



Working Paper 75

# Subnational Value Added Tax in Ethiopia and Implications for States' Fiscal Capacity

Wollela Abehodie Yesegat and Richard Krever

March 2018

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ICTD Working Paper 75

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## **Summary**

In most federal systems, state governments are funded through a combination of direct fiscal transfers from the central government, and the revenue they collect directly from locally adopted taxes. Ethiopia is a federal polity, but follows a slightly different path in the case of its most important tax source – value added tax (VAT). As is the case in many developing countries, VAT is a major source of government revenue in Ethiopia, and the tax is levied under central government legislation. However, unlike the more common practice of a central government collecting VAT and then earmarking some of the revenue for transfer to states, collection rights and administration powers over VAT imposed on a portion of the economy in Ethiopia are assigned directly to state governments. The result is a fiscal relationship between central and state governments in Ethiopia that is distinctive in three main respects.

First, responsibility for collection of the tax is divided between central and state tax administrations, with collection powers allocated on the basis of the legal form of businesses. VAT allows businesses to claim credits for VAT paid on acquisitions. A crucial feature of the successful administration of VAT is thought to be the unified administration of the tax, so claims for credits can be cross-checked against remittances from sales. The division of responsibilities in Ethiopia, and limited channels of communication between branch offices of state administrations and the central tax administration, greatly impedes the flow of information needed for efficient administration.

Second, VAT revenue is divided between central and state governments in a rather unusual way. State governments are allocated all the revenue they collect from unincorporated businesses, while central government keeps most of the revenue it collects from incorporated firms. Neighbouring businesses that differ in legal form only may be subject to different tax administrations, and pay taxes to different levels of government. As a result, the division of VAT revenue is subject to the legal form chosen by entrepreneurs for their businesses.

Third, and most importantly, all VAT revenue collected by state governments, and a portion of VAT revenue collected by the central government, are allocated to states on the basis of the seller's place of registration, rather than the location of the customer. VAT is designed to be a consumption tax, paid where consumers are located, and the allocation of revenue to the sellers' states is contrary to the fundamental principle of VAT as a tax on consumption. More significantly, the system leads to perverse cross-subsidies in the case of business-to-business sales – where VAT on sales is kept by the seller's state, while the buyer's state loses revenue when the receiving business claims a credit for VAT paid to the seller's state. As most business-to-business sales flow from wealthier states to poorer states, the result is cross-subsidies from the poorer states to their wealthier counterparts.

This report recognises the fact that unwinding the current separation of tax administration powers would be difficult to achieve in the current political climate. It suggests a process of gradual reform, commencing with better coordination, standardisation and communication between state and central administrations. It similarly recognises that for similar reasons the current entitlement of states to 100 per cent of VAT revenue remitted by unincorporated businesses, and 30 per cent of VAT revenue remitted by companies, would be difficult to

change. It suggests, however, that a clearing house system could be established to redistribute entitlements between states so the share of VAT revenue to which states are entitled is ultimately based on a 'fiscal equalisation' calculation, with the aim of enabling all states to provide equal value programmes and benefits to their citizens. Transitional rules that gradually increase the proportion of VAT revenue subject to a fiscal equalisation formula can smooth the impact of shifts of revenue that result from the change.

**Keywords:** revenue assignment; fiscal federalism; subnational VAT; fiscal autonomy; social equalisation.

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## Acronyms

ERCA	Ethiopia Revenue and Customs Authority
EU	European Union
FDRE	Federal Democratic Republic of Ethiopia
FIRA	Federal Inland Revenue Authority
GST	Goods and Services Tax
HST	Harmonized Sales Tax
ICMS	Imposto sobre Circulação de Mercadorias e Serviços – VAT levied by states in Brazil on the supply of goods and rendering of certain services
IPI	Impusto sobre Productors Industrializados – a VAT in Brazil, levied by the national government mainly on manufacturing sector
ITC	Input Tax Credit
MoFEC	Ministry of Finance and Economic Cooperation
QST	Quebec Sales Tax
RST	Retail Sales Tax
SDG	Sustainable development goals
SNNP	Southern Nations, Nationalities and Peoples
TIN	Tax Identification Number
VAT	Value added tax

# Introduction

Value added tax (VAT) is now levied by the vast majority of countries. Fiscal federalism issues in respect of VAT do not arise in unitary states, but questions arise as to the optimal division of VAT imposition rights and VAT revenue in federal states. Traditionally, the general public finance consensus is that it is highly undesirable to have separate VATs enacted by subnational governments, or for central and subordinate governments to share responsibility for collecting VAT. A single national VAT levied by the central government, which may, in turn, retain the income or use a formula to distribute some (e.g. Germany) or even all (e.g. Australia) of the revenue among the states, has generally been recommended as the preferred model for VAT in federal jurisdictions (Tait 1988), and, in particular, in the context of developing and transitional countries (Bird and Gendron 2005). A somewhat more nuanced view in the case of advanced economies has emerged following the adoption of a VAT in Canada with what are, in effect, provincial surcharges built on to the national VAT. However, the underlying consensus remains intact, particularly in the case of developing and transitional jurisdictions.

While a single VAT, levied by a federal government and distributed by means of a formula where some VAT funds are passed on to regional governments, is common, there are many deviations from this model in practice. China levies a single national VAT, but distributes half of the tax to provinces on the basis of the locations from which supplies are made.<sup>1</sup> The member states of the European Union (EU) levy separate VATs, subject to conformity with an EU law (the VAT Directive), while revenue is redistributed through a combination of VAT rules and a central clearing house on the basis of the place of consumption. Most Canadian provinces impose a surcharge on the federal VAT that is collected by the federal government on behalf of the provinces, except in the province of Quebec – where the provincial government collects the Quebec Sales Tax (QST) and federal Goods and Services Tax (GST) (as VAT is called in Canada), and passes the federal portion on to the central government. The revenue attributable to provincial surcharges is distributed to the provincial governments on the basis of place of consumption, and the federal government portion flows to the federal government's consolidated revenue.<sup>2</sup>

While not common, subnational VATs or VAT administration roles are found in a number of federal jurisdictions. The bifurcated Ethiopian VAT may be unique, however, with VAT administration and revenue from some classes of taxpayers assigned to the federal government, and from others to regional governments. VAT from unincorporated businesses, referred to as sole traders in Ethiopia, is assigned to regional governments, while VAT from private companies is jointly shared between the federal and regional governments.<sup>3</sup>

Although there is recognition in several quarters that the current system is problematic in many respects, to date there has been little study of the subnational VAT in Ethiopia. Unanswered questions range from the constitutional validity of the arrangements, through to the administration and compliance costs of the system. Nor has there been serious consideration of reform options that can address these issues within the current legal, political and economic frameworks. This study investigates these issues, assessing the legal framework and practice of assigning VAT revenue in Ethiopia, and its implications for states'

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<sup>1</sup> Provincial governments will share the 50% among themselves according to taxation location (Xinhua Finance Agency 2016).

<sup>2</sup> The provincial share of GST revenue (Harmonized Sales Tax (HST)) is allocated on the basis of place of consumption or destination. This is determined by a formula that allocates the national GST taxable base among all provinces - not just the HST provinces - and then applies the tax rate applicable to that province to its calculated share of the base (Bird 2013).

<sup>3</sup> Private companies in this paper refers to all incorporated businesses, excluding state-owned enterprises.



fiscal capacity. In this context, it reviews the operation of the current arrangements for administration of VAT by the federal and regional governments, the current arrangement of VAT revenue assignment, and the constraints that may impact on alternative VAT administrative and revenue assignment schemes.

The study is based on data obtained through in-depth interviews held with twenty-three key informants from the House of Federation, Ministry of Finance and Economic Cooperation (MoFEC), Ethiopian Revenue and Customs, Tigray regional revenue, Amhara regional revenue, Oromia regional revenue and Southern Nations, Nationalities and Peoples (SNNP) regional revenue authorities, and an academic working on fiscal federalism.<sup>4</sup> The study reviewed relevant documents, including the Federal Democratic Republic of Ethiopia (FDRE) Constitution, minutes of various meetings of the House of Federation and the House of People's Representatives, relevant proclamations, letters written by the then Minister of Revenues and the head of the Federal Inland Revenue Authority (FIRA) and other documents. Revenue, expenditure and federal grant data, among others, were sourced from MoFEC.

The study is organised into eight sections. Section 1 provides a brief survey of the fiscal structure in Ethiopia, and is followed by a review of fiscal federalism principles and scholarly views on VAT revenue assignment. Section 3 sets out the operation of subnational VAT, and is followed by a description of the allocation of VAT revenue in Ethiopia in Section 4. Sections 5 and 6 explore the consequences of the current VAT source and allocation rules and reform alternatives respectively. Finally, a path forward and conclusions are considered in Sections 7 and 8.

## 1 A brief review of the fiscal structure in Ethiopia

The federal government collects the lion's share of tax revenue in Ethiopia, with the nine regional states and two chartered cities accounting for only 25 per cent of total tax revenue in FY 2015/16. Of that amount, the largest share was collected by Addis Ababa (11.5%), followed by Oromia (4.57%), Amhara (2.71%) and SNNP (2.37%), with the remaining six regional states and Dire Dawa city administration accounting for less than 4 per cent of total tax revenue.

Tax revenue received by regional states is insufficient to meet expenditure needs, and all subordinate governments, with the exception of Addis Ababa city administration, rely on central government transfers to cover most of their spending. In FY 2015/16, for example, federal subsidies to regions (excluding Sustainable Development Goal (SDG) grants) accounted for 42 per cent of federal total revenue and 51 per cent of federal tax revenue. In that year, Tigray regional state financed 43 per cent of its expenditure from its own revenue, and Amhara, Oromia and SNNP regional states covered about 30 per cent of their expenditure from local revenue, with most other regional states relying to a greater extent on central government transfers (Table 1).

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<sup>4</sup> The in-depth interviews cover the federal government, and the four largest regional governments, in Amhara, Oromia, SNNP and Tigray regional states.

**Table 1 Revenue and expenditure (FY 2015/16) (million Birr)\***

Regional states	Revenue (tax and non-tax <sup>5</sup> )	Total tax revenue	Expenditure (recurrent and capital)	Block grants	Total grants (block and SDG grants)	Regional states' local revenue as share of expenditure
Tigray	4,094.33 (1.77%)	3,210.17 (1.68%)	9,581.94	5,203.7	6,061.74	0.43
Afar	562.24 (0.24%)	518.59 (0.27%)	3,136.44	2,272.1	2,646.53	0.18
Amhara	6,836.35 (2.95%)	5,158.32 (2.71%)	23,866.37	16,931.2	19,720.02	0.29
Oromia	10,142.77 (4.38%)	8,703.24 (4.57%)	34,616.81	23,660.3	27,554.34	0.29
Somali	1,901.82 (0.82%)	1,540.31 (0.81%)	7,274.45	5,919.6	6,893.96	0.26
Benishangul-Gumuz	513.6 (0.22%)	430.17 (0.23%)	2,213.96	1,540.9	1,798.93	0.23
SNNP	6,335.58 (2.73%)	4,517.33 (2.37%)	20,909.45	14,656.2	17,069.41	0.3
Gambella	349.21 (0.15%)	285.08 (0.15%)	1785.87	1,088.8	1268.75	0.2
Harari	348.84 (0.15%)	303.5 (0.16%)	991.61	729.6	849.63	0.35
Addis Ababa	24,306.45 (10.49%)	21,918.71 (11.50%)	20,962.77	0	0	1.16
Dire Dawa	838.15 (0.36%)	677.08 (0.36%)	1,660.79	847.6	986.78	0.5
Total (regions)	56,229.34 (24.75%)	47,262.51 (25.33%)	127,000.5	72,850.1	84,850.08	0.44
Federal government	174,427.90 (75.25%)	142,454.70 (74.77%)	Not available	42%** (51%***)	49%^(59%)^	N/A
General government	231,805.20 (100%)	190,519.70 (100%)	280,892.81	N/A	N/A	N/A

\* figures in parenthesis represent percentage share from the total

\*\* block grants to regions (excluding SDG) as a share of total federal revenue

\*\*\* block grants to regions (excluding SDG) as a share of total federal revenue

^ total grants to regions as a share of total federal revenue

^^ total grants to regions as a share of total federal tax revenue

Source: Ministry of Finance and Economic Cooperation and own computations

## 2 Fiscal federalism

Fiscal federalism comprises both the distribution of functions and tax revenue sources between central and regional governments (Oates 1999), and the distribution of decision-making power to two levels of government (Girma 2003).

It has been suggested that fiscal decentralisation – the transfer of fiscal resources and spending responsibilities from central authorities to regional governments – can improve the efficiency, autonomy and accountability of public sector institutions, and even facilitate rapid economic growth (Rodden 2006). Bird et al. (2003) further argue that decentralisation can more effectively promote democratic and participatory forms of government, improving the responsiveness and accountability of politicians and bureaucrats, and achieving closer correspondence between the basket of publicly provided goods and services, and the preferences of beneficiaries (taxpayers) in the various subnational jurisdictions.

Fiscal decentralisation encompasses three principal elements: the assignment of responsibilities and functions to different levels of government, the assignment of taxation powers to fund expenditure required to carry out those responsibilities and functions, and the

<sup>5</sup> Non-tax revenue includes charges and fees, sales of goods and services, government investment income, pension contributions, miscellaneous income and municipality revenue.

design of intergovernmental transfers of fiscal resources where taxing powers are insufficient to cover the costs of assigned responsibilities (Girma 2003). Bird (1999) discusses different approaches in the assignment of fiscal responsibilities and functions. Clearly, national public goods, such as national defence and foreign affairs, must be provided by the central government (Oates 1999). Also falling within the central government's remit is responsibility for macroeconomic stability and broad income redistribution (Oates 1999). Regional governments may be best placed to offer direct services, including local healthcare, welfare and education.

In theory, a division of government responsibilities need not be accompanied by a division of taxing powers – a central government could assign responsibilities to regional governments and make transfer payments to those lower-tier governments. A stark vertical fiscal imbalance of this sort is unlikely to achieve the objectives of decentralisation, however, and the preferable approach is to assign separate taxing rights to regional governments to achieve the goals of enhancing fiscal autonomy, responsibility and accountability (Bird 1999, 2001; McLure 2001).

Conventional fiscal federalism theory suggests taxes on mobile tax bases, redistributive taxes, taxes that could easily be exported to other jurisdictions, taxes on unevenly distributed tax bases, taxes that have large cyclical fluctuations and taxes that involve considerable economies of scale in tax administration should be assigned to the federal government (Tanzi and Zee 2000; Bird 1999). This leaves immovable bases or local activities as suitable tax bases for regional governments. In practice, however, the assignment of tax bases has as much to do with politics as with economic principles.

## 3 Subnational VAT in practice

The model VAT operates as a tax on final consumption, a goal that is achieved through two design features. The first is an input tax credit system that allows businesses to recover VAT paid on inputs so the burden of tax falls only on final consumers, and the second is a rule that zero-rates exports and taxes imports, removing all taxes in the place of supply and allowing full taxation in the place of consumption. These features are found in almost all national VATs, and assume the existence of border controls around the jurisdiction. It is, accordingly, very difficult to implement these principles using regional VATs within a single market where there are no border controls between parts of the same market (Dahlby 2001), and historically subnational VATs were considered to be infeasible (Bird 1999).

Efforts seeking to allocate VAT revenue to regional governments have developed a wide range of models to achieve this aim that roughly fall into six variations, in addition to the Ethiopian system described further in the following section.

### 3.1 Single national tax

The simplest model used to allocate VAT revenue to regional governments is that used in Germany, Austria, Belgium, Spain, Russia and Australia: a single national VAT with revenue distributed to regional governments on the basis of a formula. In the German case, about half of VAT revenue is hypothecated for distribution to the regional governments (Bird 2013), with distribution based primarily on population subject to an equalisation factor for revenue capacity. In Australia, 100 per cent of revenue from the national VAT is distributed to the states for equalisation purposes.

### **3.2 Separate regional government VATs and a multiple element allocation regime**

At the other end of the spectrum of systems to allocate VAT revenue is the EU model of exclusive subnational VATs collected by local jurisdictions, with a proportion of the net collection paid to the central authority (the EU). The system was relatively easy to operate when member states of the single economic union retained borders for tax purposes – cross-border sales within the union could be subject to border adjustments – but new systems were needed once all tax borders disappeared within the single economic union. Following several decades of experimentation, a multiple-element regime is in place with different rules for cross-border supplies to registered and unregistered customers, and, in the latter group, different rules for supplies of goods and selected services.

In the case of cross-border intra-EU supplies to registered customers, supplies are zero-rated to the supplier and taxed in the hands of the customer by means of a ‘reverse charge’ rule. Cross-border intra-EU supplies of goods and many services to unregistered customers are subject to VAT in the jurisdiction in which the supplier is located. Supplies of a limited class of services delivered by the web or electronic transmission are subject to tax in the supplier’s jurisdiction, but at the rate of the customer’s jurisdiction. The tax is distributed to the customer’s jurisdiction through a central clearing house.

The unique system used in the EU reflects the range of compromises needed to integrate separate member states’ VAT systems into a common market. With the exception of the small number of original members belonging to the European Economic Community, the EU’s predecessor, all member states had national VAT systems in place prior to joining the EU, and those remained in place following accession to the EU. The resulting system seriously compromises many fundamental principles of VAT, imposing significant compliance costs on business, high costs of administration, and, most importantly, departing from one of the basic design principles of VAT – the notion that the supplier should be indifferent to the tax status of the customer. Instead, in the current EU system businesses must determine the tax status of all out-of-state customers prior to making a supply. In recent years, a number of jurisdictions outside the EU have adopted similar place-of-taxation rules for non-resident enterprises making electronic supplies to final consumers in those jurisdictions, creating similar compliance issues.

### **3.3 Canadian four-variation systems**

A third model found in Canada combines four separate systems in a single political economic community. As with the EU outcome, the unique Canadian structure reflects the distinct history and political relationships in that jurisdiction, particularly the special relationship between the only majority French-speaking province, Quebec, and the national government. In one province, the federal GST is the only sales tax levied. In three provinces, the federal government imposes federal GST on supplies, and provincial governments impose and administer separate retail sales taxes (RSTs). In five provinces, provincial VATs are imposed as surcharges on federal GST, yielding what is known as Harmonized Sales Tax (HST). The HST is administered exclusively by the federal government, and the provincial share of the combined taxes are distributed on the basis of place of consumption, calculated by reference to national accounts data rather than tracking of actual individual supplies. Finally, one province, Quebec, imposes its own provincial VAT, the Quebec sales tax (QST), in addition to the federal GST (Bird 2013).<sup>6</sup> The QST is similar, but not identical, to federal GST.<sup>7</sup> An agreement reflecting Quebec’s unique political status in the Canadian federation has resulted

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<sup>6</sup> QST and GST rates are 9.975% and 5% respectively.

<sup>7</sup> e.g. as Bird (2013) notes, the QST restricts input credits related to goods such as fuel.

in the Quebec tax administration collecting provincial QST and federal GST, as well as out-of-province HST where Quebec firms operate in HST jurisdictions.

For over twenty years, Quebec has been the only subnational jurisdiction in the world to operate an independently administered destination-based VAT (Bird 2013). While the QST-federal GST arrangements in Canada have proven to be administratively feasible and capable of dealing with cross-border trade between registered firms, businesses subject to the two taxes may face higher compliance costs than their counterparts in provinces using the single HST (Bird 2014), although others suggest the additional costs may be minimal (Plamondon and Zussman 1998). The unique system reflects Quebec's goal of political and fiscal autonomy within a national federation, and federal accommodation of that goal in the interest of political harmony.

### **3.4 Parallel national and subnational VATs**

Until 2017, the national and state governments in India imposed an array of indirect taxes, including a tax on the manufacture and production of goods, a tax on specified services and a tax on interstate sales of goods, while states levied separate taxes on goods (OECD 2012; Mukherjee 2017; Sen 2015). While it was long recognised that the inefficient tax system, and in particular cascading taxes, acted as a restraint on economic growth, political and constitutional constraints precluded reform of the complex overlapping and cascading tax regime. With constitutional reform and political agreement in 2017, the array of central and state taxes were abolished in favour of a dual GST regime based on a national GST and separate state GSTs. The state GSTs, administered locally, apply to supplies made within a single state. Interstate supplies and imports are subject to a separate integrated GST collected by the central government (GST Council 2017). The state portion of the integrated GST tax passes to the state of the buyer with appropriate transfers of input tax credits.

### **3.5 Revenue allocation on the basis of place of sale**

Until 2016, indirect taxation in China was divided between a VAT imposed by the central government on the supply of goods, and a separate 'Business Tax' imposed by provincial governments on the supply of services (albeit on the basis of a central government regulation). Since 2016, VAT on goods and services has been levied as a national tax, with a share allocated to the subordinate jurisdictions on the basis of place of sale.<sup>8</sup> This system causes significant economic distortions on a number of fronts. In effect, the supplying jurisdiction collects all the tax, even if consumption takes place in another jurisdiction. The problem is exacerbated in the case of business-to-business sales, if sales take place in one jurisdiction and input tax credits are claimed by customers in other jurisdictions. Local governments, seeking a share of tax revenue from the local operations of a company, may regard each branch as a separate taxpayer, leading to many complications for national enterprises with branches across the country.

### **3.6 Regional taxes on supplies of goods and rendering of certain services**

A sixth model can be found in Brazil, one of the first nations to levy a VAT. The national government levies a VAT (the Imposto sobre Productores Industrializados (IPI)),<sup>9</sup> mainly on the manufacturing sector, with rates varying by commodity and an average rate of around 20 per cent. Separately, the states levy VAT on the supply of goods and rendering of certain types of

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<sup>8</sup> For a transitional period of two to three years, VAT revenue will be equally (50:50) shared between the central and provincial governments. The current rule allocating the provincial share on the basis of location of the supplier remains in place (Shen and Krever 2017).

<sup>9</sup> Tax imposed on the sale of imported and domestic manufactured goods. This tax uses multiple rates which can be *ad valorem* or specific, thus varying depending on the type of the product and how essential it is (de Carvalho 2016).

services (Imposto sobre Circulação de Mercadorias e Serviços (ICMS)) (de Carvalho 2016).<sup>10</sup> The twenty-seven regional (twenty-six states and the federal district) ICMS are origin-based, with standard rates ranging from 17 per cent to 19 per cent on supplies within the state, and a federally-established rate of 12 per cent on interstate transactions (7% on goods sent to less developed regions) (Bird 2013). As a consequence of the 1988 Federal Constitution, ICMS is not imposed on exports (de Carvalho 2016). Each state has its own ICMS law, with different rates, exemptions and incentives.<sup>11</sup> While Brazil's regional VATs have, for over forty years, succeeded in providing very substantial own revenue to state governments (Bird 2013), because they only apply to a very limited number of services they are highly problematic from a tax policy perspective. Apart from omitting the growing economic sector from the tax base, a supposed border between goods and services becomes increasingly artificial as supplies are bundled in a modern economy. At the same time, the distinction between intra-state and interstate supplies adds many levels of complexity and distortions to the tax, seen in some quarters as the 'horrible example' that proves the point that VAT should be levied by national governments only (Bird 1999).

A large dispersion of effective rates across goods and services, across the national territory, and the predominantly origin-based system, facilitate the use of the ICMS as an instrument of industrial policy, and has led to predatory competition (fiscal war) among states through the granting of incentives to attract enterprises (Ter-Minassian 2012).

## 4 Allocation of VAT revenue in Ethiopia

The design of the Ethiopian VAT looks similar to other modern VATs. In practice, however, it follows a distinctive path shaped by constitutional boundaries and interpretations, and a chain of government decisions.

### 4.1 Constitutional and administrative background

Ethiopia is a federal state comprising nine regions, referred to as states in the 1995 Constitution, and two chartered cities treated as federal territory – Addis Ababa and Dire Dawa. The FDRE Constitution identifies three groups of revenue sources that are assigned either exclusively to the federal government (Art. 96) or states (Art. 97), or jointly to both levels of government (Art. 98):

Taxes assigned exclusively to the federal government include:

- Income tax on employees of the federal government and international organisations;
- Income, profit, sales and excise taxes on enterprises owned by the federal government;
- Tax on the income and winnings of national lotteries and other games of chance;
- Taxes on the income of air, rail and sea transport services; and
- Taxes on the income of houses and properties owned by the federal government.

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<sup>10</sup> In addition to IPI and ICMS, the following consumption taxes are imposed: Social Integration Program (PIS) - a federal cumulative tax on goods and services; Contribution for the Financing of Social Security (COFINS) - a federal cumulative tax on goods and services; Contribution of Intervention in the Economic Domain (CIDE) – a federal single-stage tax on gasoline and diesel; and Tax on Services (ISS) - a municipal cumulative tax on services.

<sup>11</sup> While states set their own tax rates on intra-state transactions, the ICMS imposed on interstate trade is constrained by national rules for the ICMS, and is further regulated through several complementary laws. Each state establishes its own ICMS rate for intra-state transactions autonomously (de Carvalho 2016). Arretche (2007), cited in Bird (2013), also notes that the federal government not only establishes what states and municipalities can tax, but may also specify the conditions under which they can exercise their fiscal authority.

Taxes assigned exclusively to states include:

- Income taxes on employees of the state and private enterprises;
- Taxes on the income of private farmers and farmers incorporated in cooperative associations;
- Profit and sales taxes on sole traders carrying out business within their territory; and
- Profit, sales, excise and personal income taxes on the income of enterprises owned by the states.

Taxes assigned concurrently to both the federal government and states:

- Profit, sales, excise and personal income taxes on enterprises they jointly own;
- Taxes on the profits and sales of companies and on dividends due to shareholders; and
- Taxes on incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operations.

As the Constitution pre-dates VAT, the document contains no assignment of the power to levy VAT. Anticipating the possibility of new taxes not included in the document, the Constitution separately grants the House of Federation and the House of Peoples' Representatives the power to assign taxing rights over bases that are not specified in the Constitution when sitting in a joint session.<sup>12</sup> The two Houses met jointly in 2002, prior to the commencement of VAT, to assign the power to legislate VAT.<sup>13</sup> The joint decision was to assign all rights to legislate VAT to the federal government, while leaving the administration responsibility undecided.<sup>14</sup> The Proclamation establishing VAT was enacted in 2002,<sup>15</sup> and the tax commenced in 2003. Importantly, the Proclamation was silent on the question of how revenue would be allocated.

An issue crucial to subsequent decisions regarding administration of VAT and allocation of VAT revenue was the relationship between VAT and the sales tax it replaced. While the right of the federal government to legislate VAT derived from a decision by a joint session of the House of Federation and the House of Peoples' Representatives, the power to levy sales tax had been constitutionally divided between the different levels of government. Article 97(4) of the Constitution granted state governments exclusive power to impose sales tax on sole traders, and Article 98(2) gave the state and federal governments concurrent power to impose sales tax on private companies.<sup>16</sup> Recognising the practical difficulties of jointly imposing and collecting taxes assigned to both levels of the government, the House of Peoples' Representatives and the House of Federation amended Article 98 of the Constitution dealing with concurrent power of taxation. The amendment exclusively assigned the power of imposing and collecting revenue to the federal government; this had been assigned to both the federal government and regional states. The exclusive assignment of taxing rights and collection responsibilities to the federal government did not, however,

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<sup>12</sup> Constitution, Art. 99.

<sup>13</sup> Minutes, House of Federation and House of Peoples' Representatives joint session held on Miazia 3, 1994 EC (2002).

<sup>14</sup> Minutes, House of Federation and House of Peoples' Representatives joint session held on Miazia 3, 1994 EC (2002). On the other hand, a decision report by House of Peoples' Representatives' Budget and Finance Affairs and Legal and Administration Affairs Standing Committees on the draft VAT law, Sene 27, 1994EC (2002) shows that the decision by the joint session of two houses was on the assignment of the rights of levying and collecting a VAT to the federal government.

<sup>15</sup> VAT Proclamation No. 285/2002.

<sup>16</sup> The assignment of sales taxes imposition and collection rights over private companies is not apparent in English translations of the Ethiopian Constitution. The Amharic version of Article 98(2) of the constitution assigns sales taxes from companies to both tiers of the government. As taxing rights over state-owned, federal government-owned, and jointly state- and federally-owned enterprises are assigned to those governments in Articles 96(3), 97(7) and 98(1) respectively, the reference to 'companies' in the Amharic version of Article 98(2) can only be read as a reference to private companies.

impact the division of revenue between the two levels of government that held concurrent taxing rights. Separately, Article 62(7) of the Constitution left the allocation of revenue from concurrent taxes to be decided by the House of Federation.<sup>17</sup> The House of Federation divided tax revenue from all concurrent taxes,<sup>18</sup> allocating 70 per cent of the sales tax payable by private companies to the federal government, and 30 per cent to state governments.

On the face of it, the replacement of sales tax with VAT altered the fiscal landscape in Ethiopia significantly. As a result of the Constitution and an explicit legislative decision, the states had formerly enjoyed the right to all revenue from sales tax paid by sole traders and 30 per cent of the sales tax paid by private companies, as well as 100 per cent of the sales tax paid by state government-owned companies. The power to enact and collect VAT had been assigned exclusively to the federal government,<sup>19</sup> but there was no legislative guidance on how VAT should be distributed, and the decision of the joint session of the two Houses that handed enactment rights to the federal government did not consider the issue of who should administer VAT.<sup>20</sup> However, prior to this joint decision, each House separately debated the proposed assignment; minutes of the debate in the House of Federation reveal the expectation of representatives that VAT revenue would be divided in the same manner as its predecessor, the sales tax, notwithstanding the exclusive assignment of the right of enacting the tax to the federal government.

In the absence of clear legislative direction on the administration and assignment of VAT revenue, implementation of VAT commenced in 2003 with the Ethiopian Customs Authority collecting the tax on imports, and the Federal Inland Revenue Authority (FIRA) responsible for collecting the tax on domestic transactions. Initially, FIRA unilaterally divided all VAT revenue between the federal government and states, with 70 per cent transferred to the federal government and 30 per cent to the states.<sup>21</sup> No allocation of VAT revenue from companies was made to the two chartered cities, Addis Ababa and Dire Dawa, which technically are federal government territories though they effectively function similarly to states.

The assumption of responsibility by FIRA to administer VAT in respect of all types of taxpayers proved problematic. FIRA was not in a position to administer VAT effectively across the entire country, as it had no offices in smaller regional centres and limited capacity elsewhere to bring small taxpayers formerly administered by regional revenue authorities into the VAT net. The result was highly differential tax treatment between VAT-registered companies and largely unregistered sole traders.

A year after the official commencement of VAT, the Ministry of Revenues, recognising FIRA's limited capacity and using its tax administration powers,<sup>22</sup> delegated the responsibility for applying VAT to sole traders to the states and chartered cities on behalf of FIRA. At the

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<sup>17</sup> Minutes, House of Federation and House of Peoples' Representatives joint session held on Miazia 2, 1989 EC (1997) confirm the decision in the meeting to number the proclamation as 71/1989 EC (1997). However, in interviews conducted by the researchers, some representatives noted that the amendment to the constitution was not officially proclaimed as a law in *Negarit Gazette*, the official Gazette.

<sup>18</sup> FIRA, letter to branch offices to communicate House of Federation's decision on concurrent taxes allocation formula dated *Nehassie* 21, 1995 EC (2003).

<sup>19</sup> Interviews with officials from government agencies covered by the study.

<sup>20</sup> Minutes, House of Federation and House of Peoples' Representatives joint session held on Miazia 3, 1994 EC (2002) are silent on the assignment of VAT collection responsibilities to the federal government.

<sup>21</sup> Ministry of Revenues, letter to delegate regional states and city administrations for the administration of VAT payable by sole traders, *Nehassie* 05, 1996 EC (2004), implies that FIRA had initially divided all VAT revenue (paid by sole traders and private companies) using the formula adopted by the House of Federation for sales tax revenue from companies. On the other hand, interviews with officials were mixed. Some respondents indicated that, before the delegation in 2004, FIRA used to transfer 100% and 30% of VAT payable by sole traders and private companies respectively to regional states, while other respondents confirm what is implied in the letter to delegate regional states.

<sup>22</sup> FIRA re-establishment proclamation No 367/1995 EC (2003) provided legislative authority for these actions.



same time, the Ministry of Revenues indicated the state administrations could allocate 100 per cent of VAT revenue from sole traders to the regional governments, restoring the former sales tax allocation approach.<sup>23</sup> FIRA retained responsibility for applying VAT to private companies, and continued to apply the 70 per cent-30 per cent division of VAT revenue from companies that it had adopted initially. The division of responsibilities and revenue entitlement agreements continued, in effect, after 2008 when the Ethiopian Customs Authority, responsible for collection of VAT on imports, and FIRA were amalgamated into the Ethiopian Revenue and Customs Authority (ERCA) in 2008.

## 4.2 The source of VAT revenue

Articles 51(10) and 52(2e) of the FDRE Constitution empower the federal government and regional states respectively to levy and collect taxes and duties on revenue sources reserved to each of them. FIRA interpreted the source of sales tax revenue to be the state in which the supplier was located.

Unlike a sales tax based on specific transactions, income tax is based on a calculation of annual income and expenses, making it difficult to attribute to particular events or locations. Recognising this constraint, the Council of Ministers issued a surrogate source of income rule for the income tax. Specifically, the assignment of income tax revenue follows the place of declaration, which, in turn, refers to the place at which a sole trader is registered or a private company is incorporated.<sup>24</sup> Following the commencement of VAT in 2003, FIRA transmogrified the source of income rule and treated the source of VAT to be the place of registration or incorporation. As the place of registration or incorporation coincided with the place of Tax Identification Number (TIN) issuance for businesses, FIRA simply applied the place of TIN issuance universally as the source of VAT revenue.<sup>25</sup> Following the delegation of VAT administration to state revenue bureaus in 2004, FIRA, and later ERCA, continued to attribute VAT revenue to the place of TIN issuance of the supplier and state revenue bureaus used the same test when assessing sole traders.

# 5 Consequences of the current VAT source and allocation rules

The decision to allocate all VAT revenue from sole traders and a portion of VAT revenue from private companies to the states, together with the administrative decision to attribute the source of VAT revenue to the place of TIN issuance, has led to a number of undesirable outcomes. These include concern over the lack of an adequate legal framework, and inappropriate revenue transfers, in particular a shift of VAT revenue from less wealthy to wealthier states, and, in some cases, from one zone to another within a regional state. The latter primarily applies in SNNP regional state.

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<sup>23</sup> Ministry of Revenues, letter to delegate regional states and city administrations for the administration of VAT payable by sole traders, dated Nehassie 05, 1996 EC (2004).

<sup>24</sup> Article 23, Council of Ministers' Income Tax Regulations No 78/2002, provided that declaration of income would be made to the federal or regional tax authority, as appropriate. Specifically, it had been provided that if a resident taxpayer was engaged in more than one business activity, the declaration should be to the tax authority where the head office of the business is situated. Similarly, non-residents were required to declare their income to the tax authority where most of the income was derived. However, effective from 8 July 2017, these regulations were repealed and replaced by new regulations which appear to be silent on these matters.

<sup>25</sup> Interviews with federal authorities.

## 5.1 Lack of an adequate legal framework

The assignment of the exclusive power to enact a VAT law to the federal government, through a joint session of the House of Federation and the House of Peoples' Representatives, directly followed the process clearly set out in the Constitution for the adoption of new taxes that are not enumerated in the allocation Articles of that document. The decision by FIRA, through a letter issued by the Minister of Revenues, to delegate responsibility for collection of VAT from sole traders to state revenue authorities lay within FIRA's administrative powers to use agents where appropriate, powers that were inherited by ERCA. The only piece of the puzzle lacking a clear constitutional or legislative authority appears to be the decision of the Ministry of Revenues to allow state revenue authorities to retain 100 per cent of the VAT they collect from sole traders, and to apply the 70 per cent federal-30 per cent state sales tax division to VAT from companies. The outcome, in terms of VAT paid by sole traders and private companies, may very well reflect an assumption by the House of Federation's representatives that VAT should be allocated in the same manner as its predecessor, the sales tax. However, the states remain vulnerable so long as decisions like this rest in the hands of the federal ministry. In the absence of adequate legislative authority the states have no revenue security, while the decision impacting on revenue allocation undermines the process of effective fiscal federalism.

## 5.2 State cross-subsidy of import VAT

If VAT on imports were treated similarly to other VAT remitted by businesses, states would receive 100 per cent of import VAT collected from sole traders and 30 per cent of import VAT paid by private companies registered in the jurisdiction. Although some officials report that VAT paid by businesses on imports is periodically transferred to the state in which the importers are registered, the general consensus is that this revenue is retained by the federal government. There is some confusion concerning the basis for this retention, with some officials asserting constitutional authority for the policy on the basis of the constitutional assignment of taxes and duties on trade to the federal government.<sup>26</sup> This view may reveal a misunderstanding about the nature of trade taxes and VAT. A trade tax, such as customs duty, falls on imports. In contrast, a VAT is a tax on final consumption,<sup>27</sup> and its imposition on imports by registered businesses and domestic sales to registered businesses is more akin to a withholding tax that is recovered fully by importers by way of deduction from tax collected on later sales.

The historical precedent of sales tax divisions seems to have played an important role in guiding the current practice of allocating VAT revenue as it applies to domestic sales, but has not extended to VAT collected on imports. One consequence of the structure of VAT as a tax on final consumption is a cross-subsidy of final tax by states to the federal government if it is assumed that VAT should apply to final consumption. As noted, the mechanism used to enable traders to recover VAT paid on imports allows importers to deduct an amount equal to the import VAT that was paid to the federal government at the time of importation from tax collected on sales to final consumers. The full tax is paid by final consumers, but the smaller amount is remitted to state revenue authorities. The federal government has already received VAT on imports, so the effect of offsetting VAT deduction is a loss to the state government of 100 per cent of the amount deducted in the case of a sole trader. If the importer is a private company, the federal government would receive 70 per cent of the revenue had there been no prepayment of VAT by way of import VAT. This means the deduction for import VAT only costs the state 30 per cent of the amount deducted. In both

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<sup>26</sup> This group includes a respondent from ERCA responsible for the transfer of revenue from the federal government to regional states.

<sup>27</sup> Under destination principle, one of the core features of VAT, as a tax on consumption, is that revenue should accrue to the jurisdiction where the final consumption takes place (OECD 2011). (See further Appendix 1.)

cases, tax paid by local consumers in the states in which traders are located is shifted through the traders to the central government, an outcome inconsistent with the generally assumed assignment to states of 100 per cent of VAT paid to sole traders and 30 per cent of VAT paid to private companies.

### 5.3 Fragmented market cross-subsidies

VAT was designed to operate as a consumption tax within a single market. Registered businesses offset input tax deductions for tax paid on purchases anywhere in the country against output tax collected from customers anywhere in the country. Serious cross-subsidy consequences follow, however, if the single market is artificially segmented into regions for VAT purposes.

Technically, the actual source of VAT revenue is the destination where the tax is actually borne by a person consuming goods or services.<sup>28</sup> As noted, for simplicity and practical reasons, FIRA initially, and its successor ERCA, have used the place of issuance of TINs of a seller as a surrogate identifier of the 'source' of VAT paid by the business' customers. This policy choice reflects the difficulty of determining the contribution of each branch operating in different regional states to the VAT payable by an entire business.

The place of registration for TIN purposes and the place of supply and consumption may coincide for many small sole traders, but are equally likely not to coincide for large incorporated enterprises. Very large enterprises, in particular, often incorporate and register for TIN purposes in the large economic centres – chartered cities – prior to establishing actual operations elsewhere in the country, depending on the nature of the investment. Because VAT revenue is allocated on the basis of the place of TIN issuance, the states in which sales and consumption actually take place effectively subsidise the federal government, which collects the tax in the chartered city in which the seller is registered.

Further cross-subsidies arise in the case of business-to-business interstate supplies. If the customer is a VAT-registered business, the tax remitted by the seller in its state will be claimed as deduction in the buyer's state, reducing VAT revenue in the customer's state by the amount retained by the seller's state. The allocation of revenue in one place, and offsetting reduction in another, is equivalent to a cash subsidy from one government to another of between 30 per cent and 100 per cent of VAT collected, with the exact amount of the subsidy depending on the location of the supplier and customer and the legal status of the supplier and customer (company or sole trader). The twelve different effective subsidy regimes are illustrated in Appendix 2.

In theory, if there were equal value sales between all types of traders and between all jurisdictions in Ethiopia, the cross-subsidies from jurisdiction to jurisdiction could cancel each other out. The economic reality on the ground makes this impossible, however. It is usually the case in federal jurisdictions that wealthier states house enterprises that make supplies to other regions, and poorer states are those acquiring high-value supplies from enterprises in wealthier states.<sup>29</sup> Ethiopia is no exception to the general rule, and, as a result, in the case of business-to-business transactions, when VAT is levied on the basis of the supplier's place of

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<sup>28</sup> Under the destination principle, exports are free of VAT and imports are taxed on the same basis and at the same rate as local production. Exports are made free by zero-rating them, so there is no VAT imposed on the export sale, but the exporter is able to recover all input tax incurred on acquisitions used to make the export sale. Destination-based VAT imposes the tax on commodities in the country of consumption. On the other hand, the origin principle would see tax imposed in the country of production - exports would be taxable in the country of the exporter, while imports enter the importer's country free of VAT. (See further Appendix 1.)

<sup>29</sup> The exception to this general rule is where a resource-rich state, which is entitled to royalties for the sale of natural resource imports from wealthy industrial and commercial states in the same federation. The most important example of this is the Canadian province of Alberta, a jurisdiction lacking extensive industry but enjoying royalties for oil and gas extracted in the province.

registration, there is an explicit transfer subsidy from less wealthy states to wealthier states and the federal government.

#### **5.4 Intra-state subsidies**

In most Ethiopian regional states, VAT revenue accruing to the state government directly from sole traders, and via the federal government in the case of private companies, is applied around the state through the state's expenditure programme. The practice is not universal, however. In the SNNP Region, the government seeks to accommodate the different interests and priorities of the vast array of ethno-linguistic groups in the state by allocating VAT revenue to lower-tier governments (zones/woreda) on the basis of the zone in which the seller's TIN was issued.<sup>30</sup> All the cross-subsidy problems inherent in interstate sales noted earlier are replicated within the SNNP Region where businesses in one part of the state make sales to customers in another part.

The complications are compounded in the case of VAT payable by private companies. The federal government calculates the VAT to be transferred to a state government on a state-wide basis, combining net receipts from all incorporated persons with TIN registrations in the state. The state receives 30 per cent of the VAT revenue collected from these businesses with no detailed information about the taxpayers from which the revenue was collected or their location within the regional state. The state is thus unable to distribute the revenue on time on its preferred basis of source, as identified by the place of registration of the supplier.<sup>31</sup>

#### **5.5 Administration aspects of fragmented VAT**

Following the delegation of all administrative responsibilities regarding the application of VAT to sole traders to state revenue authorities by FIRA through the Ministry of Revenues' letter, and subsequently retained by its successor, ERCA, both the federal government and state revenue authorities administer VAT. The federal government's footprint is small – in addition to a single Large Taxpayer Office for Addis Ababa and its surroundings, and two branch offices in the capital Addis Ababa,<sup>32</sup> it has only seven branch offices for the rest of the country for domestic VAT and VAT on international trade.<sup>33</sup> It has a further eight customs offices only administering taxes and duties on international trade, including VAT on imports,<sup>34</sup> and separately the Addis Ababa chartered city has delegated responsibility for administering the city's taxes to ERCA.<sup>35</sup>

The structure of the state revenue authorities that are responsible for administering VAT to the vast majority of registered enterprises follows the general governance structure adopted in each state. Below the capital city headquarters are subordinate offices in zones, cities, sub-cities and finally woreda levels. VAT is consequently being administered by the largest offices of the national revenue authority, down to the smallest local offices of state authorities. While there is no doubt that very local tax offices have advantages in terms of knowing local businesses and being in a position to offer frontline services, capacity clearly diminishes as the distance along the chain from central offices increases. At the bottom of the chain, woreda revenue authorities cannot access staff with the training and experience

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<sup>30</sup> Interviews with officials from a regional revenue authority.

<sup>31</sup> Interviews with officials from a regional revenue authority.

<sup>32</sup> These are the West Addis Ababa Branch and the East Addis Ababa Branch.

<sup>33</sup> These are located in Mekelle, Adama, Hawassa, Bahir Dar, Jimma, Dire Dawa and Kombolcha. These branch offices administer both domestic taxes, and taxes and duties on international trade.

<sup>34</sup> These are the Addis Ababa Kaliti, Addis Ababa Airport, Mojo, Gallafi, Jigjiga, Moyalle, Djibouti and Millie customs branch offices.

<sup>35</sup> To carry out this service, ERCA has 14 tax centres (10 small taxpayers' branch offices and 4 medium taxpayers' offices) and over 100 woreda micro taxpayers' offices.

available in higher-level offices, have limited access to technology, particularly access to central records and communication, and have little or no lines of communication to revenue authorities in other states or to ERCA.

Following a brief interlude, during which the ill-equipped FIRA attempted to apply the new tax nationwide, administration quickly reverted to the divided federal government and state government system that had been in place for the earlier sales tax. The outcome is very troublesome from a VAT administrative perspective. Unlike the sales tax, which was based solely on sales, VAT is collected as a net amount calculated as output tax on sales minus input tax incurred on acquisitions. Administration requires integrated systems that monitor both acquisitions and supplies, and track transactions through supply chains. That is, one enterprise's net VAT is checked against the acquisitions of their business customers and the sales of their business suppliers. At the same time, input tax deductions claimed for imports are checked against customs records, and tax-free export sales are verified by reference to customs records. This process could only be followed in a fragmented administration system if all federal and state authorities, and all levels of administration within states, had immediate access to the full data of all other offices administering aspects of VAT. There is no indication that this will be achieved in the near future in Ethiopia.

## 6 Reform alternatives

In terms of its legal form, Ethiopian VAT resembles that of other jurisdictions, imposing a tax on final consumption by taxing all sales, but providing businesses with full deductions for VAT included in the cost of their acquisitions. However, the revenue is distributed between the federal government and states, and, in the case of interstate sales, between states, by reference to the legal form of the business and its place of TIN issuance. These rules have the effect of shifting the tax from a tax on consumption to a tax on suppliers, with states in which consumption takes place often subsidising the states in which suppliers are located or the federal government. At the same time, multiple agency administration of the single tax limits the prospect of full, fair and effective application of the tax. Reform of the tax system would address the allocation problem and provide an integrated administration regime.

The starting point for consideration of reform options must be the fiscal purpose of VAT. In all scenarios it can be assumed that VAT will be used, as was its predecessor, the sales tax, in part to fund the responsibilities of the federal government, and in part to provide revenue to state governments. Sharing VAT revenue could be used to achieve one of two goals: national social equalisation objectives or fiscal autonomy aims. While successful models for both types of systems are available, none are compatible with the current division of VAT revenue and administrative responsibilities between the federal government and state governments on the basis of legal form of a business.

### 6.1 A fiscal equalisation VAT

Whether a federal jurisdiction adopts a fiscal equalisation regime to distribute some portion of tax revenue will depend on the country's notions of national development and social justice. If many social services are provided by local governments and the country is committed to ensuring equal access to basic services for all citizens, the country is likely to adopt a fiscal equalisation formula to allocate a portion of national revenue to each state. Canada and Australia provide examples of countries with a strong commitment to fiscal equalisation principles and guaranteeing access to basic services for all citizens. Other jurisdictions, such as the United States, have no fiscal equalisation regime in place, and instead rely on specific federal government social programmes to make some services available to all citizens.

A fiscal equalisation objective for VAT is best achieved through a national tax with revenue (or a portion of revenue) distributed on the basis of a formula that takes into account the social needs and revenue-raising capacity of each state.

To date, all countries using fiscal equalisation formulas for VAT have a single national tax authority responsible for administering the tax, to ensure fair and efficient administration across the nation. This does not mean, however, that a fiscal equalisation system could not operate in the context of the current administrative arrangements in Ethiopia. The principal problem with the current system, which allocates revenue on the basis of place of TIN issuance, is cross-subsidisation in the case of interstate transactions or imports, with VAT payable in the state of supply (or supplier's TIN issuance), or federal government in the case of imports, and an offsetting tax reduction in the place of purchaser in the case of business-to-business sales. This problem disappears if all revenue were pooled and distributed on the basis of a formula. Such a system would not require actual transfers of funds in many cases – provided the integrity of information sharing could be ensured, the equalisation distributions could be offset against the retention of funds collected by each jurisdiction, with minimal correction transfers required to ensure there is no cross-subsidisation from poor jurisdictions to wealthier jurisdictions.

Two arguments have been made in opposition to a fiscal equalisation system for distributing VAT revenue. First, it is said that the adoption of a central fiscal equalisation system for VAT will undermine regional tax autonomy and regional tax administrative capacity. Both concerns can be addressed. While a shift to fiscal equalisation will affect the distribution of revenue from this particular tax, it will not impact on tax autonomy in all other respects, in particular with respect to regional states' capacity to levy local taxes. A shift also need not impair administrative capacity if current collection and assessment arrangements remain in place, with the central government overseeing any transfers needed to redistribute revenue as required.

The second concern with a fiscal equalisation formula is that it undermines local tax collection efforts if greater locally-sourced revenue will reduce entitlements under the fiscal equalisation regime. This concern can be addressed by a fiscal equalisation formula that does not reduce entitlements on a one-to-one basis with alternative revenue derived directly by state governments.

A starting point for the development of a fiscal equalisation formula could be the House of Federation's formula currently used for federal general purpose grants. This formula seeks to fund the gap between a measurement of selective tax sources that contribute more than 90 per cent of the regional states' total revenue and selective expenditure that accounts for more than 90 per cent of states' outlays. While the formula has been criticised for its failings regarding the use of reliable and up-to-date data (Negussie 2015), it can be modified to address the noted shortcomings and potential impact on tax effort.

## **6.2 Fiscal autonomy VATs**

Fiscal autonomy VATs fall into two broad categories. A system of full fiscal autonomy allocates VAT revenue to subordinate jurisdictions in which consumption actually takes place, and allows each subordinate jurisdiction to both administer its own VAT and set its own rates, encouraging local efficiencies and accommodating different social expectations. A system allowing for limited fiscal autonomy seeks only to allocate VAT revenue to subordinate jurisdictions in which consumption actually takes place, and allows local rate differentials.

An example of the full fiscal autonomy model is Canada's federal GST and QST arrangement. Specifically, the provincial VAT used in Quebec, along with a single tax

administration to collect local government and central government VAT, provides a model for a subnational VAT that provides local fiscal autonomy, while avoiding economic distortions by base conformity on all important aspects with the federal VAT that might affect compliance costs (Bird 1999). It replicates the complexity of all destination-based systems that seek to allocate taxes to the place of consumption, requiring merchants to distinguish intra-provincial and inter-provincial sales. It also requires a sophisticated tax administration at the regional government level, and the full exchange of information between central and subnational tax administrations (Bird 2013). The special political relationship between Quebec and the federal government in Canada explains why only one province in the country uses this system. In the Ethiopian context, it would require a complete change in the division of tax administration responsibilities, changing from a system based on the legal form of businesses to a jurisdictional system, with each state responsible for all VAT in the state regardless of the form of the business.

The limited fiscal autonomy model is also best illustrated with a Canadian example – the Canadian harmonized sales tax, based on a federal law, collected by the federal revenue authority but effectively set as a surcharge on the federal goods and services tax, with each participating province choosing its own rate of tax. Revenue is allocated to participating provinces on the basis of consumption, which is determined using national accounts rather than tracing individual supplies.

Many of the elements of this system could be adopted in Ethiopia, even in the context of its current administration system. It would be simple to supplement the federal tax with state surcharges that possibly vary from state to state, and have the federal government and states continue parallel administration responsibilities for the combined taxes, with revenue notionally pooled to be distributed on the basis of consumption. The systems would involve an additional cost to businesses, however, as vendors would have to ascertain and collect VAT based on the rate imposed in the customers' home states, rather than the rate in the vendor's state, if the state surcharge rates differed from state to state. The key drawback to this option is the difficulty of allocating revenue on the basis of consumption. The Canadian formula for determining where consumption has taken place is complex, and relies on very precise and detailed data from national accounts – information that is not available to the same extent in Ethiopia, where even subnational GDP measurements are incomplete. It would be even more difficult to allocate VAT revenue within a state such as SNNP Region on the basis of consumption.

In the absence of comprehensive data to measure accurately consumption by way of national data, the place of consumption could be determined by tracking individual supplies and the establishment of a clearing house to allocate input tax credits and output tax on sales for final consumption. The most successful of these is the clearing house system used in the EU. The European example shows that a clearing system that allows different tax rates in each subordinate jurisdiction is a viable alternative. At the same time, however, it demonstrates the levels of complexity imposed on businesses making interstate sales, and shows that the coordinated sharing of information is needed for the clearing house to work effectively. Current capacity in revenue offices is not sufficient to support the tracing and clearing house option, but it could be viable if full computerisation and communication facilities were installed in all offices nationwide administering parts of VAT. This is also true in the case of intra-state divisions of revenue, such as that currently required in SNNP Region, and which, given the political economy constraints, is unlikely to be changed. Any intra-state differentials in rate would add significant complexity to the system, however, as merchants would need to know the tax rate for each region within the state, as well as the rates for each state.

## 7 A path forward

Regional fiscal autonomy, including the adoption of different rates in different subordinate jurisdictions, is a feature of several VAT systems that operate at a subordinate level (e.g. the EU) or as a surcharge on a federal VAT (e.g. Canada). This has not been a feature of Ethiopian VAT, and given the challenges that will be faced implementing any significant reform of the current system, it would be most logical not to consider this option at present.

The primary shortcomings of the current system are, first, the limited capacity of tax administrations at the lowest level, and the very limited communication between different levels of government; and, second, the serious cross-subsidies, particularly from less wealthy regional states to wealthier states, which follow the allocation of taxing rights and tax revenue on the basis of TIN issuance rather than the place of consumption. In addition to limited administrative capacity, the most significant constraint to wholesale reform is that of path dependency. It appears to have been an assumption of the legislature, when VAT was adopted and assigned to the federal government for legislative purposes, that the division of revenue and administration would mirror the systems in place for the earlier sales tax, and this is the policy federal agencies and the ministry pursued. The fundamental difference between a sales tax and VAT – the deduction for input tax on acquisitions in VAT – appears to have been overlooked when the decision was made to allocate revenue on the basis of the place of TIN issuance of a business making taxable sales.

Major VAT reform would involve a complete overhaul of the tax administration and system for allocating VAT revenue. On the administration side, the federal revenue authority has conceded it lacks the capacity and resources to administer the tax at the local level. A full reform would thus see the consolidation of local and federal tax officials into a single national VAT administration, ensuring full administration of the tax in a comprehensive fashion, with full communication and information sharing across all aspects of collection, audit and enforcement of the tax. There would be no administrative schisms at state borders, or between similar businesses that have adopted different legal forms. On the revenue allocation side, the counterproductive cross-subsidies between states, most often from poorer to wealthier states, would be eliminated by the adoption of a system that maximises gains at a national level, with revenue collected by a single national authority and then distributed on the basis of a fiscal equalisation formula or on consumption. Simplicity would be achieved by avoiding rate differentials between states, leaving local fiscal differentials to be achieved through local taxes on less mobile subjects.

It is difficult to observe evidence of government or sectoral interest or fiscal drivers that might prompt wholesale reform of this sort. A far more realistic reform path is one of gradualism, which recognises and builds on the path dependency that has shaped the current VAT and its predecessor. Federal agencies seem to be comfortable with a division of administrative responsibilities based on the legal form of businesses, and with a division of revenue based on these forms.

Reform of tax administration can be gradual, commencing with the establishment of an administration coordination unit staffed with ERCA and state representatives. They would be responsible for overseeing the computerisation of all tax offices, developing communication and information exchange channels and processes, as well as joint audit and enforcement procedures, to ensure seamless and uniform administration of VAT across all types of enterprises and throughout the country.

Reform of the revenue allocation system is more challenging – any change from the existing system will produce winners and losers, and the losers under any revised allocation system are likely to include wealthier regions that possibly enjoy greater influence over general



policy. The Constitution is silent on the allocation of VAT revenue – the only legislative measure affecting VAT is the decision of the joint session of the House of Federation and the House of People’s Representatives providing the federal government with exclusive power to enact VAT law, without mention of the allocation of revenue and administration responsibilities. As noted, however, the assumption of the joint sitting was that the assignment of taxing rights to the federal government would not alter the fiscal arrangements previously in place for sales tax revenue. This assumption was bolstered by the recognition in the preamble to the VAT law that the tax was a successor to the sales tax.<sup>36</sup> The federal government readily acknowledges the precedent of the sales tax, and the expectation that it would apply a similar allocation to VAT. Also, the states continue to enjoy significant influence over the federal government, in part through their influence over representatives in the two houses.

The current system of allocating VAT revenue on the basis of notional place of supply (actually place of merchants’ TIN registration) could be replaced with a fiscal equalisation distribution or a place of consumption rule that eliminates the interstate and state-federal subsidies of the current system, while building on the current regime. Under a fiscal equalisation distribution system, all revenue could be reported to a central allocation office in MoFEC, which compares net retention in each state with entitlements under this scheme, and mandates transfers on a predetermined schedule where necessary. The shift from notional place of supply to fiscal equalisation could include transition rules that provide the greater of entitlements under the new rule, or the average revenue allocated in the three years prior to the shift for a transition period of three years, although this may require a larger contribution of federal funds for the transition period. The transitional rules could soften any opposition to the change by wealthier states.

In theory, an allocation based on place of consumption could follow the same model, with the allocation office using a consumption formula rather than a fiscal equalisation formula. Limitations in terms of national consumption data, and, in particular, sub-regional data in the case of SNNP Region, probably preclude this approach in practice, however. Slightly more cumbersome, but clearly workable, is a central clearing house that could operate in much the same fashion, but using information collected from state and federal agencies to allocate sales revenue, and input tax deductions appropriately to calculate any transfers that might be necessary. Transfers could easily be structured to involve no actual payments by states – in most, and possibly all, cases entitlements to more or less revenue could be accomplished by way of adjustments of federal transfers to states.

An important goal of the reform process, whichever reform path is followed, is the replacement of the current VAT allocation scheme operating in practice with formal legislation to ensure one of the most important elements of fiscal federalism in Ethiopia is founded on the basis of an adequate legal framework.

## 8 Conclusion

The current system for dual administration of VAT in Ethiopia and the allocation of VAT revenue on the basis of the place of supply (determined by the place of a supplier’s TIN issuance) is unique in almost all respects. No other federal jurisdiction divides responsibility on the basis of the legal form of a business, uses place of supply based on TIN issuance as the foundation for division of revenue, and no other federal jurisdiction with VAT-enacting

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<sup>36</sup> VAT Proclamation No 285/2002.

power assigned by law solely to the central government allocates revenue partly to states outside of any explicit legislative measures directing it to do so.

Modernisation of the tax administration regime is crucial for fiscal responsibility, and fair and efficient collection of revenue is needed to foster economic development in Ethiopia. Regardless of what other reforms might be contemplated, attention should be paid to information collection and sharing, and joint audit and enforcement activities where appropriate.

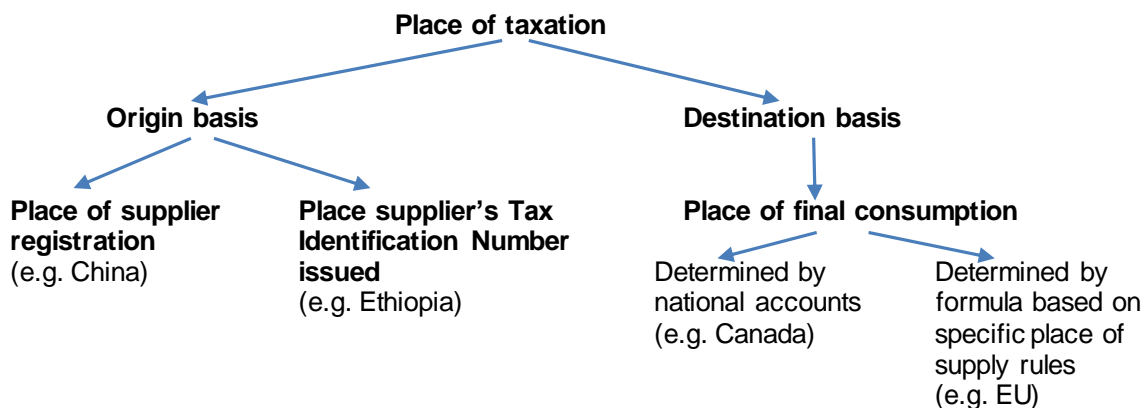
The choice between revenue distribution based on fiscal equalisation or place of consumption is a political judgment based on the government's vision for fiscal federalism in Ethiopia. Workable blueprints for either option are available.

Finally, a revenue allocation system that has evolved without explicit and adequate legislative direction should be replaced with one set out in legislation. Fiscal arrangements rooted in an explicit and adequate legal framework, including the rules prescribing any sharing of revenue between tiers of the government, are a cornerstone of a democratic federal state.

## Appendices

### Appendix 1 Origin-basis and destination-basis VAT

In the case of international and intra-federation cross-border VAT, revenue is allocated to the 'place of taxation'. However, this generic term has two very different meanings. Jurisdictions that seek to tax final consumption at the place of final consumption use a 'destination-basis' VAT, which defines the place of taxation as the place where the final consumption takes place. Jurisdictions that seek to tax supplies at the place the supplier is located use an 'origin-basis' VAT. In this system, the place of taxation is determined as the place where the supplier is registered or has its tax identification number issued.



All VAT systems operate on a destination basis for international purposes. Under this principle, no tax is imposed on exports and all tax incurred on acquisitions used to make exports is credited or refunded to the exporter. The exports thus leave the exporting jurisdiction free of any taxation. Local VAT is then imposed on the imports in the importing jurisdiction.

Within federal states that operate a single national tax, net VAT revenue is collected by the national government and distributed to regions using a formula system. Australia, for example, distributes all national VAT revenue on the basis of a fiscal equalisation formula.

Within federal systems in which each region is entitled to a share of VAT revenue based on actual supplies rather than a portion of the net national revenue, VAT revenue can be distributed through origin basis or destination basis. Where the place of taxation is determined by reference to the origin-basis principle, it can be the jurisdiction in which the supplier is registered for VAT purposes or the place where its TIN was issued (if this is different from the VAT registration number).

If the place of taxation is determined by reference to the destination-basis principle, it will look to the location at which final consumption take place. This can either be determined by using a formula based on national accounts data, or by applying specific destination-basis place of taxation rules tailored for each type of supply.

A number of VAT systems use the concept of the place of supply. In these jurisdictions, this is usually the place where the supplier is located. This is not synonymous with the place of taxation, which is determined by the interaction of VAT rules. For example, in the case of exported supplies, the place of supply will be the jurisdiction in which the supplier is located, but as a result of the zero rate rules and taxation of import rules, the place of taxation will be the jurisdiction in which consumption takes place.

## **Appendix 2 Cross-subsidies under current regime**

### **1. Supplier company in one state to different state customer company**

Supplier company sells for 100 + 15 to customer company

ERCA allocates  $.3 \times 15 = 4.5$  to supplier state

ERCA allocates  $.7 \times 15 = 10.5$  to federal government

Customer company claims an input tax credit (ITC) of 15, reducing its net VAT payable by 15.

Customer company state loses 4.5 revenue.

The tax collected by ERCA from the supplier company is offset by the tax saved by the customer company.

The **effective subsidy** by customer state to supplier state is **4.5**.

There is **no subsidy** by the customer state to the federal government.

### **2. Supplier company in one state to different state sole trader**

Supplier company sells for 100 + 15 to customer sole trader

ERCA allocates  $.3 \times 15 = 4.5$  to supplier state

ERCA allocates  $.7 \times 15 = 10.5$  to federal government

Customer sole trader claims an ITC of 15, reducing its net VAT payable by 15.

Customer sole trader state loses 15.

The **effective subsidy** by customer sole trader state to supplier company state is **4.5**.

The **effective subsidy** by customer sole trader state to the federal government is **10.5**.

### **3. Supplier sole trader in one state to different state customer company**

Supplier sole trader sells for 100 + 15 to customer company

State revenue authority retains 15.

Customer company claims an ITC of 15.

Customer company state loses  $.3 \times 15 = 4.5$  revenue.

Federal government loses 10.5 revenue

The **effective subsidy** by customer company state to supplier sole trader state is **4.5**.

The **effective subsidy** by the federal government to the supplier sole trader state is **10.5**.

### **4. Supplier sole trader in one state to different state sole trader**

Supplier sole trader sells for 100 + 15 to customer sole trader

Supplier state revenue authority retains 15.

Customer sole trader claims an ITC of 15, reducing its net VAT payable by 15.

Customer sole trader state loses 15 revenue.

The **effective subsidy** by customer sole trader state to supplier sole trader state is **15**.

### **5. Supplier company in chartered city to different state company customer**

Supplier company sells for 100 + 15 to customer company

ERCA allocates 15 to the federal government

Customer company claims an ITC of 15, reducing its net VAT payable by 15.

Customer company state loses 4.5 revenue.

Federal government has 15 revenue in chartered city and offsetting credit of 10.5 in customer's state, leaving it with net revenue of 4.5.

The **effective subsidy** by customer state to the federal government is **4.5**.

**6. Supplier company in chartered city to different state sole trader**

Supplier company sells for 100 + 15 to customer sole trader  
ERCA allocates 15 to federal government

Customer sole trader claims an ITC of 15, reducing its net VAT payable by 15.  
Customer sole trader state loses 15.

The **effective subsidy** by customer sole trader state to the federal government is **15**.

**7. Supplier sole trader in chartered city to different state company customer**

Supplier sole trader sells for 100 + 15 to customer company  
ERCA allocates 15 to the chartered city.

Customer company claims an ITC of 15.  
Customer company state loses 4.5.  
Federal government has loses 10.5.

The **effective subsidy** by company customer state to the chartered city is **4.5**.  
The **effective subsidy** by the federal government to the chartered city is **10.5**.

**8. Supplier sole trader in chartered city to different state sole trader customer**

Supplier sole trader sells for 100 + 15 to customer sole trader  
ERCA allocates 15 to the chartered city.

Customer sole trader claims an ITC of 15, reducing its net VAT payable by 15.  
Customer sole trader state loses 15 revenue.

The **effective subsidy** by customer sole trader state to chartered city is **15**.

**9. Supplier company in a state to chartered city company customer**

Supplier company sells for 100 + 15 to customer company  
ERCA allocates  $.3 \times 15 = 4.5$  to supplier company state  
ERCA allocates  $.7 \times 15 = 10.5$  to federal government

Customer company claims an ITC of 15, reducing its net VAT payable by 15.  
Federal government loses 15 revenue.

The **effective subsidy** by federal government to the supplier state is **4.5**.  
The 10.5 VAT allocated to the federal government from the supply is offset by the acquisition input tax credit claim in the chartered city.

**10. Supplier company in state to a chartered city sole trader customer**

Supplier company sells for 100 + 15 to customer sole trader  
ERCA allocates  $.3 \times 15 = 4.5$  to supplier state  
ERCA allocates  $.7 \times 15 = 10.5$  to federal government

Customer sole trader claims an ITC of 15, reducing its net VAT payable by 15.  
Customer sole trader chartered city loses 15.

The **effective subsidy** by the chartered city to the supplier company state is **4.5**.  
The **effective subsidy** by the chartered city to the federal government is **10.5**.

**11. Supplier sole trader in a state to a state customer company**

Supplier sole trader sells for 100 + 15 to customer company

State revenue authority retains 15.

Customer company claims an input tax of 15.

Federal government loses  $.7 \times 15 = 10.5$ .

The **effective subsidy** by the federal government to the sole trader supplier state is **10.5**.

**12. Supplier sole trader in a state to a chartered city sole trader customer**

Supplier sole trader sells for 100 + 15

Supplier sole trader state revenue authority retains 15.

Customer sole trader claims an input tax of 15.

Chartered city loses 15 revenue.

The **effective subsidy** by the customer chartered city to the sole trader supplier state is **15**.

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