

PROBLEMS AND PROSPECTS OF IMPLEMENTING VAT IN ETHIOPIA

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I. Introduction

One of the mechanisms in which countries raise revenue to finance government spending on the goods and services that most of us demand is taxation. As compared to the developing countries, the developed countries have been able to generate substantial revenue through imposing of taxes. One of the reasons for this has been the efficient tax system operating in the developed countries unlike the developing economies which are characterized by weak monetization and the low development of the formal sectors. In other words, these countries have employed a tax system that have one or a combination of the following desirable characteristics as economic efficiency, administrative simplicity, flexibility, political accountability and fairness. The tax system need to be economically efficient meaning the tax system should not have an impact on the allocation of resources. The tax system a country adopt should be easy and inexpensive to administer and that should be able to respond to changing economic circumstances. Taxpayers should also be able to determine what they are actually paying so that the political system can more accurately reflect the preferences of individuals. The tax system should be seen to be fair in its impact on all individuals.

It follows that optimality in a tax system requires absence of distortion in any economic activity(**Hancok, 1995**). It is expected that people's tax payments is in line with their income and they are required to pay a tax in proportion to their level of income. On the part of the tax collectors, collection of tax should be time conscious and convenient and the cost of collecting the taxes should not be high to discourage business. Alternatively, this means that the ideal tax system in developing countries should raise essential revenue without excessive government borrowing and should do so without discouraging economic activity and without deviating too much from tax system in other countries(**Tanzi, 2001**).

A good tax system should run in harmony with important national objectives and if possible, should assist the society in achieving them(**Bahitia, 1998**). It should try to accommodate the attitudes and problems of the taxpayers and should not lose sight of the administrative practicability or the goods of social and economic justice

and should also yield adequate revenue for the treasury and should be flexible enough to move with the changing requirements of the state and the economy. The dynamism of the tax system is all the more relevant for a developing economy where the structure and rates of taxes have to be constantly reviewed.

The criteria of optimality of taxation may be related to the following **(Bahtia, 1998)**. The first criterion of optimality may be conceived in terms of minimizing its resource cost. A tax system not only entails cost of collection to the authorities but also a resource cost to the taxpayers. Unfortunately, the cost to the taxpayers is usually ignored by the authorities while deciding on alternative tax measures. The second criterion is related to some kind of a measure of justice or equity related to the ability-to-pay, cost-of-service and benefits-received ones. The final criterion is some measure of economic efficiency. The concept of optimal taxation on whatever criteria based has to cover decision-making at three levels **(Bahatia, 1998)**: the aggregate amount of taxation and its division between direct and indirect taxation the composition and rate schedules of indirect taxation and the composition and rate schedules of indirect taxation.

VAT is a new tax system introduced in Ethiopia. This tax system is not new to other countries. Beginning with the adoption of Taxe sur la valeur Ajoutee by France in 1954, it was gradually been adopted by other countries **(Purhoit, 2000)**. The development of this tax system is so fast that it has now been employed by a large number of Latin American, Asian, African and Pacific countries.

This paper will attempt to discuss the problems and prospects of implementing VAT in Ethiopia. Accordingly, the paper is organized in the following manner. After making introduction in Chapter I, a review of literature is made on general overview of VAT in Chapter II. The task of Chapter III is discussion on VAT developments in Ethiopia including the tax system, the need for VAT, VAT administration and problems in implementation of VAT. Chapter IV concludes the paper by highlighting the prospects of VAT in Ethiopia.

II. An Overview of Value Added Tax (Literature Review)

2. 1 Definition of Terms

In discussion of VAT, it is important to familiarize the reader with terms related to taxation so as to have a good understanding of the whole concept behind VAT and its implementation.

Tax, direct tax and indirect tax:

Taxes are a compulsory levy, imposed by government, on either income, expenditure or capital assets, for which the taxpayer receives nothing specific in return **(Hancock, 1995)**. The money received in this regard is to be utilized for financing development efforts of a country. Two types of taxes can be identified: direct taxes and

indirect taxes (**Hancock, 1995**). Direct taxes refer to taxes that can directly reduce the taxpayer's income and that are directly related to the taxpayers' personal circumstances. Indirect taxes are taxes that are paid by an individual through purchase of goods and services and that are not directly related to the personal circumstances of the taxpayer. In case of direct taxes, the liability is determined with direct reference to the taxpaying ability of the taxpayer, while in the case of indirect taxes such ability is assessed indirectly (**Bahitia, 1998**). Examples of direct taxes are income tax, inheritance tax, expenditure tax, wealth tax and so on while excise taxes, sales taxes and import and export duties are included as indirect taxes.

Value Added Tax

Value Added Tax(VAT) is an indirect tax that is charged whenever a taxable person makes a taxable supply of goods and services in the course of his business although it is finally borne by the consumer(**Hancock,1995**). The term 'value added tax' refers to a comprehensive VAT, one that includes producers, wholesalers and retailers. In the words of **Bahitia(1998)**, VAT is a tax not on the total value of the good being sold, but only on the value added to it by the last seller who is liable to pay a tax not on its gross value, but net value, that is the gross value minus the value of inputs.

VAT is a system whose base is sales. Any item originating from the producer and transferred to the wholesaler, to the retailer and finally to the customer picks additional value at each step which would be taxed whenever transaction takes place.

Tax base and Tax Rate

The tax base define the way in which different forms of income, expenditure, wealth, or any other factor determine what is to be taxed. The tax rate on the other hand determines the proportion that is taken in tax. Alternatively, it can be said that the tax base is the object to which the tax is applied while the tax rate is the amount of tax applied per unit of tax base (**Bahitia, 1998**). The base of each tax has to be defined legally and it is be quantified for the purpose of determining the tax liability of an individual taxpayer. A tax base may have a time dimension also. For example, income tax is usually on annual basis.

2.2 Issues on the Value Added Tax

VAT has interested many scholars beginning from its inception in the 1940s. VAT has been conceived as a system that can increase government revenue with minimal economic distortions. The main issues surrounding VAT have centered around this somewhat general belief and have tried to compare and even choose from taxing income or taxing consumption, follow origin or destination principle, compute VAT through invoice credit method or subtraction method, applying zero-rate or exemption rate, single rate or multiple rate and which products, firms or sectors should be free of VAT.

Taxing Income or Taxing Consumption

The difference between consumption VAT and income VAT emerges from the treatment of capital depreciation (**Bahitia, 1998**). If a firm is allowed to deduct the entire credit when the capital equipment is purchased, the system is termed as consumption VAT. If the firm is allowed to deduct the credit as the equipment depreciates over time, the system is termed as an income VAT.

There is a conventional belief that taxing income entails higher welfare (efficiency) cost than taxing consumption (**Tanzi, 2001**). According to proponents of this idea, the reason for this is that income tax, which contains elements of both a labor tax and a capital tax, reduces the taxpayer's ability to save. The argument is that increasing income taxes should not be considered a viable option in the grounds of both policy (because of their perceived negative impact on investment) and administration (because their revenue yield is less certain and less timely than that from consumption tax changes). On equity grounds, on the other hand, taxing consumption has traditionally been thought to be inherently more regressive (that is harder on the poor than the rich) than taxing income. Data from industrial and developing countries show that the ratio of income to consumption taxes in industrial countries has consistently remained more than double the ratio in developing countries (that is compared with developing countries, industrial countries derive proportionally twice as much revenue from income tax than from consumption tax).

Origin Principle or Destination principle

The choice between the origin or destination principle is made in taxing international trade (**Riswold, 2003**). A VAT is said to use the origin principle when it taxes value that is added domestically to all goods, including goods that are subsequently exported, but does not tax value that has been added abroad and is embodied in goods that are imported and sold domestically (**Gills et al, 1990**). Under the origin principle, therefore, exports are taxable and imports are exempt. This regime is compatible with the income VAT. On the other hand a VAT is said to use the destination principle when it taxes all value added, at home and abroad, to all goods that have as their destination the consumers of that country (**Gills et al, 1990**). In this case, therefore, exports are exempt and imports are taxable. While the destination principle is well-suited to the consumption VAT, the origin principle is compatible with income VAT.

The destination principle is used by central governments in most occasions. It is argued that the preference for the destination principle may be due to the general preference for the consumption VAT and a mercantilist inclination to emphasize economic activity (employment) more than consumption (**Gills et al, 1990**). The choice between the destination and origin principles will influence the choice of the method for computing the amount of tax due.

Invoice Credit Method or Subtraction Method

The VAT system has to also choose between two methods of computation for determining VAT liability. These methods of computation are either the invoice credit method or subtraction method (**Riswold, 2003**). With the invoice credit method, VAT is charged and paid on invoices, thus the producer will remit the difference between VAT received and VAT paid. The subtraction method uses company accounts to determine VAT liability by subtracting taxable receipts less taxable purchases to obtain total value added. In other words, the subtraction method of computing a firm's VAT calls simply for subtraction of total purchase from the sales of the firm in question and the balance, the value added by this firm, is then subject to the VAT rate. The invoice credit method is preferred and is used throughout the Sub Saharan Africa (**Riswold, 2003**). Further, it is widely accepted that the transactions based invoice credit method provides several advantages such as the ability to deal with different rates and minimizing tax evasion by providing an audit trail.

Product, firms, or sectors to be free of VAT

Certain products and services are often freed from the value added tax (**Gills et al, 1990**). This is because they are to be exported (destination principle) because they are important items in the budgets of low-income families (food), or because they create benefits for society in general (education).

Certain firms are commonly freed from VAT on all their sales because the administrative and compliance costs are large compared with the tax revenue to be obtained (**Gills et al, 1990**). Compliance costs refer to how much does it cost the taxpayer to comply with the tax law quite aside from the tax itself. For example, all firms whose annual sales are less than a specified amount may be excluded.

Financial firms, especially banks and insurance companies, are commonly free of VAT because the value they add cannot be readily defined and computed (**Gills et al, 1990**). In certain other service industries, all firms are free of tax for the same reason. Whole sectors of the economy, retailing, for instance, may be left outside the scope of the VAT, chiefly for administrative reasons.

Exemption or Zero-rating

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

Zero-rating is often said to be unsuitable for developing countries just because it may require tax refunds (**Gills et al, 1990**). This is quite a weak argument since tax refunds are important in establishing fairness for tax authorities in these countries.

One line of argument against exemption is that it complicates administration, erode the tax base and distort input-choice decisions and hence they have to be kept to a minimum (**Gills et al, 1990**). According to proponents of this argument where exemptions have been almost entirely eliminated (as in Chile), the VAT has been much easier to administer and therefore quite successful. Exemptions, according to these proponents, require additional record keeping segregating taxable from exempt sales, and in practice the destination between what is exempt and what is taxed is often questionable or subjective. Some items are exempted to improve the distributional impact of the tax-a potentially reasonable tradeoff while others might be exempted for administrative or political reasons. This is exactly why developing countries exempt particular commodities as they are influenced more by distributional objectives than administrative concerns.

Administrative issues are more important under zero-rating (**Gills et al, 1990**). 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.

Single or Multiple Rates

Many countries employ multiple rates apart from a zero rate in their value added taxes. Multiple rates offer a great opportunity to fit the VAT to various social and political ends (Gills et al, 1990). A low rate, rather than exemption or a zero rate, is sometimes granted to necessities, and luxuries may be subject to a rate higher than the standard.

One line of discussion commonly raised in this regard is what should be the standard VAT rate (**Gills et al, 1990**). Some traders and tax administrators claim that standard rates of 18-20 percent are unenforceable in developing countries. According to these persons, high VAT rates provide such strong incentives for evasion that tax enforcement become all but impossible given the scant administrative resources available in developing countries. Other critics support this line of argument also. By saying that high rates tend to distort the allocation

of resources because they help inefficient enterprises by charging VAT on their sales and not paying the tax to the government that allow failing businesses could continue to operate. Some opponents of high rates even advocate repealing the VAT and returning to a cascade turnover tax which could provide abundant revenues with much lower rates.

Some critics oppose this idea of high Vat to be unenforceable in developing countries. Their line of argument is two fold (**Gills et al, 1990**). First, both Brazil and Chile have had considerable success in implementing a VAT with a standard rate of around 18-20 percent. Secondly, in developing countries a substantial proportion of VAT revenue is collected at the import stage and a large percentage of the rest is collected from relatively few enterprises and hence, in these circumstances, there is little scope for improving compliance and revenue in the short-term through reductions in the standard VAT rate which merely result in an immediate loss of revenue.

There are also critics that say that enforcing of either high or low VAT is unlikely to be so without effective administration (**Gills et al, 1990**). According to these, scarce administrative resources must be aimed at carefully chosen objectives to ensure an appropriate level of compliance especially when the standard rate is raised to meet short-term revenue needs. This means, the administration has to act quickly and effectively so that the increase in VAT rate can yield the desired revenue. This is because even large enterprises may fail to pay the tax if they are experiencing financial difficulties owing to a general downturn in the economy (**Gills et al, 1990**).

Experience in both industrial and developing countries suggest that a VAT imposed at low rates may not be worth the administrative and compliance costs involved in the switch to the VAT (**Gills et al, 1990**). The most comprehensive governmental survey of VAT options for the US also concluded the VAT is not a tax to impose at low rates, because of the additional investment in tax administration that would be required before and during the first few years of operation of the tax.

Many developing countries (like many OECD countries) have adopted two or more VAT rates. Multiple rates are politically attractive because they ostensibly though not necessarily efficiently serve an equity objective, but the administrative price for addressing equity concerns through multiple VAT rates may be higher in developing than in developed countries (**Gills et al,1990**).

2.3 Need for VAT

Value added tax is required mainly to prevent cascading, that is, to avoid taxing any ingredient of the final product more than once (**Gills et al, 1990**). For example, if tax is imposed on a sale by a steel manufacturer to an automobile manufacturer and again on the full value of the automobile when it is sold to a wholesaler or retailer, the steel ingredient is taxed twice. Alternatively, cascading occurs when a tax on inputs is not refundable and charged again on output.

It is said earlier that one of the requirements for an efficient tax system is the fact that the tax levied should be in proportion to the level of income. VAT fulfils this requirement in that its burden is shared among all residents, each according to his level and type of consumption. Moreover, it has the advantage of reducing the cost of production of industries through its inherent refund system and the fact that it does not burden exports.

The need for VAT also emanates from the very weaknesses of the sales tax that it is intended to replace **(Purhoit, 2000)**. Firstly, sales tax has a cascading effect as a result of the fact that it is levied on the gross value without allowing any credit or set-off for the taxes paid on inputs. As a result, consumer prices will increase by an amount higher than what accrues to the exchequer by way of revenues from it. Secondly, uncontrolled incidence of the tax especially in the production-distribution process. Thirdly, there is the problem of multiplicity of rates which not only dulls the progressive effects that are anticipated but also generates the need for further calculations by the sellers and increases the cost of compliance with little effect on revenue. Fourthly, it is prevailed by the characteristic of heterogeneity which arises from the fact that apart from general sales tax, most states levy an additional sales tax or a sur charge. Additional tax is based either on their total turnover or on the graduated turnover with different rates for different slabs of turnover. Fifthly, the existing system of taxes militates against ancillary industries and encourages them to produce more and more of the inputs needed rather than purchase them from ancillary industries. Last but not least, the existing system of commodity taxes is non-neutral i.e., it interferes with the producer's choice of inputs as well as with the consumers' choices of consumption, thereby leading to severe economic distortions.

It is argued that VAT would take away all the above problems and would avoid the distorting economic effects **(Purhoit, 2000)**. This means, for example, It would not cause cascading, nor would it cause vertical integration of firms. Also it offers total transparency of the incidence of tax as VAT is a multi-stage sales tax levied as a proportion of the value added. A very important advantage quoted in favor of VAT is that of lesser tax evasion **(Bahitia, 1998)**. This happens because the tax is divided into parts and therefore the incentive to evade tax by anyone firm is reduced. If any firm understates its output, it will be caught by the disclosures of the firms buying inputs from it. It is also claimed that VAT is conducive to efficiency since a firm is not exempted from its tax liability even it runs into a loss **(Bahitia, 1998)**. Moreover, as It pays a tax not on its profits but on the value produced, it tries to improve its performance and reduce the cost of production.

2.4 VAT Administration

The major activities in VAT administration are identifying taxpayers, processing returns, controlling collections, making refunds, auditing taxpayers and levying penalties. On the part of administration, it is a prior tax to identify the taxpayers. In this connection, preparation of a single master file, based on unique Tax Identification Number (TIN) is crucial and this ensures that each taxpayer's account contains all the relevant tax and payment data for that taxpayer alone. The TIN system is registration mechanism in which a taxpayer is given a single

identification number to be used in administering all taxes. The TIN system encompasses personal and business profiles of the taxpayers including full name, address, business information (like annual turnover), banking information (whether he/she has a bank account), the number of branches, contact address and related information. Different business entities owned by one company or person is categorized under one TIN number. This will avoid duplication and falsification of addresses and information serving as a pretext upon the default. In addition, the TIN has to be feasible for comparison among different taxes such as sales tax and the income tax (including tax on corporate income). The TIN system has the advantages of aiding to draw a comparison of tax statistics with the national accounts, facilitating proper use of the database of various systems and enhancing the financial recording system of the business communities.

On account of the requirements of VAT, the even functioning of VAT would perilously depend upon taxpayers keeping careful and complete records (**Purhoit, 2000**). To minimize the likely amount of high compliance costs, however, sellers are expected to maintain sufficient details to have information on the following aspects (**Purhoit, 2000**). These are particulars of invoices giving details of tax on sales and credit on purchases, details of accounts giving information of all purchases and sales and interaction between invoices, purchase and sales accounts with the tax return form.

The other part of VAT administration is assessment on VAT execution. This includes identifying taxpayers and tax evaders as well as the registered and unregistered taxpayers among the business community. It follows that the concerned tax authorities would take legal measures against people who do not comply with the VAT law, for example, on those who conceal invoices and engage in illicit business transactions. It is not only the authorities who should be responsible in assessment of execution of VAT but the consumers themselves have a key role to play.

The human resource element is essential in VAT administration. Trained personnel are what actually most developing economies lack and this has forced them, for instance, to organize their VAT activities under existing tax administrative structures. Consumers need to make sure that businesses that levy the tax are registered with the VAT administration as evidenced by a registration certificate which is expected to be posted visibly on the establishment's premises, they should receive receipts for the goods and services they purchase and they have to make sure that the receipt clearly indicates the VAT registration number and the taxable items.

Key decisions that must be made before introducing a VAT concern the choice of organization to administer the tax and the organizational changes required. Nearly all developing countries that apply a VAT through the retail stage have assigned its administration to the same organization that administers income taxation, which usually also administered the taxes that the VAT replaced.

III. VAT Development In Ethiopia

Weak tax administration stems from a number of interesting factors: overly complex and outdated tax laws and procedures, weak or outdated operating and management information systems, poorly trained staff, low remuneration packages for civil servants, bureaucratic civil service procedures, poor infrastructure and equipment and corruption and political interference in tax administration.

Tax Reform

Tax reform includes changing policies to address insufficient revenue, to correct distortions that reduce economic welfare and growth, or measures to reduce inequities. The tax reform program in Ethiopia has two components (**www.eluntazo.com**): 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 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 2001 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 taxpayer services activities, return process 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 value added tax (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 reforms that have been initiated will lay the foundations for a strengthened revenue base.

VAT Introduction

The most straightforward way of taxing only expenditure is through an indirect tax, such as VAT (**Hancock,1995**). The newly introduced VAT is one of the components designed by foreign and local experts to improve the tax collection and administration system in Ethiopia. The new tax system is invoice based, and thus required a complete revamp of the way businesses was conducted in this country. This new tax system is believed to encourage savings, export and capital accumulation as it is levied on goods and services meant for consumption.

The VAT was projected to be applicable on taxpayers that meet the minimum threshold of 500,000 Birr and above in annual turnover, but will be required to effect 15 percent tax every transaction.

Need For VAT

As I tried to point out earlier, developing countries have been unable to generate sufficient revenue to finance their economy. This emanates from these countries tax system which can be characterized as raising low amounts of tax revenue as a result of low amounts of per capita income, the subsistence nature of their economy(mostly in agriculture), poorly structured tax systems and weak tax administration. Performance of selected Sub Saharan African countries in tax shares (tax revenue as percent of GDP) shows that the average tax shares for the period 1994-1999 ranges from 6.1% of GDP in Chad to 38% of GDP in Angola.

**Table 1. Average Tax Share of Some Selected
Sub Saharan Countries (1994-1999)**

| COUNTRY | TAX SHARE (%) |
|-------------------------|----------------------|
| Angola | 38.0 |
| Botswana | 29.4 |
| Central Africa Republic | 7.5 |
| Chad | 6.1 |
| Djibouti | 25.1 |
| Ethiopia | 11.8 |
| Kenya | 23.4 |
| Lesotho | 36.6 |
| South Africa | 25.0 |

Source: Africa Development Indicators 2001

The trend of tax revenue as percent of GDP for Ethiopia has been within the range of 11.5 to 15.3 percent during the period 1996/97 to 2002/03. The highest figure of 15.3 percent is exhibited in 2001/02 fiscal year.

Table 2. TAX revenue as % of GDP

| | 1996/97 | 1997/98 | 1998/99 | 1999/00 | 2000/01 | 2001/02 | 2002/03 |
|-------------------------|---------|---------|---------|---------|---------|---------|---------|
| Tax revenue as % of GDP | 12.9 | 11.7 | 11.5 | 12.8 | 13.7 | 15.3 | 15.1 |

Source: National Bank of Ethiopia Annual Report 2002/03

In terms of tax effort i.e., growth of tax revenue to growth of nominal GDP, the performance of some selected Sub Saharan African countries for the same period (1994 – 1999) is shown below.

Table 3 Average Tax Effort for Selected Sub Saharan Africa countries (1994-1999)

| COUNTRY | TAX EFFORT |
|---------------|------------|
| Angola | 3.79* |
| Benin | 2.06** |
| Chad | 14.24* |
| Ethiopia | 5.44* |
| Guinea Bissau | 30.2* |
| Kenya | 0.77** |
| South Africa | 9.26** |

Source: Africa Development Indicators 2001

* With no VAT ** With VAT

From the above Table it can be deduced that tax revenues in Ethiopia grew on average 5.44 times faster than nominal GDP. Figures less than one but greater than zero represent growing tax revenue (on average), but at a rate less than GDP.

It is the rising revenue requirements that necessitate the adoption of alternative taxes. VAT is said to be the revenue-raising tool in the developing world. Table 3 shows total indirect tax revenues (taxes on international trade and taxes on goods and services) both before and after the introduction of the VAT for eight selected economies in Sub Saharan Africa. The actual year of introduction of the VAT was not used in the calculation due to some of the VAT's is being introduced at different times throughout the year. The results depicted in Table 3 are Tax/GDP ratios both before and after the introduction of the VAT and the years in the country column are the times the VAT has first been introduced.

Table 4 Indirect Tax Revenue with VAT

| COUNTRY | 3 YRS PRE-VAT AS % OF GDP | 3 YRS POST-VAT AS % GDP |
|--------------------|--------------------------------------|------------------------------------|
| Benin(1991) | 4.8% | 7.4% |
| Burkina Faso(1992) | 7.0% | 7.2% |
| Gabon(1995) | 7.6% | 7.6% |
| Guinea(1996) | 9.6% | 8.8% |
| Kenya(1990) | 13.5% | 15.0% |
| Togo(1995) | 6.3% | 9.3% |
| Uganda(1996) | 14.5% | 14.7% |
| Zambia(1995) | 11.7% | 12.3% |

Source: World Development Indicators 2001

The introduction of VAT has made different impacts on the eight selected countries as can be observed from the Table above. While the effect is neutral for countries like Burkina Faso, Gabon and Uganda, the introduction of VAT has made tremendous impact on the economies of Benin, Kenya and Togo.

The VAT is progressive in its incidence, and the higher revenues brought about by the VAT can provide additional funds for poverty-reducing spending, including primary education (**Munoz and Cho, 2003**). The VAT activity in Ethiopia is supported by the IMF under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement approved in March 2001.

The application of the VAT system in Ethiopia has been necessitated for the following reasons (**VAT Proclamation 285/2002**):

- ⇒ Ethiopia's total revenue from excise tax and sales tax accounts only for 11.8% of the GDP and is thus the lowest of all the countries in the Region whose revenue accounts on average for 24% of their GDP
- ⇒ The current sales tax does not allow collection of the tax on the added value created wherever sales transaction is collected
- ⇒ The value added minimizes the damage that may be caused by attempts to avoid and evade the tax and helps to ascertain the profit obtained by taxpayers
- ⇒ Value added taxation enhances savings and investment, as it is a consumption tax
- ⇒ Replacement of the current sales tax by value added tax enhances economic growth and improves the ratio relationship between government revenue and gross domestic product

Same line of argument can be proposed in introducing VAT i.e., the deficiency in sales tax. The sales tax base in Ethiopia was narrow because it was limited to imports, manufactured goods and a few selected services (**Munoz and Cho, 2003**). Because credit was given only for taxes paid on raw materials, the tax had a cascading effect, distorted efficient resource allocation, and thus likely impeded economic growth. Hence, in comparison to the sales tax, the new VAT taxes services in addition to production grants zero-rating to exports and gives exemptions to fewer basic products.

VAT Administration

According to the VAT proclamation, a person who carries on taxable activity and is not registered is required to file an application for VAT registration with the Authority if at the end of any period of 12 calendar months the person 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 that period will exceed 500,000 Birr. A person, who carried on taxable activity and is not required to be registered for VAT, may voluntarily apply to the Authority for such registration, if he regularly is supplying or rendering at least 75 percent of his goods and services to registered persons. Federal Inland Revenue Authority (FIRA) is responsible for administering the VAT in Ethiopia according to the VAT proclamation. A person applying to register for VAT is required to do so in such a form as is established by the implementation directives issued by the Ministry of Revenue. When a person carrying out taxable transactions files an application to be registered for VAT, the Authority is required to register the person in the VAT register and to issue a certificate of registration within 30 days of the registration. After the application for registration has been made, the concerned tax authority, FIRA/VAT, will give VAT registration and Tax Identification Number (TIN). The Authority shall issue a VAT registration certificate containing such details as the full name and other relevant details of the registered person; the date of issuance of the certificate the date from which the registration takes effect; and the registered person's taxpayer identification number. This is followed by a certificate of Registration that has to be displayed at the main business premises. A person registered for VAT that carries out a taxable transaction is required to issue a VAT invoice to the person who receives the goods or services. A VAT invoice is a document executed in the form stipulated by the Minister of Revenue and containing the following information: Full name of the registered person and the purchaser, and the registered person's trade name, if different from the legal name, taxpayer identification number of the registered person and the purchaser, number and date of the VAT registration certificate, name of the goods shipped or services rendered, amount of the tax payable transaction, amount of the excise on excisable goods, sum of the VAT due on the given taxable transaction, the issue date of the VAT invoice and serial number of the VAT invoice.

The current number of VAT registrants is approximately 6000 compared to the expected 3500 who actually were registered by January 1, 2003. The combined revenue from the VAT and turnover tax is approximately 13.3 percent higher than the sales tax for the comparative period to September 30, 2003. The domestic revenue contribution is approximately 20 percent higher and customs VAT revenue approximately 8 percent higher than

the sales tax from last year. An interim computer system, developed by a local company, to support the core VAT business, is operating effectively and efficiently. The more comprehensive system is presently being customized and will be implemented in late 2003.

The products that are exempted from VAT in Ethiopia are: the sale, transfer or lease of immovable property; the rendering of medical services; the rendering of educational services; the supply of electricity and water; post office operations and the provision of public transport permits and license fees. The design of the Vat includes concessions to small scale business to lessen the administrative burden, such as the relief from the requirement to register to collect VAT. Zero-rated supplies include the supply of export of goods and services and the supply of gold to the National Bank of Ethiopia.

Taxpayers who have the obligation to maintain books of accounts shall have to register with the Tax Authority the type and quantity of vouchers they use before having such vouchers printed. Any printing press before printing vouchers of taxpayers shall ensure that the type and quantity of such vouchers is registered with the Tax Authority. The Authority shall be empowered to investigate any statements, records and books of account submitted by any person at any time by sending duly accredited inspectors to check the statements, records and books of account, or any vouchers, stocks or other material items at the person's place of business or practice; requiring the person or any employee who has access to or custody of any information, records or books of account to produce the same and to attend during normal office hours at any reasonable convenience tax office and answer any questions relating thereto; and requiring any person including a municipality, body, financial institution, department or agency of Federal or Regional government to disclose particulars of any information or transactions.

The VAT in Ethiopia employs the subtraction method as the basis for VAT is only the value added at each stage of the transaction. The newly introduced VAT has a uniform rate of 15 percent on most goods and services, with a zero rate on exports and exempted goods and services. The scope of exempted goods and services differs from that under the sales tax.

Implementation Problems

Ethiopia shares developing countries' problems in their effort to establish efficient tax systems in general (**Tanzi, 2001**). Firstly, most workers in these countries are typically employed in agriculture or in small, informal enterprises and this means the possibility of regular or fixed wages is rare as they receive cash payments (i.e., off the books) that further mean difficulty to calculate the base for an income tax. Related to this, as most of the workers do not made transactions in large stores, the role played by income taxes and customer taxes is limited and little possibility for the government to achieve high tax levels. Secondly, It is difficult to create an efficient tax administration without a well-trained staff, when money is lacking to pay good wages to tax officials and to computerize the operation (or even to provide efficient telephone and mail services), and when taxpayers have

limited ability to keep accounts. Thirdly, because of the informal structure of the economy in many developing countries and because of the financial limitations, statistical and tax offices have difficulty in generating reliable statistics. This lack of data prevents policymakers from assessing the potential impact of major changes to the tax system. As a result, marginal changes are often preferred over major structural changes, even when the latter are clearly preferable. This perpetuates inefficient tax structures. Finally, Income tends to be unevenly distributed within developing countries. Although raising high tax revenues in this situation ideally calls for the rich to be taxed more heavily than the poor, the economic and political power of rich taxpayers often allows them to prevent fiscal reforms that would increase their tax burdens. This explains in part why many developing countries have not fully exploited personal income and property taxes and why their tax systems rarely achieve satisfactory progressivity (in other words where the rich pay proportionately more taxes).

Alternatively, it can be said that the whole tax system in Ethiopia is faced with such problems as unsatisfactory level of record keeping and administration inefficiency, lack of sufficiently educated/informed taxpayers, there is high cost of tax compliance, extensive evasion, over-zealous and corrupt tax officials and extremely narrow tax base-in many of the countries, 20-30 large businesses account for two-thirds of a country's tax revenue.

It is obvious that the introduction of any new tax scheme will invariably met with reservations and mixed reactions from the general public in any country, irrespective of the country's socio-economic status or its level of development. Because VAT is a new and sophisticated tax that differs significantly from the classical tax schemes with which the people were familiar, various misconceptions regarding its impact, its application, and its benefits to the national economy are normal in the initial phase of its application. Several well-meaning but insufficiently informed individuals, or otherwise people with ulterior motives, have misled the public into thinking that its impact is cumulative and claimed that its effect on consumer spending would go far beyond even the 15 percent flat rate that the tax imposes.

While VAT has been adopted in most developing countries, it frequently suffers from being incomplete in one aspect or another (**Riswold, 2003**). Many important sectors, most notably services and the wholesale and retail sector have left out of the VAT net, or the credit mechanism is excessively restrictive (that is there are denials or delays in providing proper credits for VAT on inputs), especially when it comes to capital goods.

Munoz and Cho's study on the social impact of tax reform in Ethiopia has indicated that the effective sales tax rates are lower than the effective VAT rates, since many goods and services had lower rates under the sales tax (**2003**). The replacement of the sales tax by the VAT has increased the tax payment burden for the average household. Their study has further revealed that the sales tax is more progressive than the VAT (**Munzo and Cho, 2003**). In sum, this is true because the VAT has fewer exempt items, and these items are not disproportionately purchased by the year. The VAT is more efficient, but it does shift some of the relative burden of the tax on the poor. The result is that the replacement of the sales tax with the VAT has had an adverse impact

on the poorest 40 percent of the population. Note, however that the impact is small (about 1 percent of their consumption).

The authors' analyses show that the VAT is progressive when we analyze total expenditure at the national level **(Munzo and Cho, 2003)**. However, because it has fewer exemptions and only one rate, the VAT is less progressive than the sales tax it replaced. Most of the exempt goods and services are disproportionately consumed by the relatively well to do, so the exemptions cannot be justified on equity grounds **(Munzo and Cho, 2003)**.

The other problem commonly observed is that some of the taxpayers refuse to honor their debt obligations to the VAT service while others submit their VAT returns without payments. There is also deliberate submission of nil returns, non-issuance of VAT invoices and entertainment providers and lotto operators refuse to use the VAT coupons.

The problems of introducing a VAT depend in large measure on whether the country has had previous experience with general sales taxes, the nature of the taxes that the VAT will replace, the effectiveness of the tax administration, the lead in time and the structural features of the VAT (rates, exemptions and treatment of small tax payers).

Administrative considerations have greatly influenced the structure of the VAT in Ethiopia. Because a single-rate VAT is easier to administer than a multiple rate VAT, the former has been applied. The complexity of administering full exemptions (zero-rating) has led to restrict them to exports. Small taxpayers have been dealt with by exempting those with gross sales below a certain threshold or by taxing them under a simplified system. Because of the difficulty involved in taxing service, the VAT is imposed on selected services only. Insufficiency of resources leads administrations to concentrate their enforcement efforts on large taxpayers, which can encourage noncompliance among other taxpayers.

IV. Concluding Remark: Prospects of VAT in Ethiopia

The Ethiopian government has now embarking upon a major tax reform program that will have a substantial impact on the economy of the country. The introduction of VAT has been a major part of the tax reform program not on its effect on raising revenue but on the fact that it has been a major talking issue in recent times by the business community, writers, the government and other members of the society. No attempt has been made to show the advantages and disadvantages of introducing this tax system at least in the literature. Previous discussions have clearly indicated that with efficient administration and commitment, there is a bright prospect for effective implementation of VAT in Ethiopia.

In developing nations, the VAT has tended to be something of a money machine. It has been found out that in Argentina, Chile, Costa Rica, Korea and Indonesia, for example, the ratio of revenue to GDP grew by at least 50 percent within the first three years of the VAT's adoption, compared with revenue from the indirect taxes replaced by the VAT. This is a clear indication that Ethiopia can implement the tax with minimal risk of revenue loss and with some expectations of fairly strong revenue growth, at least in the early years.

The VAT taxes each stage of value added only once, at the stage where it is added. The VAT's neutrality in so far as production efficiency is concerned is that it taxes productive inputs equally and does not promote distortion of production choices. The consumption type of VAT does not distort the choice between consuming now and consuming later, in favor of the former, as does the income tax. This means the VAT does not penalize, as does the income tax, capital accumulation and economic growth.

Ethiopia should not attempt to achieve a perfectly broad and neutral VAT as the government has to give concern for other social, economic and administrative objectives. Alternatively, the need to reduce regressivity in the structure of the tax for reasons of equity in income distribution leads to pressures to include zero-rating for some essentials and for goods designed for some special groups and to have higher than the standard tax rates for other goods that are considered nonessentials or luxuries.

As Ethiopia follows a free market policy, the design of the tax system should be as neutral as possible so as to minimize interference in the allocation process. The tax system should have simple and transparent administrative procedures so that it is clear and it is not being enforced as designed.

Ethiopia need a higher tax level to pursue a government role closer to that of industrial countries, which on average enjoy twice the tax revenue. It will need to reduce sharply its reliance on foreign trade taxes, without at the same time creating economic disincentives, especially in raising more revenue from personal income tax.

A publicity campaign aimed at both taxpayers and consumers is necessary for the successful introduction of a VAT. Where such efforts have been made, as they were in Argentina, Korea, and Mexico, for example, the VAT has been introduced without great difficulty.

Enough lead-in time should be allowed to permit careful preparation of regulations, return forms and systems for registering taxpayers and processing VAT returns and payments. Chile was able to reduce the lead time to a few months because of prior experience with a turnover tax.

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