

ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES

**AN EXAMINATION OF THE LINK BETWEEN TAX
ADMINISTRATION AND VALUE ADDED TAX
COMPLIANCE IN ETHIOPIA**

BY

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Part 1: INTRODUCTION

1.1. Background of the study

Almost unknown in the 1960s, the value added tax (VAT) is now found in more than 145 countries and raise around 20 percent of the world's tax revenue (Keen and Lockwood, 2007:3). In recent years, developing countries searching for additional revenue and/or pressured by business to modernize their sales tax have enacted value added taxes (Schenk and Oldman, 2001:25). Widely adopted in sub-Saharan Africa, it has been the centerpiece of tax reform in many developing countries. Besides, the IMF played a significant role in the spread of the VAT (Keen and Lockwood, 2007:26). The rise of the VAT has been the most significant development in tax policy and administration of recent decades (Keen and Lockwood, 2007:2).

The VAT is simply a multistage sales tax that exempts the purchase of intermediate goods and services from the tax base. The advantage of a VAT over retail sales taxes is that VAT allows business to recoup tax on their inputs (business purchase) so that tax on retail sales does not impose a tax-on-a-tax. Value added is the difference between sales proceeds and purchases of intermediate goods and services over a certain period (Ebrill et al. 2001:3; Keen and Smith 2007:4; Mieszkowski 1999:477; Webley et al. 2002:1).

Even though VAT is less vulnerable than other form of taxations, like any other tax, it is vulnerable to evasion and fraud (Keen and Smith, 2007:3). Noncompliance is also a major problem faced by countries that introduced VAT. Although, it is difficult to get an accurate picture, it is clear from the few studies that, VAT evasion is widespread and involves significant revenue losses, though the extent varies considerably across countries (Webley et al. 2002:1). For instance, a study on VAT Compliance in the UK identifies four forms of noncompliance.

- (a) Engage in taxable transactions without having registered with the tax authority
- (b) Fail to file their tax return by the statutory filling deadlines
- (c) Underreporting their tax liability or illicit claim of tax refunds, or
- (d) Underpay the amount of taxes due (tax arrears).

These forms of noncompliance give rise to tax gap representing forgone government revenue and unfair competitive advantage to noncompliant businesses.

Ethiopia has introduced VAT beginning from January 2003 as a replacement for sales tax. It is becoming the principal source of revenue for the country. For instance, for the fiscal Year 2008/09, Federal VAT revenue accounted for about 42 percent of total federal revenue from domestic sources (ERCA 2001). The report also indicates that on July 7, 2009 there were 22,307 VAT registered taxpayers in its ten different branches and offices.

According to the Value Added Tax proclamation No. 285/2002, the VAT is levied and paid at the rate of 15 percent of the value under such condition:

- every taxable transactions by a registered person;
- every import of goods other than an exempt import; and
- an import of service rendered in Ethiopia for a person registered in Ethiopia for VAT or any resident legal person by a nonresident person who is not registered for VAT in Ethiopia (Article 7(1)(a)-(c) and Article 23(1)).

Article 7(3) defines a taxable transaction as a supply of goods or rendition of services in Ethiopia in the course or furtherance of a taxable activity other than an exempt supply. Besides, Article 22(1) states a person registered for VAT is required to issue a VAT invoice to the person who receives the good and services. Unregistered person for VAT, however, does not have the right to issue a tax invoice.

From its inception, the VAT revenue shows an increment in each year. For instance as shown in table 1, between the year 2004/05 up to 2008/09 VAT revenue increase to constitute from 40 to 42.5 per cent of domestic revenue. Despite its improved trend of revenue generation, the introduction of VAT presents a major challenge to revenue administration in Ethiopia (Yesgat, 2008: 161). The tax authority faces a growing compliance risk. For instance

- (a) In the fiscal year 2008/09, around 1.8 billion Birr is collected as a penalty and 21 charges are filed on those cases of noncompliance (ERCA 2001).
- (b) From the sum of VAT collected in Western Addis Ababa Branch 12 percent and 47 per cent (total 59 per cent) were collected as penalty and interest respectively.

If taxpayers were complying promptly a large portion of revenue cannot come from the penalties and interest, and big number of prosecution for noncompliance may not exist. All these show the existence of noncompliance risk at Ethiopian Revenue and Custom Authority.

Although few attempts are done to study the VAT administration at the ERCA, Teffera(2005) and Yesegat (2008), no study has looked exclusively on VAT compliance. Whilst they did not examine exclusively on VAT compliance they states few issue about it. For instance, Teffera(2005) attempt to show the problem of noncompliance by providing information on credit filers, nil-filers and non-filers. He concludes that taxpayer's compliance problems are continuously manifests due to deliberate evasion and unlawfulness, and weak audit and enforcement capability of the tax administration. Yesegat (2008) on the other hand by demonstrating the number of audited taxpayers during the year 2004/05 and 2005/06, conclude the existence of low audit rate and this may have negative impact on the revenue potential of VAT and the level of compliance.

The above studies have not addressed the causes for noncompliance in the country. Therefore, this study examines the cause of noncompliance at ERCA.

1.2.Statement of the problem

VAT is the principal source of revenue for the Ethiopian government. For instance, as shown in table 1 below, during the last five years, between 2004/05 and 2008/09, Federal VAT revenue (on domestic transactions) accounted with slight increase in each year between for about 40-42 percent of total federal revenues from domestic source.

Table 1: Federal revenue from 1997-2001 E.C

million

Domestic Revenue	1997	1998	1999	2000	2001
Direct tax	1,681.27	2,053.46	2,646.08	3,781.41	5,396.26
VAT on goods	1,135.75	1,308.66	1,665.87	2,134.30	2,883.30
VAT on service	407.08	511.19	724.44	1,109.07	1,950.74
Total VAT	1,542.83	1,819.85	2,390.31	3,243.37	4,834.04
Indirect tax total	2,167.04	2,533.34	3,155.62	4,224.21	5,979.25
Non tax revenue	2.45	3.36	3.24	3.97	6.15
Total	3,850.76	4,590.16	5,804.94	8,009.59	11,381.66
Size of VAT (%)	40.07	39.65	41.18	40.49	42.47

Source: Summery of annex

In spite of this higher revenue-generating role, the tax authority faces a growing compliance risk. If we consider the result of VAT assessment during fiscal year 2008/09 in the three Addis Ababa branches, reports indicate the existence of higher compliance risk. For instance, as shown in table 2, in western Addis Ababa branch out of the 9282 VAT registered taxpayers in the branch, 236 taxpayers (2.5%) were assessed, and Birr 55,001,220.30 VAT (41%), Birr 16,126,394.18 penalties (12%), and Birr 62,765,900.14(47%) interests on undue payment were collected. That is, besides the gain due to increased VAT, 59% of the total revenue is collected in the form of penalties and interest. Hence, the majority of VAT income is coming from the penalties and interest. The reason for this is taxpayers are not complying. Moreover, during the same fiscal year 21 charges filed on those cases of noncompliance (ERCA 2001). All these prove the existence of high noncompliance at ERCA.

Table 2: The result of VAT assessment during fiscal year 2008/09

Details	Western branch	portion	LTO	portion	Eastern branch	portion
total taxpayers	9282		514		7067	
Audited taxpayers	236		121		452	
audit rate	2.5%		23.5%		6.4%	
VAT	55,001,220.30	41%	584,334,207.44	25.25	29,490,135.14	58
Penalty	16,126,394.18	12%	659,772,387.56	28.50	15,891,226.94	31
Interest	62,765,900.14	47%	1,071,232,721.64	46.25	5,436,283.04	11
Total	133,893,514.62	100%	2,315,339,316.64	100	50,817,645.12	100

Source: Summery of annex

Currently ERCA is greatly concentrating on strong penalties to solve the problem of higher compliance risk faced. No tax, unfortunately, collects itself and some measure of enforcement is necessary. However, it is important to understand that enforcement is only one aspect of tax administration. There is a strong need to understand the underlying causes of noncompliance. As indicated earlier there are no studies that analyzed the problem of noncompliance in the Ethiopian case. Of course, the literatures suggest the following possible reasons for VAT noncompliance (Webley, 2002:4). These are

- a. Low audit probability,
- b. The perceived fairness of VAT,
- c. Individual characteristics,
- d. Dissatisfaction with the tax authority,
- e. How business people think about the VAT money, and
- f. Malpractice

This study, focusing on the Ethiopian case will analyze the causes of noncompliance by VAT taxpayers.

1.3. Research question

The research would like to address the following basic research questions.

General research question:

In what ways and how do tax administration system affect VAT taxpayers compliance?

Specific research questions:

- a. How do audit probability result in noncompliance?
- b. How does the perceived fairness of VAT effects taxpayer noncompliance?
- c. How do dissatisfaction with the tax authority consequence in noncompliance?
- d. How do business people beliefs about the VAT money result in noncompliance?

1.4 Research objectives

1.4.1 General objective

By focusing on specific issues of tax administration, the general objective of this study is to examine the link between tax administration and VAT compliance.

Accordingly, it will analyze the impact of low audit probability, the perceived fairness of VAT, dissatisfaction with the tax authority, and how business people think about the VAT money on tax compliance.

1.5 Significance of the study

Given its high government revenue generation, VAT in general and VAT compliance in particular have received very little attention by researchers. There are only few attempts done to study the VAT administration at the ERCA by Teffera(2005) and Yesegat (2008). A study focusing on VAT compliance problem is helpful to increase the VAT's revenue generating capacity and promote pleasant relation between the tax Authority and taxpayers. In addition, this study may be used as a reference material for further studies.

1.6. Scope and Limitation of the study

In this study, detailed analysis on VAT compliance is undertaken by focusing on the administration of VAT in ERCA since 2003. Since much study is not done in this area, it was difficult to get enough resource material. Besides, even ERCA has nine branches and offices this study concentrates on the three branches due to time and resource constraints. In fact, these three branches accounts for about 76% of ERCA's VAT payers.

1.7. Research Methodology

The study focuses on the link between tax administration and VAT compliance at ERCA. To gather adequate information for analysis purpose, a combination of quantitative and qualitative methods is applied. In both case, primary and secondary data is used. Primary data collected through closed ended as well as open-ended questionnaires. For qualitative inputs, the researcher conducted interview with tax officials. For quantitative input, data obtained from ERCA were consulted.

1.7.1. Case study areas selection

On July 7, 2009, there were 22,307 VAT registered taxpayers in all ERCA's nine branches and offices. Since, these branches are spread all over the country; it is beyond the capacity of the researcher to cover all of them. Hence, to conduct the study, it is necessary to focus on few branches. Fortunately, among the nine ERCA's branches, the three's are found in Addis Ababa and they constitute 16,863 registered VAT payers (75.6 per cent of ERCA's total VAT registered taxpayers). The three sample case studies, which are created in Addis Ababa, are considered for the study. Thus, the method used for case study selection is mainly convenient sampling.

1.7.2. Selection of respondents

Out of a total of 16863 taxpayers found in Addis Ababa, 300 respondents were included in the sample. From this approached 196 responded. The details are as follows.

Table 3: Details of sample selection

Revenue authority	VAT registered as of July 7, 2009*	Size rate from ERCA A.A.	Size rate from ERCA	sample	Size rate
1. Higher taxpayers office	514	3.05	2.30	10	3.33
2. Eastern A.A. Branch	7067	41.91	31.68	130	43.33
3. Western A.A. Branch	9282	55.04	41.61	160	53.33
ERCA's A.A total	16863	100	75.59	300	100
ERCA's regional Branch total	5444		24.41		
Total ERCA	22307		100		

* ERCA's report, 2008/09

1.7.3. Data gathering tools and Techniques

The survey conducted by distributing questionnaire to VAT registered taxpayers at ERCA (Large taxpayer office, Eastern Addis Ababa branch and Western Addis Ababa branch). The questionnaires consisted of 14 questions; all answered on a five-point scale run from strongly agree to strongly disagree. Two questions answered with a simple tick and one final question, which is open-ended if they have anything to say or add. The instrument was given by Amharic to avoid language barriers and minimize responses bias due to misunderstanding.

The questionnaires distributed to 300 VAT registered taxpayers who came to the tax authority for monthly VAT reporting purposes during the month of 'Yekatit' (Feb/march). Out of the 300 questionnaires, 196(66.67 per cent response rate) were filled and returned.

1.8. Organization of the study

The rest of the study organized in three major parts. Part 2 presents a brief of literature on VAT Administration and compliance. Part three analyze VAT administration practice in Ethiopia with respect to the main administration tasks. Part 4 discusses the major cause of VAT noncompliance at ERCA: audit probability, the perceived fairness of VAT, dissatisfaction with the tax authority, and how business people think about the VAT money. Finally, part 5 provides the research findings and conclusions.

Part 2: Literature review

2.1 The concept of VAT

2.1.1 The meaning and development of value added tax

The value added tax (VAT) is simply a multistage sales tax that exempts the purchase of intermediate goods and services from the tax base. Value added is the difference between sales proceeds and purchases of intermediate goods and services over a certain period. For example, the value added for a supermarket is the difference between the total sales receipts that month and the total invoice for goods and services from its supplier. Ultimately, consumers carry the burden of the tax because everyone else in the process deducts the VAT paid on inputs from the VAT collected on their outputs. Since, consumers have no intermediate transactions to offset the tax liability to the extent to which they purchase intermediate good and services they carry the burden of the tax (Ebrill et al. 2001:3; Hyman 2005:632; Keen and Smith 2007:4; Mieszkowski 1999:477; Webley et al. 2002:1).

VAT is the principal means of indirect taxation in many countries. Summers et al., 2002 (in Teffera 2005:64) states that the rapid widespread and rise of the VAT are due to

- To do away distortions created by other indirect taxes;
- Government's need to increase their revenue and
- To replace import tariff revenues lost because of trade liberalization.

The rise of the VAT has been the most significant development in tax policy and administration of recent decades (Keen and Lockwood, 2007:2). The spread of VAT appears to have been desirable and successful, but requires good design and implementation, not only when first adopted but for many years after (Summers et al., 2002 in Teffera 2005:64).

The reasons for the spread of VAT in developing countries have some exception. In recent years, developing countries searching for additional revenue or pressured by business to modernize their sales tax have enacted value added taxes (Schenk and Oldman, 2001:25). In addition, widely adopted in sub-Saharan Africa and other

developing countries, it becomes the centerpiece of tax reform in these countries. Moreover, the IMF also played significant role in the spread of the VAT (Keen and Lockwood, 2007:26).

2.1.2 How VAT operates

Administration of a VAT does not require firms to calculate value added. There are two means of administering VAT. The most common means of administering the tax is the invoice method developed in France and used in EURO nations to collect the tax (Hyman, 2005:633). Under this method, all transactions are taxed at a fixed proportional rate regardless of whether they are final or intermediate transactions. Taxpayers are allowed to deduct the taxes paid on intermediate purchases from the taxes collected from their sales in determining their tax liability. It is called the invoice method because payment of the tax merely requires firms to maintain invoice on sales and purchases for each tax payment period (usually monthly or quarterly). Tax liability is determined simply by applying the fixed rate of taxation to total sales invoices and then deducting the amount of VAT paid previously on intermediate purchases as indicated on purchase invoice, where the tax is usually separately itemized. This method results in taxation of value added without the need to actually calculate value added (Shenken and Oldman, 2001:30)

The other means of VAT administration is the subtraction method. This method uses company accounts to determine VAT liability by subtracting taxable receipts less taxable purchases to obtain total value added (Tesfaye, 2005:5). In other words, the subtraction method of computing a firm's VAT calls simply for subtraction of total purchases from the sales of the firm in question and the balance, the value added by this firm, is then subject to the VAT rate. The invoice credit method is preferred and is used throughout the sub Sahara Africa (Riswold, 2003 in Tesfaye, 2005:6). Further, it is widely accepted that the transaction based invoice credit method provides several advantages such as the ability to deal with different rates and minimizing tax evasion by providing an audit trail.

2.1.3 Advantage of VAT

The most popular and widely accepted advantage of VAT is its high revenue potential, even in poor countries, of mass consumption taxation (Bird and Oldman, 1990:367). As mentioned earlier, VAT is simply a multistage sales tax that exempts the purchase of intermediate goods and services from the tax base. However, unlike its counterpart sales tax VAT does not impose a tax on tax effect. In the real world, the administrative costs of taxes and the risk of evasion are important determinants of the choice among taxes. In this regard, VAT has some real advantages.

In most countries, VAT is collected by the *subtraction method*, whereby firms declare their purchases from other firms in order to deduct them from their own sales, which is a fairly simple task. The difference is non-invested value added, which is the basis for VAT. Thus the report of firm A, which bought from firm B, allows the tax authority to check the sincerity of the report of firm B. This system effectively discourages evasion. This has low administrative costs and makes evasion easy to detect. The invoice method embodies a sort of built-in anti-evasion mechanism. If any firm fails to pay its tax liability at some stage of production, it then becomes the tax liability of the producer in the following stage of production. That is not to say that tax evasion is impossible. Rather it should be stressed that a VAT is not evasion-proof, and that any system will require a modicum of administrative capability (Ahmed and Stern, 1991:219).

In terms of administrative cost the least costly system would be to rely on voluntary contribution, but it would hardly be fair (and probably not very effective either). Therefore, one should realize that part of the complexity in the system is unavoidable due to equity concerns. However, still these costs should be considered when setting up or reforming a tax system. VAT is an excellent tax in that regard. On the other hand, the income tax has high collection costs and is much easier to evade. Thus, it may be better to collect at least part of the tax revenue by VAT. Consequently, many developing countries have created an income tax, but their weak tax authorities find it hard to collect the tax. These countries must therefore de facto rely in a large part on indirect taxation to finance public expenditures (Salanie', 2003:119).

The VAT is typically rebated on export sales. This makes goods of nations that use VAT more competitive in international markets when they are exported. Imported products are subject to the VAT, which increase their price to domestic consumers. Many nations allow rebate of the tax on tourist purchases of item for export. For example, Canada allows foreign tourists to receive an instant rebate of their VAT taxes on nonfood purchases of goods and services at the Canadian border by presenting their receipt for hotel and nonfood purchases for export (Hyman,2005:636).

2.2 VAT administration

The major activities in VAT administration are identification and registration of taxpayers, processing returns, controlling collections, making refunds, auditing taxpayers, investigation of tax fraud and evasion ,and leaving penalties, (Abrham, 2005:10 ; Teffera, 2005:67).On the part of administration, it is a prior task to identify the taxpayers. In this connection, preparation of a single master file, based on unique Tax Identification Number (TIN) is crucial and this ensures that each taxpayer's account contains all the relevant tax and payment data for the taxpayer alone (ibid). The TIN system has the advantage of aiding to draw a comparison of tax statistics with the national accounts, facilitating proper use of the database of various systems, and enhancing the financial recording system of the business communities.

In all countries that have implemented the VAT, bookkeeping requirements are almost the same. Nevertheless, there are differences in invoicing. In most industrialized countries, invoices are required to be issued for transactions between VAT taxpayers. Most developing and least developed countries that introduce the VAT, by contrast, require some form of invoicing for all transactions on which VAT is charged, including sales to final consumers by using a simplified form of invoice or a cash register receipt. Even though, there are complaints from the side of businesspersons that this adds to VAT compliance costs, most tax authorities in developing countries believe that this is essential for VAT enforcement. In addition, there is a conviction that when traders are required to issue invoices to final consumers they will not understate their sales and in turn gives them an incentive to demand invoices from their suppliers.

The overall impression of experts in VAT is that considerable evasion exists in developing and least developed countries by means of under-reporting of sales, abuse of the credit mechanism (by using falsified invoices), and fraudulent refund claims. Hence, the tool to cope with evasion of VAT is the introduction of a "built-in" checking mechanism of the tax, i.e. Audit of VAT guided by a clear Audit Manual. Developing procedures for comparing data on purchases and sales by various taxpayers is very important. Data processing system with massive cross-checking operations would contribute a lot to VAT auditing. Checks of invoices, particularly to ascertain whether credits against the VAT liability are supported by bona-fide invoices rather than falsified documents have proved useful for detecting taxpayers that merit further investigation.

Even though, countries have the legal and administrative framework, the administration of VAT refunds is a persistent problem. The problem emanates from a widespread of abuse and fraud in filing credits and refunds by taxpayers and exporters and the reluctance of officials to give tax refunds. These have contributed to delay of refunds to exporters, hence, stranded the competitive position of the exporters; and carrying forward of excess credits which erodes the value of capital-goods exemption. This might call for conducting too intensive checks before issuing a refund that might impair the financial capacity of exporters or conducting rapid check for all export refunds coupled with in-depth audits.

Penalties for intentional and severe tax evasion and taxpayer non-compliance with the tax laws are a common tax administration practice in the world. Nonetheless, the types of penalties imposed for violation of VAT legislations differ from country to country. Some countries send violators directly to prison. Others temporarily close the taxpayers' business premises. Some levy stringent fines for failure to register and to file returns on time.

The other part of VAT administration is assessment on VAT execution. This includes identifying taxpayers and tax evaders as well as registered and unregistered taxpayers

among the business community (Abrham, 2005:11). It follows that the concerned tax authorities would take legal measures against people who do not comply with the VAT law, for example, on those who conceal invoices and engage in illicit business transactions. It is not only the authorities, who should be responsible in assessment of execution of VAT but the consumers have also a key role to play.

The human resource element is essential in VAT administration. Trained personnel are what actually most developing economies lack. Most importantly, the effectiveness of a value added tax, like that of an income tax, depends upon efficient administrative audit to ensure taxpayers honesty.

2.2.1 Resource cost (collection cost)

In order to evaluate the administrative capabilities of a system, resource cost associated with the operation of any tax are significant aspect. There are two broad types of resource cost associated with the operation of any tax: *administrative costs* incurred by the tax authorities and *compliance costs* incurred by the taxpayers. Taken together, they are referred to here as *collection costs*.

a. Administrative cost

The most obvious administrative costs are those incurred by the revenue departments in bringing in the tax revenue. It includes salaries and wages of staff at all level, accommodation cost (rent, rates, lighting and cleaning), postage, telephone, printing, stationary, travel, computing and other equipment cost etc. An important problem that arises in studying administrative cost is the limitation on available information. Many countries do not record the detailed component of expenditure or allocate that expenditure to particular tax (IFA 1989 cited in Sanford et. al., 1989:6). To study the administrative cost it is worthwhile to scrutinize its intended purpose or practical tax administration first

b. Compliance cost

compliance cost are defined as those costs incurred by tax payers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given tax structure. They include, for individual, the cost of acquiring sufficient knowledge to meet their legal requirements; of compiling the necessary receipts and other data and of completing tax returns; payment for professional advisers for tax advice; and incidental costs of postage, telephone and travel in order to communicate with the advisers or the tax office. For a business, the compliance cost include the costs of collecting, remitting and accounting for tax on the products or profits of the business and on the wages and salaries of its employees together with the cost of acquiring the knowledge to enable this work to be done including knowledge of their legal obligation and penalties. The existence of uncertainty about the meaning of some aspect of the legislation will generate additional compliance costs (Sandford et. al., 1989:12).

Psychic (psychological) costs, whilst difficult or impossible to measure satisfactorily are an important component of compliance costs. Many people experience considerable anxiety and frustration in dealing with their tax affairs; some employ a professional adviser primarily to reduce this burden of worry. Another source of psychic cost is the anxiety, which may be generated, even for the most honest taxpayers, by a tax investigation.

The above explanation of administrative and compliance cost highlight the difference between taxes in terms of administrative and compliance costs. This helps to identify areas of high compliance costs, to indicate policy-makers the importance of administrative and especially compliance costs, and to provide tax policy-makers with guidelines on how the costs of operating the tax system might be minimized.

2.3 VAT Evasion, avoidance and Compliance

2.3.1 Tax evasion and avoidance

Tax evasion and avoidance are a worldwide phenomenon. The problem is especially acute in transition and developing economies, since they do not have an appropriate

infrastructure in place to collect taxes (McGee and Tyler, 2006:1). Tax avoidance is the legal arrangement of the taxpayer's affairs in order to minimize the tax liability, whereas tax evasion is illegal. Sometimes, however, the borderline between avoidance and evasion can become blurred, a fact that is evidenced by the huge body of anti-avoidance legislation and the development of case law in this area (Nightingale, 2003:44).

2.3.1.1 Tax evasion

Tax evasion involves the intentional disregard of the legislation in order to escape the liability to tax. Tax evasion may be achieved by understating income, overstating expenses, making false claims for allowances or failing to disclose a chargeability tax. Because of its illegal nature, there is little hard evidence as to measure the true extent of tax evasion. Whatever the actual level of evasion, it is likely to be more prevalent when the tax system is perceived to be unfair or levied at confiscatory rates (Nightingale, 2003:44). Tax evasion is illegal and the offender may be liable to prosecution, however, the authorities will usually only resort to criminal prosecution where the case involves substantial amount of lost revenue, many minor cases of tax evasion that are discovered by the revenue are generally steered out of court.

A. The vulnerability of VAT to evasion and fraud

Like all taxes, VAT is subject to evasion. For example, traders may fail to register for the tax, they may under-report sales or, where different goods are subject to tax at different rates, they may reduce their tax payments by misclassifying sales into the category subject to a lower rate (or zero rate) of tax. In some respects, the particular structure of VAT may reduce its exposure compared with other systems of sales taxation. In particular, the gradual accumulation of the tax at each stage of the chain of production and distribution may reduce the amount of tax at stake at each stage, and hence the gains to be made from making untaxed sales. This does not make the VAT 'self-enforcing', as sometimes claimed, but it does reduce its exposure to evasion compared with alternative single-stage sales taxes levied at a comparable rate, such as the retail sales taxes.

In other respects, however, VAT offers distinctive opportunities for evasion and fraud, especially through abuse of the credit and refund mechanism. Revenue may be lost through exaggerated claims for credit for VAT paid on inputs to production. Moreover, the opportunity exists for outright fraud through the construction of business activities with the sole purpose of defrauding the exchequer, because some categories of business can be entitled to net refunds of VAT from the revenue authorities. These can include firms selling predominantly zero-rated goods while claiming credit for significant amounts of VAT paid on standard-rated production inputs. While zero-rated domestic sales can create opportunities of this sort, the main point of vulnerability in the current system arises because of the VAT zero-rating of exports.

B. Determinants of tax evasion

In the standard approach to tax evasion a risk-averse individual chooses either the amount or the share of income to be concealed so as to maximize his or her expected utility of income, considering

- (i) The probability of detection,
- (ii) The penalty tax rate applied when tax evasion has been detected,
- (iii) The marginal tax rate, and
- (iv) The level of true income

All theoretical studies conclude that both the probability of detection and the penalty tax rate will negatively affect underreporting of income (Hennemann 1996: 162). That is, if taxpayers believe the probability of detection is low they will tend to underreport. In addition, if the penalty tax rate applied when tax evasion has been detected is low again taxpayers might tend to underreport. When underreporting is measured by the absolute amount of income concealed, a risk-averse individual experiencing an increase in his or her true income will underreport more.

2.3.1.2 Tax avoidance

A tax such as VAT can be avoided simply by not buying the taxed good or services. The arrangement of an individual's affairs so as to mitigate the liability to tax is tax avoidance, and provided that the taxpayer acts within the framework of the law, tax

avoidance is legal. However, where the activity is within the letter of the law but outside the spirit of the law, the distinction between avoidance and evasion may become blurred (Nightingale 2003:46).

Many forms of tax avoidance are merely tax planning opportunities that exist in the legislation for reducing the liability to tax, for example, choosing the most tax efficient savings and investments, or making sure that all available relief is used to their full advantage. However, loopholes in the legislation also create opportunities for tax avoidance. However, once loopholes have been exploited, the revenue reacts by introducing legislations to close those particular loopholes.

The increasing body of anti-avoidance legislation merely makes the tax system more complicated, detracting from the canon of simplicity even though it has been suggested that 'an economy breathes through its loopholes'. The tax avoidance industry grew to enormous proportions during the 1970s as high rates of tax made the cost of elaborate avoidance schemes worthwhile, supporting the view that 'the existence of wide spread avoidance is evidence that the system, not the taxpayer, stand in need of radical reform.

General anti-avoidance rules have been tried in Australia, New Zealand and Canada with little success, which would indicate that targeted legislation may be more desirable (ibid: 47). However, the policy makers are faced with the dilemma of how wide or narrow anti-avoidance legislation should be; too narrow and it may fail in its objectives, too wide and it may well be applied to situations for which it was not intended. Whatever steps are taken to counter tax avoidance the principles of certainty of taxation would require a definition of legitimate tax planning which may be difficult to frame as 'the boundaries move with public sentiment' with developing financial techniques and with the introduction of new statutory relief. Tax law will always have to address this equation and to determine where the line will be drawn.

2.3.2 Tax Compliance and Voluntary Compliance

Tax compliance can be defined as the degree to which a taxpayer complies (or fails to comply) with the tax rules of his country. It is widely accepted that the goal of an efficient tax administration is to foster voluntary tax compliance using all possible methods including penalties. Penalizing tax evaders or going after delinquent taxpayers are not in themselves the object of tax administration, although it would serve to encourage voluntary compliance if the taxpayers believe that the tax administration can effectively detect and punish noncompliance.

2.3.2.1 VAT Compliance

It is difficult to get an accurate picture, but it is clear that VAT evasion is widespread and involves significant revenue losses, though the extent varies considerably across countries. Webley et al (2002:1) suggests five factors seem likely to be particularly crucial: sanctions and punishments (deterrence), equity, personality, satisfaction with the tax authorities and mental accounting. Each will be considered in turn.

To minimize the gap between the tax reported by taxpayers and the statutory tax, an adequate audit plan should be implemented (Tait, 1991:67). Economic models clearly predict that higher penalties and audit probabilities should discourage non-compliance (Webley et al., 2002:2). Even if both have some deterrence effect, higher audit probabilities probably have more impact than higher penalties

The perceived fairness of a tax system is important both to its acceptability and to smooth functioning. A tax can be seen as unfair in a number of ways: if those of similar incomes are taxed differently, for example or if the government is seen as giving little back in return Cowell (1992 cited in Webley et al. :3).

Webley et al, 2002:1 suggest that some individuals may be characterized by egoistic tendencies, whilst others may exhibit a strong identification with community responsibilities, and thus be less motivated to avoid taxes owed. In other words, the more egoistic an individual, the less likely he, or she will be to comply with rules and laws when compliance conflicts with their interests.

Dissatisfaction with the tax authorities in other ways has also been suggested by a number of investigators as motivators to avoid taxation (for example, Elffers, 1991; Wallschutzky, 1984; Wärneryd & Walerud, 1982). What evidence suggests that believing the system to be inefficient correlates positively with a propensity to evade (Vogel, 1974; Wearing & Heady, 1995 cited in Webley, 2002:3).

How business people think about the VAT money they collect may also influence their behavior towards it: the notion of mental accounting (see Shefrin & Thaler, 1988 cited in Webley et al, 2002:3) may be helpful here. What is interesting in the current context is whether businesspersons psychologically separate monies owed to the VAT into a separate mental account from that of business turnover. If they do not, they may be more likely to try to evade VAT as a result of seeing it as ‘their’ money.

2.3.2.2 Improving Voluntary Compliance

The growing concern of tax administrations throughout the world is on how to simplify the tax assessment system to encourage voluntary compliance, and many countries have adopted the self-assessment system as a solution (SAS). Thus, the recent trend in developing countries sees a shift from the official assessment system to a SAS (Sarker, 2003:2).

Thus, setting up of a simple and broad based tax system is crucial to the development of a better tax administration. Studies have identified the main impediments as the lack of tax education among the taxpayers followed by poor public relation activities and inadequate penalty provisions for errant taxpayers. The need to increase training and improve the working environment of tax officials, as well as establish an information management system are also seen as important factors to be met for better tax administration.

a. SELF-ASSESSMENT SYSTEM (SAS)

In a SAS, a taxpayer is required to assess his tax liability using a tax return form in which he declares his gross income, allowable deductions, etc. This tax return must then be file with the tax authority together with a payment for the tax liability computed in said return. The basic feature of a SAS is that it is the taxpayer rather

than the tax authority that is responsible for the assessment of tax liability. A SAS has distinct merits compared to an official assessment system. The chief merits are: (i) SAS is more cost effective as it only selects exceptional cases for further scrutiny; (ii) SAS eliminates the administrative nature of assessment work, (iii) SAS encourages an early and timely collection of taxes, and, (iv) SAS reduces corruption by reducing contacts with taxpayer.

For a SAS to effectively implement there are certain critical factors that need to be considered:

- (i) The process of deciding which tax returns should be audited is crucial. Taxpayers, who know that they may not be selected for an audit, would be motivated to cheat. A deficient process will also reduce compliance,
- (ii) Under SAS, non-compliance should be dealt with justly and swiftly to encourage the majority of taxpayers to comply. In order to detect fraud or non-compliance, taxpayer data is important and this requires a certain level of computerization. In its absence, it would be extremely difficult to maintain compliance in a SAS,
- (iii) The educational level of taxpayers is crucial in determining whether the SAS will work effectively. There must also be an observance of proper accounting standard of business. For small traders, this means that must be a minimum level of record keeping. In the absence of proper accounting standards or record keeping, a taxpayer would not be able to declare his income accurately or enable the tax authority to conduct an accurate audit.

2.4 Conclusion

VAT is a tax on consumption levied whenever the value of goods and services increase as they change hands in the course of production, distribution, and final sales to the consumers. The value added at each stage of production is the difference between the sellers' cost for material and the selling price. In essence, a VAT is just a general sales tax that is collected at multiple stages.

Even if, the seller pay the government a percentage of the value added at each stage of production, in reality the consumers actually pay the VAT. Ultimately, consumers

carry the burden of the tax because every one else in the process deduct the VAT paid on inputs from the VAT collected on their output when accounting to tax authority. Despite VAT is relatively new form of tax, it is becoming the major tax instruments worldwide. The development of this tax system is so fast that it has now been employed in more than 145 countries and raise around 20 per cent of the world's tax revenue. The global trend to introduce VAT in more countries is continuing.

In order to stimulate economic development and improve the social condition of their citizens, developing countries cannot rely on investment and aid from abroad, but must secure their own financial resources through taxes. In recent years, developing countries searching for additional revenue and/or pressured by business to modernize their sales tax have enacted VAT. Hence, it has been the centerpiece of tax reform in many developing countries. Besides, the IMF also played a significant role in the spread of the VAT in these countries.

VAT has many advantages. The most popular and widely accepted advantage of VAT is its high revenue potential even in poor countries. The other advantage is the reporting mechanism. The report of one taxpayer will allow the tax authority to check the sincerity of the others. In other word, the reporting system embodies a sort of built in anti-evasion mechanism. The additional advantage is its low administrative cost due to its minimum collection costs. The final advantage is VAT allows goods of exporting nations more competitive in the international market. This is because VAT is executed in most countries according to the destination principle.

There are two means of VAT administration, namely the invoice method and subtraction method. The former is the most common means of administering the tax. It is widely accepted that the transaction based invoice credit method provides several advantages such as the ability to deal with different rates and minimize tax evasion by providing an audit trail.

The major activities in a VAT administration are identification and registration of taxpayers, processing returns, controlling collections, making refunds, auditing taxpayers, investigation of tax fraud and evasion, and leaving penalties. Above all, the

human resource element is essential in VAT administration. However, trained personnel are what actually most developing economies lack.

In order to evaluate the administrative capability of a system, resource costs associated with the operation of any tax are significant aspect. There are two broad types of resource costs associated with the operation of any tax: Administrative costs incurred by the revenue authority in bringing the tax revenue and Compliance costs incurred by the taxpayers in meeting the requirements laid upon them in complying with a given tax structure. Taken together, they are referred as collection costs. They highlight the difference among taxes in terms of them, which helps to identify areas of high compliance cost and provide tax policy-makers with guidelines on how the cost of operating the tax system might be minimized.

Tax avoidance and evasion are worldwide phenomena. The former is the legal arrangement of the taxpayers' affairs in order to minimize the tax liability, where as the later is illegal. However, the development of anti-avoidance legislation and case law blurred the borderline between them. In some respect, the salient feature of VAT may reduce its exposure to evasion. In particular, the gradual accumulation of the tax at each stage of the chain of production and distribution may reduce the amount of tax at stake. Nevertheless, this does not mean VAT is self-enforcing rather it does reduce its exposure to evasion compared with alternative single-stage sales tax. In other respect, however VAT offers distinctive opportunities for evasion and fraud, especially through abuse of the credit and refund mechanism. The determinants of tax evasion are: (i) probability of detecting, penalty tax rate applied when tax evasion is detected, marginal tax rate, and the level of true income

Tax avoidance is the legal arrangement of an individual's affairs so as to mitigate the liability to tax, and provided that the taxpayer acts with in the framework of the law.

Many form of tax avoidance are merely tax planning opportunities that exist in the legislation for reducing the liability to tax, for example, choosing the most tax efficient savings and investments, or making sure that all available relief are used to their full advantage. However, loopholes in the legislation also create opportunities for tax avoidance. However, once loopholes have been exploited, the revenue reacts by introducing legislations to close those particular loopholes. The increasing body of

anti-avoidance legislation merely makes the tax system more complicated, detracting from the cannon of simplicity even though it has been suggested that ‘an economy breaths through its loopholes’.

The policy makers are faced with the dilemma of how wide or narrow anti-avoidance legislation should be; too narrow and it may fail in its objectives, too wide and it may well be applied to situations for which it was not intended. Whatever steps are taken to counter tax avoidance the principles of certainty of taxation would require a definition of legitimate tax planning which may be difficult to frame with developing financial techniques and with the introduction of new statutory relief. Tax law will always have to address this equation and to determine where the line will be drawn.

Tax compliance can be defined as the degree to which a taxpayer complies (or fails to comply) with the tax rules of his country. It is widely accepted that the goal of an efficient tax administration is to foster voluntary tax compliance using all possible methods including penalties. Penalizing tax evaders or going after delinquent taxpayers are not in themselves the object of tax administration, although it would serve to encourage voluntary compliance if the taxpayers believe that the tax administration can effectively detect and punish noncompliance.

It is difficult to get an accurate picture, but it is clear that VAT evasion is widespread and involves significant revenue losses, though the extent varies considerably across countries. The five factors suggested by Webley et al (2002:1) seem likely to be particularly crucial: sanctions and punishments (deterrence), equity, personality, satisfaction with the tax authorities and mental accounting.

The growing concern of tax administrations throughout the world is on how to simplify the tax assessment system to encourage voluntary compliance, and many countries have adopted the self-assessment system as a solution (SAS). Thus, the recent trend in developing countries sees a shift from the official assessment system to a SAS.

Therefore, setting up of a simple and broad based tax system is crucial to the development of a better tax administration. Studies have identified the main impediments as the lack of tax education among the taxpayers followed by poor public relation activities and inadequate penalty provisions for errant taxpayers. The

need to increase training and improve the working environment of tax officials, as well as establish an information management system are also seen as important factors to be met for better tax administration.

2.5 Conceptual Framework

This part demonstrates the conceptual framework of the study on VAT compliance. First, literatures on the determinant of VAT compliance are reviewed. Then it shows the four major causes of noncompliance discussed in this study. Finally, it demonstrates the conceptual framework diagram of the study.

According to literatures, the determinant for noncompliance of VAT could be;

- ✓ **Low audit probability:** The lack of an effective audit program undermines the functioning of the entire VAT operations (Ebrill et al. 2001:147). The most obvious consequences of ineffective audits are the deterioration of VAT compliance and loss of credibility of the tax administration (ibid: 148). If the probability of penalty is low, the taxpayer will accept the risk, even if the penalty itself is sizable (Tait, 1991:67). The way to increase the probability of detecting and punishing VAT evaders is to develop a strategy based on broad and swift audit.

Like other taxes, VAT can be evaded. The development of effective audit programs is crucial to increase the risk of being detected and punish those businesses not in compliance with their VAT obligations (Ebril et al 2001:148). If other enforcement system such as the identification of non-filer and the control of delinquent taxpayers works effectively, tax noncompliance will take the form of evasion when audit is weak (Tait, 1991:67). As Edmiston and Bird (2004 cited in Yesegat 2008:153) noted the only real solution to the evasion problem is a good tax administration and, especially, a strong VAT audit program.

A strong VAT audit program needs, among other things, an appropriate audit case selection method. Jantscher (1990 cited in Yesegat 2008:153) noted that cross checking purchases and sales data by various taxpayers would provide an effective tool for selecting VAT taxpayers for audit and hence improve audit results. According to the findings of Yesegat (2008:153), the selection of audit cases by the audit selection committee. The selection criteria include credit

declaration, nil VAT declaration, non-filers, unusual VAT filing patterns, and information obtained from third parties. Cases selected based on the above criteria would be subjected to audit.

Yesegat (2008:154) further noted that the quality of auditors (VAT administrators at large) that appears to be poor coupled with their relatively small number is affecting the effectiveness of the audit program. This is, in turn, likely to impact on the revenue that could be generated through effective audit programs and on the use of effective audits as tools of deterring noncompliance.

The effectiveness of audit should not be measured in terms of its direct revenue yield-that is the amount of additional tax assessed-but the extent to which audit contributes to better tax compliance (Tait 1991:75). Judging the effectiveness of audit by the amount of additional tax assessment is similar to evaluating traffic authority by the fines collected from drivers. Therefore, the audit effort should be evaluated in terms of the quantity and quality of audits conducted and of “voluntary” collections generated.

- ✓ **The perceived fairness of VAT:** The perceived fairness of a tax system is important both to its acceptability and to smooth functioning. A tax can be seen as unfair in a number of ways: if those of similar incomes are taxed differently, for example or if the government is seen as giving little back in return. It is said that one can only govern fairly with the consent of the governed. In taxation, it is equally true that fair taxation requires the consent of the taxed. In particular, a greater dislike than taxation itself is the unfairness, which manifests itself when there is a difference in the tax burden on individuals in similar circumstances, because of the weaknesses of the tax administration. ‘Why should I pay if he doesn’t?’ Cowell (1992) has shown that how a person perceives his own role in influencing the perceived inequity is of central importance and it has been argued that a taxpayer may withdraw from the exchange relationship by evading taxes in order to offset or reduce the disparity. ‘ Public acceptance depends critically on how the public and business communities ‘see the administration’. Is the attitude of the revenue officials, particularly those in the day-to-day touch with taxpayers, reasonable and fair, showing an appreciation that taxation is after all only ancillary to their main interest of successfully promoting their business?.

- ✓ **Individual characteristics:** Weigel, Hessing and Elffers (1998 cited on Webley et al. 2002:3) suggest that some individuals may be characterized by egoistic tendencies, whilst others may exhibit a strong identification with community responsibilities, and thus be less motivated to avoid taxes owed. In other words, the more egoistic an individual, the less likely he or she will be to comply with rules and laws when compliance conflicts with their interests.

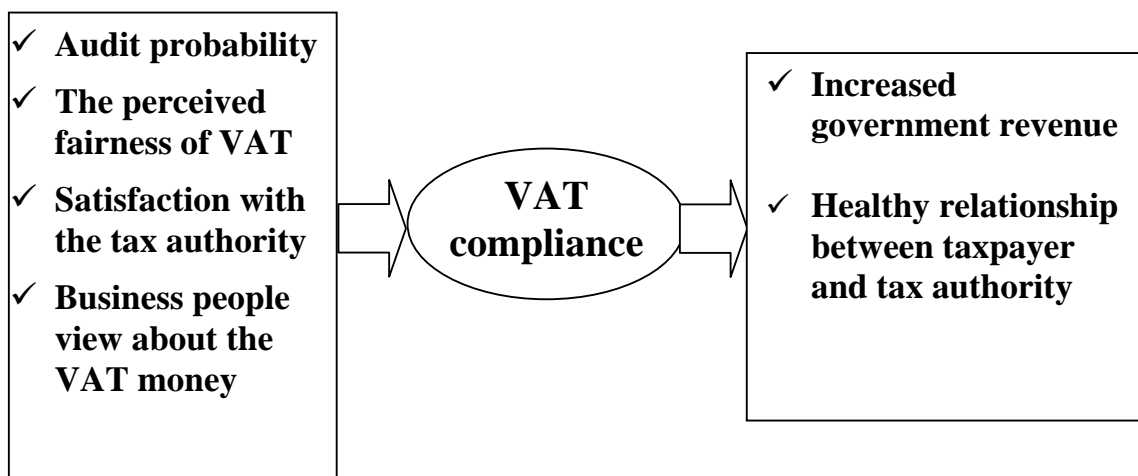
Studies also show attitudes of the citizenry are an important factor in the collection of taxes. A recent study conducted by McGee and Tyler (2006) analyzed gender, age, education, and income level differences in 33 countries related to their view on tax evasion. Their findings suggest that women are more likely to be opposed to tax evasion than men. This confirms the results of some prior studies (Akaah, 1989; Boyd, 1981; Hoffman, 1998). The study also found that older people tend to be more opposed to tax evasion than younger people. The finding is consistent with prior studies that have found that people have more respect for government and for authority, as they get older. Their findings also suggest that people with less education tend to be more opposed to tax evasion than their better-educated counterparts and poorer people tend to more opposed to tax evasion than their wealthier counterparts do.

- ✓ **Dissatisfaction with the tax authority:** Dissatisfaction with the tax authorities in other ways has also been suggested by a number of investigators as motivators to avoid taxation (for example, Elffers, 1991; Wallschutzky, 1984; Wärneryd & Walerud, 1982 cited on Webley et al. 2002:4).
- ✓ **Taxpayer view about the VAT money:** How business people think about the VAT money they collect may also influence their behavior towards it. What is interesting in the current context is whether businesspersons psychologically separate monies owed to the VAT into a separate mental account from that of business turnover. If they do not, they may be more likely to try to evade VAT as a result of seeing it as ‘their’ money.

- ✓ **Malpractice:** Revenue malpractices are the more disturbing because they often arise from an abuse of power given to revenue officers for the purpose of administering and collecting the revenue.

Among the above-mentioned factors for noncompliance, this study focus on (i) audit probability, (ii) the perceived fairness of VAT, (iii) satisfaction with the tax authority, and (iv) business people view about the VAT money.

The model below can be used as a means of depicting the cause of noncompliance at ERCA.



The study attempts to discuss these factors by summarizing the response of the questionnaires and analyzing different data. Besides, the Ethiopian experience is evaluated in connection to these dimensions. Each factor are studied as follows

Audit probability is studied by discussing the data obtained from the three Addis Ababa ERCA branches and the summery of questionnaires and interviews.

The perceived fairness of the tax is studied by analyzing the following four indicators.

- Tax equity
- Fairness of penalty
- The perceived government spending of VAT money
- Incidence of VAT fraud

The degree of taxpayers' satisfaction with the service of the tax authority is also examined by analyzing the response of taxpayers on

- Courteousness of the tax authority
- Efficiency of the tax authority
- Flexibility of the tax authority
- The response on VAT refund

Business people perception about the VAT money is studied by analyzing the response of taxpayers on

- Taxpayer belief on the relationship between VAT money and the business fund
- Taxpayers perception on the equivalent of VAT money to the value added by their business
- Taxpayers perception about their contribution on the tax collection

Prior to discussing each determinant factor, it is worthwhile to discuss first about the VAT administrative practice in Ethiopia. Thus, the following part will deal with it.

Part 3: VAT Administrative Practices in Ethiopia

VAT becomes an indispensable component of tax advice and reforms in developing countries (Goode, 1993 cited in Teffera, 2005:61). Ethiopia's tax reform program has introduced VAT since January 2003. According to the 2008/09 ERCA report, it is becoming the major source of domestic revenue for the country (42%). The report further mentions on July 7, 2009 the VAT registrant reach 22,307 taxpayers in all ERCA's branches and offices.

The Value Added Tax proclamation No. 285/2002 was issued on 4th July 2002 by the council of representatives to become into force as of 1st January 2003. The proclamation has 13 sections and 66 articles. According to this proclamation, taxpayers are those persons registered or required to be registered; persons carry taxable import of good to Ethiopia, non-resident persons who perform services

without registration for VAT and who are subject to taxation accordingly to the proclamation.

According to the proclamation, VAT is levied and paid at the rate of 15 percent of the value under such condition. (i)every taxable transactions by a registered person; (ii)every import of goods other than an exempt import; and (iii)an import of service rendered in Ethiopia for a person registered in Ethiopia for VAT or any resident legal person by a nonresident person who is not registered for VAT in Ethiopia (Article 7(1)(a)-(c) and Article 23(1)).

VAT registration is required by businesses that have annual turnover of Ethiopian Birr (ETB) 500,000 and more. The VAT legislation allows refunds to be made to mainly exporters within two months from the time applications are lodged. Non-exporting taxpayers are required to carry forward excess credits to the next five accounting periods; if there are still unused excess credits it is allowed (at least in the legislation) to be refunded within two months from the time of lodging applications.

The ERCA and the Regional Government's Finance Bureaus administer VAT. Imports are only administered by ERCA. The ERCA with its 10 offices and branches administers federal and joint VAT on domestic transactions, while regional governments' finance bureaus administer their own VAT revenues.

With this overview of the design and administration of VAT in Ethiopia, the following sections present how the tax authorities perform their responsibilities with respect to the major VAT administration tasks, including taxpayer identification and registration, VAT filing and payment, control of VAT filing and payment, VAT invoicing, VAT auditing, penalties and VAT refunds.

3.1 Taxpayer identification and registration

As mentioned above, the VAT legislation requires businesses undertaking taxable activities in Ethiopia with an annual turnover of ETB 500,000 and more to register for VAT. After the VAT was operational with such a registration requirement, the authority devised forced-registration schemes. These schemes include selective

registration requirements that compel all businesses engaged in a specific sector/form of ownership to register for VAT regardless of the level of their annual turnover.

In addition to the sector specific registration requirement, to encourage VAT registration, government institutions are obliged to transact with VAT registered businesses for transactions valued ETB 100,000 and above. These schemes were designed to help the administration in bringing taxpayers (that were required to register but did not do so) into the VAT net. On March 2008, there were about 22,307 taxpayers registered for VAT (ERCA 2009).

3.2 VAT filing and payment

Taxpayers are required to file VAT returns accompanied by the appropriate payments on monthly basis and there is no year-end reconciliation requirement. Further, the VAT legislation allows taxpayers a 30-day period within which to file returns and make payments. Nevertheless, in practice, there are three VAT reporting periods depending on whether a taxpayer is a nil, credit or payment filer. The reporting time from the end of the month is 10 days for nil filers, 20 days for credit filers and 30 days for payment filers. According to tax officials, taxpayers that fail to meet the reduced deadlines would not be fined as long as they report within 30 days from the end of the accounting period. However, such taxpayers would be given verbal warning that if they do not keep the reduced reporting periods, penalty would be applied.

Taxpayers file their VAT returns only by going to the tax office in person. In effecting their payment with VAT liability greater than ETB 1,000 may be required to effect payments with bank certified payment orders (CPOs). The use of CPOs is, in fact, to mitigate the problem of insufficient fund balance that might arise from accepting taxpayers' check.

3.3 Control of filing and payment

Based on experience, using banks to collect VAT has generally been successful, since they are used to receiving payments and handling money (Tait 1991:35). Nevertheless, ERCA is not introducing such a system. In administering VAT in Ethiopia, tax authorities use computer programs, namely: Standard Integrated

Government Tax Administration System (SIGTAS) and Automated System for Customs Data Management (ASYCUDA). The computer programs are used to maintain taxpayer register and process VAT returns. Detection of non-filers seems to be carried out mainly manually. In Ethiopia, every trader is required to renew business license annually with the pertinent offices under the Ministry of Trade and Industry or regional governments. To renew business licenses, traders are required to produce evidence from tax authorities that all taxes have been paid. The tax authorities on their part, before providing the evidence to taxpayers, check if there are delinquent taxes (Yesegat, 2008:152).

3.4 VAT invoicing

In general, the VAT law should prescribe a minimum number of records to be kept. These records, books and accounts should be kept up to date and be available for auditing at any reasonable time (Tait 1991:33). In Ethiopia, the VAT legislation states mainly two things. Firstly, the waiver of traders that have transactions with total consideration not exceeding ETB 10 from the requirement to issue invoices and secondly, simplification of the VAT invoice.

Invoices are being used as a negotiation tool between customers and VAT registered businesses. That is, full VAT is chargeable if a customer needs invoices. Such a practice can jeopardize the use of invoices as a revenue-safeguarding tool. There is also lack of awareness among the society to ask for invoice.

3.5 VAT audit

Among the different audit types, ERCA uses Comprehensive audit, Issue audit and Desk audits. Since, ERCA uses Comprehensive and issue audit jointly, this study also follow the same procedures for data consistency. Now let us see each audit types:

Comprehensive audit

As its name reveals, Comprehensive audit execute without restriction on all the records of the organization. It is generally a check of selected aspects of taxpayers' record. Its goal is to minimize evasion through frequent control checks so that evasion can be quickly identified and penalized. Therefore, during audit, the auditors either could check the whole records of the organization (Comprehensive audit) or selected records (issue audit). Even if, the results of a Comprehensive audit will give better

result and useful to combat compliance risk; it will consume relatively much time. Specially, if the audited organization is very large like Telecommunication or Commercial Bank, the audit will take lengthy time.

Desk audit

Desk audit is done as checking for arithmetic accuracy, calculating ratio from the return data and checking for completeness, and so on. It is conducted in the tax office without discussion with the taxpayers. This activity is essentially clerical and is best automated as far as possible. Desk audit was introduced in ERCA since Ter 1, 2001 E.C. (January 9, 2009) as a campaign form. The aim of the desk audit is to clear the information gap and check the consistency of the taxpayers' report. For instance, if there exists a discrepancy in the sales amount between for the VAT purpose and income tax purpose, a desk audit will be done to correspond the two reports. According to the tax and audit team coordinator of ERCA, it will continue until the authority clears the existing information gaps. An advantage of desk audit over the Comprehensive audit is that an auditor can verify many files. Nevertheless, the desk audit is not replacing the Comprehensive audit, since their ultimate goal is quite different. Hence, this study is deal with the result of comprehensive audit since the compliance behavior of taxpayers is affected by the performance of it.

According to the findings of Yesegat (2008:153), the audit selection committee performs the selection of audit cases. The selection criteria include credit declaration, nil VAT declaration, non-filers, unusual VAT filing patterns, and information obtained from third parties. Cases selected based on the above criteria would be subjected to audit.

Yesegat (2008:154) further noted that the quality of auditors (VAT administrators at large) that appears to be poor coupled with their relatively small number is affecting the effectiveness of the audit program. This is, in turn, likely to impact on the revenue that could be generated through effective audit programs and on the use of effective audits as tools of deterring noncompliance.

3.6 Penalties

As with any tax, compliance with VAT will depend largely on how well taxpayers are informed of their obligations and on how rigorously penalties for noncompliance are

enforced (Tait 1991:38). It is not enough to enact penalties in the VAT law-the penalties must actually be applied. Penalties should be sufficiently high so as to deter evaders.

The VAT legislation proclaims that taxpayers that fail to fulfill the requirements of VAT are chargeable with penalties ranging from financial penalties to imprisonment. The tax authority started enforcing the penalty provisions (including the stricter ones) of the VAT legislation to some extent. For instance, although the legislation in general stipulates a penalty of 5 per cent of the amount of VAT unreported/underpaid, in practice a late filing penalty of ETB 1,000 for each accounting period(month) the tax remained un(der)-reported is imposed. In addition, there are cases where taxpayers convicted of VAT evasion have been fined (both money and imprisonment).

In general, considering that VAT is still young in Ethiopia, focusing on the implementation of strict penalty provisions (like imprisonment of taxpayers) instead of taxpayers' education may have negative impact (Yesegat 2008:154) on the attitude of taxpayers beyond its deterrence effect. Further, the lack of consistency and transparency in administratively imposing the penalty may open a room for corruption.

3.7 VAT refund

Tait (1991:36) has noted that the administration of VAT refunds poses special problem in developing countries. In most of these countries, the legal and administrative framework is such that officials become reluctant to give tax refunds. Taxpayers often have to comply with tortuous procedures to obtain any kind of tax refund.

In Ethiopia, for the purpose of refunds, the VAT legislation categorizes taxpayers into two groups: zero-rated businesses (mainly exporters) and other (non-exporting) businesses. The tax authority makes refunds mainly to exporters in addition to employing voucher system for coffee exporters. Cash refund to non-exporting businesses was made as of February 2007. In addition, refunds claimants in the non-exporting business category are mainly importers that claim have excess VAT credits, which are not being used by carrying forward to the next five accounting periods (months). This was believed to be because at the time of import taxpayers pay VAT based on customs valuation, which is usually more than the price that taxpayers claim

they sell their products. Further, the tax authority is not in a position (in terms of capacity) to administer the refund claims of these taxpayers.

According to Yesegat (2008:156), the high customs valuation usually leads taxpayers, including genuine traders, to report excess VAT credits for a very long time. This in turn results in rejection of taxpayers' accounting records by the tax authorities and determination of taxes due using the customs valuation as a basis. This practice is resulting in higher effective taxation and is against the generally accepted accounting principles legislated to be followed in taxation in Ethiopia.

Further, in connection with refunds, it is important assessing the practices in treating VAT on capital goods. In the Ethiopian VAT system, capital goods are treated in the same way as other merchandise items. Such a custom affects mainly taxpayers that are required to carry forward credit claims including those on capital goods to future periods. This procedure, apart from tying up investors' money for a very long time, is likely to constrain business cash-flows and impact negatively on investment.

Yesegat (2008) estimated VAT administrative costs in Ethiopia in the 2005-06 fiscal year to be in the range of 0.66 to 0.8 per cent of VAT revenue. Further, Yesegat (2008) through comparative analysis with similar estimates in other countries suggested that in Ethiopia VAT administrative costs are at a low level. In this context, the low level of VAT administrative costs in Ethiopia together with the administrative problems presented previously suggests that the tax authorities are not equipped with the necessary facilities (human and material).

In addition to the administrative tasks and the availability of resources, VAT administration is concerned with the issue of who should administer the tax. In Ethiopia, the VAT legislation entrusts the responsibility of administering VAT to the federal government. Accordingly, until September 2004, the federal government's revenue organs (the EFIRA and ECA) were administering VAT. However, since September 2004, the EFIRA has delegated to regional governments the administration of VAT for sole traders residing in their respective jurisdictions revealing the trend in decentralizing the VAT administration. Besides, since 2009 the EFIRA and ECA became one authority (ERCA).

3.8 Conclusion

The major VAT administration activities are more or less similar worldwide. This might be the fact that VAT is introduced with the advice of IMF. Hence, the major VAT administration activities in Ethiopia are like the rest of the world except differences in the details. The VAT administration requires the introduction of VAT rate and threshold level. In this regard the Ethiopian Value added tax proclamation states business with annual turnover of 500,000 (ETB) and above are required to register for VAT and the VAT rate is 15 percent uniform rate of every taxable transactions. However, to bring those businesses who try to avoid their tax obligation using different tax avoidance mechanisms into the tax net, ERCA obliged to amend its directives over time. For instance, after the VAT is operational the authority devised forced registration schemes. The scheme requires all business engaged in a specific sector/form of ownership to register for VAT regardless of their level of annual turnover. In addition to this, the government institutions are obliged to transact with VAT registered business for transactions valued ETB 100,000 and above.

Concerning VAT filing and payment, taxpayers are required to bring their VAT returns to the tax offices in person. Besides, in effecting payment of more than ETB 1,000 taxpayers are required to effect payment with CPO. Both procedures increase taxpayers' compliance costs and create inconvenience especially when the deadline approaches.

Even though, the authority installs SIGTAS and ASYCUDA computer programs, filing and payment control are carried out manually. On top of this, business license renewal is used as a mechanism of control. Hence, both pave a way for malpractices. To make the tax collection impersonal and avoid the possibility of malpractice ERCA needs to use these computer systems more efficiently.

Regarding invoicing, except for a transaction of less than ETB 10, the VAT legislation requires taxpayers to issue invoice. However, due to lack of awareness among the society to ask for invoice there exists a problem in the strict implementation of the legislation.

Despite ERCA use comprehensive and desk audit, recently ERCA rely more on the desk audit. This results poor audit performance. Besides, the large taxpayers are given more priority in the comprehensive audits. Moreover, the poor quality of auditors coupled with their relative small number affect the effectiveness of the audit program.

Penalty is one aspect of VAT administrations to bring voluntary compliance. However, it should not be taken as the only one. However, in recent time the tax authority inclined to use penalty as a major means of tax administration. Considering that VAT is still young in Ethiopia, focusing on the implementation of strict penalty provisions (like imprisonment of taxpayers) instead of taxpayers' education may have negative impact on the attitude of taxpayers beyond its deterrence effect. Further, the lack of consistency and transparency in administratively imposing the penalty may open a room for corruption.

Finally, in connection with refunds, it is the most inefficient and problematic part of VAT administration in Ethiopia. This coupled with the custom valuation practice in the country, resulting in higher effective taxations and a practice which is against the intention of the legislation. Besides, it is important to reconsider the practice of VAT on capital goods. In the Ethiopian VAT system, capital goods are treated in the same way as other merchandise items. Such a custom affects mainly taxpayers that are required to carry forward credit claims including those on capital goods to future periods. This procedure, apart from tying up investors' money for a very long time, is likely to constrain business cash flows and influence investment negatively.

In short, all the above problems pertaining to the administration of VAT in Ethiopia may be due in part to insufficient resources. It is therefore important to briefly assess the resources available for the administration of VAT in Ethiopia. In this respect, Yesegat (2008) estimated VAT administrative costs in Ethiopia in the 2005-06 fiscal year to be in the range of 0.66 to 0.8 per cent of VAT revenue. Further, through comparative analysis with similar estimates in other countries suggested that in Ethiopia VAT administrative costs are at a low level. These low VAT administrative costs, as Jantscher (1990) contended, may not imply simplicity, but may show rather that important functions are being neglected and also may mean that the administration is concentrating exclusively on the largest taxpayers and ignoring the

others. In this context, the low level of VAT administrative costs in Ethiopia together with the administrative problems presented a major challenge. The relatively low level of VAT administrative costs appears to have contributed to the tax authorities' inability to implement the VAT legislation fully. As Bird (2005) noted the existence of a fundamental gap between the institutional requirements for a good VAT administration and the real fiscal institutions in place in a country is one of the factors contributing to the poor and unfair performance of VAT.

In general, the apparently low level of VAT administrative costs in Ethiopia, boil down to the importance of accessing sufficient resources and equipping the tax administration with a sufficient number of skilled personnel and physical resources. It is hence important that the government consider the possibility of recruiting and retaining a sufficient number of qualified VAT administrators. This can be achieved mainly through making revenue authorities autonomous in terms of setting better employee benefit schemes. Of course, increasing the resources by itself would not create effective VAT administration overnight. As Bird (2005) emphasized, enhancing tax administration takes time. However, this does not mean that tax authorities should be devoid of the required resources. Tax authorities need both adequate resources and sufficient political support to enable them to do their essential jobs (Bird 2005). The additional VAT administrative costs may be financed with revenues that could be generated through enhanced administration. Enhanced tax administration that is partly possible through equipping the administration with the necessary facilities is likely to generate more revenue in a fairer manner.

In addition to the administrative tasks and the availability of resources, VAT administration is concerned with the issue of who should administer the tax. In Ethiopia, the VAT legislation entrusts the responsibility of administering VAT to the federal government. Accordingly, until September 2004, VAT was being administered by the federal government's revenue organs (the EFIRA and ECA). However, since September 2004, the EFIRA has delegated to regional governments the administration of VAT for sole traders residing in their respective jurisdictions revealing the trend in decentralizing the VAT administration. Besides, since 2009 the EFIRA and ECA became one authority (ERCA).

Part 4: Analysis of the relationship between tax compliance and VAT administrations

INTRODUCTION

This chapter present data collected through questionnaire and data's from archives. It also includes the analysis and interpretation of the data collected. For the purpose of this paper, the analysis is restricted to survey questions designed to obtain information about the research questions and other primary information exclusively collected by the researcher and attached to this study as annex.

The survey was conducted by distributing questionnaire to VAT registered taxpayers at ERCA (Large taxpayer office, Eastern Addis Ababa branch, and Western Addis Ababa branch). The questionnaires consisted of 14 questions; all answered on a five-point scale from strongly agree to strongly disagree. Two questions which can be answered with a simple tick and one final question, which is open-ended if they have anything to say or add. The instrument was given by Amharic to avoid language barriers and minimize responses bias due to misunderstanding.

The questionnaires were distributed to 300 VAT registered taxpayers who came to the tax authority for monthly VAT reporting purposes during the month of 'Yekatit' (Feb/march). Out of 300 questionnaires, 196(66.67 per cent response rate) were filled and returned. The data presentation is done in such a way that the response questions and data are grouped according to the respective research questions. In view of that, the responses are presented as follows.

4.1 Audit probability

The lack of an effective audit program undermines the functioning of the entire VAT operations (Ebrill et al. 2001:147). The most obvious consequences of ineffective audits are the deterioration of VAT compliance and loss of credibility of the tax administration (ibid: 148). If the probability of penalty is low, the taxpayer will accept the risk, even if the penalty itself is sizable (Tait (1991:67), Ebrill (2001:148)). The way to increase the probability of detecting and punishing VAT evaders is to develop a strategy based on broad and swift audit. Likewise, according to Webley (2002:2), the evidence suggests that though both higher penalties and audit probabilities have some deterrence effect (Andreoni, Erard & Feinstein, 1998), higher audit probabilities

probably have more impact than higher penalties (Hessing, Elffers, Robben & Webley, 1992).

Like other taxes, VAT can be evaded. The development of effective audit programs is crucial to increase the risk of being detected and punish those businesses not in compliance with their VAT obligations (Ebril et al 2001:148). If other enforcement system such as the identification of non-filer and the control of delinquent taxpayers works effectively, tax noncompliance will take the form of evasion when audit is weak (Tait, 1991:67). To minimize the gap between the tax reported by taxpayers and the statutory tax, an adequate audit plan should be implemented.

The VAT audit plan should provide for a broad coverage of taxpayers. Most tax administration experts agree that, by international standards, an effective VAT audit program should provide for a 25-30 per cent coverage of tax payers each year (Ebrill et. al 2001:147).

Owing to this, if we look at the performance of the three Addis Ababa ERCA branches during the year 2008/09, only very few (4.8%) audits were performed. The following table shows these details.

Table 4: Comprehensive audit performance at the three Addis Ababa branch

Details	Western	LTO	Eastern	Total
VAT registered tax payers	9282	514	7067	16863
Audited VAT Payers	236	121	452	809
Per cent of audited files	2.5	23.5	6.4	4.8
VAT resulted from Audit	55,001,220.30	584,334,207.44	29,490,135.14	668,825,562.88
Penalty resulted from the audit	16,126,394.18	659,772,387.56	15,891,226.94	691,790,008.68
Interest resulted from the audit	62,765,900.14	1,071,232,721.6	5,436,283.04	1,139,434,904.82
Total (VAT + Penalty + interest)	133,893,514.6	2,315,339,316.6	50,817,645.12	2,500,050,476.38
The per cent of VAT from the total	41	25.25	58	26.75
The ratio of penalty from the total	12	28.50	31	27.67
The ratio of interest from the total	47	46.25	11	45.58
Total	100	100	100	100
Total tax collected	1,506,820,000	7,346,940,000	1,099,320,000	9,953,080,000
Portion of VAT out of the total	633,316,446	3,087,918,882	462,044,196	4,183,279,524
Per cent of VAT by the audit	21.14%	74.98%	11%	59.76

Source: Summery of annex

In table 4 above if we look at the Western Addis Ababa branch column, out of the branch's total taxpayers only 2.5 per cent have been audited. Compared to the international standard this is extremely low level of execution. Nevertheless, the branch's 21.14% of VAT revenue was generating from this very small portion of audited files. This shows that if the number of audited files were increased, the branch's VAT revenue would also increase.

The other branches also confirm similar results. In the large taxpayer's office, though the audited files are close to the international standard (23.5%), yet out of these portions of audited files 74.98% of VAT were collected. In the Eastern Addis Ababa Branch only 6.4% taxpayers have been audited, and out of it around 11 per cent of the total tax is collected. Again, this is also very low-level audit performances. Hence, the audit probability at ERCA is very low and the larger portions of the VAT revenue are generated from this small portion of audit performance. This shows taxpayers are not voluntarily comply and accept the risk because of the low level of audit probability.

Furthermore, the penalties and interest exhibits even more results that need to be investigated. From the sum of VAT collected in western Addis Ababa Branch 12% and 47% were collected as penalty and interest respectively. In the Large Taxpayers Office 28.5% and 46.5% were collected as a penalty and interest respectively. In Western Addis Ababa Branch 31% and 11% were collected as a penalty and interest respectively. The amounts collected via audit (the proportion of penalty and interest) suggest the existence of high noncompliance problem.

According to Tait (1991:67) to maximize the effect of audit the large share of audit should not be devoted to the audit of large taxpayers. Large taxpayers are unlikely to engage in gross evasion, such as making uninvoice sales or falsifying the value of their inventories (among other reasons, their own organization and accounting system would not permit this). Therefore, total collections may increase more if auditing is directed to medium and small taxpayers, because of its positive effect on the compliance level of taxpayers in general. The study conducted by Tait (1991) proofs, total VAT revenue has increased considerably where the audit strategy has been changed to cover medium and small taxpayers. With this in mind if we look at the audit performance of the three branches, the larger share of the audit is devoted to the

Large Taxpayers Office (Western branch 2.5 per cent and Eastern branch 6.4 percent and LTO 23.5 percent audit coverage). Hence, to maximize the audit results, ERCA needs to increase the audit coverage in the other branches too.

Generally, all the above indicates by increasing the audit probability and focusing on medium and small taxpayers the authority can increase its revenue substantially and ultimately increase taxpayer's compliance. Moreover, compared to other type of tax, VAT fraud is relatively easy to identify and the information of VAT is helpful for the assessment of other taxes. When significant underreporting is detected during a VAT audit, the case should be transmitted to other taxes. Hence, VAT audits need to be closely coordinated with audits of other tax liability (especially income tax) (Ebrill et al. 2001:147). This is to say that any gain on VAT has a multiplier effects. Therefore, the authority requires working a lot to increase the audit probability.

Moreover, as shown on table 5 among the 168 respondents who cite which VAT administration practice must be improved, 57 respondents (33.93% response rate) identified the audit practice and necessitate the authority to made more progress.

Table 5: Problematical area identified by taxpayer

Response	Total respondent	Frequency	Percentage
Registration	168	19	11.31
Audit	168	57	33.93
Refund	168	52	30.95
Penalty	168	92	54.76

Source: questionnaire

Again, as indicated on table 6 below among those 62 respondents who are willing to answer the open question, seven respondents mention problem related to VAT audit. These problems are; the authority is not regularly auditing their business, auditors' ethical problem, auditors' capability problems, and tax audit is performed based on custom valuation rather than their records.

Table 6: Summery of open question

Problematic area	Total respondent	Frequency	Percentage
Registration	62	7	11.29
Audit	62	7	11.29

Source: questionnaire

Some of the respondents further states to tackling this problem, the authority has to enhance the dependability of external auditors. In today's world, the authority cannot continue to perform all activities alone. Other stakeholders must also share part of its job. In this regard, certified auditors can be used as partners in building a voluntary compliance society. Therefore, enhancing both the authority as well as the external auditors' capacity should be given priority. Furthermore, to fill the existing information gap besides the desk audit the authority should get the society's support. In lieu of this, the authority needs to create a mechanism to encourage those who blew the whistle on VAT fraud. Some of the respondents also insist if the authority is creating such a mechanism they believe more compliance is achieved.

4.2 The perceived fairness of VAT

The perceived fairness of a tax system is another important factor both to its acceptability and to smooth functioning. A tax can be seen as unfair in a number of ways: if when there is a difference in the tax burden on individuals in similar circumstances, or if the government is seen as giving little back in return. In taxation, it is equally true that fair taxation requires the consent of the taxed. The perceived inequity is of central importance and it has been argued that a taxpayer may withdraw from the exchange relationship by evading taxes in order to offset or reduce the disparity (Webley et al. 2002:3).

Table 7 summarizes the responses concerning the perceived fairness of tax. In particular, it shows the believes of the taxpayers on the similarity of the tax burdens on similar incomes, the fairness of the penalty on VAT evaders, government spending of the VAT money, and finally the existence of VAT evasion in their area of business.

Table 7: Summary of responses on the perceived fairness of VAT

Item	Description	Response	Frequency	Per cent
A	Are those of similar incomes taxed similarly?	Strongly agree	13	6.7
		Agree	29	14.9
		Neutral	66	34.0
		Disagree	44	22.7
		Strongly disagree	42	21.6
		total	194	100
B	Do you believe the penalty on VAT fraud is reasonably fair?	Strongly agree	22	11.8
		Agree	51	27.3
		Neutral	52	27.8
		Disagree	34	18.2
		Strongly disagree	28	15
		total	187	100
C	Is the government spending the VAT money on projects to expand and develop the business activities?	Strongly agree	32	16.9
		Agree	39	20.6
		Neutral	80	42.3
		Disagree	21	11.1
		Strongly disagree	17	9
		total	189	100
D	Are there incidences of VAT fraud in your line of business?	Strongly agree	18	9.4
		Agree	21	10.9
		Neutral	40	20.8
		Disagree	45	23.4
		Strongly disagree	68	35.4
		total	192	100

Source: Questionnaire

A. Similarity of the tax burdens on similar incomes

When there is a difference in the tax burden on individuals in similar circumstances, taxpayers may withdraw from the exchange relationship by evading taxes in order to offset or reduce the disparity. In this regard, the response for the above-mentioned question is important on determining compliance.

Table 7 shows that only few people (N=42, 21.6%) strongly agree and agree, a great number (N=60, 34%) seems to be unsure, and most people (N=86, 44.3%) strongly disagree and disagree that those of similar income are taxed similarly. Since the majority of the respondents are either disagreeing or neutral, one can detect that, there is a problem of perceived fairness in the tax system. Besides, as indicated on table 5 out of 168 respondents 19 (11.31% response rate) exhibit a problem on VAT registration. Likewise as shown on table 6, out of the 62 open question respondents 7 (11.29%) express, those who should be registered for VAT are not registered while

those who should not be registered. This is a very critical problem that needs to be addressed. Unless this perceived inequity is properly addressed, great dissatisfaction is likely to be aroused among the majority of conscientious taxpayers. Furthermore, more of them will incline to become less compliant and join the rank of evaders.

B. Fairness of the penalty

As with any tax, compliance with VAT will depend largely on how well taxpayers are informed of their obligation and on how rigorously penalties for noncompliance are enforced (Tait, 1991:38). Penalties should be sufficient high to deter evaders but do not require to create anxiety and frustration in dealing with their tax affairs. Therefore focusing on the implementation of strict penalty provisions (like imprisonment of taxpayers) instead of taxpayers' education may have negative impact (Yesegat 2008:154) on the attitude of taxpayers beyond its deterrence effect. Hence, if taxpayers believe the penalty on VAT fraud is unfair it will have an impact on their compliance behaviors.

For the response of this question, 73 (39.1%) respondents agree and strongly agree, 52 (27.8%) seems to be neutral and 62(33.2%) are disagree and strongly disagree that the penalty on VAT fraud is fair. Here again, out of the 168 respondents' 92 (54.76%) wants the VAT penalties to be revised. The responses imply that there exists a problem of perceived fairness at ERCA. Therefore, the authority should make the VAT penalty up to taxpayers' expectation and/or before implementing strict penalty, the authority should first devote on taxpayers education.

C. Perceived government spending of the VAT money

If the government is seen as giving little back in return the tax can be seen as unfair. The responses of this question illustrate this. On this question, 71(37.5) respondents agree and strongly agree, the majority (N=80, 42.3%) seems neutral and, 38(20.1%) disagree and strongly disagree that the government spend the VAT money on projects helpful to expand and develop their business activities. On the response, the majority of the respondents are either disagree or neutral which means they have problems on the perceived fairness of the tax system. This means the majority of taxpayers did not

believe that the tax is for their own interest. This has a direct relation with their compliance behavior and needs to be addressed.

D. Incidences of VAT fraud

If, VAT fraud exists in their line of business, taxpayer will tend to be noncompliance. The question of “why should I pay” comes when such a feeling is prevails. This question is asked to get taxpayers response on this.

For this question only few people (N=39, 20.3%) strongly agree and agree, some 40(21.8%) respondents are neutral and, most people (N=113, 58.8%) strongly disagree and disagree that there is incidence of VAT fraud in their line of business. This response seems relatively encouraging since most people have the feeling that there is no incidence of VAT fraud in their line of business. That is they do not have a problem of ‘why should I pay?’

As a summary, taxpayer compliance is directly related to their perceived fairness of the tax system. The perceived fairness of the VAT is determined by the similarity of tax burden among similar taxpayers, the perceived fairness of the penalty on VAT evaders, governments’ pending of the VAT money, and the prevalence of VAT evasion in their area of business. By analyzing the taxpayer response, the study attempts to discuss all the mentioned factors.

The study found that the first three are more important in explaining the perceived fairness of VAT at ERCA. Regarding the similarity of the tax burden, the majority of the respondents (78.3%) are either disagree or neutral that those of similar incomes are taxed similarly. About the response on the fairness of the penalty, the majority of the respondent (61%) are disagree or neutral that the penalty on VAT fraud is reasonably fair. Concerning governments’ spending of the VAT money, on a similar way, the majority of the respondent (62.4%) are disagree or neutral that the government is spending the VAT money to expand and develop the business activities. Nevertheless, regarding incidence of VAT fraud the majority of taxpayers (58.8%) have the feeling that there is no incidence of VAT fraud in their line of business. Hence, incidence of VAT fraud is not the cause of noncompliance.

Generally, all the response under the perceived fairness except the last one suggests the existence of a perceived fairness problem at ERCA. To bring voluntary compliance at ERCA, these factors need to be addressed. That is, the government

should spend the VAT money for the taxpayers' interest, the tax base need to be broadened and bring all those concerned in to the tax net, enhance the taxpayers' perception on the fairness of the system, and shape the society's attitude towards taxation through education and massive awareness creation work. The last one is more important because 67% of the respondent requests, the authority should give them awareness trainings.

4.3 Satisfactions with the service of tax authority

Dissatisfaction with the tax authorities in other ways has also been suggested by a number of investigators as motivators to avoid taxation (for example, Elffers, 1991; Wallschutzky, 1984; Wärneryd & Walerud, 1982 cited on Webley et al. 2002:4). Dissatisfaction depends critically on how the public and business communities 'see the administration'. The attitude of the revenue officials, particularly those in the day-to-day touch with taxpayers, should be reasonable and fair, showing an appreciation that taxation is after all only ancillary to their main interest (successfully promoting their business). Adams (1996) and Van Giels and Elffer (1998) cited on Webley et al. 2002:16) showed that how tax authorities behave towards their clients does matter and this study tries to confirm this at ERCA.

Table 8 shows the taxpayers' perception on the service given by ERCA. In particular, it shows the belief of the taxpayer on whether the tax authority is courteous, efficient, and flexible. In addition, about the VAT refund.

A. Courteousness of the tax authority

Courteousness explains the respectfulness of the tax official to the taxpayer. It determines how the tax authority behaves towards their clients. If the tax authority is not courteous, taxpayers will be reluctant to present at the tax authority and met their obligations. Thus, it is one of the central questions in determining taxpayers' satisfaction and ultimately taxpayers' compliance behavior.

The responses of this are presented as follows. The respondents felt that the tax authorities are courteous (N=51-26.7% strongly agree and N=100-52.4% agree with this). Where as some (N=32-16.7%) respondent are disagree that the authority is

courteous. This response seems encouraging. At least this study cannot confirm, as this is a major cause for noncompliance at ERCA.

Table 8: Summary of the response on the taxpayer's satisfaction

Item	Description	Response	Frequency	Per cent
A	Do you believe the tax authority is courteous?	Strongly agree	51	26.7
		Agree	100	52.4
		Neutral	8	4.2
		Disagree	19	9.9
		Strongly disagree	13	6.8
		total	191	100
B	Do you believe the tax authority is efficient?	Strongly agree	53	27.3
		Agree	87	44.8
		Neutral	13	6.7
		Disagree	30	15.5
		Strongly disagree	11	5.7
		total	194	100
C	Do you believe the tax authority is flexible?	Strongly agree	35	18.8
		Agree	65	34.9
		Neutral	31	16.7
		Disagree	36	19.4
		Strongly disagree	19	10.2
		total	186	100
D	Do you get fast response on VAT refund request?	Strongly agree	23	12.4
		Agree	51	27.6
		Neutral	45	24.3
		Disagree	37	20.0
		Strongly disagree	29	15.7
		total	185	100

Source: Questionnaire

B. Efficiency of the tax authority

Efficiency signifies how fast and quality services are delivered by the tax authority. If the tax authority is not efficient, even those delinquent taxpayers will refrain to meet their obligations. Hence it is one of the central questions in determining taxpayers satisfaction and their compliance behavior.

The responses in regard to efficiency are presented as follows. As indicated in table 6, the respondent felt that the tax authority is flexible (N=53-27.3% strongly agree and N=87-44.8% agree with this). Where as only some (N=41-21.2%) respondents are

disagree with this. These responses also seem encouraging but 21.2% is not small fraction.

On the other hand, when taxpayers give their opinion on the level of the service provided at ERCA, they give a differing response. As indicated on table 6 out of the 62 respondents who give additional answers, 21 respondents give their opinion on the level of the service at ERCA and this presented as follows.

Table 9: The response on the level of service at ERCA

Description	Very satisfied	Good	Unsatisfied	Total
Frequency	9	8	4	21
Percent	42.85	38.1	19.05	100

Source: Questionnaire

As table 9 suggests, nine (42.85%) respondents agree the service is up to their expectations, eight (38.10%) respondents want the service to be further improved, and four (19.05%) respondents are very unsatisfied with the ERCA's service. This response suggests that the satisfaction rate seems fair but needs more effort to improve. Since, among other factors taxpayer compliance related to their satisfaction level the authority needs to progress the service.

Most respondents felt dissatisfaction during sending returns and payments. In this respect, the authority needs to modernize these activities to the extent possible. As mentioned in the literature review, experiences suggest, using bank to collect VAT has generally been successful, since they are used to receiving payments and handling money. Here in our country too, the Addis Ababa city administration's revenue authority uses the bank for other type of taxes. Therefore, ERCA needs to consider the use of banks to enhance taxpayers' satisfaction. Moreover, many countries introduce eVAT service to submit its returns online rather than bringing them personally. Here also the authority needs to see the possibility of introducing eVAT service in the country. If such a service are possible to introduce, besides enhancing the service of ERCA it will also reduce the contact of taxpayers with tax officials and eventually decrease the possibility of malpractices. More over, some respondent for the open question mentioned to attract foreign investors the authority needs to advance its service up to the international level.

C. Flexibility of the tax authority

This is another central question in determining taxpayers' satisfaction. Flexibility pertains how far the tax officials will opt to understand and resolve the taxpayers' problem. In another word, if the tax officials are not flexible enough they will abide themselves with the accustomed procedures and might not be interested to hear any protest from the taxpayers. Hence, taxpayers are reluctant to present their case to the authority. Instead, they will tend to solve their problem by not complying. The response for this question is as follows. The respondent felt the authority is not that much flexible (N=100-53.7% agree, N=31-16.7% remain neutral and N=55-29.6% disagree that the tax authority is flexible). This response suggests the authority needs to be more flexible. The tax officials must be empowered and given proper training to handle taxpayers' request.

D. The response on VAT refund request

Tait (1991:36) has noted that the administration of VAT refunds poses special problems in developing countries. In most of these countries, the legal and administrative framework is such that officials become reluctant to give tax refunds. Taxpayers often have to comply with tortuous procedures to obtain any kind of tax refund.

The response suggests that only 74(40%) of the respondents agree that they will get fast responses on VAT refund. Besides, out of 168 respondents, 52 (30.95%) respondents' needs the refund to be more responsive.

As a summary, taxpayers' compliance is directly related to their satisfaction level of the service provided by the tax authority. This is again determined by how the tax authority is courteous, efficient, flexible, and prompt to give refund. By analyzing taxpayers' response, this study attempts to discuss all the mentioned factors. Accordingly, the study found that courteousness is not a major cause of noncompliance at ERCA. Nevertheless, the efficiency of the authority might be taken as a factor of noncompliance at ERCA and a lot has to be done to improve it. Particularly, the report and payment activities need to be modernizing to the extent possible. The respondent felt that the authority is not that much flexible and the tax officials need to be more qualified and empowered. VAT refund is the most

problematic are in the service given by ERCA. Like other developing countries, VAT refund poses a major challenge to the tax authority. Refund is the most salient feature of VAT. ERCA needs to create a mechanism to enhance the refund practices. Generally, except courteousness the remaining three factors are the major causes of noncompliance at ERCA that require ERCA's attention.

4.4 Business people perception about the VAT money

How business people think about the VAT money they collect may also influence their behavior towards it. What is interesting in the current context is whether businesspersons psychologically separate monies owed to the VAT into a separate mental account from that of business turnover. If they do not, they may be more likely to try to evade VAT because of seeing it as 'their' money (Webley et al 2002:3).

Table 10 summarizes the response given to the above-mentioned question. In particular, taxpayer's believe on the VAT money, the amount of VAT money, and their contribution on VAT collections.

A. Taxpayers' belief on the relationship between VAT money and the business fund

If the taxpayers are not psychologically separate monies owed to the VAT from that of business turnover, they may be more likely to try to evade VAT because of seeing it as 'their' money. Hence, this is one of the important factors in determining VAT compliance. To get an explanation on this, taxpayers' were asked about their perception when they effect VAT payment. The response is as follows.

A large portion of the respondents disagree (N=128, 69.2%) that the VAT money is coming from their business fund. Only 42(22.7%) agree that they thought of the VAT as coming from their business funds. 15(8.1%) remain neutral. This shows the majority of the taxpayers have no problems in differentiating between the VAT money and their business fund. However, 22.7% is not a small amount and some awareness must be given to the taxpayers.

Table 10: Summary of Taxpayer perception on VAT and VAT money

Item	Description	Response	Frequency	Per cent
1	When I send of my check to the tax authority, I think of the money as coming from my business fund.	Strongly agree	16	8.6
		Agree	26	14.1
		Neutral	15	8.1
		Disagree	54	29.2
		Strongly disagree	74	40
		total	185	100
2	I believe the VAT payment is equivalent to the value added by my business.	Strongly agree	36	20
		Agree	65	36.1
		Neutral	37	20.6
		Disagree	32	17.8
		Strongly disagree	10	5.6
		total	180	100
3	When I pay VAT I fell as if I help the government on tax collection.	Strongly agree	108	56
		Agree	62	32.1
		Neutral	8	4.1
		Disagree	8	4.1
		Strongly disagree	7	3.6
		total	193	100

Source: Questionnaire

B. Taxpayers' beliefs on the equivalence of the VAT payment to their business fund value added.

If taxpayer belief their VAT payment is not equivalent to that of the value added by their business, they will consider their VAT payment will erode their business fund. If they believe so, they may be more likely to try to evade VAT. This is also one of the determinant factors of VAT compliance. The response on this presents as follows.

For the question on the equivalent of VAT payment to the value added by the business 101 (56.1%) people agreed and 42(23.4%) disagree and 37 (20.6%) are remain neutral. Here also, though great portions of the taxpayers are accepting the VAT principle, a lot has to be done on those 23.4% and 20.6% taxpayers.

C. Taxpayers' perception about their contribution on the VAT collection

Taxpayers' awareness on their contribution during the VAT collection will determine their thought about the VAT money. If they do not have a clear understanding about it, they will tend to evade VAT because of seeing it as 'their' money. Hence, the reaction on this is important in explaining taxpayer compliance.

A large portion of the respondent agree (N=170, 88.1%) that they are helping the government on tax collection and only 15(7.7%) disagree with this. This one is the most encouraging response and demonstrates the taxpayer's better knowledge on VAT collection.

Generally, the response concerning the taxpayer perception on VAT and VAT money shows, taxpayers have healthier understanding about VAT in general. However, the response of item (a) and (b) further implies the authority is still requiring to enhancing the awareness of the taxpayers. When taxpayers' awareness is enhanced, the society's attitude towards taxation will also improve. As the response for open ended question demonstrate this could achieve through education and massive awareness creation work. A continuous and in depth education and awareness about tax in general and tax compliance in particular must be given for all who are studying from the kindergarten up to universities as well as for all the society at large. Specially, the newly registered taxpayers have to be given proper guidance and education.

Conclusion

To study causes of noncompliance at ERCA, four factors are discussed in this chapter. The study found that audit probabilities, the perceived fairness of VAT, and satisfactions with the service of the tax authority are the three major factors in explaining taxpayers' compliance behavior on VAT. At least in this study business people perception about the VAT money is not a major cause of noncompliance at ERCA. Nevertheless, some concern must be given in this regard too. The study attests that if correction measures are taken about the three major factors, tax compliance can be enhanced and ultimately government revenue also increased.

Part 5: Summery and Conclusion

The study by focusing on specific issues of tax administration examines the link between tax administration and VAT compliance. The study conducted by distributing questionnaires to VAT registered taxpayers at the three Addis Ababa ERCA branches. Besides, both primary and secondary data's are used.

The literature review of this study shows that noncompliance is a major problem faced by countries that introduced VAT. Tax compliance is the degree to which a taxpayer complies (fail to comply) with the tax rules of her/his country. In some respect, the particular structure of VAT may reduce its exposure to evasion; in other respect, however, VAT offers distinctive opportunities for evasion and fraud, especially through abuse of the credit and refund mechanism.

Ethiopia has introduced VAT beginning from January 2003 as a replacement for sales tax. According to the value added tax proclamation No. 285/2002, the VAT is levied and paid at the rate of 15 per cent of the value. VAT is the principal source of revenue for the Ethiopian government. Over the past years, the revenue generated with VAT shows improvements, but the introduction of VAT has posed a major challenge to revenue administration in Ethiopia, which is the growing compliance risk.

Noncompliance is usually caused by various factors including weakness in the VAT administration practice. The study argued that there is a link between tax administration and VAT compliance. VAT in general and VAT compliance in particular have received very little attention by researchers. Hence, this study tries to fill this gap by examining the relationship between VAT compliance and tax administration.

The major activities of Ethiopian VAT administration are identification and registration of taxpayers, processing returns, controlling collections, making refunds, auditing taxpayers, investigation of tax fraud and evasion, and leaving penalties. In connection to these major activities, the study tries to demonstrate the Ethiopian VAT administrations practices. After considering the Ethiopian VAT administration, four

important issues were identified to study the link between VAT compliance and tax administration. These were

- Audit probability,
- The perceived fairness of VAT,
- Degree of satisfaction with the service of tax authority,
- Business people perception about the VAT money

VAT auditing is one of the major factors that are considered to have impact on VAT compliance. In this study, audit probability is measured by comparing the audit performance with the international standard of VAT audit coverage. Besides literatures suggests that the large share of VAT audit must not be devoted on large taxpayer. Thus, this is also taken into consideration while evaluating audit performance. In this respect, the study found that the audit probability at ERCA is very low. In addition, the large number of audit is devoted to the large taxpayers.

This study shows that by increasing the audit probability, it is possible to increase the government revenue as well as reduce the noncompliance problem. Furthermore, the authority has to enhance the dependability of external auditors. In today's world, the authority cannot continue to perform all activities alone. Other stakeholders must also share part of its job. In this regard, certified auditors can be used as partners in building a voluntary compliance society. Therefore, enhancing both the authority as well as the external auditors' capacity should be given priority. Moreover, the authority should get the societies support. In lieu of this, the authority needs to create a mechanism to encourage those who blew the whistle on VAT fraud.

The second major factor studied was the perceived fairness of VAT. Four indicators were considered to measure the degree of perceived fairness. These include similarity of tax burden on similar incomes, fairness of the penalty, government spending of VAT money and incidence of VAT fraud. The findings of this study demonstrate the existence of a problem in all the four factors and eventually perceived fairness problems on VAT. Unless the tax authority makes improvement in these regard, more of the existing sincere taxpayers will become noncompliance. In this connection, the study found the following.

Concerning the tax burden the authority needs to broaden its tax base and bring all who are expected to registered for VAT into the tax nets. Regarding fairness of the penalty, it is important to agree with the society and take sufficient time before a new tax and procedure is implemented. About government spending of the VAT money, it is also important to make taxpayers feel the money they pay is for their own benefit. This can be achieved both by spending the tax money for the society interest and by making government spending more transparent. The final one in this regard is incidence of VAT fraud. In this respect, taxpayers should be confident, as there is no VAT fraud in their area of business. Not only this, it is also important to build taxpayers assurance as to, no body evade the tax system. Here comes the implementation of proper tax administration including use of proper punishment. That is a punishment, which will not create a fear on those innocent and complying taxpayers, but strong enough to force the noncompliance to voluntary obey.

The third major factor studied was degree of satisfaction with the service of the tax authority. If taxpayers are dissatisfied with the tax authority, they will motivate to avoid taxation. Four indicators are considered in this connection. These are courteousness, efficiency, and flexibility of the tax authority and the response on refund. The study found that the tax authority is courteous and efficient but not that much flexible. However, regarding VAT refund the authority has problem. As a whole, the response on this suggests that the satisfaction rate seems fair but needs more effort to improve. In order to increase taxpayer's compliance the authority required to treat them as a king. There are a number of mechanisms to materialize this. For instance, concerning VAT report and payment, taxpayer's service can be enhanced by the introduction of online reporting and through the bank payment mechanisms. In addition, provision of prompt replay for VAT refund request is also important. In short, the authority needs to modernize its activities to the extent possible.

The final major factor studied was how business people think about the VAT money. Three indicators are considered to study this. These are taxpayers' beliefs on the relationship between VAT money and their business fund, the equivalence of VAT payment with the value added by the business, and taxpayers' contribution in the VAT collection. The findings of the study suggest these are not really a major

problems concerning tax compliance. However, the authority should build the taxpayers awareness in this regard also, because, though small in ratio there is some problems. Thus, a continuous and in depth education and awareness about tax in general and tax compliance in particular must be given for all the society at large.

Generally, in order to enhance taxpayer's compliance the tax authority should endeavor in all the above-mentioned four issues. Moreover, the audit probability and the perceived fairness of VAT are the two most serious issues needs to be considered by the tax authority the moment possible. Unless due attention is given to these issue more of the taxpayers will incline to become less compliance and join the rank of evaders. Further more, once such a trend is extended among the sincere taxpayers, it will be very difficult to bring them back to voluntarily compliance. Owing to its high revenue generating role, the tax authority is expected to give due attention and improve the taxpayers voluntary compliance.

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