



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

Wollela Abehodie Yesegat and Richard Krever

1. Background

Fiscal federalism comprises the distribution of functions and tax revenue sources between central and regional governments. Fiscal federalism issues in respect of value added tax (VAT) do not arise in unitary states; in federal states questions arise as to which level of government should levy the tax, and how revenue should be divided between central and regional governments. While a single VAT levied by a federal government with some, or in one case all, of the revenue being distributed to regional governments is common, in practice there are many variations.

China levies a single national VAT, but distributes half the tax to provinces on the basis of the location from which supplies are made. Member states of the European Union (EU) levy separate VATs, subject to conformity with an EU law, the VAT Directive, and revenue is redistributed through a combination of VAT rules and a central clearing house on the basis of place of consumption. Most Canadian provinces impose a surcharge on federal VAT, which is collected by the federal government on behalf of the provinces – except in the province of Quebec, where the provincial government collects Quebec Sales Tax and federal Goods and Services Tax (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 provincial governments on the basis of place of consumption, and the federal government portion flows to the federal government's consolidated revenue.

The bifurcated Ethiopian VAT may be unique, with VAT administration and revenue being assigned on the basis of the legal status of businesses.

2. Allocation of VAT revenue in Ethiopia

The Federal Democratic Republic of Ethiopia (FDRE) is a federal state comprising nine regions, referred to as states in the 1995 Constitution, and two chartered

cities that are treated as federal territory. 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). The Constitution predates VAT, and contains no assignment of the power to levy VAT. In 2002, prior to the commencement of VAT, the House of Peoples' Representatives and House of Federation met jointly, and, following the process set out in the Constitution, assigned all rights to legislate VAT to the federal government.

VAT replaced sales tax in 2003; this significantly altered the fiscal landscape in Ethiopia. In accordance with the Constitution, states had earlier enjoyed the right to 100 per cent of revenue from sales tax paid by sole traders and state government-owned companies, and 30 per cent of the sales tax paid by private companies. The parliamentary resolutions that assigned power to enact VAT exclusively to the federal government were silent as to 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 which level of government should administer VAT.

In the absence of clear legislative direction on the administration of the tax and assignment of VAT revenue, implementation of VAT commenced in 2003 with the Federal Inland Revenue Authority (FIRA) and Ethiopian Customs Authority administering the tax. A letter released by the Ministry of Revenues implies that initially all VAT revenue would be divided between the federal government and states – 70 per cent transferred to the federal government and 30 per cent to the states.¹ It was, however, difficult for FIRA to administer VAT for all types of taxpayers, as they had no offices in smaller regional centres.

Recognising this limited capacity, a year after the official commencement of VAT the Ministry of Revenues delegated responsibility for applying VAT to sole

traders to the states and chartered cities. At the same time, the Ministry indicated that state administrations could allocate 100 per cent of VAT revenue from sole traders to the regional governments, restoring the allocation of the earlier sales tax. 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.

Source of VAT revenue

The Constitution empowers the federal government and regional states to levy and collect taxes and duties on the revenue sources that are reserved to each of them. With the implementation of VAT, FIRA applied the source of income rule (as stated in the Council of Ministers Income Tax Regulations), and treated the source of VAT to be the place of registration or incorporation – the place where the Tax Identification Number (TIN) is issued for businesses.

3. Consequences of the current VAT source and allocation rules

Lack of adequate legal framework

While there is neither explicit constitutional nor legislative authority for the Ministry of Revenues' decision 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 may very well reflect an assumption by House of Federation representatives that VAT should be allocated in the same manner as the earlier sales tax. However, states cannot be confident that arrangements prescribed by a federal ministry will continue indefinitely without adequate legislative authority.

VAT cross-subsidies and administrative constraints

One consequence of the structure of VAT is a cross-subsidy in the case of business-to-business inter-state supplies. If the customer is a VAT-registered business, the tax remitted by the seller in their state will be claimed as a deduction in the buyer's state, reducing VAT revenue in the buyer's state by the amount retained by the seller's state. This is equivalent to a cash subsidy from one government to another (usually from less wealthy to wealthier states and the federal government) of between 30 per cent and 100 per cent of VAT collected.

A second difficulty with the current arrangement results from the limited capacity of tax administrations at the lowest level, and the very limited communication between different levels of government and the central tax administration. These greatly impede the flow of information that is necessary for efficient administration.

4. 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 would be faced if implementing any significant reform of the current system, it would be most logical not to consider this option at present.

Reform of tax administration can be gradual, and start by establishing an administration coordination unit staffed by Ethiopian Revenue and Customs Authority and state representatives. This would be responsible for overseeing the computerisation of all tax offices, developing communication and information exchange channels and processes, and joint audit and enforcement procedures – to ensure seamless and uniform administration of VAT across all types of enterprise, in all parts of the country.

The current system of allocating VAT revenue on the basis of notional place of supply (based on the proxy of place of merchants' TIN registration) could be replaced with a fiscal equalisation distribution or place of consumption rule, which would eliminate the effective inter-state and state-federal subsidies in the current system. The shift from notional place of supply to fiscal equalisation could include transition rules to provide the greater of entitlements under the new rule, and the average revenue allocated in three years prior to the shift, for a transition period of three years. This may require a larger contribution of federal funds for the transition period.

Whichever reform path is followed, an important goal of the reform process would be the replacement of the VAT allocation scheme that is currently used with formal legislation, which would ensure that one of the most important elements of fiscal federalism in Ethiopia is founded on the basis of an adequate legal framework.

Further reading

Yesegat, Wollela Abehodie and Krever, Richard (2017) *Subnational Value Added Tax in Ethiopia and implications for States' Fiscal Capacity*, ICTD Working Paper xx. Brighton: March

Credits

This paper was written by **Wollela Abehodie Yesegat**, Assistant Professor in the College of Business and Economics, Addis Ababa University, and **Richard Krever**, Professor in the Law School, University of Western Australia.



ICTD is based at the Institute of Development Studies, Brighton BN1 9RE UK.

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¹ Dated Nehassie 05, 1996 EC (2004).