

# Administration and compliance of ethiopian vat improvement plan



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Ethiopia has undertaken a comprehensive tax reform in the past couple of decades with the major aim of creating modern tax system, broadening the tax base, redistributing income and support economic efficiency. Value added tax was introduced in January 2003 as a result of this reform effort with the objective of replacing the weak sales tax. Both the policy and administration of VAT was designed to maximize revenue generation more than the sales tax. However, the VAT revenue yield was not as expected though stronger than the sales tax. The other policy objectives considered in the design of VAT were also not satisfactorily achieved. These are believed to be due to mainly low compliance and lack of efficient and effective administration. So, it is believed that there is a potential for improvement of VAT collection performance through improving the administration and compliance.

This report is, therefore, intends to provide a proposal on the measures that need to be implemented to rectify the administration pitfalls and to improve compliance. In doing so, the report in its subsequent sections briefly reviews the existing VAT administration arrangements, its strengths and weaknesses and the existing situation of compliance. The report then provides recommendations of actions that should be taken to resolve the existing weaknesses and further strengthen the administration and improve compliance.

### Background of VAT Administration and Compliance in Ethiopia

The introduction of value added tax was believed to be one of a remarkable achievement in the Ethiopian tax system since its potential in raising

revenue was believed to be much better than the then sales tax in operation. VAT is also believed to avoid cascading effect, and it can be made equitable by making it progressive. It was with this understanding of its nature that VAT was introduced in January 2003 to replace the sales tax. A single rate VAT is introduced on the supply of goods and services when they are transacted within the businesses whose annual turnover is more than or equal to Birr 500, 000; with negative list of some items exempted. The Ethiopian VAT is administered on invoice based transactions so that the consideration of the taxpayers' credit on the VAT paid on input is supported by documents. Export is zero-rated since the VAT is based on the destination principle while VAT paid on inputs is refundable based on voucher system. Fifteen percent VAT is charged on all taxable transactions of goods and services. According to the VAT legislation (Proclamation no 285/2002), businesses whose annual turnover equal and above the threshold level are legally required to register for VAT administration while the administration of VAT is solely the responsibility of the Ethiopian Revenue and Customs Authority (ERCA) through its Large Taxpayers' Office (LTO) and branch offices.

Tax administration basically consists of sets of rules and regulations guiding the tax authority to discharge its responsibilities in the implementation of the tax policy. The activities involved in the tax administration include: identifying and registering the taxpayer, invoicing, filing and payment requirements, control of filing and payments, refunds, audits and penalties. Tasks such as determining who would be administering the tax, what organizational setup to use and what resources are available are peripherally

fall under the responsibility of VAT administration (Yesegat 2008, p. 146). Failing to carry out these administration responsibilities by both the tax administrator and the taxpayer as well as existence of weaknesses in the design of these administration activities will definitely adversely impact on the administration efficiency which this in turn affects the achievement of the VAT objectives and implementation of the policy.

In terms of commencing the implementation of VAT law, ERCA began its operation by notifying the businesses legible for VAT registration to appear and register for VAT. However, at the time only few were registered. So, ERCA introduced forced registration scheme on specific businesses engaged in activities that are expected to generate annual turnover close to and above the threshold without actually assessing their actual annual turnover. Directive is also introduced to oblige Government institutions to transact only with businesses registered VAT if the transaction value they are carrying out is 100, 000 and more. Accordingly, the number of VAT registrant improved from time to time. However, as surveys done by Yesegat (2008, p. 151) on compliance revealed, the prevalence of VAT unregistered businesses is very high and resulted in uneven market competition, loss of profit by registered businesses. So the compliance for VAT registration is still a big problem in Ethiopia. As far as VAT filing and payment in Ethiopia is concerned, the legislation shows that VAT declaration and payment is to be made on monthly basis by the taxpayer while the taxpayer has to file a VAT return and payment within 30 days after the accounting month. As per the ERCA report, though most taxpayers practice the declaration on time, at the

beginning of the VAT implementation there were a lot of nil filers while the payment filers were very small which resulted in low VAT net collection.

Well, non-compliance is a result of factors such as lack of awareness, deep rooted tax evasion/fraud practices, and policy and administration defects. In the Ethiopian case to identify which factor/s led to non-compliance needs a study. However, according to Yesegat (2008, p. 151-152), with regard to payment methods, the study conducted indicated that the requirement that a taxpayer should go to the premises of the tax authority physically to file VAT returns is a problem as this definitely disobediently lead the taxpayer to incur increased compliance cost.

The other important aspect to consider with regard to VAT administration is the information management of VAT transactions and registrants, and utilization of the information for the VAT administration. In this regard, ERCA introduced an automation programs known as Standard Integrated Government Tax Administration System (SIGTAS) to handle the domestic VAT transactions and other tax transactions and Automated System for Customs Data Management (ASYCUDA++) for the use of transactions of imports and exports as well as taxes and duties including VAT. However, ERCA is at its lowest stage in terms of optimal utilization of these systems. For instance, the administration recognize non-filers indirectly when the businesses process their licences to be renewed by the Ministry of Trade and Industry as they are required to produce tax clearance from the tax authority on their tax liability including VAT; not using the either using SIGTAS or ASYCUDA++ (Yesegat 2008, p. 152). This is one of the significant problems of the tax administration as it does not utilize the existing systems such as <https://assignbuster.com/administration-and-compliance-of-ethiopian-vat-improvement-plan/>

SIGTAS optimally which as a result would have impact on the customer service and creates delays in the Government revenue collection.

With regard to VAT invoice made operational, as per the VAT law ERCA issued directive governing the type of invoice to be issued by the VAT registrant. According to article 22 of VAT proclamation no. 285/2002 all VAT taxable transactions carried out by the VAT registrant is obliged to issue a VAT invoice to the person who purchased the goods and services while non-VAT registrants cannot issue VAT invoices. In connection with this the practice of making optional the transaction of VAT with invoices by VAT registrants is a major compliance problem though this is not caused by complexity of the use of invoice. The main reasons are weak administration to enforce the regulation and low compliance level in connection with the newness of VAT and lack of awareness of the society to ask for invoices from the businesses due to low development level of the people.

Tax evasion and fraud including VAT is generally prevailing in Ethiopia as it also is common in developing countries; while on the other hand the administration control is loose as the audit rate was only 1.6 percent in 2005/06 (Yesegat 2008, p. 153-154). In this regard, the loose administration which is close to 'Laissez-Faire' approach aggravated the evasion and fraud. The ERCA administration until recently was criticized for its weak control as the tax officers only sitting at office and collect what the taxpayer owed them. High-risk taxpayers were not checked against their actual tax liability intensively and adequately due to lack of strong audit. Though existence of an audit system can be taken as a strong point, in terms of scaling up the audit rate there is a weakness in the administration in <https://assignbuster.com/administration-and-compliance-of-ethiopian-vat-improvement-plan/>

connection with budget constraint and high staff turnover due to incomparably low public sector wages. This would definitely have a repercussion on the compliance. In Ethiopia the resource allocation to the administration is believed to be unreasonably very low compared to other countries. For instance, Yesegat (2008, p. 154) mentioned the ratio of the VAT administration personnel to the number of VAT registrant in 2004/05 was 1: 234; which means on the average one personnel serves 234 VAT registrants; which shows a high burden on the tax administration. The ratio of auditors to the VAT registrants, on the other hand is 1: 786 disregarding the poor quality of the auditors which makes the situation even worst. This clearly shows that resource/budget constraint leads to poor administration. In this regard, until recently the Government has not realized the need to put some extra resource to alleviate the drawbacks of the administration.

Tax compliance in Ethiopia in general and VAT compliance in particular is at its lowest level due to lack of efficient and effective administration though there are sluggish improvements. The recent IMF (2009, p. 1) study on revenue administration reform supports this idea in its findings: “ persistent compliance management inefficiencies, an ineffective headquarters function, comparatively low staff skills and capacity, and unexploited data and performance management systems in ERCA”. The ultimate objective of the tax administration should be effective implementation of the VAT law and maximizing collection of legislated revenue with increased compliance. This can never be possible without putting in place a system which reward the compliers and penalize the non-compliers. Strict penalties on those who violate the law would have a preventive effect to encourage compliance. The

Ethiopian VAT law promulgated penalties ranging from financial fines to imprisonment on those who don't comply with the particular regulations. This is the strong part of the regulation without being made effect by the administration, though implementation of the penalty law started only recently in its strict sense. This actually requires putting in place efficient and effective risk-based revenue administration which would enable to identify the high and low risk taxpayer with a proper management of their profiles. Lack of such properly functioning system is also one of the weaknesses in the Ethiopian VAT administration.

With regard to VAT refunds, the VAT regulation allows a refund to exporters and non-exporters. In practice, however, except for the exporters VAT return is not so much practical. Particularly, the importers' credit claim has never been entertained by the administration for the reason that the taxpayers' claim is not based on the customs valuation. The taxpayers' complain is that there is a high overvaluation of the prices of their imports and they sale their product with low price which as a result the accounting always show a credit while the tax administration's view is there is undervaluation of import by the taxpayers. This issue is a live discussion among the businesses particularly for those genuine one. So, this might have contributed for the tax non-compliance including VAT.

Organizational arrangement is one of the key considerations that make differences in the improvement of tax administration and compliance. In this regard, one of the strengths of the revenue administration is the segregation of offices for significant tax payers and allocating much of the resources to the undertaking of this administration. (Revenue administration of VAT is <https://assignbuster.com/administration-and-compliance-of-ethiopian-vat-improvement-plan/>)



carried out by dedicated staff within the ERCA and this can be taken as a significant advantage in terms of providing the necessary facilitation to the VAT taxpayers and efficient control of VAT. All these achievements are the results of the recent undertakings by ERCA in its Business Process Reengineering (BPR) initiative. However, the very slow pace at which the change managements and overall reform activity are progressing should get scrutiny in order to keep up the pace at which the problems are getting solutions to a desirable level and avoid backlog of administration drawbacks and moving fast.

The issue of VAT administration at the sub-national level in Ethiopia was addressed by deciding to administer VAT centrally and transferring the collection of the sub-nationals' shares timely as they have a significant expenditure role in public finance. However, in the administration of other revenues regions have still power. The fact that revenue power is shared among Federal and Regional governments and prevailing administration inefficiencies because of this division is believed to give rise to chance of tax evasion which contaminates the overall system. Different treatments are being given to Federal and Regional taxpayers. As a result of this businesses show a tendency to move to where their tax liability would be relatively low at the expense of changing their business type.

#### Proposed Measures to Improve Administration and Compliance

It has been attempted to discuss the strengths and weaknesses of the VAT administration and compliance situation in Ethiopia in the above section of the report. What remains to present is the remedial actions that should be

implemented by the tax authority to correct the administration and to improve VAT compliance. To design a VAT system with minimum problems should take the consideration the administration aspect and socio-economic condition of the country. A VAT system which has not taken into account these considerations can never be successful (Yesegat 2008, p. 146). The reforms required to improve the administration of domestic and import/export VAT are not necessarily the same. In some circumstances for instance, bringing changes in the customs administration requires specific actions peculiar to customs management while administration of import/export VAT is integrated with customs management. So, in some circumstances recommended actions may only pertain to either domestic or import/export VAT. The following are the corresponding actions that should be implemented within the medium term.

ERCA should either expand its branches to make increased access of offices at near by area for the taxpayer (if feasible in terms of cost) or devise an electronic mode of payment system as this would greatly help improve compliance decision of the taxpayer;

ERCA needs to strengthen the capacity to utilize the existing information technology optimally to effectively follow up VAT non-filers and take the necessary enforcement measure so that the compliers are encouraged and the non-compliers are discouraged;

Intensive tax education program which aim to increase awareness of the people with regard to purpose of tax, and obligations and rights of the businesses and the people is very essential;

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Strengthening VAT audit method is an essential solution and audit should be conducted on risk-based;

The current measure taken by the Government to make the revenue authority autonomous and allocate more resources to decide on the benefits of the tax personnel is very encouraging and this is commendable then should be further strengthened;

Establish transparent and consistent system of penalty which in combination with effective tax education can bring result on the compliance improvement;

ERCA should resolve the import valuation issue by moving to a valuation which is based on actual import values as per the regulated in the customs law;

Merging the administration of regional taxpayers with significant transactions with the Federal government is crucial in terms providing efficient administration and the same treatment to similar taxpayers in order to minimize tax evasion and improve compliance;

Measures that required improving VAT administration and compliance in Ethiopia go beyond and needs tax policy changes. In this regard, the removing of exemptions of non-basic consumption goods is very essential to simplify administration, to stop abuse of exemption privileges so also to increase compliance by encouraging compliers;

Strengthening monitoring system of performance of branches from

headquarter through the use of comprehensive robust data is also very  
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crucial to couple the efforts of improving administration and compliance.

Strengthening staffs skills to utilize information technology resources and undertake data analysis is very essential;

Introducing self-assessment arrangement in the VAT administration on risk-based approach is also very essential in terms of improving compliance. In this regard, providing self-assessment for selected taxpayers based on their risk-profile and subject to monitoring through audit would enable the administration to allocate more resources to high risk areas. This requires minimization of the existing dependence of tax assessment on intensive documentary verification or desk audit task. Changing the VAT return administration to be based on audits of high-risk taxpayers is one area to strongly focus on. Strengthening tax education and customer service should couple this effort.

To effectively implement these proposed actions its needs strong and coordinated institutional arrangement and organization. In this regard, ERCA needs to make some form of reorganization of its tasks for better coordination and efficiency. Most importantly also without skilled and dedicated staff it would be almost impossible to achieve these objectives. So, ERCA should embark in intensive manpower capacity building efforts and restructure the payment system to narrow down the existing wage differential.

Concluding Remark

Sound and comprehensive remedial action to improve the VAT

administration and compliance in Ethiopia can be provided based on <https://assignbuster.com/administration-and-compliance-of-ethiopian-vat-improvement-plan/>

empirical study of real causes to the problem. However, with identification needs