Evaluate the Ethiopian VAT (Value added tax) Tax System against Principles of Good Taxation giving conclusion for policy implications

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Abstract

This paper evaluates Ethiopian VAT tax type based on ten good tax principles that are: Equity and Fairness, Certainty, Convenience of payment, Economy in collection, Simplicity, Neutrality, Economic Growth & Efficiency, Transparency & Visibility, Minimum tax Gap, Appropriate Government revenue. The findings of this evaluation revealed VAT which six principles are under positive effect in Ethiopia meets of six Conon of good tax system. Those are: Certainty for taxpayers, Convenience at the time of payment, neutrality, economic growth and efficiency, transparency and visibility, appropriate government revenue. Finally, the author suggest recommendation that could be used by the government in general and tax authorities in particularly in the preparation future tax proposal reform and issuance of any directive, proclamation, rule and procedure which is going to implemented need to encapsulate this Canon as Guiding route to improve service delivery and alleviating problem emanated from short coming from administration.

Keywords: VAT (Value added tax), Good tax policy, Canon of tax policy, Ethiopia.

1. Introduction

VAT is an indirect tax in that it is levied and charged by a government on from someone other than the person who actually bears the tax(namely the supplier(s) rather than the consumer).VAT is a multi-stage tax levied at each stage of the value addition chain, with a provision to allow input tax credit (ITC) on tax paid at an earlier stage, VAT is intended to tax every stage of sale where some value is added to raw materials, The concept of VAT was proposed first by American experts by 1920. But at that time, Americans failed to implement it and the modern concept of VAT was truly introduced in France (1954).

There are three types of VAT: Gross product type: taxes paid on purchases of capital goods fixed capitals and depreciations: are not allowed to be refunded and this type of VAT is not common as it raises stiff resistance on the part of tax payers. Income type, it's the same to gross product except it allows refund on the periodic allowance for the depreciation value of capital goods. Consumption type is almost prevalent in most states of the world. This is basically related with the fact that all business purchases including that of capital goods and related depreciations are allowed to be refund. There is no discrimination among tax payers.

Why Ethiopia Government imposed VAT? (Rationales behind Introducing VAT in Ethiopia)

In short the following are some of the reasons to introduce VAT in Ethiopia;

- ✓ Sales tax doesn't allow collection on the added value created wherever sales transaction is conducted but VAT does.
- ✓ VAT allows little room for evasion.
- ✓ VAT enhances saving and investment.
- ✓ Out dated (older version) sales tax is not capable of generating adequate revenue for the government to cover necessary expenditures.
- ✓ Ethiopia adopted VAT proclamation No 285/2002 applied and practiced from January, 1, 2003 onwards.

Good TAX administration (such as having a sound VAT system) is challenging in all countries especially in developing ones. It takes time, skill and resources all of which are in short supply in many countries including Ethiopia. Therefore, great effort is needed towards its sound implementation, on the part of general public.

Advantages of VAT

- It is a more comprehensive and equitable tax system, It reduces the possibility of tax evasion, It has less tax burden, It is neutral, It avoids cascading effect of a tax (Tax on Tax) , It improves productivity, It promotes capital investment and saving, It enhances exports

- **Criticisms against VAT**

  - It is regressive in nature, it requires advanced economic structure, It puts additional burden to tax authority, It is uneconomical.

Taxable activity, taxable transaction and Registration for VAT

Taxable activity

According to proclamation No. 285/2002 articles 6 “Taxable activity" means an activity which is carried on continuously or regularly by any person:

(I) in Ethiopia, or

(2) Partly in Ethiopia, whether or not for a commercial profit, that involves or is intended to involve, in whole or in part, the supply of goods or services to another person for consideration.

Taxable transaction is a process. It is related with supply of goods or rendition of services. Art 7(3) of the VAT proclamation provides that 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 under. Art 8.

Zero-Rated Transactions: In Ethiopia, two rates are recognized on taxable transactions: Standard rate and zero-rate, where the standard rate is 15% and zero rate 0%. It is common, under VAT laws and regulations, to see transactions as; standard rated zero-rated and exempt transaction.

As the name indicates, a zero-rated transaction is a taxable transaction that is taxed at zero-rate of tax. Because law has given blessings so that the transaction are completely free from tax.

According to Art 7(2) proc.285/2002 of the VAT proclamation, the following are some examples of transactions which are zero rated.

- ✓ export of goods and services
- ✓ The rendition of transportation or other services connected with international goods or passengers, as well as the supply of lubricants, consumption, during international flights.
- ✓ The supply of gold to the National bank of Ethiopia.
- ✓ Transfer of a business from one registered person to another registered person as a going concern.

Exempt Transactions: A supply of goods and rendition of services, import of goods or import of services is an exempt if it is a description included in VAT proc.285/2002. An exempt transaction is a transaction not subject to VAT. Thus the transaction is not considered taxable transaction for social, economic or development reasons.

Some examples of exempted transaction listed in VAT proc.285/20002 art (8) are:

- ✓ the sale transfer or lease of immovable
- ✓ rendition of financial services
- ✓ supply or import of national or foreign currency
- ✓ the import of gold to be transferred to the national Bank of Ethiopia
- ✓ the import or supply of prescription drugs specified in directives issued by minister of Health,
- ✓ Rendition of educational services provided by education institutions

.Issue related to Registration for VAT

Registration for VAT under Ethiopian tax laws is two kinds:

A. **obligatory registration of taxpayers**

According to Art 16(1) if the total taxable turnover (transaction) over a period of 12 months exceeds 500,000 ETB; the person shall be registered for VAT. This requires estimation at the end of each month, the total value of taxable goods and services supplied by the person /business entity/ for the past 12 months. Thus, two periods are to be considered, the past 12 calendar month and the second 12 calendar month, on a month-by month basis.

Where using such method of calculation if the total value exceeds 500,000 Birr, registration is compulsory. Even at the beginning when there exists reasonable ground to expect that total value of taxable transactions during 12 months period will exceed 500,000 registration is mandatory .(Art 16(2). One thing to add here is in calculating the total turnover exemptions or transactions subject to other taxes are not included. The calculation is limited to taxable transactions under VAT.

B. Voluntary Registrations

Anybody interested may apply for voluntary registration .But Art 17 provided a condition that shall be satisfied. The applicant person /business entity shall supply goods or render services at least 75% of his /its goods and services to a person /business registered for VAT.

A voluntary registered person is entitled to recover (claim credit or refund) in output VAT among other certain zero-rated supplies.

- Application For Registration

A person whose total taxable transaction exceeds the minimum requirement and not registered are required to file application for VAT registration by themselves. The application is made on the form called application for VAT registration. The authority will issue a VAT registration certificate containing;

- ✓ Full name and other details of the registered person;
- ✓ Date of issuance;
- ✓ Date from which the registration takes effect;
- ✓ The registered persons TIN.

C. Cancellation of Registration

According to regulations No. 79/2002, 10(1) a registered person must apply for cancellation of registration within 30 days of the date the person ceases to make taxable transactions.

10(2) the application for cancellation under sub-Article (1) shall be in writing, shall state the date upon which the person ceased to make taxable transactions, and shall state whether or not that person intends to make taxable transactions within 12 months from that date.

10(3)The authority shall approve an application for the cancellation of registration under(2) unless the Authority has reasonable grounds to believe that the person will make taxable transactions at any time within 12 months from the date of cessation.

10(4) While the cancellation of registration generally takes effect on the date of cessation, if the Authority is satisfied that the registered person' did not' make taxable transactions from the date the registration took effect, the Authority cancel the registration retroactive to that effective date,

10(5) When registration is cancelled to the extent provided under Article 4, Sub-Article(4) of the Proclamation, the registered person may he deemed to have sold the goods on hand in a taxable transaction.

10(6) Any obligation or liability under the Proclamation, including the furnishing of returns, of any person in respect of anything done by that person while the person was a registered person, is not affected by cancellation of the person's registration.

Penalties and Criminal Offences

Under VAT proclamation penalties are imposed and failure to observe the VAT proclamation and regulation is criminal offence, as tax law is part of public Law. Administrative penalties are inherent consequences on tax players that fail to comply with tax obligations under VAT.

The following are same failures that are related to administrative penalties and criminal offences

- ✓ engaging in taxable transactions without registration
- ✓ issuing incorrect invoice, issuing invoice without registration for VAT
- ✓ Failure to maintain tax records, file timely etc.

The degree of penalty imposed is directly related to the impact of the fault up on the enforcement of VAT in Ethiopia. Criminal offences on the other hand are tax law violations of the criminal Law of Ethiopia and thus are subject to charge, prosecution and appeal in accordance with criminal procedural law.

VAT-Vs- Principles of Good Taxation

1. Equity and Fairness

This principle states that the tax system should be judged on the criterion that the distribution of tax burden by the government among the community should be fair and effectively equal.

There are two bases to measure how governments fair in distribute the burden of tax fairly.

a) **Ability to pay principle:**

I. **Horizontal Equity** - Similarly situated taxpayers should be taxed similarly.

II. **Vertical- Equity** - A Tax should be imposed based on the ability to pay.

b) **Benefit principle** - Tax payers should be in proportion to the benefit they received from the government in the form of goods and services.

- VAT is generally regarded as regressive tax. AS a research consistently proved that the poor pay higher share of their income in VAT than the rich. This is due to MPC.

A broad based single rate VAT (as the Ethiopian case) that applies to all goods and services without compensating measure is the most regressive form of tax.

- Vertical equity and the ability to pay principles are adversely affected by a broad based single rate VAT. This is because the total tax paid represents a higher tax burden as percentage of current income of a lower income tax payer than a higher income tax payer.
- Further low income tax payers are thought to be the hardest hit because they tend to spend a larger portion of their income on basic necessities than any other group. However

in an IMF publication Ebrill et.al. (2001), pointed out that the impact of VAT is highly regressive only when measured against current income, in isolation.

- The alternative view suggested is to assess the wider impact of the overall tax system. Ebrill et.al. (2001) conclude that a broad based single-rate VAT is neither regressive nor progressive, if other compensating direct government spending program and a progressive income tax are taken into account.
- Another alternative view considers ability to pay from a consumption stand point, rather than from an income perspective. If one can afford to consume more goods, this directly indicates a higher ability to pay hence the VAT will impose a tax that is in preposition to a person's ability to pay resulting vertical equity.

2. Certainty

The tax system of a nation should not be arbitrary rather it should be certain to the tax payer, Govt. and every stockholder.

A) Certainty to the tax payers

- ✓ how the amount of a tax due is calculated
- ✓ how the tax due is to be paid
- ✓ When the tax due is to be paid
- ✓ Where the tax due is to be paid

B) Certain to the government

- ✓ How much amount the government will collect from each of particular taxes.
- ✓ When each of the particular taxes should be collected

Certainly can also be viewed as the level of confidence a taxpayer will have that he or she is computing the tax correctly.

As mentioned under the principle of "certainty" a broad based single rate VAT (like the one under effect in Ethiopia) is relatively simple to administer. Generally, under the single-rate credit-invoice VAT, all businesses collect a uniform VAT calculated on the sales price.

- At the end of the reporting period, total VAT collected is reduced by total VAT paid on all purchases.

- Assuming a profitable business with receipts higher than input purchases, the excess VAT collected is then remitted to the authorities. If VAT paid is greater than what the business collected in VAT, a refund is issued. This is a relatively simple and straightforward procedure that aids certainty.

3. Convenience of payment

- A tax should be due (paid or collected) at a time and in a manner that is most likely to be convenient for tax payers or both time and manner in which payments are executed should be convenient to the taxpayer and unnecessary trouble to the tax payer should be avoided.

- The payment of VAT by the consumer is very convenient because the consumer pays the Tax when he buys the commodities at the time when he has the means to buy the product.

- The payment of consumption tax, such as VAT is extremely straight forward and simple. It is applied on the final purchase price and is paid at the point of sale. Under broad based single rate VAT (like the Ethiopian case) most purchase of goods and services would have VAT added to the price.

- Furthermore, the manner of payment is also convenient because VAT is inclusive in the prices of the commodities and on the business front, payment of VAT is also relatively convenient. The excess VAT collected at the end of the reporting period is remitted to the tax authority.

4. Economy in collection

The tax system should not impede or reduce the productive capacity of the economy likewise the cost to collect a tax should be kept to a minimum for both the government and tax payers.

- In general introducing a new VAT system would increase the administrative burden and cost for the government, these include: training, implementation of a new IT system, administration, assessment, verification, collection, issuance of forms, instructions and technical guidance, tax payers awareness programs and enforcement plans to insure that all tax payers can properly comply with the VAT, the cost of the cash register machine etc. In this regard the cost of collecting VAT could be significantly high in VAT in Ethiopia.

- But on the other hand VAT is paid at the point of sale where selling and buying are the main actions performed by the transacting parties, the collection of tax is something to be done in conjunction with sales, accordingly VAT is known as an extremely efficient revenue generator that is why it is called “money machine.” In other words, VAT produces a high revenue yield and supports a cost effective collection process.

5. Simplicity

It states that the tax system of country should be simple and plain(clear) to understand by both the tax payers and tax administrators; and they should not be confronted(challenged) with accounting, administrative and other difficulties . This is because a complex tax system may result in error (due to failure to understand the tax laws), tax evasion (violation of tax laws), disrespect for the tax system by tax payers, and difficulty in administration by the tax administrators.

The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.

- Should reduce the amount of errors?
- Should increase respect for the system?
- Should enable taxpayers to understand tax consequences of their transactions?

- As mentioned under the principle of “certainty” a broad based single rate VAT (like the one under effect in Ethiopia) is relatively simple to administer. Businesses collect a uniform VAT on all their invoices and pay a uniform VAT on all purchases, excess VAT collected is remitted to the authorities. Capital purchases qualify for input VAT refunds. And goods for export are not taxed.

- Without special exemption and multiple rates, these forms of single rate VAT will be the easiest to comply with.

- But as the complexity of the business process, increases there could be a complexity in the collection of VAT too. VAT system in Ethiopia has involves high cost of administration, assessment, verification and collection. Hence, it is highly uneconomical and imposes high tax compliance costs.

6. Neutrality

The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum. Taxpayers should not be unduly encouraged or discouraged from engaging in certain activities due to tax law. Primary purpose of tax system is to raise revenue, not to change behavior. Taxation can be held neutral in effects if it fulfills the following two conditions: no distortion on economy and no unneutral effect on economy, which the taxes must not alter the choices or courses of action (decisions) on the part of members of the society.

As a consumption tax, VAT does not tax interest earned on savings or capital gains hence it doesn't discourage savings, also a broad based single rate VAT ensures uniformity and neutrality, the consumer choice is not distorted among various goods and services. This applies to businesses as well. There will be no economic incentives or disincentive to purchase or produce any one item, thus the neutrality of the tax system is better preserved.

7. Economic Growth & Efficiency

- The tax system should not impede or reduce the productive capacity of the economy. The tax system of a country should neither as discourage nor hinder national economic goals and polices such as economic growth, capital formation, international competiveness, investment and supply of factors of production like labor.

- Tax system should be aligned with the economic goals of the jurisdiction imposing the tax.

- For example, it should be aligned with jurisdiction's economic goals for economic growth, capital formation and investment competitiveness.
- Should not favor one industry or type of investment at the expense of others.

➢ VAT proves to be an efficient tool for revenue collection; its performance, therefore, has direct impact on fiscal mobilization, macroeconomic stability, and development.

➢ Compared with alternatives in indirect taxation, the VAT has more revenue potential: it is generally more broad-based and entails a trail of invoices that helps improve tax compliance and enforcement. VAT collection and administering costs of a government should be kept to a minimum possible level to the tax collecting authority (government).

8. Transparency & Visibility

Its states that a tax system should be transparent and visible so that the citizens should know that:

➢ a tax exists (there is a compulsory contribution to the government to fulfill a citizen obligation and citizens have to know they have pay tax)

➢ How the tax is levied on the tax payers (on their income, property, wealth, consumption)

➢ Enables taxpayers to know the true cost of transactions.

➢ Enables taxpayers to know when tax is being assessed or paid and to whom

VAT is highly transparent and visible. Which means that there is opposing VAT will be hidden between the convoluted production and distribution chain? On the other hand, VAT is extremely visible. VAT can be printed on every invoice and receipt upon purchase. Taxpayers will know exactly how much VAT is paid on every transaction, at the checkout counter. VAT is a percentage of price "which means, the actual tax burden is visible at each stage in the import, production and distribution chain.

9. Minimum tax Gap

➢ A tax should be structured to minimize non-compliance. VAT tax is divided into several parts depending on the number of stages of the production and sale. At each stage, every transaction is made using VAT invoice approved by the appropriate tax authority. In addition, each VAT registered person (supplier) has to maintain appropriate records on their sales and purchases transactions. The output VAT of seller becomes the input VAT for the buyer. Those conditions and obligations make the possibility of value added tax evasion difficult. On the other side, VAT systems depend a lot upon the cooperation of the taxpayer.

- Each firm itself calculates its tax liability and also finds out the taxes paid by the earlier firms. Once, however, the sellers realize that the administrative machinery of the government is ill-equipped to do all the necessary cross-checking, they will resort to the creation of false purchase invoices showing taxes paid by others. To the extent this happens, tax evasion becomes a major possibility and a common practice.

10. Appropriate government revenue

- The tax system should enable the government to determine how much tax revenue will be likely be collected and when.

- VAT is a percentage tax i.e. it is known in advance the amount of tax to be paid on the part of the consumer upon purchase, amount to be collected on the part of the business upon sale, having this very truth in hand it is easy for the government to determine how much tax revenue will likely be collected and when. The 'when' part is simply answered as at the time of transaction that is, at the point of sale and purchase since VAT is a consumption tax. To this end VAT fulfills both of the criteria's.

SUMMARY AND CONCLUDING REMARKS

To sum up, the overall analysis, a broad based single rate VAT which is under effect in Ethiopia meets six principles of good tax policy i.e. certainty, convenience of payment, Neutrality, Economic growth and Efficiency, Transparency and Visibility, Appropriate government revenue. However it did not fully meet the requirements for equity, simplicity, economy in collection and minimum tax gap.

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