrant or not those business owners who are not registered frustrated while hearing such question. Interview, Ato Mengesteab, supra note 296 imply that there is low voluntary registration of businesses except of those of exporters (because of zero-rating). To develop voluntary registration, the ERCA, is in away to launch a three month incentive mechanism in this year in which those non- registered would not liable for uncollected VAT and penalties during the period due for VAT registration.

³¹¹Interview with W/t Mihret Haile, inspection officer of the ERCA, at the ERCA, in October 19.

³¹² Grenade, Malta and Ghana are the best examples with this regard. See “Christophe Grandcolas, The occasional failure in VAT implementation: lessons from the pacific”, Asia Pacific tax bulletin, (January/February 2005), P.7-9. In Malta, the initial VAT threshold was zero which bring huge taxpayers and become to monitor numerous taxpayers who collectively pay little tax lead to the failure VAT. In

authorities have the capacity to administer all the businesses. Details of this question will be addressed on the third topic of this chapter.

The second option could be lowering the VAT threshold up to 100,000 because the TOT proclamation obliged traders whose annual turnover more than Birr 100,000 and less than birr 500,000 to maintain books of account. In this case, the compliance cost might be proportional since these businesses are by now obliged to take account. This option could not solve the problem too.

The third possible option is that the price value of 500,000 at this time is not as the first intention of the law and as time goes up this value will have low market value; therefore, the VAT and TOT rates should be balanced to avoid the competition unfairness of businesses below and above the threshold. Still if this option is accepted, it is doubtful whether it will bring perfect fairness because the possibility of evasion, the compliance cost advantage in VAT registrants is still with these traders below the threshold.

To sum up, are the VAT law positions challenges of enforcement? The interviews made and the questionnaire distributed signifies the following:

- The rate of value added tax is a challenge in two senses. First it is high considering the relative income of the society. Second, the TOT and VAT rate are not proportional which means that high rate of VAT upshots competition problem among traders below and above the threshold. Third, the high rate of VAT itself invites for evasion because in the one hand the amount to be gain from evasion is high on the other hand considering the high rate of VAT and the shift of consumers, it brings fraudulent contracts.
- With respect to exemptions, as all the data's imply, it is not decisive challenge considering that a few things are exempted except with issue of food exemption on equity issues.
- Apropos the threshold, it is a challenge of enforcement because it does not accommodate the small business fairly in compare to the VAT registrants. Firstly,

Grenada, the low threshold of XCD 12,000 per annum brought many small businesses similar to the case of Malta, which create widespread discontent and increasing political pressure. Lastly, in Ghana, too, the threshold for small traders to register for VAT was set at USD 14,000 at that time which brings many businesses and consequently the government repealed VAT in June 1995 in response to the civil unrest.

the rate is not proportional and secondly, the compliance cost incurred on both taxpayers is not alike.

4.3 Challenges within the Taxpayers

Taxpayers in the VAT sense does not signify the people who really pay the tax. In VAT, the final burden of the tax relies on consumers/end-users of the taxable commodities. That is why VAT becomes a consumption tax. Taxpayers/ VAT registrants are collectors of the tax instead of the authority. There is nothing lost from these registrants rather of some collection costs. It is not likely that taxpayers will be happy to every outcome of tax. The purpose of this topic is to discuss challenges that can be resolved and commonly observed in the taxpayers considering that VAT is a consumers' tax. The researcher takes three important challenges which are raised from the questionnaire and interviews made with taxpayers as well as officials of the concerned authority. These are lack of awareness, cash register related issues and the invoice/receipt mechanisms and customer related issues.

4.3.1 Lack of awareness

There is a great awareness problem between and among the taxpayers starting with the concept of the tax itself and the purpose of taxes in general. Taxpayers are not aware of from where the tax is collected. They considered it as part of their profit and when they are obliged to pay they hesitate from their obligation. Let see the following table on this issue.

Table 4.5 Knowledge of taxpayers and inspection officers in the value added tax law

N o	Proposition	Options				Total
		High	Medium	Low	I don't know	
1	How do you measure your knowledge of value added tax law?					
	Taxpayers	5(5.78%)	30(31.57%)	40(42.10%)	20(21.5%)	95(100%)
	Inspection officers	5(25%)	15(75%)	0(0%)	0(0%)	20(100%)
2	What do you think are the possible causes of taxpayers challenge in question number 11?	Low practice of paying tax Lack of awareness The behavior of unlawful enrichment Others			12(16%) 60(80%) 3(4%) 0(0%)	75(100%)
3	If you brought before the court in relation to failing to pay VAT, did you get prior notice on your fault from the authority?	Yes No			4(80%) 1(20%)	5(100%)
4	Do you think that there are taxpayers brought before the court without prior notice on their fault?	Yes No No answer			2(10%) 15(75%) 3(15%)	20(100%)

Note: the second and third are responses of taxpayers and the third for inspection officers

From the above table, there are some important outcomes of the respondents. Comparatively, taxpayers have awareness problem in which 63.05% (60 persons) respond for low or no knowledge on the value added tax. Both respondents also asked what the possible challenges of taxpayers to the enforcement and almost above half of them respond for lack of well knowledge as a challenge. This is followed by 95% respondents' suggestion on awareness campaign from the authority on what the purpose of the law is and the way and means of collection. From the table, too, 60(80%) taxpayers acknowledge that lack of awareness is the main challenge of taxpayers for the enforcement of VAT.

Related with this lack of awareness area both respondents reply for the question whether taxpayers noticed on their prior fault before they accused of VAT and from five taxpayers, 4(20%) of them respond in the affirmative and 15(75%) of inspection officers do the same. Inspection officers also confirm lack of awareness as a main challenge of the taxpayers to the enforcement of value added tax. The interviews also disclose such fact that there is no taxpayer brought to the court without warning on his fault.³¹³

Two things need to distinguish here. Is the lack of awareness on the side of taxpayers stand on the substantive part i.e. how many rate, what threshold and exemptions are? As it is discussed earlier on the law as a challenge, no data referred as to the existence of 12 or other VAT rate by the taxpayers as a fraud, the amount of threshold or what exemption amounts, with the exception of some lack of awareness problem in some sectors which is less decisive challenge. The recommendation of taxpayers as well as response of the inspection officers helped with interview with some of the taxpayers echoed for the lack of awareness why they are paying, the means of collection from whom they are collecting or the purpose of taxes in general. These all claims for high awareness creation program on taxpayers' side on what failure to pay tax brings and payment of tax conveys to the country. The data from those persons who were punished as a result of VAT fraud entails that no person again accused of VAT fraud with some exceptions.³¹⁴

4.3.2 Sales Register Machine

Sales register machine refers to a cash register machine or a point of sale machine.³¹⁵ cash register machine is “a machine that uses a firm ware that is installed in an electronic programmable read only memory chip and can record the sales of goods or services in lieu of the regular sales receipt” where as point of sale machine “means a machine that is a computerized replacement for the cash register machine and had additional capability to

³¹³Interview cited above at note 280.

³¹⁴Ibid. He responded that there are prisoners who served sentence on VAT repent on their fault. But yet there are prisoners who did not rehabilitate for their fault.

³¹⁵Council Of Ministers Regulation to Provide for the Obligatory Use of Sale Register Machines No.139/2007, Federal Negarit Gazette, 13th year, January, 2007, Art 2(1).

record and track customers orders and debit credit card accounts, to manage inventory and perform similar tasks.”³¹⁶

The cash register machine (hereafter CRM) is most commonly used in transactions which have small sized listed transactions like tea, foods but the point of sale machine (hereafter PSM) is used most commonly in huge transaction in long written phrases which shows transmission that is why it is connected with computer like printer in a slide paper.³¹⁷ Both CRM and PSM starts to apply after 2008 and they are expected to unburden the work of the authority. Before discussing challenges within sales register machine see the following table on the perception of the respondents.

Table 4.6 Responses of inspection officers and taxpayers towards sales register machine

No	Proposition	Percent	Total
1	Do you think that taxpayers are happy with sales register machine?	Yes 19(95%) No 1(5%)	20(100%)
2	Are you happy with sales register machine?	Yes 40(42.10) No 55(57.89)	95(100%)

Note: the first question is for taxpayers and the second for inspection officers

From the inspection officers (number 1), 19(95%) of them reply that taxpayer are not happy with cash register machine whereas 1(5%) answer optimistically. From the total 95 taxpayers (number 2) above half 55(57.89%) replies that they are happy while 40(42.10%) responds they are not happy with sales register machines.

Respondents also requested what the possible reasons could be and according to the inspection officers the main reasons turns around:

- The price, provision, and maintenance of the sales register machine.

³¹⁶Id. Art 2(2) and Art 2(6). The characteristics of the two sales register machine is listed down in Art 9 of the same regulation and their respective features in Art 10 and 11 of the regulation. Some of the common features of these machines are capable of generating a report showing the reading of daily sales, clearly indicated taxable and non- taxable items, supported e-mobile technology which can transmit sales data to the tax authority and so on and their particular features are cash register machine shall be equipped with a roller or its equivalent for the audit journal and a second roller for the customer receipts and the point-of-sale machines, should capable of recording automatically every sales transaction in the central server it connected to.

³¹⁷ The slide show of the point of sale machine receipt is large in its size and volume than the cash register machine receipt. The machine even have a difference in the sense that the point of sale machine is connected with computer in which it is used to list transactions but the cash register machine writes and prints within the machine

- Unfairness on its provision that all registrants are not subject of the machine.

Taxpayers also asked what could the possible reasons for their unhappiness; in addition to the above response of the inspection officers, they answered that:

- The training problem to new workers and it's vulnerability to errors
- The sales register machine should not apply to all registered businesses.

Some officials are also interviewed on this matter and accordingly the reasons of unhappiness is because the machine exposes them to perfect calculation of their income tax in addition to the VAT purpose which does not allow them to deceive the authority.³¹⁸ Don't miss that those taxpayers who undertake their business through agents or simply by third party are too much happy with the sales register machine because the machine records every transaction which avoid the fraud of the manager or the workers of the business. Besides, some taxpayers who undertake their business by themselves are happy because the machine simplifies work comparing to what was before the machine.

Two important problems are indicated by the respondents. First, the problem of provision and maintenance of these machines, and second, all inclusive obligation of the authority to buy sale register machine. Sales register machine are supplied by the private business with the permission from the authority.³¹⁹ The prices as well as other errors are going to be rectified by these private businesses.³²⁰ The complaint ongoing by the taxpayers is that the price becomes expensive of buying and repairing the machine. They recommend that the government should provide the machine and its maintenance.

The second problem is that all VAT registered traders are obliged to buy cash register machine or point of sale machine. Some businesses like construction and translation are complaining that their business is not comfortable to sales register machine.³²¹ With this

³¹⁸See interview, Ato mengesteab, supra note 296, see interview, w/t Mihret, supra note 311.

³¹⁹Regulation, supra note 43, Art.12-15. Any supplier of sales register machine should first apply to the authority to get permission and the authority shall examine the quality of the machine and whether it conducts the necessary conditions of the VAT transaction. See Id. Art 12 and 13.

³²⁰There are seven businesses that provide the sales register machine up to the last date of information, these are, Petram plc, Haron computer plc, Jupiter trading, EDDC, Omedad, Ipos plc and Addis home plc, interview supra note 296 and 311.

³²¹Interview with W/o Roman Teshome, Addis Ababa Revenue Authority, law enforcement senior officer, at the Addis Ababa Revenue Authority, on October 13, 2010. Some sectors challenge the machine, that their services are not comfortable to such machine by the reason of measurement difficulty in terms of

matter, the regulation on cash register take put specification of taxpayers by the authority through directive as a prerequisite.³²² However, no directive is issued to specify taxpayers subjected to the obligatory use of sales register machine.

4.3.3 Common Means of Evading Tax by Taxpayers

There are some common means in which the taxpayers utilize receipts to evade tax.³²³ The first is double invoicing.³²⁴ This refers to the situation that taxpayers use different sales invoice. This commonly occurs when the government and the private individual involve as purchasers. In this case, they lowered the value in case of government transactions while increase the value to private buyers. The purpose is that in case of government there is a withholding system³²⁵ which does not permit them to defraud but in private transactions they increase the value to enlarge the gain from VAT and they make it part of their profit. Second, taxpayers conclude a simulated contract with their customers by lowering their value of the sale to decrease the amount of VAT to be paid. Third, re-use of an invoice in similar consumptions particularly in cafés, restaurants and hotels. Fourth, refunding mechanism exploit during the operation of the sales register machine.³²⁶ Fifth, evading tax through non issuance of receipt. This is most commonly used on sales made to the final consumers. In this case, taxpayers usually provide options

pages? In terms of language etc. in translation service businesses and some business like construction complain on the issue that they have a few transactions in a year and hence having the machine is unnecessary.

³²² Regulation, supra note 315, Art 3.

³²³ Receipts of VAT should contain, at least, the taxpayers registered name, name of the business, Id of the taxpayer, receipt number, type and quantity of the goods or services sold, date and amount of taxable and exempted transaction. See regulation, supra note 315 Article 4(1). Taxpayers should also put notice stating that “Do not pay if a receipt is not issued” and “in case of machine failure sales personnel must issue manual receipts authorized by the authority manual” see Value Added Tax (Amendment) Proclamation No.609/2008 Federal Negarit. Gazette, 15th year No.6, 2008, Article 18(9).

³²⁴ Interview, Ato Mengesteab, supra note 296.

³²⁵ With holding system is a system that the government body who transact with taxpayers withhold the VAT paid. Initially, the VAT withholding become effective at federal level and in the future government budgetary institutions in regional states will be privileged to act as with holding agents. See በገባው ተይዞ ስለሚከፈል የተጨማሪ እሴት ታክስ አፈፃፀም የወጣ መመሪያ ቁጥር 27/2002፣ የገንዘብና ኢኮኖሚ ሚ ልማት ሚኒስቴር፣ የካቲት 2002 ዓ.ም፣ አዲስ አበባ፣ article 3.

³²⁶ In case when the sale register machine operator fail to put the correct value of the transaction the machine has a way to refund. Taxpayers, therefore, use this as a pretext to free themselves from tax. However, there are some businesses like guest houses, traders of building materials in which refunding is occur when consumer reback the materials in the former or users leave classes before their agreed contract. Interview with Ato Mengestab, supra note 23, interview with W/t Mihret Haile, supra note 311.

to their customers by asking “do you need receipt or not” and consumers automatically accept such option because they pay less since they will not be charged of VAT. Such option is provided by taxpayers because registered buyers usually require receipt to get input tax credit.

Outside the receipt, there are other usual means of evasion employed by the taxpayers. To cite some, hiding their business not to be registered, splitting of businesses to branches or use different names to escape from the registration threshold, putting small business in close proximity to the registered business to sale without VAT and others.

4.3.4 Consumers as a Challenge

Consumers have an influential power to the enforcement of value added tax. The above means of evasion used by the taxpayers, in one or another reason, are related to the consumers. If the consumer is willing full to control taxpayers, it is possible to avoid such challenges. So what is the contribution of consumers to the challenges of enforcing the VAT tax?

Table 4.7 Response of taxpayers towards contribution of consumers or end-users to the enforcement of value added tax

No	Proposition	Options	Percent	Total
1	Do you think that consumers are challenges to the enforcement of VAT law?	Yes No No answer	60(63.15%) 30(31.57%) 5(5.26%)	95(100%)
2	If your answer is yes, how do you think that consumers are challenges to the enforcement VAT law?	They inspire us to sale without VAT They do not ask us to give them receipt Both Others	20(22.22%) 55(57.8) 9(10%) 6(6.66)	90(100%)

This table indicates that consumers have their own contribution to the enforcement of VAT law. Most of the taxpayers, 64(67%), respond that consumers do not require taking

receipt and a significant number of taxpayers, 29(32.2%), respond that consumers motivate them to sale without VAT. The first challenge of consumers implies that there is awareness problem in the customers. In the one hand, consumers did not understand that VAT is a consumption tax in which it is collected from them.³²⁷ In the other hand, they are not aware of the fraud that taxpayers use the invoice to evade tax. Consumers interviewed also support this idea that they do not care off taking receipt and have no knowledge on the fraud made by the taxpayers. Some of them also respond that they are reluctant to ask a receipt because they are not happy with VAT rate. Taxpayers who answered for ‘others’ in table 4.6 reason out that consumers are challenges for VAT enforcement because they go to the non- registered traders.

To enhance the culture of taking receipt, a directive is issued by the ERCA.³²⁸ The directive provides that receipts issued within the prescribed time will enable consumers to compete in a lot.³²⁹ The receipt should contain TIN number of the taxpayer and code of the machine.³³⁰ Other procedures of the lot are similar to other lotteries. The problem is that, despite such importance, the directive is not yet effective.

Both Taxpayers and inspection officers were asked whether they agree or disagree that the main challenges of enforcing the VAT are Taxpayers. From the total taxpayers, 19(20%) agrees, 76(80%) disagree on the proposition that taxpayers are the main challenge. From the 20 inspection officers, 4(20%) agree, 14(70%) disagree and 2(10%) give no answer. From the data it can be said that taxpayers are not in the top hierarchy as challenges of VAT enforcement.

³²⁷Some consumers interviewed disclosed that the VAT in practice is not value added tax but a total sale tax. This issue also divides the standing members of the budget and finance standing committee of the house of people representatives on the issue raised by Ato Lideto Ayaliew, on VAT, Interview made with Ato Atsbaha Aregawi, chairman of the Budget and Finance Standing Committee, Oct.20, 2010. However, this is a result of misunderstanding on the types of VAT which have a similar result. See chapter two topic 2.4 on types of VAT.

³²⁸በሽያጭ መመዘኛ መሰረት የሚታተሙ ደረሰኞች ሽልማት የሚያስገኝ ዕጣ እንዲኖራቸው ለማድረግ የወጣ የአፈ.ፃፀም መመሪያ 27/2001፤ የኢ.ት.ዮ.ጵ.ያ ገቢዎችና ግምሩክ ባለስልጣን፤ ነሐሴ 2001 ዓ.ም ፤አዲስ አበባ

³²⁹Id. Art 5.

³³⁰Id. Art 6.

4.4 The Enforcing Body as a Challenge

The enforcing body refers to the ERCA and the Addis Ababa revenue authority as the case maybe.³³¹ The ERCA is the body that regulates decisive aspect of VAT. For the sake of enforcement, the previous Ministry of Revenue (which had the Federal Inland Revenue authority and Ethiopia Custom Authority) combined to one since the year 2008. Within the ERCA, there is no separate department for the enforcement of VAT. The directorates like the prosecution, investigation and intelligence are not devoted for the VAT purpose only; they also function for other taxes like custom duty and income tax. The authority also made different reforms to the good implementation of the tax laws. Regarding the VAT, as it is newly introduced tax, the authority or authorities are not expected to have a perfect enforcement mechanism. The challenges within the authority can be summarized as registration, competency and inspection officers related problems. Before discussing the detail of these problems, it better to see the data from inspection officers and taxpayers on this matter.

Table 4.8 Responses from taxpayers and inspection officers on the enforcing body as a challenge

No	Proposition	Options	Percent	Total
1	If, in question number one, the enforcing authority is included in your answer, what is/are the possible problem/s?	registration and estimation Inspection related problem Both Others No answer	45(56.25%) 15(18.75%) 12(15%) 3(3.75%) 5(6.25)	80(100%)
2	If your answer in question number one is enforcing body what are the problems?	Uneven means of registration Enforcement capacity Speedy decision All Others	4(20%) 3(15%) 1(5%) 12(60%) 0(0%)	20(100%)

Note: the first question is for taxpayers and the second for inspection officers

³³¹The ERCA inspects the registrants after they are already registered by the respective authority.

In the table above, 57(71.25%) of the taxpayers and 16(80%) inspection officers agree for the registration problem of the authority while 27(33.75%) of the taxpayers agree that there is a problem of inspection from the authority. Similar with this, 15(75%) of the inspection officers accept that there is lack of enforcement capacity of the authority and 13(65%) agree that there is a problem of speedy decision of the ERCA for taxpayers claims. Taxpayers were asked to place their reasons on what the problems of registration of the authority and the common explanations are:

- There are traders that should have been registered but not yet registered.
- The estimation process expose us to be registered

With respect to inspection problems they complain that

- They focus on means of fraud on receipt and the sales register machine(fault finders) not on the awareness creating mechanisms
- They focus on some areas and some businesses.

4.4.1 Registration and Estimation Problems

The matter on threshold and disproportionality of VAT and TOT rates are already discussed above. The problem here is that the registration unfairness among traders whose transaction is above the 500,000 threshold. During the personal observation, the researcher understood that there is unfairness on registration in which two businesses with similar activities one is registered and the other is unregistered.³³² The interview conducted with some officials also reveals such fact.³³³ The main causes are the estimation based registration and unethical behavior of the estimation officers.³³⁴ According to the directive issued for estimation purpose, the assessment process for registration of VAT is determined according to the following process.³³⁵ First, if the total transaction of the taxpayers is possible to find from third party, it will be done according to the following formula:

³³²Personal observation conducted in Oct.4, 2010 around Piazza.

³³³Interview with Ato Yohannes supra note 297, Ato Magesteab, supra note 296.

³³⁴Id. Both these officials disclosed that there is an ethical work by the estimation workers the main reasons out line let is that the workers are paid low salary and this means of salary exposed them to such corruption helped with estimation mechanisms of the registration process.

³³⁵ግብርና ታክስ በግምት ስለመወሰን የወጣ መመሪያ ቁጥር 29/2001፤ የኢትዮጵያ ገቢዎችና ግምሩክ ባለስልጣን፤ ነሐሴ 2001 ዓ.ም፤ አዲስ አበባ, Art 6

Sale = $\frac{\text{purchase}}{1 - \text{profit rate}}$

Second, if the total annual or monthly transactions are not possible to know, the next step will be personal observation or taking three similar businesses with similar type and amount as a means of comparison.³³⁶ When estimation is made by personal observation, the place of the business, the number of workers, electric, water, telephone consumption of the business, capital possession and its utilization and other similar activities should be taken in to consideration.³³⁷

This estimation process is made on subjective consideration and taking the low practice of recording and accounting, this is vulnerable to unfair registration. The problem cannot be solely attached to the authority because traders are not voluntary to show their accounts and other relevant documents in time of assessment and some of them even hide their business behind the small shop.³³⁸ The unethical behavior of the estimation committees on the assessment of taxpayers' transactions is also worth mentioning here taking in to account the low salary of these workers and opportunity cost of registering and not registering of the taxpayers.

4.4.2 Capacity of the Enforcing Body

Comparing to other countries, the VAT law proclamation seems broad based which try to include every goods and services to the tax net with few exemptions and some zero ratings. The authority is expected to regulate all the possible bases of taxes.

In the previous topics, taxpayers complain about the unfair registration process and the high threshold of the registration are discussed. The possible question here is that does the authority (ERCA or respective regional authority) have the capacity to regulate all the possible tax bases of the VAT law. Because, goods and services out of the exemption, zero rated and below the threshold are presumed to be subjected to VAT.

³³⁶Id. Art 6(1)

³³⁷Id. Art 6 (1)(e)(f)

³³⁸Interview, Ato Yohannes, supra note 297.

The ERCA starts enforcement of the VAT, at the time of introduction, with café's, restaurants and hotels and other food related activities.³³⁹ Next to this it goes to the nine sectors which are obliged to register disregarding of their annual transactions, butchery and some supermarkets. The capacity of the authority on enforcement can be measured with two related issues. First, the capacity of enforcement within the registered traders and second, those sectors that are not yet addressed by the authority but that are part of the VAT net.

In the former issue, setting aside the problem of receipts fraud and other related problems, the authority couldn't able to inspect out of the working hours.³⁴⁰ There is no inspection in holidays including the weekends and the whole night. Some taxpayers knowing this fact transact without receipt. The other problem is that, there are some businesses too difficult for inspections like night clubs, transaction with foreigners and pension services in hotels considering security, identity, and nature of the business respectively.

Regarding to the issue of accommodating all possible VAT taxpayers, the authority does not hold all possible VAT payers. Other traders that are subject of the VAT but not yet registered are out of the eye of the authority. This is solely because of the restricted capacity of the authority to register and regulate them and the low voluntary compliance of traders in the country. To cite some businesses which are not registered and do not pay VAT, boutiques, legal services, mobile centers and some other traders out of registered traders. However, there is a possibility of accommodation of these business activities through private limited or Share Company. In general, the capacity of the authority is restricted because of fraudulent behaviors of taxpayers³⁴¹ and limited competency of the authority.

³³⁹Interview, supra note 296.

³⁴⁰Ibid.

³⁴¹Interview with Ato Eshetu, supra note 280. He disclosed that almost all taxpayers are fraudulent and we prosecute considering the continuous fault of the taxpayers. Besides, the Judges are not well aware of the VAT and hence they are contributing to the existed challenges.

With regard to competency of the authority, there is a difference between the regional and the Addis Ababa VAT enforcement.³⁴² The sale register machine and strict inspection is not expanded to other regions which results a transfer of business to easy enforcement mechanisms around Addis Ababa.

4.4.3 Inspection Officers Related Problems

Visits by VAT officials often trouble the traders, irrelevant of whether they have any thing to hide or not. The traders usually feel they have been chosen for reason of suspicion.³⁴³ As it is discussed above, the reasons outlined by taxpayers towards inspection of the authority is that they are fault finders. They do not regard the reasons of the fault.

Within the inspection officers, they are limited in number comparing to the huge amount of taxpayers. The other possible problem is that inspection officers do not have security and during inspection sometimes they hesitate from their obligation because of fear of attack from taxpayers.³⁴⁴

All in all, the enforcement body has its own contribution to the challenges of enforcement. The main problems of the authority vis-à-vis the enforcement of the value added tax can be summarized as:

- There is unfair estimation and registration of taxpayers, although it is difficult to attach the whole problem to the authority, which inspire traders to escape from the VAT net through different mechanisms like splitting of business or change of trade name or change of place of business and others.
- The authority has problems of controlling those registered as well as those not registered as a result of limited capacity. Within the registered businesses, there is no inspection in holidays, weekends and nights. Besides, there are

³⁴²Ibid. The number of taxpayers listed in table 4.1 also shows there is a gap among each authority on enforcement in the sense that there is one taxpayer in Gambella and thirteen in Harari.

³⁴³Taxpayers' frustration during the distribution of the questionnaire thinking that we came from the ERCA is one indication of such fact.

³⁴⁴Interview with W/t Mihret Haile, supra note 311. She said that one jewelry business try to frustrate them through pistol opposing the VAT registration as well as inspection.

some businesses which are difficult to control like night clubs, transaction with foreigners and the like. The limited capacity of the authority is more featured when the unregistered businesses come to the spot. There are different businesses or sectors that are not yet registered. Legal services, boutiques and mobile centers are some of them.

- Considering the huge number of taxpayers, the numbers of inspection officers are limited and even these inspection officers are not secured.

Chapter Five

Conclusions and Recommendations

5.1 Conclusions

Value added tax is a consumption tax and it is most of the time a broad based tax collected in a successive ways regardless of some differences on the issue. The main reason for its introduction was to avoid the cascading effect of other consumption taxes. Comparing to other taxes such as the sales and turnover tax, value added tax has an advantage of self-enforcing, eliminating business inputs and less political pressure for incentives. It has also a better record in revenue, efficiency and neutrality. It is also indicted that the value added tax law regulates only the taxpayer and the state not the tax bearers. The issue of regressivity of VAT addresses that VAT is regressive to low income groups, but not a dried conclusion, and to avoid or minimize such problems options like exemptions, zero rating and multiple rates are usually used. There is another scenario on regressivity versus progressivity VAT i.e. annual income verses individual income controversy. The life cycle theory of consumption and saving argues that individuals go through three main phases of consumption and saving over their lives and in these stages consumption and saving differed accordingly. For that reason, it adopts distribution of the tax burden is a effectively measured relative to consumption than income. Besides, it is also warned that the issue of distributional equity can not effectively attained through the VAT but through other indirect taxes. There are three types of VAT in terms of calculation and base. To the first case, VAT can be calculated by the subtraction, addition as well as the credit invoice mechanism despite their similar effect. Concerning to the base of VAT, it can be consumption, income and gross product. Within the Ethiopian context, VAT is a consumption tax levied at successive stages with refunding mechanisms and calculated based on invoice means of calculation.

In chapter three, with the purpose of addressing the research questions, at least in theoretical manner, the features of VAT like the single rate or multiple rate, exemptions or broad based, the minimum threshold or inclusiveness of every business and their respective advantage or disadvantage comparing the Ethiopian VAT with other some

African as well as OECD member countries was made. The theoretical result shows the following.

The main advantage of multiple rates is that it may bring the distributional equity or addressing the regressivity of VAT. However, this argument is not acceptable because of two reasons. First, multiple rates do not effectively address the poor and second, compliance cost increases as the number of rates increase. In particular, higher VAT tax rates on 'luxury' goods are an ineffective means of increasing the progressivity of the fiscal system. Not only are such levies usually poorly targeted, but little equity 'benefit' attained in this fashion is unlikely to offset the costs in terms of reduced efficiency and effectiveness of the tax. Similarly, lower tax rates on 'necessities' are generally poorly targeted and ineffective. The rich may spend relatively less of their income on 'basic food' for example, but they are likely to spend absolutely more and hence receive more benefit from such concessions. Hence, the distributional equity through value added tax is not advisable but through direct taxes. International experience suggests strongly that more rates make it harder to administer a value added tax by increasing the scope for misclassification of transactions.

Despite the preponderance of expert advice to the effect that the best VAT with respect to both efficiency and administration is one with a single uniform rate applied to all taxable transactions, most countries do not seem to be listening. The numerical data indicates that the number of multiple rates exceed in OECD member countries, starting from one rate up to the seven rates in some countries than African countries. Almost all African countries have one rate, though the revenue collection of these countries is less than the OECD member countries. Considering these practices, it is found that the Ethiopian value added tax adopts single rate which is expected to facilitate the enforcement. In terms of degree of the rate, comparing to the African with an average of 16 as well as the OECD with an average of 18, the Ethiopian 15 percent rate seems acceptable with simple mathematical calculation in terms of enforcement.

Coming to the exemptions, the most common problems raised from the existence of exemptions in terms of enforcement are definitional problems, mixing the exempted with none exempted and lobbying for exemption. Theoretically, it is sated that a VAT should

be broad based and hence a limited number of exemptions which are administratively and economically inefficient are advised to be exempted. The data shows that every single one of the 29 OECD members covered in OECD actually departs to some extent from the most commonly cited exemptions i.e. financial sectors, PNC and real property. New Zealand is at one extreme: not only does it not grant any 'non-standard' exemptions it actually subjects to tax almost all of the 'standard' exemptions. However, almost every other OECD country exempts some favorite activity or other. To developing countries, it is also advised to have limited exemptions but since they cannot achieve the equity through other mechanisms and there is poor administration of tax, it is also suggested to have some equity related exemptions. Comparing to the above, the Ethiopian VAT law takes a few exemptions to its base which are commonly refer to necessities, though food is not completely exempted. Other exemptions listed in the proclamation in one or another way relates to administrative problems and an incentive approach. Theoretically, it is compared that the number of commodities listed in the Ethiopian value added tax are not that much challenges of enforcement. Even the law opts for exemption of some necessities than lowering the rate or zero rating or multiple rating, which seems that the law has a feature of deterrence of preference considering that there is no input credit mechanisms from those exempted traders which have its own impact on the number of consumers.

Within the threshold of value added tax, different options was tried to assess in terms of enforcement. Theoretically, it is agreed that a single threshold with some range is necessary taking in to account revenue and numbers of firms, and compliance cost with great warning that there should be a mechanism of accommodating those traders below the threshold to avoid distortion and competition. The result shows that most countries of OECD as well as the African countries have a threshold but the range of threshold differs in OECD countries; the threshold distributes almost equally in the sense that there is zero threshold, one threshold and two thresholds as well as three thresholds mechanisms. Developed countries with good tax administrations may be found at both end of this spectrum, from countries like Sweden with thresholds of zero-all in! to Singapore, US\$500, 000 at the other extreme. Most African countries have one threshold and few of them have zero thresholds and multiple thresholds. Comparing these data's with the Ethiopian value added tax shows that the Ethiopian value added opt for a single

threshold, with no differentiation on services or goods or sectors, with an Ethiopian 500,000 dollar, by providing a means of accommodation small businesses through the principal two percent rate of the turn over tax. The amount of the threshold comparing to the above countries gives that the Ethiopian threshold is some higher than these countries with the exception of few countries which have a threshold above the Ethiopian threshold. The advantage is that, though little revenue is forgone by dropping many small taxpayers, any such revenue loss should as a rule soon be recouped because the administration will be able to concentrate its efforts where most needed, namely, on the medium and large taxpayers who universally account for almost all the revenue from VAT.

Now the next question will be that what the practice claims? Consequently, the fourth chapter try's to see the challenges of the value added tax comparing with the above theoretical point of view. Regarding to the law as challenge, the data's inferred that there is a problem of accommodation the small businesses below the threshold in the sense that the two percent rate of the turn over tax is not proportional with the value added tax rate. According to the data, the problem raised is that there is competition unfairness between the two traders regardless of the difference on the strict enforcement, reporting and accounting, which results for shift of consumers to the unregistered traders. However, no data indicated to the use of multiple or zero rates.

Within the exemptions, the data indicated that the inherent problems of VAT exemptions are visible because of awareness related problems but they are not decisive part of the challenges. However, the main problem is the exemption of those below the threshold in the sense that there is no input credit mechanism from transactions with businesses below the threshold. The other exemption problem indicated according to the data is the issue of distributional equity that foods and some drinks are not exempted.

Within the stakeholders, the data shows there are challenges within the taxpayers on awareness and sales register machine and some frauds committed using the receipt mechanism. The data refers that the awareness of the taxpayers is not on how many rates of VAT, how many threshold, and what exemptions. However, the problem is on the low practice of compliance as a result of lack of knowledge on the purpose of tax, the means

and the nature of VAT from where it is collected because taxpayers considered it as part of their profit. The problem with cash register machine refers to the provision and maintenance of the machine which is provided and maintained by the private traders which are expensive. Besides, the data refers that every taxpayer of VAT is obliged to have a sales register machine despite the law puts for specification of those taxpayers who should have the machine. Coming to the means of fraud committed by the taxpayers, as of the data, there are different deceitful mechanisms employed using the receipt. The most common means of evasion through the receipt are double invoicing, re-use of invoice, non issuance of invoice, simulated contract and the like. The data also shows that the consumers have their own contribution to such challenge in the sense that they do not have know-how how the taxpayers utilize the receipt for evasion and what the purpose of the receipt is.

The data also imply that the authority is a challenge to the enforcement of VAT law in the sense that there is a problem of registration and estimation, lack of capacity to control the businesses that are registered and not registered and inspection officers' related problems. The first refers to unfair registration of the authority of taxpayers with an equal value of business because of the estimation mechanism itself and the unethical feature of the estimation officers. The second refers to the incompetence of the authority to regulate those registered business in holidays, and out of the working hours. Besides, the competency problem refers the limited capacity of the authority to accommodate all capable taxpayers in the sense that the authority is limited to some business and not covered all the possible VAT taxpayers. The problem with inspection officers include, according the data, the limited number of inspection officers and the security related to them.

Then where is the challenge? Are the above problems of the law, taxpayers or the authority emanated from all or one of them? The answer is then no! The questionnaire distributed to the inspection officers and the taxpayers on the question that "the challenge of enforcing VAT are presumed to be emanated from the law or/and the stakeholders. So whom do you think is/are a challenge for the enforcement of value added tax?" All inspection officers, 20(100%) agree that the challenges of enforcement are all of them.

From the taxpayers, 5(5.26%) of them opt for taxpayer, 10(10.52) for the position of the law, 10(10.52) tax enforcing body and 70(73.68) of them opts for all. Besides, the researcher provides a question that whether the taxpayers are the main challenges of the enforcement. From the total taxpayers, 19(20%) agrees, 76(80%) disagree on the proposition that taxpayers are the main challenge. From the 20 inspection officers, 4(20%) agree, 14(70%) disagree and 2(10%) gives no answer. From these data's, it can be say that taxpayer's are not the main challenges of VAT enforcement. Interview with officials of the authorities also imply all the stakeholders as a challenges of enforcement of VAT. Therefore, the challenges of enforcement of the Ethiopian value added tax arises from the law as well as the stakeholders. The challenges can be summarized as follows:

- The law takes the option of setting a threshold but it does not accommodate these businesses below the threshold fairly with the VAT payers. The means of accommodation of the law of the two traders does not inspire for VAT registration but invite for those traders that are registrants of VAT to withdraw from VAT and joined to the TOT payers. It also resulted for reduction of consumers and a loss of bidding in auction. The high rate of VAT does not consider the low income of the society and as result it invites those traders to evade tax after collection and inspires taxpayers and consumers to have a simulated transaction or transaction without VAT.
- The taxpayers are not well aware of the law on its purpose and its means of collection which results for law practice of paying VAT. Taxpayers are well aware of their fault after they are already prosecuted and brought before the court. Taxpayers also complain on sales register machine on its provision and maintenance.
- Consumers are not aware of the law from whom it is collecting and how it is collected plus the fraud that used by the taxpayers. They do not understand what the purpose of the receipt is out of using as means of knowing their cost of consumption. This awareness problem has its own contribution to receipt related challenges within the taxpayers in the above.
- The authority has a problem of registration and estimation in the sense that two traders that are competent to be a VAT payer the one registered and the other

become not registered. This because of the capacity of the authority and unethical behaviors of estimation committees. The later problem is not solely attached to the estimation committees. The means of accommodation traders below the threshold has its own contribution in the sense that the advantage gained from non registration outweighs the advantage from registration. Hence, it is possible to presume the effort of taxpayers not to be registered added with the problem of estimation process contribution on the unethical behavior of the estimation committees. The authority has not only a problem of addressing those traders that are capable of VAT registrant but also there is a problem of limited capacity to control these traders that are already registered. There is no inspection in holidays and nights. Besides, the authority does not specify those VAT registrants that should use the cash register and that should not because there are traders that the use of the sales register machine does not give sense.

5.2 Recommendations

Based on the above conclusions, the researcher recommends the following:

- The main challenges observed in the taxpayers and the consumers are in one or another reason a matter of awareness and all taxpayers through the questionnaire recommend for huge awareness creation mechanisms within the taxpayers. If there is a good understanding of the law and purpose of the law at least two things can be resolved. First, if consumers have a best knowledge of the value added tax and how it is collected; at least the frauds that are utilizing by the taxpayers discussed above can be eliminated or reduced. Secondly, the problem of voluntary compliance of the taxpayers can be reduced in which case it also minimize the administrative cost of the enforcing body in which it enable the authority to expand its enforcement to those traders that are not yet come to the VAT web and minimize the cost within the registered VAT payers. Consequently, providing a huge awareness creation campaign to taxpayers on the purpose of the tax in general and particularly what value added tax is, the collection process and from where it collects, what the payment of tax brings and what nonpayment brings with all the possible punishments, the challenges within the taxpayers can be minimized.
- To promote the awareness and practice of receipt taking of consumers, there is a directive that gives a chance to consumers to compete in a lot with a legal receipt but this directive is not yet effective. This directive should be promptly effective and if so at least it lessens lack of awareness of receipt on consumer and it can trim down the fraud made by the taxpayers on receipts.
- The advantage acquired from non registration of value added tax should not exceed the advantage from the registration and the means of regulation of the taxpayers below the threshold should not give an inspiration to those taxpayers above the threshold to withdraw from the VAT rather it should promote voluntary registration. The main challenge of the law to the enforcement of the tax is that there is competition unfairness between those businesses below and above the threshold. There are two possible means of circumventing these problems. The first is make the threshold zero and every trader will become VAT payer with some reduction of obligation those traders below 100,000 because the

TOT obliges traders to hold an account those traders above this number. However this solution cannot be a solution because the authority is not capable of regulating and controlling even the possible taxpayers above the existing threshold and it cannot avoid the fairness problem completely. Hence, lowering the threshold along with the above problems in the consumers and taxpayers will be another challenge. The other possible solution is making the rates of the two taxes proportional in the sense that at least those taxpayers below the threshold should not get a competitive advantage from the taxpayers with the final purpose of inspiring those traders below the threshold to become a VAT registrant. The concerned body should arrange the law as such.

- Taxpayers also raise not only the disproportionality of the VAT and TOT rates but also the rate of value added tax is high considering the low income of the society. Some of the consequences of the high rate of the VAT is that consumers shift to those not registered and consumers influence and inspired taxpayers to transact without VAT. Some of the effects of the high rate of the VAT is, it leads to simulated contract and without this, the amount collected from VAT is attractive for evasion and it is stated that almost every taxpayer makes an evasion. The researcher here is not to give a full-fledged recommendation but it requires the authority make a comparison of lowering the rate and the loss of revenue and the possible outcome of voluntary compliance. A small reduction of rate of the VAT through discussion with the taxpayers may create a sense of moral obligation to the taxpayers to comply voluntarily.
- The researcher recommends further research on the issue of food exemptions. Most consumers' even taxpayers complained that the VAT on food is not fair and they are not happy with the VAT because it does not consider their interests. However, the researcher fears to recommend for the exemption of food because there are questions to be answered before the decision. To cite some; is really the increase of the price of foods in these sectors as a result of the VAT rate because traders increase price immediately after a trader becomes a VAT registrant? Can't the authority compensate the revenue loss, if food is exempted, from the other

sectors since every person is affected by food, the exemption of food may create happiness not only on consumers but also on traders?

- The authority should issue a directive on those VAT registrants which need the sales register machine and those businesses which should not use the sales register machine considering the nature of their businesses.

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ANNEX

Questionnaire for taxpayers

General Directions

Dear respondents, I am a Second Year Student of the Graduate Program of Addis Ababa University Law Faculty in the business law. By now, I am doing my LL.M Thesis on the Title “challenges of enforcing value added tax in Ethiopia.” The purpose of this questionnaire is to collect data intended to serve as an input to the research on the above named title. Therefore, I kindly request you to provide your proper answers either by circling the letter to those closed questions or providing your detail responses to those open ended questions as the case may be.

Remark: Positions of the law refers Rates, exemptions and thresholds of the VAT law.

Thank You!!!

General

1. The challenge of enforcing VAT are presumed to be emanated from the law or/and the stakeholders. So whom do you think is/are a challenge for the enforcement of value added tax?
A. Taxpayers
B. Tax enforcing body
C. Position of the law
D. All
2. How do you measure your knowledge of value added tax law?
A. High
B. Medium
C. Low
D. I don't know

Questions with Respect to the Law

3. Are you happy with the value added tax?
A. Yes
B. No
4. If your answer is ‘No’ in the above question please specify the reasons? _____
5. In what manner does the law became a challenge of enforcement if position of the law(C) is included in answering question number one?
A. VAT rate is high
B. Adopting one rate
C. High registration threshold
D. Adopting several exemptions
E. The law doesn't exempt that should be exempted
F. Other

6. If your answer to No.5 is 'A', how do you think is tax rate become a challenge for the enforcement of the value added tax law? _____
7. If your answer to No.5 is 'B', how do you think adopting multiple rates avert the challenges of enforcement? _____
8. If your answer for number 5 is 'C', what are/is the problem created as a result of this?
- A. Competitional unfairness with the unregistered business
 - B. VAT and TOT rate are not proportional
 - C. Shift of consumers to the unregistered traders
 - D. Others
9. If your answer to No.5 is 'D', what are the possible challenges created as result of this?
- A. No input tax credit
 - B. It complicates book keeping
 - C. Opens for fraud
 - D. Others
10. If your answer to No.5 is 'E' what do you think should have been undertaken?
 _____ How it facilitates enforcement? _____

Questions related to taxpayers

11. The burden of the value added tax lies on the consumers, then if you think taxpayers are obstacles to tax enforcement what do you think are those problems? _____
12. What do you think are the causes for the problems (if any) for question number 11?
- A. The low practice of paying tax
 - B. Lack of legal knowledge
 - C. The behavior of unlawful enrichment
 - D. If other or any please specify?
13. Are you happy with sales register machine?
- A. Yes
 - B. No
14. If your answer is 'No' in the above please specify the reasons? _____
15. If you brought before the court in relation to failing to pay VAT, did you get prior notice on your fault from the authority?
- A. Yes
 - B. No

Enforcing body related questions

16. If in question number one the enforcing authority (B) is included in your answer, what is/are the possible problem/s?
- A. Registration and estimation
 - B. Inspection related problem
 - C. Others

17. If your answer to question number 15 is 'A', please explain the problems? _____

18. If your answer to number 15 is 'B', please specify the problems? _____

Consumers related questions

19. Do you think that consumers are challenges to the enforcement of VAT law?

A. Yes

B. No

20. If your answer to the above questions is 'A' how do you think that consumers are challenges to the enforcement of VAT law?

A. They inspire us to sale without VAT C. Others

B. They do not ask us to give them receipt

21. How do you see the number of customers before and after registration for VAT?

A. Decrease

B. No change

22. Do you agree or disagree if it is proposed that the main challenges for the enforcement of VAT are taxpayers?

A. Agree

B. Disagree

23. I am interested in knowing your recommendation to be done in relation to:

The authority _____

The Taxpayers _____

The law _____

Consumrs/buyers _____

Questionnaire for Inspection Officers

General Directions

Dear respondents, I am a Second Year Student of the Graduate Program of Addis Ababa University Law Faculty in the business law. By now, I am doing my LL.M Thesis on the Title “challenges of enforcing value added tax in Ethiopia.” The purpose of this questionnaire is to collect data intended to serve as an input to the research on the above named title. Therefore, I kindly request you to provide your proper answers either by circling the letter to those closed questions or providing your detail responses to those open ended questions as the case may be.

Remark: Positions of the law refers Rates, exemptions and thresholds of the VAT law.

Thank You!!!

General

1. The challenge of enforcing VAT are presumed to be emanated from the law or/and the stakeholders. So whom do you think is/are a challenge for the enforcement of value added tax?”
 - A. Taxpayers
 - B. Tax enforcing body
 - C. Position of the law
 - D. All
2. How do you measure your knowledge of value added tax law?
 - A. High
 - B. Medium
 - C. Low
 - D. I don't know

The law related questions

3. Which of the following do taxpayers complain about VAT rate?
 - A. VAT rate is high
 - B. Adopting single rate
 - C. VAT and TOT rates are not proportional
 - D. No complains
 - E. Others
4. If in the above question your answer is ‘A’ or ‘B’ what are the possible reasons of taxpayers of such complain? _____
5. Which of the following do you think taxpayers complain about exemptions during your inspection?
 - A. Some commodities should have been exempted
 - B. Complicates book keeping
 - C. No input tax credit
 - D. No complain
 - E. Others
6. Which of the following do you think that taxpayers complain about threshold?
 - A. Competitional unfairness with the unregistered businesses

- B. Decrease number of consumers
- C. We should not have been registered
- D. We should have been registered
- E. No complain
- F. Others

7. Is there a way that taxpayers employ the law as a means of evasion during your inspection?

- A. Yes
- B. No

8. If your answer in the above is 'A' please specify the means's? _____

9. In general, do you think taxpayers are happy with the law? _____ If you say 'No' what could be the possible reasons? _____

Taxpayers related questions

10. If, in question number one, taxpayers is included in your answer, what do you think is/are the possible problem/s? _____

11. What do you think are the possible causes of taxpayers challenge in question number 10?

12. Do you agree or disagree if it is proposed that the main challenges for the enforcement of VAT are taxpayers?

- A. Agree
- B. Disagree

13. Do you think that there are taxpayers brought before the court without prior notice on their fault from the authority?

- A. Yes
- B. No

14. Do you think that taxpayers are happy with sales register machine?

- A. Yes
- B. No

15. What could the possible reasons for their unhappiness?

The enforcing body related questions

16. If your answer in question number one is enforcing body what are the problems?

- A. Uneven means of registration
- B. Enforcement capacity
- C. lack of speedy decision
- D. if other or any please specify the reasons?

17. I am interested in knowing your recommendation to be done in relation to:

The authority _____

The Taxpayers _____

The law _____

Consumrs/buyers _____