

The Value-Added Tax Styles: Which is Adopted by Ethiopia?

DasalegnMosissaJalata

Department of Accounting and Finance, College of Business and Economics, Wollega University

Post Box No: 395, Nekemte, Ethiopia.

Email: dasseef@yahoo.com

Abstract

Currently many developed and developing countries has already adopted Value added tax (VAT) and others actively providing their intentions to introduce it. Among the three VAT model existed across the globe, Ethiopia executed that of New Zealand's model of goods and services tax (GST). The Ethiopian VAT replaces the out dated sales taxes that have operated for more than four decades by January 1, 2003. The intention of the government to adopt VAT is that of raising large amount of revenue as the engine of development and to redistribute income and wealth among members of the community residing in a state, for fulfillment of the WTO agreement and to implement the IMF directions. Hence, the Ethiopian VAT is the consumption type of tax that has 15% standard rate without reduced, zero rate and some exemptions as implied by the rules and regulations. Though some problems were there in the areas of administrations, VAT crediting and exemptions, dealing with the technological advancement and innovations, the future aspects of the Ethiopia's VAT taxing system are quite bright.

Keywords: Value Added Tax, Ethiopia, Literature review, Policy implications

1. INTRODUCTION

Currently Value Added Tax (henceforth VAT) is the most important taxing system of the world. Whether the country is developed or not, it does not matter for VAT implementations as it is evidenced from different level of economies. As shown by Cnossen (1998), "the nearly universal introduction of the VAT should be considered the most important event in the evolution of tax structure in the last half of the twentieth century." While the origins of VAT was still never been decisively settled, it was first introduced at a national level in France in 1954 though, its original coverage was limited (James, 2011). The most recent scholarly literature written by Charlet&Butdens (2012), shows as more than 150 countries which becomes about 75% of the world has now been implementing VAT. Among the developed and largely industrialized countries however, USA is the one that hasn't yet implemented the federal VAT system even though now has the trend toward it.

According to James (2011), VAT as consumption tax was considered and spread globally since it appropriately matched to the revenue needs of states in an increasingly globalized economy. Even if this depends up on each country's policy, recently some commentators of the tax system shows as VAT directly related to the country's growth and development. Considering such issues, the Ethiopian government revisited its tax policy related to the revenue required to meet these expenditures which were aggravated than ever before. And hence, tax reform was undertaken in the 2002 and VAT becomes the outcomes of such tax reform in Ethiopia. Though, in Ethiopian tax history, the system of sales tax had served for more than four decades with insignificant means of income, the VAT replaces the outdated general sales tax that operated formally for ten years before its abolitions by 2002. So VAT first implemented on January 1st 2003 in accordance with the VAT proclamation No 285/2002. However the most important question is that which styles of VAT is adopted and which type of VAT is implemented in Ethiopia?

As there is no research done on such critical concept for further understanding of VAT in Ethiopia, this paper aims at providing the general concept on the types and styles of VAT adopted and implemented concentrating on the constitutions, proclamations, directives, regulations and other related literatures. To that extent, this paper will expand the knowledge on the limited literature accessible on such concepts.

2. REVIEW OF LITERATURE AND DISCUSSIONS

2.1. When and why VAT was adopted in the world?

Before the emergence of VAT system, different countries of the world uses their own taxing system to generate revenue for the government. The latter half of twentieth century however comes up with the new agenda which are the transformations of turnover and sales tax system to VAT. And after the inceptions of VAT starting from 1950's, the world economies were largely integrated with each other. This can be reasoned for instance as many of the industrialized countries enacted some rule that must be fulfilled regarding to VAT to join Organization for Economic Cooperation and Development. Among them however, United States remains one of the few Western industrialized countries without a VAT and the only one without a VAT or a national sales tax (Reischauer, 1992). In America non adoptions of VAT have different reasons as explained by different authors. For instance, James (2011) shows as liberals criticized the perceived regressivity of a VAT and conservatives feared the

VAT's reputation as a 'money machine' that would fuel government growth. There are also countries where no consumption tax is in place, including the oil-producing countries of Saudi Arabia and the United Arab Emirates, as well as British overseas territories like Bermuda.

Even though there was no exact sources that concludes as were and when the VAT was invented for the first time across the globe, many of the investigations on such area such as Reischauer (1992), Shenk and Oldman (2007), Abate (2011), Charlet and Butdens (2012) and others quoted France as the first implementers of VAT by 1954 in the world. At that time even if France introduced VAT at a national level, its original coverage was limited and never reached to the broader retail sector until 1968. But it is the Denmark that applies full VAT among European countries by 1967 even though she did not join the European Economic Community at that time. And among the African countries, it is Cote d'Ivoire that adopts VAT for the first time by 1960. At the contemporary period however, VAT was implemented by more than 150 countries across the world even if it is limited to less than ten countries in the late 1960 (Charlet and Butdens, 2012).

So the main intentions of each country to introduce VAT are that it is easier to enforce, and it poses the simple administrative structure than other taxes such as turnover and retail sales tax. By the same chain, VAT collects large amounts of tax revenue for the government for fulfillment of the expenditure gaps. For instance, the study of Charlet & Butdens (2012) indicated as VAT is globally the third important source of revenue for governments, next to social security contributions (27%) and personal income taxes (25%) but far above corporate income tax (8%), specific consumption taxes (11%) and property taxes (5%). In addition to that, the study of Smith (2012) shows as VAT is an important component of the entire taxing regime and by 2011 China collected more than one third of its entire tax revenue in the form of VAT. While 27% of VAT collected on domestic transactions, approximately 8–10% is collected by China's Customs on imported goods. This shows as both companies and consumers are paying significant amounts of VAT in China. The study of Purohit (1993) on the adoption of VAT in India considering its problems and prospects reveals as the implementations of VAT by a rapidly growing number of countries has been one of the most remarkable events in the evolution of commodity taxation in this century and the author concludes as VAT generates sufficient amount of revenues for the government.

In similar vein, Kenya adopted (introduced) VAT on consumer expenditure in 1990 by replacing sales tax, which had been in operation since 1973 for the purpose of increasing the government revenue through expansion of tax base and by levying on consumption of taxable goods and services supplied in Kenya or imported into Kenya (Naibei & Siringi, 2011). The study of Moyi and Ronge (2006) indicates as the contribution of VAT in Kenya is estimated to an average of 5.4% of GDP from its inception period of 1990 to year 2005, while the total tax revenue itself contributed to GDP by about 19.8% during same period. In addition to that, Jalata (2014) conducts an investigation on the role of VAT on economic growth of Ethiopia and finds the significant positive relationships among them. Hence, VAT not only has very important contributions for the economies of developed countries, but also it drifts huge engines towards the developing countries economy too.

2.2. Which styles of VAT were there and which is mostly recommended?

In our planet of the earth, there are many sophisticated technological advancement and from day to day, the experts in their fields of study created the new thing or makes the things that was more preferable than what is previously existed. The same is true in the area of taxing system as the tax experts either invents the new or replaces the previously existed tax system for the purpose of improvement from the past. As the governments of different countries across the globe unable to exist without the revenue from tax, currently different Economists, Political experts and Tax experts announces VAT which is the most important system of the last half century's tax development.

In a today's taxing system, there are three main diversities or styles of VAT across the world: "The European model", "The New Zealand model and "The Japanese model" (James, 2011). The global diversity of VAT style is mostly reasoned based on the tax base, tax rate, tax implementations, administrative capacity and the political, social and economic uniqueness of each country. Even if most countries in the world accepts some recognized VAT styles, each country have their own recognized unique VAT system. For instance, Smith (2012) shows as China's VAT rules and system differ from many other countries because china has its own unique characteristics and is widely considered to be more complex when compared to most of the VAT/GST regimes around the world.

A. The European model of VAT style

The European model of VAT was mostly adopted by government of different countries. The most important characteristics that differentiate the European model of VAT style from other models were that of presentations of different multiple rates with varying notches of exemptions. Most of OECD countries have adopted this model of VAT system. The study conducted by Charlet & Butdens (2012) on the OECD International VAT/GST guidelines of the past and future developments reveals that revenues generated by taxes on general consumption (that is, VAT, sales taxes and other general taxes on goods or services) represented 20.0% of the total tax revenues of OECD countries in 2009. The proportion of taxes on general consumption as a percentage of GDP however, more than doubled between 1965 and 2009 for OECD countries and the share of VAT itself as a

percentage of total taxation has grown by more than 70%, from 11.2% on average in 1985 to 19.2% in 2009.

B. The New Zealand model of VAT style

In New Zealand, VAT is referred to as goods and services tax (GST) and it came into effect in 1986 (Yesegat, 2009). The New Zealand model of VAT applies the features that collect the VAT revenue using a single standard rate on the reasonably broad based goods and services. The introduction of GST in New Zealand was more successful than elsewhere and it is often mentioned as a model for other countries VAT or GST. Among the existed VAT models, the tax base of the New Zealand's GST is commonly considered to be the broadest of any VAT and this makes New Zealand to be the model for many countries like Singapore and others (Ainsworth, 2006).

C. The Japanese model of VAT style

The Japanese government introduced VAT in 1989 after the elapse of 10 years for debate. The Japan's consumption tax rate which is the flat rate of 5% without exemptions of goods and services from such tax is the lowest tax rate among the world especially when compared to the European and Northern American countries these who have multiple tax rates. However, currently Japan's Prime Minister Abe Shinzō announced to raise the consumption tax from its current rate of 5% to 8% which may be implemented by April 2014. In addition to that, the Japan governments have planned to raise the Japans Consumption tax rate from 8% to 10% by 2015 even if this may have some economic difficulties and merit too. The Japanese consumption tax is neutral as it neither encourages nor discourages choices among domestic or foreign purchases of goods for business inputs and corporate profits (Ainsworth, 2006). The tax base of Japanese consumption tax has a base nearly as broad as the New Zealand's GST base with the exceptions of the tax exemptions especially in the area of food. However, the Japanese tax base is more complex than any of the VAT/GST model.

D. So which is mostly recommended?

The study of Bogetic & Hassan (1993), on the emerging conventional wisdom based largely on practice and numerous country case studies, suggests that a single rate VAT (with the rate between 10 and 20 percent), with very few exemptions and, therefore, a broad based is superior to a VAT with multiple rates and many exemptions which reduces its base and complicate administration system. As compared to other models of VAT system, New Zealand's VAT is more importantly favored to generate large amount of revenue and it reduces the distortions emerged on the overall economy of one country. Hence, among the three major types of VAT in existence across the world, New Zealand's VAT model comes closest to approaching the ideal or good VAT system (James, 2011).

2.3. When and why VAT was adopted in Ethiopia?

Two decades ago, the Ethiopian government decides to collect tax revenue from the goods and services sold and purchased including both import and export state of affairs. These ideal discussions have been implemented by 1993 with the Sales and Excise Tax Proclamation No 68/1993. The sales taxes are indirect tax systems of consumption taxes and until its date of abolishment, it passes through several amendments. However, this strategy of the taxing system never aggravated revenue boosting objectives of the government. This may be due to the applications of tax on tax or what we call tax cascading concept of sales tax. In addition to that, sales tax increases the price of goods and services throughout the periods because it uses the value of goods to be sold on the final purchaser of goods and services rather than its value additions as tax base. Hence, even though the sales tax operated for more than four decades in the history of Ethiopian taxing system, its functionality has stopped by only one decade due to the occurrence of tax reform which leads to emergence of VAT in 2003.

Not only the above reasons of revenue generating agenda that Ethiopia replaced her out dated sales tax by VAT but it is for fulfillment of the forthcoming trade agreements with world trade organizations (WTO) and to meet the directions given by the International monetary fund (IMF). However, this transformation has resulted in some resistance in the economy at the starting period, yet implemented with a high level of harmony as of the today's data. So after Ethiopia incepts VAT, the revenue generated from tax increased and this increased revenue for the government can be contributed towards social, political and economic agendas and hence, it will enhance the living standards of individual citizens as they may benefit from what government provides for them.

2.4. Which styles of VAT is adopted by Ethiopia?

Different literatures were reviewed and compared with our country's constitutions, proclamations, directives, regulations and other related published and unpublished literatures and reports regarding to VAT. Due to the reason that VAT has multidimensional advantages to the country, many states to which Ethiopia is not an exception adopted it. This can be assumed as the government and tax revenue is hand and glove for each other. Hence, according to the VAT proclamation No 285/2002, Ethiopia adopted and implemented VAT by January 1st 2003 with the single standard rate of 15%, zero rate and some exemptions treated under the law and regulations. As discussed above, we have three most important models regarding to VAT: European, Japanese and New Zealand styles. Among these, even though most jurisdictions of the state across the world adopted that of the European model of VAT, many commentators and experts of taxation related to tax revenue and its administrations assumes as the New Zealand's model of VAT is the most ideal and preferable among all. To that

extent, the VAT implemented in Ethiopia has the ideal model related to that of New Zealand's model though each country has its own unique application of the VAT system as related to their socio-economic, political and living standard of its citizen's.

2.5. What challenges Ethiopian VAT?

It is known that the implementation of VAT has a multidimensional advantage for one country's social, political and economic development. While the economic merit deals with boosting of the revenue and then accumulating the capital and investment in the country, the political aspect deals with creating harmonized relations such as trade agreement with external countries and simplifying the tax administration system within the country. Finally the social attribute deals with benefiting the society of marginalized states through collecting tax revenue from where the abundant resource existed and encouraging the standard of living among the states.

However, such merits of VAT may be not without some negative effects. For instance, in case of the Ethiopian VAT system, such taxing system was regressive like that of sales tax as it has a single standard rates and these goods and services which were exempted from such tax was not systematic and hence both rich and poor's pay the same amount for the same benefits from consumptions of goods and services. In all areas of VAT system, exempted supplies of goods and services makes it more difficult and complex because businesses which make exempt supplies cannot recover all the VAT paid on the goods and services which they buy as input or raw material form. The study of Tamaoka (1994) described VAT as a regressive tax reasoning that it taxes consumption and there is the decrement of propensity to consume while the income increased at the same time. For regressive tax structure, both the average and the marginal tax rates decreases as the tax base increases and accordingly the marginal tax rate lies below the average tax rate. Hence, regressive tax imposes a heavier burden on those less able to bear and it results in a shift of tax liability from people with higher income to the ones with lower income.

In addition to that, though there is a legal and administrative frame work, the administration on VAT refund is still persistent problem. These issues make VAT types as one among the three types of VAT: Gross product, Income and Consumption types of VAT/GST. While the gross product type of VAT deals with the non-credit or non-refund applications of tax on capital goods and depreciations, income type of VAT allows refund on the periodic allowance for the depreciation value of capital goods. As different from both gross product type and income type of VAT, consumption type of VAT favors for capital goods and allows for periodic depreciation value of capital goods. Hence among all types of VAT, a consumption type was mostly accepted by different jurisdictions of state and it is more practicable than others. Among the existed VAT types, consumption type of VAT was applied in the Ethiopian context and this does not make the discriminations among the VAT registered tax payers who were the agent of the government. While examining the refunding of VAT approaches of tax administrations in 36 developing, transitional, and developed countries, Harrison & Krelve (2005) stated the refund process of VAT as difficult concept and the issue that paves the way for corruption and fraud in practical ways even though in principle refunding of the VAT system is straightforward. The fact is that most of the developing countries in which Ethiopia is not exceptions who adopted VAT typically exempt enormous number of goods and services and even that exempted goods and services were not in favor of the poor or marginalized groups. And this breaks the VAT law outlined in principle and poses some problems. Though there were many problems existed as of today, I hope with the technological advancement; the future or prospects of Ethiopia's participation in VAT taxing system are quite bright.

CONCLUSIONS

Sales tax operated for more than four decades in the history of Ethiopian taxing system. But it does not contribute what the government required from it to meet with the recently provoked expenditures. So the Ethiopian government replaced the outdated sales tax with VAT by proclamation No 285/2002 that has been effective by January 1st 2003. Even though the main intentions of VAT implementations was to raise revenue, there are also other agendas such as fulfillment of IMF and WTO agreement that smooth the country's foreign relations specially in the areas of foreign trade and foreign direct investment purposes.

Currently there are three most important VAT/GST models or styles that have adopted by different countries: the European VAT model, the Japanese VAT model and the New Zealand's VAT/GST model. Among them while European VAT model was largely adopted, the New Zealand VAT model is the ideal good VAT model over the other systems of VAT styles. Hence Ethiopia also mostly follows the Zealand's VAT model though there are different problems in the areas of administrations, VAT crediting and VAT exemptions. However, if Ethiopia takes in to considerations of some latest technological advancement and innovations, the future aspects of the Ethiopia's VAT taxing system are quite bright.

REFERENCES

- Abate, M. T. (2011). *Ethiopian Tax Accounting: Principles and Practice (New Revised Edition)*.
Abehodie, W. (June 2007). A comparative analysis of VAT design in Ethiopia, Kenya and New Zealand.

- Ethiopian Economic Association for the 5th international conference on the Ethiopian Economy.* Addis Ababa.
- Ainsworth, R. T. (2006). *Digital Consumption Tax (D-CT), Working Paper Series, Law and Economics Working paper No.06-26.* Boston: Boston University School of Law.
- Alemu, D. (2011). *Empirical Analysis of The Contribution of VAT For Economic Development and Social Spending in Ethiopia.* Addis Ababa University, Accounting and Finance. Addis Ababa: Addis Ababa University.
- Bogetic, Z., & Hassan, F. (October, 1993). Determinants of Value-Added Tax Revenue (Policy Research Working Paper, 1203). *World Bank (Europaen d Central Asia Department).*
- Brautigam, D. A., Fjeldstad, O.-H., & Moore, & M. (2008). *Taxation and State Building in Developing Countries: Capacity and Concent.* New York: Cambridge University Press.
- Caspersen, E., & Metcalf, G. (December, 1994). Is a Value Added Tax Regressive? Annual versus life time incidence measures. *National Tax Journal, vol 47, no. 4*, pp. 731-46.
- Charlet, A., & Butdens, S. (2012). The OECD International VAT/GST Guidelines: past and future developments. *World Journal of VAT/GST Law (vol 1, issue 2)*, 175-184.
- Federal Democratic Republic of Ethiopia, Value added tax proclamation No. 285/2002, *Federal Negarit Gazeta*, 8th year, No. 33, Addis Ababa, Ethiopia.
- Federal Democratic Republic of Ethiopia, Council of Ministers Value Added Tax Regulations No. 79/2002, *Federal Negarit Gazeta*, 9th year, No. 19, Addis Ababa, Ethiopia.
- Federal Democratic Republic of Ethiopia, Value added tax (Amended) proclamation No. 609/2008, *Federal Negarit Gazeta*, 15th year, No. 6, Addis Ababa, Ethiopia.
- Grinberg, I. (February 18-19, 2009, February 18-19). Where Credit is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT. *American Tax Policy Institute Conference.* Washington D.C.
- Hakim, T. A., & Bujang, I. (2011). The Impact and Consequences of Tax Revenues' Components on Economic Indicators: Evidence from Panel Group Data. *International Research Journal of Finance and Economics ISSN 1450-2887 Issue 63*, 83- 95.
- Harrison, G., & Krellove, R. (2005). VAT Refunds: A Review of Country Experience. *International Monetary Fund WP/05/218*, 1-41.
- Jalata, D. M. (2014). Taxation for Economic Growth: Evidence from Ethiopia. *International Journal of Economics and Empirical Research*, 2(7), 294-300.
- Jalata, D. M. (2014). The Role of Value Added Tax on Economic Growth of Ethiopia. *Science, Technology and Arts Research Journal*, 3(1), 156-161.
- James, K. (2011). Exploring the Origins and Global Rise of VAT. *Tax Analysts*, 15-22.
- Kuliš, D., & Miljenović, Ž. (October 1997). Estimate of Revenue From The Value Added Tax (Occasional Paper No. 2). *Institute of Public Finance.*
- Mackenzie, G. (1991). *Estimating the Base of the Value-Added Tax (VAT) in Developing Countries: The Problem of Exemptions.* International Monetary Fund, Fiscal Affairs Department.
- Moyi, E., & Ronge, E. (2006). Taxation and tax modernization in Kenya: a diagnosis of performance and options for further reforms. *Institute of Economic Affairs.*
- Naibei, K. I., & Siringi, E. M. (2011). Impact of Electronic Tax Registers on VAT Compliance: A Study of Private Business Firms. *African Research Review: An International Multi-Disciplinary Journal, Ethiopia, Vol. 5 (1), Serial No. 18*, 73-88.
- Purohit, M. C. (1993, March 6). Adoption of Value Added Tax in India: Problems and Prospects. *Economic and Political Weekly, Vol. 28, No. 10*, 393-404.
- Reischauer, R. D. (1992). *Effects of Adopting A Value-Added Tax.* The Congress of the United States Congressional Budget Office.
- Shenk, A., & Oldman, O. (2007). *Value Added Tax: A comparative Approach.* New York: Cambridge University Press.
- Tamaoka, M. (1994). The Regressivity of a Value Added Tax: Tax Credit Method and Subtraction Method — A Japanese Case. *Institute for Fiscal Studies*, 15(2), 57-73.
- Yesegat, W. A. (2009). *Value added tax in Ethiopia: A study of operating costs and compliance (PhD thesis).* New Zealand.

Biographical Note: Dasalegn Mosissa Jalata was born in Shambu, Oromia Regional State, Ethiopia on December 26, 1988. He completed his Secondary school at Shambu Compressive and preparatory School in 2007. He received his BA Degree in Banking and Finance from Wollega University, Ethiopia in June 2010. After graduation, he joined the same University as Graduate Assistant and served as Instructor till he joined School of Graduate Studies for further education in 2011. He received his MSc in Accounting and Finance from University of Gondar, Ethiopia by July 2013 and currently he has the position of Lecturer at Wollega University, Department of Accounting and Finance. His research interests include issues related to Taxation in general, Value Added tax, Sales tax, Firms Financial performances and Economic growth. He is the author of research studies published at international journals (IJEER, STAR, and others).

The IISTE is a pioneer in the Open-Access hosting service and academic event management. The aim of the firm is Accelerating Global Knowledge Sharing.

More information about the firm can be found on the homepage:
<http://www.iiste.org>

CALL FOR JOURNAL PAPERS

There are more than 30 peer-reviewed academic journals hosted under the hosting platform.

Prospective authors of journals can find the submission instruction on the following page: <http://www.iiste.org/journals/> All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Paper version of the journals is also available upon request of readers and authors.

MORE RESOURCES

Book publication information: <http://www.iiste.org/book/>

IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich's Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digital Library, NewJour, Google Scholar

