



African Tax Administration Paper 10

Practices, Challenges and Prospects for Public Sector Taxation in Ethiopia

Ronald Waiswa, Sebsbie Fekade and Asnakech Lake

June 2019

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The ICTD's African Tax Administration Papers (ATAPs) are research papers that will be of specific interest to people working in tax administration in Africa. The purpose is to encourage and support useful, policy-oriented research by African professionals directly involved in tax administration.

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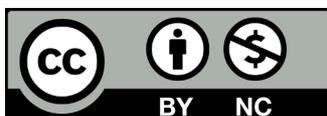
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Summary

The tax compliance behaviour of the public sector has been largely neglected in the tax literature. Other than appearing in tax laws as taxpayers, in practice the compliance strategies employed by revenue authorities do not sufficiently cater to government agencies. Enforcement of tax payments on these agencies is generally perceived to be a difficult undertaking and of less value than other priorities. One strategy to improve tax compliance in the public sector has been to separate them from other taxpayers and to provide them with special treatment. This strategy has been employed in Uganda, where it has been reportedly quite successful, and in Nigeria, where there is currently limited empirical evidence to evaluate its success. This paper aims to explore the compliance level of the public sector in Ethiopia, the legal and administrative challenges at the Ethiopian Revenue and Customs Authority (ERCA) to effectively tax public sector entities, and to assess whether segmenting the public sector from other taxpayers would be a relevant strategy in Ethiopia. The study finds that the compliance level of the public sector is wanting, especially in regards to remitting withheld taxes to ERCA. The bottleneck appears to be caused primarily by administrative weaknesses and less by gaps in existing tax laws. This study finds a number of administrative inefficiencies related to ERCA's taxation of public sector entities, including: (1) the perception that enforcing tax laws on the public sector is a hard or even impossible task; (2) a fragmented VAT withholding system; (3) malfunctioning e-filing and e-payment systems; (4) limited taxpayer sensitisation campaigns; (5) low levels of automation; and (6) unsatisfactory tax services rendered. From the perspective of public sector taxpayers themselves, the study also finds a number of factors that undermine compliance, including: (1) a lack of sufficient care and attention to tax obligations among managers; (2) the fact that some government entities use a single taxpayer identification number (TIN) for many branches makes it difficult to trace transactions; and (3) the lack of supportive actions from political leaders. The study recommends the creation of a decentralised office to administer public sector taxation, conditional on the strong support of leaders from the revenue authority as well as other key government officials.

Key words: public sector; tax compliance; tax administration; taxpayer segmentation

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Acronyms

ERCA	Ethiopian Revenue and Customs Authority
FIRS	Federal Inland Revenue Service
GBTA	Government Business Tax Department
LTO	Large Taxpayers Office
MOR	Ministry of Revenues
MTO	Medium Taxpayers Office
PAYE	Pay-As-You-Earn
PBE	Public Business Enterprise
PBI	Public Budgetary Institution
SIGTAS	Standard Integrated Government Tax Administration System
SOE	State-Owned Enterprise
TCC	Tax Clearance Certificate
TIN	Taxpayer Identification Number
URA	Uganda Revenue Authority

Introduction

A substantial body of literature on tax compliance exists, stemming from concerns about low collections. This concern is particularly acute in developing countries. The bulk of this literature focuses on the tax compliance of private sector taxpayers. Specifically, a great deal of emphasis has been placed on the taxpaying behaviour of small and medium enterprises (Dlamini 2017; Magiya 2014; Maseko 2014; Nduruchi, Makokha and Namusonge 2017), and of individual taxpayers (Kangave, Nakato, Waiswa and Zzimbe 2016; Kangave, Nakato, Waiswa, Nalukwago and Zzimbe 2018; Kubicova and Valková 2016; Fjeldstad, Schulz-Herzenberg and Sjursen 2012). Literature also exists on the compliance of large taxpayers, especially multinational corporations (Akhand 2015; OECD 2009b). Despite this broad literature on tax compliance, public sector (i.e. government agency) taxpayers have been largely neglected.

Recently, Saka, Waiswa and Kangave (2018) began to fill this gap with their study of public sector taxation in Uganda. Saka *et al.* (2018) reveal that government agencies were highly tax non-compliant until the Uganda Revenue Authority (URA) established a specialised focus on them with the creation of a public sector tax office. Outside of Uganda, however, there is very limited publicly available information about public sector tax compliance. In general, the strategy of treating government as a taxpayer itself is a new idea in the literature. While tax laws in most countries recognise government entities as taxpayers, in practice they are not treated like other taxpayers. Specifically, the enforcement of tax laws on government bodies seems to be a very difficult or even impossible undertaking.

To enhance compliance, the revenue agencies of Uganda and Nigeria have separated government entities from other taxpayers through the creation of specialized tax offices (ATAF 2017). This strategy has proven very successful in Uganda, and led to a significant increase in revenue contributions from the public sector. For instance, revenue garnered from the public sector increased 194 per cent in the first year of implementing the strategy; the public sector tax office is now the second largest contributor to the country's domestic revenue after the large taxpayers' office (LTO). Tax revenue from the public sector as a share of total domestic revenue grew from only 5 per cent in financial year 2014/15 to 17 per cent in 2016/17 (Saka *et al.* 2018). There is currently no available evidence from Nigeria to evaluate the success of its public sector tax office. Given the limited evidence base, recommending this strategy in other countries requires more country-specific analyses.

To help fill this gap in the literature, this study set out to answer the following specific questions:

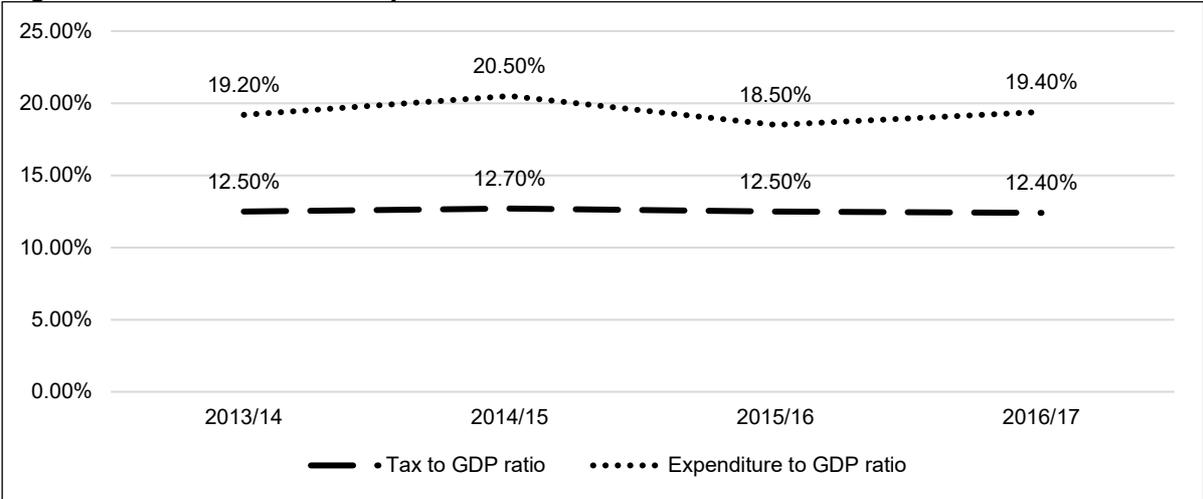
1. Is the public sector in Ethiopia tax compliant?
2. To what extent do current laws and administrative systems impact the compliance behaviour of the public sector in Ethiopia?
3. Would a specialised public sector tax office be a relevant strategy for Ethiopia?

A special focus on the compliance of government agencies in Ethiopia is justified for a variety of reasons. First, the service sector in Ethiopia, which is primarily run by the government, is the largest sectoral contributor to gross domestic product (GDP), averaging 46.6 per cent in 2015, followed by agriculture at 38.8 per cent (NBE 2015). Second, state-owned enterprises (SOEs) enjoy monopolies and other advantages in most important sectors such as finance, communications and trade logistics, and hence they tend to dominate the growth process in the country (IMF 2013). These factors signal how the public sector is vital in terms of both withholding and income taxes. Any non-compliance by these public institutions will lead

directly to an erosion of the already small tax base, which has detrimental effects on the country's growth aspirations. Third, it is counterproductive for the government to flout its own tax policies. Ideally, government should set an example for the rest of society by acting as a good taxpayer. In other words, if government wants to maintain the credibility necessary to convince taxpayers to voluntarily comply, it should put its own house in order first.

Over the preceding decades, the Government of Ethiopia has implemented various tax policy and administrative reforms to increase its domestic revenue collection. For instance, the introduction of the VAT in 2003, the creation of the Ethiopian Revenue and Customs Authority (ERCA) in 2008, and ongoing efforts to automate tax systems. Most recently, the government has divided ERCA into the Ministry of Revenue (MOR) and the Customs Commission.¹ Despite these semi-regular revisions to existing tax policy and administrative systems, revenue collection remains relatively low. Ethiopia's tax-to-GDP ratio has stagnated at less than 13 per cent, compared to the average of 19.1 per cent among African countries and over 25 per cent in developed economies (IMF 2013; Moore 2015). Ethiopia's current tax-to-GDP ratio is also lower than the tipping point of 15 per cent, which is widely acknowledged to be associated with a significant acceleration in economic growth and development. Below the 15 per cent threshold economies tend to struggle to function and to provide basic social services. Given existing trends, if no significant new measures are adopted, the government's aspiration to raise the tax-to-GDP ratio to 17 per cent by the end of 2020 is unlikely to be realised (UNDP 2016). Similarly, government expenditure-to-GDP is much higher than the tax-to-GDP ratio. As a result, tax revenue is unable to fully finance the budget and government continues to rely on external borrowing to cover budget deficits.

Figure 1 Tax-to-GDP and expenditure-to-GDP ratios, 2013/14-2016/17



A number of factors explain low tax collection performance in Ethiopia, including the country's huge informal sector that by some estimates contributes 38 per cent of GDP (IMF 2013; Schneider, Buehn and Montenegro 2010). A poor tax-paying culture and shortcomings in tax administration also contribute to making revenue collection difficult in Ethiopia. However, based on the findings of this paper, government could also do a better job to improve the situation. Currently, the function of revenue collection is left primarily to the revenue authorities, despite the fact that all government agencies are key stakeholders in improving national revenue mobilisation. The goal of this working paper is not only to

¹ At the time of data collection, our case study subject was the Ethiopian Revenue and Customs Authority (ERCA). However, the government has recently implemented changes to the federal revenue collection system. ERCA has now been replaced by the Ministry of Revenues (MOR) and the Customs Commission. The Customs Commission is accountable to the MOR. The MOR has three divisions: domestic taxes, enforcement, and modernization/corporate. The MOR is responsible for collecting taxes from incorporated businesses, while the nine regional states and two city administrations are responsible for collecting taxes from unincorporated businesses. Due to these recent reforms, ERCA and MOR are used interchangeably in this paper.

contribute to the scarce literature on public sector taxation, but, perhaps more importantly, to lay the groundwork for improving tax compliance of government agencies.

The rest of this working paper is arranged as follows. Section one discusses the public sector taxpayer segment and various international examples for how to manage this segment. Section two discusses the research methods employed to understand public sector taxpayer compliance in Ethiopia. Section three presents an analysis of evidence on tax compliance in Ethiopia's public sector, and discusses the effectiveness of government agencies as tax withholding agents. Section four outlines the key factors contributing to taxpayer compliance (or non-compliance) in the public sector, including administrative structures and legislative frameworks. Section five lays out the case for the MOR to consider the creation of a separate office for public sector taxpayers. Section six concludes the paper by discussing the key enablers to make such a public sector tax office successful in the Ethiopian context.

1 Public sector taxpayers in context

The public sector consists of organisations that are owned and operated by different levels of government, including the central government, ministries, local government units and agencies that are either fully or semi-autonomous. Public sector organizations include both those that are (1) funded entirely by government revenues, and (2) generate taxable income. In Ethiopia, the former type of organization is referred to as Public Budgetary Institutions (PBIs), while the latter is called Public Business Enterprises (PBEs). Public sector organizations play two key roles in the tax system: they are both withholding agents and taxpayers. As withholding agents, PBIs and PBEs are mandated to withhold payroll tax (known as a 'Pay-As-You-Earn' tax) from employee salaries, and sales tax from domestic payments for goods and services. Withheld sales tax can either take the form of a VAT charged at 15 per cent if goods and services are in excess of ETB1,000,000 (US\$35,000), or a turnover tax charged at 2 per cent if less than ETB1,000,000. As taxpayers, public sector organizations (and in particular PBEs) are required to remit income or corporate tax at 30 per cent on any profits, as well as rental income tax if they are engaged in renting out properties.

All revenue authorities are required to maximise the overall level of compliance within the bounds of existing tax legislation. One common strategy used by modern revenue authorities to achieve this goal has been the segmentation of taxpayers into different categories (Dohrmann and Pinshaw 2009). Differentiating taxpayers in this way enables revenue authorities to better understand the behaviours and needs of specific clients. As such, over the years more and more revenue authorities have implemented strategies to segment their taxpayers by category.

The rationale for organizing revenue bodies around taxpayer segments is that each group of taxpayers has different characteristics and tax compliance behavior. As a result of these differences, segments present different risks to the revenue authority. Appropriate client segmentation is therefore fundamental to achieving a thorough identification and categorisation of risks. Identification and categorization of segment risk in turn assists in the specification and delivery of risk treatments (Kloeden 2011; OECD 2004; 2010; Stankevicius and Kundeliene 2017).

Dohrmann and Pinshaw (2009) conducted an in-depth study of 100 best practices across core functions in 13 modern tax administrations in Australia, Belgium, Brazil, Canada, Chile, Denmark, France, Ireland, Norway, South Africa, Spain, Sweden and the United States. Of the 100 best practices studied, taxpayer segmentation was among the top four drivers of performance among tax administrations. The three other top best practices were streamlining operations, rigorous performance tracking and proactive demand management (Dohrmann and Pinshaw 2009). While most countries now use taxpayer segmentation, Dohrmann and

Pinshaw (2009) found that top performing tax administrations remain proactive by conducting extensive research on the nature and prevalence of non-compliance, and regularly refine their segmentation strategy based on insights from the research.

The most common segmentation model is based on taxpayer size (small, medium and large) or social standing (e.g. wealthy individuals, or politically-influential individuals). In this model, the most emphasized segment has been large taxpayers, who are typically served by the creation of a large taxpayers' office (LTO). The LTO controls and provides services to those taxpayers who collectively account for between 60-75 per cent of the government's overall tax revenue each year. In Anglophone African countries, for example, large businesses make up less than 1 per cent of all taxpayers but contribute more than 70 per cent of all revenue collected. In contrast, micro and small taxpayers² make up 70-95 per cent of the tax base but only contribute 0-10 per cent of revenue collected (Kloeden 2011). In addition to the three commonly-used size-based groupings in taxpayer segmentation strategies, many revenue authorities have added a 'high net worth individuals' category. The creation of a high net worth tax office is typically justified on the grounds that such individuals engage in complex commercial transactions (similar to large corporate taxpayers) and also have significant potential to contribute to total tax revenue. High net worth individuals may also be more likely to engage in aggressive tax planning schemes that have a bearing on the integrity of the tax system as a whole, and as such deserve special attention from the revenue authority (OECD 2009a).

The public sector has generally not been considered independently in taxpayer segmentation strategies. As a result, they are usually mixed with private sector taxpayers. Some are managed by the LTO, others by the MTO, and some even fit the criteria for the STO. Recent evidence, however, suggests that public sector taxpayers may pose specific risks to revenue authorities that are distinct from the risks posed by private sector taxpayers. Especially in LTOs, where most public taxpayers are handled, revenue authority staff in Uganda and Nigeria have reported significant challenges in improving compliance. Specifically, public sector taxpayers may be more likely to (1) fail to file tax returns, (2) delay or fail to remit taxes withheld on behalf of the revenue authority, and (3) accumulate large tax arrears that are eventually waived (Saka *et al.* 2018).

In Ethiopia, taxpayers are segmented by Proclamation No. 979/2016 into either Category A, B or C taxpayers. Category A is comprised of organizations or individuals with gross annual income of ETB1 million (US\$35,000) or more. Category B covers those taxpayers with gross annual incomes between ETB500,000 (US\$17,500) and ETB1 million and Category C includes taxpayers with annual income less than ETB500,000. At the federal level, ERCA (now MOR) further segments Category A into large taxpayers with annual turnover over ETB35 million and medium taxpayers with annual turnover less than ETB35 million. Regions further segment their taxpayers into small and medium categories, and Addis Ababa City Administration segments its taxpayers into medium, small and micro categories. Like in most other countries, public sector taxpayers in Ethiopia fall into one of these categories depending on their annual turnover.

² Micro taxpayers are defined differently by different tax jurisdictions. In Addis Ababa, micro taxpayers include businesses with annual turnover up to ETB500,00 (US\$17,500). Those with annual turnovers between ETB500,000 and ETB5,000,000 (US\$175,000) are referred to as small taxpayers.

2 Research methods

This study was based on interviews with tax officials, secondary data analysis, textual analysis of existing laws and policies and a review of comparative studies from Uganda and Nigeria.

Interviews were conducted with ERCA tax officials in the different offices handling government agencies. Interviews were conducted with both senior management and tax officers and auditors who have carried out compliance checks on government agencies. Discussions with tax officials were designed to provide insight into the tax compliance culture of the public sector. Not all non-compliance is deliberate, as some taxpayers fail to comply because of internal or external challenges in the course of complying. To ascertain the challenges faced by public sector organizations in the course of meeting their tax obligations, we also held discussions with individuals in government agencies, including both PBIs and PBEs managed at the federal level, the regional government level and at the municipal level.

Responses from interviewees were substantiated with data from the Standard Integrated Government Tax Administration System (SIGTAS) at the different tax offices. However, because not all tax processes are currently automated there were a number of data inconsistencies, and some interview responses could not therefore be confirmed with administrative data.

The study also sought to establish if there are any challenges with the existing legal and policy framework as far as taxing the public sector is concerned. Textual analysis of domestic tax laws including the Federal Income Tax Proclamation No. 979/ 2016, the Council of Ministers Regulations 2016, the Federal Tax Administration Proclamation 983/2016, and the VAT Withholding Directive No. 27/2009 was therefore also carried out. The purpose of the textual analysis was to examine the legal framework for taxing PBIs and PBEs in Ethiopia and to identify any loopholes that could be reformed to facilitate improvement of public sector taxation.

Lastly, our study benefited from the experiences of two African revenue authorities (in Uganda and Nigeria) that have created separate offices for public sector taxpayers. Although Uganda and Ethiopia exhibit substantially different governance structures (e.g. the latter is a federal state and the former is not) there are a few important considerations that make the comparison appropriate. First, the category of taxpayers under study in both countries is the same—they are government entities, meaning that the considerations determining their compliance behaviour are likely to be at least somewhat similar. Second, URA has extensive experience taxing government agencies, implying that it may have important lessons to provide for Ethiopia. Third, Uganda is the only African country with publicly available information on the taxpaying compliance of the public sector. Fourth, and lastly, since URA has had such great success in taxing government agencies it is worth establishing if such practices can be replicated in other developing countries, including Ethiopia. This study made use of the ICTD working paper on taxing government in Uganda by Saka *et al.* (2018), as well as discussions with URA officials in the public sector tax office. Nigeria was selected as a comparative case because (1) both Nigeria and Ethiopia operate under a federal system and both are large countries, and because (2) like Uganda, Nigeria's Federal Inland Revenue Service (FIRS) has established a special department for public sector taxation: the Government Business Tax Department (GBTD). For this study, researchers analysed FIRS documentation and also held a discussion with a senior official working in the GBTD.

3 Analysis of public sector tax compliance in Ethiopia

The most non-compliant groups of taxpayers in Ethiopia are the three conventionally hard-to-tax sectors: small businesses, services and agriculture. The next most non-compliant group, which so far has received little attention, is the public sector consisting of various types of government agencies. The situation observed in Ethiopia is not unique, as many African countries face similar challenges in the actual remittance of taxes owed by government agencies. In Nigeria, for instance, a FIRS official stated, 'There were clear cases where government entities withheld and failed to remit. They were also many cases of misclassification of transactions such as classifying VAT taxable supplies as exempt, and consultancy contracts in the construction sector being charged a withholding tax of 6 per cent instead of 10 per cent.' In Uganda, a study conducted by URA in 2014 revealed that 17.2 per cent of taxpayers, including a number of government agencies, withheld PAYE tax from their employees but did not remit to the revenue authority (URA 2014).

The situation in Ethiopia is especially worrisome for a number of reasons. For one, the government sector (both regional and federal) is very large. As shown in Table 1, there are 1,595 government agencies, of which 83 per cent are PBIs and 17 per cent are PBEs.

Table 1 Number and share of government institutions

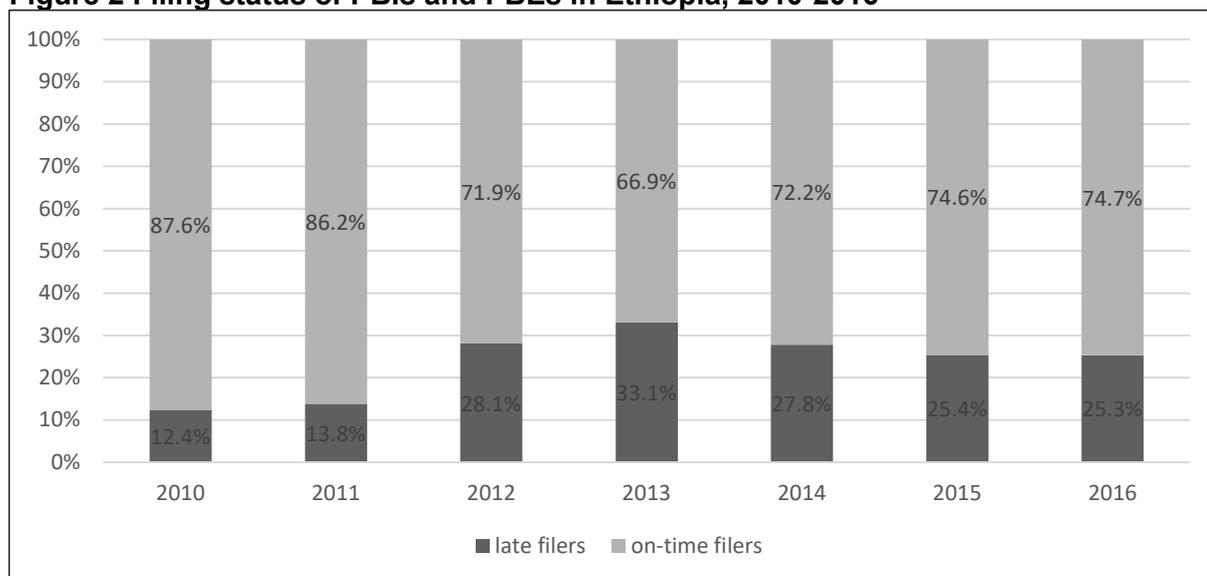
Government Institutions	All	% share
Public Budgetary Institutions (PBIs)	1,326	83%
Public Business Enterprises (PBEs)	269	17%
Total	1,595	100%

Source: ERCA (SIGTAS)

Government agencies are also not required to file tax returns periodically. They are only required to file a tax return when they are involved in a taxable transaction. However, as discussed in more detail below, there is currently no mechanism in place for the revenue authority to automatically know if a taxable transaction has taken place.

Administrative records indicate that the majority of PBIs and PBEs that declare taxable transactions do file their tax returns on time. However, ERCA staff interviewed for this study expressed concerns about the quality of returns filed by PBIs and PBEs. As one tax official commented, 'Some of the PBIs, specifically, declare information pertaining to past periods in their current returns. For monthly returns, there is also a tendency for the PBIs to include three or even six months in one return instead of filing each separately.' Thus, although some government agencies may submit tax returns on a timely basis, there could be bottlenecks at the capacity level.

Figure 2 Filing status of PBIs and PBEs in Ethiopia, 2010-2016



Similar to reports from Uganda and Nigeria, Ethiopian tax officials in two separate focus groups acknowledged that public sector organizations at times default on withheld tax money and do not remit to the revenue authority. Often, they may use withheld tax revenue to cover overhead expenses or fill budget deficits. Such practices are illegal, as public sector organizations are required by law to remit withheld taxes to ERCA within 30 days from the end of the month in which the payment was paid.

Empirical data on the number of institutions diverting withheld taxes for other purposes is difficult to find as the practice is illegal. However, unstable remittances from PBIs over time circumstantially supports the claims made by interviewed tax officials. For instance, PBIs and PBEs are required to withhold a 2 per cent sales tax on domestic payments for goods and services. Administrative records indicate that while sales tax remittances from PBEs have followed a largely stable upwards trajectory, those from PBIs have experienced large fluctuations between years. For example, as shown in Table 2, in 2012 PBIs remitted ETB475.95 million, which grew sharply by 119.2% in the next year to ETB1.04 billion, and then sharply declined by 17.4% to ETB862.08 million in 2014.

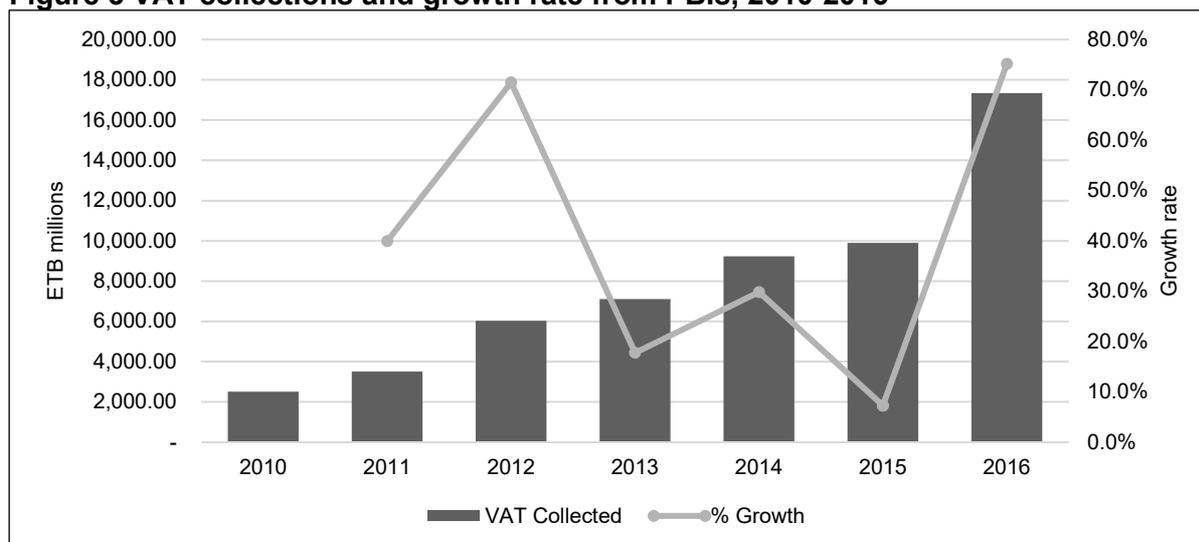
Table 2 Sales tax withheld and remitted for PBIs and PBEs, 2010-2016

Year	Sales tax (ETB millions)		Growth rate (from previous year)	
	PBIs	PBEs	PBIs	PBEs
2010	235.87	753.85		
2011	298.81	1,206.86	26.7%	60.1%
2012	475.95	2,011.47	59.3%	66.7%
2013	1,043.29	2,533.39	119.2%	25.9%
2014	862.08	3,698.80	-17.4%	46.0%
2015	933.97	4,070.64	8.3%	10.1%
2016	1,434.29	4,359.32	53.6%	7.1%

Source: ERCA (SIGTAS)

Similar fluctuations are also observed in the growth rate of collections from VAT withheld by PBIs, as shown in Figure 3. Such fluctuations thus provide further circumstantial evidence to support the claim made by multiple interviewed tax officials that many PBIs divert withheld taxes to other uses depending on their needs, and do not always remit the full amount to the revenue agency.

Figure 3 VAT collections and growth rate from PBIs, 2010-2016



Source ERCA (SIGTAS)

A withholding system of taxation can be one of the most effective ways to raise taxes in developing countries where compliance is low. A withholding system is cost-effective for the revenue collection agency, increases compliance, decreases evasion and underpayments and most importantly, taxpayers don't notice how much they have paid under a withholding system and hence are less likely to object (ICPAK 2015). When a withholding tax system is effectively managed, it represents an efficient transfer of revenue to government coffers from taxpayers who may not have otherwise complied with their tax obligations.

In Ethiopia, PBIs and PBEs play a crucial role in withholding taxes for the revenue agency. Taking the VAT as an example, it accounts for an average 45.2 per cent of all domestic tax collected in Ethiopia, as shown in Table 3. Of that amount, government agencies contribute an average of 46 per cent of all VAT collected through the withholding system. Thus, on average, government agencies contribute roughly a quarter of Ethiopia's total tax revenue through the withholding system. As such, any leakage occurring from government agencies, such as through withholding but not remitting taxes, or through not withholding taxes at all, could potentially have a huge impact on revenue collection in Ethiopia.

Table 3 Domestic tax and VAT collections, in ETB millions, 2010/11-2016/17

FY	Total Domestic tax Revenue ³	Total VAT	Government VAT	VAT as % of DT	Government VAT as % of total VAT
2010/11	26,160.79	10,725.02	7,570.02	41.0%	70.6%
2011/12	36,161.58	16,147.38	5,006.96	44.7%	31.0%
2012/13	44,915.77	21,393.77	9,204.21	47.6%	43.0%
2013/14	59,607.99	27,474.05	11,886.90	46.1%	43.3%
2014/15	73,706.28	35,893.26	16,322.49	48.7%	45.5%
2015/16	80,301.27	35,863.43	16,640.67	44.7%	46.4%
2016/17	91,632.68	39,909.08	16,832.51	43.6%	42.2%
Average	58,926.623	26,772.28	11,923.39	45.2%	46.0%

Source: ERCA Annual Report 2016/17

Finally, despite the fact that PBIs require all external service providers to provide an up-to-date business license, tax clearance certificate (TCC) and VAT registration certificate before contracts are awarded, PBI staff often do not have the capacity to verify the authenticity of

³ Domestic tax includes domestic direct tax, indirect tax (VAT inclusive) and non-tax revenue

documents. Based on interview responses from tax officials, some contracts awarded by PBIs inevitably end up with tax non-compliant service providers. Similar to ERCA’s current situation, for many years URA required that any private sector entity supplying goods or services to government provide an up-to-date TCC. However, because TCCs were manual, URA was often unable to verify their authenticity. With the introduction of a new digital TCC system in 2013 forging certificates is no longer possible (comment from a URA tax official, Saka *et al.* 2018). Interviews with PBI staff revealed that they do provide a list of service providers to ERCA for verification when they file VAT returns. However, because the e-filing system experiences such frequent breakdowns they typically end up providing manual copies to the tax office as well.

4 Primary factors contributing to public sector tax compliance behaviour

To assess the underlying factors influencing public sector tax compliance in Ethiopia, this study examined both legal frameworks and administrative structures. Findings suggest that weak administrative structures, both at ERCA and at the various government agencies, are the primary cause of non-compliance. Existing provisions in the tax legislation provide a generally strong framework to encourage compliance, with only relatively minor loopholes that could be addressed by reform.

4.1 Administrative structures

On the side of ERCA, the identified administrative inefficiencies include: (1) the perception that enforcing tax laws on the public sector is a hard or even impossible task; (2) a fragmented VAT withholding system; (3) malfunctioning e-filing and e-payment systems; (4) limited taxpayer sensitisation campaigns; (5) low levels of automation; and (6) unsatisfactory tax services rendered. Each of these findings are discussed below.

4.1.1 Perceptions about enforcing tax laws on the public sector

Tax officials in Ethiopia generally perceive the enforcement of tax laws on government agencies to be a difficult or even impossible task. As one tax official noted during the interview, ‘Penalising PBIs and PBEs for offences in connection to misuse of withheld money or failing to withhold is a tall order—they are government. You can’t enforce on the government, can’t seize their property and sell it.’ Government entities are essentially immune to the enforcement mechanisms used by ERCA, and as a result are not audited for compliance. As shown in Table 4, in the last three years not a single PBI has been audited. In 2017/18, one PBE was audited by the LTO, resulting in an ETB2.8 billion (US\$10 million) tax bill. At the time of writing this paper, this tax bill is yet to be paid. One interviewed official stated, ‘In the selection process for audits, government entities are out of selection. They are only audited during the sale of public enterprises.’ Most of ERCA’s enforcement mechanisms focus on the private sector because of a general belief within the tax authority that enforcement actions on PBIs and PBEs are unlikely to yield results.

Table 4 Number of taxpayers audited, 2015/16-2017/18

Audits	2015/16	2016/17	2017/18
# of PBIs audited	0	0	0
# of PBEs audited	0	0	1
# of private taxpayers audited	2,913	3,148	3,053

Source: ERCA

4.1.2 A fragmented VAT withholding system

In Ethiopia's existing legal provisions, the VAT withholding system is not implemented down to the Woreda (district), zonal, sub-city, and town levels.

4.1.3 Malfunctioning e-filing and e-payment systems

Respondents from the PBIs and PBEs stated that the e-filing and e-payment systems are almost always down or running very slowly, especially around due dates for filing returns. System downtime and slow speeds were generally attributed to poor internet connectivity, both at ERCA and within the different government entities. As a result, taxpayers are usually forced to file tax returns manually. The legislated requirement to submit electronic returns then forces taxpayers to file twice. Because of system slowdowns, the filing period is characterised by long queues and long working hours, as taxpayers fear incurring penalties for delaying to file their returns. The e-payment system is also only usable by a few taxpayers, and often experiences system downtime.

4.1.4 Limited taxpayer sensitisation campaigns

Interviewed PBI and PBE staff all acknowledged to have an awareness of their tax obligations in the public sector. Despite this awareness, they reported having difficulties in using the e-filing system and in accessing different revisions to tax laws, as information obtained from the ERCA website is not comprehensive and is frequently out-of-date. Public sector staff are typically not targeted by taxpayer sensitization campaigns, and may thus have limited knowledge of the systems and regulations required to meet their obligations.

4.1.5 Low levels of automation and lack of interface with other government systems

Currently, there is no system at ERCA that is interfaced with other government entities, making it difficult to obtain tax-related information from third parties. Even within ERCA, there are a number of fragmented systems for sharing information between departments and offices. For instance, tax information housed at headquarters cannot be accessed through the web-based system used in the branch tax offices. Information within the existing e-filing system is still not detailed and comprehensive enough to enable effective scrutiny of taxpayer declarations.

4.1.6 Unsatisfactory services rendered

Staff interviewed from the PBIs and PBEs stated that ERCA staff create the impression that they are to be feared, and that they sometimes either take too long or even fail to provide answers to questions.

In addition to these administrative bottlenecks that were found within ERCA, government agencies—and especially PBIs—also experience a number of administrative challenges. Interviewed ERCA staff, for instance, noted that PBIs do not take sufficient care of their tax obligations and lack support from political leadership to do so. Additionally, some government agencies have many branches that all use the headquarters' taxpayer identification number (TIN). As a result, it can be difficult for ERCA to trace and verify transactions carried out by these different branch offices.

4.2 Legislative frameworks

As part of this study, the Federal Income Tax Proclamation No. 979/ 2016, the Council of Ministers Regulations 2016, the Tax Administration Proclamation No. 983/2016, and the VAT Withholding Directive No. 27/2009 were all reviewed for potential inconsistencies and loopholes. In general, the provisions in these regulations provide a strong legal framework for taxing the public sector. The only identified potential loophole was in the VAT Withholding Directive No 27/2009. The VAT directive allows government agencies to file a return only when they carry out a taxable transaction. However, as there are no mechanisms for ERCA

to know when these transactions take place, it's possible for public sector entities to avoid reporting all taxable transactions to ERCA.

Below are some of the legal provisions that are sufficient to improve public sector tax compliance:

Subsection 97 of the Federal Income Tax Proclamation No. 979/ 2016 specifically requires that withholding agents (including government agencies) shall pay to the revenue authority the withheld amount within 30 days after the end of the month in which the tax was paid. The proclamation also requires that the agent file a withholding tax declaration in the approved form along with the payment. If the withholding agent fails to withhold as required or, having withheld, fails to pay to the authority as required, then the offending agent becomes personally liable to pay the amount of tax to the authority.

The Tax Administration Proclamation No. 983/2016 elaborates on the penalties in case of breach of the tax laws by any taxpayers (including government agencies). Subsection 106 of chapter two, for instance, highlights the withholding tax penalties. An agent that fails to withhold tax or, having withheld, fails to pay the tax to the revenue authority as required, is liable for a penalty of 10 per cent of the tax owed. Additionally, in such cases the manager, chief accountant, or any other officer responsible for ensuring the timely remittance of withheld taxes to the authority can be held personally liable for a penalty of ETB2,000 (US\$70). Other penalties outlined in the proclamation include those relating to the failure to maintain appropriate documentation, TIN misuse, late filing, failure to issue appropriate invoices and VAT penalties, among others. These are all mistakes that interviewed officials said are common among PBIs.

Together, the combination of these various provisions in the different regulations provide a strong legal frame work to enforce tax compliance in the public sector. However, it is one thing to have a strong legal framework and quite another to ensure that legal provisions are translated into practice. As already discussed, the public sector is often non-compliant amidst these strong provisions.

5 The case for a specialized public sector tax office in Ethiopia

Staff from the PBIs and PBEs, as well as tax officials at ERCA (now MOR) that participated in the study, expressed support for the idea of a public sector tax office in Ethiopia. Staff from the PBIs and PBEs stated that a specialized office could assist them in accessing quicker tax services, such as tailored training sessions and responses to their queries. ERCA officials, in turn, supported the idea of segmenting public sector taxpayers on the grounds that it could improve their compliance levels.

Tax officials, however, noted that such a public sector tax office would need to be decentralised, given the wide spread of government entities across the country. Tax officials suggested that each tax office would require a separate unit for the public sector organizations under their jurisdiction. The LTO has actually already been thinking in this direction. The LTO, for instance, has developed plans to provide specialised treatment to some of the government agencies that contribute or have the potential to contribute significantly to tax revenue. However, smaller government agencies currently under the jurisdiction of the MTO or the STO will not benefit from this specialized treatment. This paper proposes the separation of public sector taxpayers from private sector taxpayers for four main reasons:

1. Public sector organizations demand high-quality tax services that address their specific challenges and meet their expectations. To improve compliance, the MOR should therefore handle government agencies similar to the way that private businesses handle their ‘very important clients’—by providing a service that makes them feel they are needed and highly valued. Banks, for example, create specialized offices or even whole branches that cater specifically to their very rich clients separately from other customers. Government entities are key stakeholders in revenue mobilisation because they (1) influence tax policy design, (2) influence the compliance of other taxpayers, and (3) hold a lot of revenue in withholding taxes. Even with this crucial role, public sector taxpayers are also aware that enforcement has less of an impact on them. Maximizing public sector compliance is therefore largely dependent on winning their trust by offering high-quality services rather than through harsh enforcement measures. In particular, these high-quality services need to revolve around listening to the concerns raised, advising appropriately, and assisting with online compliance procedures. Specialized tax offices have been used to achieve similar goals for other high-value taxpayers, and are also relevant to the public sector. A specialized public sector tax office would help make government agencies feel that their specific needs in relation to tax administration are being addressed. Further, it will ensure that they are served quickly and are given special tax support services for their tax-related problems.
2. Public sector organizations already contribute significantly to government revenue, and have the potential to contribute significantly more. As previously discussed, Ethiopia’s PBIs’ contribute a significant portion of withholding taxes. For withheld VAT, on average 46 per cent is contributed by government agencies. Currently, public sector organizations in the LTO contribute close to 49 per cent of total LTO collections. A separate office to closely monitor these entities will help minimize the risk of losing this abundant source of revenue.
3. A specialized tax office could help with gathering information on other taxpayers. There are currently no mechanisms in place to receive real-time information from public sector organizations regarding other taxpayers that they work with (e.g. service providers). It is therefore currently very difficult to track transactions between government entities and the private sector, although government is the biggest consumer in the country. Failure to track these financial flows introduces huge risks both for the MOR and for the government more generally. A specialized public sector tax office could help ensure that all government service providers are well profiled and hold verified copies of the required documents. Ensuring availability of this information will go a long way to enforcing tax compliance on government service providers.
4. Lastly, the nature and operations of public sector organizations are very different from the private sector businesses with whom they are currently grouped. Handling the tax affairs of public sector entities thus requires a different tax administration skillset, such as knowledge of public sector management and accounting practices, and an ability to negotiate with public officials. A focus on both extremes—private businesses engaged in complex tax planning on the one hand, and public sector non-compliance due to administrative and capacity constraints on the other—is stretching LTO staff capacity very thin (Saka *et al.* 2018). The LTO, additionally, faces major ongoing challenges to ensure optimal tax compliance from the private sector. Removing public sector entities from under their responsibility will enable to LTO to focus more strongly on the complex non-compliance strategies employed by private businesses.

6 Conclusions and way forward

This paper argues that managing the tax compliance of government agencies would be better served by segmenting them from other taxpayers with the creation of a specialized taxpayers office. However, segmentation on its own will not be sufficient. Effective tax revenue collection requires a whole-of-government approach and strong political support, and is not a task for revenue authorities to accomplish alone. To effectively tax government entities, the senior management teams at MOR, as well as other key government officials, need to be on the front line. There is a substantial body of literature that confirms the positive relationship between strong leadership and organisational performance (Agle, Nagarajan, Sonnenfeld and Srinivasan 2006; Arslan and Staub 2013; Kieu 2010). Even in Uganda, the success of the public sector office is to a great extent a result of the involvement URA's top management in the process, along with support from key government officials such as the permanent secretary and secretary to the treasury, the permanent secretary for local government, the commissioner of local government administration, and the governor of the Bank of Uganda (Saka *et al.* 2018). Similarly, in Nigeria, in addition to the involvement of top management at FIRS, the accountant general supports the public sector office by deducting an amount equivalent to the tax that has been defaulted on from future budget allocations for particular agencies.

Leaders of the various government entities will be more likely to respond positively if they are engaged by their counterparts at a similarly high level, rather than by more junior tax administration staff. In some of the sensitisation campaigns, it will therefore be important to have senior members of MOR attend. Similarly, much more success will be achieved if the highest office (i.e. the prime minister) is convinced as to the utility of a public sector tax office. To support this initiative, high-ranking government officials could come out boldly, and instruct the different public entities in writing to comply with their tax obligations, as well as supporting the MOR to identify new taxpayers. In such communications, high-level officials could also inform their relevant agencies of the harsh penalties for non-compliance, including the termination of contracts for responsible managers, or even not allocating or cutting budgets to non-compliant entities.

Equally important as the creation of a new office will be the need for sensitisation campaigns and continuous follow-up with public sector organizations. Not all non-compliance is deliberate. Some government agencies may be failing to comply simply because their staff cannot access or do not understand existing MOR systems. Extensive sensitisation campaigns for key officials in the relevant public agencies should therefore be a priority of any effort to improve tax compliance of the public sector in Ethiopia.

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