



# **WOLKITE UNIVERSITY**

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**DEPARTMENT OF GOVERNANCE AND DEVELOPMENT STUDIES**

**A SENIOR ESSAY SUBMITTED TO DEPARTMENT OF GOVERNANCE  
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GOVERNANCE AND DEVELOPMENT STUDIES**

**ASSESMENT OF FACTOR AFFECTING REVENUE  
COLLECTION FROM VAT IN ETHIOPIA**

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## Contents

Acknowledgements.....	iv
LIST OF ACRONYM .....	v
Abstract.....	vi
CHAPTER ONE.....	1
Introduction .....	1
1.1 background of the study.....	<b>Error! Bookmark not defined.</b>
1.2 Statement of the Problem.....	<b>Error! Bookmark not defined.</b>
1.3 Objective of the study .....	3
1.4 Research Question.....	<b>Error! Bookmark not defined.</b>
1.6 Scope of the Study .....	<b>Error! Bookmark not defined.</b>
1.7 RESEARCH METHODOLOGY .....	<b>Error! Bookmark not defined.</b>
1.8 Report Writing and Quality Assurance .....	<b>Error! Bookmark not defined.</b>
1.9 LIMITATION OF THE STUDY .....	<b>Error! Bookmark not defined.</b>
1.10 Organization of the paper.....	<b>Error! Bookmark not defined.</b>
CHAPTER TWO.....	<b>Error! Bookmark not defined.</b>
LITERATURE REVIEW .....	<b>Error! Bookmark not defined.</b>
2.1 Conceptual Definition .....	<b>Error! Bookmark not defined.</b>
Chapter Three .....	<b>Error! Bookmark not defined.</b>
3. Empirical Evidence from secondary source .....	<b>Error! Bookmark not defined.</b>
3.1. Vat Regime in Ethiopia.....	<b>Error! Bookmark not defined.</b>
3.2. VAT Rate .....	<b>Error! Bookmark not defined.</b>
3.3. Registration .....	<b>Error! Bookmark not defined.</b>
3.4. Non-compliance to VAT Proclamation.....	<b>Error! Bookmark not defined.</b>
3.5. Value Added Tax (VAT) Administration Practice.....	<b>Error! Bookmark not defined.</b>
3.6. Types of VAT .....	<b>Error! Bookmark not defined.</b>
3.7. Powers of Levying and Collection Enforcement for VAT .....	<b>Error! Bookmark not defined.</b>
3.8. Appeals .....	<b>Error! Bookmark not defined.</b>
3.9. Empirical review on challenges of revenue collection from VAT in Ethiopia.....	<b>Error! Bookmark not defined.</b>
3.10. Factors affecting revenue collection from VAT in Ethiopia .....	<b>Error! Bookmark not defined.</b>
3.11. Methods enhancing revenue collection from VAT .....	<b>Error! Bookmark not defined.</b>
Chapter 4 .....	<b>Error! Bookmark not defined.</b>
Conclusion and Recommendations .....	<b>Error! Bookmark not defined.</b>
4.1 Conclusion .....	<b>Error! Bookmark not defined.</b>
4.2 Recommendations.....	<b>Error! Bookmark not defined.</b>
REFERENCE .....	<b>Error! Bookmark not defined.</b>

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LIST OF ACRONYM

FIRA	Federal Inland Revenue Authority
FDRE	FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
GDP	Gross Domestic Product
EPRDF	Ethiopia People's Revolutionary Democratic Front
ERCA	Ethiopian Revenue and Customs Authority
IMF	International Monetary Fund

## **Abstract**

Value Added Tax (VAT) is a consumption tax that is being charged and embraced by many developed and developing countries, which is relatively easy to administer and very difficult to evade. As most of the developing countries do, Ethiopia was highly dependent on external financial resources to finance its development activities. For many decades, the tax contribution to GDP was very less and this needs an improvement. On the other hand, the Ethiopian Government has a strong belief and commitment to eradicate poverty and assure sustainable development; and it is impossible to achieve such a goal without generating sufficient revenue that can cover at least the budget of the government. To narrow the gap, VAT was introduced before ten years and is showing dramatic changes in generating government revenue.

The study is expected to assess the key factor that hinder revenue collection process focus on VAT in Ethiopia and then recommend mechanisms for improvement. In addition, it also has an aim of recommending mechanisms for enhancing the performance in the revenue collection process. In the study, due to the pandemic corona virus (covid 19) we are used only secondary data sources are employed. In addition, qualitative data are gathered and then analyzed. The study also emphasizes the need to strengthen the administration capacity in general and the VAT collection system in particular as efficiently as possible. The empirical analysis disclosed that VAT contributes significantly to the increase of the total government revenue and the economic growth of Ethiopia at large. Finally, if Ethiopia joins the World Trade Organization, the country needs to enhance domestic based resources mainly generated from Value Added Tax. In this regard, the paper has far-reaching policy implication in an effort to improve tax collection.

# CHAPTER ONE

## Introduction

### 1. Background of the study

One of the mechanisms in which countries raise revenues to finance government spending on the good and services that most of us demand is taxation. As compared to the developed countries, the developing countries have been able to generate a low level of revenue through imposing of taxes one of the reasons for this has been the inefficient and ineffective tax system operating in the developing economies which are characterized by weak monetary and low development of the formal sectors (Gebrie, 2008).

Recently the federal government of Ethiopia adapted VAT system at national level. All VAT eligible will not registered due to different reasons, failure to main records file timely, and failure to notify change in business address and business live (Yohanis and Sisay, 2009) . ‘‘VAT’’- value added tax- has spread throughout the world since its introduction in 1955. Its format has changed and know incorporate once offshoot- ‘‘GST’’ (goods and service tax). France was the first country to introduce VAT effective from April 10, 1954. By 1969, only eight nation had adopted VAT, out of this cote-Devoir was the first country in Africa to introduce VAT in 1960. Since 1979 VAT has been adopted as the main form of indirect tax by many countries in different part of the world. (Misrak, 2008).

Value Added tax (VAT) is a general consumption tax assessed on the value added to goods and service. In other words, it is a consumption tax because it is borne ultimately by the final consumer. In many countries it is regarded as one of the main source of government revenue.

Ethiopia introduced VAT on January 01, 2003 replacing the sales tax. So, it is only before nine years that VAT is introduced in our country. VAT is a broad based tax on the consumption of goods and services. It is collected at all stages in the production and distribution process beginning with the importers and producers of raw materials and ending with the retailers.

According to IMF more than 4 billion, 70 percent of the world’s population now lives in countries with VAT, and it raises about \$ 18 trillion in tax revenue, roughly one quarter of all government revenue. Much of its spread has taken place over the last fifteen years from having been the preserve of more developed economies in Europe and Latin America; it has become a pivotal component of the tax systems of both developing and transition economies. VAT rate is 15%, Nigeria and Algeria have the minimum and maximum standard VAT rate in Africa with 5% and 21% respectively. (Misrak, 2008). VAT in Ethiopia is at its infant stage. It came into realization in January, 2003 (Proclamation No. 285/2002) replacing the former sales tax system. Ever since, it is playing an important role in the economy in terms of its contribution to ever increasing domestic revenue and reducing budget deficit.

The Ethiopian Government has replaced the former sales tax so as to broaden the tax base and make the tax collection more efficient. The introduction of VAT is expected to be efficient and effective so that taxpayers' compliance can be enhanced, investment can be encouraged and revenue generation can be increased but there is a bottlenecks in the collection of revenue from VAT in general in Ethiopia. This research then had an objective of investigating the factors affecting revenue collection specifically focus on VAT in Ethiopia.

## **1.2 Statement of problem**

Most developing countries are currently dependent more on external financial resources to fund their development activities. The tax contribution to GDP is very less as compared to developed countries. In Ethiopia the tax revenue to GDP is less than 10%. Ethiopia being one of the least developing countries was depending on external financial resource to run its main governmental activities.

The VAT Proclamation No.285/2002 was issued on 4th July 2002 by the Council of People's Representatives to be enforced as of January 2003. On the other hand, the Ethiopian Government has a strong belief and commitment to eradicate poverty and achieve the status of a democratic lower-middle-income country with good governance and where social justice prevails by the Ethiopian by 2020 E.C. It is impossible to achieve such a goal without generating sufficient revenue that can cover at least the budget of the government. Nowadays, encouraging results are observed as far as collecting revenue is concerned. VAT was introduced before nine years and is showing dramatic changes in generating government revenue. Literature also shows that not all expected revenue collected from VAT in developing countries are studied and well-documented or there is the research gap relates to the factors affecting revenue collection from VAT and this problem is sever in Ethiopia in general. This research tries to fill the research gap that existed in factors affecting collection of revenue from VAT in Ethiopia by using different literatures.



### **1.3 Objective of the Study**

#### **1.3.1 General Objective of the Study**

The main objective of the study is to assess factors affecting revenue collection from Value-Added Tax (VAT) in Ethiopia.

#### **1.3.2 Specific objective**

- To identify the major problems encountered by the business firms in providing VAT receipts for consumer during the transaction of goods and service
- To identify the challenge why the consumer fail to ask VAT receipts when buying goods and service.

### **1.4 Research Question**

The main research question of the study is “what is the factors affect revenue collection from VAT in ethiopia Revenue and Customs Authority? In addition, the research has also try to answer the following sub-questions.

1. Why do the business firms fails to provide VAT receipts during the transition of goods and service?
2. Why do consumer fail to ask for VAT receipts which buying goods and service?
3. What are the challenge facing the revenue collecting authority in raising a revenue from VAT?
4. How can the authority be able to increase revenue collected from VAT?

### **1.5 Significance of the Study**

The research is expected to assess the key factor that hinder revenue collection process focus on VAT in Ethiopia and then recommend mechanisms for improvement. In addition, it also has an aim of recommending mechanisms for enhancing the performance in the revenue collection process. Hence, the study will play key role in the development process of the nation by recommending mechanisms of enhancing the capacity, efficiency and effectiveness of revenue collection process in Ethiopia. Ethiopia custom and revenue office may use this finding to revise its strategies concerning tax collection from VAT. Furthermore result of finding will serve as a reference for other researcher on this area.

### **1.6 Scope of the Study**

The scope of the study is limited to VAT only; it did not consider other types of taxes. In addition, it is going to be conducted in Ethiopia Branch of the Revenue and Customs authority. Hence, the study doesn't include the revenues collected through the custom's part of the authority.

## **1.7 RESEARCH METHODOLOGY**

### **1.7.2 RESEARCH DESIGN**

A **research** design is a plan, structure and strategy of investigation so conceived as to obtain answers to research questions or problems. The plan is the complete scheme or program of the research (Kumar, 2011).

This research paper was designed in such way that enables the researchers to study problem more easily and clearly using only qualitative methods. It is structured to provide relevant information, by qualitative, to sufficient level that would be essential for further processing. Qualitative one will be useful to understand people's feelings and expectations which have linkage to the research questions raised at the beginning.

### **1.7.3 Source of Data**

In the study, due to the pandemic corona virus (covid 19) we are used only secondary data sources are employed. In addition, qualitative data are gathered and then analyzed.

### **1.7.4 Secondary data**

Some of the methods used for collecting secondary data are: Reports, official documents, publications and other forms of literatures, that are available about VAT are be collected and integrated with the data obtained from the primary sources. The data from all available sources that were utilized during the research process and are integrated and collected, to conclude the data collection stage.

## **1.8 Report Writing and Quality Assurance**

As part of the data quality assurance, the trustworthiness of the results was ensured by careful selection of Reports, official documents, publications, websites and other forms of literatures, that are available about VAT.

## **1.9 Limitation of study**

This study is limited to asses' factors affecting revenue collection from VAT in Ethiopia. Currently due to the pandemic corona virus (covid 19) it is difficult to collect primary data therefore the study is limited to only secondary data such as report, proclamation and other findings on VAT.

### **1.10 Organization of Paper**

The paper is organized in four chapters. General introduction and research design and methodology is given in the first chapter. And the relevant literatures in the field are discussed in the second chapter. In chapter three empirical evidence from secondary source are presented. Following this, finally chapter four contains conclusions and recommendations are presented in the chapter.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.1 Conceptual Definition

##### 2.1.1 Value Added Tax

Value Added Tax (VAT) is a tax on consumption. It is a multi-point levy collected in installments at each stage of production. The final and total burden of this tax is borne by the domestic consumers of goods and services Astha & Ahuja (2007), VAT Indian and Global Experience). VAT is levied on sellers of goods and services based on value added by their respective units. The base for VAT is determined by value added at a particular stage of production or distribution. In other words, inputs of a firm are not taxed. At each point, the firm is reimbursed the tax which it has already paid at the time of purchasing the inputs. Schenk & Aldman (2003) defines VAT as a general consumption tax designed to be imposed on all commercial activities involved in the process of producing goods or rendering services (a general tax) and a tax to be borne by consumers (a consumption tax). VAT is a tax on consumption; the more you buy the more tax you pay. It is also a neutral tax on businesses in that it does not represent a real cost to anyone but the end consumer, Schenk & Aldman (2003).

##### 2.1.2 FEATURES OF THE VAT

the reasons why so many countries have adopted the V AT are usually connected with the following assumed features of the tax; neutrality, stability and flexibility, in addition to its revenue potential Singhvi (2003).

- VAT is considered to be neutral with respect to foreign trade, and does not distort domestic production and distribution.
  - VAT is considered to be neutral regarding the production technique that a business adopts. In other words, it makes no difference for the tax liability whether a product is manufactured with a capital- or labor-intensive technology.
  - VAT is considered not to be influenced by the forms or methods by which business is conducted.
  - VAT is considered to be a relatively stable source of government revenue.
- Since consumption as a share of GDP fluctuates little, by implication the VAT is a stable source of revenue.
- VAT is a relatively flexible tax instrument; a change in the rate translates immediately into more or less revenue. This is partly because the consumption as a share of GDP in general fluctuates little, and partly because the V AT is collected on a current terms.

In addition to the points made above, consumption taxes are often considered as an efficient means of taxation, since it is less likely to distort economic behavior than income taxes, see Atkinson and Stiglitz, (1980), Kay (1990). With high marginal rates of income tax, individuals

may have less incentive to work hard. With a consumption tax, the extra income is not taxed until it is spent. Consumption taxes can also be levied on a wide base. The wider the tax base, the lower rate is needed to raise a given amount of revenue. In theory, people should be taxed on everything they buy; in practice, many countries have numerous exemptions from VAT while others tax some goods at lower rates

### **2.2.2 HISTORY OF VAT**

Emergence and rapid spread of VAT is among the most important tax development of the later 20th c VAT invented in 1954 by a French economist Maurice Laurie who was joint director of the French tax authority. The theory is that the end consumer carries the burden of VAT, not the business, which is merely collecting the VAT on behalf of tax authority. According to international monetary fund report 2004, more than 4 billion, 70% of the world population now live in countries with VAT, raise about 18 trillion in tax revenue, roughly one quarter of all government revenue over 136 (72%) of them have made VAT part of their tax system, and from 53 member of countries of African union 33(60%) of them are introduced VAT (Gebrie, 2008, pp.186-187).

### **2.2.3 VAT IN ETHIOPIA**

VAT is a recent tax system introduced in Ethiopia this tax system is not new to other countries. The modern concept of VAT was truly introduced in France in 1954. The concept of VAT was propounded first by American experts by 1920's. But at that time Americans failed to implement it. In Ethiopia, VAT was introduced since January 1/2003 designed to replace the cut dated sales tax which was served for more than four decades, which was collected at manufacturing level. VAT is taken as dispensable components of tax reforms in developing countries such as Ethiopia by considering it a miracle tax to replace direct and indirect taxes entirely. Since 1993 the Ethiopia government has made major economic shift from central planning to market oriented economic system (Yohanes and Sisay, 2009, pp. 186-187).

### **2.2.4 NATURE OF VAT**

VAT is characterized by the following features;

- ✓ VAT is “general tax or comprehensive” that applies in principle to all commercial activities in valuing the production and distribution of good and provision of services.
- ✓ VAT is “consumption tax” because it is levied in sales of good and the provision of service rather than income, capitals or saving.
- ✓ VAT is “broad based tax” since the government collects such tax from all sectors that is importer, manufacturing whole sale, and retailer sector.
- ✓ VAT is “percentage of price” which means, the actual tax burdens is visible at each stage in the production and distribution chain.

- ✓ VAT is collected “fractionally” because each time the item is changes hand in the process of production and distribution the VAT is assessed on the incremental value.
- ✓ VAT is “neutral” because regress of how many transactions are involved VAT liability the amount of tax they have paid to other person on purchases for their business activities.
- ✓ VAT is indirect tax because VAT is paid total authority by the seller of the goods, who is the taxable person but it is actually paid by the buyers to the seller as part of the price.

The federal democratic republic of Ethiopia (FDRE) has adopted VAT in to be a tax system in 2003. It has been introduced on January 1/2003, replacing the former sale tax system. The VAT proclamation no 285(2002) has been ratified by the house of people representatives six months before VAT implementation.

VAT is introduced in Ethiopia by proclamation (285/2002 replacing sale tax, with the following objective.

- ✓ To collect tax on the added value whenever the sale transaction is conducted since the former sale tax system did not allow collection is conducted.
- ✓ To minimize the damage that may be caused by attempts to avoid and evade the tax and ascertain the profit obtained by tax payers
- ✓ To enhance economic growth and improve the rational relationship between the gross domestic production and gross revenues.
- ✓ To enhance saving and investment as it is a consumption tax and doesn't a tax capital.

## **2.2.5 REGISTERED FOR VAT**

### **2.2.5.1 Who has to be registered for VAT?**

In Ethiopia, registration for VAT is categorized in to two:-

- I. obligatory registration
- ii. Voluntary registration

## **I. OBLIGATORY REGISTRATION**

Any person conducting a commercial enterprise or instancing to conduct commercial enterprises or intending to conduct a commercial enterprise may apply to be registered for VAT. However if the taxable turnover of the enterprise, which is gross income for 12 calendar monthly exceeds or is likely to exceeds birr 500,000, the person conducting the enterprise must be register for VAT with FIRA or. The Federal Inland Revenue. If the turnover is below birr 500,000 of business activity one may apply for voluntary registration (Gebrie, 2008, pp.201-2002).

## **II .VOLUNTARY REGISTRATION**

A person, who carried on taxable activity and is not required to be register for VAT, may voluntarily apply to the authority for such registration. If he/she regularly is supplying or rendering at least 75% of his good and services to registered persons (Gebrie , 2008, pp. 202-203)

### **2.2.6 Advantage and disadvantage of VAT**

#### **2.2.6.1 Advantage of VAT**

#### **The following are some of the advantages of VAT**

a. It avoids cascading effect of tax (tax on tax)

VAT works on the principle of that when the raw material passes through various manufacturing stages and manufactured products through various distribution stages, tax should be levied on the incremental value at each stage and not on the gross sale price. This insures that some commodity does not get taxed again and again, and this there is no cascading effect. Putting the concept in simple terms, in VAT system, each input is taxed only once (Misrak, 2008, p. 310).

b. It is major comprehensive and equitable tax system

Even though the ultimate burden of VAT full on the final customer, VAT is collected by the government from all sectors that is from import manufacturing, whole sale and retail sectors. Therefore, it is a more compressive and equitable taxes system. On the contrary, sales tax is normally levied at one stage of whole marketing (Misrak, 2008, p. 310).

c. It reduces the possibility of the tax erosion

In the case of VAT the taxes are divided into several parts depending on the number of stage of production and sales. In each stage every transaction is made using VAT invoice approved by tax authority. In addition each VAT registered person (supplier) has to maintain appropriate records on their sale and purchase transaction. Those obligations make tax evasion difficult (Misrak, 2008, p. 310).

d. It has less tax burden Under VAT system, the tax is collected in small fragments at different stage of production and sale. Hence, the VAT payers feel the burden of the less (Misrak, 2008, p. 310).

e. It is neutral Regardless of the number of stage of production and distribution, VAT is collected in each stage, therefore; VAT is expected to be perfectly neutral in the location of resources in the form of production and commercialization (Misrak, 2008, p. 310).

f. It improves productivity In VAT system, a firm has to pay tax even though it goes into loss. The firm cannot claim any exception for loss because it pays taxes on the value produced and not on profits. So, firms will always try to improve their performance and reduce the cost of production. As a result, the overall productivity of the country will be improved (Misrak, 2008, p. 310).

g. It promotes capital investment and saving VAT is a consumption tax since one pays VAT on its expenditure and has the option to pay or not to be taxed. Furthermore, relief from tax on capital goods may encourage investment. Potential investors also consider tax legislation as one of the factors in making investment decision (Misrak, 2008, p. 311).

h. It enhances exports of goods and services in most countries that implement VAT are liable to VAT. At zero rates this may make exports internationally competitive and thus encourage exports (Misrak 2008, p. 311).

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#### 2.2.7 DISADVANTAGE OF VAT

The following are some of the main disadvantages of VAT

a. It is regressive in nature A straight forward single rate VAT with few exemptions would tax lower income groups (the poor) more heavily than the higher income groups (the rich). It is thus incongruent with the basic principle of taxation which states that reason should be taxed according to his ability to pay. This makes VAT regressive tax system.

In order to compensate for its regressive effect a number of countries have exempted basic goods particularly food items from VAT (Misrak, 2008, p.311).

b. It requires advanced economic structure. The proper collection of VAT system requires organization and advanced financial and economic structure as it is a complicated system. VAT system also requires proper record keeping of invoice at each stage of production and sale by both the seller and buyer. Hence, it becomes difficult to implement the system in all types of economy (Misrak, 2008, p. 312).

c. It puts additional burden on tax authority. In VAT system, the manufacturers, wholesalers and retailers have to fulfill various legal formalities in the form of maintaining various records,



accounts, books, etc. the verification of those formalities put additional burden to the enforcing authorities (Misrak, 2008, p. 312).

d. It is uneconomical VAT system involves high of administration, assessment, verification collection, etc. hence; it is highly uneconomical (Misrak, 2008, p. 312). It has reams loopholes for tax evasion Although VAT system requires proper record keeping of invoices at each stage of production and distribution by both the buyer and seller, it has ream loopholes for tax evasion. This may include the following:

- Tax payers could over report sales of zero rated goods.
- Tax payers could use invoices they received for personal purchase to claim tax credits.
- It enables buyers and sellers to strike secret deals with regards the issuance of receipts. It could lead to the formulation of forged ponies' recipients to claim tax credit on input VAT, etc. (Misrak, 2008, p. 312).

## CHAPTER 3

### EMPERICAL EVIDENCE FROM SECONDARY SOURCE

#### 3.1. Vat Regime in Ethiopia

The Value Added Tax (VAT) proclamation No 285/2002 which has rescinded and replaced the sales and excise tax proclamation No. 68/1993 (as amended) and which has come into force as of January 1st, 2003 is a consumption tax which is levied and paid as value added tax at a rate of 15 percent of the value of every taxable transaction by a registered persons, every import of goods, other than an exempt import and an import service rendered in Ethiopia for a person registered in Ethiopia for VAT or any resident legal person by a non-resident person who is not registered for VAT in Ethiopia. (Article 7 (1) (a)-(c) and Article 23 (1) and (2)).

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. (Article 7(3))

A taxable activity is any activity, which is carried on continuously, or regularly by any person in Ethiopia, or partly in Ethiopia, whether or not for a pecuniary profit that involves, in whole or in part, the supply of goods or services to another person for consideration. (Article 6 (1) and (2))

Supply means the sale of goods or rendition of services or both and rendition of services means anything done, which is not a supply of good or money. (Article 2(17) and Art. 4(1)) For the purpose of the VAT proclamation the following are considered as taxpayers on whom the VAT law is applicable. These are: -

- (a) A person who is registered or is required to register for VAT;
- (b) A person carrying out a taxable import of goods to Ethiopia;
- (c) A non-resident person who without registration for VAT renders service in Ethiopia for any person registered in Ethiopia for VAT or any resident legal person (Article 3(1), (a)-(c)-cum Article 23 (1) and (2)).

For the purpose of the VAT proclamation “person” means any natural person, sole proprietor, body, joint venture, or association of persons. (Article 2(11)) Article 2 (15) of the Proclamation, which deals with definition, states that “Resident person” shall have the meaning given to it under the Income Tax Proclamation.

The new Income Tax law of Ethiopia Proclamation No 286/2002 defines and/or outlines who and what constitutes a resident in Ethiopia. Article 5 defines and outlines the principle of residence.

Accordingly under Article 5 (1) (a)-(b) an individual shall be resident in Ethiopia. If he/she

- A. Has a domicile within Ethiopia;
- b. Has a habitual abode in Ethiopia; and or
- c. Is a citizen of Ethiopia and a consular, diplomatic or similar official of Ethiopia posted abroad?

Pursuant to article 5 (2) an individual, who stays in Ethiopia for more than 183 days in a period of twelve (12) calendar months, either continuously or intermittently, shall be resident for the entire tax period. With regards to a body, pursuant to Article 5 (3), a body shall be resident in Ethiopia,

If it;

- a. Has its principal office in Ethiopia;
- b. Has its place of effective management in Ethiopia and/or
- c. Is registered in the trade register of the Ministry of Trade and Industry
- d. It should be noted that according to Article 5(4) “Resident person” includes a permanent establishment of a non-resident person in Ethiopia.

### **3.2 VAT Rate**

The VAT law contains two VAT rates. One is the standard 15 percent rate and the other is zero rated. The following taxable transactions are charged with tax at a rate of zero percent.

- a. The export of goods or services
- b. The rendering of transportation or other services directly connected with international transport of goods or passenger, as well as the supply of lubricants and other consumable technical supplies taken on board for consumption during international flights
- c. The supply of gold to the National Bank of Ethiopia; and
- d. A supply by a registered person to another registered person in a single transaction of substantially all of the assets of a taxable activity or an independent functioning part of a taxable activity as a going concern. [Article 7 (2) (a) - (d)]

There is a basic difference between VAT exemption and zero rate VAT. The difference is that though zero rate transactions do not pay VAT on the goods and services they render under

transactions listed in (a) – (d) above, for the purpose of VAT registration they are considered as taxable service thus enabling and making these transactions eligible for collecting tax rebate. This has the advantage of granting VAT rebate which can help redress in put tax paid on purchase of goods and services necessary for the furtherance of the zero rated transactions. On the other hand, VAT exemptions granted by the VAT law does not allow for the collection or entitlement of VAT rebate for the simple reason that they are assumed not to have paid in put tax, therefore disabling exempt categories from registering for VAT and taking advantage of the VAT rebate provisions.

### **3.3 Registration**

Under the VAT law any person who carries on a taxable activity and at the end of any period of 12 calendar months has 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 the period will exceed 500,000 Birr, has the obligation to register for VAT. (Article 16(1) (a) and (b)) According to Article 17, a person who carries on taxable activity and is not required to be registered for VAT may voluntarily apply to the Tax Authority for such registration, if he regularly is supplying or rendering at least 75% of his goods and services to registered persons.

### **3.3 Non-compliance with VAT Proclamation**

Non-compliance with VAT Proclamation failure to register for VAT as per VAT registration requirement, failure to issue a tax invoice, failure to maintain recorder such as original tax invoices received and a copy of tax invoices issued and failure to file timely return shall be liable to administrative penalties ranging from a fine 100 percent of the amount of tax payable and a fine of up to 50,000 Birr. In addition to administrative penalties tax offenders such as tax evasion, making false or misleading statement and failure to notify are all criminal offences under Ethiopian law. Accordingly, tax fraud - making false or misleading statements is punishable with a fine ranging from 1000 Birr to 100,000 Birr and an imprisonment ranging from 3 years to five years where the making of false or misleading statement is made knowingly or recklessly such an offence is punishable by a fine of up to 200,000 Birr of an imprisonment of up to 15 years.

### **3.4 Value Added Tax (VAT) ADMINISTRATION PRACTICE**

VAT is a tax on consumer expenditure. It is collected on business transactions and imports. A taxable person can be an individual, firm, company, as long as such a person is required to be registered for VAT. Most business transactions involve supplies of goods or services. VAT is payable if they are: Supplies made in Ethiopia; Made by a taxable person; Made in the course or furtherance of a business; are not specifically exempted or zero-rated. The Value Added Tax would be levied at the rate of 15% of the value of: Every taxable transaction by a registered person; every import of goods, other than an exempt import; and Import of services. 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 exceeded 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 (EFDR Proclamation 78/2002).

### **3.6 Type of VAT**

Though there is legal and administrative frame work, the administration on VAT refund is still persistent problem. The problems are attributed in one way or another to the existence of widespread of tax abuse and reluctance on the part of tax officials. But, one feature in VAT, as we discussed earlier, is the prevalence of refund to business entities of the tax they paid in their business against their taxable sales. The treatment for crediting or rebating varies. Accordingly, we have three types of VAT: Gross product type, Income type and Consumption type HailemariamMamo (2011).

#### **I) Gross product type**

In this type of VAT, taxes paid on purchases of capital goods fixed capitals and depreciations there to are not allowed to be refunded. If a person registered for VAT purchases equipment's, buildings, different machineries, though there exists obvious depreciation value rebut is prohibited this type of VAT is not common as it raises stiff resistance on the part of tax payers.

## **ii) Income type**

Here, again refund on the purchase value of capital goods is prohibited like in case of goods product type of treatment. But, unlike the previous one, it allows refund on the periodic allowance for the depreciation value of capital goods.

## **iii) Consumption type**

This type of VAT is the most used and widely accepted one. It 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 rebated. Thus, it is accepted easily on the part of the community subject to VAT registration. Stated otherwise in this kind of VAT, there is no discrimination among tax payers.

### **3.7 Power of levying and collection of VAT**

In federal states like Ethiopia, concurrent powers of taxation are given both to federal (central) governments and regional states. As we have seen at the beginning, the FDRE constitution divides powers of taxation between and among the federal and regional governments in the following manner. Powers exclusively given to federal government, powers exclusively given to regional governments, and concurrent powers of taxation. With respect to new taxes, that might be introduced in the future in reaction to societal needs and technological advancements the constitution submits the issue to be decided by the joint session of the house of federation and the house of people's representatives (art.99 of the FDRE constitution.) When VAT is introduced in 2002 power of taxation was resolved by similar procedure and the joint session decided in favor of the federal government. Thus it is only the federal government that has power to levy VAT in Ethiopia. One open fact here is people subject to VAT reside both federal and regional states. Since VAT requires cooperation, regions are given delegations to collect returns from VAT. Regarding collection enforcement mechanisms, the FIRA (federal Inland Revenue authority) is entrusted with the duty of implementations of the VAT proclamation and regulation issue to supplement the proclamation.

Thus, FIRA is authorized to investigate any statements records, books of accounts submitted by any person at any time. The authority can send duly accredited inspectors to check the

statements, records and books of accounts or any vouchers stocks or other material items at the person's place of business, requiring the person, or an employee who has access to produce the same. The person is duly bound to answer questions related with the collection of taxes in VAT. For this purpose, any municipalities' body, financial institution, department, or agency of federal or regional governments is required to render full information to the authority. The power is extended even up to seizure of the properties of the person liable to pay tax and failed to comply with his obligation to pay tax.

### **3.8 Appeals**

Anybody that feels his rights are jeopardizing by administrative tribunal or regular courts can bring his case before competent organ. Appeal is a constitutional right as far as made in accordance with law. The VAT system is not exception to these rules. A tax payer under VAT, who is aggrieved by the decision of tax authorities, may lodge his complaint to a body competent to hear and decide on such application. The aggrieved parts have two options: tax appeal commission or regular courts. The tax payer objecting the assessment by revise committee while taking appeal to Tax Appeal Commission is required to deposit 50% of the additional tax assessed Art 43(1).)

### **3.9 Empirical Review on challenge of VAT collection in Ethiopia**

Wollela (2009), despite the concentration of most of the prior tax compliance literature on direct taxes (mainly income tax) neglecting indirect taxes, it was noted that VAT noncompliance appeared to be prevalent, especially in developing countries. VAT noncompliance could take various forms including not registering for VAT, registering but not levying VAT (partially or wholly) on sales, levying VAT on sales but not reporting (partially or wholly), claiming credit on purchases more than the input tax paid, not claiming input VAT credits and not maintaining proper books and supporting documents. The prevalence of these forms of VAT noncompliance could be because of any of the determinants of tax noncompliance; and the level of VAT compliance costs was shown to be one of the factors potentially affecting VAT compliance decision of taxpayers.

Regarding revenue raised by VAT, in Wollela (2008), the Federal Inland Revenue Authority (2007) indicated that VAT is the principal source of revenue for the country. For instance, at the

Federal level, from 2007/8-2009/10, on average in each year, the share of the VAT to total tax revenue is about 38.55% (FRCA, 2010). In Addis Ababa, in the same year, it amounts to 21.43% (AACRA, 2010). In terms of the VAT administration problem, Wollela (2008:145) stated “in Ethiopia revenues raised by VAT are usually garnered at the expense of erosion in its salient features. This may be caused by factors including poor VAT administration, that is, the incapacity of tax authorities to implement the attributes of the tax in practice. Wollela (2012) examines the decentralization of VAT revenue and its administration in Ethiopia is likely to impact on the proper functioning of the VAT system, and achieve the government’s policy objectives at large. So, considering the practical difficulties of administering VAT at regional governments’ level and the distortions of VAT revenue decentralization (revenue import among different regional governments), it is worthwhile for the government to reassess the assignment of VAT revenue and the decentralization of its administration.

Generally, one can see that the empirical studies undertaken thus far for developing countries, particularly for Ethiopia, bothered little or no to see the potential challenges faced by taxpayers and the tax authorities in administering different tax activities such as VAT registration, VAT assessment and VAT collection. The performance of the tax administration will have a bearing on the capacity to raise revenue for a country since it includes primarily the registration, assessment and collection activities. Therefore, this research will identify the factor affecting VAT revenue collection Challenges in Ethiopia.

### **3.10 FACTOR AFFECTING REVENUE COLLECTION IN ETHIOPIA**

From secondary source the researcher observed that, less experienced tax officers, and taxpayers changing their business type and falsification of address, Lack of a taxpaying culture, Weak accountability, Lack of transparency, unstable tax amendments, tax officer’s turnover, lack of awareness on tax rules and regulation, lack of Knowledge about tax rules and regulations, corruptions in both sides, tax officials and taxpayers which is in line with the study by Gebeyehu (2008). Lack of awareness on tax rules and regulation, lack of Knowledge about tax rules and regulations were in line with Mihiret, (2011).



## **Institutional factor**

- ✓ Problem of staff experience on rules regulations and new amended proclamations.
- ✓ The tax officials are less confidential because of job insecurity.
- ✓ VAT assessment and collection officers are in frustration and aggressive in administering.
- ✓ There is lack of sufficient training at all for all tax officials, there is no consistent Vat rules and regulation.
- ✓ there are also intelligence and investigation officers they exercise their duty wrongly that means they add frustrations by looking and informing immaterial things i.e. tax notifications to anticorruption commission due to this fact tax official develop less confidence.
- ✓ Tax appeal committees are not professionals and they do not know the tax rules and proclamations due to this taxpayer are not satisfied enough.
- ✓ The capacity of employees, commitment to apply the designed penalty system; and development of a client-oriented tax administration and an effective audit Program.
- ✓ In Ethiopia, the VAT legislation proclaims that taxpayers that fail to fulfill the requirements of VAT are chargeable with penalties ranging from financial penalties to imprisonment.
- ✓ Lack of adequate communication especially between employees are the challenges lead to dwindling revenue collections.

### **3.11 methods of enhancing revenue collection from VAT**

Effective VAT collection is very important to achieve objectives and generate enough amount of revenue to run the day to day activities of government. Unless it very difficult for government to achieve the desired objective and cover government expenditures. There are different methods to increase revenue collection from VAT; these are;

#### **A. Penalty**

A person who should be involved in value added tax has to respect the law states otherwise, the person is penalized with such illegal action of: registration, invoice receiving or issuing, using accounting records, and filing the period turnover. Tax laws being used in different countries do

not put a clear demarcation between penalty and fines. A fine is imposed by a court when you are convicted of a criminal offense, whereas a penalty is used by an appropriate authority, when you have not complied with the law but you have not committed a criminal offense (Munyentwali, 2014).

### **B. Awareness of tax payers**

According to Cullis and Jones (1992), they highlighted the concept of false awareness in citizens, which are optimistic and pessimistic. Optimistic refers to the citizens who ‘underestimate the tax load incurred from public services’. While, pessimistic are citizens who have overestimated tax burden or inaccurately estimate public service burden with the tax imposed to the public. The contradictive views have continually provided misconception on tax requirements.

Awareness of taxpayers is one of the important variables for the effectiveness of VAT collection. If there are well aware taxpayers about the VAT proclamation and regulation it can increase a chance of effective VAT collection currently and also for the future.

### **C. Employees competencies**

Employee’s competency is a combination of skills, knowledge, and behaviors that is attributable for enhancing the collection effectiveness of VAT. Human resource plans that address training and development of employees, adequate staffs as well as empowering the staffs on the ethical behaviors free from fraud and corruption will enhances optimal revenue collection

### **D. Employee integrity**

Employee integrity involves characters required by employees at work place. It includes; commitment, maturity, responsibility, honesty, trustworthiness, self-discipline and moral courage. In essence, employee with the right integrity fosters the development of high professional standards and demonstrates the values of the organization Van Iddekinge et al., (2012). Employees with high integrity create an ethical and professional workplace which is the best safeguard against improper conduct, misconduct and corruption. Measuring integrity of an employee is not an easy task Berry et al., (2007). Therefore, for the purpose of this study, Employee integrity is defined as the characters required by employees at work place.

### **E. Adequacy of manpower**

To deal with the manpower issue, ERCA should consider the following;

- It should employ adequate manpower to be able to meet the challenges related to the number and quality of employees.
- Continuous trainings and workshops should be perpetuated to enhance the staffs with the new ways of handling challenges.

### **F. Taxpayer Identification**

To address the problem related with taxpayers' identification, the following might be considered;

- There should be a cross follow-up to both small and medium sized businesses to ensure that they are registered under VAT if they qualify for registration.
- There should be a clear record of all businesses as to their nature, and performances. Close monitoring of their operations and location will facilitate their easy identification for tax purposes. Proper record keeping is necessary especially as regards residence of mobile taxpayers.

### **F. Taxpayer Audit**

The taxpayer audit should consider the following;

Proper assessment should be emphasized before the VAT returns start being filed to ERCA. This will help in ascertaining the collections from the specific businesses. That is, an analysis of a business should be done in its entire business circle when times are good and when they are bad.

The assessment should be done frequently as opposed in the findings as mostly it is done once in a year. This will help in reducing the chances for tax evasion and so lead to better revenue performance of VAT.

### **K. Taxpayer Sensitization**

To create more awareness and knowledge among the taxpayers and those who are still not registered, the following should be considered;

A multi-media approach to sensitization should be adopted to get taxpayers informed. Administrators should mainly communicate through meetings, seminars, radio programs,

televisions, taxpayer visits and posters should as well be used to reach all eligible taxpayers and get them to appreciate the importance of VAT and been registered under the VAT law.

## **L. VAT Exemptions**

Exemptions are contrary to the neutrality feature of VAT. Neutrality should be maintained. It also makes the “broad tax base feature” suffer and so it should be reviewed.

- Significant amounts are being foregone due to exemptions. For a poor country like Ethiopia whose budget has been supported mostly by loans and grants makes no sense at all of perpetuating such exemptions. A review should be made on the exemptions.

### **General reasons for a good revenue performance of VAT**

Recovery of tax arrears

- Effective audits
- Close follow up of non-filers
- Tight controls over special reliefs and VAT refunds
- Training conducted to staff
- Assurance management programmer’s
- Implementation of the Departmental Action Plans

## CHAPTER 4

### Conclusion and Recommendation

"VAT"-value added tax -has spread throughout the world since its introduction in 1955. France is credited with first implementing VAT. It did so in 1955. The tax spread through Europe, South America and parts of Africa in the 1960s and 1970s before taking a hold in other regions. Today, it is a key source of government revenue in more than 130 countries. About 70 percent of the world's populations now live in countries with a VAT (Kean & Lock Wood, 2007).

Value Added Tax has also become an indispensable component of tax reform in developing countries. It is the most important tax innovation of the second half of the twentieth century. In line with this perception, an increasing number of developing countries have converted their sales tax to Value Added Tax (VAT). The continuing introduction and evolution of general sales taxes, especially of the value added tax has been the outstanding feature in development taxation in recent years (Goode, 1984).

Accordingly, Ethiopia introduced value added tax (VAT) in the year 2003 as a replacement to sales tax. The VAT has applied a uniform rate of 15% on most consumption goods and services with the exception of exports and exempted goods and services. The registration of VAT is both voluntary and obligatory. VAT is the principal source of revenue for the Ethiopian government right now. For instance, in the 2006–07 fiscal year, federal VAT revenue (on domestic transactions) accounted for about 41 per cent of total federal revenues from domestic sources (EFIRA, 2007). Further, since its introduction, VAT has been more revenue productive than sales tax (Teferra, 2004). To sustain VAT's revenue role in the government's finance, it is important to ensure that the revenue generated by this tax is raised as efficiently as possible. However, in Ethiopia revenues raised by VAT are usually garnered at the expense of erosion in its salient features. This may be caused by factors including poor VAT administration, i.e., the incapacity of tax authorities to implement the attributes of the tax in practice. A good tax administration is essential in fully implementing the design features of VAT and achieving government's policy objectives at large.

The findings of the analyses suggested that in Ethiopia there is divergence between the effective VAT taxation and the legislation. The main areas where there are gaps and problems include registration, record keeping, VAT invoicing, issuing VAT receipts, the threshold level and penalties. In addition, the outcomes of the research showed lack of tax awareness among the society and strong education programs as well as lack of trust between taxpayers and administrators as major challenges to the VAT system in the country. The gaps and problems identified in the study were partly because of under staffing of the tax authority, limited automation and inadequate public relation work.

It is hence suggested that the government would better look at the possibility of making sufficient resources available for the administration of VAT. Of course, this would be a challenge for countries like Ethiopia where resources appear to be limited. However, considering the role of VAT administration in the overall financial system of the Ethiopian government, allocating reasonably sufficient resources is worthwhile to consider.

This paper is therefore, finally concluded by highlighting the following bigger implication of VAT practices and implementations in Ethiopia since January 2003:

1. Impact of the Tax System on Government Revenues: The adoption of VAT in 2003 has led to a significant rise in the share of revenues generated by consumption taxes. It is clear, however, that this has not been without some adverse effects on private businesses and there remains widespread uncertainty and misunderstanding amongst taxpayers about both the theoretical and practical operation of VAT. Nonetheless, the tax reform has not adequately addressed the agricultural sector and the informal sector. Indeed, the tax burden on the agricultural sector has fallen significantly in recent years. This has resulted in a weaker revenue generation performance for the government and a higher tax burden on the wealth-generating private business sector – a “lose-lose” situation. The tax level (ratio of revenue to GDP) in 2007/08 in Ethiopia stood at 10.3 percent. The tax level for the agriculture sector was just over 0.1 percent, with that for non-agriculture standing at over 20 percent. Business is bearing considerably more than its fair share of the tax burden with agriculture remaining essentially untaxed.

Given the weak VAT coverage, the Ethiopian economy continues to grow. Government revenues are also growing, but at a lower rate than GDP and are still excessively reliant on foreign trade taxes. Hence, the tax structure needs to strike a balance between the inland revenues and trade taxes. There is little scope to squeeze the private sector further; hence other sectors of the economy must take on a greater burden of revenue generation.

2. Tax Administration: Audit, Investigation and Intelligence need to be better integrated and targeted. The new proclamation limits audit to process within a 5-year period. The implementation of the time limits keeps the taxpayers from high tax compliance cost. Real audit should be carried out, with the intention of identifying deliberate evasion rather than simple errors, sometimes beyond the control of business owners/managers.

Proclamation No. 286/2002 Article 76/1b mandates refunds to effect within 90 days, and entitles taxpayers to the payment of 25 percent interest over and above commercial interest rates. All refunds of tax need to be expedited on time and in accordance with the law. Besides, the degree of administrative discretion available to tax officials in determining assessments and penalties is an open invitation to malpractice.

## 4.2 Recommendation

Based on the findings from secondary source, the following recommendations are made.

1. In Ethiopia, VAT is a recently introduced taxation system and was introduced before ten years. Within this very short period of time, the experience gained and the revenue Generated is very encouraging. This is a big achievement that has to be celebrated. At this Point in time, it is necessary to document and share the best practices that the country gained within the last few years so that we can capitalize our strong points and then correct the weaknesses that we may have. Hence, it is important to organize experience sharing sessions for such a purpose.

2. Different types of problems are observed during the collection process of the VAT. One of the main problems as explained by the taxpayers and tax officers is attitudinal problem. It seems that the tax payers have some attitudinal problems towards VAT. Results show that most of the problems emanate from lack of awareness and information. This is the main challenge that the VAT administration has faced in the process. Hence, coordinated efforts must be exerted (at all levels) to enhance the awareness of the tax payers and other members of the community.

3. The study shows that not all companies and business people who should get registered for VAT are registered. This is a very serious problem. Therefore, urgent action has to be taken in letting those who should get VAT registered to get registered on time. This also demands a coordinated effort of all the concerned government bodies.

4. Simplify Appeal Procedure and VAT Refunds: The cash deposit to appeal need to be revisited and such prerequisites has to be rationalized to a certain extent that would keep in balance the benefits of the Government and the private sector. VAT refunds are legally mandated to be made within a period of 90 days. However, VAT refunds are mostly carried over from one tax year to the other. This practice is unlawful and should cease immediately.

5. Strengthen systems of taxpayer information and support, including a comprehensive support web site and information publications made available at all tax offices.

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