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# The Value Added Tax and Sales Tax in Ethiopia: A Comparative Overview

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**Abstract**
This paper appraised and compared concisely the Ethiopian Value added tax (VAT) and Sales Tax. No extensive research has been done in these essential and critical features of the comparison of sales tax with VAT in the Ethiopian context. And this paper aims at comparing both of them by focusing on the general context of tax base, tax rate, the methods applied to implement and administer them based on the proclamations and regulations available for each. Replacing the outdated sales tax, VAT is still the most fashionable taxing system in Ethiopia. The paper revealed that there are some common features and different structures among VAT and sales tax. Both of them are consumption tax and revenue is collected from some entity other than the entity that actually bears the tax cost. While sales tax levied on the total value of an economic exchange, VAT comprehensively applied on all exchanges used in the production, distribution and consumption process. In addition, while sales tax has reduced but no zero rates, VAT has zero rates without reduced rate. As compared to sales tax, VAT contributed positively for the economy of one country if it is implemented and administered appropriately. Otherwise, the problem of sales tax continues in the VAT system too.
**Keywords:** Value Added Tax, Sales tax, General perception, Comparison, Ethiopia

## 1. INTRODUCTION

The Value Added Tax (VAT) and sales tax are indirect tax systems of consumption taxes. They have some common characteristics and also there are significant differences among them. VAT is a tax which is placed on the value added at each stage of production and distributions. It is the system that converts the distortionary sales taxes in to less distortionary as it takes many efforts to collect sufficient tax revenue while reducing the cascadity effects of sales tax. Much like retail sales tax, a VAT is an indirect tax that revenue is collected from someone or some entity other than the person or entity that actually bears the cost of the tax. While a sales tax was levied on the total value of an economic exchange, a VAT is a tax on all exchanges used in the production and distribution process.

Though it operated for more than four decades, sales tax was formally introduced in Ethiopia in 1993 by the Proclamation No 68/1993 and until its abolition with replacing by VAT it passes through several amendments. VAT replaces the outdated sales tax with the aim of collecting sufficient revenue in 2003 in accordance with proclamation No 285/2002 and still it is the most fashionable tax system. In the words of Charlet & Butdens (2012), the majority of countries which becomes about 75% of the globe where currently in the large chorus of implementing VAT system. The study of Adereti, *et al.*, (2011) shows as VAT was introduced in sub-Saharan African countries such as in Benin Republic, Cote d'Ivore, Guinea, Kenya, Madagascar, Mauritius, Niger Republic, Senegal, Togo and Nigeria. Most of them implemented VAT by replacing sales tax and some of them newly implemented and others used both of them hand in hand.

Because no extensive research has been done in these essential and critical features of the comparison approaches of both sales tax and VAT in the Ethiopian context, this paper aims at comparing both of them by focusing on the general context of tax base, tax rate, the methods applied for each to implement and administer them based on the proclamation and regulations available for each. So the paper will expand the knowledge on limited available literature as there is no an extensive study on the subject area.

## 2. REVIEW OF LITERATURE AND DISCUSSIONS

### 2.1. The General concept of Sales Tax and VAT

According to Shenk & Oldman (2007), indirect taxes have long been the heart of taxation in developing countries and it provide two-thirds or more of tax revenues in many countries. Similarly, indirect tax is more important instrument for the poorest countries to boost domestic tax revenues on goods and services. VAT is tax on consumption of goods and services and it is to be charged on the value of imports and on value added on goods and services supplied by one business to another till it reaches to final consumers (Bird, 2005).

Value added tax was originally developed to tackle some of the disadvantages associated with general sales tax. This is due to the reason that under a general sales tax system, taxes are charged in full at each stage of the production process with no opportunity for recovery. This indicates that in sales tax, as much as the production chains are longer, the liability of taxation was higher. General sales tax can therefore increase the prices across the chains, distort market signals and influence efficient allocations of resources, and hence impeded economic growth. In contrast to sales tax, VAT is imposed at each stage of value addition and there is no scope for cascading of the taxing system if it implemented appropriately. Then, VAT shall enhance economic growth as it cannot create cascadity effect, and has minimum distortionary effects. Likewise, VAT enhance saving and investment as it does not tax capital but consumption. It also improves the relationships between government revenues and gross domestic product (GDP). As supported by the findings of Adereti, *et al.*, (2011), when revenue was collected from VAT; it contributes to the total government revenue and hence boosts economic growth. Brautigam *et al.*, (2008) contended as VAT increases government revenue, improves economic efficiency, promotes exports, reduce disincentives to formal activity, raise revenue rapidly, simplify the tax administration procedures, widen the tax base and be an instrument of economic growth. The study of Aizenman & Jinjarak (2005) explained as the VAT revenue is unavoidably collected as far as there were the chain of production and consumptions of goods and services.

As stated by Emrana & Stiglitzc (2005) countries that do impose a VAT tend to be larger, wealthier, and more industrialized than those that do not. This is due to the reason that VAT is imposed on buyers at each stage of value adding chains, and no one refuses to pay it unless otherwise refuses to purchase the goods and services. As compared to VAT however, sales tax creates tax cascadity, it reduces the revenue generated for the government and hence it deteriorates the well-functioning of the macro-economy of one country.

### 2.2. Implications of Tax Base and Tax Rate

#### *A. Tax base of sales tax and VAT*

Value added tax is often considered to be essentially a retail sales tax. Nevertheless, it differs from a retail sales tax in that it is collected at each stage of the production and distribution process, not solely at the stage where a product is sold to the consumer. A VAT is an indirect tax like that of sales tax as both of them applied on the goods sold and purchased. However, unlike sales tax that uses the tax base of the value of goods sold and purchased, VAT uses the value added at different stages of production and distributions as the tax base. As such, the tax paid of VAT is therefore only on the value added by the seller to the inputs that the seller bought. Hence, while the tax base of sales tax is the purchase price; that of VAT is value addition in the delivery of value addition in the goods and services. The seller receives a tax credit for taxes paid on inputs that the seller purchased and used in the course of production when the computations of VAT payable is carried out. However this is not always true in case of sales tax system.

According to Munoz & Cho (2003), in the sales tax, the tax paid on some inputs including raw materials were narrowly defined to include materials embodied in the final product which was credited against the output tax. However, no credits were given to tax paid on capital equipment or on other inputs in the areas of distribution, warehousing, and administration. In addition, the author noted as the sales tax base in Ethiopia was narrow because it was limited to imports, manufactured goods, and a few selected services. As such, sales tax distorted efficient resource allocation, and thus likely it impeded economic growth since the credit was given only for taxes paid on raw materials.

#### *B. Tax rate of Sales tax and VAT*

The study of Purohit (1993) concludes as harmonization of tax system is necessary because of the wide range of tax rates that exist across the nations, varying from 15 to 25 percent especially in the European neighboring countries. Hence, all countries have a genuine need for simplifying their taxing system as far as implementing it to raise sufficient amount of revenue. Before its eliminations in 1993, Ethiopian sales tax was levied on imports and domestically produced goods at the maximum rate of 15 percent (Proclamation No 285/2002). Unlike, newly introduced VAT, sales tax system has reduced rate which is 5%. Conversely, many goods primarily such as agricultural products and food, pharmaceutical products, printed books, financial services and work contracts were taxed at a lower 5 percent rate. However, a few specified services were taxed at the 15 percent rate. The sales tax also allows for the complete exemptions of water, electricity, medical and educational services. In contrary to sales tax, being in its infancy arena in the history of Ethiopian taxing system, the newly introduced Value added tax system has a uniform rate of 15 percent on most goods and services without reduced rate (lower rate), with a zero rate mostly on exports and exempted goods and services by law or agreements.

### 2.3. Implications of Sales tax and VAT towards the general Economy

The study conducted by Hillman (2009), indicates that the consequences of tax evasion are the difference between legal and effective tax incidence. Taxes can be evaded by untrue sales of final goods for consumption to people outside the tax authority who are not required to pay the tax. So there is no tax to deliver for the government since tax revenue is converted to private income. In addition to that, corruption also facilitates the documentation required for the fictitious sales carried out to evade the tax revenue from sales tax. The study of McGee (2008) states the practice of tax evasion as the expressions of people's feelings on the tax administration of a given country. The author also added as tax evasion reflects a feeling of injustice in which people might sense that taxes take too much of their earned incomes and deliver too little in return through public spending. Hence in contrary to VAT, it is evidential that sales tax rate increases the market price of goods and services throughout its applicability and the person responds by decreasing demands of that goods and services which again distorts the economic development of one country. However, VAT applied on the amount of value added (mark-up) throughout the passage of goods and services from one stage to another. Therefore, VAT makes the burden of taxation invisible to the customers since it was applied to the price of goods and services, and it doesn't allows tax on tax but provides the tax credits for the tax payers. As such in comparison to sales tax, the application of VAT can minimizes the economic cost of tax collections and it facilitates effective administrations of tax system and hence it boosts up both growth and development of the economy in general.

According to Abate (2011), the most important issue about VAT as compared to sales tax is that, it ignores the ownership at stages of production but sales tax depends on the structure of ownership of productive activities while determining tax payments. Hence, VAT provides no incentive for the owner of the product to own that goods. Furthermore, sales tax would be paid every time a market transaction took place, by means of the tax levied on the complete value of the product but for VAT, a tax can be levied only on the amount of value added through the process of production, distributions and consumptions.

Consistent with the proclamation No. 285/2002, Ethiopia introduced VAT due to the following reasons: to minimize the damage caused by attempts to avoid and trade the tax and ascertain the profit obtained by tax payables, to enhance economic growth and import, to enhance the relationship between domestic production and government revenue, to increase saving and investment as it is essentially a consumption tax and does not tax capital. This replacement was done because sales tax lacks such ability to benefits the government and the societies in general. However, if the VAT is not appropriately implemented and administered, the problem of sales tax still continues in the case of VAT. Because in the incident of single standard VAT rate and tax exempted goods and services that does not constituted a significant fraction of the consumption of poor people, the regressivity problem of the sales tax can be again continued in case of VAT system. But if it is properly implemented and administered, the system of VAT contributes largely for one country's economic growth and development than that of the sales tax in general.

## 3. CONCLUSIONS AND POLICY IMPLICATIONS

This paper appraised and compared concisely the Ethiopian Value added tax (VAT) and Sales Tax. Because no extensive research has been done in these essential and critical features of the comparison approaches of both sales tax and VAT in the Ethiopian context, this paper aims at comparing both of them by focusing on the general context of tax base, tax rate, the methods applied for each to implement and administer them based on the proclamations and regulations available for each. The paper revealed that there were some common features among VAT and sales tax such as both of them is an indirect tax system of consumption tax and that revenue is collected from some entity other than the entity that actually bears the tax cost. The paper also discloses as both VAT and sales tax have different structures. While a sales tax was levied on the total value of an economic exchange, a VAT is a tax on all exchanges used in the production, distribution and consumption process. As compared to sales tax, VAT is the tax which is highly comprehensive and includes; producers, wholesalers and retailers. In addition, while sales tax has peak, reduced and exempted tax rate without zero rate, VAT has the 15% standard rate, zero rate and exempted rate without reduced tax rate.

As compared to VAT, sales tax has no credits provided for the tax paid on capital equipment or on other inputs in the areas of productions and distributions. However, the credit against the output tax were given on the tax paid on some inputs, including raw materials which are narrowly defined to include materials embodied in the final product. Hence, VAT was originally developed to tackle some of the disadvantages associated with general sales tax and this reduces the taxes charged in full at each stage of production process with no opportunity for recovery. Thus VAT has no scope for tax cascadity, has minimum distortionary effects, enhance saving and investment as it does not tax capital but consumption and finally it enhances economic growth of one country if it is implemented and administered appropriately. But what is not to be forgotten is that the problem of sales tax such as the issue of regressivity still continues for the country that have single standard rate like Ethiopia and for these who haven't clearly identified these goods and services under the category of tax exemption in favor of poor individuals.

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