

**ADDIS ABABA UNIVERSITY**  
**SCHOOL OF BUSINESS AND PUBLIC ADMINISTRATION**  
**MBA PROGRAM**

**“IMPLEMENTATION of VALUE ADDED TAX AND ITS  
RELATED PROBLEMS IN ETHIOPIA” (The Case of ERCA)**

**By: Hailemariam Mamo**

**Advisor: Venkati Ponnala (PhD)**

**A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF  
THE REQUIREMENT FOR A MASTER OF BUSINESS  
ADMINISTRATION IN FINANCE**

**June 2011**

**Addis Ababa, Ethiopia**

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**June 2011**

## **DECLARATION**

I Hailemariam Mamo declare that this research, titled “Implementation of Value Added Tax and Its Related Problems in Ethiopia” (The Case of ERCA), is done with my own effort. I have produced it independently except for the guidance and suggestions of my research advisor. I assure that this study has not been submitted for any scholarly award in this or any other university.

---

Hailemariam Mamo  
Researcher

## CERTIFICATE

This is to certify that student Hailemariam Mamo has carried out his research work on the topic titled “Implementation of Value Added Tax and Its Related Problems in Ethiopia” (The Case of ERCA), under my supervision. This work is original in nature and it is appropriate for submission for the partial fulfillment of the requirement for Masters of Business Administration.

Venkati Ponnala (PhD)

School of Business and Public Administration

Addis Ababa University

Addis Ababa, Ethiopia

Research supervisor

## **DEDICATION**

*“A gift of book has a great role than any other gifts”. So, this thesis is dedicated to my lovely brothers Asfaw Mamo A. and Senay Mamo A.*

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## **Acronyms**

A.A	Addis Ababa
VAT	Value Added Tax
ERCA	Ethiopian Revenue and Customs Authority
FAD	Fiscal Affairs Department
SIGTAS	Standard Integrated Government Tax Administration System
MoFED	Ministry of Finance and Economic Development
BRO	Baltic countries, Russia, and other countries of the former Soviet Union
RST	Retail Sales Tax
GDP	Gross Domestic Product
GNP	Gross National Product
CBRO	Central Europe, Baltic countries, Russia, and other countries of the former Soviet Union
TIN	Taxpayer Identification Number
P.A.Y.E.	Pay As You Earn
FIRA	However the Federal Inland Revenue Authority
Art.	Articles
LTO	Large Tax Office

## **ABSTRACT**

*Developed and developing countries of the world generate most of their government's revenues from taxes. Taxes can be classified as direct and indirect taxes. Direct taxes are taxes that are directly related to the taxpayers; whereas indirect taxes are taxes paid by an individual through the purchase of goods and services. VAT is one of the indirect taxes levied on consumption where the value of goods and services increases as they change hands in course of production, distribution and final sales to the consumer. Ethiopia has implemented the Value Added Tax in January, 2003 primarily to raise more revenue, modernizing its tax administration and encourage investment and trades. The Ethiopian Customs and Revenue Authority (ERCA), who takes the responsibility is facing with a substantial problem of tax collections and implementations of tax rules. The authority couldn't collect sufficient revenue from the proper implementation of the Value Added Tax. This study was focused particularly on identifying and assessing the problems rose in association with the implementations of VAT by the Ethiopian Revenue and Customs Authority. To achieve this objective, the researcher used both qualitative and quantitative descriptive research designs and a sample of taxpayers and employees of the authority were selected using stratified random sampling method. The researcher used questionnaires, Interviews and relevant documents to collect primary and secondary data from the data sources. Pie charts, graphs, table, Percentages were used in analyzing the collected data (findings). VAT is a tax system that has replaced the sales tax in Ethiopia and has applied a uniform rate of 15% on most consumption of goods and services. Since VAT is applied on the value added at each stage of production and distributions, it solves the tax cascading effect and reduces tax evasion with its modern administration system that sales tax cannot. VAT is payable if there are supplies made in Ethiopia, made by a taxable person, made in the course of making of another business and is not specifically exempted or zero rated. VAT implementation in Ethiopia has faced different challenges. The main problems that encountered are: misunderstanding of the public in general and business community in particular regarding the VAT laws, resistance against registrations for VAT by some traders, administration inefficiency from ERCA, provisions of understated financial statements, and non-issuance of invoices or issuance of illegal invoices exercised by registered business enterprises. All these constraints hinder the smooth implementations of VAT and achieve the desired objectives as possible. On the basis of these findings, the study recommends that the authority should train the taxpayers about the rules and regulations of VAT continuously, recruiting new employees and give nonstop training for the existing once, delegate the tax authority to regional and city administration and it should also increase its follow-up and investigation to control noncompliance enterprises, as well as effectively and efficiently performing the tasks of identification of VAT taxpayers, processing of returns, controlling collections, making refunds on time, auditing taxpayers, recognizing genuine taxpayers and levying penalties to tackle the problems it has encountered. The business communities should also obey the current VAT rules and regulations and they should perform their activities according to the current VAT laws as well as start to work in cooperation with the authority in fighting against those enterprises that are violating the rules and regulations of VAT.*

## **CHAPTER ONE**

### **1. BACKGROUND OF THE STUDY**

#### **1.1.INTRODUCTION**

Value added tax (VAT) is an indirect consumption tax assessed on the value added to a product at each point in the cycle of production and distribution. It is a consumption tax because it is ultimately borne by the consumer, who pays a fixed percentage of the final sale price of a product. A VAT is levied on the difference between the purchase cost of an asset and the price at which it can be sold (i.e., the amount of value added to it). Producers and distributors typically pass the cost of the VAT on to the final consumer in the form of price increases. Tax is added to a product's price each time it changes hands until delivery to the customer takes place, when the final tax is paid.

Value-added tax falls under the general category of a consumption tax, meaning taxes are paid on what people buy rather than on their earnings, savings, or investments. VAT has also been referred to as a sort of national sales tax, though it functions very differently. Sales tax is imposed on the total. (Encyclopedia of Management, 2009)

VAT, levy imposed on business at all levels of the manufacture and production of a good or service and based on the increase in price, or value, provided by each level. Because the consumer ultimately pays a higher price for the taxed commodity, a VAT is essentially a hidden sales tax. VAT was originally introduced in France (1954); it is now a major part of the tax structure of most Western European nations as well as the rest countries of the continents throughout the world. In the early 1990s the U.S. government considered instituting a VAT to fund national health care programs.

This study has tried to assess the VAT implementation in the country specifically in Addis Ababa (ERCA) on the title “Value Added Tax implementation and its related problems”. The objective is to assess and analyze the implementation of VAT and problems associated with, in Ethiopia. The respondents were those employees from tax administration department of the ERCA and some taxpayers in Addis Ababa city selected using stratified random sampling techniques.

## 1.2.Statement of the problem

The value-added tax is the one method of collecting revenue that many conservatives actually love. A VAT taxes each step in the chain of production, calculating the increasing value of a commodity or service as it moves toward distribution. A sales tax, in contrast, is levied at the final retail stage only. Popular in Europe, the VAT is an encumbrance that conservatives would rather not have, of course, and they worry that it could be increased too easily. But at least it hits the right sorts of people, consumers. The conservative ideal is for taxes to be imposed on consumption rather than investment, and the VAT fits the bill. If taxes are necessary (and even the most conservative commentators agree that they are), they should at least provide an incentive for people to save and not to spend. The pool of capital that's accumulated as a result of that incentive is what the right wing believes helps the economy to grow. Conservatives also appreciate that a VAT acts economically very much like a flat tax, which is a long-time right-leaner's favorite.

Liberals have traditionally been wary of the VAT for some of the same reasons that conservatives approve of it. The last thing a liberal wants is a tax that places a disproportionate burden on the people who are least able to pay it. And the VAT, like all taxes on consumption, is regressive at its core. Low-income people spend a much larger percentage of their earnings on consumer goods than rich people do. Liberals prefer the progressive income tax as a revenue source because the higher up the income scale people go the higher tax rate they pay. From the vantage of the political left, a VAT is the wrong way to go.

However, more and more people, including liberals, are pointing to a VAT as a better solution. One reason is the realization, among left-leaning economists, that a VAT's regressivity can be reduced, if not completely offset, by exempting staple such as food and clothing. Another is the recognition that if a VAT is used to fund a major social program otherwise unavailable to the middle class and working class (such as universal health care) the overall effect will be progressive even if the tax itself is regressive. ([Jeffrey H. Birnbaum](#), 2007, p.1-2, retrieved on February 2011, <http://superpages.com>)

Therefore, this study attempts to assess the problems associated with VAT implementation in Addis Ababa (ERCA). It is very evident that many researches are being carried on the same subject. The main purpose of this research is to address the following basic questions.

- What VAT rules and regulations does the country implement?
- What are the objectives of implementing these rules and regulations of VAT?
- To what extent does the business community know the VAT rules and regulations?
- Does the business community accomplish their business activities on the basis of the business rules?
- How strong enough is the tax administrating authority to administer and control those noncompliance and delinquent tax payers?
- What are the objectives of VAT imposition?
- Does the implementation of VAT in Ethiopia meet its objectives?
- Does the VAT encourage the growth of investment and export in the country?
- What are the problems that hinder the implementation of VAT in the country, Ethiopia?
- What measures has been taken to alleviate these implementation problems?

### **1.3.Objectives of the study**

#### **General objective**

This thesis tries to assess and analyze the implementation of VAT and its related problems in Ethiopia, specifically in Addis Ababa. This may give some possible insights to the higher officials of the Ethiopian Revenue and Customs Authority and policy makers to give closer attention towards tackling the problems raised with the statement of the problem part above by providing appropriate suggestions.

#### **Specific objectives**

Specifically this study tries to address the following issues:

- To assess whether the taxpayers are conscious enough about VAT concept;
- To assess whether the taxpayers have sufficient knowledge about the VAT rules and regulations;
- To assess whether the taxpayers do their business with the compliance of the VAT rules and regulations currently in use;

- To assess whether VAT implementation effectively meets its objectives;
- To identify the main problems that hold back the VAT implementation practices in Ethiopia; and
- To provide alternative solutions that may help to tackle the problems identified.

#### **1.4. Significance of the study**

It is obvious that an economic development of a country can be certain by an effective and efficient administration and collection of taxes. This is so because, when the implementation and administration of tax system is effective, the government's revenue that helps to fulfill the socioeconomic needs of the society will be amplified. Hence this research can indicate the ways that what the authority's officials have to do in the future based on the views of the taxpayers towards tax, it can provide the way for other researchers who want to conduct further investigation on the area raised as a title, give some possible insights to the higher officials of the authority to tackle the problems identified with this finding, initiates the authority to give closer attention towards the administration and follow ups as well as conduct awareness creation programs to achieve the desired objectives of VAT implementation, inform the policy makers to take the problems identified in to account by providing appropriate suggestions as well as it can serve as an additional source of reference material for those who want to conduct a full time research.

#### **1.5. Scope of the study**

This study basically deals with the VAT implementation analysis and related problems in ERCA starting from the introduction of the VAT proclamation. The data used was gathered from tax administration department of the ERCA and some taxpayers in Addis Ababa city. While it is difficult to cover the whole registered taxpayers the study is delimited to some Addis Ababa VAT registered taxpayers and employees of ERCA. This is so because the researcher strongly believes that some of the Addis Ababa VAT payers and employees of the authority will represent most of the VAT payers throughout the country and employees of the ERCA as far as the tax rate and concept of VAT is considered as the same.

#### **1.6. Limitations of the study**

It is obvious that adequate and reliable information is important to undertake any kind of survey precautions. However, the unwillingness and carelessness of some respondents while filling the questionnaires during data collection were considered as constraints to the study.

In addition, since VAT is a recent phenomenon, the absence of enough reference materials regarding the VAT implementation and related problems in the authority, time and fund constraints as well as lack of experience of the researcher were other limitations of conducting this study.

### **1.7. Organization of the paper**

This thesis attempts to identify, assess and analyze the VAT implementation and related problems in Ethiopia, ERCA. Accordingly, the paper is organized in a way that chapter one deals with the Introduction of the study, chapter two presents the Review of the Related Literature, chapter three presents the Review of the VAT Implementation and Development in Ethiopia, chapter four brings the Research Methodology part of the study, chapter five presents the Data Analysis and Results of the Findings and the last chapter, chapter six, deals with the Conclusion and Recommendation parts of the study under taken.

## CHAPTER TWO

### 2. REVIEW OF THE RELATED LITERATURES

#### 2.1. What is VAT

VAT is an indirect tax levied on domestic consumption of goods and services imported. It is designed to be paid on the value added which is the difference between the value of sales and value of purchase at the point of transaction throughout the production and distribution chain. Any producer owes tax only in the value added; in practice this means that the producer will have refund for VAT paid on all the purchases or inputs.

Despite its name, the VAT is not generally intended to be a tax on value added as such: rather it is usually intended as a tax on consumption. Its essence is that it is charged at all stages of production, but with the provision of some mechanisms enabling firms to offset the tax they have paid on their own purchases of goods and services against the tax they charge on their sales of goods and services.

Although this characteristic feature is very clear-cut, the VATs observed in practice show considerable diversity as regards, among other things, the range of inputs for which tax offsetting is available and the range of economic activity to which the tax applies (that is, the base of the tax). Some major countries (such as china) currently do not grant credits for taxes on capital goods purchases; moreover, of those that allow credits in respect of such purchases, some do not refund excess credits (any excess of tax paid on inputs over tax chargeable on outputs). Most countries exclude exports from the VAT, in the sense that tax is not charged on sales for export but tax paid on inputs is recoverable, although some (in the BRO region, the Baltic countries, Russia, and other countries of the former Soviet Union, at least until recently) have systematically levied VAT on some exports. Some countries extend the VAT only to the manufacturing stage; others do not levy it on services. Practices also vary in how tax offsetting is implemented: by far the most common method is through the use of invoices, but the same effect can be achieved on the basis of books of account.

As a result of the diversity of practice, there can be disagreement as to whether a given tax is properly called a VAT or not. For definiteness, though at the risk of creating the impression of an overly sharp dichotomy, we take a VAT to be: *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 inputs.* This leaves scope for dispute, but does highlight what is taken here to be the key feature of the VAT: the tax is charged and collected throughout the production process, with provision for tax payable to be reduced by the tax paid in respect of purchases. (Liam Ebrill..., 2001)

Value added tax (VAT) is an indirect tax that is charged whenever a tax payable person makes taxable supply of goods and services in the course of the business and imports, although it is a tax on consumer expenditure. VAT is a tax not on consumer expenditure. VAT is a tax not on the total value of goods being sold, but only on the value added to it by the last seller who is liable to pay a tax not on its gross value, but on the value that is the gross value minus the value of inputs.

## **2.2.Evolution of VAT**

Value Added Tax or VAT, first introduced less than 60 years ago, and remained confined to a handful of countries until the late 1960s.

Value added tax (VAT) was first started in France in 1948 G.C, where it was initially applied up to the manufactured stage and give credit for tax on capital goods (Purhoit and Mahesh, 2000). By 1969 only eight countries adopted VAT. Out of these eight countries, Cote d'Ivoire is the first country in Africa to introduce VAT. Since 1979 the VAT spread rapidly in industrialized as well as in the developing countries. Today, most countries have a VAT, which raises, on average, about 25 percent of their tax revenue. This makes VAT is the first tax system which spread quickly within a short time after its introduction.

As of 2003 from the 53 member countries of the African Union about 31 of them introduced VAT. Following this, the government of Ethiopia introduced VAT with different objectives on January 1, 2003 by replacing sales tax.

The following table depicts those African countries with their rates and year of introduction.

Table 1: African countries with VAT

<b>country</b>	<b>Date introduced</b>	<b>Standard Rate (%)</b>	<b>country</b>	<b>Date introduced</b>	<b>Standard Rate (%)</b>
Algeria	1992	21	Mauritania	1995	14
Botswana	2002	15	Mauritius	1998	10
Burkina Faso	1963	18	Morocco	1986	20

Benin	1991	18	Mozambique	1999	17
Cameroon	1999	18	Namibia	2000	15
Chad	2000	18	Niger	1986	17
Congo republic	1997	18	Nigeria	1994	5
Cote-Devoire	1960	20	Senegal	1980	20
Ethiopia	2003	15	Rwanda	2001	15
Egypt	1991	10	South Africa	1991	14
Gabon	1995	18	Sudan	2002	10
Ghana	1998	10	Tanzania	1998	20
Guinea	1996	18	Togo	1996	18
Kenya	1990	16	Tunisia	1998	18
Madagascar	1994	20	Uganda	1996	17
Malawi	1989	20	Zambia	1995	17.5
Mali	1991	15			

Source: Misrak Tesfaye, 2008, Ethiopian Tax Accounting Theory and Practice (pp.310-311)

The following table again shows the VAT rates of some European and non-European countries (other than African countries).

Table 2: world countries with VAT

<b>country</b>	<b>Standard Rate (%)</b>	<b>country</b>	<b>Standard Rate (%)</b>	<b>country</b>	<b>Standard Rate (%)</b>
Australia	20	Romania	19	Lebanon	10
Belgium	21	Slovakia	19	Moldova	20
Bulgaria	20	Slovenia	20	Macedonia	18
Cyprus	15	Spain	16	Malaysia	5
Czech republic	19	Sweden	25	Mexico	15
Denmark	25	United kingdom	17.5	New Zealand	12.5
Estonia	18	Argentina	21	Norway	25
Finland	22	Australia	10	Paraguay	10

France	19.6	Bosnia & H	17	Peru	19
Germany	19	Canada	6	Philippines	12
Greece	19	Chile	19	Russia	18
Hungary	20	China	17	Serbia	18
Ireland	21	Croatia	22	Singapore	5
Italy	20	Ecuador	12	South Korea	10
Latvia	18	El Salvador	13	Sri Lanka	15
Lithuania	18	Guyana	16	Switzerland	7.6
Luxembourg	15	Iceland	24.5	Thailand	7
Malta	18	India	12.5	Turkey	18
Netherland	19	Israel	15.5	Ukraine	20
Poland	22	Japan	5	Venezuela	8
Portugal	21	Kazakhstan	14	Colombia	45

Source: Misrak Tesfaye, Ethiopian Tax Accounting Theory and Practice, 2008 (pp.311-312)

### **2.3.General Definition and Objectives of VAT**

Taxes are a compulsory levy, imposed by government and those who are taxed have to pay the sums of irrespective of any corresponding return of service or good by the government. Taxes are important sources of public revenue. The existence of collective consumption of goods and services necessitates putting some of our income into government hands. Such public goods such as roads, power, municipality services, and other infrastructures have favorable results on many families, business enterprises, industries and the general public's. Although the specific reasons for adopting the VAT differ from one country to another, the main argument is that a properly designed VAT raises more revenue with less administrative and economic costs than other broadly based taxes. A VAT with few exemptions can generate revenues of some 0.4 percent of GDP for every percentage point of the rate. Furthermore, a VAT does not influence the methods of doing business. The tax bill is the same for a product made in the corporate or non-corporate sector with capital-intensive or labor-intensive technology or for one made by integrated or specialized firms. The VAT also ensures neutrality in international trade by freeing exports of tax and by treating imports and domestic goods the same; this is an important attribute in an interdependent, high-tax world.

As a transactions tax, which must be shown on invoices, the VAT is harder to evade than an income tax. (Sijbren, Cnossen, 1998)

#### **2.4.Characteristics of VAT**

The ideal VAT is a transactions tax on all goods and services collected on sales at all stages of production and distribution. Tax neutrality can be ensured by confining the tax to the value added at each stage. (Value added is defined as the difference between the value of sales and the value of purchases at the stage.) Tax neutrality is achieved by giving registered firms a credit for the tax paid on all taxable purchases from registered suppliers (including capital goods) against the tax payable on sales. As a result, the same value added is never taxed twice; that is, there are no cumulative effects, as would be inherent to a gross turnover tax. Similarly, tax neutrality in international trade is achieved by applying a zero rate to exports (which results in a refund of any tax paid in earlier stages) and by taxing imports on a par with domestically produced commodities.

Not all VATs are neat, broadly based, tax-credit, net consumption taxes that extend through the retail stage and that are imposed on the destination principle. Some VATs stop at the manufacturing or wholesale stage, which makes it unlikely that services would be included in the base. Furthermore, these and other VATs may not allow a full or immediate credit for the tax on capital goods. Here all tax-credit types of sales tax, regardless of the stage at which they are imposed, are defined as VATs, provided that the tax is levied on goods (but not necessarily services) comprehensively and that there is a credit for the tax on raw materials and intermediate goods (but not necessarily capital equipment). By this definition, production taxes that permit a deduction of purchases from sales and tax-credit types of excise systems are not considered to be VATs. The production taxes are not levied on transactions; administratively, they are not akin to a business income tax.

Evidences show that, the coverage of VAT may extend through the retail stage, the wholesale stage or the manufacturing stage. Furthermore, the base may comprise all consumer goods and services, unless specifically exempted. The rates for each VAT are tax-exclusive, in accordance with the practice in most countries. A distinction is made between standard rates, lower-than-standard rates (including exemptions), and higher-than-standard rates. (Sijbren, Cnossen, 1998)

## **2.5. Need for VAT**

The need for VAT emanates (originates) from the very weakness of the sales tax that it is intended to replace (Purhoit, 2000). First, sales tax has a cascading effect as a result of the fact that it is levied on the gross value without allowing any credit or set off the taxes paid on inputs. As a result, consumer's price will increase by an amount higher than accrues to the exchequers (government department in charge of revenue) by way of revenue from it.

Secondly, VAT has the advantage of reducing the cost of production of industries through its inherent refund system and the fact that it does not burden exports.

Thirdly, it offers total transparency of the incidence of tax as VAT is multistage sales tax levied as proportion of the value added. A very important thing that quotes in need of VAT is less tax evasion. This happens because the tax is divided into parts and therefore the incentive to evade tax by any one firm is reduced. If any firm understates its output, it will be caught by the disclosures of the firms buying inputs from it. In general it is argued that VAT would take away all the above problems and would avoid the distorting economic effect.

## **2.6. The Comparison between VAT and Retail Sales Taxation**

The VAT is of course not the only possible form of consumption tax. It is natural to compare it, in particular, with the retail sales tax (RST). As a single stage tax levied in principle at the point of sale of the final product, the RST may appear to be a simpler way achieving the same key effects-preserving production efficiency and avoiding cascading-as a VAT. Among the key points of comparisons of RST and VAT the following are the most one:

- In practice, it is difficult to ensure that RST does not fall on business inputs. Ring (1989) estimates (for 1989) that in the U.S. states that have a RST about 40 percent of the revenue collected was from business purchases.
- On the other hand, the alleged "self-enforcing" feature of the invoice credit VAT- the notion that the purchasers will help enforce the VAT as a consequence of their interest in obtaining a proper invoice from their suppliers-is not as important in practice as has sometimes been argued: purchasers do not care, for instance, whether tax has actually been paid by their suppliers, only about the acceptability to the authorities of the

invoices they hold. There is evidently a potential problem in the claiming of credits on the basis of fraudulent invoices.

- What does appear important in securing revenues, however, is the collection of revenue at many points under the VAT rather than simply at the final stage under the RST. This renders the RST much more vulnerable to evasion.

These features are reflected in something of conventional wisdom among tax practitioners: while the RST may work well at relatively low rates, below say 5-10 percent, at higher rates it proves too vulnerable. This has certainly been widely argued by FAD: Tanzi (1995), for instance, believes that “10 percent may well be the maximum rate feasible under an RST.” There are of course those who argue for the superiority of the RST over the invoice-credit VAT, including those currently advocates it for the United States. On balance, however, the judgment appears to be that expressed as: “... although... some of the advantages of the VAT have been exaggerated by its proponents, it seems difficult to argue that the VAT is not on balance superior to the standard RST.” In any event, it is indeed notable that very few RSTs are set at rates above 10 percent while few VATs are set at rates below. (Liam Ebrill..., 2001)

### **2.7.Has the VAT Raised More Revenue than the Sales Taxes it replaced?**

The performance of a tax must be gauged by more than the revenue it raises. It must also be assessed in terms of the efficiency and fairness with which it raises that revenue, and the costs incurred by government and taxpayer in doing so. Nonetheless, revenue needs are often a key concern in the introduction of a VAT. At the time of its introduction, the VAT is generally perceived as an explicit replacement for some preexisting sales tax. It may also be that VATs have been adopted at times when fiscal difficulties are so pressing that a significant increase in tax levels becomes politically feasible, and could have been achieved even under the predecessor tax system. Some upward trend in tax revenues can, moreover, be expected as development proceeds. And, not least, in those cases in which a VAT is introduced both to replace a sales tax and tariff revenues lost as a consequence of trade liberalization, any increase in revenues might in part reflect the fact that the VAT is substituting for both sales tax and tariffs. For a longer-term perspective, one should compare the revenue performance of the VAT with the broad set of possible alternative taxes to the VAT rather than with just sales taxes.

Despite these caveats, the extent of the revenue gains with VAT system is impressive. The average revenue increase in the West African countries, in particular, is more than 1 percent of GDP.

Comparing the two or three years either side of introduction, and subject, of course, to the same caveats-for a wider range of countries: all that have adopted VATs since 1985 and for which sufficient data are available to compare revenue over the two or three years after the introduction of the VAT with that from the predecessor indirect tax.

This confirms the impression of a gain, on average, in sub-Saharan Africa. The apparent gain is even larger in the Africans and, especially, the Small Islands. The reduced tax share in CBRO is striking; however, in these cases the VAT was introduced against the background of a trend decline in the ratio of tax revenue to GDP associated with the economic transaction itself. Excluding the CBRO countries, the share of VAT revenues in GDP exceeds that of the predecessor tax, on average, by about 1.1 percent of GDP.

## **2.8.Types of VAT**

In the modern world there are four types of VAT, namely, consumption, production, income and wage VAT.

### **2.8.1. Consumption VAT**

In this type of VAT, the firm is allowed to deduct from the gross value of its product not only the non-capital input purchased from other firms but also the capital equipment purchased. Thus, in consumption type VAT, tax base is the difference between gross value and total value of inputs purchased (capital and non-capital).

### **2.8.2. Production VAT**

In the production type VAT, the value of the inputs purchased by the firm from other firms is not deducted in full. Only the value of non-capital purchase is deducted. Furthermore, no depreciation is permitted on the purchase of capital goods even in subsequent years. Thus, the tax base in production type VAT is equal to gross value less value of non-capital goods purchased.

### **2.8.3. Income VAT**

According to income type VAT, the firm is allowed to deduct the depreciation on the capital goods (during the year) apart from the full value of its non-capital purchases. Here, firms

cannot deduct the entire value of the capital goods purchased during the year but they can deduct the respective amount of depreciation attributable to that year.

#### **2.8.4. Wage VAT**

In wage type VAT, the firm is able to deduct the net earnings from its capital in order to arrive at the tax base. It is unlikely to be used for taxation by any government.

### **2.9. Principal Components of VAT**

There are two principal components of VAT. These are Input VAT and Output VAT.

#### **2.9.1. Input VAT**

Input VAT is the VAT payable by a taxable person on goods and services supplied to him and on goods which he imports for the purposes of a business carried on by him and for which registered for VAT. Viewing the concept from the other angle, it is the VAT payable on purchase of taxable supply including capital goods and operating and administrative expenditures. For a VAT registered person (taxable person) input VAT is not a component of the cost of purchase/import rather the registered person is entitled to take input VAT deduction against the VAT charge on sales or is recoverable from the Tax Authority. Hence, input VAT is a receivable for a registered person.

#### **2.9.2. Output VAT**

Output VAT is the VAT collectible by a taxable person at the time of sale of taxable goods and services (supply). It is the VAT chargeable on sales of taxable goods and services whenever a taxable person supplies taxable goods or services to other person. VAT must be included in the price charged for those taxable goods or services. This is the output VAT for the supplier. Output VAT is not a component of the sales price rather it is a liability to the taxable person which is collected on behalf of the Tax Authority.

The logic of VAT is that during a VAT accounting period, a VAT registered person pays VAT on its purchases, which is called input VAT; and the person charges VAT on its sales, which is called output VAT. At the end of the VAT accounting period, the difference between the amount of output tax and input tax represents either VAT payable to the Tax Authority or VAT Refundable from the Tax Authority.

If the output VAT exceeds the input VAT, the VAT registered person has collected more tax from its sales and, thus, the excess VAT collected (net VAT) must be paid to the Tax Authority, say ERCA, at the end of the VAT accounting period.

**Output VAT > Input VAT → VAT payable/VAT Liability/**

If the input VAT exceeds the output VAT, the difference results in VAT refundable or VAT credit. A VAT credit may be allowed to be carried forward and offset against periods output. A refund may be made by the government after that if input VAT still exceeds output VAT.

**Input VAT > Output VAT → VAT Credit/ VAT Refundable/**

## **2.10. Administrative and Compliance Costs of VAT**

There are two broad types of resource cost associated with the operation of any tax: *administration* costs-incurred by the tax authorities, and *compliance costs*-incurred by taxpayers. Taken together, they are referred to here as *collection cost*. Administration costs are akin to a reduction in tax revenues and appropriately viewed as such. Compliance costs, however, should be weighted rather less heavily than administration costs when evaluating the costs and benefits of a tax: the purpose of taxation being to transfer resources from the private to the public sector; \$1 left in the private sector is worth less than \$1 accruing to the public sector. This is simply to say that, in the jargon of public finance, that the marginal cost of public funds generally exceeds unity.

High collection costs are not necessarily a sign of a bad tax, but may simply reflect inefficient or corrupt administration. Nor are low administrative costs (even relative to revenue raised) necessarily a sign of a good one, since one could, for instance, raise substantial revenue under a VAT with low administration costs by assigning few resources to the payment of refunds. Indeed such is the potential role of the VAT as a catalyst for organizational and cultural change both within the tax collection agencies (spearheading, for instance, the modern use of information technology and the development of audit methods) and among taxpayers (developing a culture of record-keeping) that there is an important sense in which a successful VAT is in some circumstances bound to involve substantial collection costs, especially in its early years.

Collection cost figures must thus be interpreted with care. The even more fundamental difficulty, however, is obtaining such figures. In terms of administration costs, the organizational structure and reporting practices of tax authorities may make it difficult to isolate costs attributable to the VAT. The exercise may be especially difficult in function-based organizations, where VAT is administered along with other taxes, by the same people

in the same offices. Even when a separate VAT department is in place, there may be genuine common costs arising, for instance, from joint auditing for VAT and income tax purposes. In terms of compliance costs, a tailored survey of taxpayers is needed to extract accurate information. These difficulties mean that even for developed countries hard numbers on these matters are relatively difficult to come by. In developing countries, it is almost entirely unavailable. It has not been possible, within the resources of this study, to rectify this important gap.

Absent such information, some guide is nevertheless provided by various studies of VAT collection costs that have been conducted for OECD countries (usefully reviewed by Cnossen, 1994).

- Administration costs for a broadly “best-practice” VAT are put by Cnossen at around \$100 per registrant per annum. These costs vary widely, with the general perception that they are significantly lower where the VAT is simpler: they are estimated at around \$50 per registrant in New Zealand (with a single nonzero VAT rate) and \$200 in the United Kingdom (where there are two rates and substantial zero-rating).
- Compliance costs for a best-practice VAT are estimated by Cnossen at around \$500 per registrant per annum. For Singapore, Jenkins, and Khadka (1997) estimated continuing compliance costs to be about \$700. Since these are largely fixed costs, independent of the amount of tax payable, they fall especially heavily on smaller traders: Cnossen (1994) puts them in the order of 2 percent of turnover for those with turnover below \$50,000, falling to about 0.3 percent for those with turnover above \$500,000.

These dollar figures will overestimate the corresponding costs in developing countries, since they largely reflect labor costs-including those of the taxpayer. Nevertheless, it is clear that compliance costs in particular can be significant for smaller traders. Suppose the threshold is set at \$50,000, for instance, and that traders at this level do indeed incur compliance cost of 2 percent tax on turnover. With a profit margin of 20 percent on sales, this is equivalent to a 10 percent tax on income. This implicit tax may be to some degree passed on to consumers in the form of higher prices, though insofar as smaller traders naturally tend to have relatively little market power much of the burden will remain with them. There is thus the possibility of some regressive impact.

One clear implication of the evidence for developed economies is that the collection costs associated with a VAT are likely to be significantly affected by the design of the tax. A simple structure with a single rate, few exemptions, reliance on self-assessment, and with a high threshold appears conducive to relatively low collection costs.

It should be borne in mind that it is not the collection costs of the VAT in itself that matters, but those costs relative to those of alternative taxes. The weight of evidence for developed countries suggests, for instance, that the VAT is less costly than an income tax. (Liam Ebrill...., 2001)

### **2.11. Empirical Studies**

Bekure Herouy, on his study of “The VAT Regime under Ethiopian Law”, (2004) distinct Value Added Tax (VAT) as is a general consumption tax assessed on the value added to goods and services. It is a *general tax* that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services. It is a consumption tax because it is borne ultimately by the final consumer. It is not a charge on companies. It is charged as a percentage of prices, which means that the actual tax burden is visible at each stage in the production and distribution chain. It is collected fractionally, via a system of deductions whereby taxable persons (i.e., VAT registered businesses) can deduct from their VAT liability the amount of tax they have paid to other taxable persons on purchases for their business activities. This mechanism ensures that the tax is neutral regardless of how many transactions are involved.

According to Bekure Herouy, VAT has spread throughout the world since its introduction in 1955. Its format has changed and now incorporates what was once an offshoot, "GST" (goods and services tax). France is credited with first implementing VAT. It did so in 1955. The tax spread through Europe, South America and parts of Africa in the 1960s and 1970s before taking a hold in other regions. For example, the tax spread throughout the South East Asia/Pacific region from 1984 (Indonesia) to 1999 (Australia).

Today most countries throughout the world have the tax. All members of the OECD and all leading economies in the world have a VAT (or very broadly comparable tax), apart from the US. For most of the twentieth century, the principal federal tax on individuals in the United States has been on income, whether it is earned from labor (wages and salaries) or capital (interest, dividends, and capital gains). But a growing number of economists and

politicians have concluded that the United States should replace the income tax-partially or entirely- with a tax on consumption. Most of the political debate over a consumption tax has centered on whether the United States should adopt a value-added tax (VAT) similar to the ones that European countries have. While a VAT definitely is a tax on consumption, it is not the kind that most consumption, tax advocate prefer. What's more, the debate over whether to add a VAT to the U.S. tax code has obscured the more basic issue of whether to tax income or consumption.

Every Member State of the European Union has a Value Added Tax (VAT). The First VAT Directive of April 11, 1967 (as amended) required that Member States replace their general indirect taxes by a common system of value added tax. In fact, the assessment base for the Member States' VAT constitutes one of the critical components of "own resources", the EU's budgetary revenue.

Yet the laws establishing the VAT are national laws, each framed within certain parameters specified by the EU in the Sixth Council Directive 77/388/EEC (as amended) on the common system of VAT and the uniform basis for its assessment. This Sixth VAT Directive aims to ensure that each Member State has a broadly identical "VAT base", VAT levied on the same transactions. Its subsequent amendments have attempted to remove anomalies.

Economic theory has been central to the spread of the tax throughout the world. Economic theory changed its assessment of VAT throughout the 20th century. To greatly oversimplify:

- Up to 1950, the tax was regarded as undesirable because it discriminated in the market place via influencing consumers' decisions. Economists during this period assumed that an indirect tax would tax commodities at different rates. Hence, one commodity might be taxed at 10% and a comparable one at 20% -thereby providing a tax favored market place for the former. Income tax was favored over this discriminatory tax.
- Throughout the 1950s and 1960s, the tax was regarded on a par with income tax. This was because income tax was also discriminatory. For example, income tax taxes income so as to provide a bias for leisure (not taxed) over work (taxed). Income tax could not therefore be viewed as superior to VAT.
- During the 1970s, VAT began to be classified as the preferred tax. Economists concluded that taxing all goods and services at a single rate meant that there was no resulting bias to purchase one commodity over another. A single rate comprehensive

VAT was therefore to be preferred over (discriminatory) income tax. Hence, there was a staggered shift in attitude to VAT more especially during the third quarter of the 20th century. This change in sentiment produced the following practical outcome. Once there is sufficient discontent in a local economy with the existing tax system, the preferred option for tax reform is likely to be the introduction of VAT. Hence, the formula that has resulted in the internationalization of VAT is: economic theory + local discontent with tax system = VAT is introduced.

Three distinct models of VAT have developed to dictate why there are different forms of the tax. They are linked to the prevalent economic model at the time the tax was adopted.

1. From 1955 to the early 1970s - when economic theory stated that income tax was no longer superior to VAT - the tax was introduced in France and spread in Europe, South America and Africa. As envisaged by economists, the tax was almost invariably a multi-rate, multi-exemption model ("variation 1").
2. From the mid 1970s to the present day, countries adopting the tax usually opted for a single rate/widespread exemption model ("variation 2"). The change to single rate partially conformed to the new preferred model under economic theory - the single rate/minimal exemption variation. Some countries which had adopted "model one" of the tax during the prior period now upgraded to "model two"; most noticeable here being the EU's ongoing efforts to achieve a single rate for all of its members' VAT regimes.
3. In 1986, New Zealand introduced a single rate/limited exemption model along the lines favored by economists. The main exemptions here being financial services, residential rent, and exported goods and services. It coined the term "GST" (goods and services tax) to differentiate this variation from earlier models. Many countries after 1986 studied the New Zealand "GST" model and intended to introduce it (e.g. Canada, Singapore, South Africa and Thailand). However, political and equitable considerations resulted in them adopting further mainstream exemptions education, health, and food being common examples. They therefore actually ended up with a single rate/widespread exemption tax ("model 2"). One very minor consequence of this was that some of the countries called their tax "GST", thereby ensuring that the phrases "VAT" and "GST" became interchangeable and of little practical distinction.

In summary three types of VAT regimes now exist throughout the world: these are

- Multiple rates/multiple exemptions
- Single rate/widespread exemptions
- Single rate/limited exemptions.

While economic theory now advocates the last-mentioned model, political and equitable realities usually ensure the adoption of the single rate/widespread exemptions structure.

According to A. Mohammad Salmeen, GST or VAT is not a new tax system. Most countries in the world have already adopted this taxing system. However, in implementing GST, the government should take into consideration several problems or factors that might retard the development of the GST system. Problems can occur on both sides of taxpayers and administrators. Therefore, a properly planned GST system should be looked upon before the system is introduced. For example, the public should be properly educated with general knowledge on GST system, since the end consumers will bear the burden of the cost of tax.

The business entities should be briefed on the administrative side since remittance of revenues to the government will be done by the supply chain. The business entities should also be encouraged to update their accounting records to facilitate audit and investigation process. On the government side, well trained personnel should be provided in assisting the public. The government should also need to determine the right GST rate so that the welfare of the lower income citizen will not be so much affected. Decisions should also be made on the products which are exempted from tax.

Overall, the GST or VAT system is considered to be effective since it can increase the total revenue of the government. However, the implementation will need a well planned system since without it; a comprehensive GST system will not be achieved. But the potential revenue which can be raised from the VAT depends on a number of factors, such as how broad the tax base will be and the extent to which businesses will comply with the tax .So to increase the revenue from implementing VAT the government must move aggressively to broaden the base but this is not easy especially for countries that have large informal sector like agriculture sector and some goods that are exempt from this system. In essence, achieving equity is difficult from implementing VAT in a country that has informal sector since it affects the poorest portion of its population.

The effect of value-added taxes (VATs) on international trade depends on two features of VAT implementation, that is whether there are high effective rates on imports, and whether rebates for exports are delayed or difficult to obtain.

Dr. Wollela (2009), Despite the concentration of most of the prior tax compliance literature on direct taxes (mainly income tax) neglecting indirect taxes, it was noted that VAT noncompliance appeared to be prevalent, especially in developing countries. VAT noncompliance could take various forms including not registering for VAT, registering but not levying VAT (partially or wholly) on sales, levying VAT on sales but not reporting (partially or wholly), claiming credit on purchases more than the input tax paid, not claiming input VAT credits and not maintaining proper books and supporting documents. The prevalence of these forms of VAT noncompliance could be because of any of the determinants of tax noncompliance; and the level of VAT compliance costs was shown to be one of the factors potentially affecting VAT compliance decision of taxpayers.

J. Auerbach and R. Gordon states that Even if the appropriate treatment of financial services under a VAT is clear in an abstract theoretical model, the actual implementation of such a tax on financial services can face many more practical problems than exist in other sectors. The standard approach to implementing a VAT would be to impose a tax on the cash flow from transactions in real commodities, an "R-base tax" in the terminology of the Meade Committee Report (James E. Meade et al., 1978). Since the product sold by financial intermediaries is by definition a financial service, however, any cash-flow tax on their real inputs must instead take the form of an (R + F)-base tax that includes in its base all financial receipts and allows a deduction for all financial payments. This approach immediately raises the issue of "over taxation," as it would impose a tax not only on the real resources used by the financial sector, but also on the risk premiums received by intermediaries. As discussed above, spreads generated by risk premiums do not involve the use of real resources and hence do not require the imposition of a VAT. On the other hand, under certain assumptions about market completeness, a tax applied to risk premiums may not affect the market equilibrium. In addition, though, there would be many coordination and enforcement problems if part of the economy were subject to an R-base tax while the financial sector faced an (R + F)- base tax. For example, firms purchasing financial services should receive a credit for value-added taxes paid by financial intermediaries on services the firm purchases

from them, but these financial transactions would not normally be part of an R-base tax. Evasion opportunities would also be rife, with one side of a financial transaction facing a very different tax treatment than the other side of the transaction. Border corrections required under a destination-based VAT will also be much harder when dealing with financial intermediaries. In theory, exports should be exempt from the VAT, whereas imports should be subject to the VAT. However, when financial services are "imported" (e.g., someone purchases insurance from a foreign financial intermediary), there is no feasible monitoring at the border. Evasion of tax should then be easy, since there are no obvious costs of importance for individuals when they use a foreign financial intermediary (e.g. a foreign branch of a domestic firm), when purchasing financial services. Of course the same pressures are now being faced for a broader set of transactions with the growth of internet and mail-order sales.

Bekure Herouy (2004), the classic ingredients of VAT that determines how the tax does work are:

- The tax is charged on certain transactions such as the sale of goods, the provision of services, and other types of supplies.
- It is charged at each stage of the production and distribution chain by businesses and other persons carrying on a continuous or taxable activity.
- Such businesses do not incur the cost of the tax - they simply ensure that it is charged when they supply a commodity (collecting the tax on behalf of the Revenue) and claiming a credit from the Revenue for tax paid on their business inputs.
- Specified supplies are charged at the rate of 0% or are exempt from the tax. Zero rated businesses can claim a credit for VAT paid on inputs, exempt businesses cannot.
- The cost of the tax is therefore borne by businesses, which make exempt supplies, and by unregistered end consumers. Both parties pay the tax when acquiring commodities but are unable to claim a compensating VAT credit.

These then are the characteristics of value added tax regimes. Minor variations occasionally apply. In Canada and Australia, for example, exempt financial entities can claim a partial VAT credit on certain expenses.

The cost of the tax is borne by VAT exempt institutions and unregistered end-consumers. Obviously, the latter consumes more so that VAT primarily taxes the non-business end

consumer. In comparison, income tax applies across all spectrums of the community. VAT differs radically in a second respect from income tax. Income tax taxes income (i.e. amounts coming in) while VAT taxes spending (i.e., amounts going out). Economic theory therefore classifies income tax as a "direct tax" and VAT as an "indirect tax" or a "consumption tax".

## CHAPTER THREE

### 3. VAT IMPLEMENTATION PROCESS IN ETHIOPIA

#### 3.1.Introduction

Value Added Tax is a tax levied on sales of goods and services rather than an income generated. It is borne ultimately by the final consumer on its expenditure. VAT is a tax not on the total value of goods sold or services rendered but only on the incremental value or newly created value by the last seller. The incremental value is the difference between sales proceeds and purchases of intermediate goods or services excluding the preceding VAT. It is the base for VAT computation.

The government of Ethiopia has been introduced and effectively implemented the Value Added Tax on January 1, 2003 by replacing the sales tax. Before practicing VAT, there are a number of issues that given prior concern, like capacity building of the tax collection system including effective computerization and tax officials training, considering the merit and demerits of VAT with regard to the society living standard and avoiding the business crises raised from the unsuccessful taxation system attempted.

Six month after the VAT proclamation No. 285/2002 has been ratified by the parliament. The council of ministers also issues VAT registration no. 79/2002 pursuant to the Value Added Tax proclamation for the implementation. In other words, VAT implementation in Ethiopia is based upon the proclamation which has 13 sections and 66 articles and regulation cited above.

The six months period between the issue of the VAT laws and its effective introduction was preparation for effective implementation of VAT administration. According to separate VAT departments, the four functional divisions has been organized and settled within Federal Inland Revenue Authority (FIRA) currently named as Ethiopian Revenue and Customs Authority (ERCA). Intensive taxpayer's educational campaign, which consisted pre-implementation seminars, information sessions, publications, media releases and taxpayers advisory services was conducted. These taxpayers education program had a positive effect on the taxpayers understanding about the VAT proclamation and the related obligation and entitlements.

As stated repeatedly, VAT is a tax on consumer expenditure. It is collected on business transactions and imports. A taxable person can be an individual, firm, company, as long as such a person is required to be registered for VAT.

Most business transactions involve supplies of goods or services. VAT is payable if they are:

- Supplies made in Ethiopia;
- Made by a taxable person;
- Made in the course of furtherance of a business;
- Are not specifically exempted or zero-rated.

The Value Added Tax would be levied at the rate of 15% of the value of:

- Every taxable transaction by a registered person;
- Every import of goods, other than an exempt import; and
- Import of services. (Taxation in Ethiopia, 2005)

The reasons why VAT became most preferable by most developing countries like Africans are:

- To broaden the tax base to cover more taxable points and items for better yield in revenue
- To modernize the tax administration system
- VAT serves as an incentive mechanism to encourage foreign investment and export trade
- The tax credit method avoids cascading of tax (i.e. tax on tax) on business inputs
- VAT enables to make domestically manufactured goods to be more competitive in the international market places by removing the tax content from goods for exported
- As the VAT is less evaded, the minimizing of the tax avoidance supports the maintenance of equity and fairness in the application of tax legislation

VAT is tax system that has replaced sales tax in our country since Jan. 1, 2003. The tax is collected at all stages in the production and distribution process beginning with importers and producers of raw materials and ending with the final consumer.

The VAT legislation is now consolidated by various directives issued with a view successfully face difficulties in implementation. It is probably necessary to first and for most do some examinations what VAT, as a tax system is at least to be able to appreciate the need for strong administration.

VAT is no doubt becoming a prominent element in most fiscal paws of action by government especially in the developing countries like Ethiopia. This is because, it is easy to administer, and this makes it a highly variable source of revenue. No wonder the tax has been described as manifestation in the country of an enduring success in human endeavors to maximize tax revenue with less administrative cost.

It can simply say, VAT is a tax on consumption collected by an agent from a third party on behalf of the tax authority. What are consumed in VAT is numerous, and they vary even within a class of goods or services. Value Added Taxable transactions in some are clear and straight forward while in some, they are controversial. Furthermore, using men and materials at its disposal, the tax authority is strictly obliged to account for its stewardship to the government in accordance with the provision of enabling legislation. This, there for, portrays VAT as a tax system involving a spectrum of human activities within a broad hierarchy of levels of responsibilities right from the consumers to the registrant /VAT payers who subsequently render returns to the tax authority which also, in turn, as a revenue agency, remits what is collected to the coffers of government. With this analysis, it is not out of place to describe VAT as a system of multiple agency in which effective administration is inheritable.

As was mentioned repeatedly, VAT is introduced in Ethiopia by proclamation No. 285/2002, replacing sales tax with the following objectives:

- To collect tax on the added value whenever a sales transaction is conducted since the former sales tax system (already replaced) did not allow collection of the tax on the added value created whenever a sales transaction is conducted;
- To minimize the damage that may be caused by attempts to avoid and evade the tax and to ascertain the profit obtained by the taxpayers;
- To enhance saving and investment as it is a consumption tax and does not tax capital;
- To enhance economic growth and improve the ratio relationship between Gross Domestic Product and Gross Revenue.

### **3.2. Structure of Value Added Tax in Ethiopia**

VAT is increasingly being used throughout the world, including many African countries to raise government revenue with less administrative and economic costs. It is believed to be a good means to raise government revenue when relatively poor administered. Ebrill and Keen

(2001) also strengthen this idea empirically. They found that in the countries that have adopted VAT, revenue from this source accounted on average 27% of the total tax revenue or 5% of the GDP. And about 70% of the world's population now lived in countries with a VAT. This implies that VAT is a key source of most government revenues in the world.

As per different empirical evidences, VAT is a major source of revenue in most of African countries. The share of VAT in total tax revenue it ranges from 17.4% to 42.4% Ebrill and keen (2001). This share is higher in Ethiopia compared to other African countries. This is so because, Ethiopia's GDP is lower than other sub Saharan African countries. The VAT to GDP ratio ranges from 2.7% in Egypt to 6.5% in Tunisia with an average 4.6% similarly many sub Saharan African countries have also experienced an increase in revenue from VAT. The revenue performance of VAT as measured by the ratio of VAT to GDP in Ethiopia which is 5.7% is much higher than the African average (4.6%) and stood the fourth among the selected African countries. This implies that VAT in Ethiopia is showing a good revenue performance but this does not mean VAT is collected potentially. The ratio of VAT to GNP or disposable income is still insignificant because the ratio is only between 2 and 3.6% from 1988 to 2001 E.C.

### **3.3.Effects of VAT on Consumption and Investment**

Whenever the VAT has been adopted controversy emanated in relation to its effect on retail prices. In some countries the introduction of VAT would increase prices and aggravate the existing inflation since VAT is a consumption tax which is borne by the financial consumer i.e. a tax that could be shifted to consumers, it might at times have an inflationary effect. In Ethiopia, VAT should not be viewed as a fundamentally new concept; rather it should be seen as a logical and progressive development of sales tax, which had 15% & 5% rate. On the other hand, except zero rated exports and limited number of exemptions, VAT is levied at a uniform rate of 15% on all goods and services. Thus on account of this fact it could be argued that VAT may lead to inflation.

Differently it could also be argued that VAT may lead to an increase in price on those goods but not much since the newly taxable value is a small percentage of total taxable goods and services (Schenk, 2002). The experience of many other countries supports this fact. Although in some cases the introduction of VAT was associated with a rise in consumer

price index, it was a once and for all shift, there was no further and continuous price increase (Gillis 1990).

There are also other researchers who argue that it is only if other actions, such as increase on many supplies are, taken together that a general price increase could occur. In other words it is not VAT itself that can be inflationary but other policies makes it so (Tanzi 1992). Tanzi suggested that care should be taken particularly at the initial stage of introducing of VAT on curb such undesired result.

Though, it is difficult to evaluate the inflationary effect of VAT only after a year of its implementation, taking the above argument, VAT in Ethiopia is not accompanied with inflation problem. However a price increase is being observed in almost all goods and services which can explained by market imperfection and devaluation of Ethiopia currency and a general price increase of goods would wide especially the increase in price of petroleum than by the effect of VAT only.

#### **VAT Effects on Investment**

VAT is assumed to promote investment and export since full credit is given for the tax paid on the purchase of capital goods and export are zero credited. As compared to the previous sales tax which only allows partial refund of the tax paid on purchases of goods and services, the current VAT system, the domestic investment cost would be reduced by the amount of tax refunded and thus provide incentive for investment. Moreover, under VAT, exports are zero rated. As a result of which we have a refund of the VAT paid in earlier stages and thus would help the Ethiopian business community to become competitive in international trade. This also leads to increase in export and hence an improvement in current account balances of the country.

#### **3.4.VAT Registration**

The initiation function of VAT administration is to identify and register those who are obliged to collect VAT. According to ERCA the VAT registration program was commenced in august 2002 with an aggressive campaign and during the first year of VAT operation, the number of taxpayers registered was 4,137 throughout the country. Though the currently VAT registered taxpayers are not clearly known, because of the problem related with the system administration, there is a strong believe that can reach more than 85,000.

### **3.4.1. Registration procedures**

A person applying to register for VAT is required to do so in such a form as is established by the implementation directives issued by the Ethiopian Revenue and Customs Authority; When a person carrying out taxable transactions files an application to be registered for VAT, the authority is required to register the person in the VAT register, and to issue a certificate of registration within 30 days of the registration; A person registered for VAT is required to use his taxpayer identification number on all VAT invoices, and on all tax returns and official communications with the authority.

There is a VAT invoice prepared by the ERCA containing the following information:

- Full name of the registered person and the purchaser, and the registered;
- Person's trade name, if different from the legal name;
- Taxpayer Identification Number (TIN) of the registered person and the purchaser;
- Number and date of the VAT registration certificate;
- Name of the goods shipped or services rendered
- Amount of the taxable transaction;
- Amount of the excise on excisable goods;
- Sum of the VAT due on the given taxable transaction;
- Issue date of the VAT invoice, and
- Serial number of the VAT invoice

The registered person is required to issue the VAT invoice to the purchaser of goods or services up on the supply or rendering, but not later than 5 days after the transaction.

There are two ways of registration stated in the VAT proclamation no. 285/2002. These are obligatory and voluntary registrations. (Taxation in Ethiopia, 2005)

#### **3.4.1.1. Obligation Registration**

A person who carries on the taxable activities and is not registered is required to file an application of VAT registration in the authority if at the end of any period of 12 calendar months the person made, during that period, taxable transactions the total value which exceeded 500,000 birr; Or if at the beginning of any period of 12 calendar months there are reasonable grounds to expect that total value of taxable transactions to be made by the person during that period will exceed 500,000 birr. Depending on this sub-articles (sub-articles 1(16) in article 16) the nine trade activities (line) whose annual taxable income is

expected to be more than 500,000 birr to be registered for VAT and registering all companies having legal entities for VAT without any prerequisite at the current condition.

There are nine trade activities

- Jewelry trade
- Flour factories
- Electronic trade (like television, refrigerator, deck trade, etc)
- Shoes producers
- Leather and leather producers
- Computer and computer accessories trade
- Contractors from grade 1-9
- Plastic and plastic product manufactures
- All permanent importers

#### **3.4.1.2. Voluntary Registration**

According to countries context, taxpayers attitudes, knowhow and consensuses determines the number of voluntary taxpayers. This kind of registration is made by a person who carried on taxable activities and is not required to be registered for VAT, may voluntarily apply to the authority for such registration, if he/she regularly is supplying or rendering at least 75% of his goods and services to registered persons. In the voluntary registration input VAT can be recovered if a person is registered. It will therefore be beneficial to voluntarily register where the person makes mainly zero-rated supplies. In such a case, input VAT will be recovered, and no VAT will be charged on zero-rated outputs.

#### **3.5. Cancellation of VAT Registration**

A person who has registered for VAT may cancel his or her registration by arrangement with ERCA, department of VAT. The reason for deregistration include:

- If the business closes trading permanently;
- If the business is sold;
- When the value of taxable supplies falls consistently below the VAT registration threshold;
- If he or she has been registered in error, or she has ceased to be a taxable person

When registration for VAT is cancelled, the authority is required to remove the person's name and all other details from the VAT register and the person is required to return back

the issued certificate of registration. VAT registered person cannot charge VAT or issue tax invoices for any supplies made and cannot claim a refund of VAT incurred on any goods and services purchased from the date of the registration is cancelled.

### **3.6.Record keeping requirement**

A registered person or any other person liable for VAT under the proclamation shall maintain for 10 years in Ethiopia:

- Original tax invoices received by the person;
- Copy of all tax invoices issued by the person;
- Customs documentation relating to imports and exports;
- Accounting records; and
- Any other records as may be prescribed by the ERCA by directives.

### **3.7.Administrative penalties**

The following penalties are imposed for violations of the VAT proclamation:

- Where any person engages in taxable transactions without VAT registration where VAT registration is required-100% of the amount of tax payable for the entire period of operation without VAT registration;
- Where any person issued incorrect tax invoice resulting in a decrease in the amount of tax or increase in accredit or in the event of the failure to issue a tax invoice-100% of the amount of tax for the invoice or the transaction;
- Where a person who is not registered for VAT issues a tax invoice-a penalty of 100% of the tax which is indicated in the tax invoice and is due for transfer to the budget but has not been transferred; and
- Where a person fails to maintain records required-2,000 Birr for each month or portion thereof that the failure continues.

A person who fails to file a timely return is liable for a penalty equal to 5% of the amount of tax underpayment for each month (or portion thereof) during which the failure continues, up to 25% of such amount. The penalty is limited to 50,000 Birr for the first month (of portion thereof) in which no return is failed. If any amount of tax is not paid by the due date, the person liable is obliged to pay interest on such amount for the period from the due date to the date the tax is paid. The interest is set at 25% over and above the highest commercial lending interest rate that prevailed during the preceding quarter. (Taxation in Ethiopia, 2005)

### **3.8.VAT Refund**

For any VAT refund period (month) if the allowable input tax is greater than the output tax the amount of the excess is normally repayable to the taxable person by the authority as a tax refund. If at least 25% of the value a registered person's taxable transactions for a month are taxed at a zero rate, the authority will refund the excess amount of VAT within a period of two months after the registered person files an application for refund.

In the case of other registered persons, the excess amount of VAT is to be carried forward to the next five months and credited against payments for these months, and any unused excess remaining after the end of this five month period will be refunded by the authority within a period of two months after the registered person files an application for refund.

If the authority does not pay the refund by the specified date, the authority will pay interest at 25% over and above the highest commercial lending interest rate prevailed during the preceding quarter.

### **3.9.Exemption or Zero-rating**

As the name indicates, exemption means no VAT is charged on the supply and no credit can be taken for VAT paid on purchases used to make the supply while zero-rating means the supply is charged with a VAT at zero (0) percent but credit can be taken for VAT paid on purchases used to make the supply. Exemption of an entire firm on all its sales is allowed usually because the firm is below a certain size and in order to facilitate administration or compliance. The aim of zero-rating, on the other hand, is to lift the entire VAT, including that already collected at earlier stages, from a particular service or good. This is accomplished by allowing full credit for the tax shown on the invoices for purchases if the good in question or of inputs into it. It is argued that exemption should be granted where the lawmaker would rather not free the firm, but feel compelled to do so owing to administrative and compliance difficulties while zero-rating is to be given when the purpose is to lift the VAT completely from a good or service, for social and economic ends (Gills et al, 1990).

Zero-rating is often said to be unsuitable for developing countries just because it may require tax refunds. This is quite a weak argument since tax refunds are important in establishing fairness for tax authorities in these countries.

One line of argument against exemption is that it complicates administration, erodes the tax base and distorts input-choice decisions and hence they have to be kept to a minimum.

According to prominent of this argument where exemptions have been almost entirely eliminated (as in Chile), the VAT has been much easier to administer and there for quite successful. Exemptions, according to these proponents, require additional record keeping segregating taxable from exempt sales, and in practice the destination between what is exempt and what is taxed is often questionable or subjective. Some items are exempted to improve the distributional impact of the tax-a potentially reasonable tradeoff while others might be exempted for administrative or political reasons. This is exactly why developing countries exempt particular commodities as they are influenced more by distributional objectives than administrative concerns.

Administrative issues are more important under zero-rating. Since zero-rating increases the number of VAT refunds, most developing countries astutely have limited it to exports. In addition, tax administrations in such countries are poorly equipped to handle refunds of any kind, and adding to the number of refunds would divert administrative resources from enforcement of the VAT. (Gills et al, 1990)

The following types of supplies as well as imports of goods (other than by way of export) or rendering of services are exempt from payment of VAT:

- Sale, transfer or the lease of a used dwelling;
- Rendering of financial services;
- Supply/import of national/foreign currencies and of securities;
- Import of gold to be transferred to the national bank;
- Rendering of religious organizations or church services;
- Import or supply of prescription drugs specified in directives issued by minister of health, rendering of medical services;
- Educational services provided by educational institutions, or child care services for children at pre-school institutions;
- Supply of goods or rendering of services in the form of humanitarian aid, as well as import of goods transferred to state agencies of Ethiopia and public organizations for the purpose of rehabilitation after natural disasters, industrial accidents, and catastrophes;
- Supply of electricity, kerosene, and water;

- Goods imported by the government, organizations, institutions or projects exempted from duties and other import taxes to the extent provided by law or by agreement;
- Supplies by the post office authorized under the Ethiopian Postal Service Proclamation, other than services rendered for a fee or commission;
- Provision of transport; permits and license fees;
- Supply of goods or services by a workshop employing disabled individuals if more than 60% of staff are disabled;
- Import or supply of books and other printed materials. (Taxation in Ethiopia, 2005)

### **3.10. VAT Administration**

The Ethiopian constitution provides the central and regional governments with the power of taxation, and the bases up on which revenue is shared between the government is established by proclamation No. 33/1992. The ERCA administers VAT nationally as per the joint decision made by the house of representative and council of federation.

Although VAT is administered centrally by ERCA, the revenue is shared between central and regional governments based up on the established revenue sharing.

ERCA established a separate VAT department in Addis Ababa, and organized with appropriate material and human resources. Beside it has expanded its branch office network by opening new office in all regional states of the country. VAT departments core personnel were trained on VAT legislation in order to undertake the taxpayer's education and subsequent tax administration functions. Some of the ERCA tax administration activities are identifying and register the taxpayers, controlling collection, processing returns, securing delinquent declarations and collection of tax arrears, making refunds, auditing taxpayers account, make different investigation to minimize and avoid tax fraud and evasion, and following up of tax office have to be revitalization measure taken in order for VAT to live up to the expectation as an efficient and fair source of country revenue.

The following were administration measure taken by ERCA before exercising the VAT proclamation and regulations effectively:

- Identification of taxpayers to be registered for VAT and distribution of booklet was made and orientations about VAT were given to taxpayers for the purpose of introduction of rules and regulations.

- VAT department was established separately to make effective and efficient VAT administration system. Four divisions were formed with in this new department and job descriptions /procedures/ was prepared. However, currently it is centralized but when problems and ambiguities are occurred, it will be administrated and solved by VAT department.
- Journey to different countries were done by some selected staff to share the idea and experience of different countries that used and currently using VAT system. The VAT department established within ERCA has been organized in line with core VAT administration function, namely:
  1. taxpayers registration and education division
  2. revenue collection and enforcement division
  3. revenue accounts and consideration division
  4. assessment and audit division

### **3.11. VAT Implementation Problems in Ethiopia**

After the introduction of VAT, VAT revenue collection has shown growing trends as compared with the replaced sales tax. The impact of VAT on government tax revenue is also shown in the structure of tax. The contribution of VAT on domestic goods and services as well as foreign trade shows a substantial increase though the domestic source is by far lower than that of foreign trade. This might be associated with administrative difficulty to collect the tax from the domestic economy and the existence of illegal practices on VAT. VAT collection from imported goods is easy since it is collected at entry point.

In principle, VAT is collected from consumption of goods and services. So, the maximum potential that can be collected from consumption expenditure is VAT rate multiplied by consumption expenditure of a particular year.

Problems that are observed during the implementation of VAT related with external and internal factors.

The external problem associated with the illegal practices of the taxpayers. Even though intensive education program has been undergoing by the tax administration, the following illegal practices are observed:

- some VAT registered business enterprises have collected the tax with illegal invoice and retain the tax for themselves,

- some eligible business entities have not yet registered for VAT,
- some VAT registered business enterprises offers customers an opinion to pay or not to pay VAT,
- Some did not declare the tax they collected as per the law, and etc.

The weakness of tax administration highly attributed to the above illegal practices. The tax administration is weak in the area of auditing, follow-up and enforcement though the VAT department of ERCA has computerized its tax system. (Demirew Getachew, 2004)

### **3.12. Standard Integrated Government Tax Administration System (SIGTAS)**

The Standard Integrated Government Tax Administration System (SIGTAS) is an integrated information system that enables governments to automate the administration of taxes and licenses. This software is designed to meet the needs of developing countries who wish to increase their control over state revenue by equipping themselves with computerized systems. Since 1996, SIGTAS has been implemented in 20 countries located in Africa, the Caribbean, the Middle East, Eastern Europe and Asia.

SIGTAS was designed to adapt to the changes affecting the country's tax policy. Accordingly, declaration forms, penalty rates and interest can be modified without programming. Thanks to its integrated nature, SIGTAS is able to manage every facet of the tax management process including:

- Taxpayer registration;
- Handling of tax declaration forms;
- Assessments (including payments and withholdings);
- Collections case management and objection case management;
- Cashing, penalties and calculation of interest and penalties;
- Audit (case tracking and follow-up).

The software also provides for documentation management, objections (appeals) and payment agreements handling. In addition, SIGTAS offers the possibility of developing interfaces to share data with external systems such as customs, government financial software or other government divisions. SIGTAS can operate in three languages simultaneously, which makes it possible for tax agents to perform operations in the language of their choice and facilitate correspondence with taxpayers.

Tax Types supported by SIGTAS are: Income Tax, VAT, sales taxes and other indirect taxes, Licenses and permits (alcohol, professional, etc.), Pay as You Earn (P.A.Y.E.), Excise Tax, Driving Licenses and Motor Vehicle Registration, Licenses, General Income, Property Taxes, Withholding Taxes and others.

In modern tax administration, computerizing the tax collection procedure satisfies the taxpayer's requirements in the best possible manner. Change the administration in computerizing way satisfies two possible requirements. On one hand, it makes the work effective and efficient, and on the other hand, to the taxpayer requirements, fairness and justice and rehabilitates the management of the authority.

However the Federal Inland Revenue Authority (FIRA), now existing as Ethiopian Revenue and Customs Authority (ERCA), announces from 24 February 2004 the development of new software enabling to carryout duty of the collection of Value Added Tax through computer systems named, Standard Integrated Government Tax Administration System (SIGTAS). SIGTAS is an integrated package with all modules necessary to manage all taxes and licenses.

### **The Benefits of SIGTAS**

For governments, it improves the efficiency of the tax collection, simplifying administration of tax law and providing better control over compliance, is fully integrated so that government can easily compare the taxes assessed and taxes collected, provides a detailed tax roll along with each taxpayer's assessments and payments, provides many management and statistical reports to keep the government fully informed on the state of tax administration. For tax authority complete system to manage all aspects of system administration including the taking of late-files and late-payers, exemption period-automatically provides an overall view of all taxpayer liabilities and payments, eliminates manual calculation of penalties and interest, help ensure that data collected is valid, provides an easy to use and allows assessment calculation from previous year as well as the current years.

### **3.13. VAT Terminologies**

The following are some of the terms that are common in VAT literature.

- **Input VAT:** - the VAT that your business pays over on taxable supplies made (VAT paid on purchase) and can be recovered only insofar as your business is VAT-registered and makes taxable outputs.
- **Output VAT:** -the VAT that your business collects over on taxable supplies (VAT paid on sales)
- **VAT Payable:** -this is the net VAT to be paid to the ERCA by a taxable person. It is arrived at by the formula;

$$\text{VAT payable} = \text{OUTPUT TAX} - \text{INPUT TAX}$$

- **VAT Refundable:** the net VAT that a taxable person expected from the tax authority, say ERCA when input VAT exceeds output VAT. In Ethiopian case, ERCA does not refund upon declaration date rather taxable person shall carry forward the balance for 5 *months* until it offset by output VAT. If taxable person doesn't sell taxable supplies within these 5 months, he/she is entitled for refund.
- **Zero-Rating:** the supply is charged with VAT at 0% but credit can be taken for VAT paid on purchases used to make the supply.
- **Positive rate (standard rate):** the supply is charged with at the rate of 15%.
- **Exemption:** the supply is exempted from VAT. No VAT is charged on the supply and no credit can be taken for VAT paid on purchases used to make the supply.
- **Exempt supplies:** supplies which are not liable to VAT. Exempt supplies are not taxable supplies and do not form part of the taxable turnover for VAT purposes. A person making only exempt supplies cannot be registered for VAT.
- **Threshold:** this is the level of turnover of taxable supplies prescribed by the law at or above which a person must register for VAT.
- **Taxable person:** is a legal entity such as company, partnership, sole proprietor, who is liable to be registered for VAT. It is the person, not the business that is registered for VAT.
- **Taxable supplies:** these are business transactions which are liable to VAT at zero or standard rate.

## CHAPTER FOUR

### 4. RESEARCH METHODOLOGIES

This study was conducted in Ethiopian Revenue and Customs Authority (ERCA) of Addis Ababa in the year of 2011 to investigate problems associated with the implementation of Value Added Tax. The sources of the data used in the analysis were both the primary and secondary sources.

In the primary data collection section interviews, questionnaires and schedule (interview questionnaires) were used as appropriate tools to gather relevant information for the problem under study.

On the other hand in the secondary data collection section the data were collected from the organizational documented materials and different publications as well as reports on the tax administration departments, Ministry of Finance and Economic Development (MoFED) and different statistical bulletins and websites has referred.

#### **4.1.Data collection procedures and Sampling techniques**

From the total population of the VAT registered taxpayers (large tax VAT payers, Addis Ababa branch VAT payers and sole proprietors VAT payers) and employees of the authority (ERCA), the researcher selected about 450 (350 and 100 from both VAT registered taxpayers and employees of ERCA respectively) samples using stratified random sampling techniques. The researcher uses this sampling method because it is more reliable, valid, as well as each individual (respondents) has an equal probability of being selected and the sample can be generalized to the larger population and they have experienced the central phenomenon. Farther for this research the researcher uses a questionnaire as the best data collecting tool. This is so because questionnaire is more reliable and valid for the study as well as it is least expensive, time saving and encourage the respondents to fill their feeling.

#### **4.2.Method of Data Analysis**

After the researcher make discussions about the proposing research deeply, and review related literature, the researcher proceeds to the preparation of questionnaires. Hence the questions were:

1. Yes/No that the respondents can answer easily
2. Small in number
3. not time consuming and

4. Do not need the creativity of the respondents

The procedures followed in gathering the data includes:

- A) By asking the willingness of the respondents
- B) By telling the respondents to give answers and encourage to fill their feelings
- C) By insuring that their response will not be identified from others
- D) By insuring that their response will not touch their dignity and will keep as confidential
- E) By giving heart full thanks for their cooperation in giving their responses and golden time

The collected data were analyzed by adopting the statistical methodology. Based on percentage, tables and figures the statistical analysis has conducted. Farther quantitative methods of data analysis were adopted in the case of descriptive statistics.

## CHAPTER FIVE

### 5. FINDINGS, DATA PRESENTATION AND INTERPRETATIONS

#### 5.1. Introduction

The nature of this research is descriptive type that incorporates fact finding inquiries and surveys with regard to the Value Added Tax implementation and its related problems. The main aim (objective) of this research is to assess and analyze the implementation of VAT and its related problems in Ethiopia, specifically in Addis Ababa. This may give some possible insights to tax related policy makers to give closer attention towards tackling the problems raised in association with the VAT implementations by providing appropriate suggestions. Quantitative analysis techniques, ranging from creating simple tables or diagrams that showing the frequency of occurrences through establishing statistical relationships between variables to simple statistical modeling, are used to analyze the collected data. Thus the analysis of the data is accessible by means of percentages, tables and figures with simple mathematical calculations.

The study analyzed the data collected through a questionnaire from the selected Large VAT registered taxpayers, Addis Ababa Branch VAT registered taxpayers and sole proprietor VAT registered taxpayers as well as the selected employees of ERCA. as a result the analysis is concerned on the practical application and the challenges faced on the implementation of VAT and suggesting relevant and more appropriate recommendations considered as an suitable solutions for the constraints (problems) being raised in relation to the issue.

The survey was conducted by distributing questionnaires to both VAT registered taxpayers (LTO, A.A Branch office and sole proprietorship) and employees of ERCA. Close and open ended questionnaires were prepared for both respondents on the basis of simplified lists of Yes or No and detailed information requirements along with any kind of comment given by the respondents. The questionnaires distributed to both VAT registered taxpayers and ERCA employee respondents were prepared with an Amharic version so as to avoid language barriers and minimize response biases due to misunderstanding.

From the total sample of 450 (350 and 100 from VAT registered taxpayers and employees of ERCA respectively), 352 (78%) responses were gathered (i.e. 263 (75%) from VAT registered taxpayers and 89 (89%) from employees of ERCA). Among the 350 selected

VAT registered taxpayer respondents, 80(23%) were from the LTO, 150(43%) were from the A.A branch and 120(34%) were from the sole proprietorship selected using stratified random sampling technique. Among 352 respective respondents that give their reply properly, 263 were from the VAT registered taxpayers which incorporates 55 (21%) Large VAT taxpayers, 125(47%) A.A Branch VAT registered taxpayers and 83 (32%) sole proprietor VAT registered taxpayers. The large taxpayers includes the taxpayers of share companies, partnerships, joint ventures, etc whose annual turnover is equal to or greater than birr 5 million. Whereas A.A branch VAT taxpayers includes share companies, partnership, joint ventures and the like but their annual turnover is less than birr 5 million.

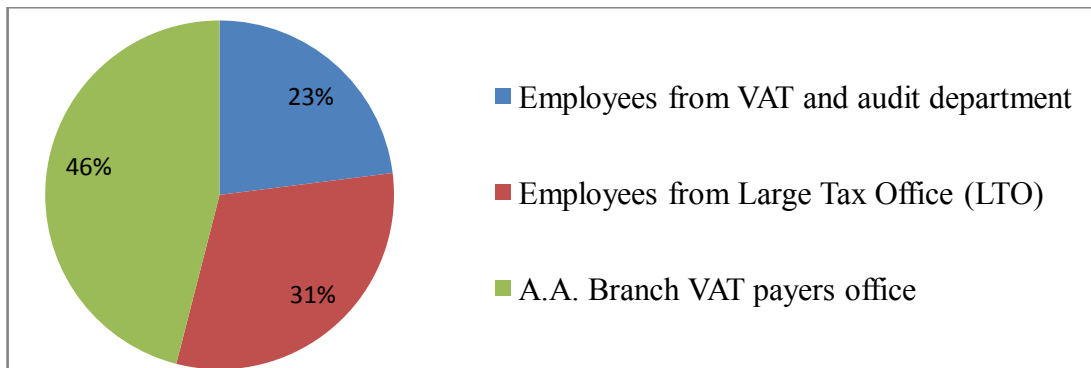
Among the 100 respected respondents from the authority employees, 23(23%) were from the authority's VAT and audit department, 32(32%) were from the Large tax officers and 45(45%) were from the A.A branch office. Coming to the responses provided by employees of ERCA among the 89 respondents, the employees of VAT and audit department shares 20 (23%), employees of large taxpayers takes 28 (31%) and employees of A.A branch VAT registered taxpayers takes the largest share of 41(46%) of the total. The following table summarizes about the respondents from both sides.

Table 1: employees of ERCA and VAT registered taxpayer respondents

<b>Employees of ERCA</b>	Sample size	%	Number of respondents who provide their reply	%
Employees from VAT and audit department	23	23	20	23
Employees from Large Tax Office (LTO)	32	32	28	31
A.A. Branch VAT payers office	45	45	41	46
<b>Total</b>	<b>100</b>	<b>100</b>	<b>89</b>	<b>100</b>
<b>VAT payers</b>				
Large VAT registered taxpayers	80	23	55	21
A.A. Branch VAT registered tax payers	150	43	125	47
Sole proprietor VAT registered taxpayers	120	34	83	32
<b>Total</b>	<b>350</b>	<b>100</b>	<b>263</b>	<b>100</b>
<b>TOTAL</b>	<b>450</b>		<b>352</b>	

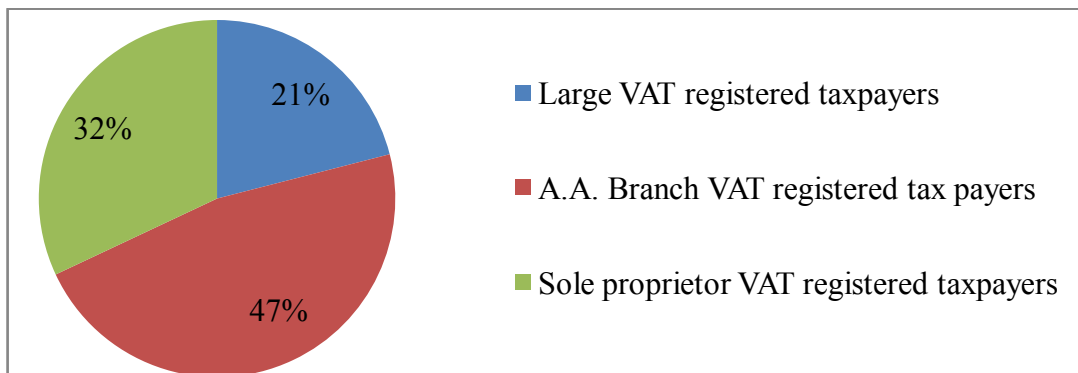
Source: computed from survey data, 2011

Figure 1: Respondents of ERCA Employees



Source: computed from survey data, 2011

Figure 2: Respondents from VAT payers



Source: computed from survey data, 2011

Having these samples and responses the researcher tried to analyze and interpret the results of the findings in the following manner.

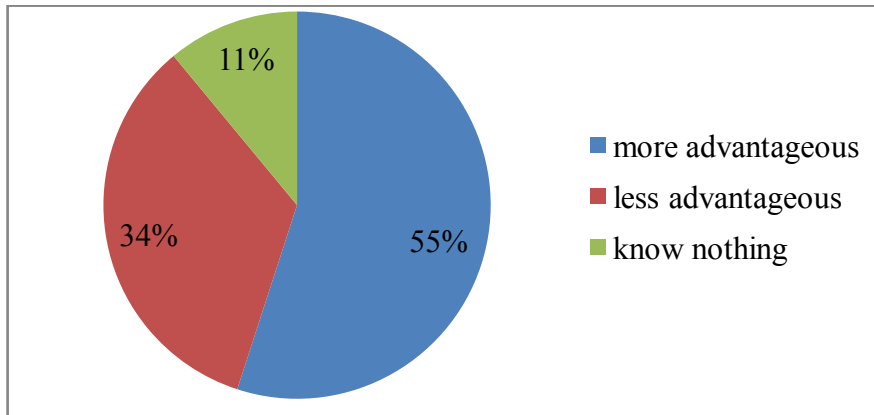
### 5.2. Comparisons between VAT and sales tax

The VAT is of course not the only possible form of consumption tax. It is natural to compare it, in particular, with the retail sales tax. VAT is applied at each stage of production and distribution when additional value is created. And this makes VAT a broad based tax that enables the government to raise more revenue. Comparing sales tax to Value Added Tax, the foundations of sales tax is narrower because it was limited to imports, manufactured goods and few selected services.

With the survey, both the VAT registered enterprises and employees of ERCA were asked whether VAT is more advantageous than the replaced sales tax or not. Among the 263 VAT registered taxpayers, 145 (55%) respondents replied that VAT is more advantageous than the sales tax, 89(34%) respondents said that VAT is less advantageous and 29(11%) of the

respondents replied as they know nothing about both taxes (VAT and sales tax). The following figure shows the responses provided by VAT registered taxpayer respondents:

Figure 3: comparing the advantages of VAT with sales tax



Source: computed survey data, 2011

As can be observed from the above figure most of the respondents 145(55%) replied that VAT is more advantageous than the sales tax. They started to say so by putting as it (VAT) is a refundable tax when input tax exceeds output tax and it doesn't affect the business community since it is collected from the consumer as a reason. But the rest of the respondents including those who know nothing are puzzled with the difference between and has got a difficulty of comparisons. So the authority should give the respective taxpayers intensive awareness creating trainings so as to make them clear more about the merits of VAT.

Further, the survey was also conducted by asking the employees of ERCA whether VAT is more important than the sales tax on their point of views. From 89 employee respondents of the authority, 60(67%) replied that VAT is more advantageous than the sales tax. The rest 29(33%) of the respondents from the authority know nothing about the sales tax so that they say nothing about the difference between VAT and the sales tax. As mentioned by the majority of the respondents, VAT is more advantageous than the sales tax. This is so because, VAT avoids double taxations, it is easy to control tax frauds and reduces the possibility of tax evasions, generates more revenue to the government (since it is collected from all sectors), and avoids cascading effect of tax (tax on tax).

From the points mentioned by both respondents (taxpayers and employees of ERCA) above, we can say that VAT is more advantageous than the sales tax. This is so because VAT

reduces the cascading effects of tax, it is collected from all sectors so that it is a major source of revenue to the government, it improves productivity, it promotes capital investment and saving, it enhances exports at zero-rate, it is not paid by the taxpayers rather it is collected from consumers, and it makes the net of the system to easily expand to control tax fraudulent activities and helps to avoid the possibilities of tax evasions.

### **5.3.VAT rules and regulations**

According to the VAT proclamation of Ethiopia, introduced in January 1<sup>st</sup>, 2003, VAT is payable and would be levied at the rate of 15% if: the supplies are made in Ethiopia, made by a taxable person, made in the course or furtherance of a business and are not specifically exempted from tax or zero charged.

With this point of view the survey was carried by asking both the VAT registered taxpayers and employees of the authority on whether they are familiar with the VAT rules and regulations. For this question, from 263 taxpayer respondents, 95(36%) respondents said that they know very well the rules and regulations of VAT, 147(56%) of them replied as they know little about the rules and regulations of VAT and 21(8%) of the respondents replied that as they know nothing about the rules and regulations of VAT. On the other hand, almost all, 87(98%) of the respondents from the authority are more familiar with the rules and regulations of VAT. The rest 2(2%) of the respondents know little because of the fact that they have stayed with the authority as an employee for short periods. Though majority of the ERCAs employees are familiar with the VAT rules and regulations, the dominating number of taxpayers are not clear with the VAT rules and its implication. Therefore, due to the presence of innocent but in doubt business community about VAT laws, the implementation of VAT in the country becomes more difficult. So the employees of ERCA who are very familiar with the VAT laws should work more on the areas of awareness creation about the concept, advantages and roles of VAT rules and regulations to the society's welfare and entire economic growth and development of the country.

### **5.4.Clarifications about VAT concept**

Both respondents were also asked whether the authority had made sufficient clarifications to the public about the implications of the VAT concepts. Among the 263 taxpayer respondents, 76(29%) of them replied that as they believe the explanations conducted by the

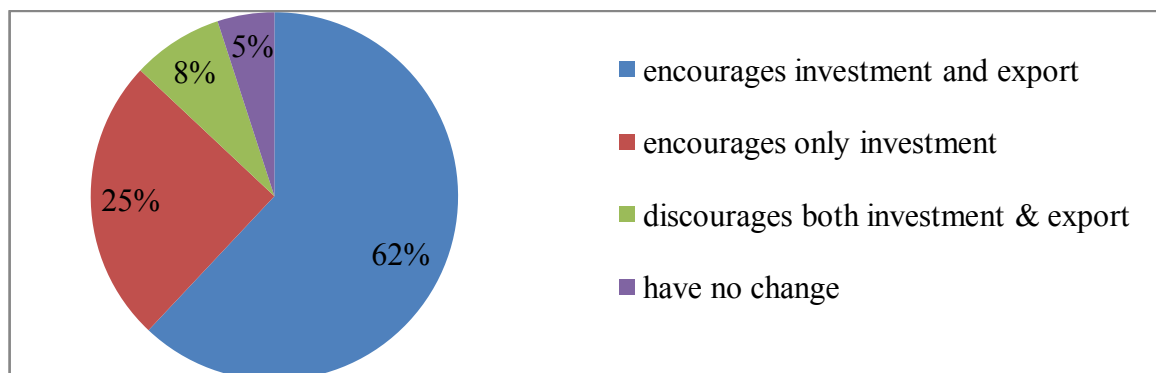
authority about VAT are sufficient, 105(40%) replied that even though the authority had made clarifications to the business community it cannot be considered as it is enough and sufficient and 82(31%) replied that the authority had made sufficient clarifications to the community at all. From this we can understand that the authority is highly expected to conduct sufficient awareness creation programs so as to create taxpayers feeling happy because of the tax payments they made.

On the other hand the employees of ERCA were also asked to reflect their views whether they believe that the authority had made sufficient clarifications to the public about the VAT concepts or not. From the 89 respondent employees, 37(42%) replied that the authority had made sufficient clarification to the society, 44(49%) respondents replied that the programs conducted to aware the society about the values and benefits of VAT to the government revenue were not done satisfactorily. There are also about 8(9%) respondents that have said No or know nothing about the activities conducted by the authority to inform the public about the merits of VAT. Both respondents agree that the explanations carried out by the authority to the public about VAT are not considered as that much of note. This shows that the authority is highly expected to conduct additional programs to update the society about the concepts, laws, advantages and uses of the Value Added Tax.

### **5.5. Impact of VAT**

Some of the major objectives of introducing the Value Added Tax by replacing the sales tax are to enhance saving and investment as it is a consumption tax and does not tax capital; and to enhance economic growth and improve the ratio relationship between Gross Domestic Product and Gross Revenue. Based on these ideas one of the important issues raised by the researcher towards the VAT registered taxpayers and employees of ERCA were about the impact of VAT in relation to investment and export. The survey was conducted on VAT registered enterprises to know their views about the importance of VAT for the growth of investment and export. Out of the 263 taxpayer respondents, 163(62%) replied that VAT is important for the growth of investment and exports, 66(25%) respondents respond that VAT encourages only investment, 21(8%) respondents replied that VAT discourages both investment and exports and the rest 13(5%) respondents replied that they have no idea on the change of investment and exports.

Figure 4: The impact of VAT



Source: computed survey data, 2011

As can be observed from the above figure 163(62%) respondents agree that the objective of VAT in relation to investment and exports is encouraging. But there are respondents that are uncertain with the VAT objectives towards investment and exports on the other side. From this finding we can say that majority of the taxpayers have better understanding about the importance of VAT in relation to investment and exports. But the authority is still expected to convince the taxpayers that has a doubt about the objectives of VAT rules and regulations with regard to the encouragement of investment and exports.

The survey further was conducted by asking the ERCA employees to give their opinion about the impact of VAT on the investment and international trades. Out of the 89 employee respondents that replied the questionnaires properly, 87(98%) respondents replied that VAT encourages investment and exports, 2(2%) respondents replied that it doesn't encourage investment and exports. For more details the question was raised in the form sated in the following table.

Table 2: impact of VAT

Survey Question	Items		Total
Do you believe that the implementation of VAT is important for the development investment and international trade?	Encourages investment and export	Discourages investment and exports	
	87(98%)	2(2%)	89(100%)

Source: computed survey data, 2011

As can be observed from the above table, almost all of the respondents, 87(98%), replied that the implementation of VAT encourages both investment and exports. The respondents who said yes were further asked to give their reasons how value added tax encourages investment and export and they put as:

- Since VAT is tax standard accepted by most countries throughout the world, it paves the way for companies to invest any where they go and become internationally competitive
- It encourages an export by making the input tax at zero rating
- It allows a fair competition exist in the market
- It allows a refund when the input tax exceeds the output tax
- Allow potential investors to consider tax legislation as one of the factors in making investment decision
- Encourage investment by giving relief from tax on capital goods.

#### 5.6. Contribution of VAT

Although the specific reasons for adopting the VAT differ from one country to another, the main argument is that a properly designed VAT raises more revenue with less administrative and economic costs than other broadly based taxes. Hence money collected from taxes and custom duties is one of the major sources of the government revenue. So the respondents of the authority employees were asked whether they believe that the current VAT contribution to the governments revenue is sufficient or not. The question was raised like in the manner illustrated in the following table.

Table 3: Contribution of VAT

Survey question	Items		Total
	Yes	No	
Do you believe that the current VAT contribution to the government's revenue is sufficient?	28(31%)	61(69%)	89(100%)

Source: computed survey data, 2011

As can be observed from table 3, out of the 89 respondents, 28(31%) replied as they believe that the VAT contribution to the government revenue is sufficient and 61(69%) replied as they don't believe that the revenue collected through VAT to the government is sufficient.

The respondents who said the contribution of VAT to the government revenue is not sufficient list down their reasons as follows:

- Lower alertness of the society about the benefits of VAT to the government's revenue and the country's economy
- Weak tax administration and follow-up systems by the authority against both compliance and disobedience taxpayers
- The higher level of the threshold that doesn't govern all business entities
- Lack of skilled manpower and equipments
- Less efforts of identifying and rewarding genuine enterprises by the authority
- Existence of unethical employees and taxpayers refrain some interested business entities from their intention of registration for VAT

Therefore, the authority has to solve all of these problems so as to attract the taxpayers and achieve the desired objectives of collecting huge amount of money from the increasing number of registrants and business enterprises entering to the market.

#### **5.7.VAT assessment and collection**

Since the government's main source of revenue is money collected from taxpayers, the system using to collect this money needs to be effective and efficient in assessing and collecting mechanisms. Voluntary compliance needs timely filing and reporting of the required tax information, the current self assessment of taxes owed, and the timely payment of those taxes without any reminder, notice, or enforcement actions. Having this in mind the authority's employee respondents were asked whether the VAT assessment and collection mechanism followed by the authority is effective and efficient or not. Out of the 89 respondents, 37(41%) replied that VAT assessment and collection mechanism currently followed by the authority are effective, 22(25%) replied that the assessment and collection mechanisms are not effective and efficient and 30(34%) replied that the collection mechanisms and assessment requires additional efforts to be effective although it shows a little progress. The main reasons that the respondents put are associated with the inconveniency of the system (SIGTAS) that the authority is using to decide and collect the tax, the presence of corrupted auditors in the authority, weak performance and inefficiency of the employees and lack of consciousness of the taxpayers about the responsibilities that

they do have in relation to taxpaying. Therefore the authority has to pay a considerable attention to improve its tax administration, auditing, follow-up and enforcement systems.

### **5.8.Threshold**

According to the VAT proclamation of Ethiopia, the enterprises whose annual turnover is half a million (500,000) birr and above are compulsory to register for VAT. A threshold for VAT registration has been put in place for administrative purpose. VAT registered tax payers and the employees of ERCA were asked to forward their views whether the existing threshold is fair or not for VAT registration. Out of 263 taxpayer respondents, 108(41%) replied that the threshold is fair, while 142(54%) taxpayer respondents replied that the threshold level is not fair and 13(5%) respondents kept from giving their ideas by saying have no idea. As can be understood from the responses provided by the taxpayers, the majority, 142(54%) said that the current threshold level (500,000 birr) is high and hence allows most business communities whose return is below the threshold but actively participating in the market competition to stay unregistered. Therefore the current threshold level should be adjusted by considering the increasing number of entities engaging in different businesses and should be minimized to incorporate almost all sector traders that are actively participating in the market.

On the other hand, the survey was also conducted by asking the employees of the authority to know their views whether they believe that the threshold level is fair or not. Out of the 89 respondents from ERCA, 39(44%) respondents replied that the current threshold level is fair, 43(48%) respondents replied that the threshold level is not fair, and 7(8%) respondents replied as they don't have any idea. Based on the findings, majority of the respondents, 43(48%) replied that the current threshold level is not fair. From this point of view of the respondents, the researcher raised a question of how much it should be and put their reason behind. Accordingly, the respondents said that the threshold is not fair because it is high. Therefore the threshold should be lowered though following this strategy is costly and requires additional and capable manpower and effective administration system. Both the respondents (VAT registered taxpayers and employees of ERCA) were asked by the researcher why they have said the threshold level is high. The reasons of the respondents why they have said it is high are:

- It doesn't incorporate all enterprises that are actively participating in the market but are not registered for VAT because of the higher level of the threshold
- It affects only those few and honest business enterprises whose returns is  $\geq$  500,000br
- It paves the way for some VAT registered business enterprises that have collected the tax with illegal invoice and retain the tax for themselves
- It encourages the presence of taxpayers that did not declare the tax they collected as per the law,
- It weakens the capacity of those registered enterprises to compete in the market because of the existence of entities that are not governed by the current threshold level
- It paves the way to declare an understated financial statements so as not to take the responsibility of collecting VAT by the business enterprises
- Because of the increasing number of new entrants to the market it should be lowered to make them start with and include their business activities within the tax net

Even though the current threshold level is high and doesn't incorporate the whole business community, the administration capacity of ERCA is not sufficient enough to govern the existing number of VAT registered taxpayers and attract the nonregistered ones into the tax net. Therefore the authority has to amend the existing threshold level into more rational level in order to incorporate at least those business enterprises that are actively participating in the market competition and balance the revenue generated from the tax. This can be carried out by hiring more qualified and professional employees and reducing the threshold to the lower level as well as strengthen its enforcement and follow-up activities.

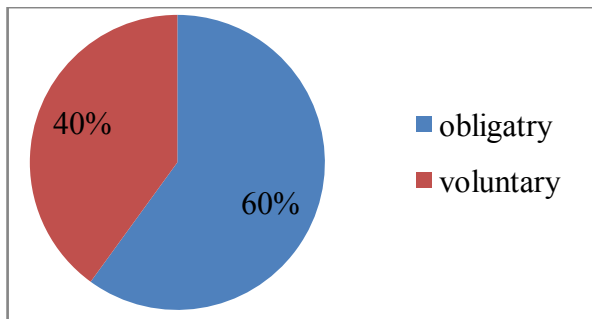
#### **5.9.Registration procedures**

The government of Ethiopia has been introduced and effectively implemented the Value Added Tax on January 1, 2003 by replacing the sales tax after the VAT proclamation No. 285/2002 has been ratified by the parliament and the council of ministers has issued VAT registration no. 79/2002 as pursuant to the Value Added Tax proclamation for the implementation. A VAT proclamation declares that a person who runs an enterprise or activity where the value of his taxable transaction Birr 500,000 and above in any period of

12 months immediately preceding his application to the tax authority or his turnover in respect to taxable transactions is expected to exceed the threshold in the following 12 months is liable to register for VAT. A person applying to register for VAT is required to do so in such a form as is established by the implementation directives issued by the Ethiopian Revenue and Customs Authority; When a person carrying out taxable transactions files an application to be registered for VAT, the authority is required to register the person in the VAT register, and to issue a certificate of registration within 30 days of the registration; A person registered for VAT is required to use his taxpayer identification number on all VAT invoices, and on all tax returns and official communications with the authority.

Having this in mind, the survey was conducted by asking the taxpayers whether they agree with the idea that most of the taxpayers are registered for VAT obligatory or not. Out of the 263 taxpayer respondents, 158(60%) replied that **yes** most of the taxpayers are registered obligatory, 105(40%) replied that the registration for VAT is maintained by the taxpayers of their own accord. The following figure depicts the registration processes of taxpayers for VAT

Figure 5: VAT registration process



Source: computed survey data, 2011

As can be observed from the figure above, majority of the taxpayers, 158(60%), said that they are registered for VAT obligatory. In order to know the reasons why the taxpayers did not registered keenly the researcher asked them to explain their reasons. Accordingly their reasons why they registered reluctantly are lack of knowledge (awareness) of the business community about the time, ways and reasons of registering for VAT, the exaggerated VAT rules imposed on the taxpayers, the inconsistent VAT registration system followed by the authority, the need of the society to buy goods and services without VAT because of their

limited purchasing power as well as the offers made by the business enterprises to pay with or without VAT for their purchases.

#### 5.10. Implementation Problems

The contribution of VAT on domestic goods and services as well as foreign trade shows a substantial increase though the domestic source is by far lower than that of foreign trade. This might be associated with administrative difficulty to collect the tax from the domestic economy and the existence of illegal practices on VAT. In principle, VAT is collected from consumption of goods and services. Like it has been observed in many developing countries, VAT implementation in Ethiopia has faced different problems at the initial stage. Problems that are observed during the implementation of VAT related with external and internal factors. With this perspective the survey was conducted by asking the employees of ERCA about the bottlenecks that hinder the smooth implementation of VAT in Ethiopia. The question was raised in the form that can be seen from the table below.

Table 4: implementation problems

Survey Question	Items			Total
Do you believe that VAT implementation is smooth in this country?	Yes	No	Have no idea	89(100%)
	23(26%)	62(70%)	4(4%)	

Source: computed survey data, 2011

As can be observed from the above table, out of the 89 employee respondents of the authority, 23(26%) said **yes** there is no problem that the authority faces during the implementation of VAT in Ethiopia, 62(70%) of the respondents said the implementation of VAT in this country is not easy or smooth and 4(4%) of the respondents kept from giving their views. From the responses given by the majority respondents, 62(70%), the implementation of VAT in Ethiopia is not an easy task. Taking these responses into account the respondents were asked to provide what they think are the problems that hinder the smooth implementations of VAT system. The respondents replied that the major problems that hinder the smooth implementation of VAT are the absence of efficient VAT administration system, existence of eligible business entities that have not yet registered for VAT, existence of some VAT registered business enterprises that have collected the tax with

illegal invoice and retain the tax for themselves, the presence of taxpayers that did not declare the tax they collected as per the law, low level of tax awareness of the community, existence of VAT registered business enterprises that offers customers an opinion to pay or not to pay VAT for the purchases they made in the market and provisions of forgery VAT invoices as well as the lower level of the purchasing power of the community which increases the needs of searching goods and services that excludes VAT value from its prices. Hence, in order to alleviate these challenges, the authority has to recruit sufficient and capable employees, devote time on consistently educating the taxpayers through different Medias, improve the collection network and strengthen in the areas of auditing, follow-up and enforcement as well as consistently follow the implementation procedures and taking serious actions over those who provide understated financial statements and forgery VAT invoices.

In order to gather more detailed information's in addition to the problems identified and stated on the above paragraphs, some interviews has been conducted by the researcher with some selected higher officials of the authority. This was maintained by asking them what are the root causes that hider the proper implementations of the VAT rules and regulations. Accordingly the respected higher officials of the authority put the following factors as the major problems of VAT implementations in the country:

- Shortages of skilled manpower and materials that are needed for the facilitations of VAT administration
- Weaknesses raised from the authority to enforce those noncompliance business enterprises
- the insignificant recognition given to the benefits, rules and regulations of VAT by the taxpayers since some of them are illiterate
- The ascendancy of nonregistered business entities existing in the market
- Voluntary compliance of the tax payers registered for VAT is very low
- Weakness raised from the authority in identifying and recognizing those genuine taxpayers
- Misunderstanding of the society as a whole to pay tax and the reasons of paying taxes.

### 5.11. VAT administration

The Ethiopian Revenue and Customs Authority administer the Value Added Tax nationally as per the joint decision made by the house of representative and council of federation. Although VAT is administered centrally by ERCA, the revenue is shared between central and regional governments based up on the established revenue sharing. ERCA established a separate VAT department in Addis Ababa, and organized with appropriate material and human resources. The main tasks that must be performed by any department in charge of VAT are: identification and registrations of taxpayers, processing returns, controlling collections, making refunds, auditing taxpayers, investigation for tax frauds and evasion or levying penalties. In order to administer these tasks, the department in charge has to be well organized and conduct publicity taxpayer's education and information during the moment in time.

The survey was conducted by asking the officials of the authority whether the tax administration is strong enough to control non-registered and illegal activities of VAT payers. Among the 89 respondents from the authority, 20(22%) replied as **yes** that the VAT administration capacity is strong to control illegal activities, 63(71%) replied that it is not strong, and 6(7%) kept themselves from giving their ideas. For those majority, 63(71%), respondents who said the authority's VAT administration capacity is weak, the researcher asked why they have said the administration is weak and what the authority has to do to strengthen its administration capacity. The reasons that they put for are:

- Less motivations observed on some employees of the authority due to less remunerations
- Lack of sufficient number of ethical, trained and skilled employees
- Accelerations of rotating the employees within the authority and firing of senior officials
- Absence of strong enforcement activities
- The difficulties that the authority has faced to distinguish the between honest and disobedient traders
- Provisions of weak service qualities by the authority

- The absence of strong controlling system against the frauds and evasions performed by some noncompliance enterprises.

From the results of the survey we can say that the VAT administration of the authority is not strong enough to bring those nonregistered enterprises to be registered and to the control illegal activities of VAT payers. Therefore the authority should work strongly to alleviate the existing bottlenecks and achieve the desired objectives by improving the service qualities it is rendering, solving the problems raised in association to frauds, auditing activities and tax evasions promptly, recognizing the activities of genuine traders, hiring qualified manpower and improving the collection system and strengthen its follow-ups.

#### 5.12. **Businesses not registered**

The survey was also conducted by asking the officials of ERCA whether there are eligible business enterprises in the market whose annual turnover are more than or equal to the threshold but have not yet registered for VAT. Out of 89 employee respondents 87(98%) replied that **yes** there are business entities whose annual turnover are more than the threshold but not registered for VAT and the rest 2(2%) replied as they don't think that there are enterprises whose turnover are equal to or more than the threshold but not registered for VAT. From this we can conclude that there are business entities in the market whose annual turnover is equal to or more than the threshold of Birr 500,000 but not registered for VAT. By taking the responses provided by the officials of the authority in to consideration the researcher also asked them why such enterprises don't want to register for VAT but have to be. They put their reasons for this as:

- Some enterprises fear that registration for VAT may lose their customers due to the price differences of purchasing goods and services from VAT registered and unregistered
- The absence of uniform registration system followed by the authority
- Low level of awareness of the business community and the public as a whole about the rules and benefits of tax
- The existence of some employees who deal for their personal benefits rather than for the responsibilities given by the government (authority) during the collection and investigations as well as auditing the enterprises returns (corruption)

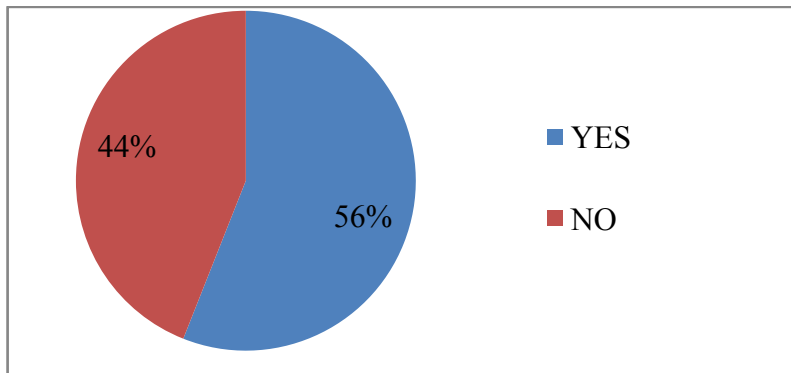
- The undermined assumptions of the power of the authority by the taxpayers
- The absence of sufficient information acquired by the authority about the business entities capacity to decide whether they have to be registered for VAT or not
- The need of the enterprises to dominate the market with least price competitions
- The authority do not identify those genuine enterprises and recognize their activities

In order to reduce the obligatory registrants and promote voluntary tax compliance, the ERCA should engage in continuous awareness creating programs to educate the public aiming to awake the business community on various VAT issues. In addition the authority has to improve the quality of services provided to taxpayers, follow uniform VAT registration systems, consistently examine and take actions over those unethical workers, identify and recognize those honest and genuine enterprises as well as their activities, and enforce those business enterprises that their annual turnover is equal to or above the threshold but are not yet registered for VAT to be registered. The business community should also obey the VAT rules and regulations and so they should register for the VAT according to the registration process of the VAT without any enforcement actions taken over them by the authority as well as the public have to work in harmony with the authority to bring the noncompliance enterprises to the court front.

#### 5.13. **Number of Registered vs. Nonregistered**

Further respondents from the authority were asked whether they agree that the number of non-VAT registered business enterprises exceeds the number of VAT registered taxpayers in the country. Among the 89 respondents, 50(56%) replied as they agree with the idea that the number of non-VAT registered exceeds the registered ones and the rest 39(44%) do not agree that the number of non-VAT registered is more than the VAT registered business entities. The following figure portrays the responses that respondents said Yes/No.

Figure 6: Number of Registered vs. Nonregistered



Source: computed survey data, 2011

From the figure above, we can understand that there are many business entities in the market that are not registered for VAT but have to be registered. Therefore, the authority has to devote its time in convincing the non-VAT registered enterprises to bring them in to registration and strongly expand its enforcement campaigns over the non-registrant enterprises as well as aware the public to experience the culture of taxpaying using different Medias.

#### 5.14. VAT collections

Except the value of goods and services exempted by the VAT proclamation all imported materials, locally produced items and services rendered are taxed by 15%. Export of goods and services, international transport of goods and passengers, gold supplied to National Bank of Ethiopia, transfer of organization on movement are zero rate taxed goods and services. The purchase of goods and services for economic, social and institution of the country's development are exempted.

VAT is considered as a credit invoice method because it is a tax system in which issuance of invoice serves as a cornerstone for the tax collection process. VAT proclamation No. 285/2002 Article 22/1 stipulates that a person registered for VAT is required to issue a VAT invoice for a taxable transactions, but a person who is not registered for a VAT does not have the right to issue a tax invoice. Therefore VAT registered enterprises perform their business transactions using an invoice. Hence the tax administration would not be expected to estimate the total sale or purchase made for levying the tax rather the invoice would depict the taxable sales and the buyer claims on what he has paid on his input.

Nevertheless this proclamation has seen violated by some business entities as the information that the researcher obtains from the officials of the authority and tried to be displayed in the table below. This is so because of the fact that several number of VAT registrant do not issue VAT invoices properly during transactions. This means that the tax collected by taxpayers is not paid to the tax authority and the normal tax operation system becomes jeopardized as the buyers could have no evidence for offsetting the tax paid in the course of business activities.

Having this as an appetizer the survey was conducted by asking the officials of ERCA whether there are VAT registered business enterprises that have collected the tax with illegal invoices or not. The question was raised in the manner depicted in the table below:

Table 5: Value Added Tax collection

Survey Question	Items			Total
Are there VAT registered business enterprises that have collected the tax with illegal invoices?	Yes	No	Know nothing	89(100%)
	84(95%)	2(2%)	3(3%)	

Source: computed survey data, 2011

As can be observed from the above table, out of the 89 respondents, 84(95%) replied that **yes** there are traders in the market that collect the tax with illegal invoices, 2(2%) respondents replied that there are no traders that collect taxes with illegal invoices and 3(3%) replied that they know nothing. For those respondents who said yes the researcher asks what they think of the reasons that make the traders not to collect the taxes legally. The reasons that they have discussed are:

- The absence of strong follow-up by the authority
- The existence of large number of nonregistered enterprises
- The need of registered enterprises to attract customers so as to compete with nonregistered enterprises
- Lack of awareness of the society about the benefits, uses and rules of the tax
- The need of the enterprises to grow with a little effort and short periods and by retaining government tax for self benefits illegally

- The existence of employees that deal for their own benefits rather than governing for the rules, duties and responsibilities
- The absence of strong enforcement and controlling mechanisms by the authority

As can be observed from the results of the findings, most of the business entities have not comply with the laws and regulations of VAT and they committed illegal activities by preparing fake invoices and they remitted the tax income for themselves rather than to pay the government. And when we see on the side of the authority, it is incapable to identify and control business enterprises that are noncompliance with the laws and regulations of VAT. This is because of the absence of sufficient and well equipped manpower.

Therefore the authority should strengthen its follow-up, appraise the performance of existing and recruit qualified new employees, strengthen its controlling mechanisms, improve its administrative systems and prepare programs to provide intensive education to the society about the benefits, rules and regulations of taxes specifically VAT. In addition to these tasks expected to be performed by the authority, the society should also accept and obey the existing VAT rules and regulations.

#### 5.15. **Customers willing**

In addition the taxpayer respondents were asked whether there are customers in the market who are not willing to purchase goods and services with VAT. Out of the 263 respondents, 113(43%) replied that **yes** there are customers who are not willing to purchase VAT inclusive goods and services, 108(41%) replied that there are no customers that are not willing to purchase goods and services with VAT and 42(16%) replied that they know nothing about. The majority of the respondents, 113(43%), agree with the idea that there are customers in the market that are not willing to pay for the goods and services they have purchased with VAT. And the respondents put the reasons why these customers are not willing to purchase goods and services that include VAT rate in to its prices. The main reasons are related to the purchasing powers and awareness of the society regarding VAT. The currently increasing level of inflation affects the purchasing power of the society and manifests the customer's need of searching goods that doesn't incorporate VAT value in its prices. On the other hand there are also customers that purchase goods and services that

exclude the VAT value in its prices intentionally made by the sellers providing falsified invoices.

#### 5.16. **The authority's manpower**

The survey was also conducted by asking the taxpayer respondents whether they believe that the authority has adequate number of and skilled manpower or not on their views. Out of the 263 respondents, 124(47%) respondents agree that the existing number and skills of employees of the authority is excellent and 139(53%) do not believe that the number and quality of the employees of the authority are sufficient. Based on the responses of the majority of the taxpayer respondents, the authority is expected to increase its manpower by recruiting literate and qualified manpower as well as appraise the performance and skills of the existing employees through trainings and preparing awareness creation programs as well as workshops so as to match its performing capacity with the increasing number and consciousness of the society.

#### 5.17. **Actions taken**

The survey has also conducted by asking the taxpayers whether the authority has taken some measures to alleviate the existing problems or not. Out of the 263 taxpayer respondents, 205(78%) said that the authority has taken some measures to alleviate the problems of VAT implementation committed by illegal business enterprises, 10(4%) respondents replied that the authority did not take corrective measures to alleviate the problems, 48(18%) respondents have no idea regarding the measures taken by ERCA to minimize the problems faced during the implementation of VAT. From this we can conclude that the authority has taken different actions in order to alleviate the problems that has faced though additional measures are also expected to be done. Therefore it is highly advisable for the authority to take more actions over those enterprises that are not convenient for the proper implementations of the VAT system in the country. This can be maintained by recruiting additional and capable employees, conducting continuous discussions between the taxpayers and the authority, providing continuous and intensive trainings to the existing taxpayers and its employees, improving the system (SIGTAS) that the authority is using, enforcing those business enterprises that scored their return equal to or above the threshold to register for

VAT and recognize and encourage those genuine traders as well as it should take legal action over those noncompliance business enterprises.

#### 5.18. **Process for refund**

For any VAT refund process, if the allowable input tax is greater than the output tax, the amount of the excess is normally repayable to the taxable person by the authority as a tax refund. In relation to this issue, a question was raised to the taxpayer respondents about whether the VAT refunding process being made by ERCA are maintained on time effectively. Out of 263 taxpayer respondents, 131(49.8%) replied that the VAT refunding process are being made on time and effectively, on the other hand 132(50.2%) respondents replied that the VAT refunding process is not being made on time and effectively. The respondents who do say the refunding process is not being made on time and effective put their reasons as even if VAT refund time table is clearly stipulated in the VAT proclamation, the tax authority is not being met the time table stated at the proclamation because of:

- weak VAT administration system of the authority
- The complexity of the assignment to decide for the refund
- Refund requires mandatory waiting periods of 5 months
- The refunding period needs an assessment maintained by the authority auditors

In general the refunding process being made by the authority is not as easy and effective. It demands time and efforts from the respective authority and honest business enterprises. Therefore the authority has to look again on the ways that can improve the effectiveness of the refunding procedures at a lower effort, cost and time.

#### 5.19. **Processes for declaration**

In modern tax administration, computerizing the tax collection procedure satisfies both the taxpayers' and the authority's requirements in best possible manners. Changing the administration in the computerized way satisfies two possible requirements. On one hand, it makes the work effective and efficient while on the other hand, it rehabilitates the management of the authority to the taxpayer requirements for fairness and justice. Concerning the declaration process a question was raised to the taxpayer respondents whether they believe that the declaration process for VAT is easy and effective or not. Out of the 263 respondents, 145(55%) replied that **yes** the declaration process is easy and

effective, and 118(45%) replied that the VAT declaration process is not easy and effective. As can be observed from these responses the declaration process is not as easy as possible. The respondents who said so put the interruption of light, absence of skilled manpower in relation to the cash registry machines, the incompatibility created between the authority auditor's report and report produced by the system and absence of consistent follow-up as the main reasons. Thus, the authority has to think the ways to solve problems raised around these areas by giving continuous trainings to the employees and the business community and improving its controlling and administration systems as well as strengthening its follow-ups.

#### 5.20. **Process for registration**

The survey further was conducted by asking both respondents about whether the process of VAT registration is smooth and easy for taxpayers or not. Out of the 263 taxpayer respondents, 147(56%) replied that the registration process is easy and smooth, but 116(44%) replied that the registration process is complicated or not easily accompanied. On the other hand out of 89 employee respondents of the authority, 85(96%) respondents replied that the registration process is very easy for tax payers and the rest 4(4%) replied that the registration process is not that much clear and trouble-free. As can be observed from the responses replied by majority of both respondents, the registration process is smooth and easy for taxpayers. But it further needs some modifications in order to make it very undemanding and soft to attract the business community to be registered and accomplish their businesses in a more formal and legal ways. The 116(44%) and 4(4%) taxpayer and employee respondents who said the registration process is complicated respectively were asked to put their reasons why they have said so. They put their reasons as the registration process demands additional and cumbersome accounting procedures, the registration process is time taking, and there are employees in the authority with the absence good personality (existence of corrupted employees). Therefore, to coil these problems the authority should improve the quality of services provided to the business communities and promote and reward those senior honest and compliance of voluntary registrants so as to attract new registrants. Besides this the authority should take a prompt action of those entities operating their businesses without obeying of the rules and regulations of VAT.

## 5.21. **Benefits from competition**

Both the taxpayer and authority employee respondents were further asked whom they think has benefited from the market competition between VAT registered and nonregistered and how it could be. Out of the 263 taxpayer respondents, 139(53%) respondents replied that enterprises that are not registered for VAT are more benefitted from the market competitions, 105(40%) respondents replied that VAT registered enterprises are more benefitted and 19(7%) said that they have no idea. From the result of the survey most respondents, 139(53%) replied that enterprises that are not registered for VAT are taking the advantages of the market competition and this leads to discourage the compliance business communities and aggravates the market distortion. Hence, the authority should strengthen its administration capacity for controlling of some noncompliance business communities so as to alleviate imbalance competition in the market. In connection, the survey was conducted by asking the taxpayer respondents about why they thought that the nonregistered enterprises benefited more from the market competition. They give their reasons as:

- Purchasing of goods and services with VAT requires incurring additional cost than without VAT. Hence, customers prefer to purchase goods and services from those entities that exclude the VAT rate from the prices of the items that they provide to their customers
- The absence of customers that have taxpaying habits and experiences
- The low purchasing power of the community that leads the public to cooperate with illegal activities
- expansion of evasions and frauds due to insufficient tax administration
- The presences of unethical employees in the authority are the most common reasons.

The same question was also raised for respondents from the authority. Among the 89 respondents, 33(37%) replied that enterprises that are registered for VAT outweigh the benefits they obtained from the market competitions, 32(36%) replied that enterprises that are not registered for VAT are more benefitted from the market competitions than the registered ones and 24(27%) replied as they don't have ideas to conclude. The respondents

who have said the registered taxpayers are more benefited from the market competition put their point of views to say which is summarized in the following manner;

- It provides more chances to those who are registered for VAT to participate in different governmental and non-governmental propositions
- Taxpayers that are registered for VAT also can take the advantage of confidently performing their business when the authority starts an investigation campaigns against those entities that are not registered to pay taxes, violating the tax rules, fraudulent and tax evasions and collecting taxes illegally
- It allows taxpayers to ask for refunds against the payment of input tax
- Since VAT collection is based on the declaration stated by taxpayer entity it makes the collection system easy and manifests clarity when the authority performs auditing. Hence, enterprises registered for VAT facilitates the authority's auditing performance and receive the advantage of recognition for their being genuine from the authority
- Since the society's awareness is showing an improvement from time to time and the government is trying to expand settled market situations, the advantages of the benefits from the market competition will outweigh to the legally recognized taxpayers in the future

On the other side respondents who have said the nonregistered taxpayers are more benefited from the market competition put their opinions as:

- the nonregistered business entities can freely decide on the prices of the goods and services that they are selling so as to take the market advantage
- the nonregistered business enterprises can be benefitted from the market by setting the prices of its commodities using the prices stated by registered business entities as a base
- the nonregistered business enterprises can also take the market advantage from registered once by lowering the prices of their products proportional to the VAT rate of 15% to attract price oriented customers
- Because of the lower level awareness of the community towards the advantages and contributions of VAT to the country's economy and government revenues,

the public prefer to buy goods and services from entities that exclude the VAT value from its prices so the nonregistered will be benefitted.

Based on the responses replied by both respondents, the market competition between VAT registered and nonregistered enterprises is not balanced. That is the benefits that nonregistered business enterprises attain outweighs the benefits that registered enterprises are intended to obtain from the market competition. Thus, to balance the market distortion the authority should improve and consistently modify its administrative capacity. The authority should also investigate and bring those entities that are not yet registered for VAT but are able to register (their annual turnover is  $\geq$  Birr 500,000) and the registered taxpayers should perform their activities with the compliance of VAT laws. In addition the authority is highly expected to provide intensive education to the public about the rules and advantages of VAT to the economic development of the country and create an awaked society concerning the tax collected through VAT is the main source of revenue to the government. The business communities in particular and the public in general have also pay their attention to the messages transmitted through different Medias and make themselves ready to learn and acquire sufficient knowledge about the Value Added Tax proclamations and act in accordance with the VAT rules and regulations.

#### 5.22. **Effectiveness of VAT**

The main objectives of VAT implementation was to collect tax on the added value whenever a sales transaction is conducted; to minimize the damage that may be caused by attempts to avoid and evade the tax and to ascertain the profit obtained by the taxpayers; to enhance saving and investment as it is a consumption tax and does not tax capital; and to enhance economic growth and improve the ratio relationship between Gross Domestic Product and Gross Revenue.

From these points of view the employees of ERCA were asked about whether they believe that the implementation of VAT is successful and achieve its objectives or not as shown in the following table.

Table 6: Effectiveness of VAT

Survey Question	Items		Total
	Yes	No	
Do you believe that the implementation of VAT is successful and achieve its objectives?	42(47%)	47(53%)	89(100%)

Source: computed survey data, 2011

As can be observed from the table above, among the 89 employee respondents, 42(47%) replied that the implementation of VAT for the last consecutive years was successful and the rest 47(53%) replied that it is difficult to say the implementation of VAT in this country was successful and achieve the desired objectives. As per the findings, majority of the respondents agree that the implementation of VAT requires more effort to achieve the desired objectives effectively. This is so because:

- the society is less conscious about VAT rules and contribution of VAT to the country's growth and development,
- tax administration system of the authority is weak,
- the way and methods of fraudulent activities and tax evasions on VAT by taxpayers are increasing from time to time and
- The attitude of the business community towards VAT is still negative.

Therefore the authority has to work more on the areas of awareness creations, strengthening enforcements, upraising the capacities of the employees, updating the system under use, educating the public using different Medias to make them develop taxpaying as their culture and strengthen the activities of identifying illegal business enterprises from the legal ones and taking corrective legal actions over the illegal traders.

## CHAPTER SIX

### 6. CONCLUSION AND RECOMMENDATIONS

#### 6.1. Conclusions

These days the best instrument which government can use as a source of revenue is taxation. It is obvious that an economic development of a country can be certain by an effective and efficient administration and collection of taxes. A good tax system should have one or a combination of desirable characteristics as economic efficiency, administrative simplicity, flexibility, political accountability and fairness for the purpose of good tax system. This is so because, when the implementation and administration of tax system is effective, the government's revenue that helps to fulfill the socioeconomic needs of the society will be amplified. It is possible to say that the major function of taxation is to marshal the necessary funds to finance the increasingly expanding level of public expenditures.

VAT is an indirect tax levied on domestic consumption of goods and services as well as on imported goods. It can be considered as the most important tax innovation of the second half of the twentieth century. VAT is primarily collected by business firms or individuals at all stages of production and distribution beginning with importers and producers of raw materials and ending with retailers. In line with this perception, VAT is implemented in many developed as well as developing countries.

Following the an increasing number of developing countries that have converted their sales tax to VAT, the government of Ethiopia has introduced VAT on January 1, 2003 replacing the sales tax aiming to raise more revenue, modernize its tax administration and encourage investment and trades. The replaced sales tax was collected only at the point of sales; as the result it is exposed for double taxation and had severe tax evasion problem. VAT on the other hand is applied on the value added at each stage of production and distribution. This means that the producer will be refunded for VAT paid on all the purchase of inputs.

As per the VAT proclamation, VAT will be levied on most consumption goods and services with the exception of exports and exempted goods and services charging a uniform rate of 15% of sales. The taxpayers required to be registered for VAT has both obligatory and voluntary behaviors. Under the obligatory registration a person who carries on taxable activity and is not registered is required to file an application for registration if his annual

return exceeds or equals to the threshold level (Birr 500,000). The voluntary VAT registered business enterprises are eligible to claim input tax while nonregistered are not given this opportunity. For those business enterprises whose annual turnover of taxable goods is less than the VAT registration threshold, are required to pay a turnover tax at a rate of 2% for goods and 10% for service.

As it was discussed repeatedly, VAT is a broad tax and this nature of the tax enables to raise more government revenue. The rate of VAT is uniform and the scope of exemption under this tax is limited and it is applied at each stage of production and distribution i.e. whenever additional value is added the tax is applied. After the implementation of VAT in Ethiopia VAT collection has shown an increasing trend in the government revenue as compared to the replaced sales tax. This is because of the fact that VAT has the advantage of reducing the cost of production of industries through its inherent refund system and the fact that it does not burden exports; and it offers total transparency of the incidence of tax as VAT is multistage sales tax levied as proportion of the value added. A very important thing that quotes in need of VAT is less tax evasion. VAT in Ethiopia could be helpful in simplifying and modernizing the tax administration with its invoice based characteristics and its requirements for the registrants to hold a systematic book of accounting. Economically, VAT does encourage investment by providing a refund for a tax paid on inputs and encourage export by zero rating items exported. With the very concept of VAT, output tax is charged at each stage of production and distribution to ensure that only final consumption is exposed to be taxed.

In Ethiopia, the implementation of VAT which is a new and sophisticated tax that differs significantly from the classical tax schemes with which the people were familiar with the formerly existed taxes is not an easy task. Hence, various misconceptions regarding its impact, its application, and its benefit to the national economy and its advantage to simplify the tax administration system were normal in the initial phase of its application. These misunderstandings pave the way for the researcher to think about the gap of the implementation of Value Added Tax and the problems it is encountering.

Accordingly a survey was conducted to identify, assess and analyze the implementation of VAT by distributing questionnaires for information's gathered from VAT registered taxpayers and employees of ERCA. Based on the results of the findings, VAT

implementation has faced different problems when it comes to the ground. The major ones are: administration inefficiency to control noncompliance taxpayers, lack of cognizant taxpayers, existence of reluctant enterprises to register for VAT, existence of registered enterprises issuing illegal VAT invoices, existence of unwilling customers to buy goods and services priced with VAT, the authority's weak follow-ups and controlling mechanisms against those taxpayers registered but doesn't use proper VAT invoices and those nonregistered enterprises but have a transaction of more than or equal to the threshold level, inability of the authority to render quality services and weak audit technique, failing of some taxpayers to notify the collection of VAT to the tax offices, and existence of many important sectors, most notably services and the wholesale and retail sectors, that have left out of the VAT net, the existence of taxpayers that refuse to honor their debt obligations to the VAT service while others submit their VAT returns without payments, the deliberate submission of nil returns and non-issuance of VAT invoices by the business enterprises.

The main causes of these problems were raised not only from the tax laws and proclamations but also from lack of awareness and deliberate resistance not to comply with the VAT laws of the business community, absence of sufficient materials and skilled manpower, the negative attitudes of some business societies towards VAT, weak purchasing powers of the society forcing to search goods and services that exclude the value of VAT from its price, and weak system of auditing performance. Hence the whole tax system in Ethiopia is faced with such problems as there is high cost of tax compliance, extensive evasion overzealous and corrupted tax collecting employees. As the result of these constraints the implementation of VAT in Ethiopia could not meet its objectives as effectively as it was desired.

Identifying taxpayers, assessment on VAT execution (includes identifying taxpayers and tax evaders as well as the registered and unregistered taxpayers among the business communities), processing returns, controlling collections, making refunds, auditing taxpayers, and levying penalties are the major activities in VAT administration. However, due to the absence of sufficient manpower the authority could not perform its activity properly, so some taxpayers couldn't obey the existing VAT rules and regulations. As per the results of the survey the authority has taken legal measures against people who do violate the VAT laws. Some of the measures that ERCA has to taken to solve the problems

stated above were: conducting intensive taxpayers education programs, conducting implementation seminars, rendering taxpayers advisory services (tax audit), release information through Medias, conducting forced registration campaigns, trying to strengthen the tax administration systems, and increasing the investigation operations over illegal movements of taxable goods as well as upgrading the performing capacity of employees and improving the networking capacity of the Standard Integrated Government Tax Administration System (SIGTAS).

Currently the numbers of tax registrants are increasing throughout the country. Taking this into account the authority has delegated regional/city administrations to collect the tax and administer taxpayers with their respective jurisdiction and act as the revenue organ. This can help to reduce mal-practices exercised against the tax system such as reluctance to register, failure to file returns, non-issuance of VAT invoices and it helps in maintaining uniformity of VAT system among regions, it enhances service delivery, it increases the number of VAT payers as region/city revenue offices have more access to the transactions of the traders with their vicinity, thereby increase tax revenue and it enhances tax administration skills of regions tax officers through transfer of knowledge and application of information communication technology as well as sharing of experiences.

To tackle the obstacles for the implementations of VAT in the country, the public at large and the government have to reach an agreement to work together to increase the taxpaying habits of the society. Since the ultimate goal of tax specifically VAT is to collect sufficient amounts of money that significantly be able to help the government to finance social and economic development and reduce poverty by introducing a new tax culture which actually demands an alliance with all taxpayers and organizational strength and efficiency from the side of the tax administrations. ERCA has also take actions to manage the adverse situations, such as education campaign, strengthen tax administration functions, forced registration for enterprises that its annual business transaction is over or equal to the threshold level, and increases the controlling system for those taxpayers who are strongly violate VAT laws and regulations as well as strengthen its follow-ups and upgrading the performance of its employees.

## 6.2.Recommendations

The major recommendations that come out from the survey result goes towards both the authority and the business community. The recommendations to the authority are:

- VAT is increasingly being used throughout the world to raise government revenue with less administrative and economic costs than other broad based taxes. Like it has been observed in many developing countries, VAT implementation in Ethiopia has been facing different problems at the initial stage. Since a poorly administered VAT raises less revenue that can change the very nature of the tax resulting in unintended economic distortions, the Ethiopian Revenue and Customs Authority (ERCA) has to build its administration capacity on both human and material resources to carry out its duties and responsibilities effectively and efficiently. This can be maintained through hiring of more qualified employees, provision of consistent training and development for staffs who will join and who have joined and using advanced information and communications technology so as to improve its administration capacity and control those noncompliance VAT payers.
- There is a strong believe that well-informed taxpayer society can be considered as an important asset for the tax authority. Therefore, the authority should conduct a consistent awareness creation programs to update the business community and the society at large about the concepts, rules and regulations, advantages and uses of the Value Added Tax. This can be carried out by intensively educating the public using mass-medias like television, radio, news papers, creating accessible websites, distribution of brochures, preparations of different seminars and workshops on a regular basis to increase awareness.
- Even though the primary objectives of VAT implementation in Ethiopia is to raise government revenue, to encourage investment by providing a refund for a tax paid on inputs and encourage export by zero rating export items, VAT has not been implemented effectively and meet its objectives as desired as possible. This is because of the existence of taxpayers that are not compliance with the current VAT laws and inefficient tax administration to control those noncompliance taxpayers. Therefore to tackle these constraints and achieve the desired objectives ERCA should strengthen its tax administration by delegating responsibilities to regional/city administration revenue

collection organs to administer taxpayers with their jurisdiction and also the taxpayers should comply with current VAT rules and regulations. When the authority delegates responsibilities to city or regional administrations they start acting as an agency; the reluctance of business enterprises to register for VAT, failure to file returns, non-issuance of VAT invoices violations of VAT laws will be highly reduced, uniformity of VAT system among regions, quality service delivery, the number of VAT payers as region/city revenue offices have more access to the transactions of the traders with their vicinity will be enhanced, thereby increase tax revenue and it enhances tax administration.

- A threshold for VAT registration has been put in place for administrative purpose. The current threshold level (500,000 birr) is high and hence allows most business communities whose return is below the threshold but actively participating in the market competition to stay unregistered. Therefore the current threshold level should be adjusted into more rational level by considering the increasing number of entities engaging in different businesses and should be minimized to incorporate at least those business enterprises that are actively participating in the market competition and balance the revenue generated from the tax. This can be carried out by hiring more qualified and professional employees and reducing the threshold to the lower level.
- The VAT ensures neutrality in international trade by freeing exports of tax and by treating imports and domestic goods the same; this is an important attribute in an interdependent, high-tax world. Even though VAT as a transactions tax, which must be shown on invoices, is harder to evade than an income tax, there are results that show the violations of VAT proclamation by some business entities in Ethiopia because of the fact that several number of VAT registrants do not issue VAT invoices properly during transactions. This means that the tax collected by taxpayers is not paid to the tax authority and the normal tax operation system becomes jeopardized as the buyers could have no evidence for offsetting the tax paid in the course of business activities. Therefore the authority should strengthen its follow-up, appraise the performance of existing and recruit qualified employees, strengthen its controlling mechanisms, improve its administrative systems and special focus should be paid in strengthen its audit and

enforcement wings. In addition to these tasks expected to be performed by the authority, the society should also accept and obey the existing VAT rules and regulations.

- To reduce the undesirable consequences that may undermine the whole reform program, the organizational and human resource should be adjusted in order to cope up with the increased number of VAT registrants that currently is observing. Particularly, manpower requirement should be given special attention since the business community is in advance in searching for shortcomings of the tax administration. The result of the survey shows that the non-taxpayers are very large in number and most registrants as VAT payer claim credit. To tackle this problems investigation and enforcement work should be strengthened and measures on those taxpayers who are constantly failing to comply with the tax rules and regulations should be taken.
- In general the implementation of Value Added Tax in Ethiopia has faced various problems such as tax evasion and fraud, false invoices prepared by enterprises, increased number of enterprises that collect VAT for their selves, selling products by offering invoices of VAT inclusive and VAT exclusive, resistance from the business community against registration for VAT, preparations of understated financial statements and making a business transaction reports under threshold level after it has launched. However, to sustain the VAT system as a good means to raise government revenue, the Ethiopian Revenue and Customs Authority should take actions such as: train the taxpayers about the rules and regulations of VAT continuously, recruiting new employees and give continuous training for the existing once, delegate the tax authority to regional and city administration and it should also increase its follow-up and investigation to control noncompliance enterprises, as well as effectively and efficiently performing the tasks of identification of VAT taxpayers, processing of returns, controlling collections, making refunds, auditing taxpayers, and levying penalties to tackle the problems it has encountered.

The recommendations forwarded towards the taxpayers and the public are:

In addition to the tasks performed by the tax authority, the business communities should also obey the current VAT rules and regulations, develop the culture of taxpaying as a sign of modern thinking, pay attentions towards the government's effort to collect and fund the long

run projects carrying out all through the country, take into account as the government's main source of income to fund to the social and public affairs is the wealth collected and accumulated from taxes, consider paying tax as a means of directly or indirectly putting one's own contribution on changing the life of each citizen and they perform their activities according to the current VAT laws as well as start to work in cooperation with the authority in fighting against those enterprises that are violating the rules and regulations of VAT.

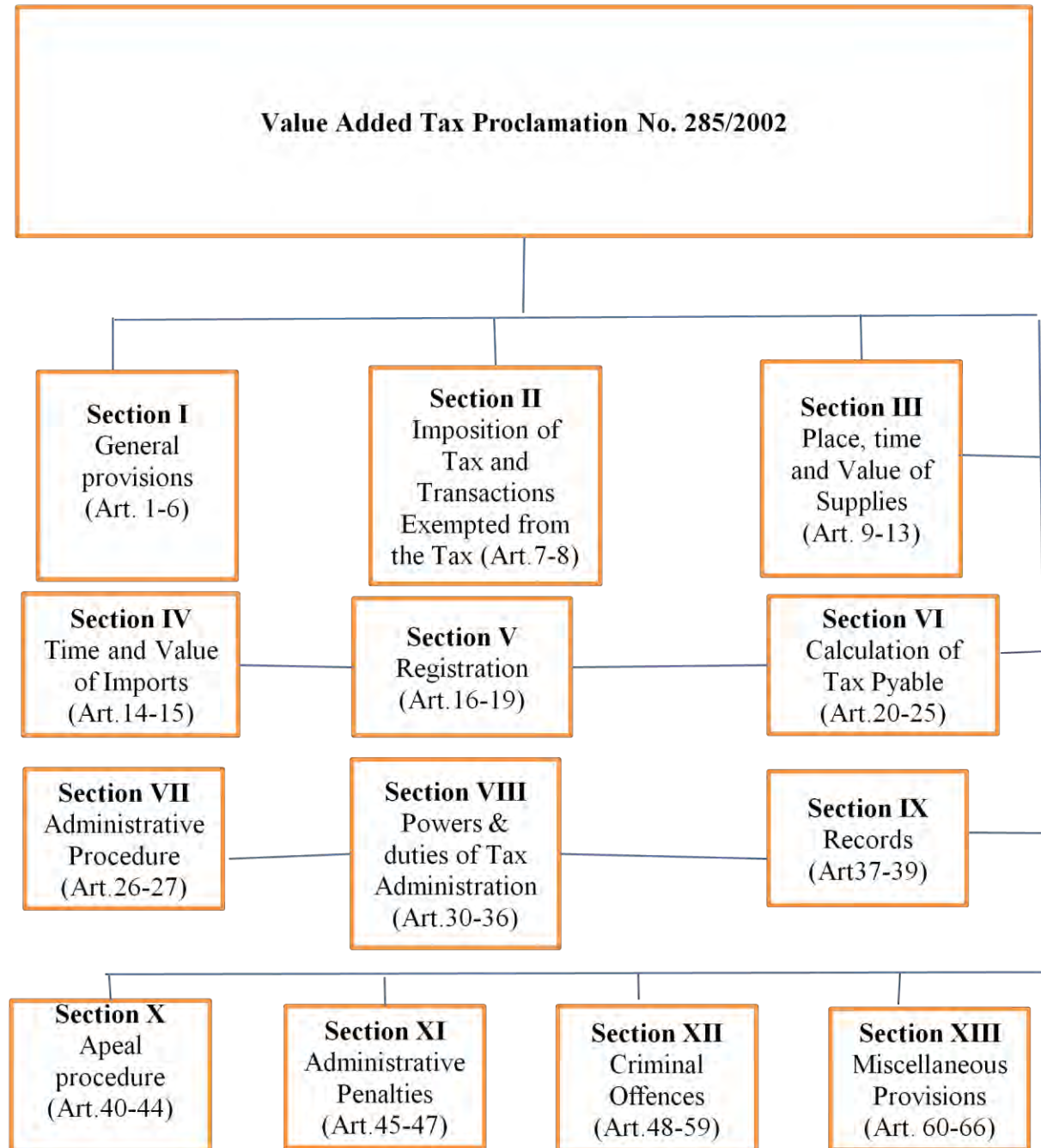
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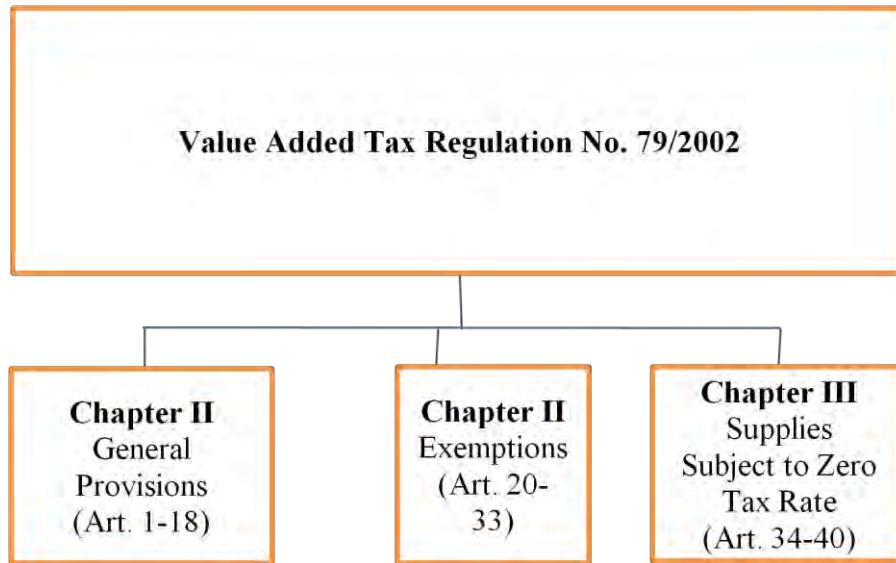
## APPENDICES

### Appendix 1: the framework of Value Added Tax Proclamation No.285/2002



Source: Misrak Tesfaye, Ethiopian Tax Accounting Theory and Practice, 2008

Appendix 2: the framework of Value Added Tax Regulation No.79/2002



Source: Misrak Tesfaye, Ethiopian Tax Accounting Theory and Practice, 2008

### **Appendix 3: Questionnaires for VAT registered taxpayers**

**Addis Ababa University**

**College Of Graduate Studies**

**School of Business and Public Administrations**

**MBA Program in FINANCE**

Dear participants:

You are being asked to participate in a survey that intends to assess VAT implementation and related problems in Ethiopia especially in ERCA. The purposes of the study are to: assess and describe the practice of VAT in Ethiopia, identify the inductive factors and investigate the possible problems for the adoption and implementation and recommended solutions to help the program implemented successfully.

I respectfully request your kind cooperation in answering the questions that follow a clearly and frankly as possible and your response will be highly confidential.

Thank you in advance for your kind cooperation

Section I: Classification/identification questions

Answer by putting a thick (√) in one of the blank spaces corresponding to each item.

1. Age group (in year): 20-30 \_\_\_\_\_, 30-40 \_\_\_\_\_, 40-50 \_\_\_\_\_, 50+ \_\_\_\_\_
2. Sex: Male \_\_\_\_\_, Female \_\_\_\_\_
3. Level of education: below 12 grade \_\_\_\_\_, certificate \_\_\_\_\_, diploma \_\_\_\_\_, bachelor degree \_\_\_\_\_, masters and above \_\_\_\_\_
4. Type of the business/unit \_\_\_\_\_
5. Your status/position in the unit/business \_\_\_\_\_
6. Year of experience in the specific office/units \_\_\_\_\_

Section II: survey questions

Select an appropriate answer from the given alternatives and circle it, for other questions please provide your answers on your own words.

1. Do you think that the introduction of VAT in Ethiopia is necessary by replacing the sales tax? A) yes                      B) No                      C) I have no idea
2. As a taxpayer, do you think that you/your organization are familiar with VAT proclamations and regulations?  
A) Yes                      B) to some extent                      C) no                      D) I have no idea

3. The intention of VAT implementation in Ethiopia is:
  - A) Encouraging investment and export
  - B) Discouraging investment and export
  - C) Encouraging investment but not exports
  - D) I have no idea
4. Are there measures taken by the ERCA to alleviate the problems associated with the implementation of VAT?
  - A) Yes
  - B) No
  - C) I have no idea
5. Do you think that the threshold of VAT (500,000) is fair?
  - A) Yes
  - B) No
  - C) I have no idea

If your answer for question no.5 is **No**, what do you think of it should be?

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Why? \_\_\_\_\_

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6. Do you think that VAT is more advantageous in comparison with the replaced sales tax?
  - A) Yes
  - B) No
  - C) I don't know

If your answer for question no.6 is **yes**, can you mention how it could be please?

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7. Do you believe that ERCA had made sufficient explanation to the public regarding VAT?
  - A) Yes
  - B) to some extent (little)
  - C) No

If your answer for question no.7 is **„B'** or **„C'** what do you think of the Authority to do?

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8. Do you believe that the process of VAT registration is smooth and easy for taxpayers?

- A) Yes                      B) No

If your answer for question no.8 is **No**, what do you think of the reasons?

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9. Do you agree with the idea that most of the VAT payers are registered obligatorily?

- A) Yes                      B) No

If your answer for question no.9 is **yes**, what do you think of the reasons why they are not voluntarily registered? \_\_\_\_\_

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10. Do you think that the VAT refunding processes being made are on time effectively?

- A) Yes                      B) No

If your answer for question no.10 is **No**, what do you think of the reasons?

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11. Do you believe that the declaration process is easy and effective?

- A) Yes                      B) No

If your answer for question no.11 is **No**, what do you think of the problems that makes it difficult?

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12. Are there customers who are not willing to purchase goods and services with VAT?

- A) Yes                      B) No                      C) I don't know

If your answer for question no.12 is **yes**, what do you think of the reasons?

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13. Do you believe that the Authority have adequate number of and skilled man power?

- A) Yes                      B) No

14. Do you think that the non-VAT registered taxpayers are more benefited than those of VAT registered enterprises from the competition in the market?

- A) Yes                      B) No                      C) I have no idea

If your answer for no.14 is **yes**, how do you think of they are as so?

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15. What do you think of the measures that have to be taken by the Authority over the enterprises that are evading tax payments?

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## **Appendix 4: Questionnaires for officers of the Authority, ERCA**

**Addis Ababa University**

**College of Graduate Studies**

**School of Business and Public Administrations**

**MBA Program in FINANCE**

Dear participants:

You are being asked to participate in a survey that intends to assess VAT implementation and related problems in Ethiopia especially in ERCA. The purposes of the study are to: describe the practice of VAT in Ethiopia, identify the inductive factors and investigate the possible problems for the adoption and implementation and recommended solutions to help the program implemented successfully.

I respectfully request your kind cooperation in answering the questions that follow as clearly and frankly as possible and your response will be highly confidential.

Thank you in advance for your kind cooperation

Section I: Classification/identification questions

Please answer by putting a thick (√) in one of the blank spaces corresponding to each item.

1. Age group (in year): 20-30 \_\_\_\_\_, 30-40 \_\_\_\_\_, 40-50 \_\_\_\_\_, 50+ \_\_\_\_\_
2. Sex: Male \_\_\_\_\_, Female \_\_\_\_\_
3. Level of education: below 12 grade \_\_\_\_\_, certificate \_\_\_\_\_, diploma \_\_\_\_\_, bachelor degree \_\_\_\_\_, masters and above \_\_\_\_\_

Section II: survey questions

Select an appropriate answer from the given alternatives and circle it, for other questions please provide your answers on your own words.

1. Are you familiar with the Ethiopian VAT Laws and proclamations?  
A) Yes                      B) No
2. Do you think that the Authority (ERCA) had made sufficient clarifications to the public about the concept (meaning) of VAT?  
A) Yes                      B) No                      C) I have no idea
3. Do you believe that the current VAT contribution to the government's revenue is sufficient?  
A) Yes                      B) No

If your answer for question no.3 is **No**, what do you think of the reasons to generate sufficient revenues? \_\_\_\_\_

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4. Do you believe that VAT implementation is more advantageous than the replaced sales tax?

- A) Yes                      B) No                      C) I have no idea

If your answer for question no.4 is **yes**, can you mention how it could be please?

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5. Do you believe that the implementation of VAT is successful and achieve its objectives?

- A) Yes                      B) No

6. Do you believe that the process of VAT registration is smooth and easy for taxpayers?

- B) Yes                      B) No

If your answer for question no.6 is **No**, what do you think of the reason?

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7. Do you think that tax administrations are strong enough to control non-registered and illegal activities of VAT payers?

- A) Yes                      B) No                      C)I have no idea

If your answer for question no.7 is **No**, what do you suggest to strengthen their control system?

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8. Are there VAT registered business enterprises that have collected the tax with illegal invoices?

- A) Yes            B) No            C) I don't know

If your answer for question no.8 is **yes**, what do you think of the reasons?

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9. Do you think that there are some eligible business enterprises in the market that haven't yet registered for VAT?

- A) Yes            B) No

If your answer for question no.9 is **yes**, what do you think of the reasons?

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10. Do you agree that the number of non-VAT registered taxpayer exceeds the number of VAT registered taxpayers in the country?

- A) Yes            B) No            C) I don't known

11. Do you think that the threshold level (Br 500,000) in the VAT proclamation is fair?

- A) Yes            B) No

If your answer for question no.11 is **No**, please mention your suggestion how much it should be?

Why? \_\_\_\_\_

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15. Do you think that the VAT assessment and collection mechanism is effective and efficient?

- A) Yes                      B) No                      C) little

If your answer for question no. **15** is „**B**“ or „**C**“ what do you think of the reasons?

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16. What do you think of the alternative solutions to alleviate the problems identified?

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17. Any further information you want to suggest:

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