Value Added Tax withholding in Ethiopia: Implications for revenue performance and refund (Preliminary findings)

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Wollela Abehodie Yesegat

Addis Ababa University

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Abstract

Limited fiscal capacity poses a significant challenge in Ethiopia. Recently Ethiopia has implemented VAT withholding system with the aim of mitigating evasion and increasing revenue collections. This study assesses the trend in the revenue performance of VAT, taxes in general, and the introduction of VAT withholding scheme. The study uses in-depth interviews held with selected officials from the Ethiopian Ministry of Finance and Economic Cooperation (EMoFEC) and Ethiopian Revenue and Customs Authority (ERCA) and taxpayers in Addis Ababa. Further, the study employs data and documents obtained from EMoFEC and ERCA.

Based on the trend analysis the study shows that there is no significant change in revenue collections; the revenue performance measured in terms of tax to GDP ratio remains far below the average for Sub-Saharan African and low income countries in general. The study finds that VAT withholding related refund request is continuously increasing and is imposing burden on the tax administration and business cash flows. In view of the problems of VAT withholding and poor revenue collections, this study suggests that the government should consider the possibility of abolishing the scheme and taking other measures such as increasing the registration threshold. It is also important to enhance information exchange with government agencies and exclude those taxpayers who fail to comply with the tax system from the list of suppliers to the government.
**Introduction**

Value-Added Tax (VAT) (or Goods and Services Tax (GST) as termed in some countries) has become a major tax instrument in a large number of countries worldwide. Ethiopia introduced VAT as a replacement to sales tax in the year 2003. The introduction of VAT aimed at enhancing economic growth and improving revenue performance measured in terms of government revenue to Gross Domestic Product (GDP) ratio (FDRE 2002). However, VAT revenue performance appears to be declining and is low compared to that in neighboring countries. For instance, VAT and other indirect taxes\(^1\) accounted for about 27 percent of total tax revenue in the year 2013 in Ethiopia, while these taxes contributed about 51 percent in Rwanda and 56 percent in Uganda.\(^2\)

To mitigate the problem of VAT noncompliance and increase revenue the Government of Ethiopia (GoE) introduced VAT withholding scheme in 2009. This scheme requires selected government institutions and public enterprises to withhold 100% of the VAT on their purchases and remit the amount to tax authorities within 30 days from the end of the month in which the VAT was withheld. Taxpayers are allowed to offset VAT withholding against VAT payable in a period. If the withholding VAT and the input VAT exceed the VAT payable on sales, the excess is claimable as refund.

Several Latin American countries and some in Africa also use VAT withholding as a means of tackling tax evasion and increase revenue collections. While this scheme is believed to help in increasing revenue collections, it is likely to create pressure on companies’ cash flows for refunds usually take longer time, and tax administrations (Waerzeggers 2008).

So far, to the researcher’s knowledge, there appear to be no studies on refund and revenue implications of VAT withholding in Ethiopia. This study is, hence, to assess the VAT withholding system in Ethiopia and the implications for revenue collection and refunds. The

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\(^1\) Other indirect taxes mainly refer to excise taxes

\(^2\) World Bank (2015), How to Collect More and Better –Revenue: study on Ethiopia, a presentation made at the meeting with MoFEC held on November 5, 2015
outcomes of this study are expected to inform the government's policy on the design and practice of VAT refunding.

The remaining parts are organized in four sections. The first section presents the background setting the context for the study. This is followed by a statement of objectives and research methods in section two. Section three presents the results while the final section presents discussions and concluding remarks.

1. **Background**

A VAT/GST is a broad-based tax on the supply of goods and services, with systematic crediting of the tax paid on inputs. The VAT/GST was first introduced in France in 1948 (Ebrill et al (2002); Azaria and Robinson (2005)). Since its introduction, VAT/GST has spread around the world and has been adopted in more than 160 countries worldwide; it raises approximately 20 percent of the tax revenue in OECD countries and worldwide (OECD 2014). In Sub-Saharan Africa, VAT/GST has been introduced in many countries including Benin, Cote d’Ivoire, Ethiopia, Ghana, Guinea, Kenya, Madagascar, Mauritius, Niger, Nigeria, Senegal, South Africa, Tanzania, Togo and Uganda. Such international proliferation of the VAT/GST owes its expansion to various factors including its revenue raising potential when it is properly designed and administered. Further, the reasons for the spread of VAT/GST include broadening of the tax base, making tax systems fairer and intending to reduce the burden of personal income taxes. For example, in New Zealand the introduction of its GST was supplemented by a reduction of marginal tax rates (Douglas, 2007; Muir 1993). Similarly, in Australia the introduction of its GST was accompanied by a cut in personal income tax, increases in government benefits, and removal of a number of taxes levied by the Australian States and Territories (OECD 2001).

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3 The advocacy role played by the Fiscal Policy Department of the IMF and the success of VAT in the EU member countries have contributed to the spread of VAT (Bird and Gendron 2007).

4 VAT is by no means necessarily the “money machine” that it has sometimes been called. Further, if a VAT can be administered adequately, the conventional conclusion that it offers the best way for a country to make up revenue losses from trade liberalisation (Cnossen, 1998).

5 The major reason for the original adoption of VAT in Europe was to facilitate trade by turning the then existing sales taxes into destination-based consumption taxes (Bird, 2005).
The VAT/GST is a major source of revenue in many developed countries. For instance, in all OECD member countries (except the United States) VAT/GST is a significant source of revenue, in the year 2012, VAT/GST accounted for an average of 6.6 percent of GDP of OECD member countries (OECD 2014). VAT has become the main stay in government finance in most developing countries as well. To increase further VAT revenue collections and tackle the problem of evasion some countries use VAT withholding scheme. The subsequent discussion presents features of VAT withholding and countries experience in using this scheme.

VAT withholding regimes are tax collection mechanisms implemented by Tax Authorities to enforce and shorten the time in which VAT is collected from certain taxpayers and specific economic sectors. VAT withholding is the application of the reverse charge mechanism on transactions carried out within a given tax jurisdiction. VAT withholding systems oblige typically bodies and large taxable persons to withhold VAT charged to them by their suppliers. Instead of paying the VAT to their suppliers, VAT withholding agents are required to remit the VAT directly to the treasury.

The rationale for using VAT withholding includes the scheme ensures that unregistered traders, particularly in hard-to-tax sectors, are forced to pay at least some VAT. It is claimed that these scheme provides a way of increasing VAT collections where administration is weak and attitudes to taxation are poor, particularly among smaller traders, where the risk of noncompliance is considered to be high. For example as Ainsworth (2011) notes Ecuador responded to VAT fraud in small and medium sized businesses by extending VAT withholding to third-party credit/debit card companies. As Ainsworth (2011) further indicates the Ecuadorian regime addresses a common policy concern; the problem of small suppliers. These sellers frequently make supplies, charge VAT, and do not report the transaction. VAT withholding is an attempt to limit evasion in the small business sector (Ainsworth 2011).

However, VAT withholding scheme can lead to several problems. Waerzeggers (2008) indicates that this scheme can result in an increased VAT burden for the supplier that never has access to or use of the VAT payment and which may encounter difficulties in getting any refund if the
withholding leads to excess input tax credits. VAT withholding schemes create cash flow problems for compliant firms that do not receive their excess VAT credit. The cash flow difficulties this system creates have been severe enough in some jurisdictions to force VAT withholding to be removed; VAT withholding is not the “perfect” solution to under-reporting by small businesses (Ainsworth 2011). Fossat and Bua (2013) also emphasize that while VAT withholding may have an initial positive impact in terms of revenue collections it also results in serious cash flow problems for suppliers. Fossat and Bua (2013) further note that opponents of the scheme point to the increase in refund claims if withholding rates are set too high.

The withholding system can lead to confusion among taxable persons who consider that they are freed from further VAT obligations when VAT has been withheld by their clients and who thus fail to subsequently declare the taxable supplies they have made. Fossat and Bua (2013) indicate that VAT withholding schemes encourage significant abuses on the part of the withholders, including delays in payment of the VAT withheld. In this regard, Waerzeggers (2008) states withholding agents fail to remit withheld VAT to the treasury, often considering the withheld amount to be compensation for their own outstanding excess input tax credits or other claims on the treasury. Finally, the withholding regime adds a layer of administrative complexity for taxable persons, withholding agents and for the tax administration. Waerzeggers (2008) further notes that while very comprehensive withholding systems bolstered revenue collection in the short term; these gains, however, may wipe out in the long run proving the system to be less convincing. These systems do not appear to be an appropriate proxy for effective and efficient management, control and recovery of the VAT (Waerzeggers, 2008).

In general, although opinions on withholding differ somewhat, there appears to be consensus that the proliferation of such schemes can seriously undermine the integrity and long-term health of the VAT (International Tax Dialogue (2005)), and this scheme is not compatible with the modern VAT (Fossat and Bua 2013).

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6 Withholding agents must register with the tax administration, issue vouchers at the time of withholding the tax, file a declaration of withheld VAT etc.
Some scholars argue that the better way to deal with VAT compliance problems in the small business sector is to regulate the number of registered taxpayers by adopting an appropriate VAT threshold.\textsuperscript{7} With regard to government contracts, the best approach is to develop effective exchanges of information and to eliminate those businesses that fail to comply with their VAT obligations from the list of eligible government suppliers (ITD 2005).

Against this argument, however, there are a number of countries, particularly those in Latin America and some in Africa that are currently operating the VAT withholding scheme (ITD, 2005). Waerzeggers (2008) also states that a number of West African Countries introduced throughout the 1990s VAT withholding schemes to secure VAT collection. More specifically, Latin American countries with VAT withholding scheme include Mexico, Argentina, Ecuador, Colombia and Panama. As Jean (2008) notes lack of a registration threshold in several Latin American countries has often led to the adoption of VAT withholding systems to offset the difficulties of administering the VAT owed by small and micro enterprises.

Similarly, in Africa, there are countries like Kenya, Rwanda and a number of West African Countries that are currently using VAT withholding as a means of tackling tax evasion. According to Ainsworth (2011), Cameroon abolished its VAT withholding scheme in January 2010. Later, however, deduction of VAT\textsuperscript{8} at source has been obligatorily operating for all the supplies to public bodies (State, Regional and Local Authorities, Administrative Public Establishments and other subsidized entities) (Cameroon Ministry of Finance, 2015). In Senegal the VAT withholding system was abolished. IMF (2014) notes VAT revenue shortfalls following the abolition of VAT withholding by public agencies in Senegal in the context of the 2013 reform of the General Tax Code.

In the Republic of Congo, there is no registration threshold. Exporters\textsuperscript{9} subject to VAT and who realize more than 80\% of their sales transactions abroad are obligated to withhold VAT paid on

\begin{itemize}
\item As a recent survey of the countries where a VAT withholding system has been implemented shows almost all have very low VAT registration thresholds (International Tax Dialogue 2005).
\item It seems that Cameroon reinstated its VAT withholding in 2011 as IMF (2011) reveals the key measures foreseen in the 2011 budget and currently being implemented include reinstating VAT withholding at source procedures.
\item Tax authorities publish the list of exporters entitled to withhold VAT.
\end{itemize}
the purchases of goods and services (PWC, undated, para. 9). In Nigeria, According to PWC (2014), government and government agencies, and oil and gas companies, including oil services companies are required to withhold VAT at source from all VATable supplies. With the background so far, this study intends to assess the VAT withholding system in Ethiopia.

2. **Research objective and methods adopted**

This study intends to examine the VAT withholding system in Ethiopia and the implications for revenue collection and refunds. Based on this broad objective, the following specific research questions (RQ) were developed.

**RQ1.** *How is the VAT withholding legal framework and practice in Ethiopia in light of the experience internationally?*

**RQ2.** *How is the impact of VAT withholding on revenue collections in Ethiopia;*

**RQ3.** *How is the pressure of VAT withholding on taxpayers’ cash flows, VAT refund procedures and the tax administration at large?*

**RQ4.** *What are the problems in VAT withholding system in Ethiopia?*

The study employed both qualitative and quantitative approaches. The quantitative aspect mainly used data (revenue and refund related data) that was obtained from the Ethiopian Revenue and Customs Authority (ERCA) and the Ethiopian Ministry of Finance and Economic Cooperation (EMoFEC\(^\text{10}\)). These were supplemented by data that were obtained through interviewing six selected tax officials and six taxpayers who are affected by the VAT withholding scheme. Further, using available information comparative analysis of the basic features of VAT withholding in Ethiopia with those in other countries was carried out.

3. **Results and discussion**

\(^{10}\) Before September 2015’s restructuring of Ministries following the 2015 election, the Ministry was named as Ethiopian Ministry of Finance and Economic Development (EMoFED).
VAT withholding with the aim of increasing VAT revenue collections was introduced in Ethiopia in the year 2009. VAT amendment Proclamation No. 609/2008 provides the legal basis for VAT withholding and empowers the EMoFEC to determine the manner of VAT withholding. Accordingly, EMoFEC issued VAT withholding directive No. 27/2009 (as amended), which has become the basis for the application of the scheme in the country.

As per the directive and also interviews with ERCA and EMoFEC officials, federal, regional and city administration institutions and selected state owned enterprises\(^{11}\) are required to withhold VAT on their purchases.\(^{12}\) Further, as stipulated in the directive VAT withholding applies on transactions valued more than ETB 5000 (including the tax)\(^ {13}\); i.e., if the transaction is valued ETB 5000 or less withholding agents are not required to withhold the VAT. Agents are obliged to withhold 100 percent of the VAT and remit it to the revenue authorities in 30 days from the end of the month in which the VAT was withheld. Taxpayers offset the VAT withheld against the net VAT payable in a period.\(^ {14}\) If the withholding VAT exceeds the amount due, the excess is claimable as refund after carrying it forward to the next two months.\(^ {15}\)

From the side of revenue authorities they are legally obliged to accept and process VAT withholding related refund claims that are carried forward for two months. In order to reduce the cash flow pressure on the private sector, especially those having over 50 percent of their

\(^{11}\) According to interviews with EMoFEC and ERCA officials these state owned enterprises include: Ethiopian Airlines, Merchandise Wholesale and Import Trade (MWIT), Commercial Bank of Ethiopia, Ethiopian Electric Power, Ethiopian Electric Utility, Metals and Engineering Corporation (MetEC), Ethiopian Sugar Corporation, Ethiopian Railways Corporation and Industrial Park Development Corporation.

\(^{12}\) VAT withholding does not apply to purchases of telecommunication services.

\(^{13}\) VAT withholding applies on all purchases by withholding agents regardless of the VAT registration status of the supplier. If the purchases including the tax exceed ETB 5000, the withholding agent has to withhold the tax regardless of the VAT registration status of the supplier. Further, directive 27/2002 (as amended) requires government agencies to buy goods and services valued ETB 50,000 and above from suppliers who are registered for VAT.

\(^{14}\) For example, assume total sales for a period subject to VAT is Ethiopian Birr (ETB) 1 million; total VAT for the period is ETB 150,000 of which ETB 90,000 is government withholding VAT voucher while the remaining ETB 60,000 is collected in cash. Assume further input VAT for the period is ETB 70,000. Net VAT payable is ETB 80,000 (ETB 150,000 – 70,000); this is offset against VAT withholding of ETB 90,000 and the excess VAT withheld is carried forward to the next month.

\(^{15}\) If suppliers’ transactions with withholding agents make 50% and above of the total transactions, these suppliers are allowed to offset the withholding VAT against input and output VAT for one month and claim refund then after.
transactions with withholding agents, the refund claim is allowed to be carried forward only for one month.

The Ethiopian VAT uses government agencies and institutions as withholding agents. This is against the experience in most Latin America countries and Kenya that use large businesses as withholding agents (See Appendix 1). In Latin American countries, Ecuador in particular, VAT withholding systems target the hard to tax segment of the economy, mainly small and medium enterprises (Ainsworth 2011). They use debit and credit card companies as withholding agents. Unlike the Ethiopian VAT withholding, in Kenya, withholding agents include government institutions, parastatals, banks, financial institutions, Co-operative Societies, Insurance companies and regular exporters. Apart from government institutions, 1004 large taxpayers are listed as withholding agents (Kenya Revenue Authority (KRA), undated). The Ethiopian system requires withholding of 100 percent of the VAT. This is again different from the practice in many of the Latin American countries that use 100 percent VAT withholding on a selective basis. In Kenya, withholding agents are required to withhold only 6 percent of the taxable value of transactions (KRA 2014).

VAT withholding is used by countries that have no VAT registration threshold or the threshold is kept at a very low level. In this regard, Jean (2008) notes lack of a registration threshold in several Latin American countries has often led to the adoption of VAT withholding systems to offset the difficulties of administering the VAT owed by small and micro enterprises. In Ethiopia the VAT registration threshold is ETB 500,000; there is also sector specific registration requirement which requires businesses engaged in such selected sectors as gold smiths, plastic products manufacturers, and computer and accessories suppliers to register for VAT regardless of the level of their annual turnover. Such an approach apart from the erosion in the VAT registration threshold for the last 14 years, has contributed to the increase in the number of VAT registered businesses and the related abuse in the system.

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16 This registration threshold is provided in the VAT law which was enacted in the year 2002.
In general, the practice in Ethiopia in respect of VAT withholding agents and the rate is against the experience in most countries that use VAT withholding. Specifically, the choice of withholding agents in Ethiopia aims at collecting VAT from relatively large businesses that are supplying to government agencies and institutions. This is not consistent with the rationale for using VAT withholding, i.e., ensuring compliance in the hard to tax sector, smaller businesses in particular (Ainsworth 2011). The requirement to withhold 100 percent of the VAT has its own contributions to the rising VAT withholding related refund requests; this, in turn, adds to the pressure on the tax administration and business cash flows, and the risk of VAT refund fraud.

Regarding the revenue role of VAT withholding, views of interview respondents are mixed. Some respondents from ERCA and EMoFEC believe that the scheme has increased the revenue performance of VAT in Ethiopia, though they do not have researched evidence. On the other hand, a respondent from ERCA believes that considering the burden of VAT withholding on the tax administration and business cash flows, the increase in revenue is not that significant.

In addition to interview results, this study assessed the trend in the revenue performance of taxes, VAT in particular. The revenue performance of the GoE as measured in terms of tax to GDP ratio shows erratic behavior. The ratio declined to less than 9 percent in the 2008/09 fiscal year (Graph 3.1); this was on the face of the implementation of VAT withholding scheme in March 2009. The overall tax revenue performance in Ethiopia is low compared to the average for Sub-Saharan African countries and low income countries in general.17

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17 The average tax to GDP ratio in sub-Saharan African countries and low income countries is 18 percent and 15 percent respectively (IMF 2015).
Out of the total government revenue, the federal government raises about 80 percent while regional states collect the remaining (Graph 3.2).

Source: EMoFEC
VAT has a good share in the government’s tax revenue. For example, VAT, Turnover Tax (ToT) and excise taxes for the general government make up about 50 percent of total government tax revenues (Graph 3.3). In terms of the components of VAT, since 2008/09 fiscal year, the share of domestic transactions’ VAT, ToT and excise taxes in total tax revenue has become more than that of the VAT and excise on international trade. Since then the former has shown a slight increment while the latter is continuously declining. In the year 2014/15, the share of domestic transactions’ VAT, ToT and excise taxes in total tax revenue reached a little over 30 percent (Graph 3.3).

**Graph 3.3: Trend in VAT, ToT and Excise Tax Revenues**

![Graph 3.3: Trend in VAT, ToT and Excise Tax Revenues](image)

Source: EMoFEC

Graph 3.3 is based on revenue data which includes ToT and excise tax revenues. However, to see the trend in VAT separately from ToT and excise taxes, we use tax revenue data for the federal government, which, as noted earlier, represent about 80 percent of the GoE’s tax revenue. Domestic transactions VAT as a share of total tax revenue for the federal government falls in the range of 19 percent to 27 percent (Graph 3.4). This is consistent with the trend in the share of domestic VAT, ToT and excise taxes in total tax revenue of the general government.
Graph 3.4: VAT revenue (Federal Government)

Source: ERCA and EMoFEC

The percentage changes in domestic VAT revenue show a declining trend. For instance, the changes in domestic VAT revenue in 2012/13 from the preceding year were a little over 40 percent which went down to about 10 percent in the 2014/15 fiscal year (Graph 3.5).

VAT withholding scheme’s contribution to the federal government’s domestic VAT has increased since its introduction. In 2014/15, VAT withholding raised nearly 50 percent of total domestic VAT revenue of the federal government. Looking at the periodic percentage changes in domestic VAT at the federal government level, however, reveal a declining trend. The change in VAT revenue collections in 2011/12 from the preceding fiscal year was about 50 percent which continuously declined then after and reached 13 percent in 2014/15 fiscal year. Similarly, the percentage change in VAT withholding revenue was over 140 percent in 2012/13 which went down after that and reached a little over 10 percent in 2014/15 fiscal year (Graph 3.5).
The results so far show the trend in the GoE’s tax revenue collections, VAT in particular. As noted earlier, in the year 2014/15, the share of VAT, ToT and excise taxes on domestic transactions in total tax revenue reached a little over 30 percent. Consistently, VAT on domestic transactions as a share of total tax revenue for the federal government was about 27 percent. This is very low compared to the share of domestic VAT in total tax revenue in countries including Rwanda (50.7 percent), Kenya (45.1 percent), Malawi (45.1 percent), Tanzania (48.5 percent) and Uganda (56.3 percent) (World Bank Group, 2015). In general, domestic VAT as a share of total federal tax revenue shows no significant change even after the introduction of the VAT withholding system in Ethiopia.

As indicated earlier, the share of VAT withholding revenue in federal domestic VAT revenue was increasing and reached about 50 percent, in 2014/15 fiscal year. Nevertheless, the percentage changes in domestic VAT and VAT withholding revenue of the federal government were continuously decreasing while the share of VAT on domestic transactions in total federal government revenue remained below 30 percent. In sum, the trend analysis so far shows that the introduction of VAT withholding has not resulted in a significant change in VAT revenue.
collections, tax revenue performance in general, against the views of most interview respondents from ERCA and EMoFEC.

The rationale for using VAT withholding includes increasing VAT collection from those where attitudes to taxation are poor, particularly, among smaller traders and where the risk of noncompliance is considered to be high. For example as Ainsworth (2011) notes Ecuador responded to VAT fraud in small and medium sized businesses by extending VAT withholding to third-party credit/debit card companies. As Ainsworth (2011) further indicates the Ecuadorian regime addresses a common policy concern; the problem of small suppliers. These sellers frequently make supplies, charge VAT, and do not report the transaction. VAT withholding is an attempt to limit evasion in the small business sector (Ainsworth 2011). In Ethiopia, the VAT withholding system targets mainly suppliers transacting with government agencies and institutions. These suppliers are mostly large businesses and relative to medium and small enterprises they are able to maintain proper documentation. The chance for detecting evasion in this segment of taxpayers is likely to be high, which, in turn, signals the existence of less evasion. In this context, the introduction of VAT withholding targeting this segment of taxpayers is likely to have less effect in increasing revenue collections.

Regarding VAT refund, interviews with tax officials reveal that VAT refund requests come usually from federal government taxpayers. In addition, most VAT refund requests are filed with the large taxpayers’ office (LTO), West, East, Adama and B/Dar branches of ERCA. Hence, the following discussion on VAT withholding related refund requests is based on data for LTO, West, East and Adama branch offices. Of the different VAT refund types, VAT withholding related refund requests were continuously increasing and represented about 90 percent and 81 percent of the total VAT refund requests filed with LTO in the fiscal years 2014/15 and 2015/16 respectively. Similarly, the share of VAT withholding related refund requests from total VAT refund was increasing and represented a major share at East ERCA branch. At Adama branch office, the share of VAT withholding related refund requests was increasing while the share fluctuates at West branch office of ERCA (Graph 3.6). This increase in VAT withholding related refunds could be due to the high withholding rate in Ethiopia. As noted earlier, unlike most
countries in Latin America that use VAT withholding and Kenya, the VAT withholding rate in Ethiopia is 100 percent. Fossat and Bua (2013) note that opponents of VAT withholding scheme point to the increase in refund claims if withholding rates are set too high.
Graph 3.6: VAT refund requests: Selected branch offices of ERCA

A. LARGE TAXPAYERS OFFICE

B. EAST BRANCH

C. WEST BRANCH

D. ADAMA BRANCH

Source: ERCA branch offices
In addition, according to respondents from ERCA, the VAT withholding system has contributed to the increase in VAT refund requests which, in turn, are consuming scarce administrative resources of revenue authorities and cause delays in the payment of refunds. Revenue authorities pay VAT refunds after verifying the accuracy of each and every document pertinent to the refund request.\textsuperscript{18} Carrying out full document verification together with the increasing number of refund requests exacerbates the delays in paying VAT refunds. In addition, delays in paying refunds\textsuperscript{19} are caused by shortage of funds available for this purpose. In Ethiopia, each revenue branch office is allowed to retain 10 percent of its VAT collections for refund. Respondents from ERCA noted that the 10 percent retention rate is too small to accommodate the refund requests of taxpayers. Consequently, after VAT refund decision is made, refund claiming taxpayers are forced to wait for long time and their cash flows are highly constrained. To tackle the delay in VAT refund payments, some ERCA branch offices are paying refunds on installment basis.

The lack of time limit for taxpayers to request for VAT refund was mentioned as another problem for there are taxpayers that file VAT refund claims accumulated for 3 to 4 years. Processing refund claims accumulated for a long period aggravates the pressure on the tax administration.

As the literature shows, the pressure on the tax administration and business cash flows is one of the challenges of VAT withholding system. Specifically, Waerzeggers (2008) indicates that this scheme can result in an increased VAT burden for the supplier that may encounter difficulties in getting any refund. VAT withholding schemes create cash flow problems for compliant firms that do not receive their excess VAT credit. VAT withholding is, hence, considered to be not a “perfect” solution to under-reporting by small businesses (Ainsworth 2011) let alone for relatively large business who transact with government agencies and institutions in Ethiopia.

In addition to the discussion so far, interviews reveal a number of problems in the VAT withholding system. Some of these include:

\textsuperscript{18} VAT refund processing in Ethiopia is not based on risk analysis.

\textsuperscript{19} According to a respondent from ERCA, the delay in paying VAT refunds is mainly a problem to the construction sector for there are a number of large government construction projects in the country and those whose transactions are largely with government institutions and agencies are highly affected.
Increase in price: as taxpayer and tax official respondents noted, suppliers, considering the time and effort it takes to get VAT refund, usually charge relatively high prices for goods and services supplied to withholding agents. This is to reduce the impact of the delay in VAT refund payments on taxpayers’ cash flow.

The difference between invoice and payment dates: the difference between the dates credit invoice is issued and payment is received by the supplier is another problem. Taxpayers are forced to pay the VAT on credit sales invoices while withholding agents withhold the VAT when payment is effected to the supplier later. This problem usually happens when buyers (withholding agents) delay payments to suppliers. In this situation, taxpayers are forced to pay the VAT which, later (at the time of payment by the withholding agent), is subject to withholding. Charging the VAT twice exacerbates the cash flow constraint on suppliers.

Failure /delay in remitting the VAT withheld to the revenue authority: according to respondents from ERCA there are a few withholding agents which are not paying the withheld VAT to the revenue authorities within the period specified in the law. There are also government agencies which are withholding agents but are not withholding VAT on their purchases. Fossat and Bua (2013) indicate that VAT withholding schemes encourage significant abuses on the part of the withholders, including delays in payment of the VAT withheld. In this regard, Waerzeggers (2008) states withholding agents fail to remit withheld VAT to the treasury, often considering the withheld amount to be compensation for their own outstanding excess input tax credits or other claims on the treasury.

The order of offsetting net VAT payable against withholding VAT and VAT credit brought forward: taxpayer respondents indicate the problem of offsetting the net VAT payable for a period against first VAT withholding and then VAT credit brought forward.20

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20 This happens because in Ethiopia nonexport businesses are required to carry forward their VAT credits (from normal VAT procedures), to the next 5 VAT periods (5 months) and offset them against VAT payable. Such a feature of VAT in Ethiopia creates complication in the order of offsetting VAT credit brought forward and VAT withholding against net VAT payable for a period.
For example:

Total output VAT in July 2016 = ETB 100,000
Government VAT withholding voucher July 2016 = ETB 25,000
VAT collected in July 2016 = ETB 75,000
Input VAT for July 2016 = ETB 25,000
VAT credit brought forward from previous period (June) = ETB 100,000

Net VAT payable = VAT collected in July 2016 - Input VAT in July 2016
= ETB 75,000 – ETB 25,000
= ETB 50,000

The issue is whether ETB 50,000 should be offset against first the VAT withholding or the VAT credit brought forward. Tax officials require the offsetting to be first against VAT withholding while taxpayers demand the offsetting to be first against VAT credit brought forward from previous period. Taxpayer respondents noted that this is a mechanism of preventing taxpayers from getting their VAT withholding related refund claims in a shorter time. This causes disagreement between taxpayers and tax officers and is imposing unnecessary pressure on the administration and taxpayers.
4. Conclusion and recommendations

Ethiopia implemented VAT withholding scheme with EMoFEC’s approval of the directive in 2009. The introduction of VAT withholding aims at addressing the noncompliance problem and increasing revenue collections. Government agencies and institutions are appointed as withholding agents. These agents are required to withhold VAT on their acquisitions and remit the amount to revenue authorities in 30 days from the end of the month the VAT was withheld.

This study intended to assess the design and practice of VAT withholding and its implications for VAT revenue collections and refunds in Ethiopia. The study used the results of in-depth interviews held with selected taxpayers and officials from ERCA and EMoFEC. In addition, the study used quantitative data and documents obtained from ERCA and EMoFEC. The study revealed a number of findings.

Firstly, the design of VAT withholding was found to be different from that of most Latin American countries using VAT withholding scheme and Kenya in respect of the appointed withholding agents and the withholding rate. As presented earlier, in Ethiopia withholding agents are government agencies and institutions while withholding agents in most other countries include large businesses and debit and credit card companies as well. VAT withholding schemes mostly aim at mitigating the noncompliance especially among smaller business. However, in Ethiopia, the application of VAT withholding is on relatively large businesses, which are able to supply to government agencies and institutions; this approach functionally excludes the majority of small and medium enterprises from the scheme.

Similar to other countries, appointing large businesses as VAT withholding agents and requiring them to withhold VAT on their supplies to other businesses (medium and small size businesses) would not address the problem either for the existence of the equalization tax (ToT) would add another layer of complexity to the system. In addition, the VAT withholding rate in Ethiopia is 100 percent while the rate is less than 100 percent in most other countries that use the scheme.
This practice has its contribution to the escalation in VAT withholding related refund requests and the resultant pressure on both the tax administration and taxpayers.

Secondly, the views of respondents from ERCA and EMoFEC on the revenue role of VAT withholding are mixed. Although it is important to analyze statistically the revenue contributions of VAT withholding in Ethiopia, the trend analysis earlier showed the poor revenue performance of taxes, VAT in particular even after the implementation of VAT withholding scheme.

Thirdly, the VAT withholding system has contributed to the increase in VAT withholding related refund requests. This, in turn, has exacerbated the burden of VAT on tax authorities for tax officials have to carry-out full verification of the increasing number of VAT refund requests. Furthermore, delays in processing and paying VAT refunds highly constrain business cash flows.

Fourthly, the study highlighted a number of other problems in the VAT withholding system. The difference between credit sales and payment dates was noted to be one of the problems in VAT withholding system as the system requires taxpayers to pay the VAT on credit sales which is subjected to VAT withholding at the time of payment by the buyer. The other problem is the order of offsetting net VAT payable against VAT credit brought forward from previous periods and VAT withholding. This problem is caused by partly the feature of VAT; in that, in Ethiopia, non-export businesses are required to carry forward their credit claims to the next five VAT periods (five months). With the VAT withholding system the order of offsetting net VAT payable has become one of the areas of disagreement for it has implications for VAT refunds timing. VAT withholding agents’ failure to remit the revenue withheld to revenue authorities within the set time and failure of legally appointed agents to withhold the VAT were also indicated as the other problems in the VAT withholding system.

In general, as noted in the literature, VAT withholding is considered to be not a perfect solution to the problem of noncompliance among small businesses let alone larger ones. As Waerzeggers (2008) notes very comprehensive withholding systems may bolster revenue collection in the short term; these gains, however, may wipe out in the long run proving the system to be less
convincing. These systems do not appear to be an appropriate proxy for effective and efficient management, control and recovery of the VAT (Waerzeggers, 2008). Hence, in Ethiopia to address issues in the VAT withholding, and VAT in general, it is important for the government to consider the possibility of abolishing the VAT withholding scheme and adopting an alternative approach for effective management and control of VAT noncompliance. As shown in ITD (2005) the better way to deal with VAT compliance problems in the small business sector is to regulate the number of registered taxpayers by adopting an appropriate VAT threshold. Increasing the threshold and revising the sector specific registration requirements are important considerations. Furthermore, with regard to government contracts, the best approach is as ITD (2005) noted to develop effective exchanges of information and to eliminate those businesses that fail to comply with their VAT obligations from the list of eligible government suppliers.

Finally, in order to strengthen the arguments against VAT revenue role of the VAT withholding system in Ethiopia, it is important to support the study with statistical analysis of VAT revenue collections and the implementation of VAT withholding scheme.
References


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EY (2013), Venezuela — Changes to the VAT withholding regime, VAT Newsletter, Issue No. 7, 20113.


EY (2016), Indirect Tax Alert, Update on Kenya’s withholding VAT system, EY Global Tax Alert Library


World Bank Group (2015), How to Collect More and Better –Revenue; Study on Ethiopia, a presentation made at the meeting with MoFEC held on November 5, 2015
### Appendix I: Summary of VAT withholding scheme in selected countries

<table>
<thead>
<tr>
<th>Country</th>
<th>VAT rate</th>
<th>VAT withholding agents</th>
<th>VAT withholding Rate</th>
<th>VAT registration threshold</th>
<th>Frequency of VAT reporting</th>
<th>Year VAT was introduced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nigeria</td>
<td>Standard rate 5% and zero rate applies to mainly exports</td>
<td>Government and government agencies, and oil and gas companies, including oil services companies</td>
<td>100% of the VAT</td>
<td>No registration threshold</td>
<td>Monthly</td>
<td>1993</td>
</tr>
<tr>
<td>Republic of Congo</td>
<td>Standard rate 18%, reduced rate 5% (on imports) and 0 rate on exports</td>
<td>Exporters (tax authorities publish the list of exporters entitled to withhold VAT) subject to VAT and who realize more than 80% of their sales transactions abroad.</td>
<td>100% of the VAT</td>
<td>No registration threshold</td>
<td>Reporting on monthly basis</td>
<td>2012</td>
</tr>
<tr>
<td>Cameroon</td>
<td>Standard rate of 19.25% and reduced rate of 16.143% under simplified regime</td>
<td>Public bodies (State, Regional and Local Authorities, Administrative Public Establishments and other subsidized entities)</td>
<td>100% of the VAT</td>
<td>F.CFA 50 million</td>
<td>Monthly</td>
<td>1999</td>
</tr>
<tr>
<td>Rwanda</td>
<td>Standard rate 18% and zero rate on mainly exports</td>
<td>-Government and public institutions&lt;sup&gt;22&lt;/sup&gt;</td>
<td>100% of the VAT</td>
<td>Annual turnover of RwF20&lt;sup&gt;23&lt;/sup&gt; million</td>
<td>Monthly and (quarterly for those with annual turnover upto RwF 200 million)</td>
<td>2001</td>
</tr>
<tr>
<td>Kenya</td>
<td>Standard rate 16% and zero rate</td>
<td>Government Ministries, Departments and agencies</td>
<td>6% of the transaction price</td>
<td>KShi5 million (12 months)</td>
<td>Monthly</td>
<td>1990</td>
</tr>
<tr>
<td>Turkey</td>
<td>Standard rate 18% and</td>
<td>-Public entities financed through the Withholding rates range from 1/3&lt;sup&gt;rd&lt;/sup&gt;</td>
<td>None</td>
<td>None</td>
<td>Monthly</td>
<td>1984</td>
</tr>
</tbody>
</table>

<sup>21</sup> Exchange rate: 1USD = 583.92 FCFA, September 30, 2016  
<sup>22</sup> Tax facts and Figures 2015 ([www.pwc.com/rw](http://www.pwc.com/rw))  
<sup>23</sup> Exchange rate: 1USD = 791.77 RwF, August 8, 2016
<table>
<thead>
<tr>
<th>Country</th>
<th>Rates and Exclusions</th>
<th>Reduced Rates and Exclusions</th>
<th>Reduced Rates and Exclusions</th>
<th>Reduced Rates and Exclusions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Philippines</td>
<td>Standard rate 12% and 0 rate (exports mainly)</td>
<td>Government or any of its political subdivision, instrumentalities, or agencies, including government-owned or controlled corporations</td>
<td>5%–25% (out of the 12% VAT) on VATable sales upon payment to value added tax sellers of goods or services.</td>
<td>Gross sales or receipts in excess of P 1,919,500 in a 12-month period Declaration and payment is monthly. Additional quarterly filing of returns is required; 1988</td>
</tr>
<tr>
<td>Mexico</td>
<td>Standard rate 16%, and zero rate</td>
<td>Financial institutions that receive goods in lieu of payments or acquire goods by legal resolutions or trusts</td>
<td>2/3 of the VAT</td>
<td>No registration threshold Monthly 1980</td>
</tr>
<tr>
<td></td>
<td><strong>Legal entities:</strong></td>
<td><strong>Legal entities:</strong> Acquire scrap to be used as raw material in industry or for its commercialization.</td>
<td><strong>Legal entities:</strong> Acquire scrap to be used as raw material in industry or for its commercialization.</td>
<td><strong>Legal entities:</strong> Acquire scrap to be used as raw material in industry or for its commercialization.</td>
</tr>
<tr>
<td></td>
<td>-Receive independent personal services from individuals, or temporarily use or enjoy good property of individual</td>
<td>-Receive independent personal services from individuals, or temporarily use or enjoy good property of individual</td>
<td>-Receive independent personal services from individuals, or temporarily use or enjoy good property of individual</td>
<td>-Receive independent personal services from individuals, or temporarily use or enjoy good property of individual</td>
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<td></td>
<td></td>
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</tr>
</tbody>
</table>

24 There are some special rules that one must be aware of in dealing with the government sales – final withholding VAT on sales to government in the Philippines, accounting and fill-out of value added tax returns in the Philippines (Tax and Accounting Inc., undated).

25 This 5% withholding tax represents the net VAT payable by the seller to government. This could mean that the seller will not be made to pay more than 5% out of the 12% VAT on sales to the government Philippines. In the VAT returns, however, the 12% value added tax on sale to government has to be declared for transparency purposes (Tax and Accounting Inc., undated).

26 1 US dollar = 46.9345 Philippine pesos
<table>
<thead>
<tr>
<th>Country</th>
<th>VAT Rates and Additional Requirements</th>
<th>Entities</th>
<th>Withholding Rates</th>
<th>Registration</th>
<th>Filing Frequency</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Columbia</td>
<td>Standard rate 16%, reduced rate 5% &amp; 0 rate on mainly exports</td>
<td>Government departments, Large taxpayers designated by the government, Individuals and VAT taxpayers using the common regime and entities or individuals that provide goods or services to international trade companies.</td>
<td>-Agents are responsible for withholding 15% of the VAT rate applicable to the transaction; -For the sale of tobacco and scrap metal, the withholding rate is 100% of the applicable tax rate;</td>
<td>Gross income in the previous year less than USD57,863 (based on an exchange rate of COP1,900 = USD1); additional requirements apply 27</td>
<td>Bimonthly/Quarterly/Annually</td>
<td>1983</td>
</tr>
<tr>
<td>Ecuador</td>
<td>Standard rate of 12% and 0 rate</td>
<td>-debit and credit card intermediaries, insurance companies (financial institutions); public entities, taxpayers designated by tax administration ruling, other taxpayers specified by statute</td>
<td>-30% of VAT on purchases of goods taxed at 12% -70% of VAT on the acquisition of services taxed at 12% -100% of VAT for services rendered by professionals; -transaction between two companies qualified as “special taxpayers” VAT withholding rates are as follows: (10% of VAT on purchases of goods; and 20% of VAT on the acquisition of services);</td>
<td>Registration No</td>
<td>Monthly 28</td>
<td>1981</td>
</tr>
<tr>
<td>Guatemala</td>
<td>Standard rate of 12%, 0 rate</td>
<td>Regular exporters (a minimum monthly</td>
<td>65% of VAT generated</td>
<td>No registration</td>
<td>Monthly</td>
<td>1992</td>
</tr>
</tbody>
</table>

28 Taxpayers who perform only 0% VAT rated sales and purchases must file a VAT return every 6 months (EY 2015)
<table>
<thead>
<tr>
<th>Drawback entities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government entities (excluding municipalities):</td>
</tr>
<tr>
<td>Credit and debit card operators:</td>
</tr>
<tr>
<td>Gas stations</td>
</tr>
<tr>
<td>Special taxpayers:</td>
</tr>
<tr>
<td>Other withholding agents:</td>
</tr>
</tbody>
</table>

| Honduras | Standard rate 15% and increased rate of 18% |
|-------------------|
| Effective from November 2010, large taxpayers are required to withhold VAT on payments related to the following: |
| • Transportation services |
| • Cleaning and fumigation services |
| • Printing and screen printing services |
| • Investigation and security services |
| 15% of the purchases |
| None\(^{29}\) |
| Monthly |
| 1964 |

\(^{29}\) Those with annual taxable turnover below HNL250,000 (approximately USD11,652) are not required to file returns monthly (EY, Worldwide, VAT, GST and Sales tax guide, 2015)
<table>
<thead>
<tr>
<th>Country</th>
<th>Standard rate</th>
<th>Higher rates</th>
<th>VAT rates applicable</th>
<th>Withholding agents</th>
<th>Withholding rate applicable</th>
<th>Taxpayer status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Panama</td>
<td>7%</td>
<td>10% for alcoholic beverages and hotel services; 15% for tobacco products</td>
<td>0% for export</td>
<td>State agencies, decentralized entities, public enterprises, municipalities and other public sector entities; as well as all non-exempt entities making payments or administrating money of the state for the acquisition of goods and taxable services; Individuals or legal entities with annual purchases of goods and services equal to or exceeding US$10 million during the preceding tax year.</td>
<td>50% of the VAT, except for professional services rendered to the Government, for which the withholding rate increases to 100% of the VAT.</td>
<td>Gross annual income of USD36,000 or month average above USD3,000</td>
</tr>
<tr>
<td>El Salvador</td>
<td>13% standard rate and 0 rate (exports);</td>
<td>-Companies having the status of Large Taxpayers will act as withholding agents when acquiring goods or receiving services from other taxpayers not having this status.</td>
<td>The withholding rate applicable in this case would be 1% of the transaction price.</td>
<td>2% of the VAT triggered by sales of taxable goods and services paid with debit or credit cards. The rate will increase to 50%.</td>
<td>Annual turnover of US$5,714.29 or fixed assets of US$2,285.71</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>12% standard rate and 0 rate (exports);</td>
<td>-the National Public Entities;</td>
<td>None</td>
<td>Monthly</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Other rates: 16.5%, 10%, 8%</td>
<td>-taxpayers who have been appointed as</td>
<td>Monthly</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

30 During a transition period that runs from 1 November 2015 to 31 October 2016, the withholding rate will be 2% of the VAT triggered by sales of taxable goods and services paid with debit or credit cards. On 1 November 2016, the withholding rate will increase to 50% (EY 2015).

31 These include the Office of the President of the Republic and the Executive Vice-President; Ministries; Autonomous Services; the Office of the Attorney General of the Republic; National Offices created by the Office of the President of the Republic; the National Assembly; the Supreme Court of Justice and Courts of the Republic; the Judiciary Service; the Office of the General Comptroller of the Republic; the National Electoral Council; the National Armed Forces; the Executive Directorate of the Judiciary; and the Central Bank of Venezuela.
<table>
<thead>
<tr>
<th>Country</th>
<th>Rate Description</th>
<th>Entity Processing Payment</th>
<th>Withholding Rate</th>
<th>Period</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costa Rica</td>
<td>Standard rate 13% and other rates 10%, 5% and zero rate</td>
<td>Public or private entities processing payment of credit or debit cards</td>
<td>Withholding up to 6% of the net sales price</td>
<td>None</td>
<td>Monthly</td>
</tr>
</tbody>
</table>


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32 Effective 1 July 2013, Venezuela made changes to the VAT withholding regime (EY 2013)