



**PRACTICES AND CHALLENGES OF  
VALUE ADDED TAX IMPLEMENTATION IN ETHIOPIA  
POST JANUARY 2003 ASSESSMENT**

**A PROJECT SUBMITTED TO DEPARTMENT OF MANAGEMENT IN PARTIAL  
FULFILLMENT OF THE REQUIRMENTS FOR THE DEGREE OF EXECUTIVE  
MASTERS OF BUSINESS ADMINISTRATION**

**BIZUALEM BELETE**

**ADDIS ABABA UNIVERSITY  
COLLEGE OF BUSINESS AND ECONOMICS  
DEPARTMENT OF MANAGEMENT  
EXECUTIVE MASTERS OF BUSINESS ADMINISTRATION**

**ADDIS ABABA**

**February 2015**

**Addis Ababa University**

**College of Business and Economics**

**Department of Management**

**Executive Masters of Business Administration Program**

Practices and Challenges of VAT Implementation in Ethiopia Post  
January 2003 Assessment.

By Bizualem Belete

Approved by Board of Examiners:

_____	_____	_____
Advisor	Signature	Date
_____	_____	_____
Examiner	Signature	Date
_____	_____	_____
Examiner	Signature	Date



## Acknowledgements

Above all, I am owed to the Almighty God for giving me the blessing to be here and granting sanctification of health, enthusiasm, energy and patience and without whose help, nothing would happen.

My special thanks must go to my Advisor Dr. Yitbarek Takele for his guidance, and important advice towards to the completion of the project paper and for my future use too. Sometime, long discussion has off no use, if not; ice breaking ideas are there. Honestly, speaking, on short discussions times, I spent with Dr. Yitbarek Takele the ideas I secured, experiences I exchanged have had an enormous use and advantage. That is why, I am saying; sometimes, time has little role in a certain output.

My heartfelt thanks also goes to my wife Meseret T/Tsadik for her support, constructive feedbacks and always beside me.

I am also indebted to my friend Abraham Abebe, for his proof reading, providing materials for reading and editorial comments.

Last but not least, my special thanks goes to Zelalem Yohannes, for his support in formatting editorial comments.

Bizualem Belete

# Table of Contents

Letter of Declaration .....	ii
Acknowledgements.....	iii
List of Tables .....	vii
List of Figures .....	viii
Acronyms .....	ix
<i>Abstract</i> .....	x
1.1. Background of the Study.....	1
1.2 Statement of the Problem.....	3
1.3 Objectives of the Study .....	5
1.4 Significance of the Study.....	5
1.5 Scope of the Study .....	5
1.6 Hypothesis.....	6
1.7 Limitation of the Study.....	6
1.8 Organization of the Paper .....	6
2.1 Introduction .....	7
2.2 Concepts and Definition.....	8
TAX .....	8
Sales Tax.....	8
Turnover Tax (TOT) .....	8
Value Added Tax (VAT) .....	9
Exemption .....	9
Zero-Rating.....	9
2.3 Theoretical and Empirical Review.....	9
2.3.1 Types of VAT .....	9
Consumption VAT .....	10
Income VAT .....	10
2.3.2 Impact of VAT on Revenue .....	11

2.4. Tax Development and Reform in Ethiopia .....	13
2.4.1 An overview of the tax system and the tax reform .....	13
2.4.2 The three major taxes and tax reform .....	14
Taxes on income and profits .....	14
Taxes on goods and services .....	14
Taxes on international trade .....	15
2.4.3 The administrative reform .....	15
2.4.4 The VAT Regime in Ethiopia .....	17
2.4.4.1 Basic Notion of the Law and its interpretations .....	17
2.4.5 VAT Rate .....	19
2.4.6 Registration .....	20
2.4.7 Exemption for Specific Categories of Goods and Services .....	20
2.4.8 Tax Credit, Procedures for Filling Tax Return and Payment of VAT and VAT Refund or Rebate... 23	
2.4.8.1 Tax Credit .....	23
2.4.8.2 Procedures for Filling Tax Return and Payment of VAT .....	24
2.4.8.3 VAT Refund or Rebate .....	24
2.4.8.4 Non-compliance to VAT Proclamation .....	25
3.1. Research Approach and Design .....	26
3.2 Method of Data Collection, Instruments and Data Type .....	27
3.3. Population and Sampling Design .....	27
3.3.1. Target Population .....	27
3.3.2. Sampling Method .....	28
3.3.3. Sample Size Determination .....	28
3.3.4. Procedure of Data Collection .....	29
3.4. Unit of Analysis .....	29
3.5. Method of Data Analysis .....	30
3.6. Research Model .....	30
Time series Analysis Model .....	30
3.7. Measurement of Reliability and Validity .....	31
3.7.1. Validity .....	31
Internal Validity .....	31

External Validity .....	31
Construct Validity.....	32
Content validity .....	32
Statistical Conclusion Validity .....	32
3.7.2. Reliability .....	32
4.1 Descriptive Analysis.....	35
4.1.1 Background Information of Respondents .....	35
4.1.2 Do the business communities know the VAT rules and regulations properly? .....	37
4.1.3 Do the Business Communities Perform Their Business Activities on the Basis of the Current VAT Laws?.....	39
4.1.4 Does the Administration Capacity of ERCA Strong Enough to Control those Non-Compliance and Delinquent Taxpayers? .....	41
4.1.5 Have the Implementation of VAT in Ethiopia Met Its Objectives Properly and Encourages for the Growth of Investment and Export? .....	44
4.1.6 What are the Problems that Hinder for the Smooth Implementation of VAT in Ethiopia?....	53
4.1.7 Does ERCA have taken Some Measures to Alleviate the Problems of those Obstacles for the Smooth Implementation of VAT? .....	62
5.1 Research Findings .....	65
5.1.1 ERCA Employees and its Institutional Capacity.....	65
5.1.2 Findings from VAT payers' Perspective .....	66
5.1.3 Legal Compliance and VAT Contribution to the GDP .....	67
5.2 Conclusion .....	68
5.3 Recommendations .....	71
Bibliography .....	73
Appendices.....	76

## List of Tables

Table 1: Revenue Performance of VAT in Selected African Countries.....	12
<i>Table 2: Sample Size for ±5% Precision Levels where Confidence Level is 95% and P=0.05 .....</i>	<i>29</i>
<i>Table 3: Sex of Respondents.....</i>	<i>35</i>
<i>Table 4: Age of Respondents.....</i>	<i>36</i>
Table 5: Respondents’ Educational Status.....	36
Table 6: Business Community’s Awareness of the VAT Proclamation and its Rationale .....	37
Table 7: Knowledge of VAT and Its Application .....	38
Table 8: Business Traders’ Source of VAT Related Information .....	38
Table 9: Closure and/or Address Change.....	39
Table 10: Traders Practice of Issuing VAT Receipts to All Buyers .....	40
Table 11: Business Traders’ Practice VAT Reporting.....	40
Table 12: ERCA’s Capacity to Reach the General Public .....	41
Table 13: The Research Unit of ERCA.....	42
Table 14: All Eligible Business Traders Get Registered as VAT Payers.....	43
Table 15: Institutional Capacity of ERCA in Managing VAT.....	43
Table 16: Awareness Creation and Media Dissemination for VAT Payers .....	44
<i>Table 17: Implementation of VAT is Successful.....</i>	<i>45</i>
<i>Table 18: Implementation of VAT has met Its Objectives .....</i>	<i>45</i>
<i>Table 19: VAT Implementation Effectiveness Compared with Neighboring Nations.....</i>	<i>46</i>
<i>Table 20: Implementation Strategy of VAT in Ethiopia.....</i>	<i>47</i>
Table 21: The Introduction of VAT and Its Importance .....	47
Table 22: VAT’s Advantage over the Sales Tax .....	48
Table 23: A Single Rate of 15% VAT .....	49
Table 24: The VAT Proclamation Goals.....	49
<i>Table 25: Consumers’ Willingness and Determination to Transact with a Proper VAT Receipt .....</i>	<i>50</i>
Table 26: Regression result of Gross domestic product model 1 (equation 1) .....	51
Table 27: Regression result of Total revenue model 2 (equation 2).....	52
Table 28: Non-VAT payers, who are challenging the VAT payers’ Performance .....	53
Table 29: The Market Competition between VAT Registered and Non-Registered.....	54
Table 30: A Person not Registered as a VAT Payer but Issuing a VAT Receipt .....	55
Table 31: Business Traders’ who are not Issuing VAT Receipts to Buyers .....	55
Table 32: Businesses which Collect VAT with Illegal Invoice .....	56
Table 33: Business Traders’ who do not Maintain Proper Record Keeping of Operations .....	57
Table 34: The Threshold Level for VAT Registration.....	58
Table 35: Customers are a Challenge for Implementing the VATG Law .....	58
<i>Table 36: Getting the VAT Registration Machine .....</i>	<i>59</i>
<i>Table 37: The Quality of the VAT Registration Machine .....</i>	<i>59</i>
Table 38: Under or Over Invoicing Where Issuing VAT Receipts .....	59
Table 39: A VAT payer Using Unauthorized and Unregistered VAT Machine .....	60



Table 40: Traders Manipulated the Machine to Generate False Report.....	60
Table 41: Business Enterprises Selling Unauthorized and Unregistered Machine .....	61
Table 42: Timely Reporting While the VAT Machine Interrupts Its Services .....	61
Table 43: Business Traders Using Unregistered VAT Machine .....	62
Table 44: ERCA’s Enforcement Practice of the VAT Proclamation .....	62
Table 45: Governmental Administration Units Participation in Enforcement Practices.....	63
Table 46: Authorized Officers of ERCA.....	64
Table 47: The VAT Exemption Scheme .....	64

## **List of Figures**

<i>Figure 1: Questionnaire response success rate .....</i>	<i>35</i>
<i>Figure 2: The growth pattern of VAT and GDP .....</i>	<i>50</i>

## Acronyms

FIRA	Federal Inland Revenue Authority
GDP	Gross Domestic Product
EPRDF	Ethiopia People’s Revolutionary Democratic Front
ERCA	Ethiopian Revenue and Customs Authority
IMF	International Monetary Fund
LTO	Large Taxpayer’s Office
MOFED	Ministry of Finance and Economic Development.
SIGTAS	Standard Integrated Government Tax Administration System.
TIN	Taxpayer’s Identification Number
TOT	Turnover Tax
VAT	Value Added Tax
TGR:	Total Government Revenue
WTO	World Trade Organization
MoR	Ministry of Revenue

## *Abstract*

The objective of the study is to examine the nature, practices, and challenges of VAT implementation in Ethiopia and identify areas of weaknesses and strengths towards the achievement of VAT Objectives. In doing so, the paper further assesses the impact of VAT to gross domestic product and total government revenues.

The study used both qualitative and quantitative research methods to collect and analyze both primary and secondary data. Self-administered questionnaires to the ERCA employees and VAT registered respectively were used to collect primary data. Secondary data was collected from ERCA, MoFED by way of reviewing documents from previous studies. The Statistical Package for Social Sciences (SPSS) version 17 and STATA 11 was the method used for quantitative data analysis

The study paper discovered that during the implementation of Valued Added Tax since the year 2003 till to date; the major challenges hindering ERCA from generating what was initially planned are: lack of sufficient number of skilled personnel, limited staff capacity, non-responsiveness by the management, limited awareness creation, problems related with invoicing, unfair competition, and control centered management tendency. The paper suggests that in Ethiopia, attempting to implement what is legislated in the main areas deserves the Government's due attention. The study also emphasizes the need to strengthen the administration capacity in general and the VAT collection system in particular as efficiently as possible. The empirical analysis disclosed that VAT contributes significantly to the increase of the total government revenue and the economic growth of Ethiopia at large. Finally, if Ethiopia joins the World Trade Organization, the country needs to enhance domestic based resources mainly generated from Value Added Tax. In this regard, the paper has far-reaching policy implication in an effort to improve tax collection.

Keywords; VAT, WTO, government revenue, unfair competition, GDP

# Chapter one

## Introduction

---

### **1.1. Background of the Study**

Ethiopia's tax reform program has introduced VAT at the rate of 15% (fifteen percent) on January 1, 2003 to replace the sales tax proclamation that provides exemption for basic necessities and domestic transportation and zero rating to encourage exports and capital investments. Subsequent to the introduction of VAT, additional exemptions were extended to basic foods, agricultural fertilizers and to other products. Unlike the sales tax, VAT provides relief of tax on all business inputs, including capital goods and business expenditures and will provide further business incentives by zero rating exports and the international transport of goods and passengers. Since domestically produced goods relieved of VAT, they will be more competitive within international markets.

In the Ethiopian context of VAT system, a threshold of half a million Birr is a level above which registration for VAT is legally compulsory. However, the taxpayers below this threshold and engaged small scale businesses such as distributions of goods and domestic trade services are also forcefully categorized as VAT payers contrary to the proclamation.

Governments use tax revenues to pay soldiers and police, to build dams and roads, to operate schools and hospitals, to provide food to the poor and medical care to the society, and other purposes. Taxation is the most important source of revenues for modern governments. The remainder of government revenue comes from borrowing and charging fees for services. Countries differ considerably in the amount of taxes they collect. In addition to using taxation to fetch money, government may raise or lower taxes to achieve social and economic objectives, or to achieve political popularity with certain groups. In a nut shell, taxation can redistribute society's wealth by imposing a heavier tax burden on one group in order to fund services for another and serve as an important tool for maintaining the stability of a country's economy ((Wogene 1994).

Taxes are normally classified as direct and indirect. Direct taxes are levied on the income, profit, capital gain and wealth of persons and companies, the most well-known direct tax being personal

income tax. On the other hand, indirect taxes are levied on transactions, goods and service, not directly imposed on companies and individuals. Value Added Tax (VAT) is one of those indirect taxes. The value added at each stage of production is the difference between the seller's material costs and the selling price. In essence, VAT is just a general sales tax that is collected at multiple stages. VAT is a key source of government revenue in most of the nations. It was introduced in more developed countries of Europe and Latin America. The first proposal emerged in France in the 1920 and was recognized in 1948. The developing and transitional economies adopted the tax in the 1980s and 1990s. Côte d'Ivoire was the first African country to introduce VAT in 1960.

Since, taxes are important sources of public revenue, the government of Ethiopia recognized the need to overhaul the tax legislation and to strengthen the administration capacities of the Federal Inland Revenue Authority (FIRA) and the Regional Tax Administrations. Consequently, the government devised the tax reform program as one of the key initiatives under its national capacity building program. The tax reform measures are designed to encourage local and direct foreign investment and to increase tax revenues through the establishment of a broader tax system and ensuring equity, fairness, consistency and honesty in the administration of the tax laws in the country.

Although, the Revenue Sector Reform was thought to be commenced in May 1999, the government acknowledged that it had been burdened with delays during the first two years. During the restructuring of the Ethiopian government in 2001/2002, one of the changes included the upgrading of the Revenue Board to a Ministry of Revenue (MoR), which become responsible for directing, supervising, controlling, evaluating and coordinating the three revenue institutions: the Federal Inland Revenue Authority (FIRA), the Ethiopian Customs Authority (ECUA) and the National Lottery Administration (ERCA, 2011 Statistical Annual Bulletin).

The purpose of this research paper is to describe the, practices, implementation and challenges of VAT in Ethiopia since January 2003, and pinpoint the weak links from both ERCA side and VAT payers perspective. Besides, the study also tries to identify areas of strengths that can be capitalized.

## 1.2 Statement of the Problem

VAT is a tax on the final consumption of certain goods and services. But it is collected at every stage of production and distribution. VAT is gathered by all entities providing taxable goods and services and imposed on sales to all purchases. A business firm calculates its VAT liability by the VAT rate.

The VAT Proclamation No.285/2002 was issued on 4<sup>th</sup> July 2002 by the Council of People's Representatives to be enforced as of January 2003.

The introduction of VAT facilitates substantial improvement in overall tax administration, and indeed adoption of the VAT is often seen as an opportunity for overall tax administration and modernization.

The introduction of the VAT, however, has occasionally disrupted the functioning of an existing administration because of inadequate preparation, lack of uniformity in application, lack of awareness by the side of the Taxpayer, application contrary to the law and problems related with institutional capacity.

Since the VAT is a tax that is levied on the consumer, it does not constitute a tax on business. In effect, a registered VAT taxpayer is charging and collecting funds that are being held in trust for the government before being remitted to the Ethiopian Revenue and Customs Authority (ERCA). However, ERCA took adequate experiences from other countries before enacting the law and even after due implementation regarding the types of fraudulent activities that have been commonly encountered by many countries where by VAT laws have been introduced.

Fraudulent actions deny countries revenue entitlements; create competitive inequalities in the business environment and affect honest business taxpayers. Even though, ERCA has undergone an intensive educational program to improve awareness of tax payers and the general public, there are various problems which restraint for the effective implementation of VAT in the country.

In practical terms, the Ethiopian Customs and Revenue Authority have faced with the following challenges which the study paper tried to find out the depth and extent of the problems. Some of the key challenges of the VAT implementation are as follows:

1. Lack of institutional capacity in mobilizing the tax payer and;
2. Loose Partnership and cooperation between VAT Payers and employees of ERCA;
3. Lack of commitment by the side of the ERCA employees towards VAT implementation;
4. Delay in decision making for complaints raised by VAT payers
5. Lack of awareness by the side of the VAT payers while fulfilling its obligations;
6. Tendency of ERCA towards penalizing the defaulting VAT Payers instead of creating common understanding

In addition to examining the above already identified gaps, the study also tried to answer the following areas:

- ❖ Do the business communities know the VAT rules and regulations properly?
- ❖ Do the business communities perform their business activities in compliance with current VAT laws?
- ❖ Is the administration capacity of ERCA strong enough to control those noncompliance and delinquent taxpayers?
- ❖ Has the implementation of VAT in Ethiopia met its objectives properly and encourages for the growth of investment and export?
- ❖ What other constraints are with in ERCA and VAT payers that hinder the smooth implementation of VAT in Ethiopia?
- ❖ Has ERCA taken some measures to alleviate the problems of those obstacles for the smooth implementation of VAT?

### **1.3 Objectives of the Study**

Specifically, this research paper tries to address the following issues:

- ❖ To assess whether the tax payers do their work with the compliance of the current rules and regulations of the VAT.
- ❖ To assess whether the implementation of Value Added Tax has met its objectives of generating more government revenue, encouraging investment and export.
- ❖ To locate areas of institutional weakness and strengths that ERCA has passed through and lessons learnt in due process while implementing the Value Added Tax in Ethiopia.
- ❖ To make a comparative assessment of VAT contribution to the Growth Domestic Product(GDP) and total government revenue vis a vis other selected African countries

### **1.4 Significance of the Study**

Among other things, this paper will have the following significance:

- ❖ Enable the reader to observe the economic importance of VAT.
- ❖ Highlight the major challenges of Value Added Tax in Ethiopia and its future implication.
- ❖ Highlight areas of weaknesses and strengths during VAT implementation
- ❖ Would enable ERCA to observe how the VAT developed is used as a measure of their success.

### **1.5 Scope of the Study**

This research paper deals with analyzing the practices, and challenges of Value Added Tax implementation in the Ethiopian; in the case of Addis Ababa since January 2003. As it is difficult to cover the whole VAT registered tax payers; emphasis was given to some Addis Ababa VAT registered tax payers whose annual turnover exceeds Birr Fifty Million(50,000,000.00) and employees of ERCA based at its central office.



## **1.6 Hypothesis**

The research is further augmented with empirical analysis to show the correlation of VAT to Gross Domestic Product and VAT to Total Government Revenue. The hypotheses applied to support this study were summarized here below.

Hypothesis 1: H0: VAT revenue has significant impact on the economic growth of Ethiopia

Hypothesis 2: H0: VAT revenue has significant impact on general government revenue in Ethiopia

## **1.7 Limitation of the Study**

Area wise, the study population was from Addis Ababa City Administration of 10 sub cities that preclude regional Offices. This may lead to hasty generalization to conclude about the practices and challenges of VAT implementation in Ethiopia. While collecting feedbacks from employees of ERCA and VAT Payers, unwillingness to complete the questionnaire and/ or giving inadequate attention was a major challenge, too. From secondary source of data, only 10 years' time series data was used to analyze the impact of VAT on Ethiopian economy which may have its own limitation to show the full picture and impact of VAT implementation in Ethiopia since January 2003.

## **1.8 Organization of the Paper**

The paper is organized in five chapters: In the first chapter are the background of the study, the general and specific objectives, the research questions, the significance, the scope and limitations of the study. Chapter two is review of related literature. Chapter three is Research Methodology; Chapter four is aimed at dealing with results and discussions. The last chapter five deals with findings, conclusions and recommendations depending on the results discussed under the fourth chapter.

# Chapter Two

## REVIEW OF RELATED CONCEPTUAL FRAME WORK

---

### 2.1 Introduction

By any standards, the rise of the VAT has been the most significant development in tax policy and administration of recent decades. In terms of meaning and essence, Value Added Tax (VAT) is a general consumption tax assessed on the value added to goods and services. It is a general tax that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services. It is a consumption tax because it is borne ultimately by the final consumer. It is charged as a percentage of price, which means that the actual tax burden is visible at each stage in the production and distribution chain. It is collected fractionally, via a system of deductions whereby taxable persons (i.e., VAT-registered businesses) can deduct from their VAT liability the amount of tax they have paid to other taxable persons on purchases for their business activities. This mechanism ensures that the tax is neutral regardless of how many transactions are involved.

"VAT" - value added tax - has spread throughout the world since its introduction in 1955. France is credited with first implementing VAT. It did so in 1955. The tax spread through Europe, South America and parts of Africa in the 1960s and 1970s before taking a hold in other regions. Today, it is a key source of government revenue in more than 130 countries. About 70 percent of the world's populations now live in countries with a VAT (Kean & Lock Wood, 2007).

Value Added Tax has also become an indispensable component of tax reform in developing countries. It is the most important tax innovation of the second half of the twentieth century. In line with this perception, an increasing number of developing countries have converted their sales tax to Value Added Tax (VAT). The continuing introduction and evolution of general sales taxes, especially of the value added tax has been the outstanding feature in development taxation in recent years (Goode, 1984).

The key feature of VAT is its being broad-based, which is levied at multiple stages of production. The advantage of this is that revenue is secured by being collected throughout the process of production (unlike a retail sales tax) but without distorting production decision as a turnover tax does.

## **2.2 Concepts and Definition**

Familiarizing readers with basic terms related to taxation will have a paramount importance in understanding the subsequent literature review of Value Added Tax.

### **TAX**

It is defined as an amount of money levied by a government on its citizens and used to run the financial activities of the government. A tax is an unrequited payment by individuals or businesses to a government without Quid Pro Quo. This means tax is an involuntary payment without any expectation of direct return in benefit. In the private sector you get what you pay for. But in public sector with regard to tax you don't get what you pay for. In short there is no direct relationship between the tax payment and the benefit to be received by the taxpayers.

### **Sales Tax**

Taxation imposed on the sale of goods or services. The tax is computed as a Percentage of the total sales price. Sales tax may be imposed on the purchaser or on the seller; in the former case they are charged on each transaction and in the latter they are collected as a percentage of the gross receipts during a given period (ERCA, Annual Bulletin 2014)

### **Turnover Tax (TOT)**

Turnover tax derives its name from the fact that the tax applies to the sales of a good every time turnover from one firm to another (Auld and Miller, 1984). It is an equalization tax imposed on persons not registered for value added tax to fulfil their obligations and also to enhance fairness in commercial relations and to complete the coverage of the tax system.

## **Value Added Tax (VAT)**

VAT is a tax levied on the increase in value of commodity that has been created by the taxpayer's stage of the production or distribution cycle. It is a sales tax based on the increase in value or price or price of the product at each stage in its manufacture and distribution. The cost of the tax is added to the final price and is eventually paid by the consumer (Byrd et al (1996/97)).

## **Exemption**

As the name indicates exemption means that no VAT is charged on the supply and no credit can be taken for VAT paid on purchases used to make the supply. If particular enterprises are exempted, the tax applies to their purchases and they received no credit for or refund of this tax since they are not taxpayers (John F.Due, 1976).

## **Zero-Rating**

Zero rating means the supply is charged with a VAT at zero percent but credit can be taken for VAT paid on purchases used to make the supply. Zero rating may be applied to classes of sales such as exports or sales to government agencies, correspondingly reducing the tax payable by the seller or, where his sales are predominantly zero rated, entitling him to a credit or refund the aim of zero rating on the other hand is to lift the entire VAT, including that already collected at earlier stages from a particular goods or services. This is accomplished by allowing full credit for the tax shown on the invoices for purchases of the goods in question or of inputs into it.

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

## **2.3 Theoretical and Empirical Review**

### **2.3.1 Types of VAT**

There are several bases for classifying value added taxes of particular importance are the extent of vertical coverage through production and distribution stages; the treatment of amounts paid for

producers' goods, particularly durable capital equipment and the method used for calculating tax liability. Conceptually, there are two types of VATs: consumption and the income (Rob Capehart, 1999).

### **Consumption VAT**

The tax base of a consumption type VAT is the value of goods and services sold or transferred for personal consumption. For example, in consumption, credit- subtraction VAT, a taxpayer typically claims an input credit for VAT paid on purchases of capital goods, as well as on inventory and intermediate goods and services used in his business. A consumption VAT is calculating by adding together the amount of a firm spends on consumption, interest, dividends and expended capital during the year (Alan and Oliver, 2001).

Bhatia (2003) also states about the types of VAT, if a firm is allowed to deduct the entire credit when the capital equipment is purchased, the system is termed as consumption VAT. Thus the tax actually applies only to purchase for personal household use, with all purchases for use in production by taxpaying firm being excluded from tax. Thus the term consumption type is used the tax is limited to purchase to personal consumption purpose.

A purchase of an investment good is treated like any other material input. Its full value is subtracted from sales in the consumption, despite the fact that it is durable. This is referred to as a consumption type of VAT because the tax base excludes investment and involves only consumption (Harvey S. Rosen, 1995).

### **Income VAT**

A second type of VAT is income type, it is one that does not permit deduction of the purchase price of durable capital goods in the period of purchase but instead allows the deduction of an annual depreciation charge arising from such purchases (that is if the firm is allowed to deduct the credit as the equipment depreciates over time, the system is termed as income VAT). Each period, firms may deduct only the amount by which investment goods depreciate. The tax base is thus total income net of depreciation, which is why this is characterized as a net income type VAT. Expended capital consists of the amount depreciation a firm has during the year since, by

definition, the life of an asset extends over several years and depreciation represents the amount of that asset used during any particular year.

### **2.3.2 Impact of VAT on Revenue**

VAT is increasingly being used throughout the world, including many African countries to raise government revenue with less administration and economic costs than other broadly based taxes. It is believed to be a good means to raise government revenue even when relatively poorly administered. Ebrill and Keen (2001) also strengthen the above idea empirically. They found that in the countries have adopted VAT, revenue from this source accounted on average 27 percent of the total tax revenue or 5% of the GDP. And about 70% of the world's populations now live in countries with a VAT. This implies that it is a key source of government revenue in more than 126 nations.

Sales tax is collected without any threshold on the annual transaction. On the other hand VAT is collected on all sales of commodities at every stage of production and distribution with threshold on the annual turnover. Most taxable transactions will appear on two tax returns (that is the buyer's and the seller's) so that tax authorities will have two opportunities to detect evasion. Further, because sellers provide the tax administration a record of their purchases by claiming input credits, tax administrations are more able to estimate what sales and therefore VAT due should be and thereby can detect evasion more easily in a VAT than in a retail sales tax. Under the VAT the amounts of tax liability at risk in most transactions is only a fraction of the total tax assessed on the sales of the good or service to a consumer. This is because the VAT is collected in smaller pieces at each stage of production, while the entire retail sales tax is collected on a final consumer sale. The lower effective tax rate on each transaction may reduce the intensive to evade the VAT. It is argued that VAT avoids cost-cascading effect. A conventional sales tax leads to compounding of the tax liability, while VAT does not. (Bhatia,2003).

In order to compare VAT revenue with that of sales revenue, the turnover tax should be added on VAT since sales tax was replaced by VAT and turnover tax.

*Table 1: Revenue Performance of VAT in Selected African Countries*

Countries	Date of VAT introduced	VAT standard Rate%	VAT Revenue (% of tax) revenue	Percent of GDP
Benin	1991	18	41.6	5.6
Algeria	1992	17	31	3.1
Egypt	1991	15	17.9	2.7
Tunisia	1988	18	25.3	6.5
Senegal	1980	20	37.1	6.2
Tanzania	1998	20	32.3	3.2
Uganda	1996	17	33.6	3.4
Zambia	1995	17.5	29.8	5.8
Kenya	1990	18.0	25.9	5.5
Mauritius	1998	10	17.4	3.0
Madagascar	1994	20	39.3	4.3
Ethiopia	2003	15	42.4	5.7

Source: Ebril and Keen (2001), computed from own source

As can be seen from Table 1, VAT is a major source of revenue in most African countries. The share of VAT in total tax revenue ranges from 17.4 percent in Mauritius to 42.4 percent in Ethiopia. The average for 31 African countries (24.3 percent) is lower than the world average (27 percent). In Ethiopia the share of VAT in total revenue, which is 42.4 percent is the largest as compared to the sampled countries. The VAT to the GDP ratio ranges from 2.7 percent in Egypt to 6.5 percent in Tunisia with the average of 4.6 percent. Similarly many sub-Saharan African countries have also experienced an increase in revenue from VAT. The revenue performance of VAT as measured by the ratio of VAT to GDP in Ethiopia which is 5.7 % is much higher than the African average (4.6%) and stood the fourth among the twelve African countries under consideration.

## **2.4. Tax Development and Reform in Ethiopia**

As Demirew Getachew (2004) stated, faced with severe macroeconomic imbalances such as fallings, worsening balance of payments, mounting debts and declining economic growth, the country undertook various policy measures since 1992/93 following a major economic shift from central planning to market oriented system. In the fiscal front, the aim is to expand the tax base and allow government expenditure to grow moderately so that the level of budget deficit could be reduced to a reasonable level. Prior to the tax reform, the government noticed different signals indicating the need to overhaul the tax system. The major ones are:-complex and outdated tax law, weak tax administration, failure of the tax system to generate adequate revenues for government expenditure and the like.

### **2.4.1 An overview of the tax system and the tax reform**

The first major change in Ethiopia's tax system was initiated in the post-Second World War period (1942-1944), the years 1947-1952 covering its second stage. These changes were generally discretionary, including amendments to property taxes (land and cattle). Broad-based taxes on goods and services were also introduced in the mid-1950s.

Later in the decade and in the early 1960s, changes were also made in the rate and structure of taxes, especially on income. In the post-revolution period (1974-91), particularly during 1976-79, significant major changes on the rate and structure of all types of taxes were made. These involved widening the land tax base, introducing capital and surplus transfers from nationalized firms, as well as certain minor arrangements on other taxes (Wogene 1994).

Leaving aside this brief description of the evolution of the tax system before the 1991/2 reform, the subsequent taxing system in Ethiopia can be divided into three broad categories:

(i) taxes on income and profits, (ii) taxes on goods and services and (iii) taxes on international trade. Most of these taxes have been reformed and amended in the last decade following the general 1992 liberalization (or reform) policy. Some institutional reforms aimed at enhancing the government's capacity to raise tax revenue have also been made.



## 2.4.2 The three major taxes and tax reform

### Taxes on income and profits

Tax on employment income used to be guided by Income Tax Proclamation No. 173/1961. In the 1990s, this proclamation was amended with modifications to the legislation regulating income tax on employment: rural land and agricultural income tax; rental income tax; taxes on business and other profits; tax on income from mining activities; capital gains tax, and taxes on other sources of income such as chance wining (which carries a tax rate of 15 percent), royalties (with a tax rate of 5 per cent) and tax on non-resident persons offering services in Ethiopia (which carries a tax rate of 10 percent).

This reform resulted in a schedule for marginal tax rate which is currently being applied to income exceeding Birr 150, the assumed minimum wage rate. Compared to the marginal tax rate of 89 per cent during the military (*Derg*) period, the current reform which reduced the maximum marginal tax rate to 35 per cent was quite radical. The 1978 income tax for rural land and agricultural activities was also amended in 1995 and 1997. For land use, farmers are now taxed Birr 10 for the first hectare and Birr 7.5 for each additional half hectare.

### Taxes on goods and services

The reform in this category refers to Excise Tax Proclamation (Nos 68/193, 77/1997, and 149/1999), and the applicable tax rate ranges from a low of 10 per cent on textiles and television sets to 100 per cent for alcohol, perfumes and automobiles. Sales tax on goods constitutes the second category and these ranges from 5 percent (mainly for agricultural goods) to 15 percent.

Many basic goods are exempt from taxation. The reform also introduced a 5 per cent tax rate for work contracts and financial services, while a 15 per cent rate is applied to the sale of other services. Valued-added tax (VAT) was introduced in January 2003 and may mean a shift from Ethiopia's dependence on foreign to domestic trade, but it is too early to evaluate its impact. It is not, however, difficult to see that its implementation is a challenge, owing to the predominance of small and informal operators in the country, its history of tax evasion and corruption, lack of standard recordkeeping systems as well as the lack of knowledge about VAT and a tax base for its computation.

## Taxes on international trade

The reform of taxes on international trade relates to levies on imports (customs duty, import excise tax, import sales tax) and tax on exports. The custom tariff reform that took place between 1993 and 2002 grouped imports into 97 categories based on the Harmonized System of Tariffs Classification Code. An *ad valorem* rate ranging from 0 to 35 per cent was introduced. The same rates were applied for import excise and sales taxes as those established for goods and services (see section above). An important development in the export sector was the abolition of all export taxes, with the exception of coffee. Similarly, to encourage exports, schemes for duty drawback and duty free imports were implemented. Other miscellaneous tax-related reforms have been carried out in the last decade. These include the amendment of stamp duties (Proclamation No. 110/1998); the introduction of a 3 per cent withholding tax (Proclamation No. 227/2001), a 2 per cent withholding tax on income (Proclamation No. 227/2001), as well as a 5 per cent withholding tax on interest income (Proclamation No. 227/2001).

### 2.4.3 The administrative reform

The current tax-to-GDP ratio of about 13.7 per cent calls for reform not only on the tax rates but also on its administration. Tax reform began in 1999, and one of the changes was to scale up the ‘revenue board’ to ministerial level to become the Ministry of Revenue. This ministry controls the three revenue collection institutions: Federal Inland Revenue, Ethiopian Custom Authority and the National Lottery Administration.

Major components of the reform focused on reducing corporate income tax from 35 to 30 per cent and the maximum income tax rate applicable to a sole proprietor from 40 to 35 per cent. The new income tax law also allowed deductions for business expenditures such as tax payments, land lease payments, interest payments on loans, insurance premiums and other expenditures, which previously were not deductible from taxable income. It also provided provisions for loss carry-forward, and capital gains as well as withholding taxes (MoR 2003). The reform also improved application of the business income tax by replacing the earlier assessment method of presumptive tax that had been based on estimates with a more simplified standard method less vulnerable to corrupt practices. Based on a recent study, the government has also revised the outdated

profitability rate that had been used for the computation of taxes. New presumptive taxes were established: an advance business profit income tax on commercial imports (3 per cent on cif) and withholding tax of 2 per cent on payments made by private limited companies (MoR 2003).

To align the Ethiopian system with the international trend towards indirect taxes, the government introduced a value-added tax (VAT) of 15 per cent on 1 January 2003 to replace the earlier sales tax on imports and domestically manufactured goods. VAT is not applied to transportation or kerosene nor on medical, financial and educational and other services. This, together with the reduction in income tax, is believed to ease the tax burden of the low-income population. Turnover tax was also introduced for business enterprises whose annual turnover of taxable good is less than the VAT registration threshold of Birr 500,000. The tax applied is 2 per cent for goods and 10 per cent for services (MoR 2003). The excise tax proclamation of January 2003 also included provisions for a reduction in tax payment by excluding depreciation from the cost of production.

In conjunction with this reform, the Ministry of Revenue re-organized the FIRA by introducing and improving operational programme, systems and procedures. The other reform measures include the establishment of additional branch offices, training and recruitment of qualified personnel, introduction of performance and accountability measures, setting up a taxpayer education programme and similar initiatives aimed at implementing the new income tax, VAT, turnover tax and excise tax proclamations. The government is currently in the process of upgrading its computer system, implementing the use of a tax identification number for the enforcement, verification and processing of sales tax and VAT refund claims (MoR 2003). These reform efforts are being carried by ensuring the participation of the regional tax authorities in the development of these new tax legislations. (MoR 2003; see also Fantahun 2002).

Tax reform include changing policies to address insufficient revenue, to correct distortions that reduce economic welfare and growth, or measure to reduce inequalities. The tax reform program in Ethiopia has two components: overhauling of the tax legislation and improving the tax administration. The reform aims at establishing a sustainable domestic revenue base, encouraging trade and investment, ensure fairness, equity and transparency in the administration of the tax laws.

The Ethiopian government has introduced VAT as a part of the overall tax reform program. The tax reform program is preceded by establishment of a new Ministry of Revenue as a first step to

improve tax collections and to combat fiscal fraud. Various activities have been conducted subsequent to this: the increase in the sales tax and the removal of import duty surcharge in 2000; a new legislation on presumptive taxation and a 5 percent withholding tax on imports became effective in February 2001; legislation was approved in March 2002 to introduce the TIN system to reinforce the collection powers of revenue agencies, and a tax reform implementation task force was established; a large taxpayer was made operational in July 2001; in October 2001; a draft VAT legislation was submitted to parliament and this is approved and implemented beginning January 1, 2003. A revised income tax law has been approved and made operational. This revised law includes enhanced enforcement procedures and an improved penalty regime, with a view to increasing the efficiency of income tax collection, and ensuring the recovery of income tax arrears.

Prior to the introduction of VAT, the Ethiopian government has initiated a number of processes (Africa Development Bank, 2003). These include the design and computerization of the taxpayer registration process; the operational development of taxpayers' services activities and debit and audit activities; publicity campaign and taxpayer education. These measures are expected to improve the government's revenue position.

Tax policy reforms focus on improving the efficiency and equity of the income tax system, modernizing tax administration by enhancing technical capacities and reforming indirect taxation. The main reform to indirect taxation, hence, was the introduction of a VAT which is made operational beginning January 1, 2003 as said earlier. The tax system reform project aims to create a tax system that is more supportive of private sector development, improving revenue collection and ensuring equity and fairness of the tax system. The tax reform that has been initiated will lay the foundations for strengthened revenue base (Munoz and Cho, 2003).

## **2.4.4 The VAT Regime in Ethiopia**

### **2.4.4.1 Basic Notion of the Law and its interpretations**

The Value Added Tax (VAT) proclamation No 285/2002 which has rescinded and replaced the sales and excise tax proclamation No. 68/1993 (as amended) and which has come into force as of January 1st, 2003 is a consumption tax which is levied and paid as value added tax at a rate of 15

percent of the value of every taxable transaction by a registered persons, every import of goods, other than an exempt import and an import service rendered in Ethiopia for a person registered in Ethiopia for VAT or any resident legal person by a non-resident person who is not registered for VAT in Ethiopia. (Article 7 (1) (a)-(c) and Article 23 (1) and (2))

A taxable transaction is a supply of goods or a rendition of services in Ethiopia in the course or furtherance of a taxable activity other than an exempt supply. (Article 7(3))

A taxable activity is any activity, which is carried on continuously, or regularly by any person in Ethiopia, or partly in Ethiopia, whether or not for a pecuniary profit that involves, in whole or in part, the supply of goods or services to another person for consideration. (Article 6 (1) and (2))

Supply means the sale of goods or rendition of services or both and rendition of services means anything done, which is not a supply of good or money. (Article 2(17) and Art. 4(1)) For the purpose of the VAT proclamation the following are considered as taxpayers on whom the VAT law is applicable. These are: -

- (a) A person who is registered or is required to register for VAT;
- (b) A person carrying out a taxable import of goods to Ethiopia;
- (c) A non-resident person who without registration for VAT renders service in Ethiopia for any person registered in Ethiopia for VAT or any resident legal person (Article 3(1), (a)-(c)-cum Article 23 (1) and (2))

For the purpose of the VAT proclamation “person” means any natural person, sole proprietor, body, joint venture, or association of persons. (Article 2(11)) Article 2 (15) of the Proclamation, which deals with definition, states that “Resident person” shall have the meaning given to it under the Income Tax Proclamation.

The new Income Tax law of Ethiopia Proclamation No 286/2002 defines and/or outlines who and what constitutes a resident in Ethiopia. Article 5 defines and outlines the principle of residence. Accordingly under Article 5 (1) (a)-(b) an individual shall be resident in Ethiopia. If he:

- a. Has a domicile within Ethiopia;
- b. Has a habitual abode in Ethiopia; and or
- c. Is a citizen of Ethiopia and a consular, diplomatic or similar official of Ethiopia posted abroad?

Pursuant to article 5 (2) an individual, who stays in Ethiopia for more than 183 days in a period of twelve (12) calendar months, either continuously or intermittently, shall be resident for the entire tax period. With regards to a body, pursuant to Article 5 (3), a body shall be resident in Ethiopia, if it;

- a. Has its principal office in Ethiopia;
- b. Has its place of effective management in Ethiopia and/or
- c. Is registered in the trade register of the Ministry of Trade and Industry

It should be noted that according to Article 5(4) “Resident person” includes a permanent establishment of a non-resident person in Ethiopia.

#### **2.4.5 VAT Rate**

The VAT law contains two VAT rates. One is the standard 15 percent rate and the other is zero-rated. The following taxable transactions are charged with tax at a rate of zero percent.

- a. The export of goods or services
- b. The rendering of transportation or other services directly connected with international transport of goods or passenger, as well as the supply of lubricants and other consumable technical supplies taken on board for consumption during international flights
- c. The supply of gold to the National Bank of Ethiopia; and
- d. A supply by a registered person to another registered person in a single transaction of substantially all of the assets of a taxable activity or an independent functioning part of a taxable activity as a going concern. [Article 7 (2) (a) - (d)]

There is a basic difference between VAT exemption and zero rate VAT. The difference is that though zero rate transactions do not pay VAT on the goods and services they render under transactions listed in (a) – (d) above, for the purpose of VAT registration they are considered as taxable service thus enabling and making these transactions eligible for collecting tax rebate.

This has the advantage of granting VAT rebate which can help redress in put tax paid on purchase of goods and services necessary for the furtherance of the zero rated transactions. On the other hand, VAT exemptions granted by the VAT law does not allow for the collection or entitlement of VAT rebate for the simple reason that they are assumed not to have paid in put tax, therefore

disabling exempt categories from registering for VAT and taking advantage of the VAT rebate provisions.

#### **2.4.6 Registration**

Under the VAT law any person who carries on a taxable activity and at the end of any period of 12 calendar months has made, during that period, taxable transactions the total value of which exceeds 500,000 Birr or at the beginning of any period of 12 calendar months there are reasonable grounds to expect that the total value of taxable transactions to be made by the person during the period will exceed 500,000 Birr, has the obligation to register for VAT. (Article 16(1)(a) and (b)) According to Article 17, a person who carries on taxable activity and is not required to be registered for VAT may voluntarily apply to the Tax Authority for such registration, if he regularly is supplying or rendering at least 75% of his goods and services to registered persons.

#### **2.4.7 Exemption for Specific Categories of Goods and Services**

Tax-exempt goods and services are supplies on which VAT, both the standard rate and zero-rate tax, are not paid on. If a person who is engaged in a taxable activity that fully falls under the tax-exempt category, such a person cannot register for VAT. If a person is engaged partially in a tax exempt category activity and partially in a taxable activity, such person cannot register for VAT and be legible for tax rebate which could be beneficial to redress cost paid for input tax on his taxable transactions.

Under the VAT Law, the following types of supplies of goods (other than by way of export) or rendering of services as well as the following types of imports of goods are also exempt from payment of VAT;

- a. The sales or transfer of a used dwelling, or the lease of a dwelling;
- b. The rendering of financial services;
- c. The supply or import of national or foreign currency, and of securities;
- d. The import of good to be transferred to the National Bank of Ethiopia;
- e. The rendering by religious organizations of religious or church related services;
- f. The import or supply of prescription drugs and the rendering of medical services;

- g. The rendering of educational services provided by educational institutions, as well as child care service for children at pre – school institutions;
- h. The supply of goods and rendering of services in the form of humanitarian aid, as well as import of goods transferred to state agencies of Ethiopia and public organizations for the purpose of rehabilitation after natural disasters, industrial accidents and catastrophes;
- i. The supply of electricity, kerosene, and water;
- j. Goods imported by the government, organizations, institutions or projects exempts from duties and other import taxes to the extent provided by law or by agreement;
- k. Supplies by the post office;
- l. The provision of transport;
- m. Permits and license fees;
- n. The import of goods to the extent provided under schedule two of the customs tariffs regulations;
- o. The supply of goods or services by a workshop employing disabled individuals if more than 60 percent of the employees are disabled; and
- p. The import or supply of books and other printed materials. (Article 8(2) (a)-(p))

By virtue of Article 8(4), the Minister of Finance and Economic Development may by directive exempt other goods and services. In a similar manner Income Tax Proclamation No 286/2002, Article 13 (e) has empowered the Council of Ministers and the Minister of Finance and Economic Development to exempt by regulation any income for economic, administrative or social reasons.

All The aforementioned exemptions have a common feature and that is; they are designed and intended to encourage and enhance the health, education and financial sector of the economy and to protect and promote social and public interest; and the exemptions have been granted for economic, administrative or social reasons.

The Council Ministers for the proper interpretation of the VAT proclamation issued the Value-Added Regulation No 79/2002.

The major areas on which proper and broader interpretation has been rendered include exemptions granted by the VAT proclamation whereby general areas of exemptions have been listed without



detailed interpretation and implementation terms and conditions. In this regard, the regulation clearly states what falls under the exempted items and what does not fall under or constitute exemption under the VAT proclamation. These exemptions include inter-alia provision relating to religious or church-related services and provisions relating to supplies of humanitarian aid.

The Regulation provides that generally, services rendered by a religious organization that are integral to the practice of that religion come within the exemption. The donation in kind or money (such as church plate donation) or services is not subject to tax if there is no direct link between the payment and any benefit received by the donor. (Article 23 (1), (2), (4) and (6))

However, the activities of a religious organization that compete with the private sector or that are not integral to the practice of the religion do not come within the exemption. In which case, if the values of these taxable supplies exceed the threshold of 500, 000 Birr, the religious organization must register. A religious organization that operates taxable activities through a development commission or similar entity must separately register the commission or the similar entity.

The Regulation also provides that the exemption for supplies of humanitarian aid applies to goods imported or purchased locally by organizations registered as humanitarian organizations for such purpose. (Article 26 (1) and (2))

The exemption covers the import of goods or purchase of goods locally with an announcement or declaration of a natural disaster, industrial accidents, or catastrophe by the Disaster and Prevention Commission.

The Regulation contains a provision that deals with import exempt by law or agreement.

An exemption by agreement covers tax exemption for certain import of goods only if the agreement is entered into by the government or the agreement is entered into with permission granted by the government. (Article 28 (3) and (4))

The exemption by agreement includes exemption provided under;

- a. A technical assistance or humanitarian assistance agreement entered into between governments of any country;
- b. The Diplomatic Immunities and Privileges Convention;
- c. An International Convention having the force of law in Ethiopia; and

d. Any other multilateral agreement to which Ethiopia is a party.

## **2.4.8 Tax Credit, Procedures for Filing Tax Return and Payment of VAT and VAT Refund or Rebate.**

### **2.4.8.1 Tax Credit**

Under the VAT law the amount of VAT that is creditable is the amount of VAT payable (paid) by a registered person in respect of tax invoices or customs declaration issued to the person for:

- a. Imports of goods that take place during the current accounting period; and
- b. Taxable transactions involving the supply of goods or rendering of services that are considered to take place during the current or preceding accounting period.

Where the goods or services are used or are to be used for the purpose of the registered person's taxable transactions. (Article 21(1)(a) and (b))

In cases where only a part of the supplies made by a registered person during a tax period are taxable transactions, the amount of tax credit or rebate for that period is determined;

- a. In respect of a supply or import received, which is directly allocable to making of taxable transactions, the full amount of tax payable in respect of the supply or import is allowed as credit or rebate.
- b. In respect of a supply or import received which is directly allocable to the making of exempt transaction, no amount of tax payable in respect of the supply or import shall be allowed as a credit or will be allowed as a credit.
- c. In respect of a supply or import received which is used both for the making of taxable and exempt transactions, the rule of apportionment of the credit will be determined by a directive to be issued by the Ministry of Revenue. (Article 21 (2) (a) – (c))

Where VAT indicated in the VAT invoice or customs declaration for a transaction exceeds VAT payable on this transaction, the registered person is allowed a credit for the amount of the excess in the accounting period in which the event referred to occurred.

However if the supply was made to a person who is not a registered person, no credit will be allowed unless the excess tax has been repaid to the recipient of the supply.

(Article 21(5))

A person who registers for VAT after the introduction of VAT will be entitled to credit in the first accounting period in which the person is registered for VAT paid or payable on goods (including capital goods) that are on hand on the date of registration.

However this will be applicable only to the extent that the purchase or import of the goods occurred not more than six months prior to the date of registration. (Article 21(6)) A beneficiary of the duty draw – back scheme under proclamation No. 249/2001 – a proclamation to establish Export Trade Duty Incentive Scheme is not entitled to a refund of VAT paid on imports under the VAT credit system of the VAT law. (Article 21(7))

#### **2.4.8.2 Procedures for Filing Tax Return and Payment of VAT**

Under the VAT law every registered person is required to: (a) File a VAT return for each accounting period, whether or not tax is payable in respect of that period; and (b) pay the tax for every accounting period by the deadline for filing the VAT return. The VAT return for every accounting period must be filed not later than the last day of the calendar month following the accounting period. (Article 26, 1(a) and (b) and (2))

#### **2.4.8.3 VAT Refund or Rebate**

If at least 25 percent of the value of a registered person's taxable transactions for the accounting period is taxed at a zero rate, the tax authority will refund the amount of VAT applied as a credit in excess of the amount of VAT charged for the accounting period within a period of two months after the registered person files an application for refund, accompanied by documentary proof of payment of the excess amount. (Article 27(1))

In the cases of other registered persons, the amount of VAT applied as a credit in excess of the amount of VAT charged for the accounting period is to be carried forward to the next five accounting periods and credited against payments for these periods, and any unused excess remaining after the end of this five- month period shall be refunded by the tax authority within a period of two months after the registered person files an application for refund, accompanied by documentary proof of payment of the excess amount.

(Article 27 (2)) Where the tax authority is satisfied that a person who has made an application for refund has overpaid tax, the tax authority shall first apply the amount of the excess in reduction of any tax, levy, interest, or penalty payable by the person under the VAT proclamation, the customs proclamation, the income tax proclamation, or the sales and excise tax proclamation and then repay any amount remaining to the person if the amount to be refunded is more than 50 Birr. (Article 27 (5) (1) (a) and (b))

If a registered person is entitled to a refund and the tax authority is satisfied that the person has overpaid tax, then if the tax authority does not pay the refund within the specified two months period, the tax authority will pay the person entitled to the refund, interest set at 25% (twenty five percent) over and above the highest commercial lending interest rate that prevailed during the preceding quarter. (Article 27(6))

#### **2.4.8.4 Non-compliance to VAT Proclamation**

Non-compliance with VAT Proclamation failure to register for VAT as per VAT registration requirement, failure to issue a tax invoice, failure to maintain recorder such as original tax invoices received and a copy of tax invoices issued and failure to file timely return shall be liable to administrative penalties ranging from a fine 100 percent of the amount of tax payable and a fine of up to 50,000 Birr.

In addition to administrative penalties tax offenders such as tax evasion, making false or misleading statement and failure to notify are all criminal offences under Ethiopian law.

Accordingly, tax fraud - making false or misleading statements is punishable with a fine ranging from 1000 Birr to 100,000 Birr and an imprisonment ranging from 3 years to five years where the making of false or misleading statement is made knowingly or recklessly such an offence is punishable by a fine of up to 200,000 Birr of an imprisonment of up to 15 years.

# Chapter Three

## Research Methodology

---

Chapter two has presented the review of the existing literature on the nature, practices and challenges of Value Added Tax (VAT) implementation in Ethiopia post January 2003 assessment. This chapter presents the methodology or approaches used such as quantitative, qualitative and mixed approaches in relation to this research paper. In this part, research approach and design, research method, research instrument, sampling design, data type and measurement scale, variables of the study, method of data analysis and reliability and validity instruments are presented.

### **3.1. Research Approach and Design**

The research has followed quantitative approach, A quantitative approach is one in which the researcher primarily uses postpositive claims for developing knowledge (i.e., cause and effect thinking, variables and hypotheses and questions, use of measurement and observation, and the test of theories), employs strategies of inquiry such as experiments and surveys, and collect data on predetermined instruments that yield statistics data. (Creswell, 1999). The research is designed as descriptive and correlational research.

The purpose of this study is to describe practices and challenges of VAT implementation in Ethiopia since January 2003 and trace areas of weaknesses and strengths towards the implementation of VAT Objectives. As can be seen from the research problem it is more of descriptive type and tries to assess and justify current practice and specific factors that affecting its intended implementation. The study is a descriptive type of research whereby both primary and secondary data will be used. The reason for opting such type is due to simplicity and the nature of the topic selected.

According to Burns and Grove (2003), descriptive research is designed to provide a picture of a situation as it naturally happens. It may be used to justify current practice and make judgment and also to develop theories. In order to benefit from the advantage of quantitative and qualitative approaches, the mixed method will be in use for this study.

## **3.2 Method of Data Collection, Instruments and Data Type**

Leedy and Ormond (2005) state that survey research involves acquiring information about one or more group of people perhaps about their characteristics, opinions, attitudes, or previous experiences-by asking them questions and tabulating their answers. Creswell (2009) also states that the purpose of survey research is to generalize from the sample to the population in order to be able to make inferences about some characteristic, attitude or behavior of the population.

Survey design is selected for this research because of budget and time constraint (economical advantage of the design).

The survey method was conducted using a structured questionnaire for both ERCA employees and VAT registered taxpayers. Review of records and various documents of published and unpolished of ERCA were used. The questionnaire was prepared in English language for ERCA employees, whereas, for VAT registered taxpayers translated in Amharic and it was classified into two sections. The first part of the questionnaires were designed to collect participants' profile (background information), whereas, the second part of the questionnaire were focused on VAT related issues that addresses the research questions.

In addition, the study used documentary review, specifically, the ERCA magazines and brochures in relation to VAT implementation. The purpose of the documentary review is believed to augment findings in the questionnaire survey and the deep interview to be carried out.

## **3.3. Population and Sampling Design**

### **3.3.1. Target Population**

According to Diamantopoulos (2004), a population is a group of items that a sample will be drawn from. The target population defined as suitable for this study is employees of ERCA and VAT register taxpayers, whose annual turnover greater than fifty million Birr in Addis Ababa to collect different information and data on the nature, practice and challenges in relation to VAT implementation.

Among the very reasons why Addis Ababa was selected for this study is; firstly, the majority of VAT registered taxpayers living in Addis Ababa vis-a-vis other main cities in Ethiopia. Second, Addis Ababa is a capital city of Ethiopia and a major source of government revenue due to large number of population. In addition to this, residential consumers in Addis Ababa is the better representative of other cities also to assess the nature, practice and challenges that affects the VAT implementation in the country.

### **3.3.2. Sampling Method**

A sample refers to a set of individuals/companies/ selected from an identified population with the intent of generalizing the findings to the entire population. A sample is drawn as a result of constraints that make it difficult to cover the entire research population (Leedy and Ormord, 2005). Sample design deals with the sample frame/population, sample size, sampling techniques. Paragraphs that follow discuss issues pertaining to sample frame, sample size and sampling techniques respectively.

The type of sampling used for this researcher is purposive sampling technique. It is because to focus on particular characteristics of a population that are of interest, which enable me to answer my research questions. The two purposive sampling considered in the study are both employees of ERCA and VAT registered taxpayers.

### **3.3.3. Sample Size Determination**

Sampling refers to the statistical process of selecting and studying the characteristics of a relatively small number of items from a relatively large population of such items, to draw statistically valid inferences about the characteristics of the entire population Prior to the actual data collection, emphasis was made on the determination of sample size that is mainly dependent on the purpose of the study, available resource and precision (variance) required.

According to Sangeeth, (2007), sampling formula uses two key factors: (1) the risk the researcher is willing to accept in the study, commonly called the margin of error, or the error the researcher is willing to accept, and (2) the alpha level, the level of acceptable risk the researcher is willing to accept that the true margin of error exceeds the acceptable margin of

error. Often, the sample size is expressed in terms of variance. Yamane (1967:886) provides the following simplified formula to calculate sample sizes,

$$n = \frac{N}{1 + N(e)^2}$$

Where n is the sample size, N is the population size, and e is the level of precision

*Table 2: Sample Size for ±5% Precision Levels where Confidence Level is 95% and P=0.05*

Stratum	Size of Population(N)	Proportion of total(p)	Sample size(n)
Employees ERCA	350	0.53	187
Large tax VAT payers(earning >50 Million)	1500	0.21	316
Total	1850	0.27	503

**Source: Own computation**

### **3.3.4. Procedure of Data Collection**

To conduct the survey, (3) data collectors and (1) driver were recruited by headhunting i.e approaching those who have prior experience of collecting data and have some information on ERCA and registered VAT payers, who can easily reach and collect the required data. Data collectors were responsible to on average 168 questionnaires each. Detail briefings were given and make sure the methodology is clear to the data collectors. These questionnaires had been checked by the researcher. The survey period was December 15, 2014 – December 26, 2014. At time of data collection, 503 questionnaires were distributed.

### **3.4. Unit of Analysis**

The unit of analysis for this study is ERCA employees and VAT registered taxpayers on individual base. The VAT registered taxpayers are those whose annual turnover is greater than 50 million in Addis Ababa.



### 3.5. Method of Data Analysis

The statistical analysis is conducted based on Percentages, Tables and Figures. In case of descriptive statistics, a quantitative method of data analysis is adopted. The data collected from survey questionnaires were carefully coded and checked for consistency and entered into the Statistical Package for Social Scientists(SPSS) statistical package. The analysis was performed with a method of SPSS version 17. Descriptive statistics was employed to analyze data and the results were tested with non-parametric tests of significance.

To conduct documentary analysis, the study employed a time series data covering a period of 2003 – 2012, data are obtained from the Ethiopian Customs and Revenue Authority statistical bulletin, the Federal Inland Revenue Service, Ministry of Finance and Economic Development annual statistical abstracts and the authors’ computations.

### 3.6. Research Model

#### Time series Analysis Model

In addition to the descriptive analysis, the study also employed a time series data covering a period of 2003 – 2012, data are obtained from the Ethiopian Customs and Revenue Authority statistical bulletin, Ministry of Finance and Economic Development annual statistical abstracts and the authors’ computations.

#### Model Specification

The models for this study are based on Adereti, S.A (2011) and specified as follows:

$$GDP = \beta_0 + \beta_1 VAT + et \dots\dots\dots 1$$

Where GDP = Gross Domestic Product, VAT = VAT Revenue,

Equation (1) is a GDP equation which is going to be estimated, where;  $\beta_0$  &  $\beta_1$  are coefficients to be estimated and  $et$  = error term

$$TGR = \beta_0 + \beta_1 VAT + et \dots\dots\dots 2$$

Where TGR = Total Government Revenue, VAT = VAT Revenue

Equation (2) is a TGR equation which is going to be estimated, where;  $\beta_0$  &  $\beta_1$  are coefficients to be estimated and  $e_t$  = error Term

### **3.7. Measurement of Reliability and Validity**

The study validated the measurements using reliability and Validity.

#### **3.7.1. Validity**

According to Leedy et al (2005), validity is the ability of an instrument used to measure what it is designed to measure. They further explained two basic questions: does the study have sufficient control to ensure that the conclusions the researcher draw are truly warranted by the data and can the researcher use what he/she has observed in the research situation to make generalization to the population beyond that specific situation? The answers to these two questions address the issues of the content validity, internal validity and external validity.

#### **Internal Validity**

The easy way to describe internal validity is the confidence that one can place in the cause and effect relationship in a study to check whether there could be an alternative cause, or causes, that explain the observations and results or not. Though the dependent variables have other wide ranges of factors as independent variables, the researcher maximize the internal validity by focusing on individual's perception which were not examined in the previous studies and set up strong controls to isolate other factors by asking open ended questions to get the major extraneous variables and control their effect on the independent variable. (<http://www.inclentrust.org>; extracted on December 21,2014 at 10:00am)

#### **External Validity**

External validity is the generalizability of the research, that is, ability of its conclusion to be validly extended from the specific environment in which the research study is conducted to similar "real world" situations. Externally valid research with generalizable conclusions is obviously more valuable than externally invalid research, whose conclusions are restricted to specific research settings in a given study.

This survey research was conducted using stratified sampling techniques in Addis Ababa as per ERCA's revenue collection centers. Though the sample is too small as compared to the population, the sample representativeness validity is realized so that, study's findings are generalizable to the rest of VAT registered taxpayers in Addis Ababa.

### **Construct Validity**

Construct validity defines how well a test or experiment measures up to its claims. It refers to whether the operational definitions of a variable actually reflect the true theoretical meaning of a concept and quality of an instrument. The researcher has tried to refer different literatures regarding the constructs only with some customization and thereby matching with the basic theories. So, all behaviors under each construct are measured properly realizing the issue of construct validity.

### **Content validity**

Content validity is the extent to which the measurement method covers the entire range of relevant behaviors, thoughts, and feelings that define the construct being measured. The instrument was tested through different stages. It is reviewed and some basic modifications were conducted to avoid ambiguity of items and maintain the precision to be clear for the customers to answer correctly.

### **Statistical Conclusion Validity**

Statistical conclusion validity can measure the degree to which conclusions about the relationship among variables based on the data are 'reasonable'. Since the current research is based on well-defined instrument, the methodology is carefully designated that fits with the nature of the data used. So the statistical conclusion made in this study is reliable assuring statistical conclusion validity in the research.

### **3.7.2. Reliability**

Cronbach's alpha measured how well the set of statements measured the constructs. Cronbach's alpha determines reliability. Reliability comes to the forefront when variables developed from summated scales are used as predictor components in objective models. Since summated scales

are an assembly of interrelated items designed to measure underlying constructs, it is very important to know whether the same set of items would elicit the same responses if the same questions are recast and re-administered to the same respondents. Variables derived from test instruments are declared to be reliable only when they provide stable and reliable responses over a repeated administration of the test constructs.

# Chapter Four

## Results and Discussions

---

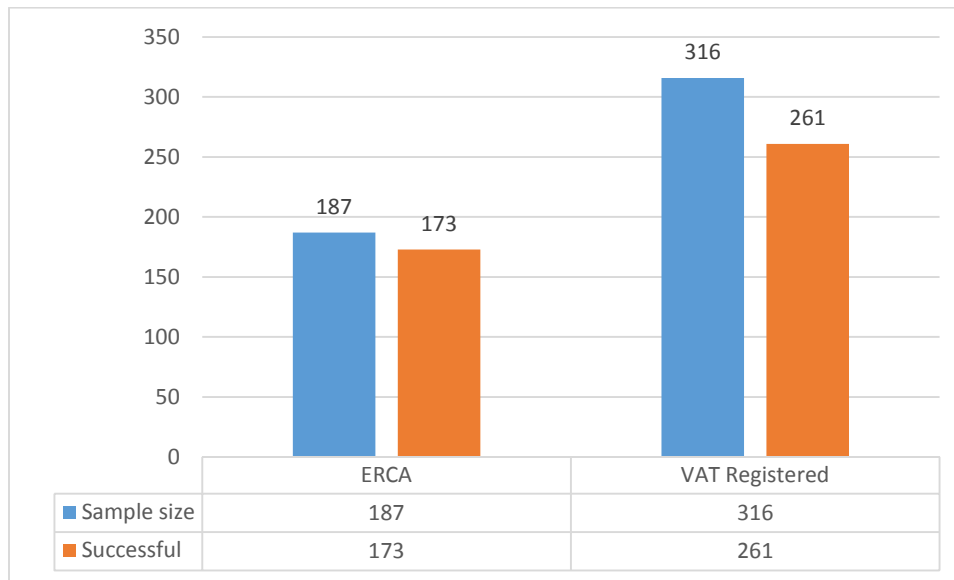
This chapter represents the findings of the study conducted to assess on the practices and challenges of VAT implementation in Ethiopia (in the case of Addis Ababa) since January 2003. The survey respondents were asked questions about a number of different aspects of the VAT tax implementation and its administration, ranging from the perceived simplicity and transparency of the VAT system to specific issues such as awareness, fairness, enforcement and compliance. The full questionnaire is attached as Annex 1 and 2.

The data collected from survey questionnaires were carefully coded and checked for consistency and entered into the Statistical Package for Social Scientists (SPSS) spreadsheet. The analysis was performed with SPSS version 17. Descriptive statistics was employed to analyze data and the results were tested with non-parametric tests of significance.

The questionnaire was distributed to both ERCA employees and VAT registered taxpayers, who have comprehensive experience in VAT practices selected randomly from all ERCA and traders (VAT registered taxpayers).

Out of 503 (187 for ERCA employees and 316 for VAT registered taxpayers) questionnaires physically distributed to the target population, 434 usable responses were collected (173 collected from ERCA and 261 from VAT registered taxpayers, whose annual turnover is greater than 50 million). The response success rate of ERCA respondents is 92.5% of them were returned, while the remaining 7.5% of the questionnaires were not returned. On the other hand, the response success rate of VAT registered respondents is 82.6% of them were returned, while the remaining 17.4% of the questionnaires were not returned at all because of the reluctance of respondents to complete and give back the questionnaires. The responses of the respondents are summarized and presented in the following section (figure 1).

Figure 1: Questionnaire response success rate



Source: Own computation from survey data

## 4.1 Descriptive Analysis

### 4.1.1 Background Information of Respondents

#### ❖ Sex of respondents

The majority of the respondents are male and they accounted for 63.4% of the total respondents (i.e. respondents from ERCA and VAT registered traders) and the remaining 36.6% are female respondents (see table 3 below).

Table 3: Sex of Respondents

Variables	Categories	Frequency	Percent
Sex	Male	275	63.4
	Female	159	36.6
	Total	434	100

Source: survey data

❖ **Age of respondents**

The relevance of the age of respondents is to check whether the respondents do they have the required level of maturity to respond correctly to the given questionnaires. The statistical result of the age of respondents shows that the majority of participants 331(76.3%) were those whose age 20 -30, followed by 16.1%, 5.1% and 2.5% were those respondents, whose age group are 31-40, 41-50, and 50+ respectively (see table 4 below).

*Table 4: Age of Respondents*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Age group of respondents	20-30	331	76.3
	31-40	70	16.1
	41-50	22	5.1
	50+	11	2.5
	Total	434	100

Source: survey data

❖ **Respondents' Educational Status**

Bachelor degree (BA) holders constitute 81.6% of the respondents and they are followed by respondents with Master's Degree and above who represent 11.0%, while the remaining 7.4% of the respondents a diploma level education and below (see table 5 below for details). This shows that the respondents are qualified enough to easily understand and respond the questionnaire correctly.

*Table 5: Respondents' Educational Status*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A. Level of Education	12 grade and below	6	1.4
	Certificate	12	2.8
	Diploma	14	3.2
	Bachelor	354	81.6
	Master and above	48	11.0
	Total	434	100

Source: survey data

## 4.1.2 Do the business communities know the VAT rules and regulations properly?

### ❖ The Business Community’s Awareness of the VAT Proclamation

The issue is how the VAT rules and regulations are simple in order to taxpayers to understand the rules and comply with them cost effectively so as to reduces the number of errors, improves compliance, and increases respect for the system; promotes transparency and cost effective collection.

Respondents were asked their opinions on the understanding of VAT rules and regulations. The results are shown in table 6 below, 19.7% of the respondents replied “yes”, whereas 67% of the respondents stated “partially. This indicated that taxpayers and the society in general do not know much about the tax. The taxpayer survey respondents further noted that the tax authority has not made sufficient effort in increasing the awareness about the tax. This means that the authority should have to strengthen the tax education program. The remaining 7.5% and 5.8% of the respondents declared that “not at all” and “not worried at much” respectively.

*Table 6: Business Community’s Awareness of the VAT Proclamation and its Rationale*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
The business community is well aware of the VAT proclamation and its rationale	Yes	34	19.7
	Partially	116	67.0
	Not at all	13	7.5
	Not worried that much	10	5.8
	Total	173	100

Source: survey data

### ❖ Knowledge of VAT and Its Application

The knowledge of the VAT and its application by both taxpayers, as well as the authority employees are a prerequisite to comply with the rules and regulation of the VAT proclamation. As the result shown in table 7 below, 82.2% of the respondents claimed that they have adequate knowledge of VAT and its application, but 14.7% of the respondents felt that little knowledge of VAT and its application. The remaining 3.1% of the respondents stated that they do not have the



required knowledge concerning VAT and its application. As per the respondents survey results, it can be declared that the business community has the knowhow about the VAT rules and regulations.

*Table 7: Knowledge of VAT and Its Application*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Adequate knowledge of VAT and its application with its purpose in relation to VAT payers	Yes	212	82.2
	No	8	3.1
	Little	38	14.7
	Total	258	100

Source: survey data

### ❖ **Business Traders' Source of VAT Related Information**

The majority of the respondents clearly stated that they have developed the idea of VAT through different means, such as by radio, TV, reading brochures, and from other VAT payers, which accounts 81.1%. This implies that the business Traders have enough source of information to understand the VAT rules and regulations. The others 13.1% of the respondents updated themselves about VAT by reading brochures and the remaining 5.8% of the respondents from another VAT payer (see table 8 for details).

*Table 8: Business Traders' Source of VAT Related Information*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Traders' Source of VAT related information	Reading Brochure	32	13.1
	From another VAT payer	14	5.8
	All	198	81.1
	Total	244	100

Source: survey data

**❖ Closure and/or Address Change**

Whenever, there is a business closure or address change the proclamation sets out the need to notify the authority within 3 days. The examination of the respondents result indicated that 68.4% of the respondents confirmed that yes the traders notify the authority as per the requirements whenever any business closure or address change, but 31.6% of them they said that the traders did not notify the authority within established time (see table 9 for details). This indicates that the business communities know the VAT rules and regulations to comply with.

*Table 9: Closure and/or Address Change*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Whenever, there is business closure and/or address change, traders notify the authority as per the requirement (within 3 days)	Yes	106	68.4
	No	49	31.6
	Total	155	100

Source: survey data

**4.1.3 Do the Business Communities Perform Their Business Activities on the Basis of the Current VAT Laws?**

**❖ Business Traders Practice of Issuing VAT Receipts to All Buyers**

As per the VAT proclamation business traders are expected to issue VAT receipts to all buyers without fail and depositing collected amount to the government account every month. This is actually, an indication how the business community well understood the VAT proclamation to put into practice. To this end, 56.2% of respondents confirmed that they are issuing VAT receipts without fail to all buyers and deposit collected VAT to the government account every month. However, 29.6% of the respondents acknowledged that they did not practice that at all, while the remaining 14.2% of the respondents do it sometimes (see table 10 for details).

*Table 10: Traders Practice of Issuing VAT Receipts to All Buyers*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A. Traders practice of issuing VAT receipts to all buyers without fail and depositing collected amount to the government Account every month	Yes	91	56.2
	Not at all	48	29.6
	Some times	23	14.2
	Total	162	100

Source: survey data

### ❖ **Business Communities Practice of VAT Reporting**

This is actually, to see whether the business communities were practicing of VAT reporting as stated in VAT proclamation or not. Based on this, the majorities of the respondents from ERCA replied that on average most of the business communities were paying VAT regularly and declared their income timely to the authority. As per the summarized data of respondents, 33.4% of the respondents replied “good”, 50.3% of the respondents said “fair”, 13.3% of the respondents selected “not good”. The remaining 3% of the respondents responded as “worse” (see table 11 for details). This result showed that there is still a gap to fully comply on the basis of the current VAT laws.

*Table 11: Business Traders’ Practice VAT Reporting*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
B. Business community practice of VAT reporting	Good	55	33.4
	Fair	83	50.3
	Not good	22	13.3
	Worse	5	3.0
	Total	165	100

Source: survey data

#### 4.1.4 Does the Administration Capacity of ERCA Strong Enough to Control those Non-Compliance and Delinquent Taxpayers?

##### ❖ ERCA’s capacity to reach the general public

Why ERCA does need the capacity to reach the general public? Since it is the people at the end of the day pays the VAT and thus, it is very essential to create awareness to the general public. Based on this essence 37.7% of respondents replied that ERCA has the capacity to reach the general public to implement the law, whereas 45.3% of the respondents said that ERCA has no adequate capacity to reach the general public. The remaining 17% of the respondents stated that “quite not, but showing progress” (see table 12 for details).

Responses made by the respondents to the open ended questionnaire reaffirmed that the majority of both respondents (ERCA and VAT registered taxpayers) do not believe that ERCA has capacity to reach the general public. Some of the reasons they were mentioned concerning the lack of capacity of the organization were: its staff members are not well trained; there is a high turnover of employees, less attention is given to professional services (more attention given to politics most of the time), lack of motivation of employees and so on. This implies that the authority should have to give due attention to improve the capacity of its employees both professionally and morally in order to discharge its objectives as stipulated in the proclamation. Since the dynamic nature of the subject and the complexity of the area, as well as the VAT system being new for the country, it demands that the authority to take the necessary measures, such as to have the required number of workforces with the required capacities and skills so as to reach and create VAT related awareness to the general public.

*Table 12: ERCA’s Capacity to Reach the General Public*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Respondents who believe that ERCA has capacity to reach the general public	Yes	160	37.7
	No	192	45.3
	Almost not/Quite not, but showing progress	72	17.0
	Total	424	100.0

Source: Survey data

**❖ The Research Unit of ERCA is Strong Enough in Modernizing the VAT System**

The research unit of any organization is very vital in modernizing the system. In the case of ERCA, it is one of the very important organizations that established by the government to properly manage and collect government revenues at most. As a result, the collected responses indicated that 37% of the respondents attested that the research unit of ERCA is strong enough to modernize the VAT system, whereas 63% of the majority of the respondents confirmed that the research unit of ERCA does not have the capacity so as to modernize the VAT system (see table 13 for details).

*Table 13: The Research Unit of ERCA*

Variables	Categories	Frequency	Percent
The Research Unit of ERCA is strong enough in modernizing the VAT system	Yes	60	37
	No	102	63
	Total	162	100

Source: survey data

**❖ All Eligible Business Traders Get Registered as VAT Payers**

The respondents stated that ERCA was not working as expected to get registered all eligible business traders, due to lack of capacity. The respondents mentioned that they are many business traders not yet registered as they may not want to carry out this responsibility, as well as with the intention to do hidden business and being profitable illegally (Unlawfully). The respondents also added that there are many businesses with high volume of sales even they have no a business license let alone register for VAT. The summarized survey data indicated that 49.1% of the respondents replied that all eligible business traders get registered as VAT payers, whereas, 50.9% of the respondents said not all eligible business traders get registered (see table 14 for details). This showed that the administration capacity of ERCA is not strong enough to control those non-compliance and delinquent taxpayers fully into the system. However, the authority has showed some progress so as to control con-compliance and delinquent taxpayers.

*Table 14: All Eligible Business Traders Get Registered as VAT Payers*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
All eligible business traders get registered as VAT payers	Yes	85	49.1
	No	88	50.9
	Total	173	100

Source: Survey data

### ❖ **The Institutional Capacity of ERCA in Managing the VAT Application**

VAT in particular requires administrative capacity both within the tax authority and on the part of the private sector through accounting and reporting. It is clear that the capacity of much of the private sector is so low that it forms a major obstacle to effective implementation of the law. On the other hand, whilst there is quite a spread of opinions, the capacity of ERCA to administer the tax laws is considered by a small majority to be average or better. Given that tax authorities are not generally held in high regard in any jurisdictions around the world, this should be considered to be a fairly positive assessment of ERCA.

A good VAT administration is critical in fully implementing tax and reducing gaps between the effective taxation and what it is supposed to be in the proclamation. In general, a good VAT administration is important to achieve the policy objectives of a government. The institutional capacity of ERCA is by and large acceptable with the exception of other capacity problems, such as awareness creation, the required number of staff with the required qualification, etc. This is because; almost 83.6% of the respondents indicated that the institutional strength of ERCA is adequate (good and very good), but the remaining 16.4% of the respondents said poor (see table 15 for details).

*Table 15: Institutional Capacity of ERCA in Managing VAT*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
The institutional capacity of ERCA in managing the VAT application	Poor	26	16.4
	Good	123	77.3
	Very good	10	6.3
	Total	159	100

Source: Survey data

#### ❖ The Awareness Creation and Media Dissemination for VAT Payers

The awareness creation and media dissemination for VAT payers are playing a vital role for successful implementing of the VAT law. The summarized survey data showed 88.2% of the respondents confirmed that the awareness creation and media dissemination to VAT payers are very satisfactory; on the other hand, the remaining 11.8% of the respondents said that the awareness creation and media dissemination of ERCA to VAT payers are poor (see table 16 for details).

*Table 16: Awareness Creation and Media Dissemination for VAT Payers*

Variables	Categories	Frequency	Percent
The awareness creation and media dissemination for VAT payer	Poor	20	11.8
	Good	120	71.0
	Very good	29	17.2
	Total	169	100

Source: survey data

#### 4.1.5 Have the Implementation of VAT in Ethiopia Met Its Objectives Properly and Encourages for the Growth of Investment and Export?

#### ❖ The Implementation of VAT is Successful

The majority of VAT registered respondents replied that the implementation of VAT was unsuccessful or little. The summarized data indicated that 36.98% of the respondents replied yes, the implementation of VAT is successful, while 47.8% of the respondents believed that VAT implementation success is unsatisfactory (little). The remaining 15.4% of the respondents said the implementation of VAT is unsuccessful (see table 17 for details). A central issue which is seen to reduce the fairness of the VAT system is that of the implementation directives which are issued by government organs. Unlike the proclamations and regulations, these directives are not readily available and accessible to taxpayers, hence making it difficult for taxpayers to know exactly their responsibilities.

*Table 17: Implementation of VAT is Successful*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A. The implementation of VAT is successful	Yes	91	36.8
	No	38	15.4
	Little	118	47.8
	Total	247	100

Source: survey data

### ❖ **The Implementation of VAT has met Its Objectives**

VAT is believed to be a good means to raise government revenue even when relatively poorly administered. Ebril and Keen (2001) also strengthen the above idea empirically. They found that in the countries have adopted VAT, revenue from this source accounted on average 27% of the total tax revenue, whereas in the case of Ethiopia revenue performance of VAT was 42.4% of total revenue, which is above the average of 27% (see table 1 for detail). The survey data revealed that 54.8% of the VAT registered respondents confirmed that the implementation of VAT has met its objectives, whereas the remaining 45.2% of respondents responded that the implementation of VAT has not met its objectives (see table 18 for details). In general, the computed percentage showed that more or less the implementation of VAT has met its objectives.

*Table 18: Implementation of VAT has met Its Objectives*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
B. The implementation of VAT has met its objectives	Yes	132	54.8
	No	109	45.2
	Total	241	100

Source: survey data



**❖ VAT Implementation Compared with Neighboring Nations (Kenya, Sudan and Tanzania).**

As can be seen from Table 1, VAT is a major source of revenue in most African Countries. The share of VAT in total tax revenue ranges from 17.4% in Mauritius to 42.4% in Ethiopia. In Ethiopia the share of VAT in total revenue, which is 42.4% is the largest as compared to the sampled 31 countries, which consisted of Neighboring Nations of Ethiopia. The revenue performance of VAT as measured by the ratio of VAT to GDP in Ethiopia which is 5.7% is much higher than the African average of 4.6% (see table 1 for details). In terms of VAT implementation effectiveness, 88.8% of the respondents confirmed that Ethiopia is effective compared to neighboring nations (Kenya, Sudan and Tanzania) in VAT implementation. The remaining 11.2% of the respondents replied that Ethiopia is not effective compared to the neighboring countries (see table 19 for details). Owing to the above, it is adequate enough the implementation of VAT in Ethiopia has met its objectives in this respect.

*Table 19: VAT Implementation Effectiveness Compared with Neighboring Nations*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
VAT implementation effectiveness compared with neighboring nations	Excellent	10	8.0
	Very good	21	16.8
	Good	80	64
	Poor	14	11.2
	Total	125	100

Source: survey data

**❖ The Implementation Strategy of VAT in Ethiopia**

This is the very critical area that everybody observes everywhere, but the important thing is to tackle such a challenge in order to revert it from its wrong direction. The survey results of 26.1% of the respondents attested that they have personally challenged the implementation strategy of VAT in Ethiopia when it is going wrong or inadequate, but 73.9% of the respondents stated that no such instances (see table 20 for details).

*Table 20: Implementation Strategy of VAT in Ethiopia*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Any instances that you have personally have challenged the implementation strategy of VAT in Ethiopia when going wrong.	Yes	40	26.1
	No	113	73.9
	Total	153	100

Source: survey data

### ❖ **The Introduction of VAT and Its Importance**

For effectiveness of VAT proclamation, transparency is a critical issue. Taxpayers should know that a tax exists and how and when it is imposed upon them and its importance. This suggests that efforts by the tax authority to improve the transparency of the tax system would be beneficial. To this end, the vast majority (i.e. 92.9%) of the respondents do believe that VAT is important for the development of investment and international trade. Nevertheless, 4.7% of the respondents do not believe that is the case. The remaining 2.4% is not sure whether or not the VAT is important for the development of investment and international trade (see table 21 for details).

*Table 21: The Introduction of VAT and Its Importance*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A. Importance of VAT for the development of investment and international trade	Yes	235	92.9
	No	12	4.7
	Indifferent	6	2.4
	Total	253	100

Source: survey data

### ❖ **VAT's Advantage Over the Sales Tax It Replaced**

A conventional sales tax leads to compounding of the tax liability, while VAT does not (Bhatia, 2003). In order to compare VAT revenue with that of sales revenue, the turnover tax should be added on VAT since sales tax was replaced by VAT and turnover tax. Further, since its introduction, VAT has been more revenue productive than sales tax (Teferra, 2004). The VAT implementation by replacing the sales tax brought a dramatic change in the improvement of the

government revenue when it is compared the replaced sales tax. The responses of 68.5% of the respondents confirmed that VAT is more advantageous than the replaced sales tax, while 5.9% of the respondents said no. The remaining 25.6% of the respondents they don't have the adequate knowhow to differentiate between the two (see table 22 for details). This can be also supported.

*Table 22: VAT's Advantage over the Sales Tax*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
VAT's advantage over the sales tax it replaced	Yes	174	68.5
	No	15	5.9
	I don't know	65	25.6
	Total	254	100

Source: survey data

#### ❖ **A Single Rate of 15% VAT**

Many business traders, as well as the majority of the people complained about the high rate of VAT. It should be noted in this regard, however, that the Ethiopian rate of 15 percent is not excessive by international standards and is, in fact, fairly typical of VAT rates around the world. With regards to the reasonableness of a single rate of 15% VAT is 42.7% of the respondents confirmed that the single rate of 15% is reasonable, but 14.6% of the respondents replied that it is not reasonable. The remaining 42.7% of the respondents were not sure on the reasonableness or not (see table 23 for details)

A further point on the VAT rate is in order; revenue derived from VAT now accounts for over 40 percent of total tax revenue for the Government of Ethiopia. If the rate were to be reduced, this would cause an immediate and massive loss of revenue to the government, which would have to be offset by other tax means. Although revenue can be increased by broadening the tax base, this approach is much more long term, hence there would seem to be little practical alternative to continuing with VAT at its current level. Ethiopia is applied to be a member of World Trade Organization (WTO) that demands the country to reduce other tariffs that has a direct effect on the total revenue. Therefore, Ethiopia will be forced to work hard to increase and make efficient the VAT system in order to compensate other tariff reductions.

*Table 23: A Single Rate of 15% VAT*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A single rate of 15% VAT is reasonable	Yes	70	42.7
	No	24	14.6
	Indifferent	70	42.7
	Total	164	100

Source: survey data

### ❖ **The VAT Proclamation Goals**

The VAT proclamation 285/2002 aimed at encouraging investment and in turn to bring economic changes to the country. VAT is one of the sources of government revenue that enhance the development of infrastructure and other social services, which in turn is encouraging and attract investment in the country. As indicated on the below table, 78.2% of the respondents said “yes” or agreed about the importance of VAT for encouraging investment so as to bring change to the country. The remaining 21.8% of the respondents did not believe that the goals of the VAT proclamation are met (see table 24 for details).

*Table 24: The VAT Proclamation Goals*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Respondents who believe the goals of the VAT proclamation are met	Yes	133	78.2
	No	37	21.8
	Total	170	100

Source: survey data

### ❖ **Consumers’ Willingness and Determination to Transact with a Proper VAT Receipt**

The willingness and determination of the consumers to transact with a proper VAT receipt is the key and decisive factor for successful implementation of VAT. The purpose of awareness creation to the general public is to have such consumers, who play an important role in the implementation of the VAT proclamation. 42.6%) of the respondents confirmed that consumers are willing and determined to transact with a proper VAT receipt, while 57.4% of the respondents said no, which implies that the consumers prefer to transact without proper VAT receipts (see table 25 for details).

Not all consumers but some consumers are not willing to transact with a proper VAT receipt because they need to conceal the tax. Most of the time consumers prefer to transact without receipt so as to get cheaper price at least reduced by VAT amount.

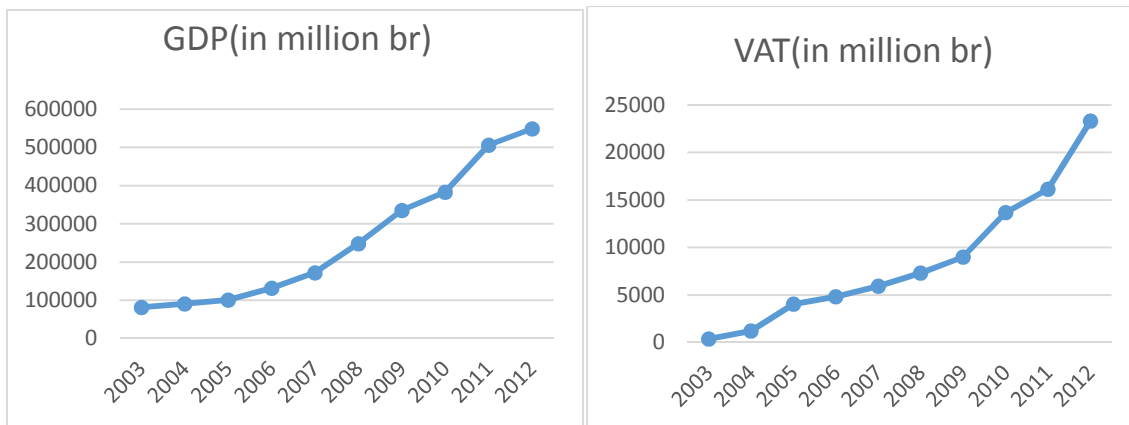
*Table 25: Consumers’ Willingness and Determination to Transact with a Proper VAT Receipt*

Variables	Categories	Frequency	Percent
Consumers’ willingness and determination to transact with a proper VAT receipt	Yes	72	42.6
	No	97	57.4
	Total	169	100

Source: survey data

In addition to the above, secondary data was used to support the importance of VAT to Gross Domestic Product (GDP) and Total Government Revenues (TGR). This helps the researcher to assess whether the implementation of VAT in Ethiopia has met its objectives properly and encourage for the growth of investment and report. This section contains the presentation, analysis and interpretation of the data collected for this research work. Consequently, it entails the application of statistical techniques to provide the basis for the testing of the hypotheses.

*Figure 2: The growth pattern of VAT and GDP*



Source: Author’s computation based on data from ERCA and MOFED

Hypothesis to be tested

H0: VAT revenue has significant impact on the economic growth of Ethiopia ... (1)

*Table 26: Regression result of Gross domestic product model 1 (equation 1)*

Source	SS	df	MS			
Model	2.5716e+11	1	2.5716e+11	Number of obs =	10	
Residual	1.7771e+10	8	2.2213e+09	F( 1, 8) =	115.77	
Total	2.7493e+11	9	3.0548e+10	Prob > F =	0.0000	
				R-squared =	0.9354	
				Adj R-squared =	0.9273	
				Root MSE =	47131	

gdp	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
vat	23.4998	2.184067	10.76	0.000	18.46334	28.53627
_cons	58202.92	23945.92	2.43	0.041	2983.526	113422.3

Source: STATA 11 Outputs

In Table 26 above, Gross Domestic Product (GDP) = 58202.92 +23.49 VAT. The estimated regression equation above reveals the fact that there has been a significant positive increase on Ethiopia's GDP over the years. This is shown by the constant term having a positive significant value (58202 million ETB). This implies that if for any reason, the value of the country's VAT is zero, the country will still have a positive GDP which is an indication of growth. The co-efficient of 23.49 suggests that a unit increase in VAT revenue will increase GDP by 23.49 units. The R-square and co-efficient of determination of 0.93 indicates that about 93% of the systematic variations in the dependent variable (GDP) has been explained by the changes in VAT revenue (VAT). The adjusted R-squared shows that after adjusting for the degree of freedom the model could explain about 92% of the systematic variations in GDP which is very high for forecasting. On the basis of the overall statistical significance of the model as indicated by the F-statistic, we observe that the model was statistically significant since the calculated Prob> 0.0000. It was observed that changes in VAT revenue have a marginal significant impact on GDP as indicated by the p-value of 0.000. Therefore we reject the null hypothesis and declare that there is significant relationship between the variance of VAT target and VAT budgeted on economic growth. In general, the computed result confirmed that VAT has encouraged the growth of investment and international trade by increasing the country's GDP.

**H0:** VAT revenue has significant impact on general government revenue in Ethiopia...(2)

*Table 27: Regression result of Total revenue model 2(equation 2)*

. regress tgr vat

Source	SS	df	MS			
Model	6.0209e+09	1	6.0209e+09	Number of obs =	10	
Residual	518380242	8	64797530.3	F( 1, 8) =	92.92	
Total	6.5393e+09	9	726585654	Prob > F =	0.0000	
				R-squared =	0.9207	
				Adj R-squared =	0.9108	
				Root MSE =	8049.7	

tgr	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
vat	3.595757	.3730261	9.64	0.000	2.735557	4.455957
_cons	6572.637	4089.826	1.61	0.147	-2858.517	16003.79

Source: STATA 11 Outputs

Table 27, Total government revenue (TGR) = 6572.63 +3.59 VAT. The estimated regression equation above reveals the fact that there has been a significant positive increase on Ethiopia's government revenue over the years. This is shown by the constant term having a positive significant value (6572 million ETB). This implies that if for any reason, the value of the nation's value added tax is zero, the country will still has positive government revenue which is an indication of growth. The co-efficient of 3.17 suggests that a unit increase in VAT revenue will increase total government revenue by 3.59 units. The R-square and co-efficient of determination of 0.92 indicates that about 92% of the systematic variations in the dependent variable (TGR) has been explained by the explanatory variable (VAT). The adjusted R-squared stood at 91%, only about 9 % of the systematic variation of TGR was left unaccounted for by the model hence captured by stochastic disturbance term in the model. This indicates a good fit of the regression line and also the model has a high degree of forecasting power. The researcher observed VAT revenue has a significant impact on total government revenue in Ethiopia as shown by the p-value of 0.00. Consequently we reject the null hypothesis and assert VAT revenue has a significant impact (positive) on Government revenue in Ethiopia.

#### 4.1.6 What are the Problems that Hinder for the Smooth Implementation of VAT in Ethiopia?

##### ❖ **Non-VAT Payers, Who are Challenging the VAT Payers' Performance**

Respondents of VAT registered taxpayers stated on the open ended questionnaire that the VAT system should be comprehensive enough to maintain fairness and equity among traders. The respondents added that ERCA should work first to create awareness about the importance of VAT through different mechanisms to the general public and tax payers so that the people with ERCA will have impact on the implementation. This in turn is bringing those illegal traders into the system. The authority should improve its capacity that in turn helps them to strengthen the enforcement system equally to all.

In summary, 73.7% of the respondents of VAT registered traders were replied that their performance are challenged by many non-VAT payers, but the remaining 26.3% of the respondents declared that no impact on the performance of VAT registered tax payers by non-registered traders (see table 28 for details). The result presented in this case implied that us how the non-VAT registered traders are influencing the performance of VAT registered taxpayers. In other words, this might create unfair competition between VAT registered and non-registered traders for the same type of goods or services.

*Table 28: Non-VAT payers, who are challenging the VAT payers' Performance*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Many non-VAT payers and challenging the VAT payers' performance	Yes	182	73.7
	No	65	26.3
	Total	247	100

Source: survey data

##### ❖ **The Market Competition Between VAT Registered and Non-Registered**

The introduction of VAT has been perceived by registered and non-registered businesses as having a number of negative impacts. The most significant of these are unfair competition, cited by many respondents, and additional costs to deduct and collect from customers, record keeping, training and hiring external accountants and other professionals. The survey data responses of 50.6% of



the respondents were argued that VAT registered traders are benefited from the market competition, since registered traders have privileged to compete for different government bids at the same time they have the right to get refund for input VAT. Whereas, 49.4% of the respondents claimed that the non-registered traders are benefited because they can sale more goods and service by lowering unit prices at least by the amount of VAT (see table 29 for details).

Following on from issues of the perceived competitive disadvantage of being registered for VAT, business traders were asked their views on the threshold for compulsory registration (anyhow the widely held view that many businesses are avoiding registration at the current level). Although VAT is a tax on consumption, due to the availability of VAT non-registered businesses, VAT registered businesses are not always able to pass the whole amount of VAT onto consumers. The alternative is to reduce profit margins.

The major impacts include the weakening of the VAT- registered businesses, a shift of businesses from the formal to informal sector, and flourishing of unfair competition; amongst others. A number of suggestions were made by business traders' respondents on the open-ended questionnaire in order to mitigate these effects. Among the more practical were wider VAT registration and better harmonization of TOT with VAT. Better control of contraband goods and clamping down on abuse of tax-free privileges were also proposed.

*Table 29: The Market Competition between VAT Registered and Non-Registered*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A. Who benefited from the market competition between VAT registered and non-registered	Registered	121	50.6
	Non-registered	118	49.4
	Total	239	100

Source: survey data

#### ❖ **A Person not Registered as a VAT Payer but Issuing a VAT Receipt**

The prevalence of poor and weak controlling system by ERCA is a main reason for the creation of loophole for fraudulent activities by others to deceit the consumers and the government. The authority should have to work to establish a system that minimizes or controls such a practice. The responses of 12.9% of the respondents replied that they have encountered such persons with the

purpose of cheating the customers, as well as the government in order to get illegal income. The remaining 87.1% of the majority respondents said no such kind of practice in the business community (see table 30 for details).

*Table 30: A Person not Registered as a VAT Payer but Issuing a VAT Receipt*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A person not registered as a VAT payer but issued a VAT receipt	Yes	28	12.9
	No	189	87.1
	Total	217	100

Source: survey data

### ❖ **Business Traders' Who are not Issuing VAT Receipts to Buyers**

The VAT registered respondents mentioned to the open ended questionnaire that some business traders are not issuing VAT receipts. This might be tax fraudulent activities or lack of awareness about the VAT rules and regulations. Some others indicated that they have the intention to compete with other traders by lowering the price (at least by the amount of VAT). 75.6% of VAT registered respondents replied that the business traders are not complying on the basis of the current VAT law. Actually, failure to issue VAT receipts to buyers shall be liable to administrative penalties. Whereas, 10.8% of the respondents said that business traders are issuing VAT receipts to buyers and performing on the basis of the current tax law. The remaining of 13.6% respondents stated that they do not have information (see table 31 for details). This shows that how the VAT implementation activities are being challenged by the tax collectors, however the VAT amount is being collected from consumers.

*Table 31: Business Traders' who are not Issuing VAT Receipts to Buyers*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Traders who know that there are businesses who do not issuing VAT receipts to buyers	Yes	189	75.6
	No	27	10.8
	I have no information	34	13.6
	Total	250	100

Source: survey data

### ❖ **Businesses which Collect VAT with Illegal Invoice**

Collecting of VAT with illegal invoice by a business organization is the practice made to evade government income. This is out of the essence of the proclamation and challenging the implementation of VAT. This kind of practice is considered as tax evasion, which is criminal offence under Ethiopian law that is subject for punishment. Albeit, this is contrary to the VAT proclamation, 63.6% of the VAT registered respondents confessed that they know some VAT registered business people collect the tax with illegal invoice. The remaining 36.4% of the respondents responded no (see table 32 for details).

*Table 32: Businesses which Collect VAT with Illegal Invoice*

Businesses which collect VAT with illegal invoice	Yes	159	63.6
	No	91	36.4
	Total	250	100

Source: survey data

### ❖ **Business Traders' Who Do not Maintain Proper Record Keeping of Operations**

The business traders have the responsibility to maintain proper recording system, so that they can have the required information as needed. Otherwise, it is very difficult to properly manage the operations of the business, i.e. their incomes and expenses of the business. Besides, failure to maintain records of the business transactions is considered as non-compliance with VAT proclamation, which is against the current VAT law. However, 61.2%) of h respondents from ERCA revealed that some traders do not maintain proper record keeping of their business operations due to many reasons. Some of the reasons stated by these respondents were the culture that they have in financial record keeping, fear of government and lack of confidence, cheating of the tax authority, lack of awareness and trained professionals to maintain their financial operations. The remaining 38.8% of the respondents declared that they don't know business traders, who don't maintain the records of their business operations (see table 33(A) for details).

On the other hand, to the same issue, 64% of respondents from business trader respondents confirmed that some business people do not properly maintain records of their transaction in accordance with the VAT law, due to different reasons as they indicated in their comments. Some of the comments were: some tax payers deliberately manipulated when they issued the VAT invoices, lack of the knowhow and awareness about the benefit to maintain accounting records and

other reasons. 12.4% of the respondents said they don't know and the remaining 23.6% of the respondents declared that they don't have information (see table 33(B) for details).

*Table 33: Business Traders' who do not Maintain Proper Record Keeping of Operations*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A. Some Traders not maintaining proper recording of business operations (ERCA employees Response)	Yes	104	61.2
	No	66	38.8
	Total	170	100
B. Some Business People not maintaining proper recording of business operations (Business Traders Response)	Yes	165	64
	No	32	12.4
	I have no information	61	23.6
	Total	258	100

Source: survey data

#### ❖ **The Threshold Level for VAT Registration.**

The threshold level of Birr 500,000 annual turnover was set for VAT registration in the proclamation before 10 years ago. The respondents indicated in their response to the open-ended part of this questionnaire that the threshold level should be revised for VAT registration, since the threshold was set before 10 years ago and hence Birr 500,000 is very small as the purchasing power of money is decreasing constantly due to inflation. On the other hand, there is a broad range of views, it can be said that there is a strong body of opinion that the existing threshold of Birr 500,000 should be reduced in order to bring more businesses into the VAT net.

77.5% of the respondents replied "yes or reasonable" but 15.5% of the respondents said "no or little". The remaining 4% of the respondents stated that the threshold amount of 500,000 Birr is "too much" for VAT registration and 3% the respondents said no option. The other point mentioned in their responses that about the need to exclude from VAT registration like that of food and other necessary goods and services to the public (see table 34 for details). In general, as a result of this threshold level the VAT implementation is challenged due to the existence of VAT registered and non-registered traders in the market competition.

*Table 34: The Threshold Level for VAT Registration*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
The threshold level of Birr 500,000 in the VAT proclamation is fair	Too Much	16	4.0
	Little/No	62	15.5
	Reasonable	311	77.5
	No/No Option	12	3.0
	Total	401	100.0

Source: survey data

### ❖ **Customers are a Challenge for Implementing the VAT Law.**

According to the VAT registered taxpayer respondents, the majority of them agreed that the buyers/customers are a challenge for implanting the VAT law by not willing to pay the VAT. As per the survey data 69.1% replied that customers are not willing to transact with VAT receipt and pay VAT, which became a challenge for the implementation the VAT law, whereas 30.9% of the respondents said that customers are willing to transact with a proper VAT receipt and hence assisting the implementation of the VAT law (see table 35 for details).

*Table 35: Customers are a Challenge for Implementing the VATG Law*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Customers are a challenge for implementing the VAT law	Yes	177	69.1
	No	79	30.9
	Total	256	100

Source: survey data

### ❖ **Getting the VAT Registration Machine**

As per the VAT registered respondents, how they did get the VAT registered machine, 27.5% of the respondents said from the market, but 72.5% of the respondents indicated that from the ERCA supplied (from those registered traders and authorized by ERCA to import and sale) (see table 36 for details). The VAT registration machine is available on demand from those suppliers, who secured approval from ERCA.

*Table 36: Getting the VAT Registration Machine*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Getting the VAT registration machine	From market	52	27.5
	From ERCA supplied	137	72.5
	Total	189	100

Source: survey data

### ❖ **The Quality of the VAT Registration Machine**

Regarding the quality of the VAT registration machine, 65.5% of the respondents confirmed that good, but the remaining 34.5% of the respondents said poor (the machine frequently interrupted and discontinued services, as a result the tax payers are forced to use manual VAT receipts and also the receipts not clear, as well as sometimes ineligible) (see table 37 for details).

*Table 37: The Quality of the VAT Registration Machine*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
The quality of the VAT registration machine	Good quality	116	65.5
	Poor quality	61	34.5
	Total	177	100

Source: survey data

### ❖ **Under or Over Invoicing Where Issuing VAT Receipts**

The under or over invoicing where issuing VAT receipts by the business traders could be by mistake or deliberately in order to deceit VAT. 49.7%) of the respondents replied that sometimes they faced and when such a mistake is was taking place they reported to the tax authority and justified to adjust the mistake accordingly. The remaining 50.3% of the respondents said no (see table 38 for details).

*Table 38: Under or Over Invoicing Where Issuing VAT Receipts*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Under or over invoicing where issuing VAT receipts	Yes	95	49.7
	No	96	50.3
	Total	191	100

Source: survey data

❖ **A VAT Payer Using Unauthorized, as well as Unregistered VAT Machine**

This kind of practice is a challenge for VAT implementation. This kind of fraudulent activities might be emanated as the authority has poor capacity, as well as administration system (26.1%) of the respondents declared that they have encountered a VAT payer using unauthorized, as well as unregistered VAT machine, on the other hand, 73.9% of the majority of the respondents confirmed that they didn't encounter a VAT payer using unauthorized, as well as unregistered VAT machine (see table 39 for details).

*Table 39: A VAT payer Using Unauthorized and Unregistered VAT Machine*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A VAT payer using unauthorized, as well as unregistered VAT machine	Yes	41	26.1
	No	116	73.9
	<b>Total</b>	<b>157</b>	<b>100</b>

Source: survey data

❖ **VAT Registered Traders Manipulated the Machine to Generate False Report**

As can be learnt from the respondents of ERCA Employees for this particular issue, 73.2% of the respondents said that the VAT registered traders did not manipulate the machine to generate false report, while only 26.8% of the respondents stated that they manipulate the machine to generate false report (see table 40 for details).

*Table 40: Traders Manipulated the Machine to Generate False Report*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
VAT registered traders manipulated the machine to generate false report	<b>Yes</b>	<b>44</b>	<b>26.8</b>
	<b>No</b>	<b>120</b>	<b>73.2</b>
	<b>Total</b>	<b>164</b>	<b>100</b>

Source: survey data

❖ **Business Enterprises Selling Unauthorized and Unregistered Machine**

This kind of unlawful activities are being practiced not only VAT registered machines, but also on other items in order to get deceit profits. 91.4% of the respondents dismissed the proposition of business enterprises are selling unauthorized and unregistered machine. Only the remaining 8.6% of them said yes business enterprises are selling unauthorized and unregistered machine (see table 41 for details).

*Table 41: Business Enterprises Selling Unauthorized and Unregistered Machine*

Variables	Categories	Frequency	Percent
Business enterprises selling unauthorized and unregistered machine	Yes	13	8.6
	No	139	91.4
	Total	152	100

Source: survey data

❖ **The VAT Payers’ Timely Report While the VAT Machine Interrupts Its Services due to Various Reasons**

With regards to the VAT payers timely reporting while the VAT machine interrupts its services due to various reasons, 98% of the respondents replied yes they do, whereas only 2% of the respondents said they do not report (see table 42 for details).

*Table 42: Timely Reporting While the VAT Machine Interrupts Its Services*

Variables	Categories	Frequency	Percent
The VAT payers’ timely report while the VAT machine interrupts its services due to various reasons	Yes	148	98
	No	3	2
	Total	151	100

Source: survey data

❖ **Business Traders Using Unregistered VAT Machine**

The main reasons of the VAT-registered business traders are using of unregistered machine are to survive in the market competition as a result of non-registered traders in the market. As a result, they started a shift of business from the formal to informal sector and flourishing of unfair competition, amongst others. 28.1%) of the respondents confessed yes due to the fraudulent



activities and tax evasion, whereas 71.9% of the majority of respondents said no (see table 43 for details).

*Table 43: Business Traders Using Unregistered VAT Machine*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Business traders using unregistered VAT machine	Yes	64	28.1
	No	164	71.9
	Total	228	100

Source: survey data

#### **4.1.7 Does ERCA have taken Some Measures to Alleviate the Problems of those Obstacles for the Smooth Implementation of VAT?**

- ❖ **Any occurrences that the VAT law has been enforced outside the content of the law or its spirit**

The way in which the VAT laws of a country are enforced is an important element of the business environment. The responses of 20.6% of the respondents confirmed that there are occurrences that the VAT law has been enforced outside the content of the law, as an example they mentioned some businesses whose annual turnover are less than 500,000 Birr are forced to register by ERCA Officers. Actually, this measure was taken with the assumption of reducing the unfair competition in the market between VAT registered and non-registered traders. Whereas, the majority of 79.4% the respondents dismissed such occurrences and said no (see table 44 for details). As mentioned by some respondents' directives are not always consistent with the primary legislation that they are intended to implement. In such a case, it can be argued that they are unlawful and should be struck down by the courts

*Table 44: ERCA's Enforcement Practice of the VAT Proclamation*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
A. Any occurrences that the VAT law has been enforced outside the content of the law or its spirit	Yes	32	20.6
	No	123	79.4
	Total	155	100

Source: survey data

**❖ Various Governmental Administration Units Participate in the Process and in Enforcement of the VAT Law**

The participation and contribution of various governmental administration units are very vital in the process and enforcement of the VAT law. The responses of 60.5% of the respondents attested that “good” and “very good” various governmental administration units in the process and in enforcement of the VAT law. Whereas, the remaining 39.5% of respondents confirmed that the participation in the process, as well as in the enforcement of the VAT law is little and very little (see table 45 for details).

*Table 45: Governmental Administration Units Participation in Enforcement Practices*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Various governmental administration units up to kebele level participate in the process and in enforcing the VAT law	Very little	22	13.6
	Little	42	25.9
	Good	88	54.3
	Very good	10	6.2
	Total	162	100

**Source: survey data**

**❖ Authorized Officers of ERCA**

Non-compliance with VAT proclamation, such as failure to register for VAT as per the requirement, failure to issue a tax invoice and others are source of administrative penalties. The authority should have to take some time to assess and see the effects before to seize and take measures, since the action might not be deliberate sometimes. The survey result revealed that 58.9% of the respondents said yes they can when they have tangible evidence, but 41.1% of the respondents replied that no they need to have a court order to seize any illegal documents or property (see table 46 for details).

*Table 46: Authorized Officers of ERCA*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
Authorized Officers of ERCA have the power to seize any illegal vouchers without court order	Yes	129	58.9
	No	90	41.1
	Total	219	100

Source: survey data

### ❖ **The VAT Exemption Scheme**

As can be learnt from the respondents' response to the reasonableness of the VAT exemption scheme provision in the proclamation, 66.7% of the respondents declared that the VAT exemption scheme provided in the proclamation is adequate, whereas 33.3% of them said the exemption is inadequate (see table 47 for details). Almost one third of those respondents requested that VAT be removed from food items. A very restricted range of food products (milk, bread, cereals, pulses and palm oils) is already exempt from VAT but there is a case to be made that a wider range of food items should be subject to a zero VAT rate (which is not quite the same as exempting it from VAT) in order to address objections about the regressive nature of VAT.

*Table 47: The VAT Exemption Scheme*

<b>Variables</b>	<b>Categories</b>	<b>Frequency</b>	<b>Percent</b>
The VAT exemption scheme in the proclamation is adequate	Strongly agree	14	8.5
	Agree	96	58.2
	Disagree	32	19.4
	Strongly disagree	23	13.9
	Total	165	100

Source: survey data

# Chapter Five

## Research Findings, Conclusion and Recommendations

---

### 5.1 Research Findings

Since the enactment of the VAT law of No. 285/2002 and its implementation effective January 1, 2003, the Ethiopian Revenue and Customs Authority (ERCA) passed many ups and downs in order to put in place the VAT law and make use of its benefit. The study tried to see the, Practices, and challenges of VAT implementation in Ethiopia post January 2003. While undertaking the project paper, the researcher used both qualitative and quantitative data to clearly observe the VAT implementation and its impact to the business community/VAT payers/ in particular and its contribution to the national economy in general.

Therefore, the study identified the following as the major findings regarding the implementation of VAT by the ERCA in relation to VAT payers, ERCA employees, and institutional strength of ERCA:

#### 5.1.1 ERCA Employees and its Institutional Capacity

1. The Ethiopian Revenue and Customs Authority is not yet at its full strength of VAT collection capacity and it has left everything to the taxpayers including bearing the cost of collection. No other workable strategy has also been designed till to date at least to share the burden of the VAT payers.
2. In terms of control and business intelligence; the Ethiopian Revenue and Customs Authority is still not strong enough and VAT payers predominantly the small ones tend to maximize interests by seeing the weakness of the business intelligence of ERCA. Weaknesses in its intelligence unit in identifying those not issuing VAT receipts and not getting registered as VAT payers after fulfilling the Birr 500,000 annual turnover, affects the tax collection rate.

3. The ERCA relies heavily on coercion, penalties and imprisonment for transgression which the VAT payers of both complying and not complying are very much frightened off.
4. The VAT administration and compliance system is not well designed and VAT has created economic distortions amongst VAT registered and non-registered taxpayers. The exclusion of businesses with annual turnover less than ETB 500,000 is the major causes for the prevailing competition problem. Registered VAT payers are very frustrated by this disparity and their level of profit is declining. Some tend to cease their business operations and would like to issue business license and register as TOT than VAT Payers.
5. ERCA is now under automation, but it is not adequately equipped with appropriate information technology (IT) and there are still gaps between the tax laws and implementation.
6. Appeal Procedure and VAT Refunds are lengthy: VAT payers are required to pay 50 of the tax before appealing. VAT refunds are legally mandated to be made within a period of 90 days. However, VAT refunds are mostly carried over from one tax year to the other. This practice is unlawful and should cease immediately.
7. The awareness creation by providing substantive Information to the taxpayers through publications and making ready and updating websites timely need to be further exacerbated as it is not sufficient as depicted in from the responses of both tax payers and ERCA employees. 45.3 % of ERCA employees responded that the Authority lacks the institutional mechanism to reach the general public in creating awareness.
8. There is inadequate dialogue between Tax payers and the ERCA which need to be improved.

### **5.1.2 Findings from VAT payers' Perspective**

1. Despite the tax authority did a good job in raising public awareness on taxation and VAT, still a lot of work is remaining as the majority of respondents of both tax payers and ERCA employees said the target people are not fully aware of the consequences of not meeting obligations and the essence of tax collection to the nations vis-vis other countries

experiences and their level of development. From the study it was identified that 67% of VAT payer response showed the Business community lacked awareness.

2. The VAT payers engaged in small scale industry and domestic services are very reluctant to issue VAT receipts if they feel that clients don't demand.
3. The implementation of VAT has shown improvement from year to year even though it is lower than the intended. From the overall respondents, 47.8% responded, the implementation is little, while 36.8% said good.
4. Many taxpayers lack skills to provide accurate information on total sales, especially related to VAT. This is an area in which business needs to help itself; if businesses cannot or will not keep adequate records they can hardly complain at their treatment by the tax authorities. Design a mechanism that Tax payers shall improve the record keeping.

### **5.1.3 Legal Compliance and VAT Contribution to the GDP**

1. In pursuit for answering one of the research questions, the researcher examined the effect of value added tax on the economic growth of Ethiopia. The result shows that VAT contributes significantly to the total government revenue and consequently the economic growth of Ethiopia. The growth pattern of GDP from 2003 (the year of VAT inception) to 2012 was increasing. Similarly, the VAT revenue growth had consistent increase though the growth was not as explosive as that of the GDP. To boost general revenue, the government has to boost revenue collected from VAT.

It is also believed that a great deal of VAT payer response there is a conviction over the importance of VAT introduction and it's superseding of sales tax i.e. 68.5% of respondents believed VAT is very important for the development of investment.

2. The legal enforcement of VAT law has been done with due process of law and this is justified by 79.4% the respondents while only 20.6% said the implementation is out the content of the law, i.e. arbitrarily.

## 5.2 Conclusion

"VAT" - value added tax - has spread throughout the world since its introduction in 1955. France is credited with first implementing VAT. It did so in 1955. The tax spread through Europe, South America and parts of Africa in the 1960s and 1970s before taking a hold in other regions. Today, it is a key source of government revenue in more than 130 countries. About 70 percent of the world's populations now live in countries with a VAT (Kean & Lock Wood, 2007).

Value Added Tax has also become an indispensable component of tax reform in developing countries. It is the most important tax innovation of the second half of the twentieth century. In line with this perception, an increasing number of developing countries have converted their sales tax to Value Added Tax (VAT). The continuing introduction and evolution of general sales taxes, especially of the value added tax has been the outstanding feature in development taxation in recent years (Goode, 1984).

The key feature of VAT is its being broad-based, which is levied at multiple stages of production. The advantage of this is that revenue is secured by being collected throughout the process of production (unlike a retail sales tax) but without distorting production decision as a turnover tax does.

The first major change in Ethiopia's tax system was initiated in the post-Second World War period (1942-1944), the years 1947-1952 covering its second stage. These changes were generally discretionary, including amendments to property taxes (land and cattle). Broad-based taxes on goods and services were also introduced in the mid-1950s.

Later in the decade and in the early 1960s, changes were also made in the rate and structure of taxes, especially on income. In the post-revolution period (1974-91), particularly during 1976-79, significant major changes on the rate and structure of all types of taxes were made. These involved widening the land tax base, introducing capital and surplus transfers from nationalized firms, as well as certain minor arrangements on other taxes (Wogene 1994).

Leaving aside this brief description of the evolution of the tax system before the 1991/2 reform, the subsequent taxing system in Ethiopia can be divided into three broad categories:

(i) taxes on income and profits, (ii) taxes on goods and services and (iii) taxes on international trade. Most of these taxes have been reformed and amended in the last decade following the general 1992 liberalization (or reform) policy. Some institutional reforms aimed at enhancing the government's capacity to raise tax revenue have also been made.

Accordingly, Ethiopia introduced value added tax (VAT) in the year 2003 as a replacement to sales tax. The VAT has applied a uniform rate of 15% on most consumption goods and services with the exception of exports and exempted goods and services. The registration of VAT is both voluntary and obligatory. VAT is the principal source of revenue for the Ethiopian government right now. For instance, in the 2006–07 fiscal year, federal VAT revenue (on domestic transactions) accounted for about 41 per cent of total federal revenues from domestic sources (EFIRA, 2007). Further, since its introduction, VAT has been more revenue productive than sales tax (Teferra, 2004). To sustain VAT's revenue role in the government's finance, it is important to ensure that the revenue generated by this tax is raised as efficiently as possible. However, in Ethiopia revenues raised by VAT are usually garnered at the expense of erosion in its salient features. This may be caused by factors including poor VAT administration, i.e., the incapacity of tax authorities to implement the attributes of the tax in practice. A good tax administration is essential in fully implementing the design features of VAT and achieving government's policy objectives at large.

The findings of the analyses suggested that in Ethiopia there is divergence between the effective VAT taxation and the legislation. The main areas where there are gaps and problems include registration, record keeping, VAT invoicing, issuing VAT receipts, the threshold level and penalties. In addition, the outcomes of the research showed lack of tax awareness among the society and strong education programs as well as lack of trust between taxpayers and administrators as major challenges to the VAT system in the country. The gaps and problems identified in the study were partly because of under staffing of the tax authority, limited automation and inadequate public relation work.



It is hence suggested that the government would better look at the possibility of making sufficient resources available for the administration of VAT. Of course, this would be a challenge for countries like Ethiopia where resources appear to be limited. However, considering the role of VAT administration in the overall financial system of the Ethiopian government, allocating reasonably sufficient resources is worthwhile to consider.

This paper is therefore, finally concluded by highlighting the following bigger implication of VAT practices and implementations in Ethiopia since January 2003:

1. Impact of the Tax System on Government Revenues: The adoption of VAT in 2003 has led to a significant rise in the share of revenues generated by consumption taxes. It is clear, however, that this has not been without some adverse effects on private businesses and there remains widespread uncertainty and misunderstanding amongst taxpayers about both the theoretical and practical operation of VAT. Nonetheless, the tax reform has not adequately addressed the agricultural sector and the informal sector. Indeed, the tax burden on the agricultural sector has fallen significantly in recent years. This has resulted in a weaker revenue generation performance for the government and a higher tax burden on the wealth-generating private business sector – a “lose-lose” situation. The tax level (ratio of revenue to GDP) in 2007/08 in Ethiopia stood at 10.3 percent. The tax level for the agriculture sector was just over 0.1 percent, with that for non-agriculture standing at over 20 percent. Business is bearing considerably more than its fair share of the tax burden with agriculture remaining essentially untaxed.

Given the weak VAT coverage, the Ethiopian economy continues to grow. Government revenues are also growing, but at a lower rate than GDP and are still excessively reliant on foreign trade taxes. Hence, the tax structure needs to strike a balance between the inland revenues and trade taxes. There is little scope to squeeze the private sector further; hence other sectors of the economy must take on a greater burden of revenue generation.

2. Tax Administration: Audit, Investigation and Intelligence need to be better integrated and targeted. The new proclamation limits audit to process within a 5-year period. The implementation of the time limits keeps the taxpayers from high tax compliance cost. Real audit should be carried

out, with the intention of identifying deliberate evasion rather than simple errors, sometimes beyond the control of business owners/managers.

Proclamation No. 286/2002 Article 76/1b mandates refunds to effect within 90 days, and entitles taxpayers to the payment of 25 percent interest over and above commercial interest rates. All refunds of tax need to be expedited on time and in accordance with the law. Besides, the degree of administrative discretion available to tax officials in determining assessments and penalties is an open invitation to malpractice.

### **5.3 Recommendations**

The following recommendations are made based on the conclusion and findings of the study:

1. ERCA must improve the information technology (IT), and subsequently train its staff in order to match the ever growing complexity of tax collection and VAT payers increase from time to time.
2. Currently tax is collected in a manner that aggravates administrative and compliance costs. The absence of a strategy for collecting tax has increased the burden of the VAT registered taxpayers and has increased the incidence of penalties. Hence, ERCA, need to develop a strategy that speed up the tax collection, instead of leaving the burden of tax collection to the tax payers.
3. The present system whereby taxpayers are subject to stiff penalties for even minor errors while ERCA suffers no sanction for equivalent errors is patently unfair. This is not to suggest that the tax authorities should be fined for errors but that mistakes by taxpayers should be corrected rather than penalized.
4. Encouragement rather than coercion. The overwhelming majority of taxpayers, whilst not being enthusiastic about paying tax, recognize that it is their civic duty to do so. The tax administration system should take this as its starting point and concentrate primarily on helping people to get their tax affairs right rather than threatening them if they get them wrong.
5. Simplify Appeal Procedure and VAT Refunds: The cash deposit to appeal need to be revisited and such prerequisites has to be rationalized to a certain extent that would keep in balance the benefits of the Government and the private sector. VAT refunds are legally

mandated to be made within a period of 90 days. However, VAT refunds are mostly carried over from one tax year to the other. This practice is unlawful and should cease immediately.

6. Strengthen systems of taxpayer information and support, including a comprehensive support web site and information publications made available at all tax offices.
7. The rights of the taxpayers have to be respected. Taxpayers should be treated properly and in accordance with the law and the constitution by tax authorities and decisions on tax issues must be rendered quickly and these decisions should be implemented without delay. Specially, the appealing procedure should be as fast as possible and advance payment of 50% for tax complains need to be reduced to build tax payers confidence.
8. Where taxpayers keep records, these records must be accepted by the tax authorities unless evidence of falsehood is found.
9. Business organizations such as Chambers of Commerce and Sectorial Associations should help the businesses sector to build their capacities to keep adequate records, not just for tax purposes but to help them run their businesses better.

## Bibliography

- Alan Schenk and Oliver Old Man (2001), Value Added Tax, A Comparative approach in Theory and Practices, Transitional Publishers, Inc, Ardsley, New York.
- Arega Hailu (2004), Assessment on the Value Added Tax: Implementation in Ethiopia: Paper presented to the Second International Conference on the Ethiopian Economy held at the United nations Conference Centre, Addis Ababa, Ethiopia.
- Bekure Herouy( May,2004), The VAT Regime under Ethiopian Law with Emphasis on Tax Exemption, The Ethiopian and International Experience.
- Bird R.M. 1989, 'The administrative dimension of tax reform in developing countries' in M. Gillis (ed.) Tax Reform in Developing Countries, Duke University Press, Durham, North Carolina, pp. 315–346.
- Bird, R.M. 2005, 'Value added taxes in developing and transitional countries: Lessons and questions', ITP Paper No. 0505, International Tax Program, Rotman School of Management,
- Byrd,Chen and Jacobs(1996/1997) Canadian Tax principles, Clarence Byrd University of Ottawa, Prentice Hall Canada, Inc. Scarborough, Ontario.
- Council of Ministers – Federal Democratic Republic of Ethiopia 2002, 'Value Added Tax Regulation, Council of Ministers Regulation No. 79/2002', Federal Negarit Gazeta, Addis Ababa, Ethiopia.
- Demirew Getachew (2004), Tax Reform program in Ethiopia and Progress to Date, Paper Presented to the Second International Conference on the Ethiopian Economy, held 3-5 June 2004 at the United Nations Conference center, Addis Ababa, Ethiopia.
- Ethiopian Delegates 2006, 'Value added tax in Ethiopia', Speech at the 9th Value Added Tax Administration in Africa (VADA) Forum, Zimbabwe.
- Emran (2001), The Value Added Tax Experiences and Issues: Background paper Prepared for the International Tax Dialogues Conference on the VAT, Rome.
- Adereti, S.A., Sanni M.R. & Adesina J.A. (2011). Value Added Tax and economic Growth of Nigeria. European Journal of Humanities and Social Science. 10(1), 456-471.

- ERCA(2011) Statistical Bulletin, On Foreign Trade and federal Duty and Tax Collection(2005/06-2009/10) 10 Ethiopian Fiscal Years, A publication of Macro Data Processing Analysis Team, Addis Ababa ,Ethiopia.
- FDRE 2002, ‘Value Added Tax Proclamation No. 285/2002’, Federal Negarit Gazeta, Addis Ababa, Ethiopia.
- FDRE 1995, Constitution of the Federal Democratic Republic of Ethiopia, the Ethiopian Federal Government, Addis Ababa.
- Gills,Malcolm,Carls Shoup and Gerado Sicat(1990), Value Added Taxation in Developing Countries. A World bank Symposium.(Washington: The World bank Symposium)
- Harrison, G. and R. Krellove 2005, ‘VAT refunds: A review of country experience’, IMF Working Paper No. 05/218, IMF, Washington DC.
- Hancock, Dora (1995), Taxation: Policy and Practice. Chapman and Hall, 3rd Edition
- Harvey S. Rosen (1995), Public Finance, Value Added Tax Implementation Issues. The United states revenue system.
- H.L. Bhatia ( 2003 ), Public Finance, 24th revised edition, department of Economics, shri Ram College of Commerce, University of delhi, Vikas Publishing House Pvt Ltd.
- IMF 1989, ‘Tax administration in developing countries: Strategies and tools of implementation’, Policy, Planning and Research Working Papers (WPS 43), background paper for the 1988 World Development Report.
- Jantscher, M. Casanegra de 1990, ‘Administering the VAT’ in M. Gillis, C.S. Shoup and G.P. Sicat (eds) Value Added Taxation in Developing Countries, World Bank, Washington DC.
- Jira Jebessa ( 2005 ), Taxation in Ethiopia, Direct and Indirect Taxes, Categories Of Tax payers Declaration of income Assessment of Taxes ,Addis Ababa,2005.
- Jo Beth Mertens and Jean Tesch ( 2001 ), VAT Revenue in the Russian Federation: The Role of Tax Administration in their decline.
- John F. Due (1976), Value Added Tax in developing Economies: taxation and Development: edited by N.T Wang, Published by Praeger Publishers, Inc, With The Cooperation of the United Nations, New York.

- Kassahun Borssa (2006), The Role of Tax Accounting and Tax Audit for Enhancement of Tax Revenue : A Journal of Accounting society of Ethiopia, Volume 2, Issue 1
- Keen and Lockwood(2007) : The Value Added Tax: Its Causes and Consequences  
Liam Ebrill, Michael Keen, Jean-Paul bodin and Victoria Summers ( 2001 ), The Modern VAT , International monetary Fund, Washington , D.C.
- Leedy PD & Ormrod JE. 2005. Practical research: planning and design. 8th edition. Upper Saddle River, NJ: Pearson.
- Tadesse, K. 2007, 'VAT implementation, lack of infrastructure and good governance trouble business in Ethiopia: ECCSA', Capital News, November 11
- Teffera, A.H. 2004, 'Assessment on the value added tax implementation in Ethiopia', Paper presented at the 2nd International Conference on the Ethiopian Economy, United Nations Conference Centre, Addis Ababa.
- Yesegat, W A (2008) 'Estimating VAT administrative costs in Ethiopia', Paper presented at the 8th International Conference on Tax Administration, Atax, Sydney.

## Appendices

### Annex 1: Questionnaire for ERCA Employees

**Dear Participants,**

The questions are prepared to collect information and write Executive MBA research paper on the Nature, Practices, and Challenges of Value Added Tax Implementation in Ethiopia post January 2003 Assessment.

The purpose of the study is to assess, investigate and analyze the implementation of Value Added Tax and its impact on investment and development.

In order to attain the stated objectives, collecting relevant and genuine data is highly significant. In this regard, questionnaires, interview and discussion guides are prepared to the respective respondents.

I am, therefore, kindly requesting you to take some time and fill the questionnaire with utmost care. If you have any questions or concerns, please contact me through:

0911-88810 or bizuaem\_belete@yahoo.com

Thanks a lot in advance for your keen cooperation.

➤ **Please respond the following questions using tick mark (√) to your best choice.**

#### **Part I: Personal information**

1. Gender: Male  le
2. Age: 20-30  30-40  40-50  50 >
3. Education: Below 12 grade  Certificate  Diploma   
Bachelor  Master and Above
4. Position: \_\_\_\_\_

## Part II: Questions

1. Are you well aware of the VAT proclamation and its amendment?

- (a) Little  (b) Good   
(c) Indifferent  (d) Very much acquainted

2. Do you feel that the enactment of the VAT proclamation was made at the right time?

- (a) Yes  (b) Too early  (c) No  (d) Should take some time

If your answer to question # 2 is either of the choices, what do you think is the reasons behind your answer?

---

---

---

---

3. Do you think that a Birr 500,000 annual turnover as a minimum threshold is reasonable for VAT registration?

- (a) Too Much  (b) Little  (c) Reasonable  (d) No Option

If your answer to the above question is “too much; or little”, specify your reasons:

---

---

---

---

4. The VAT proclamation 285/2002 aimed at encouraging investment and in turn to bring about economic change. So, do you think that the application of VAT proclamation brought about the desired goal?

- (a) Yes  (b) No

If your answer is either of the two, please describe the reasons behind the answer.

---

---

---

---

5. Do you think that ERCA has capable and required work force empowered to implement the law?

- (a) Yes  (b) NO  (c) quite not, but showing progress



If your answer is B or C, what do you recommend to be done in the future

---

---

---

6. Does ERCA thought the general public and specifically the Tax payers regarding the content of the law and its implementation?

(a) Has thought art  (b) Thought well   
(c) Not done adequately  (d) Not at all

If your answer to question # 6 is “c” or “d” what are the reasons for not teaching and results observed for not doing

---

---

---

7. What other comments you would like to say about the public relation work of ERCA?

---

---

---

8. Are the business communities well aware of the VAT proclamation and its rationale?

(a) Yes  (b) Partially  (c) Not at all   
(d) Not worried that much

9. Are the business Community paying VAT regularly and declare their income timely?

(a) Good  (b) Fair  (c) Not good  (d) Worse

10. Do you believe that all eligible business traders get registered as VAT payer?

(a) Yes  (b) Not

If your answer is “not”, please indicate the rough estimate of those not yet registered and why not?

---

---

---

---

11. Do you know that some traders do not maintain the proper recording of their business operations in accordance with business practices and reputation?

(a) Yes  (b) No

If “yes”, what are the reasons please explain:

---

---

---

---

12. Are consumers willing and determined to transact with a proper VAT receipt?

(a) Yes  (b) NO

If your answer is “No” what do you think is their reason?

---

---

---

---

13. Do you think that the research Unit of ERCA is strong enough in modernizing the VAT system?

(a) Yes  (b) No

➤ If your answer is “yes” what benefits have already brought?

---

---

---

---

➤ If your answer is “No” what Problem sustain by not having the research unit?

---

---

---

---

14. Are there any occurrences that the VAT law has been enforced outside the content of the law or its sprit?

(a) Yes  (b) No

If your answer is "Yes" please explain what really happens?

---

---

---

---

15. Is there any instances that you have personally has challenged the implementation strategy of VAT in Ethiopia when going wrong or inadequate?  
(a) Yes  (b) No

If your answer is "yes" please state the incidents and explain the situation.

---

---

---

---

16. How do you rate the institutional capacity of ERCA in managing the VAT application?  
(a) Poor  (b) Good  (c) Very good   
If your answer is "Poor" please describe the reasons for being poor.

---

---

---

---

17. How is the awareness creation and media dissemination for VAT payer?  
(a) Poor  (b) Good  (c) Very good

If your answer is "poor" please describe how you labelled us poor.

---

---

---

---

18. To what extent that various governmental administration units up to kebele level participate in enforcing the VAT law and participate in the process?

(a) Very little  (b) Little  (c) Good  (d) Very good   
If your answer is "very little or little please, specify your reasons.

---

---

---

---

19. Do you think that the VAT law enactment started lately and the government lost what it should have earned?

(a) Yes  (b) No

20. The VAT exemption scheme in the proclamation is adequate

(a) Strongly agree  (b) Agree   
(c) Disagree  (d) strongly disagree

If your answer to the above question is “disagree or strongly disagree”, please state your reasons below:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_.

21. Do you think that a single rate of 15% VAT is reasonable?

(a) Yes  (b) No  (C) Indifferent

If your answer is either “Yes” or “NO” Please, specify your reasons for the reply?

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_.

22. How is the effectiveness of the VAT implementation against neighboring nations of Kenya, Sudan, and Tanzania?

(a) Excellent  (b) Very good  (c) Good  (d) Poor

If your answer is “Poor” kindly explain why you classified as poor.

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_.

23. Have you encountered a VAT payer using unauthorized as well as unregistered VAT machine?

(a) Yes  (b) No

If your answer is “yes”, please explain as to how it happened?

\_\_\_\_\_

---

---

24. Have you encountered that VAT registered traders manipulated the machine to generate false report?

(a) Yes  (b) No

If "yes", please explain what was done?

---

---

---

25. Have you got business enterprises selling unauthorized and unregistered machine?

(a) Yes  (b) No

If "yes", explain what was done?

---

---

---

26. Whenever, there is business closure and/or address change, do traders notify the Authority as per the requirement (that is within 3 days)?

(a) Yes  (b) No

If "no" explain the reason further?

---

---

---

---

27. Do the VAT payers timely report while the VAT machine interrupts its services due to various reasons?

(a) Yes  (b) No

If "no", kindly state what happened once known?

---

---

---

---

I thank you for your time and contribution in conducting this research work and sharing your honest feedbacks.

## Annex 2: Questionnaire for VAT Registered

### Dear Participants

The purpose of this questionnaire is to Access the Practices, implementation and nature of VAT application in Ethiopia post January 2003, for the partial fulfillment of Master of Executive MBA of Addis Ababa University.

In the process, the study tries to see the impact of VAT introduction, capacity of Ethiopian Revenue and Customs Authority to enforce the law, the awareness of the VAT payers and their compliance towards smooth implementation.

I am, therefore, kindly requesting you to take some time and fill the questionnaire with utmost care. If you have any questions or concerns, please contact me through: 0911-688810 or bizualem\_belete@yahoo.com

Thanks a lot in advance for your keen cooperation.

➤ Please respond the following questions using tick mark (√) to your best choice.

### Part I: Classification and Identification

1. Gender: Male  Female
2. Age: 20 – 30  30 – 40  40 – 50  50+
3. Educational level: Below 12 grade  Certificate  Diploma   
Bachelor  Maters & above

### Part II: Questions

1. Do you believe that VAT is important for the development of investment and international trade?  
(A) Yes  (B) No  (C) indifferent

If you have a different view of VAT's developmental import, you may point out your position below.

---

---

2. Are you issuing VAT receipts to all buyers without fail and deposit to the government account every month?

(A) Yes  (B) not at all  (C) some times

If you answer is either “B” or “C”, please indicate your rationales.

---

---

3. Do you know that there are business traders not issuing VAT receipts to buyers?

(A) Yes  (B) No  (C) I have no information

If your answer is “A”, what do you think is the reason for not issuing VAT Receipts?

---

---

4. Do you believe that the Ethiopian Revenue and Customs Authority reach the general public and specifically the VAT Payers through various mechanisms adequately?

(A) Yes  (B) No  (C) Almost not

If your answer is either “B” or “C”, what do you think is the reason?

---

---

5. How did you know the concept of VAT?

(A) By radio  (B) TV  (C) Reading Brochure

(D) From another VAT Payer  (E) All

6. Do you think that there are many non-VAT payers and challenging the VAT Payers performance?

(A) Yes  (B) No

If your answer is “yes”, what do you suggest to bring the non-tax payers under the law?

---

---

7 Do you think that the threshold level of Birr 500,000 in the VAT Proclamation is fair?

(A) Yes  (B) No

If your answer is “no” or have a different opinion, kindly indicate your rationales.

---

---

---

8. Whom do you think is benefited from the market competition between VAT registered and non-registered;

(A) Registered  (B) Non-registered

If your answer to question # 8 is either “A” or “B”, kindly reason out how benefits

---

---

---

9. Do you know that some business people do not properly maintain records of their transactions in accordance with the VAT law?

(A) Yes  (B) No  (C) I have no information

If your answer to question # 9 is “yes”, please indicate the causes for poor recording.

---

---

---

10. Do you think that buyers/customers are a challenge for implementing the VAT law by not willing to pay the VAT?

(A) Yes  (B) No

11. If your answer to question # 10 is “yes”, how is their number and periodic growth?

(A) Too many and growing  (B) too many but declining

(C) Too small but constant  (D) decreasing dramatically

12. If your answer for question # 11 is “A” or “B”, how did you deal with them?

(A) Sometimes with VAT receipt and sometimes without receipts

(B) Not entertain without VAT receipt



(C) Entertain without VAT receipt

13. If your answer to question # 12 is "A" or "C", did you imagine the consequence of not issuing VAT receipts and its impact on the Country?

(A) Yes  (B) No

14. Do you think that VAT is more advantageous than the replaced sales tax?

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

If your answer is "No" please state your reasons

---

---

---

15. By now, do you feel that you have adequate knowledge of VAT and its application with its purpose?

(A) Yes  (B) No  (C) Little

16. Do you know that some VAT registered business people collect the tax with illegal invoice?

(A) Yes  (B) No

17. How did you get the VAT registration machine?

(A) From market (B) from ERCA supplied

If your answer is either of the two how the availability up on demand

---

---

---

18. How did you get the quality of the VAT registration machine?

(A) Good quality  (B) Poor quality

If your answer is "B" what do you suggest the solution

---

---

---

19. Do you face under and over invoicing where issuing VAT receipts?

(A) Yes  (B) No

If your answer is “yes”, what do you do and report to ERCA?

---

---

---

20. If there is no electric to issue a receipt with a VAT registering machine, what other options do you have?

---

---

---

21. Do you believe that the implementation of VAT is successful?

(A) Yes  (B) No  (C) Little

22. Do you believe that the implementation of VAT has met its objectives?

(A) Yes  (B) No

23. By your observation as a VAT payer, what do you think is the major challenges for the implementation of VAT in Ethiopia?

---

---

---

24. For the above challenges or problems, what do you suggest as a solution?

---

---

---

25. If you have issues or opinions you may raise, kindly write down in the following lines.

---

---

---

26. Have you encountered a person not registered as a VAT payer but issued a VAT receipt?

(A) Yes  (B) No

If “yes”, please specify what kind of client he is and for what purpose he did and how the VAT receipts secured?

---

---

---

27. Do you know that authorized Officers of ERCA has the power to seize any illegal vouchers without court order?

(A) Yes

(B) No

28. Do you know business traders using unregistered VAT machine?

(A) Yes

(B) No

If “yes”, explain why they use it?

---

---

---

Thanks for taking your precious time and served me well.

Annex 3: Descriptive statistics of the variables

Year	VAT(in million Birr)	GDP(in million Birr)	TGR(in million Birr)
2003	372.2	81421.07	16626.41
2004	1220.7	91044.09	20057.88
2005	4032.05	100908.4	18534.39
2006	4809.15	131641.5	13544.66
2007	5931.48	171989.1	15382.71
2008	7312.89	248302.7	30134.46
2009	8988.18	335392	45649.11
2010	13677.83	382938.7	52562.22
2011	16156.12	506079.1	69455.1
2012	23313.27	548921.6	92345.25

Source: ERCA, MoFED annual statistical Bulletin

Annex 4: Descriptive statistics for econometrics variables

. summarize vat gdp tgr

Variable	Obs	Mean	Std. Dev.	Min	Max
vat	10	8.576637	1.248346	5.919431	10.05678
gdp	10	12.24427	.722288	11.30739	13.21571
tgr	10	10.31009	.6896392	9.513747	11.43329

Annex 5: Correlation matrix of the variables

```
. correlate vat gdp tgr  
(obs=10)
```

	vat	gdp	tgr
vat	1.0000		
gdp	0.8924	1.0000	
tgr	0.7290	0.9160	1.0000