

TAX COMPLIANCE COST BURDEN AND TAX PERCEPTIONS SURVEY IN ETHIOPIA

MAY 2015

TAX COMPLIANCE COST BURDEN AND TAX PERCEPTIONS SURVEY IN ETHIOPIA

MARCH 2016



Disclaimer

The organizations (that is, IBRD, IFC, and MIGA), using their best efforts in the time available, have endeavored to provide high-quality services hereunder and have relied on information provided to them by a wide range of other sources. However, they do not make any representations or warranties regarding the completeness or accuracy of the information included in this report, or the results that would be achieved by following its recommendations.

About the World Bank Group's Trade and Competitiveness Global Practice (T&C GP)

The Trade & Competitiveness Global Practice (T&C GP) provides policy advice and lending support to help client countries increase trade and investment, improve productivity and competitiveness at the national and industry levels, and create an inclusive, competitive private sector. The T&C GP works with governments to identify policies that promote growth, while helping identify and remove impediments to the smooth functioning of markets (such as gaps in coordination, undersupply of public goods, non-competitive market structures, and regulatory constraints).

The Ethiopia Investment Climate Program, managed by the World Bank Group's Trade and Competitiveness Global Practice, aims at streamlining and simplifying high priority regulatory practices and processes burdensome to the private sector and address investment climate issues that are holding back investment and productivity growth in Ethiopia.

Acknowledgments

The WBG would like to thank the Ethiopian Revenue and Customs Authority for their support in conducting the tax compliance cost burden and tax perceptions survey in Ethiopia. The survey was conducted by Department of Economics of the Addis Ababa University.

The survey is conducted as part of the Tax Administration Component of the WBG Ethiopia Investment Climate Program. Mamo Mihretu, Program Manager at WBG, coordinated the overall work and program.

This report is prepared based on the results of the survey. Contributors to the report include Wollela Abehodie Yesegat (Consultant), Denis Vorontsov (Consultant), Jacqueline Coolidge (Consultant), and Laurent Olivier Corthay (Senior Private Sector Specialist).

We gratefully acknowledge the financial contributions made by Department of Foreign Affairs, Trade and Development (DFATD) of Canada, Sweden International Development Agency (SIDA), Department for International Development (DFID) and the Italian Cooperation.

Contents

Executive Summary	vii
Background	xiii
1 Overview of Ethiopian Tax System and Recent Reform Initiatives	1
2 Objectives and Methods Adopted	5
1.1 Survey: Sampling Design	5
1.2 Survey: Instrument and Actual Conduct of the Surveys	7
3 Survey Results	9
3.1 Profile of Respondents	9
3.2 Tax Compliance Costs	14
3.3 Perception of Taxpayers to Aspects of the Tax System and the Business Environment	22
3.3.1 Views about Registering for Taxes	22
3.3.2 Perception of Sales Register Machine (SRM) Usage	26
3.3.3 Perception of VAT Registration and Refund	26
3.3.4 Perception Towards Tax Inspections, Penalties and Appeals	28
3.3.5 Perceptions of Tax Compliance and the Business Environment	31
3.3.6 Difficulties with the Tax System	35
3.3.7 Computer and Bank Account Usage and Other Issues	36
4 Conclusions and Recommendations	41
References	47
Annex 1: Tax Compliance Costs—International Comparisons for Ethiopia	49
Annex 2: Examples of Thresholds Applied to Reduce the Compliance Burden of Small Businesses	61

Figures

Figure E1: Bookkeeping Practices of Businesses—Formal	viii
Figure E2: Bookkeeping Practices (percent)—Informal	viii
Figure E3: Businesses Involved in Outsourcing and In-House Activities for Bookkeeping and Tax Accounting (percent)	viii
Figure E4: Distribution of Full Outsourcing Cost of Tax Compliance by Tax Type (in percent) (N = 171)	ix
Figure E5: Average Total Compliance Costs (in ETB)	ix
Figure E6: International Comparison of Tax Compliance Costs	x
Figure E7: Perception about Tax Inspections (N = 1003)	xi
Figure 2.1: Sectoral Distribution of Informal Businesses (percent) (N = 499)	7
Figure 3.1: Position of Respondents—Formal Businesses (in percent, N = 1003)	9
Figure 3.2: Gender of Respondents—Formal (in percent, N = 1003)	10
Figure 3.3: Gender of Respondents—Informal Businesses (N = 499)	10
Figure 3.4: Gender of Owners—Formal (in percent, N = 1003)	10
Figure 3.5: Period of Establishment	11
Figure 3.6: Working Premises of the Sample Firms (N = 499)	11
Figure 3.7: Number of Employees—Informal (N = 499)	12
Figure 3.8: Bookkeeping Practices of Businesses—Formal	12
Figure 3.9: Bookkeeping Practice of Businesses—Formal (by category)	13
Figure 3.10: Bookkeeping Practices (percent)—Informal	13
Figure 3.11: Bookkeeping Practices by Location (percent, yes)—Informal	13
Figure 3.12: Average Total Compliance Costs (in ETB)	15
Figure 3.13: Tax Compliance Cost as a Share of Turnover by Turnover Band	16
Figure 3.14: International Comparison of Tax Compliance Costs	17
Figure 3.15: Businesses Involved in Outsourcing and In-house Activities for Bookkeeping and Tax Accounting (percent)	18
Figure 3.16: Distribution of Full Outsourcing Cost between General Bookkeeping and Tax Compliance (in percent) (N = 174)	19
Figure 3.17: Average Cost of Full Outsourcing for Businesses That Outsource (in ETB) (N = 174)	19
Figure 3.18: Distribution of Full Outsourcing Cost of Tax Compliance by Tax Type (in percent) (N = 171)	19
Figure 3.19: Average Cost of (full) Outsourcing for Businesses That Outsource by Tax Type in ETB (N = 171)	19
Figure 3.20: Person-Days Spent on In-house Bookkeeping and Tax Compliance (N = 627)	20
Figure 3.21: Distribution of Time Spent on In-house Tax Accounting by Tax Type (N = 592)	20

Figure 3.22: Person-Days Spent on Tax Compliance by Tax Activity (N = 627)	20
Figure 3.23: In-house Compliance Cost of Time Spent on General Bookkeeping and Tax Accounting in ETB (N = 537)	21
Figure 3.24: Opinion of Respondent Firms about the Biggest and Second Biggest Disadvantages of Registering for Taxes (N = 1003)	23
Figure 3.25: Opinion of Respondent Firms about the Biggest and Second Biggest Disadvantages of Registering for Taxes (by tax payers' category) (percent)	24
Figure 3.26: Reasons for Giving Up or Never Considered Nor Applied (N = 498)	24
Figure 3.27: Most Important Factors That Encourage or Persuade Business to Consider Registering for Tax (N = 499)	25
Figure 3.28: Perception on the Likelihood of Registering for Tax (N = 499)	25
Figure 3.29: General Perception on First Biggest Disadvantages of Registering for Tax (N = 499)	25
Figure 3.30: Biggest Advantages of Using Sales Register Machine (percent) (N = 1003)	26
Figure 3.31: Biggest Disadvantages of a Sales Register Machine (percent) (N=1003)	26
Figure 3.32: First and Second Biggest Advantages of Registering for VAT (percent) (N = 1003)	27
Figure 3.33: First and Second Disadvantages of Registering for VAT (N = 1003)	27
Figure 3.34: Eligibility for VAT Refund (percent)	27
Figure 3.35: Application for VAT Refunds (percent)	27
Figure 3.36: Reasons for Not Applying for the VAT Refund (N = 82)	28
Figure 3.37: Time Taken for VAT Refund Process (N = 75)	28
Figure 3.38: Perception about Tax Inspections (N = 1002)	29
Figure 3.39 Inspections and Audits by Turnover	29
Figure 3.40: Number of Inspections and Audits and Time Spent Among Those Who Reported any Inspection	29
Figure 3.41: Whether or Not Appeals Were Filed (N = 146)	30
Figure 3.42: Perception about Statements Related to Tax Appeals (N = 68)	30
Figure 3.43: Opinions on Tax Compliance (N = 1003)	31
Figure 3.44: Respondents Perception about Taxes—Formal (percent)	32
Figure 3.45: Perceptions about Taxes and Tax System—Informal (N = 499)	33
Figure 3.46: Respondents Perception about Business Environment—Formal (percent, N = 1003)	34
Figure 3.47: Perception on Elements of Business Environment (N = 499)—Informal	34
Figure 3.48: Perceptions about Calculating and Filling in Tax Returns	35
Figure 3.49: Perceptions about Submission of Tax Returns and Payments	35
Figure 3.50: Perception about Filling Out and Submitting Tax Returns—Informal	36

Figure 3.51: Percentage of Businesses Who Stated Availability of Information Source on Taxation	36
Figure 3.52: Firms' Use of Computers (percent)	37
Figure 3.53: Firms' Use of Internet	37
Figure 3.54: Firms' Use of Bank Account	37
Figure 3.55: Use of Bank Account for Business Operations (by legal status)	38
Figure 3.56: Use of Bank Account (informal) (percent) (N = 499)	38
Figure 3.57: Knowledge about Tax Information and Requirements by Location—Informal	39
Figure 3.58: Perception about Keeping Accounting Records and Books for the Businesses—Informal	39

Tables

Table 2.1: Distribution of Sample Firms—Formal (by region and category)	6
Table 2.2: Sectoral Distribution of Businesses—Formal (by taxpayers' category)	6
Table 2.3: Business Category by Turnover (percent)	6
Table 3.1: Gender of Respondents—Formal (by taxpayers' category) (in percent)	10
Table 3.2: Number of Workers in Sampled Businesses—Formal (total and by categories)	11
Table 3.3: Types of Taxes Paid by Category and Ownership Type (percent)	14
Table 3.4: Average Tax Compliance Costs (in ETB and as a share of turnover) by Taxpayers' Category	16
Table 3.5: Tax Compliance Costs (in ETB and as a share of turnover) by Taxpayers' Ownership Type and Sector	17
Table 3.6: Time Spent on Bookkeeping and Tax Accounting by Ownership Type and Turnover	21
Table 3.7: In-house Compliance Cost of Time Spent on General Bookkeeping and Tax Accounting in ETB (by ownership type and turnover)	22
Table 3.8: In-house Compliance Cost of Time Spent on General Bookkeeping and Tax Accounting in ETB by Category	22
Table 3.9: General Opinion on the Reasons for Not Applying for Tax Registration (among those who have considered but did not apply) (N = 166) (percent)—Informal	23
Table 3.10: Reasons for Not Filing an Objection (N = 53) (percent)	30
Table 3.11: Appeals Resolved and Still in Process (N = 68) (percent)	30
Table 3.12: Percent of Total Annual Sales Declared for Tax Purposes by Turnover (among those reporting less than 100%)	31
Table 3.13: Percent of Actual Expenditure Overstated in Tax Returns by Turnover	31
Table 3.14: Business-Related Visits to Tax Offices—Formal	39

Executive Summary

This study attempts to estimate tax compliance costs and assess views of taxpayers on aspects of the tax system in Ethiopia. The study uses evidence mainly from a survey of both formal and informal businesses in Addis Ababa and four major cities (Adama, Hawassa, Mekele and Bahir Dar) in the four largest regional states. The survey covered 1003 formal businesses (based on a representative sample of business taxpayers from ERCA database) and 499 informal businesses (using area-based sampling) in the above mentioned locations. Survey questionnaires were informed by the results of four focus group discussions conducted in Addis Ababa and Adama.

Most of the firms in the sample are small firms: More than 82 percent of the firms are small firms belonging to category C and they are mainly sole-proprietorship (93 percent) form of establishments.

The largest proportion of businesses (formal and informal) operate in service and trade sector: about 51 percent and 40 percent of businesses (formal) were found to be engaged in the service and trade (both wholesale and retail trade) sectors. Similarly, about 87 percent of informal businesses that participated in the survey reported that their primary activity is services or trade.

Most businesses that participated in the survey obtained tax identification number (TIN) and registered for VAT (if required) within the period 2002–2004 EC. During this period, more than 64 percent of businesses that participated in the survey obtained TIN; and about 60 percent of the VAT payers (that participated in the survey) registered for VAT.

About half of informal business survey respondents reported that they are likely or very likely to register for tax in the coming two years. The proportion of respondents who said that they are unlikely or very

unlikely to register for tax in the next two years was about 26 percent.

About 63 percent informal business operators claimed to have neither considered nor applied to register for tax by the time of the survey, although it varies across locations. Some of the reasons for not applying for registration included perceptions about the financial burden of being formal (including taxes, fees) (27 percent), and the concern that tax laws and regulations are not clear, fair or appropriate (15 percent).

About half of formal businesses in the survey were keeping all receipts and invoices in an organized manner: although there are substantial differences across the three categories: almost all category A taxpayers do this but only 40 percent of category C taxpayers. Overall, about 42 percent maintain full records of revenues and expenses (not necessarily using computer). A slightly larger percentage of businesses (about 52 percent) do bookkeeping for revenue but not necessarily for expenses. Only about 3 percent of informal businesses keep receipts, although about 16–17 percent report that they keep records of sales and/or purchases (Figures E1 and E2).

A larger proportion of businesses submit business profit tax return: close to 60 percent of formal business respondents reported that they submitted business profit tax return while 31 percent and 12 percent were found to have submitted turnover tax and VAT returns respectively. Withholding tax on payments and employment related taxes and contributions were primarily paid by category A and category B taxpayers.

A large share of businesses in the survey perform bookkeeping activities in-house: in particular, there is limited outsourcing of bookkeeping activities of

FIGURE E1: Bookkeeping Practices of Businesses—Formal

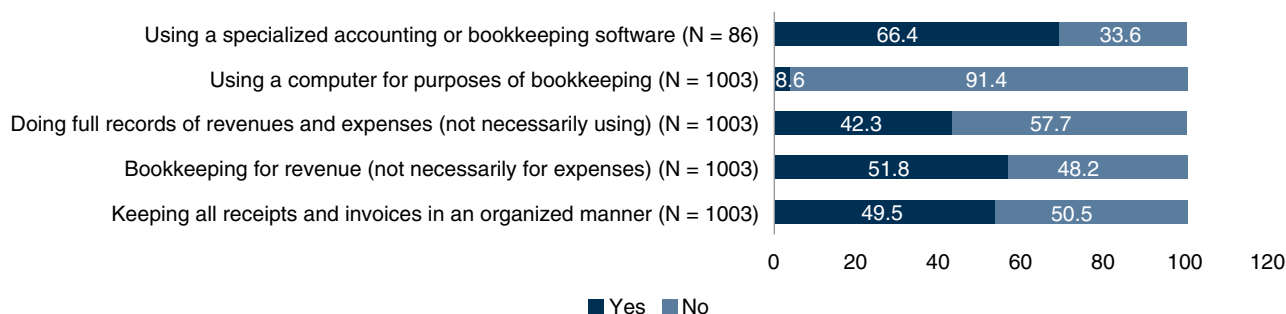
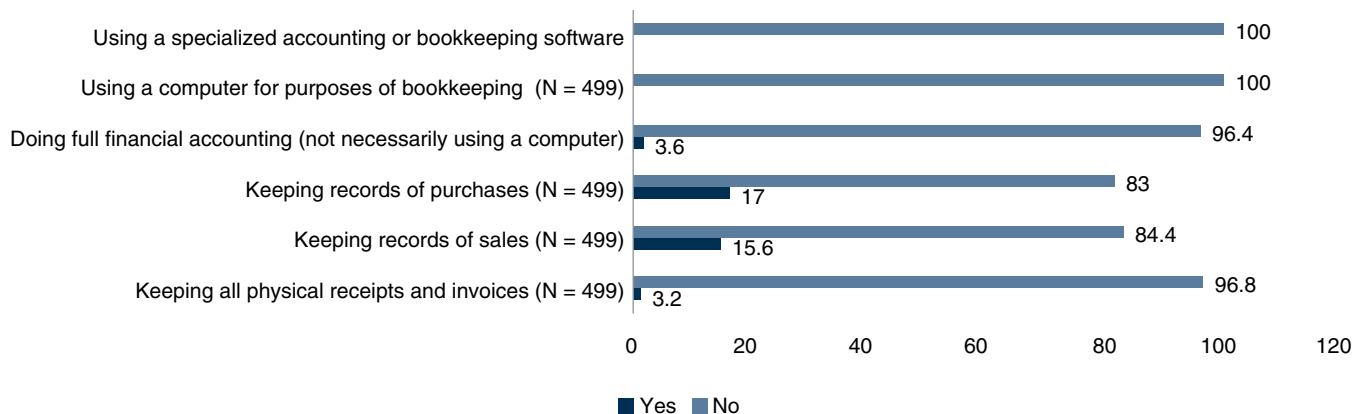


FIGURE E2: Bookkeeping Practices (percent)—Informal



businesses, with about 85 percent of them doing it completely in-house.

Close to half of businesses that file VAT returns outsource their VAT compliance activities (completely or partially): about a third of businesses that file for business profit tax outsource profit tax activities completely or partially (with similar figures for withholding income tax on payments and employment related taxes and contributions). Only 15 percent of ToT payers outsource. This suggests that businesses

consider VAT as being the most complex and often requiring external support (Figure E3).

The cost of outsourcing depends on tax type: half of the cost of outsourcing tax compliance activities is for tasks related to business profit tax (50 percent) which is followed by value added tax (20 percent) and turnover tax (18 percent) (Figure E4).

Businesses that outsource business profit tax compliance activities incurred an average of ETB 2,267 per business

FIGURE E3: Businesses Involved in Outsourcing and In-House Activities for Bookkeeping and Tax Accounting (percent)

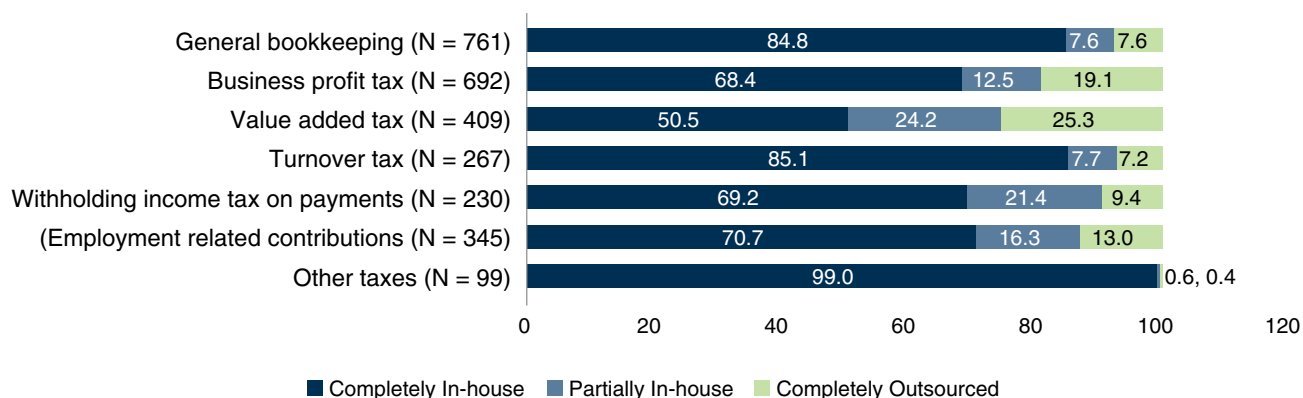
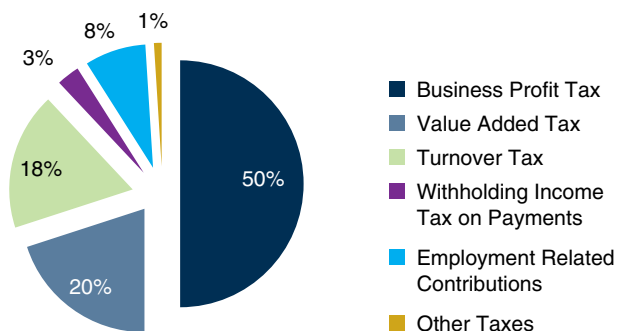


FIGURE E4: Distribution of Full Outsourcing Cost of Tax Compliance by Tax Type (in percent) (N = 171)



in the 2012/13 fiscal year, which is the highest for a tax type. Value added tax compliance is the second highest in terms of average outsourcing cost by tax type amounting to ETB 913.

The number of person-days spent increases as turnover increases: on average, a business spends about 106 person-days of its employees' time for in-house bookkeeping and tax compliance. General bookkeeping accounted for about 74 percent (78 person-days), while tax compliance accounted for 26 percent of the total time spent (i.e., about 28 person-days). Large businesses spend more time on bookkeeping and tax accounting related activities than smaller businesses.

Time spent on in-house tax compliance activities varies with tax types: half of the total time spent by a business on tax accounting goes to business profit tax while another 31 percent goes to turnover tax. Value added tax takes 8 percent of the time spent.

Total tax compliance cost, consisting of outsourcing and in-house costs, is high in Ethiopia: in the year 2012/13, the average cost to a business for general bookkeeping was found to be ETB 9,804 (USD 523.2). In the same year, average total tax compliance cost of a business including costs of acquisition and maintenance of software and hardware was ETB 7,609 (USD 406) while average total tax compliance cost without acquisition and maintenance costs was ETB 5,842 (USD 311.7) (Figure E5).

Tax compliance costs varies with tax type: business profit tax takes the largest share of total tax compliance costs (both internal and external costs), followed by value added tax and turnover tax. The burden of compliance costs of business profit tax and value added tax shows that these two taxes do have complexities that resulted in taxpayers incurring high costs of compliance in terms of staff time and professional fees paid to external assistance.

Tax compliance cost varies with the size of businesses: the average tax compliance cost of a business (with acquisition and maintenance costs of software and hardware) as a share of turnover is about 5.4 percent while the share of tax compliance cost in total turnover without acquisition and maintenance costs is 4.7 percent. Small businesses face a relatively larger tax compliance cost as a share of turnover compared with large businesses. Tax compliance cost as a share of turnover tends to decrease as the turnover of businesses

FIGURE E5: Average Total Compliance Costs (in ETB)

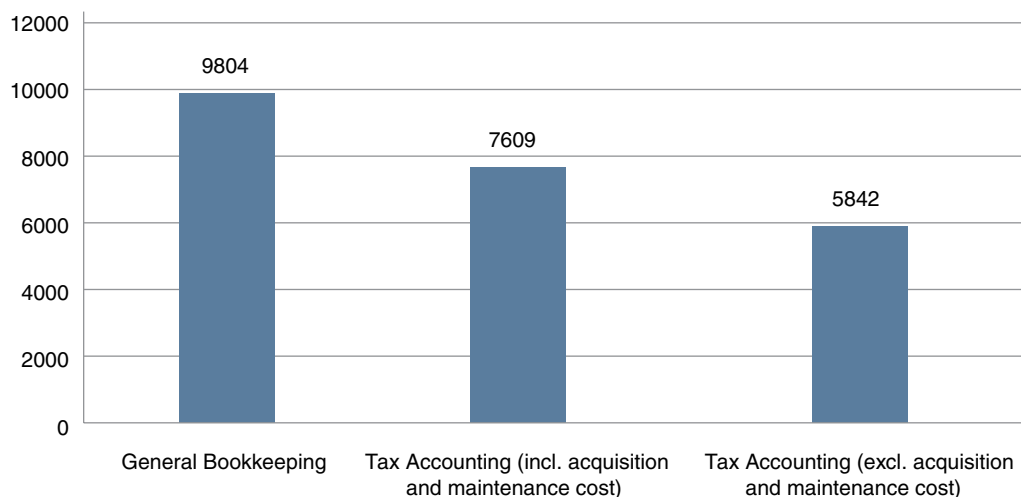
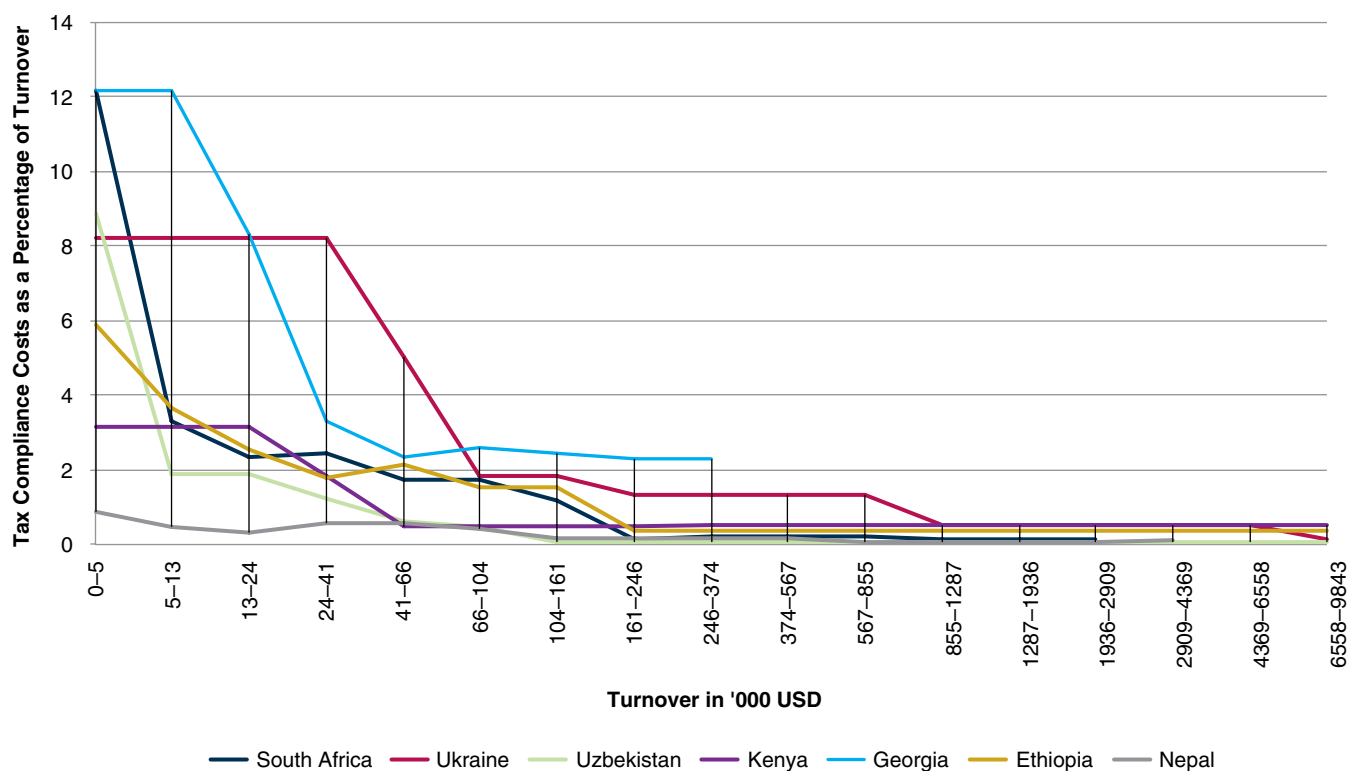


FIGURE E6: International Comparison of Tax Compliance Costs



increases suggesting that it is regressive. Similarly, the relative tax compliance cost (excluding cost of acquisition and maintenance) as a share of turnover is larger for category C (5.03 percent) compared with category A (3.85 percent). In absolute terms, however, tax compliance cost for category A businesses is well over 5 times the cost for category C businesses (both when tax accounting cost includes and excludes acquisition and maintenance costs). Overall, the total tax compliance cost in Ethiopia is estimated to be about ETB 5.8 billion (about USD 309.5 million)¹ and ETB 7.5 billion (USD 400.5) (depending on whether tax compliance cost includes acquisition and maintenance cost of software and hardware). This is between 4.5 and 5.8 percent of Ethiopia's total government revenue collected in 2012/13 and about 1 percent of its GDP during the same year.

Tax compliance cost in Ethiopia is high in comparison to the countries considered in this study (Figure E6), since most of the countries that have had such a survey were the ones already known to have a problem with tax compliance costs.

¹ Assuming average exchange rate for the fiscal year 2012/13, USD 1 = ETB 18.59.

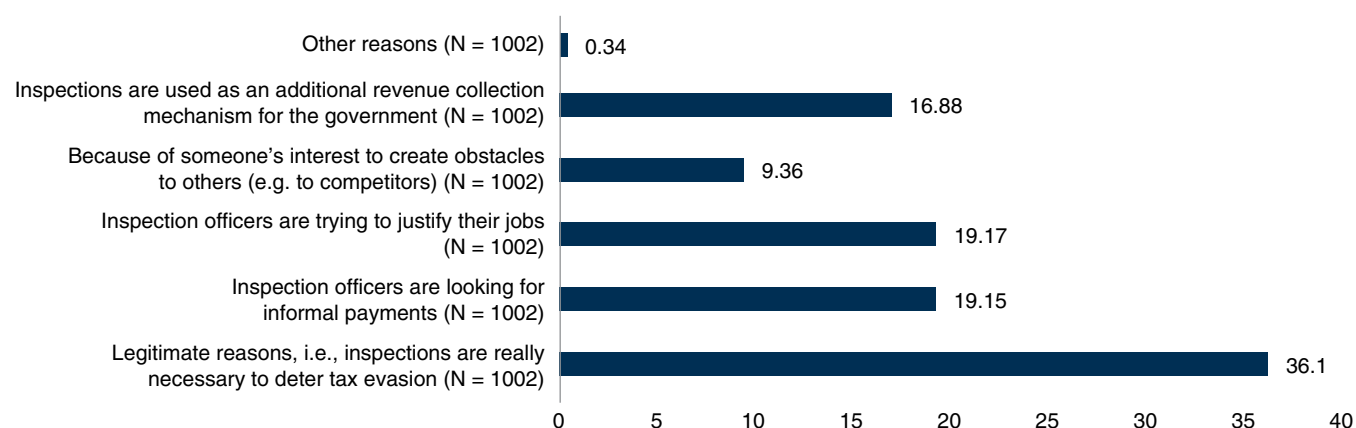
The process of complying with taxation is perceived to be more burdensome than the amount of tax itself: about 54 percent of businesses agree to the statement that the process of tax compliance is more burdensome than the actual tax due.

Avoiding government retribution (formal and informal businesses) and better access to land and premises (informal) are perceived to be the biggest advantages of registering for taxes: relatively larger percentage of both formal and informal businesses in the sample believes that avoiding government retribution is the biggest advantage of being a registered taxpayer (about 23 percent each). In addition about 22 percent of informal businesses perceive better access to land and premises as the first biggest advantage of registering for tax.

Businesses perceive high tax burden or high tax rates as the biggest disadvantage of registering for taxes: businesses perceive higher tax burden or high tax rates (34 percent), complicated tax compliance procedures (13 percent), harassment by government officials (8 percent), and frequent inspections (8 percent) as some of the disadvantages of registering for taxes.

Businesses perceive some advantages of registering for VAT: cash flow benefits and participating in

FIGURE E7: Perception about Tax Inspections (N = 1003)



government tenders have been considered as the biggest advantages of registering for VAT.

Businesses perceive some disadvantages of registering for VAT. Among the various disadvantages for registering for VAT, higher prices of goods and services compared to those by non-VAT registered businesses considered the first and second biggest disadvantages for registering for VAT (42 percent).

Businesses also perceive multiple advantages and disadvantages of sales register machine (SRM) usage: advantages include less opportunity for theft (20 percent), updated and easily available sales information (22 percent), and easy to comply with tax requirements (17 percent). In terms of disadvantages, difficulty of correcting errors (36 percent) and cost of the machine (19 percent) were perceived to be disadvantages of using SRM.

Businesses face frequent inspections/audits, although larger businesses experienced relatively more inspections, compared with smaller businesses: the survey indicates that around 31.7 percent of respondents reported that their businesses had faced some kind of inspection or audit by tax authorities in the last two tax years. About 48 percent and 46 percent of category A and B businesses experienced inspections or audits.

Businesses perceive only a relatively a small proportion of inspections and audits as happening for legitimate reasons: businesses perceived that only about 36 percent of tax inspection and audits happened for legitimate

reasons. This is lower compared to the perception on the same issue in other countries such as Georgia. About 19 percent of tax inspections and tax audits were also perceived to be happening because inspection officers were looking for informal payments, and another 19 percent because it was in someone's interest to create obstacles to others (Figure E7).

Simplify the tax regime for micro and small enterprises: to reduce the tax compliance burden on smaller businesses as is evident from this study and from the review of the standard assessment system and also encourage business formalization simplification of the tax regime for this segment is worth considering.

Offer a fixed tax and turnover based tax to respectively micro and small enterprises: in between poverty—level micro —enterprises paying a fixed tax and medium-large businesses paying regular profit tax and VAT, it is often helpful to offer an intermediate regime for “small” businesses that can pay a turnover tax in lieu of both profit tax and VAT (with an option for any business to register for regular profit tax and VAT Voluntarily). In addition, adjusting business categorization threshold for inflation is worth considering.

Review the income tax rate structure and exempt income threshold: reviewing the income tax rate structure (along with the tax exempt threshold) in addition to simplification of the entire tax system is important in reducing the burden of taxes and changing the attitudes of taxpayers and also encouraging formalization of businesses. The income tax exempt threshold should be set a approximately the poverty

level, and adjusted regularly over time to account for inflation and other relevant factors.

Adjust the VAT registration threshold periodically for inflation: the VAT registration threshold should be adjusted periodically for inflation and is usually set at the lower turnover level for a “medium” size business (taking into account also the capacity for the necessary bookkeeping for VAT compliance. The current threshold is quite low by international standards.

ERCA should try to expedite payment of refund to taxpayers to help businesses avoid unnecessary cash flow difficulties. In particular adopting of risk based refund processing and also accepting bank bonds as a security for VAT payment (risky businesses) could be considered as suggested at the Ethiopian Chamber of commerce and Sectoral Association’s forum.

Reduce the frequency of VAT filing: the compliance cost is high for VAT, it is recommended to reduce the frequency of VAT filing (e.g., make it quarterly), for relatively smaller businesses.

Investigate the entire dispute resolution system: it is important to investigate why a large number of appeal decisions were not in favor of the tax authority and what causes them. It is in general important to investigate the entire dispute resolution system and address the issues in the tax system.

Improving the risk based audit system and hold discussions with businesses: to mitigate the compliance burden (pertaining to audit) on businesses especially smaller ones and also increase taxpayers’ perception that tax audit is for legitimate reasons, it is important to consider improving the risk based audit system in addition to developing the culture of holding discussions with taxpayers.

Exercise caution in imposing business profit tax based on bank deposits: it is important to exercise caution by the tax administration in imposing income tax on bank deposits as that would increase taxpayers’ mistrust on the tax authority and reduce the incentive to use banking in business operations.

Background

The extent of tax burden is one of the main factors that the private sector considers when deciding to create, move or expand its businesses as high tax burden is a disincentive to private sector development. It should be noted that both the burden of tax payments and of tax compliance, which includes the time and cost associated with preparing tax returns, filing, effecting payment and interacting with tax authorities, are likely to deter business formalization. Evidence from a number of surveys (Coolidge, 2012) indicates that the burden of tax compliance can often be heavier than the actual tax payments, especially for small businesses (e.g., equivalent to a turnover tax of 5% or more).

The Government of Ethiopia (GoE), in its five year Growth and Transformation Plan (GTP) (2010/11–2014/15), indicates that the expansion and quality of infrastructure investment and the development of small and micro enterprises (SMEs), which are the basis for the transition towards medium and large-scale manufacturing industries are, among others, crucial pillars for sustained growth. This implies two things: first, enhancing the participation of the private sector in the development process; secondly, improving domestic resource mobilization to finance massive investment initiatives envisaged in the GTP (MoFED, 2010).

The capacity of any government to mobilize domestic resources is a crucial factor in the process of poverty reduction and its overall economic development. Cognizant of this, the GoE has given due emphasis to the introduction of reforms to its revenues and expenditures management. This emphasis can be seen from GoE's five year GTP where the expected growth of the revenues from domestic sources in general, and its tax revenue in particular, relies on the government's plan to improve tax compliance, broaden the tax base and to improve the tax administration capacity of revenue authorities. As indicated in the GTP, tax

revenue as a share of GDP is expected to increase from 11.3 percent in 2010/11 to 15 percent in 2014/15. Accordingly, the success in increasing tax revenues, which is of critical importance for the success of other components of the GTP, depends for most part on the performance of the Ethiopian Revenue and Customs Authority (ERCA) whose interaction with the taxpayers plays a significant role.

The actual tax revenue as a share of GDP (≈ 13 percent) is low compared to that of the average for Sub-Saharan African and low income countries. The share of tax revenue in GDP hardly changed, suggesting that tax revenue (which should rise relative to GDP due to progressive rate structure) has failed to grow as much as expected with the overall economic growth. This situation in the revenue system might be due to such things as poor tax compliance behavior and weak tax administration. In order to address issues of tax compliance to some extent, reducing complexities in the tax regime may be necessary.

Complexity of tax regimes (e.g., multiple taxes, several different bases, requirements for multiple filings per year, etc.) increases tax compliance costs, especially in developing countries. Findings from the Investment Climate Department of the World Bank Group (WBG) indicate the severity of tax compliance burden for businesses, especially for micro, small and medium enterprises (IFC 2010).

This analytical report intends to assess tax compliance costs and businesses' perceptions towards taxation in Ethiopia. The report is based on the findings of a survey of businesses (both formal and informal businesses) in Ethiopia as conducted by the Department of Economics of the Addis Ababa University on behalf of the Ethiopian Revenue and Customs Authority (ERCA) and the International Finance Corporation (IFC)/ World Bank group. Given the diversity of the country,

the study covered four regional states apart from Addis Ababa. The findings of the study are expected to offer tax policy makers and tax administrators an opportunity to pinpoint specific problems to help them reduce the cost of complying with tax policies and procedures, thus improving the revenue performance and also the efficiency and business-friendliness of the tax system.

The report is organized in four sections. The first part presents an overview of the Ethiopian tax system and recent reform initiatives; this is followed by a discussion of research objectives and the methods employed in section two. Section three presents results of the survey while the last section presents conclusions and recommendations.

1 | Overview of Ethiopian Tax System and Recent Reform Initiatives

The 1995 Constitution of the Federal Democratic Republic of Ethiopia (FDRE) classifies taxation power into three: as those assigned exclusively to the federal government, regional states, and concurrently to both regional and federal governments. As per the constitution, regional states have the power to levy and collect taxes from sources assigned to them.

Federal government revenues include:

- Income tax on employees of the federal government and international organizations;
- Income, profit, sales and excise taxes on enterprises owned by the federal government;
- Tax on income of air, rail and sea transport services;

Regional states revenues include:

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

Joint federal and regional states revenues:

- Profit, sales, excise and personal income taxes on enterprises they jointly establish;
- Taxes on the profits 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

Following the assignment of revenues, tax administration organs are ERCA and regional revenue authorities. ERCA is responsible for administration of revenues that belong exclusively to the federal government and those concurrently owned by both. Regional revenue authorities are entrusted with the responsibility of administering taxes assigned to them.

The principal taxes that affect businesses in Ethiopia are income taxes, value added tax (VAT), turnover tax (TOT) and excise taxes. The subsequent discussions briefly present the basic features of each of these taxes.

Income tax proclamation No. 286/ 2002 (as amended) and council of Ministers regulations 78/ 2002 (as amended) provide the legal basis for income taxation in Ethiopia. According to this legislation, there are four schedules of income, namely: income from employment (schedule A), income from rental of buildings (schedule B), business profit (schedule C) and other income (schedule D). A further look at the income tax under schedule C (business profit tax) shows that the tax is imposed on profit obtained from an entrepreneurial activity. It is chargeable at rates ranging from 10 to 35 percent if the taxpayer an individual (unincorporated entity) and 30 percent on profits earned by a body (an incorporated entity). The income tax legislation classifies businesses into three categories

as A, B, and C. Category A businesses are those that have annual turnover of ETB 500,000 or above and all incorporated entities; category B includes those that are not already classified as A and have annual turnover of more than ETB 100,000 but less than ETB 500,000. Category C taxpayers are those that are not already included in categories A and B and have annual turnover up to ETB 100,000.

For categories A and B the tax is assessed based on the profit and loss statement prepared in accordance with the Generally Accepted Accounting Principles (GAAP) subject to the specific rules as provided in the income tax legislation.

On the other hand, the tax from category C taxpayers is levied and collected in a separate regime—the “standard assignment” which uses a classification of businesses into more than 80 business sectors and 19 turnover bands. This regime is based on daily sales estimates, which the government carries out once in a few—years time. For example, the Addis Ababa city administration carried out daily sales estimates for category C businesses twice since the overhaul of the income tax system in the year 2002. Daily sales are estimated by a committee of tax officials by asking the concerned taxpayer questions and also observing the business location and the nature of the business. In practice, the tax is calculated using the annual turnover estimated based on the daily sales estimate and profit margin specified in the regulation (as amended). Category C taxpayers are expected to make an annual declaration of annual sales, but are not required to keep books of account. If category “C” taxpayer maintains book of accounts acceptable to the Tax Authority, the taxpayer may pay the tax on the basis of book of accounts.

Categories A and B are required to file tax returns and pay the tax due in respectively 4 months and 2 months from the end of their accounting year while category C taxpayers pay the tax due in one month from the end of the accounting year. The latter may request to make their tax payments in installments in cases of cash flow difficulties.

The income tax legislation requires such agents as incorporated entities, government organizations, and Nongovernment organizations (NGOs) to withhold

2 percent² of the payments for the purchase of goods and services.³ In addition importers are required to pay 3 percent of the Cost, Insurance and Freight (CIF) value of goods imported for commercial purposes as a withholding income tax on imports. Withholding income tax on payments is required to be remitted to the tax authority within 30 days from the end of the month in which the income was withheld. Both withholding income tax on imports and purchases of goods and services are allowed to be offset against business profit tax due from the supplier by the end of the accounting year in which the tax was withheld.

Further, as per the income tax legislation businesses are obliged to withhold employment income tax (schedule A income) from payments to employees and remit the amount to the concerned tax office in the next month the income is withheld.

Schedule B, as noted above, deals with income from rental of buildings. The basic provisions with respect to tax rates, determination of taxable income etc are very similar to schedule C income (for business profit).

Proclamation 285/2002 and council of Ministers’ regulation 79/2002 (as amended) provide the legal basis for the imposition and collection of VAT in Ethiopia. Similarly, proclamation 308/2002 (as amended) governs the imposition of TOT. In terms of design VAT is imposed on the supply of goods and services other than exempted supplies (such as bread and milk). VAT is based on the invoice credit method in which taxpayers are given credit for the VAT paid on inputs when it is supported by the relevant documents. The tax is also based on the destination principle in that imports are taxed but not exports. VAT is chargeable at a standard rate of 15 per cent on all taxable supplies of goods and services other than those zero rated (mainly exports) and exempted. VAT registration is required by businesses that have annual turnover of ETB 500,000 and more. In addition to annual turnover as a basis for registration of taxpayers, Ethiopia uses

² If the recipient does not provide the tax identification number then the law requires 30 percent of the payment to be withheld.

³ The withholding income tax on payments threshold for goods and services is respectively ETB 10,000 and ETB 500 per one transaction.

sector specific registration schemes, in that those engaged in such sectors as plastic and plastic products manufacturing, shoes manufacturing, computer and accessories suppliers and gold smiths are required to register for VAT regardless of their annual turnover.⁴ The accounting and reporting period for VAT is one calendar month regardless of the size and capability of businesses. The VAT legislation allows refunds to be made to mainly exporters within two months from the time refund application is filed. Non-exporting taxpayers are required to carry forward excess credits to the next five accounting periods (five months); if there are still unused excess credits it is allowed to be refunded within two months from the time of lodging application for refund. Very recently, the government has introduced VAT withholding scheme where federal government institutions are required to withhold the VAT on their purchases and remit the amount to the tax authority.

Businesses supplying taxable goods and services and not required to register for VAT are expected to pay TOT on their supplies of goods and services. TOT is considered as an equalization tax between VAT registered and unregistered businesses. The applicable rates are 2 percent on goods supplied domestically and on contractors, grain mills, tractors and combine-harvesters; and 10 percent on all other services (e.g., barbers/hairdressers, car mechanic, etc.). Certain services are exempt, including financial services, the supply of electricity, water and kerosene, the provision of transport; educational institutions, child-care). Estimation of sales for category C taxpayers follow the same procedure as for income tax, but must also take into account an estimate of the split of income between goods and services.

The accounting period for TOT differs among the different category of businesses. Category A businesses have accounting period of one month; in that taxpayers in this category are required to file and pay turnover tax on a monthly basis. Category B businesses are required to file and pay their TOT on a quarterly basis while category C businesses pay TOT annually.

⁴ Voluntary VAT registration is allowed for those that transact at least 75% of their transactions with VAT registered businesses.

In addition to business profit tax and VAT/TOT, businesses engaged in the importation and or production of selected products are liable to excise taxes as provided in excise tax proclamation 307/2002. Excisable goods include textile and textile products, vehicles, tobacco and tobacco products, drinks (including all types of alcoholic and soft drinks), sugar and salt. The base for computation of excise tax is the cost of production for locally produced goods and cost, insurance and freight (CIF) value and custom duties of imported goods. The tax rate ranges from 10 percent to 100 percent. Generally excise tax is payable on imported goods at the time of clearing the goods from customs area and on goods produced locally, not later than 30 days from the date of production.

In addition to the above domestic taxes affecting businesses, there are duties and taxes imposed on the import and export operations of businesses. Since this report is about tax compliance costs and perceptions towards taxation focusing on domestic taxes, we do not deal with these duties on international trade.

RECENT TAX REFORM INITIATIVES

In an effort to streamline and simplify the tax system, the GoE adopted a series of tax reform measures focusing on reducing tax rates, removing unproductive taxes, broadening the tax base and improving and modernizing revenue collection (MoFED, 2014). The key reform measures taken in the early 2000 were overhaul of the income tax regime which was operational for over four decades (with no major changes), and introduction of VAT as a replacement to sales tax. Specifically, the introduction of taxpayer identification number (TIN) along with finger prints and the presumptive tax regime (standard assessment) for category C taxpayers could be mentioned, among others.

The introduction of electronic sales register machine is also a very recent phenomenon in the Ethiopian tax system. The government has further launched electronic filing system and established a call center. The Electronic Single Window Project (for a better trade facilitation) is the other initiative.

In respect of tax administration, recently the tax administration was organized as a separate and autonomous government body, which later resulted in the establishment of Ministry of Revenue (MoR) coordinating and supervising the three revenue agencies of the Federal Government, namely Federal Inland Revenue Authority (FIRA), Ethiopian Customs Authority (ECA) and the National Lottery. Later the government reorganized and restructured the tax administration at federal level by merging FIRA, ECA and MoR into one authority- ERCA. ERCA is organized as an authority with direct accountability to the Prime Minister.

Very recently ERCA and Addis Ababa city government's revenue agency have merged and ERCA is currently administering taxes on behalf of the Addis Ababa City Revenue Agency. To closely follow taxpayers in Merkato, ERCA has opened tax offices in Merkato. Currently, ERCA administers domestic taxes in its 10 branches offices (Large Taxpayers' Office (LTO), West Addis Ababa Branch, East Addis Ababa Branch, Mekelle, Adama, Hawassa, Bahir Dar, Jimma, Dere Dawa, Kombolcha). Similarly for customs duties ERCA has 11 branches throughout the country (Addis Ababa Kaliti, Addis Ababa Airport, Adama, Mojo, Dere Dawa, Jigjiga, Moyalle, Kombolcha, Mekelle, Bahir Dar, and Millie customs branch offices).

2 | Objectives and Methods Adopted

The main objective of this study was to estimate tax compliance costs for private businesses in Ethiopia and assess business taxpayers' perception on the tax system and the business environment at large.

In order to achieve the above objective, the study employed a survey of businesses—both formal and informal businesses—operating in Ethiopia. The subsequent discussion presents the survey design in respect of sampling, instrument design and actual conduct of the survey.

2.1 SURVEY: SAMPLING DESIGN

Ethiopia has nine Regional States and two City Administrations (Addis Ababa and Dire Dawa). Each region is divided into zones and each zone into Woredas. Woredas are further divided into Kebeles, the lowest administrative units. In City Administrations, especially in Addis Ababa, the administrative division is slightly different. Each city is divided into sub-cities and each sub-city into Woredas, the lowest administrative unit. The survey was conducted in four major regional states and Addis Ababa. The total number of eligible business taxpayers in the sampling frame was 987,923 (formal businesses). The eligible sampling frame was stratified by region, sector, category (A, B and C) and ownership status and the sample was randomly selected. In each region, one major city or town was selected using urban population size as a criterion. In total, five major cities were covered: Addis Ababa, Mekelle (representing

TIGRAY and Afar), Bahir Dar (AMAHARA and Benishangua), Adama (OROMIA, Dire Dawa, Harari and Somali), and Hawassa (SNNPRS and Gambela).

The valid sample size was 1003 for formal businesses. The regional distribution of the sample firms is as follows: approximately 37 percent were from Addis Ababa City Administration; 25 percent were from Oromia, Harari, and Somali regional states and Dire Dawa City Administration; about 19 percent were from Amhara and Benishangul-Gumuz regional states; about 11 percent were from Tigray and Afar regional states; and about 9 percent were from SNNP and Gambella regional states (Table 2.1).

In terms of the legal status of firms in the sample, the largest proportion (92.5 percent) of 1003 firms belongs to sole-proprietorship status. Cooperatives and private limited companies represent very small proportions, respectively, 4 and 3.3 percent of the total firms in the sample, mostly in category A. However, about 18% of the businesses in category B reported they were a PLC.

In-line with the sectoral configuration of firms in the country, the largest proportion of the 1003 firms in the sample (about 50 percent) operate in the service sector followed by trade (both wholesale and retail trade) which represents about 41 percent. Firms that engage in the manufacturing sector are only about 8 percent of the sample. As might be expected, manufacturing firms are more likely to be found in category A (where they make up over 20% of the group) than in categories B

TABLE 2.1: Distribution of Sample Firms—Formal (by region and category)

Location	Category A		Category B		Category C	
	N	Percent	N	Percent	N	Percent
Addis Ababa	57	65	61	67	251	30
Oromia, Dire Dawa, Harari, and Somali	18	20	17	18	219	27
Amhara and Benishangul-Gumuz	6	7	9	10	172	21
Tigray and Afar	4	4	3	3	103	12
SNNPR and Gambella	3	4	2	3	79	10
Total	87	100	92	100	824	100

TABLE 2.2: Sectoral Distribution of Businesses—Formal (by taxpayers' category)

	Category A (N = 342)	Category B (N = 253)	Category C (N = 408)
Manufacturing	20.7	9.8	6.3
Trade (wholesale and retail)	42.6	28.3	42.6
Other services	35.6	59.8	50.5
Others	1.1	2.1	0.6
Total	100	100	100

TABLE 2.3: Business Category by Turnover (percent)

	Category A (N = 342)	Category B (N = 253)	Category C (N = 408)	Total (N = 1003)
Less than ETB 100,000	20.7	38.0	88.1	77.7
ETB100,001-ETB500,000	20.7	47.8	11.4	15.6
ETB500,001-ETB 10,000,000	49.4	14.1	0.5	6.0
Above ETB 10,000,000	9.2	0.0	0.0	0.8
Total	100.0	100.0	100.0	100.0

or C (where they make up 10% and 6% respectively) (Table 2.2).

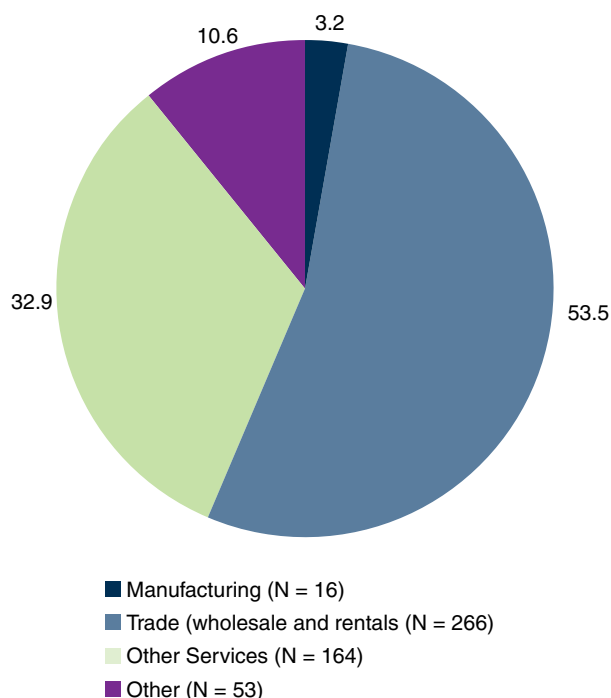
The distribution of businesses by category and turnover band shows that about 40 percent of those in category A were found to have turnover less than ETB 500,000. These businesses could be incorporated entities for they are categorized as A regardless of their annual turnover. From those in category B about 30 percent were found to have turnover less than ETB 100,000 (Table 2.3). This could be due to the fact that, for the year under consideration, those businesses' turnover was than the ETB 500,000. A majority of those in category C (about 90 percent) were found to have turnover less than ETB

100,000 consistent with the definition of category C businesses.⁵

In respect of informal businesses, the sampling technique adopted was area based sampling. The sampling frame consisted of the list/size of urban population by zone, the administrative level at which the aggregation was made.

⁵ It is important to note that the difference between reported category and category of businesses as per ERCA's records might be due to the fact that ERCA's records mostly show the category of businesses at the time of registration for taxes.

FIGURE 2.1: Sectoral Distribution of Informal Businesses (percent) (N = 499)



The urban population by zone was prepared using the 2007/8 Population and Housing Census conducted by the Central Statistical Agency (CSA). Before drawing the actual sample for the survey, a complete list of zones and Kebeles/Woredas (lowest administrative units) was prepared for Addis Ababa, Mekelle, Bahir Dar, Adama, and Hawassa. The actual sample was selected using probability sampling with probabilities proportional to urban population size of the Kebeles/Woredas located in each city/town.

The valid sample size achieved for informal business survey is 499 informal business operators. The largest proportion of the firms is sampled from Addis Ababa;

approximately 78 percent are from this survey site. The remaining 22 percent of the firms is almost evenly distributed across the other four survey areas: approximately 6, 4, 6, and 5 percent, from respectively Mekelle, Bahir Dar, Adama, and Hawassa.

The distribution of the sample firms in terms of their primary activities is similar to that of the formal businesses. That is, only very small percent of informal businesses that participated in the survey reported that their primary activity is manufacturing, while about 87 percent of firms reported to operate activities that are classified as trade and other services (Figure 2.1).

2.2 SURVEY: INSTRUMENT AND ACTUAL CONDUCT OF THE SURVEYS

Based on the literature (IFC 2011), two structured survey questionnaires for both formal and informal business surveys were developed. The questionnaires were further developed using data obtained through focus group discussions (FGDs) and on the outcomes of pilot testing (conducted with 40 respondents). Questions in the instruments included those pertaining to estimation of compliance costs (formal business survey questionnaire), perception of tax administration procedures and difficulties with the tax system. The reference period for all questions was the fiscal year 2005 E.C. (2012/2013).

Both surveys of formal and informal businesses were conducted using face-to-face interview approach. The survey was conducted between May 2014 and August 2014.

3 | Survey Results

This section presents the results of the survey (formal and informal businesses). Specifically, it presents the findings of the study with respect to tax compliance costs of formal businesses and perceptions of both formal and informal businesses about aspects of tax compliance and the business environment.

Before analysis of the data began, it was necessary to generate sampling weights to obtain representative data that could be generalized to the target population. Frequency distributions were calculated and, as part of the analysis of the estimated compliance costs, international comparisons with the results of similar surveys were made. It should be noted that the percentages and averages reported are weighted averages or percentages unless stated otherwise.

3.1 PROFILE OF RESPONDENTS

Almost all the respondents to both formal and informal business surveys were owners of the businesses. Of the total formal business survey respondents, about 90 percent were owners followed by director/manger (or deputy) representing 7 percent (Figure 3.1). And even higher proportion of informal business survey respondents (98 percent) were owners of the businesses.

In terms of the taxpayers' category (formal business survey), most of the owner respondents are in category C. As might be expected for relatively larger firms, there is more diversity in categories A and B, with a "Director/Manager" answering for about a quarter of category A businesses and 18 percent of category B businesses. A chief accountant answered for about 7 percent of category A businesses.

FIGURE 3.1: Position of Respondents—Formal Businesses (in percent, N = 1003)

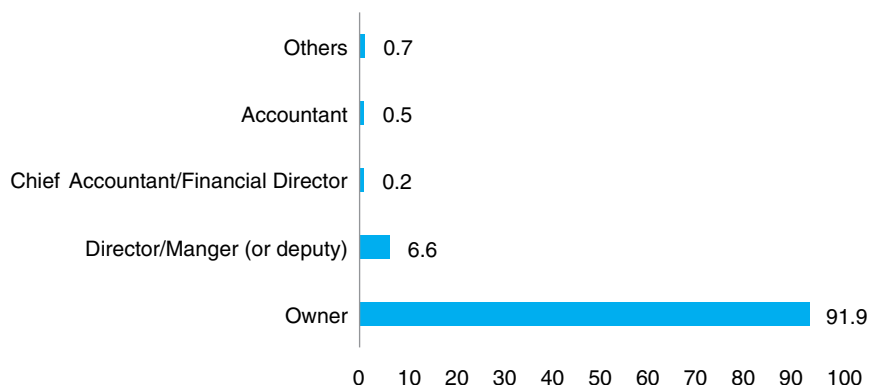
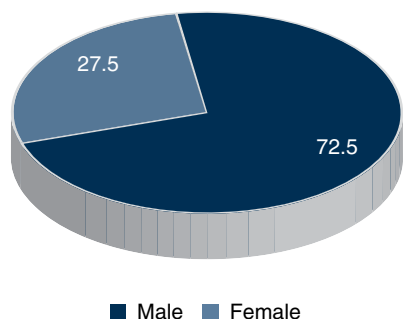


FIGURE 3.2: Gender of Respondents—Formal
(in percent, N = 1003)

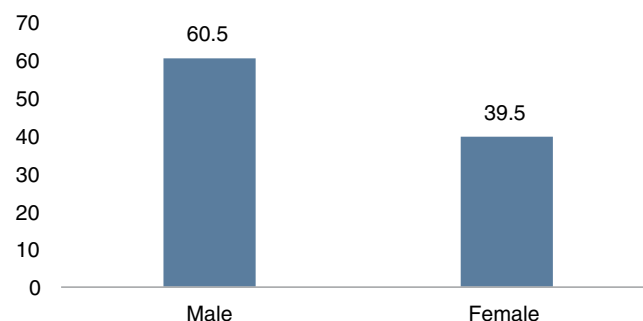


Gender wise, most of formal business survey respondents are male representing 72.5 percent while female respondents accounted for 27.5 percent (Figure 3.2). Combining the figures for the position of respondents in the establishment with that of gender distribution indicates one of the stylized facts of business firms in developing countries like Ethiopia, i.e., women are underrepresented both as owners of business firms and in positions of decision making in business firms.

The gender of respondents in the different tax payers' categories shows opposite trends in the sense that the percentage of male respondents decreases from category A to C while that of female respondents' increases from category A to C. This seems to indicate that women are relatively more engaged in smaller business (either as owners or managers); given the largest proportion of the respondents in the sample are owners (Table 3.1).

Similarly in the informal business survey, the results showed male respondents dominance (Figure 3.3). However, the gender gap is smaller for the informal businesses (approximately 60 and 40 percent for male and female respondents, respectively) compared to that of the sample formal businesses presented. Thus, we see a continuation of the same trend, i.e., relatively

FIGURE 3.3: Gender of Respondents—Informal Businesses (N = 499)



smaller businesses have relatively higher proportions of female ownership.

In addition, in terms of the gender of owners of businesses (formal) about 67 percent were found to be owned by men while women owned businesses were lightly more than a quarter of the establishments covered by the study (Figure 3.4).

In the case of informal businesses, consistent with the gender of respondents (most of them were owners), the gender distribution indicates that about 60 percent of businesses in the sample are male-owned while 39 percent are female-owned

Formal business survey data reveals that most of the businesses (more than 64 percent) in the sample obtained Tax Identification Number (TIN) over the period 2002–2004 EC. In terms of the time period of establishment, most of the informal businesses that participated in the survey (approximately 76 percent) were established during the period 1991–2000 (Figure 3.5).

FIGURE 3.4: Gender of Owners—Formal (in percent, N = 1003)

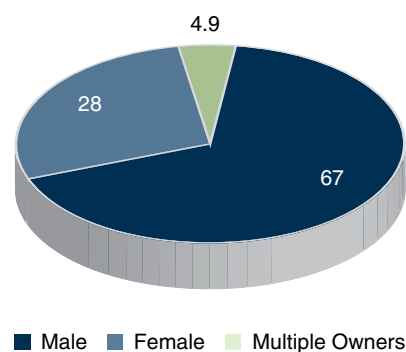
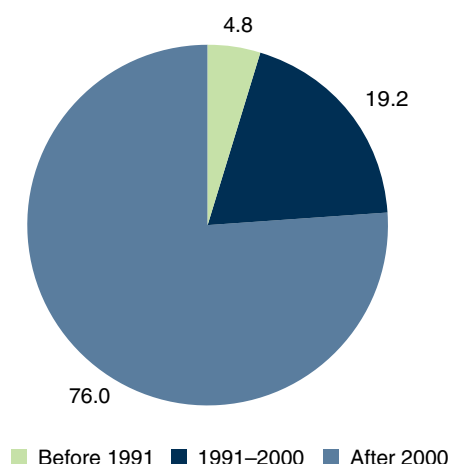


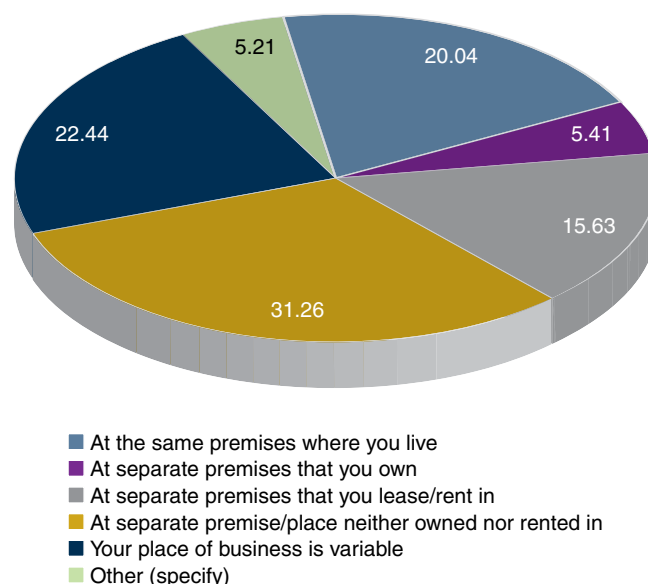
TABLE 3.1: Gender of Respondents—Formal
(by taxpayers' category) (in percent)

	Category A (N = 342)	Category B (N = 253)	Category C (N = 408)
Male	87	75	71
Female	13	25	29

FIGURE 3.5: Period of Establishment

When informal business respondents were asked about their working premises, about 20 percent of them operate at their living place, 15% rent a separate working premise and only 5% of them own a separate working premise (Figure 3.6). More than 31 percent of the firms reported that their working premises are separate from their living place but neither own or rented in the place. Significant number of respondents (more than 22 percent) indicated that they do not have a fixed business place—their places of work are variable.

In addition to the above examination of the results (in both surveys) with respect to number of employees

FIGURE 3.6: Working Premises of the Sample Firms (N = 499)

and working premises shows that overall the average number of workers in the formal businesses is about 5 workers per establishment. Of this number, about 4 workers are full time workers (Table 3.2). As should be expected, category A businesses have higher numbers of workers (about 26) than categories B (7 workers) and C (2 workers).

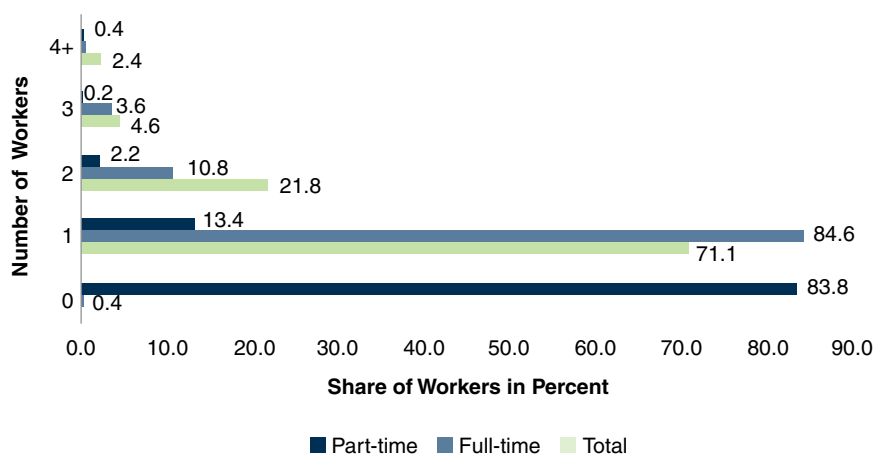
The data from the informal business survey reveal that most of the firms in the sample are operated by

TABLE 3.2: Number of Workers in Sampled Businesses—Formal (total and by categories)

Variable	N	Mean	Median	Std. Dev.	Min	Max
Total number of workers	1003	5	3	23	1	1618
Full time workers	1003	4	2	18	0	878
Part time workers	1003	1	0	12	0	74
Total number of workers (category A)	342	26	8	73	1	1618
Full time workers (category A)	342	20	5	57	1	878
Part time workers (category A)	342	7	1	38	0	740
Total number of workers (category B)	253	7	3	8	1	40
Full time workers (category B)	253	5	2	5	0	25
Part time workers (category B)	253	2	0	5	0	33
Total number of workers (category C)	408	2	2	2	1	300 ⁶
Full time workers (category C)	408	2	1	1	0	67
Part time workers (category C)	408	1	0	2	0	300

⁶ This is just one large vegetable cooperative which employs 300 temporary workers and does not have permanent workers. Although this cooperative is self-reported to be under category C, it is not clear why this cooperative is in this category.

FIGURE 3.7: Number of Employees—Informal (N = 499)



a single person (Figure 3.7). More than 70 percent of informal businesses that participated in the survey are operated by 1 person and approximately 85 percent of the firms reported that the number of full-time workers is just one. Furthermore, most of the firms (about 84 percent) do not have part-time workers. This is not surprising given that most informal firms are operated by individual owners.

Both formal and informal business survey respondents were asked about their bookkeeping practices. The results show that about half of the formal sector respondents reported that they kept all receipts and invoices of transactions in an organized manner, while 42 percent maintained full records of revenues and expenses (not necessarily using computer) (Figure 3.8). Only about 9 percent use a computer for purposes of bookkeeping; about two-third of those who use computers also use specialized accounting or bookkeeping software.

The bookkeeping practice of formal businesses by category also reveals that about 98 percent of category

A businesses were found to have kept all receipts and invoices in an organized manner. Similarly about 80 percent of businesses in category A who use a computer for purposes of bookkeeping were found to be using specialized accounting or bookkeeping software. On the other hand, only 40 percent of businesses in category C were found to have kept receipts and invoices in an organized manner (Figure 3.9).

In the case of informal businesses almost all of them reported that they did not maintain physical receipts and invoices of transactions (Figure 3.10). Only 15.6 percent and 17 percent said that they kept records of sales and purchases, respectively. This shows that the bookkeeping practice in the informal sector is very limited compared to that of the formal sector.

In terms of regional variation, about 18.8 percent of respondents in Adama and Mekelle maintained physical receipts and invoices of transactions, compared with 15.1 percent in Addis Ababa and 13.6 percent in Bahir Dar (Figure 3.11). Keeping records of purchases

FIGURE 3.8: Bookkeeping Practices of Businesses—Formal

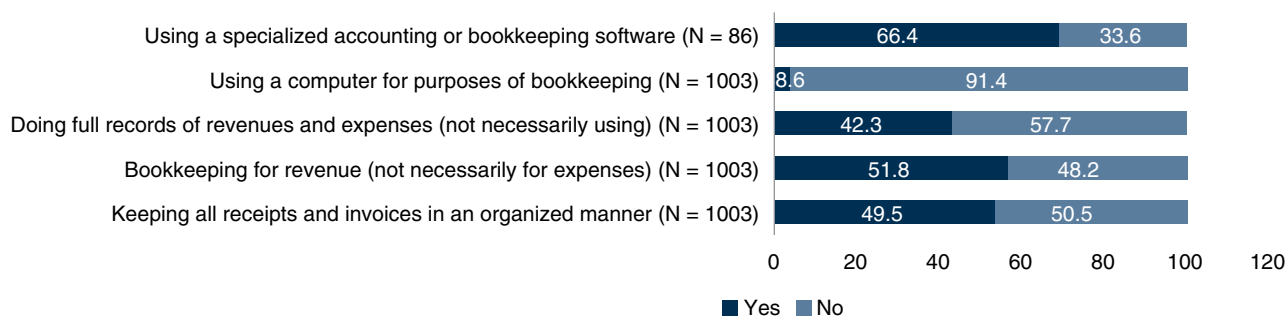


FIGURE 3.9: Bookkeeping Practice of Businesses—Formal (by category)

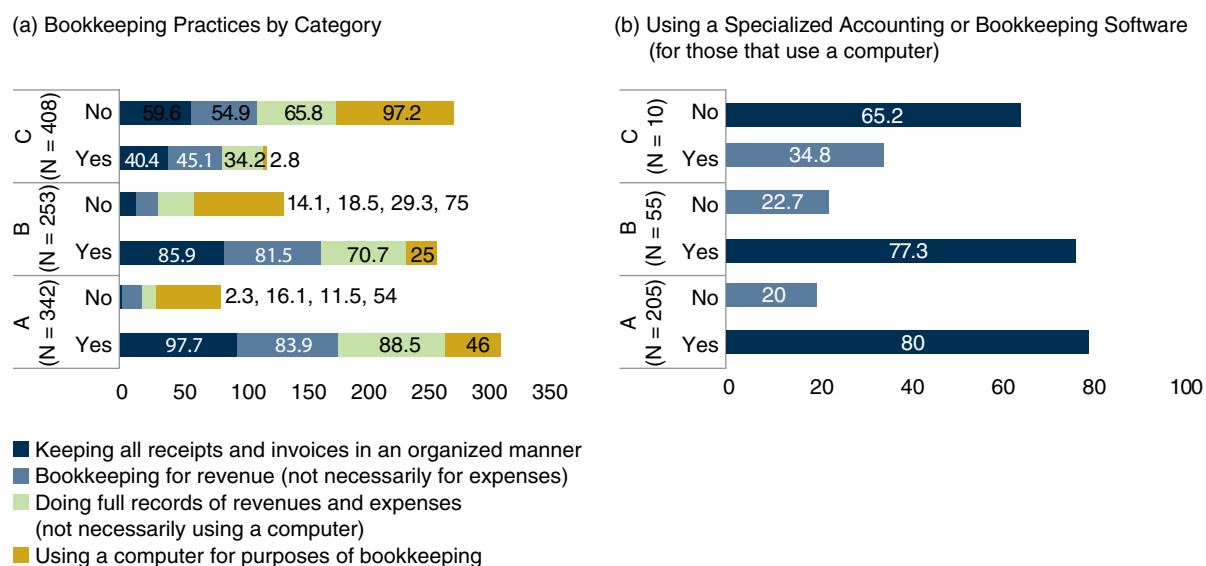


FIGURE 3.10: Bookkeeping Practices (percent)—Informal

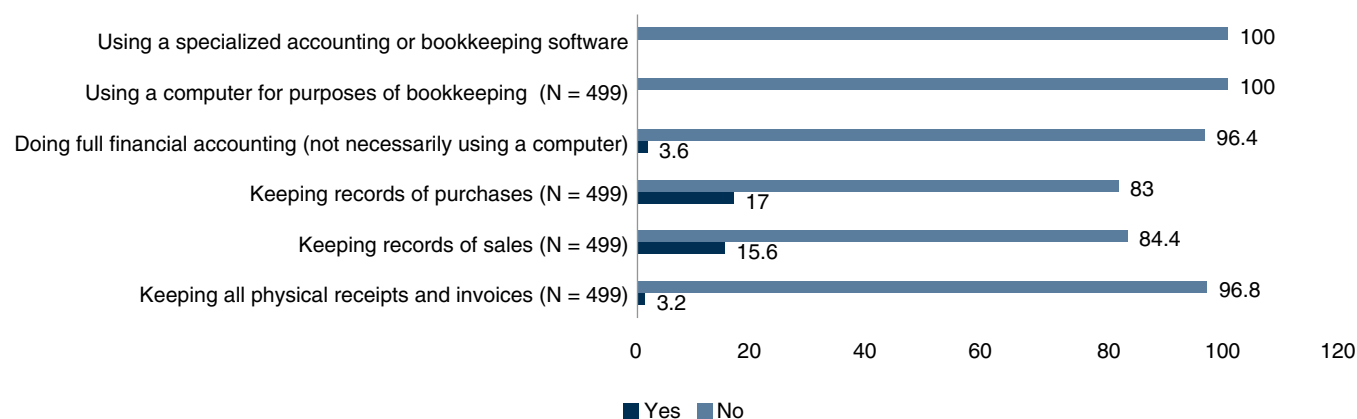
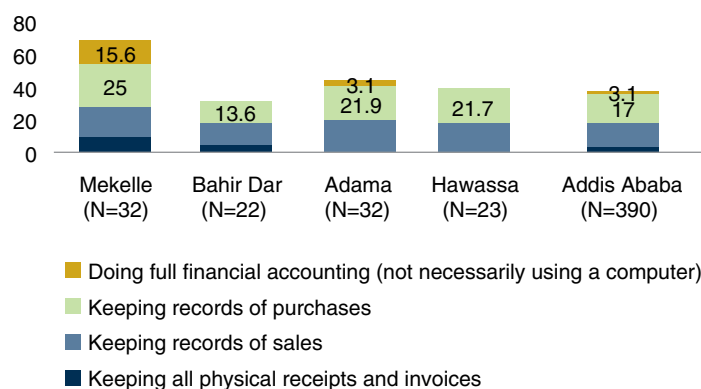


FIGURE 3.11: Bookkeeping Practices by Location (percent, yes)—Informal



and or sales seems important compared with other bookkeeping practices.

Businesses were asked about the types of taxes for which they submitted tax returns in the last tax year (2012/13). About 61 percent submitted business profit

tax returns which was the largest followed by turnover tax (36 percent of formal businesses). Value added tax return submission was reported by about 12 percent while the corresponding figure for employment related tax and contributions was about 15 percent. Other

TABLE 3.3: Types of Taxes Paid by Category and Ownership Type (percent)

	Category			Ownership Type			
	A	B	C	Individual/Sole Proprietorship Percent	Private Limited Company	Cooperative Society	Others
Business profit tax (N = 740)	85	79	55	58	85	71	64
Value added tax (N = 410)	77	37	3	9	70	32	56
Turnover tax (N = 255)	14	37	32	31	6	43	8
Withholding income tax on payments (N = 228)	45	19	2	4	66	28	62
Employment related contributions (N = 340)	59	39	6	10	77	48	90
Other taxes (N = 157)	10	14	24	22	30	14	13

tax returns submitted include withholding income tax on payments (8 percent) and “other taxes” (including excise tax, building rental income tax, and property tax) (24 percent). We also note that well over one-fifth of businesses (and over half of category C taxpayers) have not reported submitting tax returns mainly because they are operating under the standard assessment whereby the tax they pay is fixed by the tax authority. Other businesses reported paying rental income tax (included under “other taxes”) (Table 3.3).

As expected a much larger percentage of businesses from category A (77 percent) submitted value added tax returns compared with category C businesses (3 percent). On the other hand, a larger percentage of category B (37 Percent) and C (32 percent) businesses submitted turnover tax returns compared with those in category A (14 percent). The proportion of businesses in a category that submitted returns for other taxes is much larger for category C (24 percent) compared with others, due to the relative significance of rental income tax for this group.

We also note from Table 3.3 that, as expected, a much larger proportion of private limited companies (85 percent) submitted profit tax returns compared with sole proprietorships which have the lowest share by ownership type (58 percent). Similarly a larger percentage of private limited companies (70 percent)

submitted value added tax returns compared with sole proprietorships (9 percent). This is reversed for turnover tax (6 percent) for private limited companies and 31 percent for sole proprietorships. We may also note the lower percentage of businesses submitting value added tax and turnover tax is due to exemptions from payment of value added tax and turnover tax for businesses such as providers of education, health and transport services as well as those that rent out residential premises.

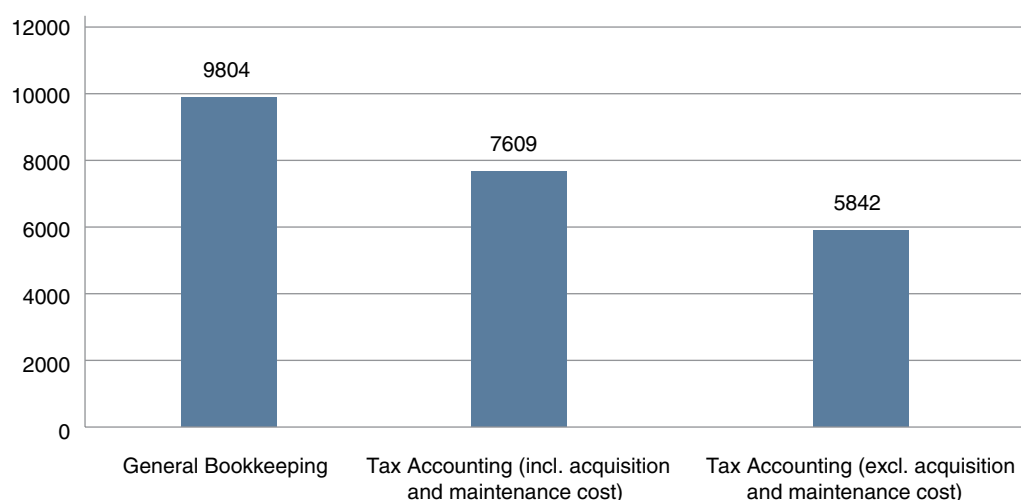
3.2 TAX COMPLIANCE COSTS

Sandford (1995) defined tax compliance costs as costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities; costs over and above the actual payment of tax; costs which would disappear if the tax was abolished.

In this study tax compliance costs (TCCs) is estimated using the following:

$$\begin{aligned}
 \text{TCCs} = & \text{In house cost of time spent by employees} \\
 & + \\
 & \text{Outsourcing costs} \\
 & + \\
 & \text{Costs of software/ hardware/ dataware/} \\
 & \text{information}
 \end{aligned}$$

FIGURE 3.12: Average Total Compliance Costs (in ETB)



For the ease of respondents, the questionnaire asked them first about the total amount of time spent on both general bookkeeping and tax compliance tasks.

In-house cost of time spent by employees = time spent by various individuals on bookkeeping and tax accounting tasks * salaries (salaries of relevant workers was asked in the survey);

Outsourcing costs = Outsourcing cost paid to outside personnel for bookkeeping and tax accounting tasks;

Cost of software/hardware/dataware/information = Money spent by business on acquisition and maintenance of software, hardware, dataware and information in the five year period before the survey divided by five.

The overall cost is then divided into general bookkeeping costs and tax accounting costs. In this study general bookkeeping is defined to include all bookkeeping activities that will be undertaken even if the business did not comply with tax requirements. All other activities are considered under tax accounting.

General bookkeeping cost = cost of in-house time spent for general bookkeeping + cost of outsourcing for general bookkeeping.

Tax accounting cost = cost of in-house time spent for tax accounting + cost of outsourcing for tax accounting

Or

= cost of in-house time spent for tax accounting + cost of outsourcing for tax accounting + acquisition and maintenance cost of software/hardware/dataware/information

The average total cost of a business for general bookkeeping was found to be ETB 9,804 (USD 523.2)⁷ in the last tax year (2012/13). In the same year, average total tax compliance cost of a business including costs of acquisition and maintenance of software and hardware was ETB 7,609 (USD 406) while average total tax compliance cost without acquisition and maintenance costs was ETB 5,842 (USD 311.7) (Figure 3.12).

The relative cost of tax compliance was calculated as a percentage of turnover. The average tax compliance cost of a business (with acquisition and maintenance costs of software and hardware) as a share of turnover is about 5.4 percent while the share of tax compliance cost in total turnover without acquisition and maintenance costs is 4.7 percent (Table 3.4). In absolute terms, tax compliance cost for category A businesses is well over 5 times the cost for category C businesses (both when tax accounting cost includes and excludes acquisition and maintenance costs). However, relative tax compliance cost as a share of turnover is larger for category C compared with category A.

⁷ Average exchange rate for the year 2012/13 was USD 1 = ETB 18.59 (NBE annual report 2012/13)

TABLE 3.4: Average Tax Compliance Costs (in ETB and as a share of turnover) by Taxpayers' Category

	Category		
	A	B	C
N	323	199	201
Tax accounting cost in ETB (excl. acquisition and maintenance cost)	17185	10068	2637
Tax accounting cost in ETB (incl. acquisition and maintenance cost)	21639	13162	3203
Tax accounting cost as share of turnover (%) (excl. acquisition and maintenance cost)	3.85%	3.84%	5.03%
Tax accounting cost as share of turnover (%) (incl. acquisition and maintenance cost)	4.70%	5.39%	5.51%

In addition, tax compliance cost as a share of turnover tends to decrease as the turnover of businesses increases suggesting that it is regressive (Figure 3.13). This is true whether we include or exclude cost of acquisition and maintenance cost of software and hardware. Those with turnover under ETB 100,000 faced compliance costs of almost 7 percent (for those who had tax hardware/software); otherwise about 6 percent.

Table 3.5 shows tax compliance costs by ownership type and sector of businesses. Sole proprietorships have the lowest tax compliance cost (ETB 4,046) while the tax compliance cost of other ownership types is much higher (for example, the cost for private limited companies is ETB 28,104 or ETB 35,793 depending on

whether acquisition and maintenance cost of software and hardware is excluded or not). The relative cost of tax compliance does not differ much across most of the ownership types with the exception of cooperative societies where the percentage is visibly lower than the others.

In terms of sector of businesses, compliance cost is the lowest for 'other services' and the highest for 'other sectors' which largely includes agriculture. On the other hand, the relative cost of tax compliance is the highest for trade and the lowest for 'others'

Figure 3.14 shows tax compliance cost as a share of turnover for different countries including Ethiopia. For

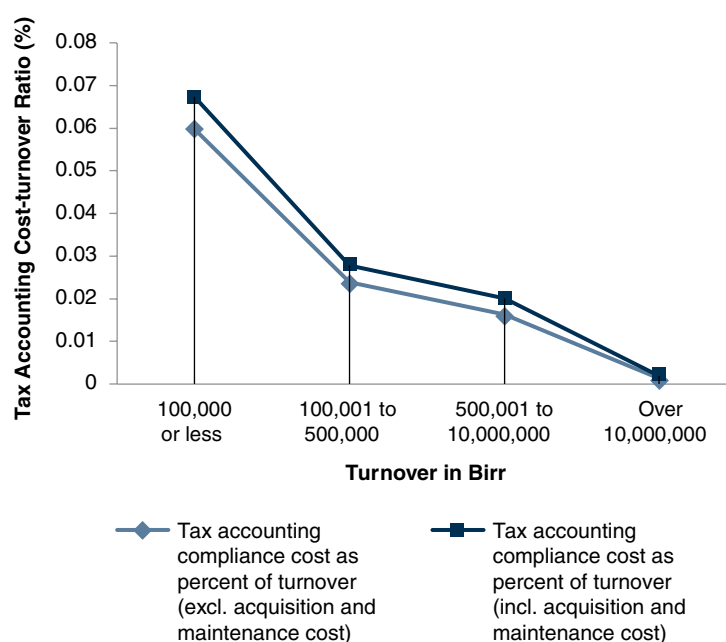
FIGURE 3.13: Tax Compliance Cost as a Share of Turnover by Turnover Band

TABLE 3.5: Tax Compliance Costs (in ETB and as a share of turnover) by Taxpayers' Ownership Type and Sector

	Ownership Type				Sector			
	Individual/ Sole Proprietorship	Private Limited Company	Cooperative Society	Others	Manufacturing	Trade	Other Services	Others
N	541	128	42	12	67	334	281	41
Tax accounting cost in ETB (excl. acquisition and maintenance cost)	4046	28104	11671	26267	9789	5448	5189	16611
Tax accounting cost in ETB (incl. acquisition and maintenance cost)	5279	35793	13645	36333	17673	6821	6661	21658
Tax accounting cost as share of turnover (excl. acquisition and maintenance cost)	4.77%	4.92%	3.52%	5.36%	3.18%	5.77%	4.07%	2.61%
Tax accounting cost as share of turnover (incl. acquisition and maintenance cost)	5.45%	5.66%	4.04%	5.52%	4.40%	6.26%	4.74%	3.19%

FIGURE 3.14: International Comparison of Tax Compliance Costs

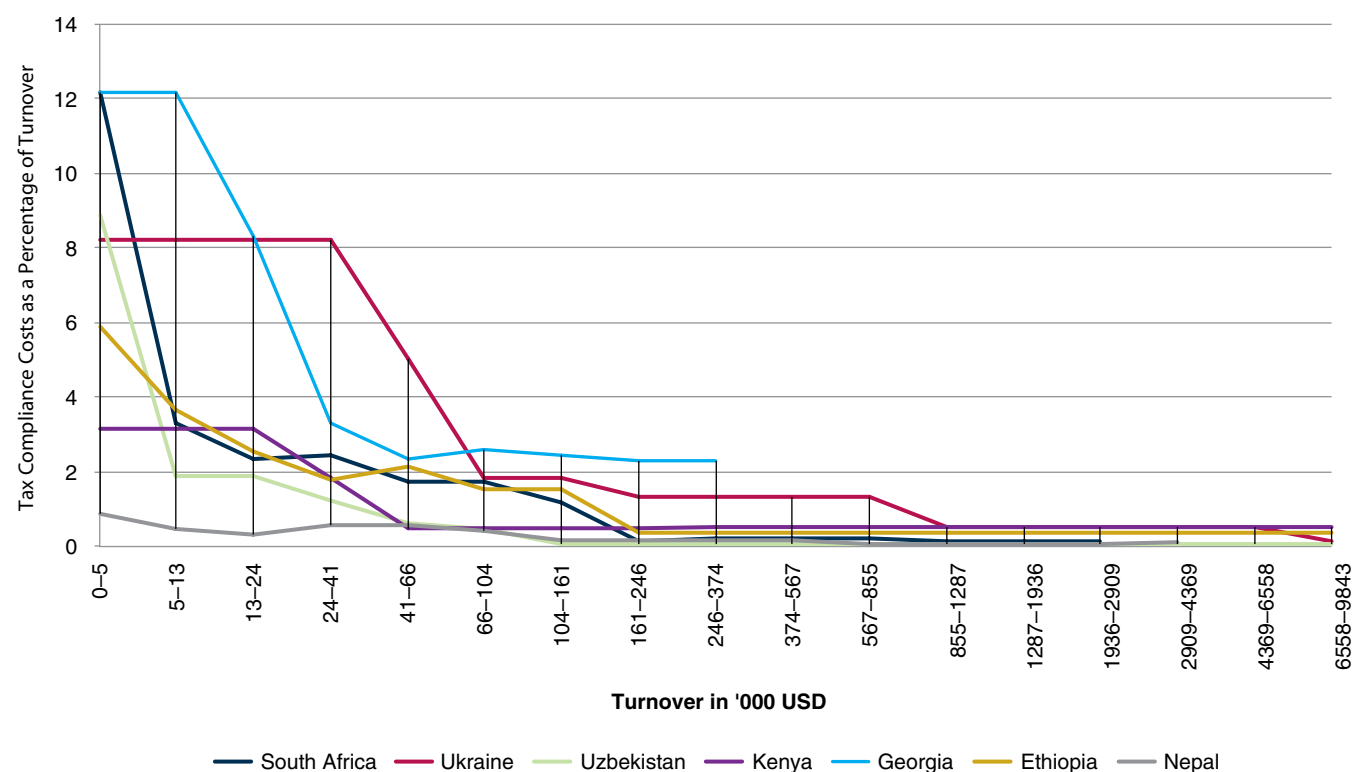
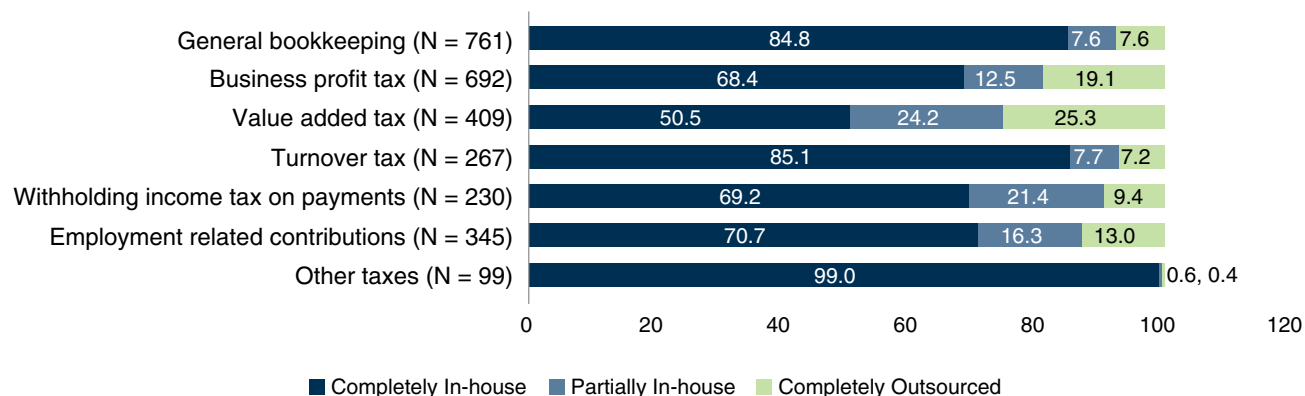


FIGURE 3.15: Businesses Involved in Outsourcing and In-house Activities for Bookkeeping and Tax Accounting (percent)



this purpose we use the tax compliance costs measure for Ethiopia that excludes costs of acquisition and maintenance of software and hardware so that the results are more comparable across countries. We may also note that such comparisons have some limitations as detailed definitions (such as legal requirements and general practices of record-keeping and reporting) differ across countries. Generally tax compliance cost as a percentage of turnover for Ethiopia is higher compared to that of countries including Kenya and Nepal (Figure 3.14), (see Annex 1 for detailed informational comparisons). Tax compliance cost in Ethiopia is high even in comparison to the countries considered, since most of the countries that have had such a survey were the ones already known to have a problem with tax compliance costs.

Based on the results of the survey, with about one million businesses in Ethiopia, we estimate the total tax compliance cost to be about ETB 5.8 billion (about USD 309.5 million⁸) and ETB 7.5 billion (USD 400.5) (depending on whether tax compliance cost includes acquisition and maintenance cost of software and hardware). This is between 4.5 and 5.8 percent of Ethiopia's total government revenue collected in 2012/13 and about 1 percent of its GDP during the same year.

Studies in other countries also show that the size of compliance cost varies across countries.⁹ For instance, the overall average tax compliance cost was about USD 1.48 billion or 1 percent of GDP for Ukraine in 2007. Similarly, for Indonesia, TCC as a share of GDP and revenue was about 0.19 percent and 3.2 percent in 2010, respectively (Susila and Pope, 2012). A similar study in Nepal indicates that the overall average compliance cost of about 0.46 percent of GDP or 2.7 percent of tax revenue in 2012 (SEDF, 2012). In Slovenia, total compliance costs (for personal income tax) accounted for around 0.18 per cent of GDP and 2.8 percent of personal income tax revenue (Klun, 2004), while the figure for Croatia was 0.03 percent of GDP and 0.81 percent of personal income tax (Blazic, 2004). Overall, there is considerable variation in terms of the size of tax compliance cost across countries depending on their economic size and tax revenue. For instance, tax compliance cost as share of tax revenue was about 11.5 percent (or 1.1 percent of GDP) in Armenia (Jrbshyan and Harutyunyan, 2006), while the figure for Canada was 2.7 percent (Charron et al., 2008).

In order to estimate tax compliance costs precisely it is important first to examine the practice of using external assistance for tax compliance (a direct monetary cost for a business) versus doing work in-house (i.e., staff time). As Figure 3.15 shows a large majority of

⁸ Assuming average exchange rate for the fiscal year 2012/13, USD 1 = ETB 18.59.

⁹ See Yesegat (2009) and Susila and Pope (2012) for detailed review of literature on compliance cost.

FIGURE 3.16: Distribution of Full Outsourcing Cost between General Bookkeeping and Tax Compliance (in percent) (N = 174)



businesses do most or all of their bookkeeping and tax accounting activities in-house. Only 15 percent of businesses outsource any of their general bookkeeping work, although about half outsource at least some of their VAT compliance work, and about one third outsource at least some of the compliance tasks for business profit tax.

Looking at costs based on the practice of using external assistance for tax compliance and general bookkeeping activities reveals that over half of the total external professionals' cost was incurred in tax compliance activities.

As Figure 3.16 shows 55 percent of the outsourcing cost goes to cover costs of tax compliance while 45 percent is for general bookkeeping activities. Average external (complete outsourcing) cost in ETB and its distribution between general bookkeeping and tax compliance is shown in Figure 3.17.

FIGURE 3.17: Average Cost of Full Outsourcing for Businesses That Outsource (in ETB) (N = 174)

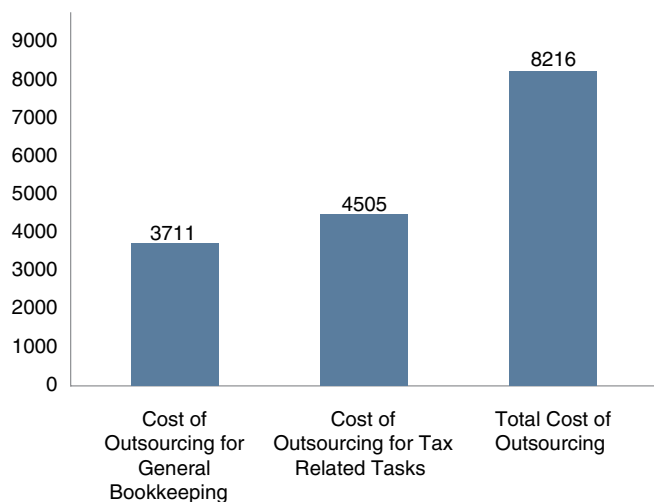
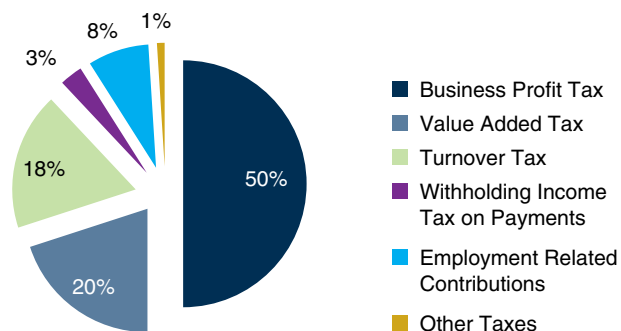


FIGURE 3.18: Distribution of Full Outsourcing Cost of Tax Compliance by Tax Type (in percent) (N = 171)



In terms of distribution of the external professionals' costs of tax compliance across tax types, half of this is for tasks related to business profit tax (50 percent) followed by value added tax (20 percent) and turnover tax (18 percent) (Figure 3.18).

Businesses that outsource business profit tax compliance activities incurred an average of ETB 2,267 per business in the 2012/13 fiscal year, which is the highest for a tax type. Value added tax compliance is the second highest in terms of average outsourcing cost by tax type amounting to ETB 913 (Figure 3.19).

The internal costs of tax compliance measured in terms of the monetary value of staff time spent for general

FIGURE 3.19: Average Cost of (full) Outsourcing for Businesses That Outsource by Tax Type in ETB (N = 171)

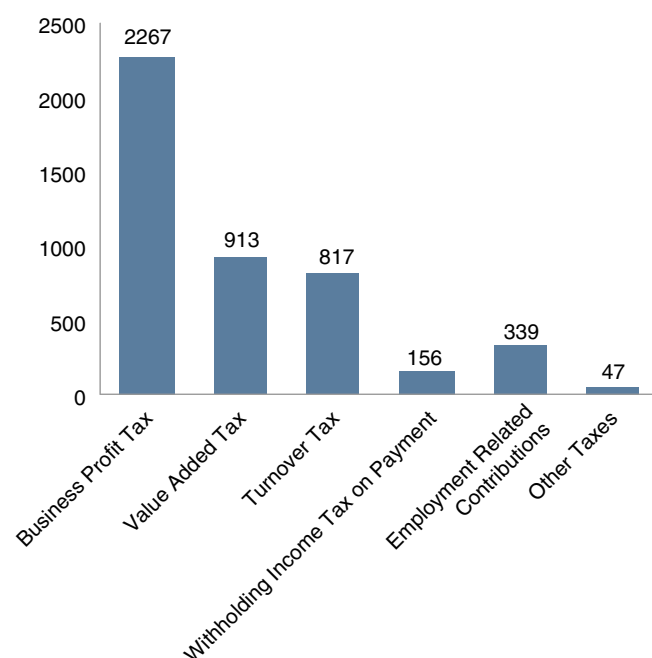
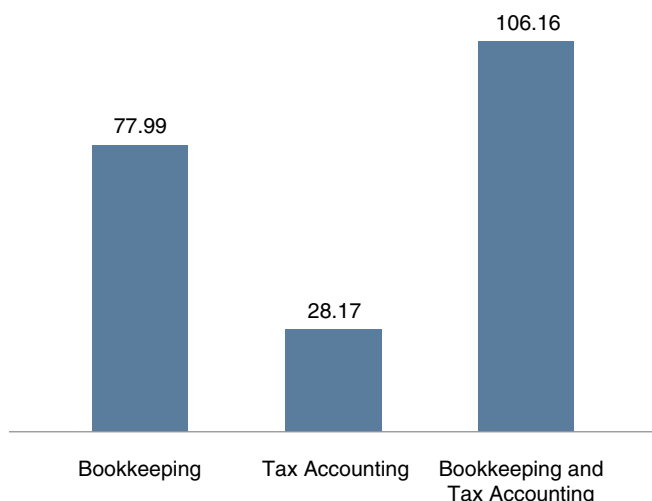


FIGURE 3.20: Person-Days Spent on In-house Bookkeeping and Tax Compliance (N = 627)



bookkeeping and tax compliance related activities reveals similar picture. In terms of in-house time about 74 percent of the time (78 person-days) was spent on general bookkeeping while the rest (about 28 person-days) was spent on tax compliance tasks (Figure 3.20).

Half of the total time spent by a business on tax accounting goes to business profit tax while another 31 percent goes to turnover tax. Value added tax takes 8 percent of the time spent (Figure 3.21).

From the discussions so far, it can be noted that business profit tax takes the largest share of total tax compliance costs (both internal and external costs), followed by value added tax and turnover tax. The burden of compliance costs of business profit tax and value added tax shows that these two taxes do have complexities that resulted in taxpayers incurring high costs of compliance in terms of staff time and professional fees paid to external assistance.

In addition, looking at the in-house tax compliance costs by tax activity indicates that on average a business spent about 11 person-days on filing activities during the last tax year which is the highest time spent by tax activity. Pre-filing took the second highest of the three activities (10 person-days) with post-filing taking the smallest amount of time (about 7 person-days (Figure 3.22).

Table 3.6 presents person-days spent on bookkeeping and tax accounting as well as the share of worker types

FIGURE 3.21: Distribution of Time Spent on In-house Tax Accounting by Tax Type (N = 592)

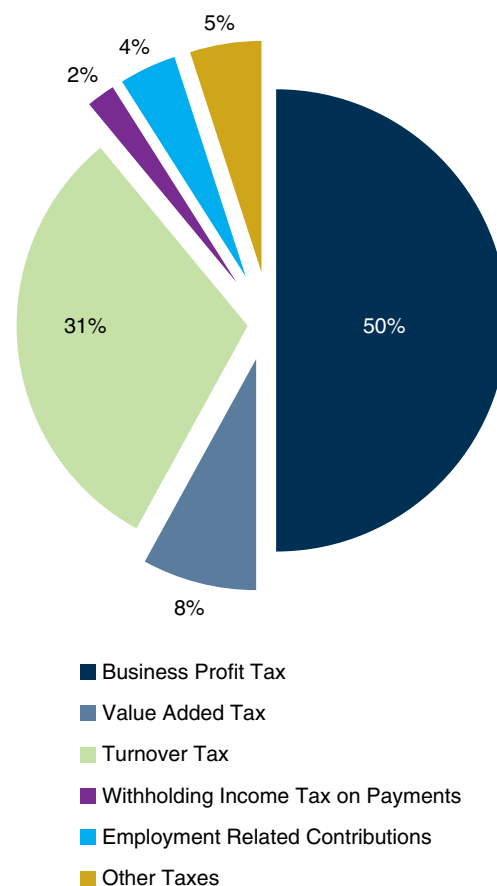
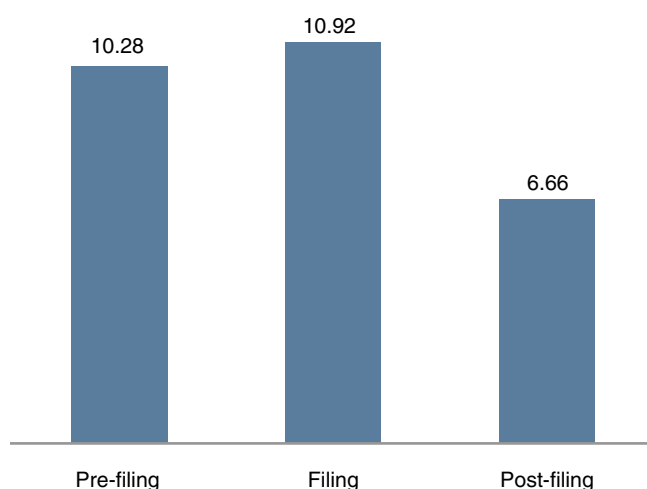


FIGURE 3.22: Person-Days Spent on Tax Compliance by Tax Activity (N = 627)



by ownership type and turnover. By ownership type individuals or sole proprietorships have the lowest compliance costs in terms of person-days spent on bookkeeping and tax accounting. For example, sole proprietorships spent about a quarter of the time that

TABLE 3.6: Time Spent on Bookkeeping and Tax Accounting by Ownership Type and Turnover

	Ownership Type			Turnover in ETB			
	Individual/Sole Proprietorship	Private Limited Company	Cooperative Society	100,000 or Less	100,001 to 500,000	500,001 to 10,000,000	Over 10,000,000
N	521	120	39	292	188	168	44
Person days spent on bookkeeping and tax accounting	96	271	151	92	97	229	522
Person days spent on bookkeeping	73	149	109	70	71	144	337
Person days spent on tax accounting	23	123	42	22	26	84	185
Share of person-days spent on tax accounting by worker type (percent)							
Bookkeepers and accountants	14%	71%	57%	13%	20%	69%	83%
Owners and managers	84%	24%	43%	87%	76%	26%	12%
Others	2%	6%	1%	0%	4%	5%	5%

private limited companies spend on tax accounting. In terms of share of person-days spent on tax accounting by ownership type sole proprietorships rely on time of owners and managers much more than the other groups which is to be expected (Table 3.6). We note that the number of person-days spent increases as turnover increases.

In terms of worker type used, the share of the total time spent increases with turnover for bookkeepers and accountants showing that as businesses become larger they rely more and more on bookkeepers and accountants for their bookkeeping and tax accounting activities. The share of time spent by owners and managers decreases as turnover increases which is generally to be expected. The share of the ‘other’ worker category does not change much as turnover increases except those in the lowest turnover category where the share is zero (Table 3.6).

In-house compliance cost of time spent on bookkeeping and tax accounting is calculated by converting time spent into money using salary of workers types involved. Salary of worker types is obtained from the survey. Businesses were asked to indicate the average gross remuneration (including salaries, bonuses, insurance and all other benefits) per month per person a similar business would pay. Respondents provided answers to each of the three groups of workers

(bookkeepers/accountants, managers/owners and other workers) working on general bookkeeping and tax accounting related tasks. The daily equivalent of such payments was then used to calculate the cost of person-days spent for each category of workers.

The total in-house cost of general bookkeeping was found to be ETB 9,382 (USD 500.6) while the cost of tax accounting (tax compliance) was ETB 3,906 (USD 208.4) for a business in the last tax year (Figure 3.23).

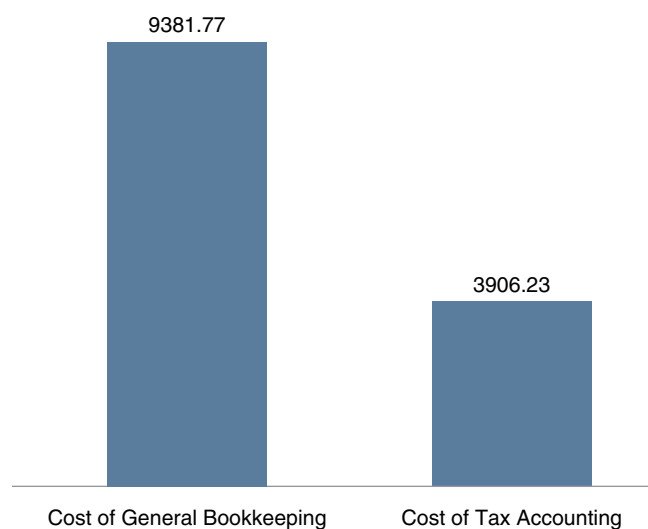
FIGURE 3.23: In-house Compliance Cost of Time Spent on General Bookkeeping and Tax Accounting in ETB (N = 537)

TABLE 3.7: In-house Compliance Cost of Time Spent on General Bookkeeping and Tax Accounting in ETB (by ownership type and turnover)

	Ownership Type				Turnover in ETB			
	Individual/ Sole Proprietorship	Private Limited Company	Cooperative Society	Others	100,000 or Less	100,001 to 500,000	500,001 to 10,000,000	Over 10,000,000
N	521	120	39	12	292	188	168	44
Cost of general bookkeeping	7856	32501	15226	33172	6618	9137	22007	74435
Cost of tax accounting	2623	27686	6128	29453	2162	4170	15317	45235

TABLE 3.8: In-house Compliance Cost of Time Spent on General Bookkeeping and Tax Accounting in ETB by Category

	Category		
	A	B	C
N	245	184	263
In-house compliance cost of time spent on gen. bookkeeping	24179	14749	6529
In-house compliance cost of time spent on tax accounting	15176	9135	1954

The relative importance of compliance cost of general bookkeeping and tax accounting is different across ownership type. In particular, the cost of tax accounting for sole proprietorships is less than half of the cost of general bookkeeping while the share of tax accounting in total in-house compliance cost is much larger for other ownership types (Table 3.7). In terms of turnover of businesses, as would be expected, the in-house cost of compliance increases for those with larger turnover. This is also true by category where category A businesses have a higher in-house compliance cost compared with category C (Table 3.8).

3.3 PERCEPTION OF TAXPAYERS TO ASPECTS OF THE TAX SYSTEM AND THE BUSINESS ENVIRONMENT

This section presents the views of respondents to aspects of the tax system and the business environment

at large. Specifically, the subsequent discussions focus on views pertaining to registration for taxes, sales register machine usage, VAT registration and refund process, penalties, appeals, and inspections and audits, and tax compliance.

3.3.1 Views about Registering for Taxes

As shown earlier, the largest share of formal business survey respondents obtained their TINs during 2002–2004 EC. Asked about the disadvantages of registering for taxes, a relatively large proportion of formal businesses indicated higher tax burden or high tax rates (about 34 percent) as the biggest disadvantage. Further, such factors as complicated tax compliance procedures (13 percent), high cost of raw materials and inputs (9 percent), harassment by government officers (8 percent), and frequent inspections (8 percent) also stood out as the other biggest disadvantages of registering for taxes (Figure 3.24)

As the perception of respondents about the biggest disadvantages of registering for taxes shows, the different categories of taxpayers encounter different constraints. The only problems that seem to attract a relatively significant proportion of firms as the biggest disadvantage of registering for taxes is higher tax burden/tax rates: 26 and 37 percent of firms from category B and C, respectively, identified this problem to be the biggest disadvantage (Table 3.9). However, when we aggregate over some of the disadvantages listed we see some similarity in terms of two disadvantages: higher tax burden and/or tax rates and complicated tax compliance procedures. These two

FIGURE 3.24: Opinion of Respondent Firms about the Biggest and Second Biggest Disadvantages of Registering for Taxes (N = 1003)

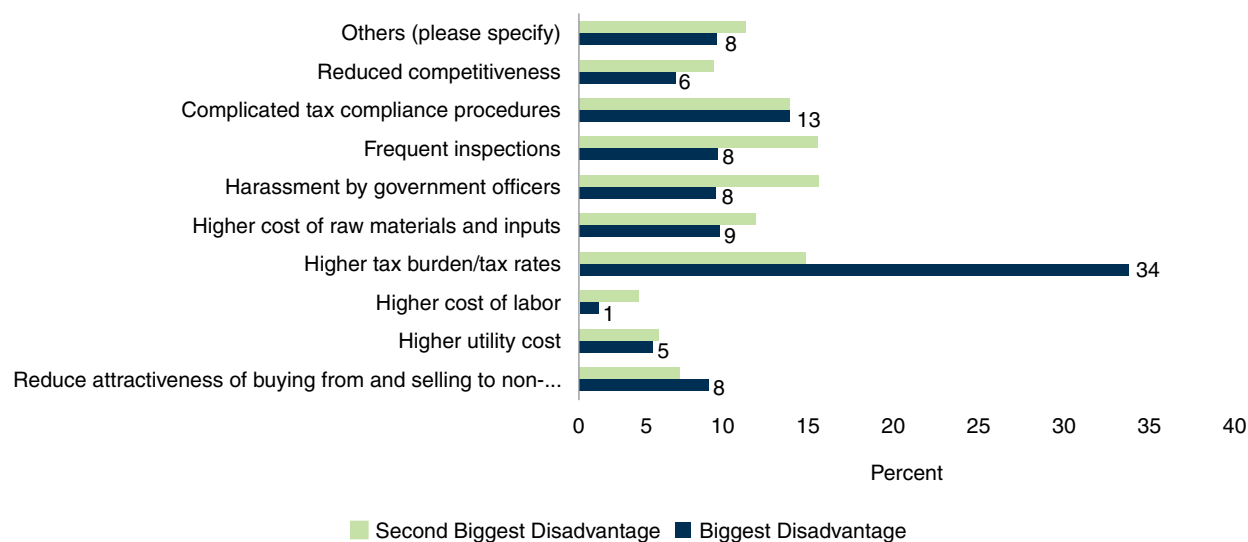


TABLE 3.9: General Opinion on the Reasons for Not Applying for Tax Registration (among those who have considered but did not apply) (N = 166 (percent)—Informal

Finding necessary information is too complicated and difficult	9.5
Tax laws and regulations are not clear, fair or appropriate	14.9
I don't want to deal with the tyranny/corruption of public o	0.6
Lack of enforcement	0.6
Financial burden of being formal (including taxes and fees)	26.2
Lack of trust in government to use tax revenues productively	2.4
I have no knowledge and/or capacity to deal with tax related	6.5
A business like mine should not pay taxes	16.7
Tax authorities do not treat all businesses equally	4.2
Other	6.0
Total	100

disadvantages are indicated as the biggest disadvantages of registering for taxes by 30, 47, and 49 percent of the firms in categories A, B, and C, respectively (Figure 3.25).

Similarly, informal business survey respondents were asked about whether or not they have ever considered

registering their business for tax.¹⁰ About 63 percent claimed to have neither considered nor applied to register for taxes. Over 30 percent of respondents reported that they have considered applying for but never tried it.

Respondents who said they had considered but never tried to register were also asked to provide reasons for not applying for tax registration, and about 26 percent said that financial burden of being formal (including taxes and fees) was the main reason for not applying for tax registration. About 15 percent of respondents said that lack of clarity in tax laws and regulations as another reason for not applying for tax registration. About 17 percent also believe that a business like theirs should not pay taxes (Table 3.9)

Those respondents who replied “neither considered nor applied” were asked why they did not consider to apply; and about a third of respondents replied “No one will help me” for registering for tax with tax authorities. Similarly, about 23 percent and 20 percent also indicated “it was too complicated” and “I had to wait too long” respectively as their reasons for not considering tax registration(Figure 3.26).

¹⁰ Only one percent of respondents have a TIN, but not filed tax returns in the last three years.

FIGURE 3.25: Opinion of Respondent Firms about the Biggest and Second Biggest Disadvantages of Registering for Taxes (by tax payers' category) (percent)

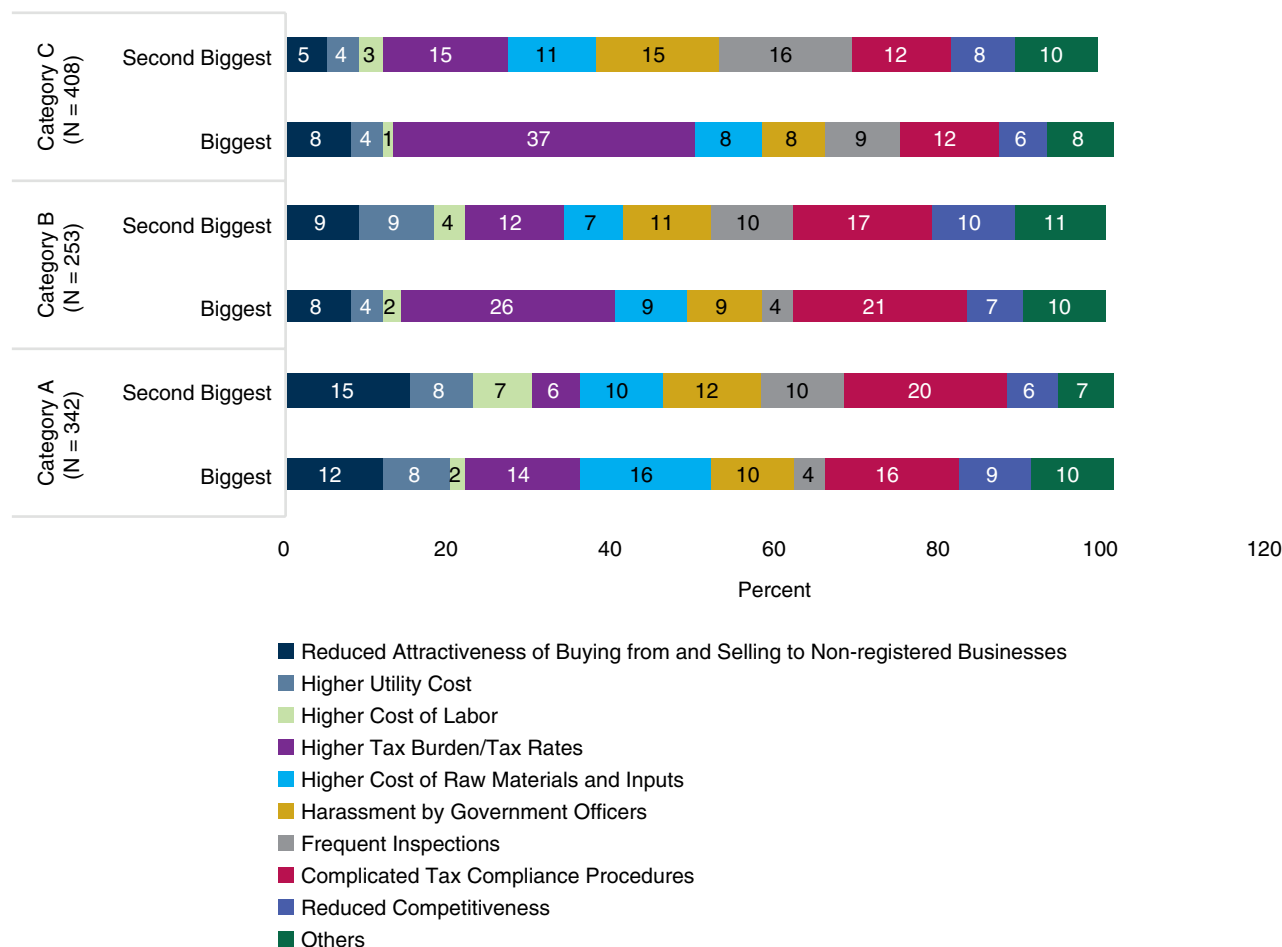
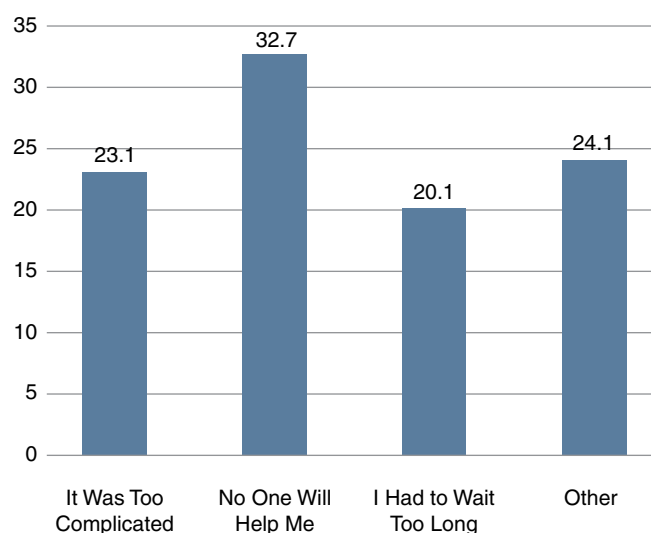


FIGURE 3.26: Reasons for Giving Up or Never Considered Nor Applied (N = 498)



Respondents were also asked about factors that might encourage them to consider registering for taxes and operate in the formal sector. A relatively higher percentage (about 28 percent) of respondents showed that reduction of tax rates as the most important factor for registering for tax (Figure 3.27).

In addition, when respondents were asked about whether or not they have any intentions of registering for tax in the next two years. About half of respondents had said that they are likely or very likely to register for tax in the coming two years. However, the percentage of respondents who said that they are unlikely or very unlikely to register for tax in the next two years was about 25 percent (Figure 3.28).

FIGURE 3.27: Most Important Factors That Encourage or Persuade Business to Consider Registering for Tax (N = 499)

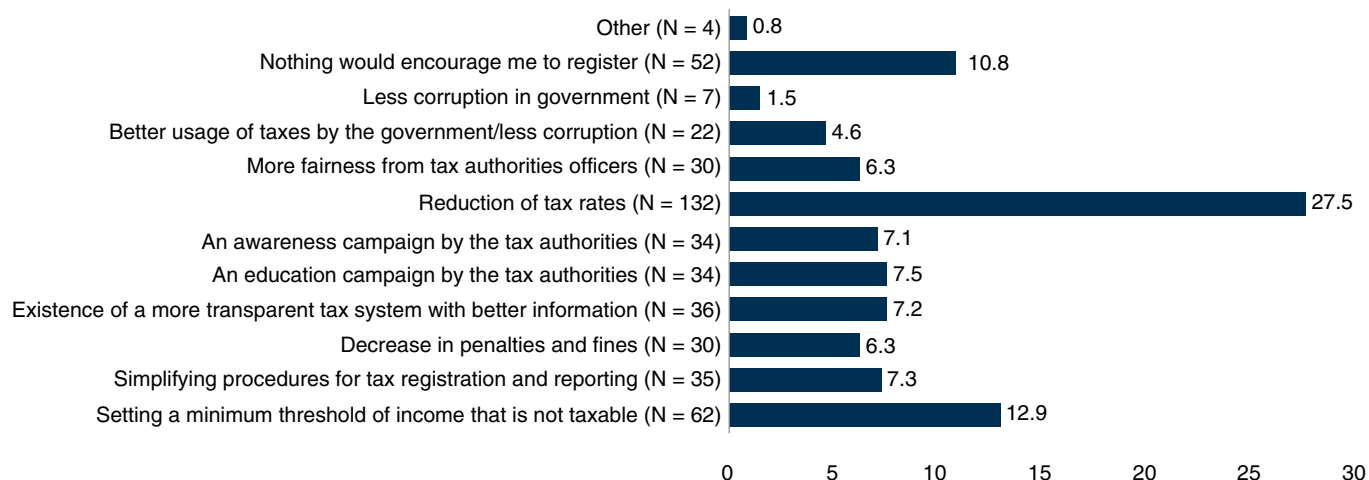


FIGURE 3.28: Perception on the Likelihood of Registering for Tax (N = 499)

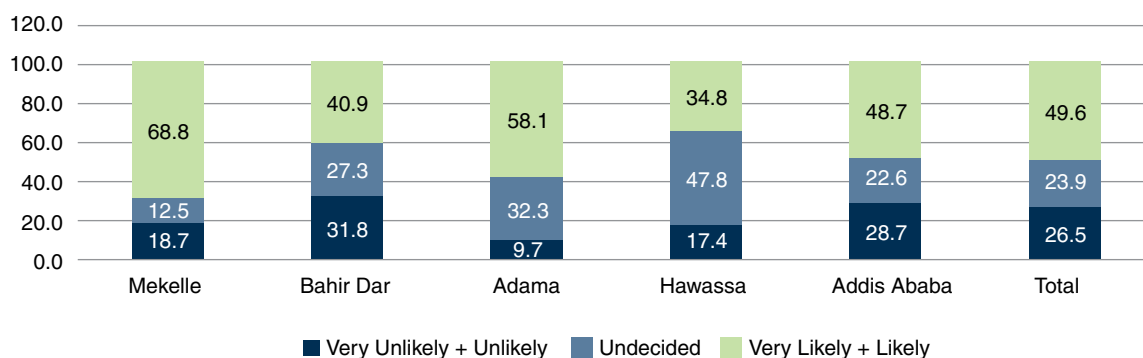
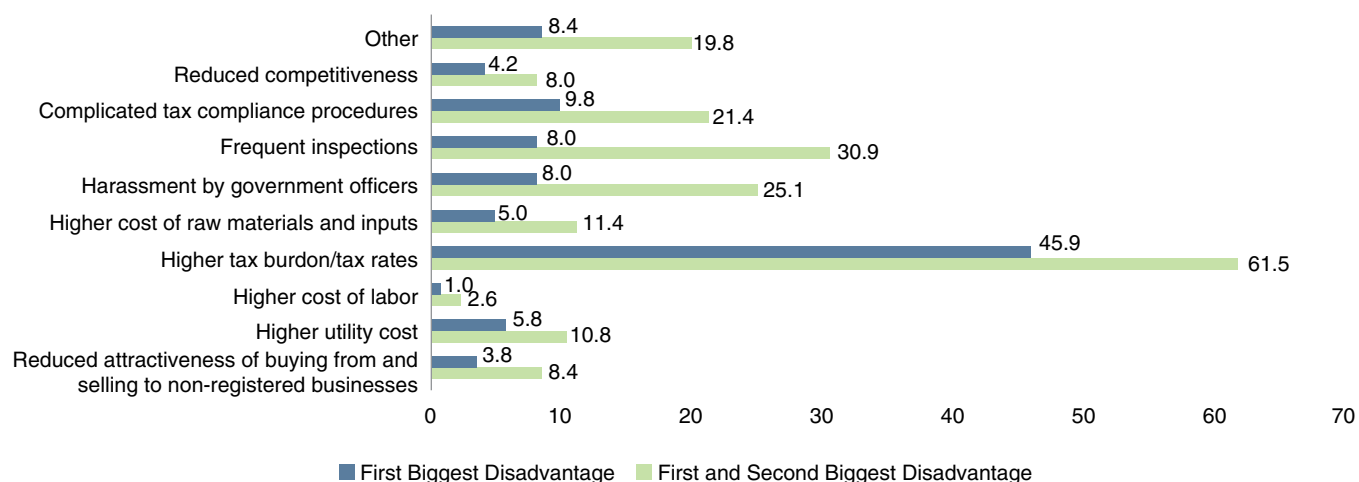


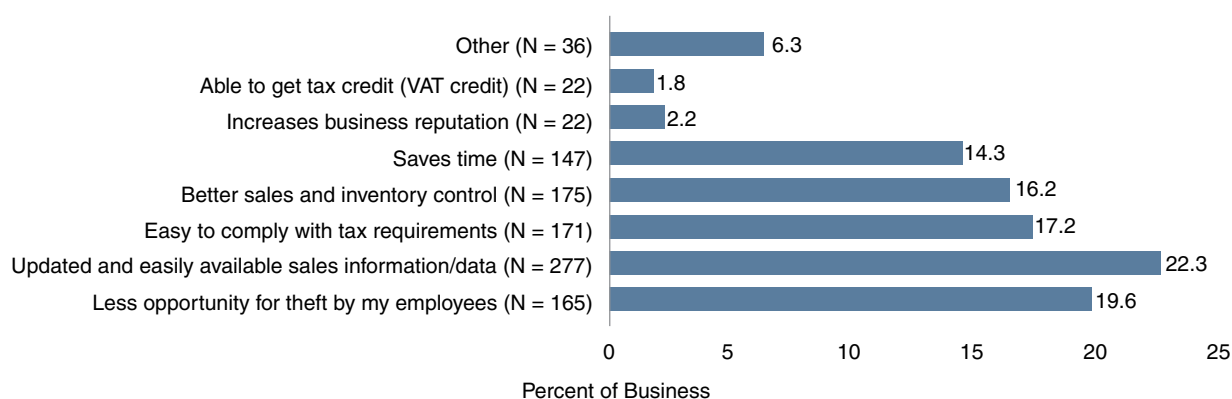
FIGURE 3.29: General Perception on First Biggest Disadvantages of Registering for Tax (N = 499)



Informal business survey respondents were also asked about the biggest disadvantages of registering for taxes and a larger proportion (46 percent) ranked higher tax burden/tax rates as the first biggest disadvantage

(Figure 3.29). Respondents said that high tax burden, frequent inspections, harassment by government officers and complicated tax compliance procedures as the first and second biggest disadvantages of registering for taxes.

FIGURE 3.30: Biggest Advantages of Using Sales Register Machine (percent) (N = 1003)



3.3.2 Perception of Sales Register Machine (SRM) Usage

Sales register machine is required to be used by businesses in categories A and B. Survey results on SRM usage reveals that only about 80 percent of respondents in category A was found to have SRM, and only just over half (52 percent) of category B businesses reported having one. Meanwhile, just over 4 percent of category C businesses were found to have an SRM.

Asked about the “advantages of using” SRM, about 22 percent cited “updated and easily available sales information,” and almost 20 percent reported “less opportunity for theft by employees” as biggest advantages of using SRM (Figure 3.30). Other advantages noted included that use of SRM makes it “easy to comply with tax requirements” and “better sales and inventory control.”

However, respondents also reported several disadvantages of using SRM; the biggest disadvantage

being the “difficulty of correcting errors” (over 35 percent) followed by “cost of buying the machine” (over 15 percent) (Figure 3.31).

3.3.3 Perception of VAT Registration and Refund

With regard to the advantages of registering for VAT, Cash flow benefits and opportunity for participating in government tenders were shown to be the first biggest advantages of registering for VAT as reported by 24 percent and 15 percent of respondents respectively (Figure 3.32). Respondents also noted that registering for VAT allowed them to trade with a larger number of suppliers and customers (Figure 3.32).

Regarding the disadvantage of registering for VAT, among others, higher price of goods and services compared with non-VAT registered businesses were considered to be the first and second biggest disadvantage of VAT (Figure 3.33). Additional first

FIGURE 3.31: Biggest Disadvantages of a Sales Register Machine (percent) (N = 1003)

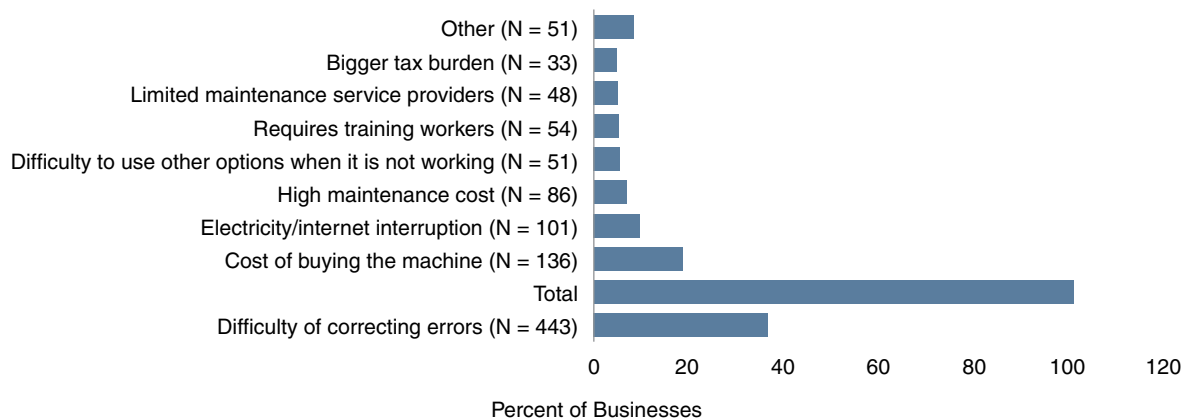


FIGURE 3.32: First and Second Biggest Advantages of Registering for VAT (percent) (N = 1003)

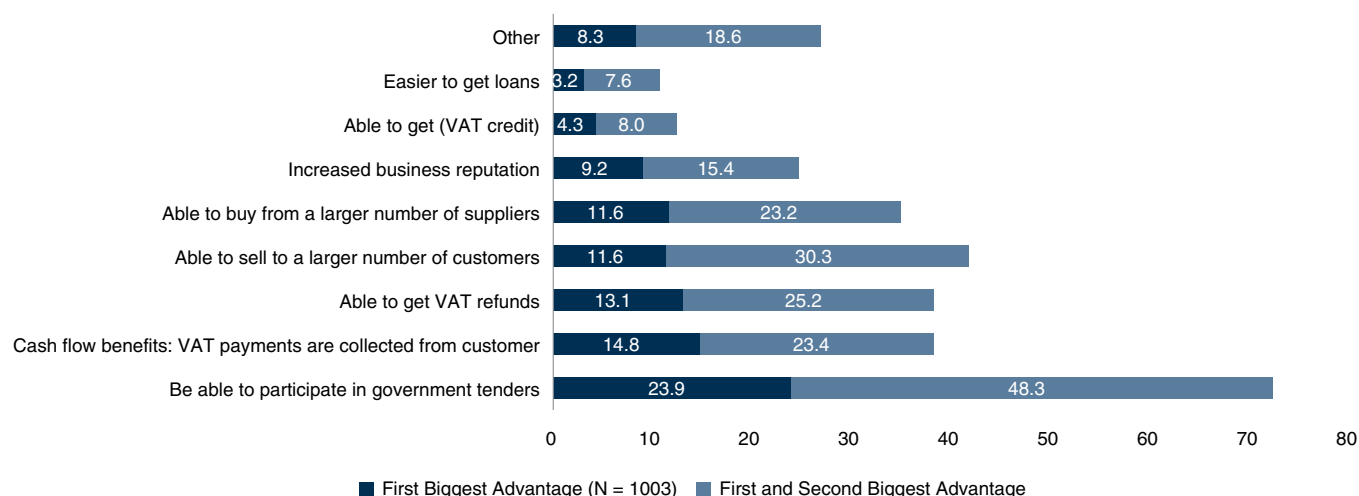


FIGURE 3.33: First and Second Disadvantages of Registering for VAT (N = 1003)

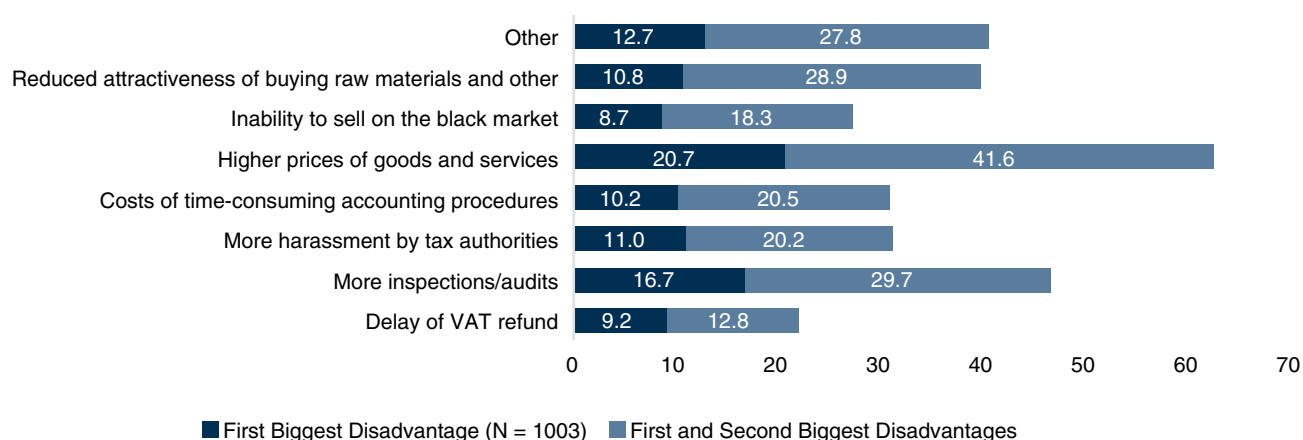


FIGURE 3.34: Eligibility for VAT Refund (percent)

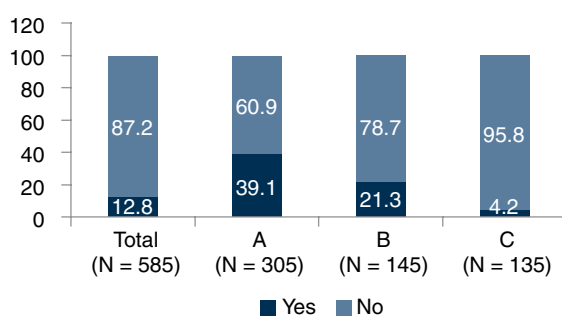
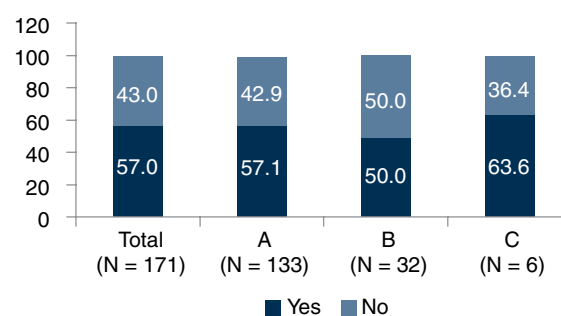


FIGURE 3.35: Application for VAT Refunds (percent)



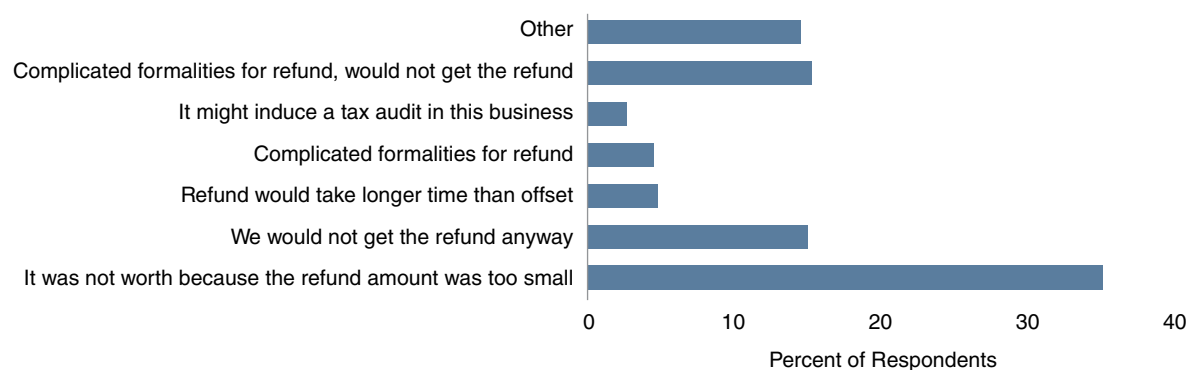
biggest disadvantages included more inspections/audits and harassment by tax authorities as reported by 16.7 percent and 11 percent of respondents, respectively.

The study also assessed perceptions about the VAT refund system. Of the respondents who were filing VAT (less than 20 percent of the total), the overwhelming

majority (about 87 percent) reported that they were not eligible for VAT refund in the 2012/13 fiscal year (Figure 3.34).

From among eligible for VAT refund, only about 57 percent said they had applied for VAT refund in the tax year under consideration (Figure 3.35).

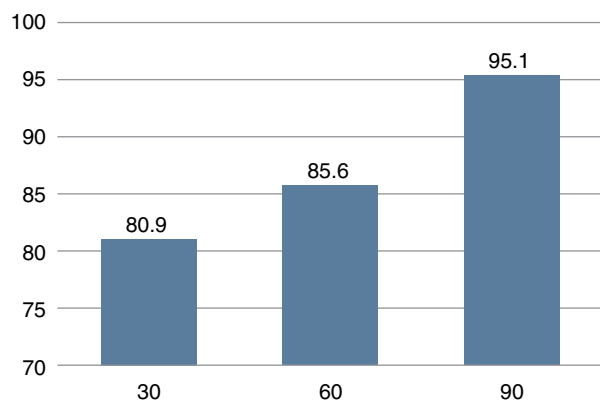
FIGURE 3.36: Reasons for Not Applying for the VAT Refund (N = 82)



About 43 percent of eligible respondents did not apply for VAT refund in the last tax year. Although several reasons were mentioned for not applying for the refund, the major ones included small refund amount (35.1 percent), belief they would not get the refund (15.3 percent), and complicated formalities for refund (15.3 percent) (Figure 3.36). Although the percentage of respondents who were in view of not getting the refund and complicated procedures is not big, these issues need to be addressed in order to maintain a healthy VAT system that has less impact on doing business environment.

With regard to VAT refund process and period, respondents (that reported they had applied for VAT refund) indicated that the average time taken by the tax office for processing refund was about 24.5 days (N= 22). About 80 percent, 85 percent and 95 percent of respondents also reported that processing VAT refunds took them up to 30 days, 60 days and 90 days respectively (Figure 3.37). From Figure 3.37 it can

FIGURE 3.37: Time Taken for VAT Refund Process (N = 75)



be noted that VAT refund processing took more than 90 days for about 5 percent of the respondents.

3.3.4 Perception Towards Tax Inspections, Penalties and Appeals

In this section we present views of taxpayers towards tax inspections, penalties and appeals. Concerning audit and inspection, on average only about 36 percent of them perceived to be happening for legitimate reasons (“inspections are really necessary to deter evasion”), leaving the largest share to other reasons such as perceptions that tax inspections and tax audits happen as mechanisms of seeking informal payments by tax officials (19 percent), officials inspect and audit taxpayers only to justify their jobs (19 percent), while 9 percent of tax inspections and tax audits happen because of someone’s interest to create obstacles to others which would spoil the business environment. A further 16 percent were perceived to be happening as an additional revenue collection mechanism for the government (Figure 3.38). From the above discussion, it can be noted that only a small percentage of audits and inspections are perceived to be legitimate, which should be further investigated to understand the prevalence of this perception.

In comparison, perceptions among formal businesses in Georgia were that more than 70 percent of inspections were for “legitimate reasons” (see Annex 1).

In terms of the actual audit and inspection experience, about 32 percent said their business had been inspected or audited by tax authorities in the last two tax years (Figure 3.39). A significantly higher proportion of relatively larger businesses (45.5 percent) faced

FIGURE 3.38: Perception about Tax Inspections (N = 1002)

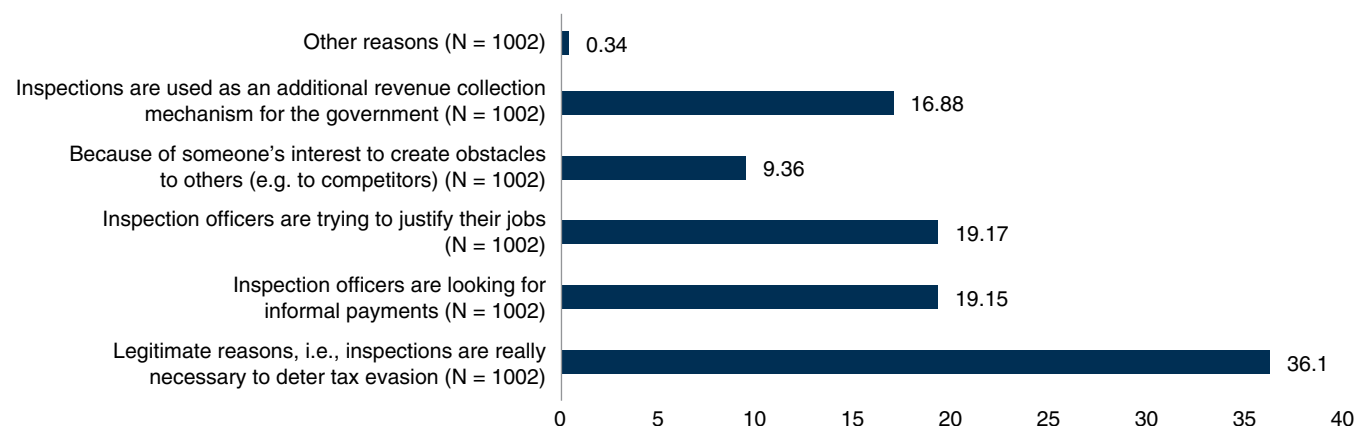
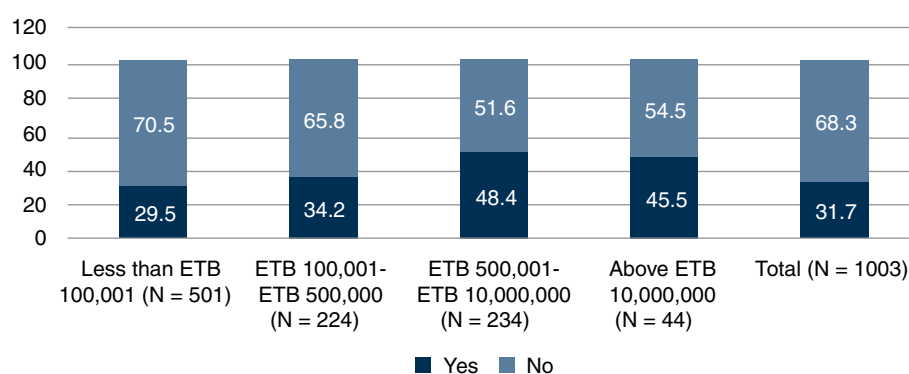


FIGURE 3.39: Inspections and Audits by Turnover

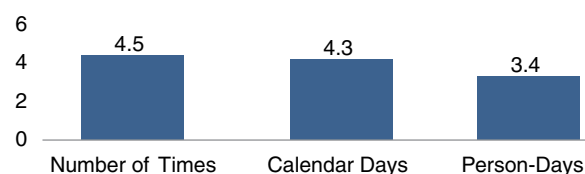


inspections and audits compared to smaller businesses (29.5 percent which is generally considered an appropriate audit focus).

However, overall inspections are much lower in countries that use risk based audit (RBA) for audit selection. For example, as per FIAS (2008), small and medium businesses (those with turnover under about \$2 million) in South Africa¹¹ in the year 2006 faced only about a 2 percent chance of inspection for Income Tax and Employees taxes and about 3 percent for VAT. Some of the less populous provinces showed a slightly higher likelihood of inspection (see Annex 1 for details).

With regard to the frequency of inspections, total days, and total person days spent on inspections, those who reported inspections said that their businesses were inspected between four to five times, each lasting for about 4 days (Figure 3.40). The respondents said they

FIGURE 3.40: Number of Inspections and Audits and Time Spent Among Those Who Reported Any Inspection

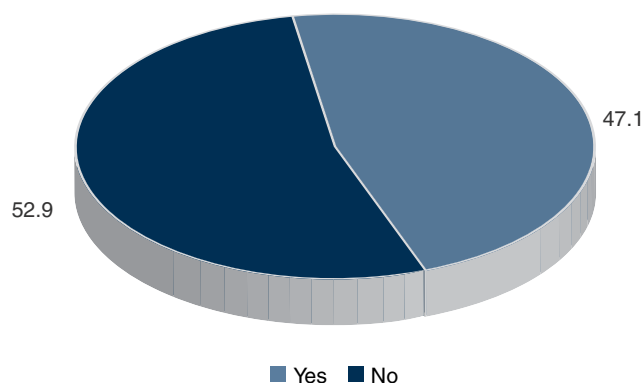


spent about 3 person days during inspections and audits. It should be noted that the response on the number of times (4.5 times on average) includes all types of inspections (desk audit, inspection of purchases and sales, SRM usage etc) and other visits of tax officials.

With respect to penalties, from all survey respondents (formal businesses) about 10 percent reported that they incurred penalties and or fines in the last two tax years. From respondents that incurred fines and or penalties about half (47 percent) had filed an objection

¹¹ South Africa is an example of a country with a well-functioning system of Risk Based Audit.

FIGURE 3.41: Whether or Not Appeals Were Filed (N = 146)



(Figure 3.41). The appeals were higher for large taxpayers (about 67 percent), compared with just under 47 percent for smaller businesses (Figure 3.41).

In respect of the reasons for not filing objections against the decisions of tax officers a large percentage of respondents indicated the length of time appeal procedures take and the feeling that fair trial would not be obtained (36.7 percent and 34.7 percent respectively) as their reasons. Although it was not investigated in the survey, it might be because taxpayers lack confidence on the quality of their self-assessment (Table 3.10).

Table 3.11 shows the number of appeals resolved to business' satisfaction, number of appeals not resolved to the business' satisfaction and number of appeals still in process. While about 60 percent of the appeals were resolved to the business' satisfaction, 37 percent of the appeals were not resolved to the business satisfaction. This sends the message that there is a need to investigate further why a large number of appeal decisions were not in favor of the tax authority and what causes them.

TABLE 3.10: Reasons for Not Filing an Objection (N = 53) (percent)

Audit outcomes, penalties and/or fines were fair	18.4
Appeals would cost too much	4.1
Appeal procedures take very long time	36.7
The advance payment to file appeal was too high	0.0
Amount of additional tax, penalties/fines was too small	6.1
We would not get a fair trial	34.7
It would induce additional tax audits in our business	4.1

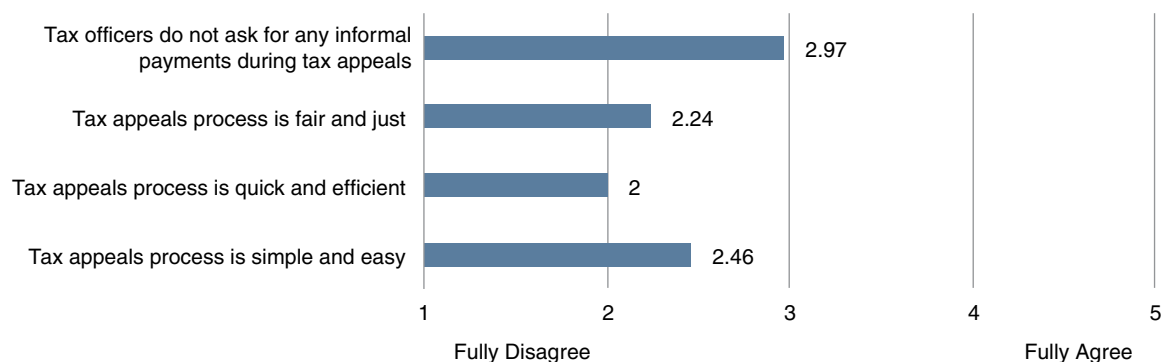
Totals do not add up to 100 due to multiple coding nature of the question.

TABLE 3.11: Appeals Resolved and Still in Process (N = 68) (percent)

How many of these appeals were resolved to the business's satisfaction?	60.3
How many of these appeals were resolved not to the business's satisfaction	36.5
How many of these appeals are still in process?	3.2

The study further investigated the perception of respondents towards tax appeal related issues. While most respondents somewhat disagreed with the statement that "Tax appeals process is quick and efficient", most respondents said that "Tax officers do not ask for any informal payments during tax appeals". The results with respect to efficiency of the appeal process appear to be consistent with the results concerning the length of time the appeal procedures take as presented previously. These perceptions of business taxpayers are likely to make the dispute settlement system not being seen as a useful method of resolving tax disputes and might force them to use

FIGURE 3.42: Perception about Statements Related to Tax Appeals (N = 68)



an illegal means of resolving tax issues (like by bribing officers and other mechanisms). It is, hence, important to address the issues in the dispute resolution system.

3.3.5 Perceptions of Tax Compliance and the Business Environment

The study further assessed taxpayers' perceptions towards compliance and respondents were asked to rate general statements regarding the methods used by typical businesses in Ethiopia to artificially reduce tax burden on a scale of 1 to 5 where 1 means "Fully disagree" and 5 means "Fully agree." As per the results, respondents view sales without invoices and use of fictitious invoices as the main mechanisms used to evade taxes (Figure 3.43).

Table 3.12 provides average responses to the question "having in mind businesses similar to yours, in your

opinion, what percent of total annual sales do such businesses in Ethiopia declare for tax purposes?". Of the total number of 991 respondents, about 7.1 percent believed that businesses like theirs would declare 100 percent of their total annual sales for tax purposes. The remaining 92.9 percent believed that they would declare, on average, about 53 percent of their total annual sales for tax purposes. Generally, larger businesses perceived better compliance than did smaller ones.

In terms of overstatement in expenditures, of the total number of respondents, about 22 percent reported "do not know." About 4 percent indicated that businesses like theirs overstated zero percent of actual expenditure in their tax returns. The remaining 74 percent of the respondents believed they overstated, on average, about 38.4 percent of their actual expenditures in tax returns (Table 3.13).

FIGURE 3.43: Opinions on Tax Compliance (N = 1003)

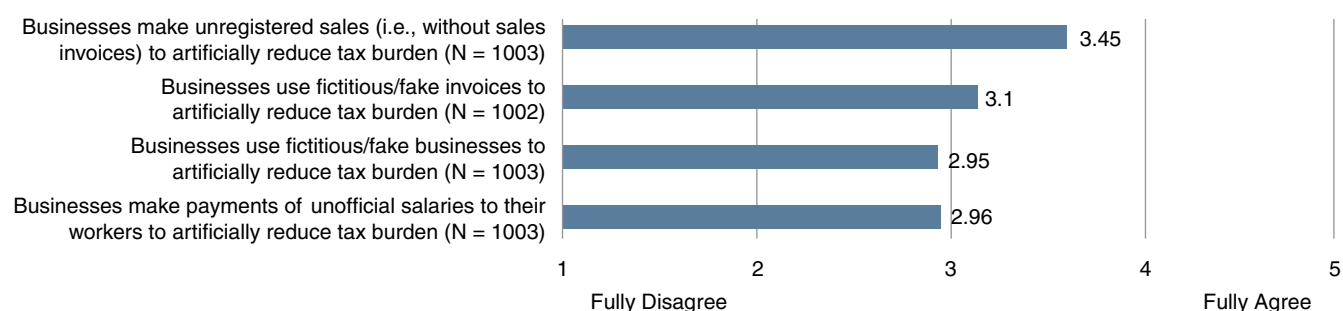


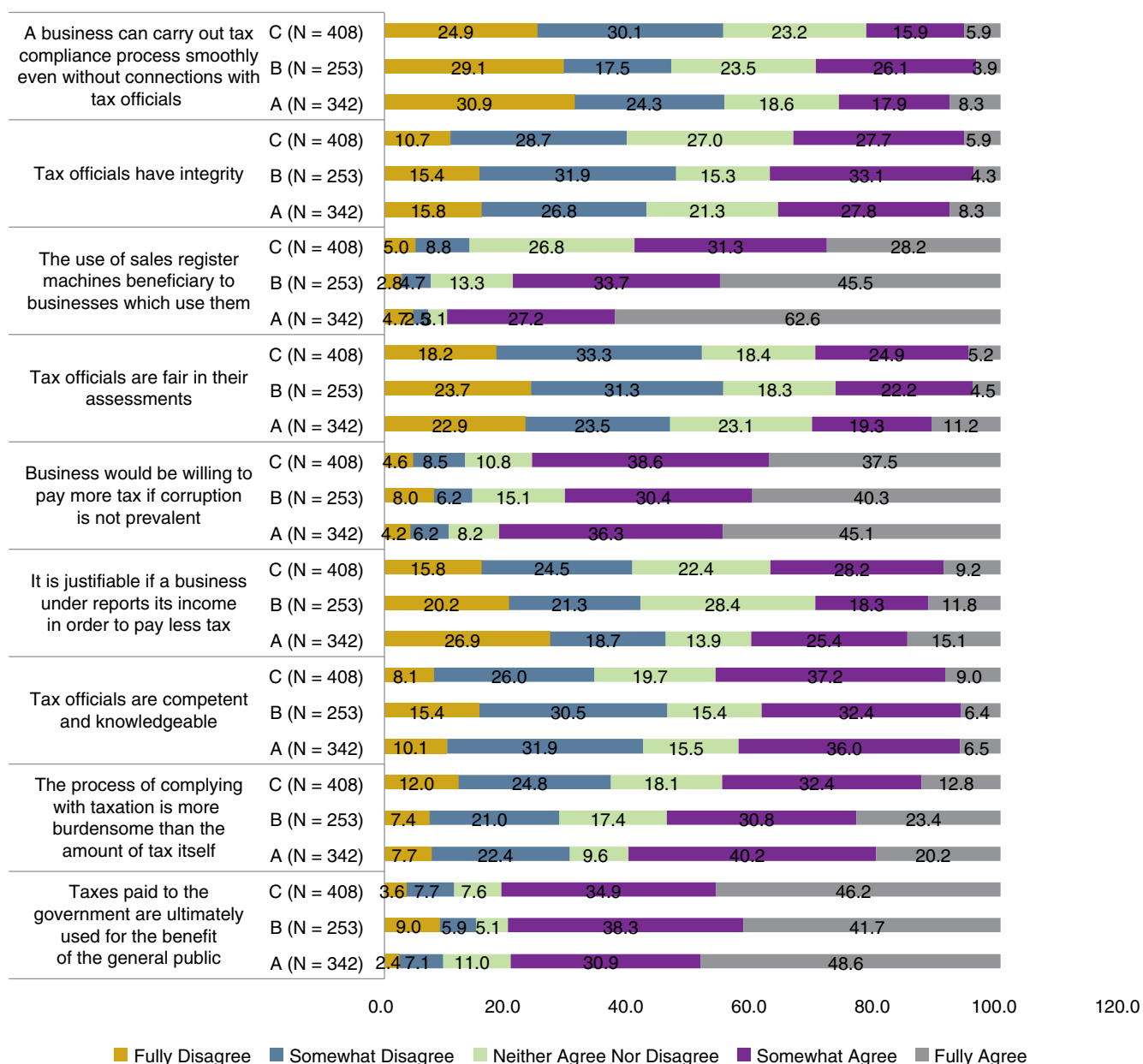
TABLE 3.12: Percent of Total Annual Sales Declared for Tax Purposes by Turnover (among those reporting less than 100%)

	Total	Turnover (in ETB)			
		Less than ETB 100,000	ETB 100,001 – ETB 500,000	ETB 500,001 – ETB 10,000,000	Above ETB 10,000,000
N	913	458	206	214	35
Percent of total annual sales declared for tax purposes	53.4	51.6	61.5	54.8	64.4

TABLE 3.13: Percent of Actual Expenditure Overstated in Tax Returns by Turnover

	Total	Turnover (in Ethiopian ETB)			
		Less than ETB 100,000	ETB 100,001 – ETB 500,000	ETB 500,001 – ETB 10,000,000	Above ETB 10,000,000
N	772	372	176	184	40
Percent of annual expenditures overstated	38.4	38.7	36.3	37.3	53.1

FIGURE 3.44: Respondents Perception about Taxes—Formal (percent)



Both of these results (misstatement of sales and expenditures) show how respondents perceive their peers' tax compliance behavior, which is expected to reflect their own compliance decision. As preliminary findings of a study by Yesegat and Fjelstad (2014) revealed, there is a statistically significant relationship between taxpayers perception of others' compliance and their own attitudes towards compliance; the latter is expected to affect taxpayers actual compliance behavior. It is hence important for the government to work not only improving compliance behavior but also

changing the perceptions of taxpayers towards others' compliance behavior.

In addition, the perception of firms about various aspects of taxes is another item that the survey attempted to capture (Figure 3.44). The responses show that almost about 80 percent of all categories of firms either agree fully or somewhat, that the taxes paid to the government are ultimately used for the benefit of the general public, which is a positive indicator of tax morale. Also, about 90 percent of firms in category A,

80 percent of those in category B, and 60 percent in category C perceive that the use of sales register machine is beneficial to businesses which use them.

However, about 46 percent of firms in category A, 55 percent of those in category B, and 51 percent of those in category C disagree or somewhat disagree that the assessment of tax officials is fair. Most businesses also tend to agree that “businesses would be willing to pay more tax if corruption is not prevalent”, and disagree that “A business can carry out tax compliance process smoothly even without connections with tax officials.”

Another interesting finding is that about 60 percent, 54 percent and 44 percent in categories A, B and C respectively fully and somewhat agreed that the process of complying with taxation is more burdensome than the amount of tax itself.

Similar to formal businesses, informal businesses agreed that taxes paid to the government are ultimately used

for the benefit of the general public and businesses. Further, respondents seemed to agree that there are many benefits for paying taxes. However, they also believe that businesses would be willing to pay more taxes if corruption is not prevalent (Figure 3.45).

In addition, considering the severity of some factors that are commonly mentioned as constraints faced by businesses operating in developing countries, perception of the business environment was assessed. Figure 3.46 shows a relatively larger proportion of formal businesses indicated that access and cost of finance is either a very severe problem or major problem affecting business performance.

Similar to formal businesses, among the statements presented to informal businesses, most respondents agreed to that access to finance (availability and cost) and availability and cost of working premises pose moderate to major problem to the business environment (Figure 3.47).

FIGURE 3.45: Perceptions about Taxes and Tax System—Informal (N = 499)

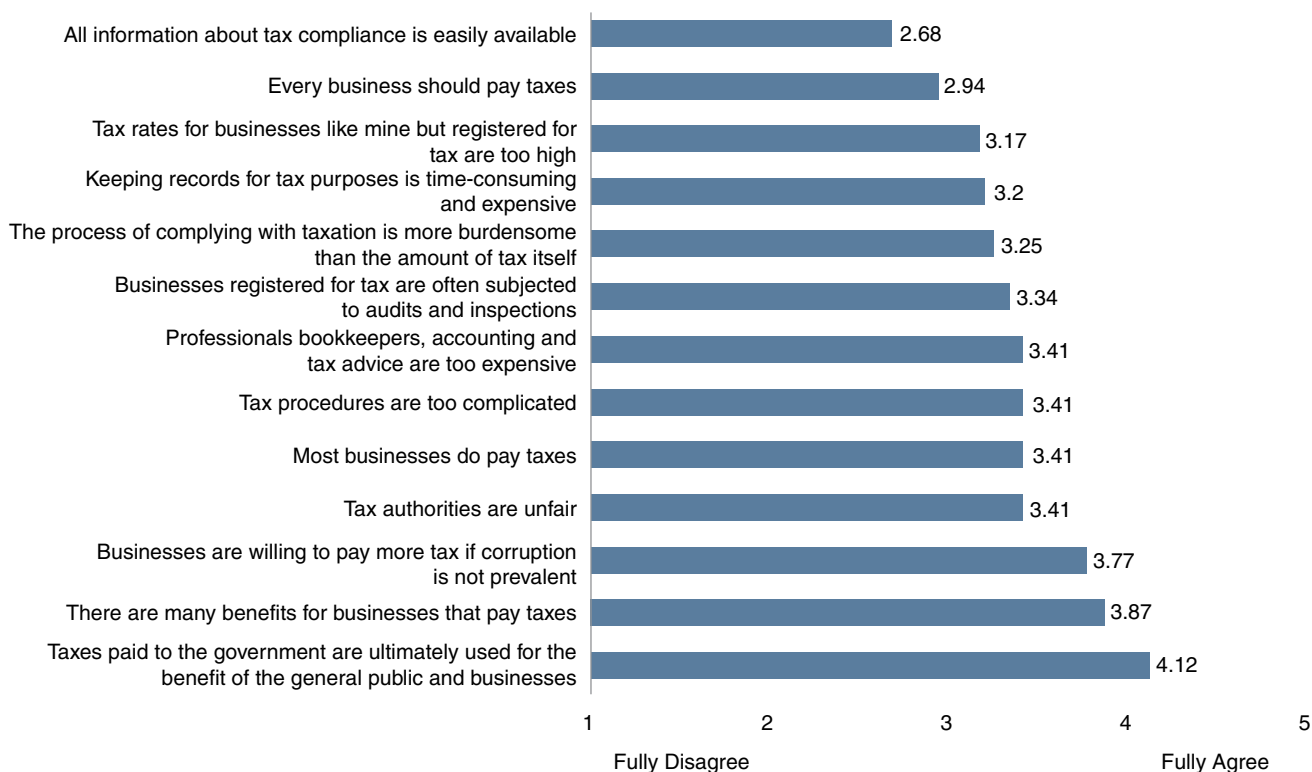


FIGURE 3.46: Respondents Perception about Business Environment—Formal (percent, N = 1003)

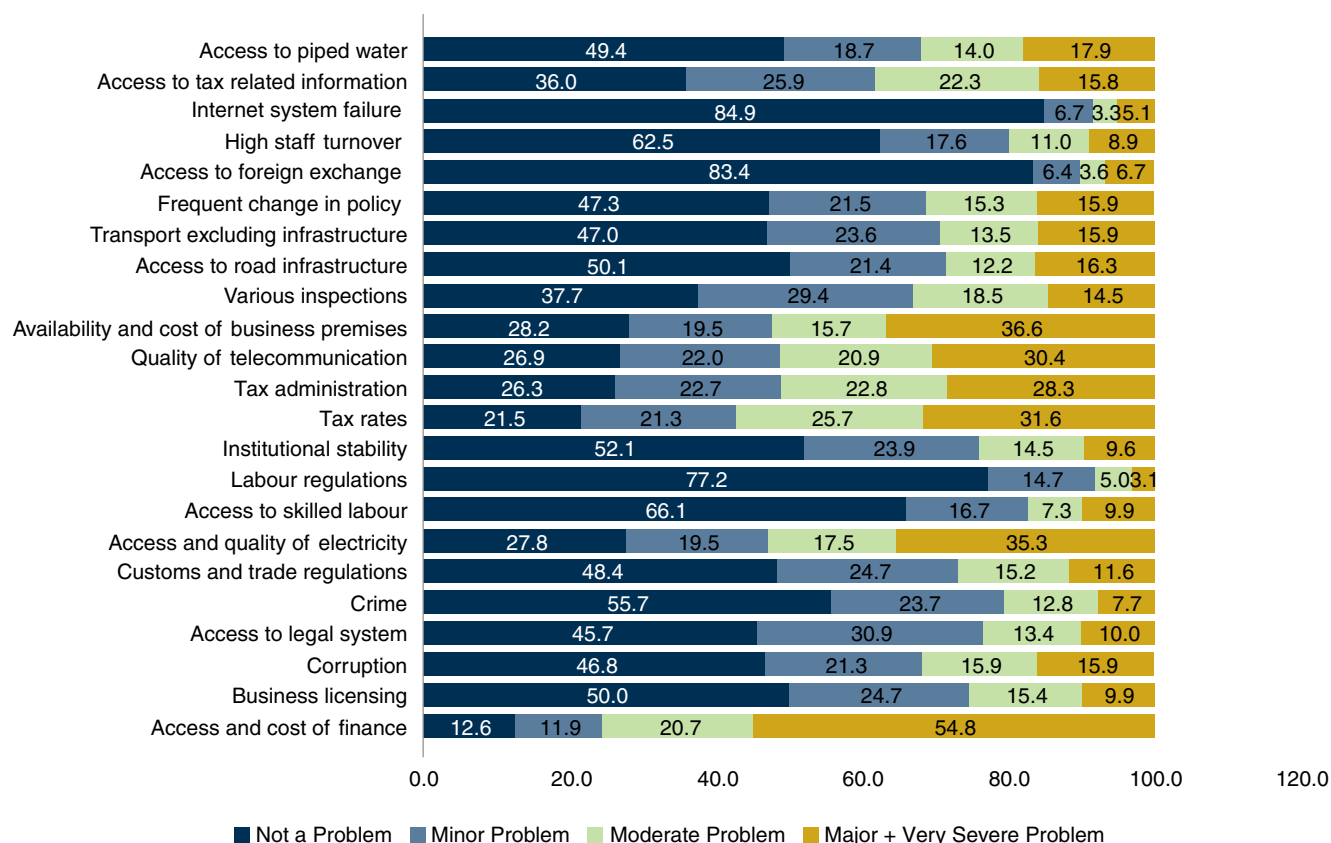


FIGURE 3.47: Perception on Elements of Business Environment (N = 499)—Informal

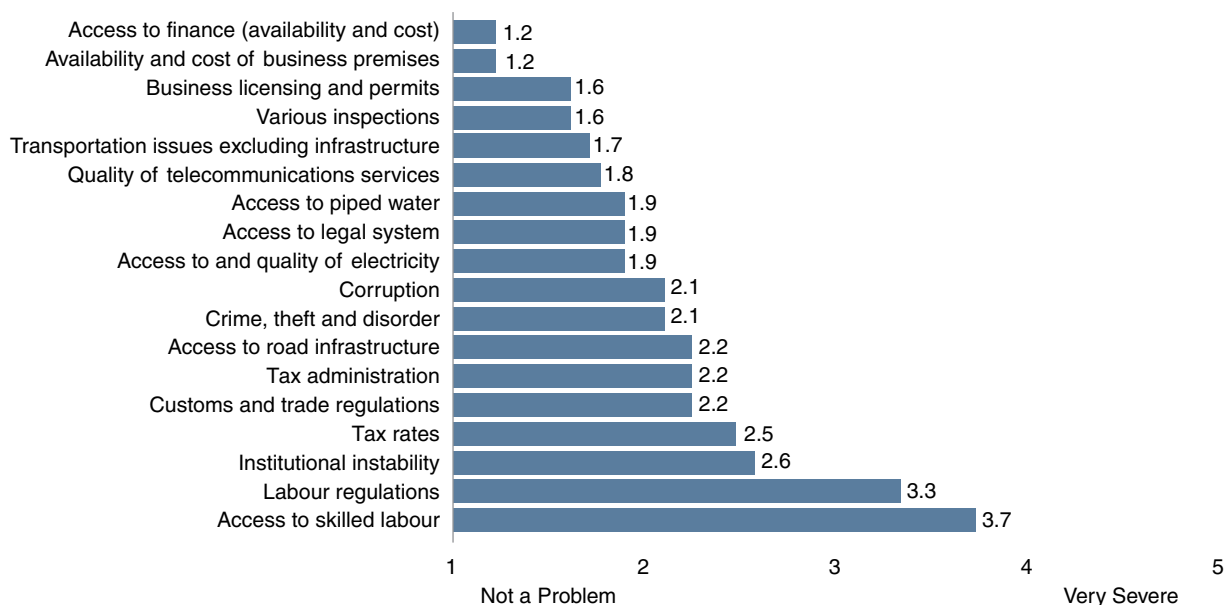
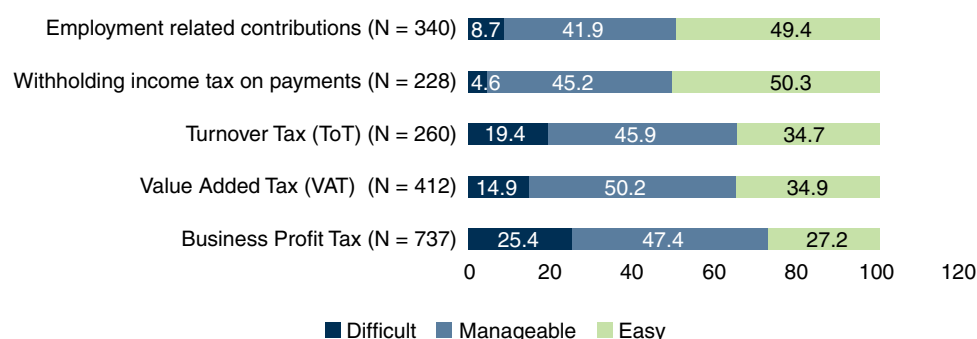


FIGURE 3.48: Perceptions about Calculating and Filling in Tax Returns



3.3.6 Difficulties with the Tax System

Formal business respondents were asked about the difficulty of calculating and filling in tax returns and about 25 percent of those paying business profit taxes reported that calculating and filling in tax returns were difficult, while 47 percent viewed it manageable (Figure 3.48). Similarly, close to half of respondents considered calculating and filling in tax returns to be manageable for all types of taxes. However, 15 percent and 19 percent of the VAT and TOT payers respectively considered the process to be just easy.

When respondents were asked about the level of difficulty in submitting forms and paying taxes, about 31, 18 and 28 percent thought it was relatively difficult to submit tax forms and pay for business profit tax, VAT and TOT, respectively (Figure 3.49).

The overwhelming majority of respondents considered submission of tax returns and payments as manageable for all tax types. Among the different types of taxes, it was easier for firms to submit tax returns and pay withholding income tax on payments than other forms of taxes.

Informal businesses were also asked about their perceptions about the difficulty of filling out and submitting tax returns. About 34 percent of respondents said that filling out and submitting tax returns as quite a problem or extremely problematic, with variations across locations. About 41 percent and 30 percent of respondents in Hawassa reported that this activity as quite a problem or extremely problematic, respectively (Figure 3.50).

FIGURE 3.49: Perceptions about Submission of Tax Returns and Payments

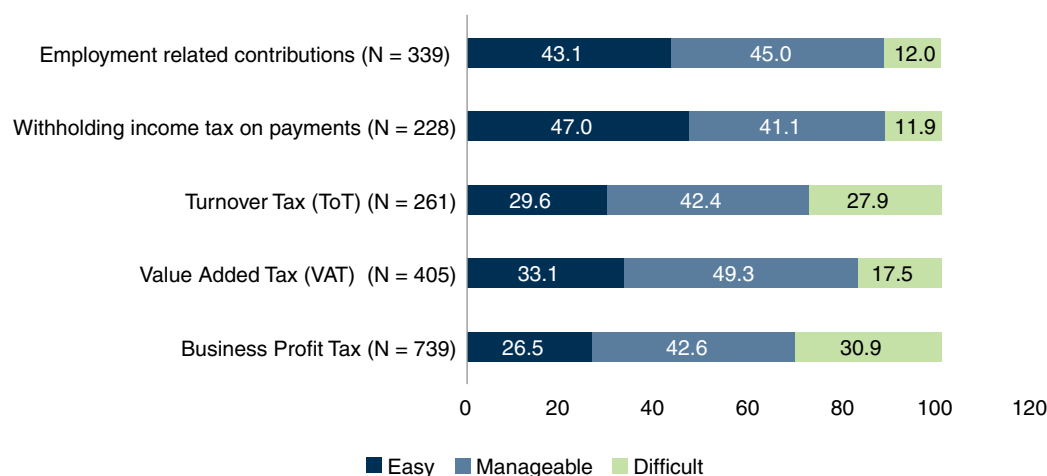
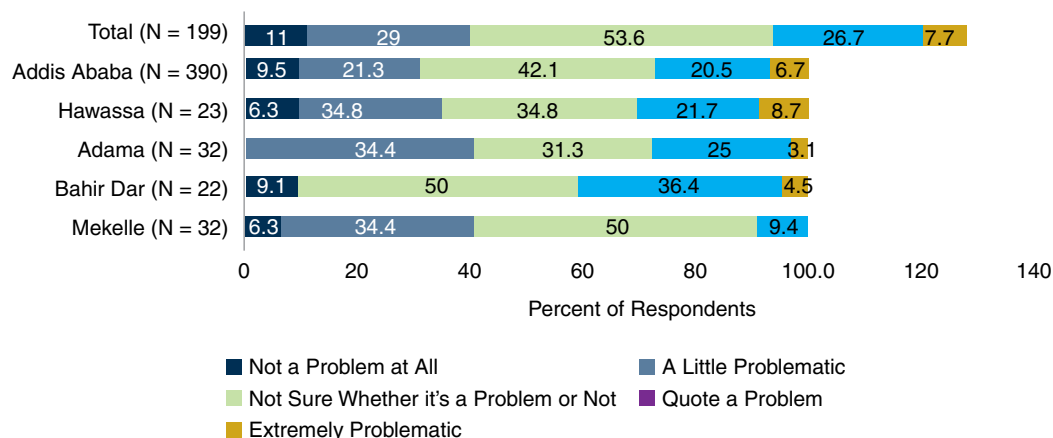


FIGURE 3.50: Perception about Filling Out and Submitting Tax Returns—Informal



Businesses were asked to indicate which information sources on taxation were available to them. For those businesses that indicated the availability of an information source, they were also asked whether they used that information source. The extent of preference of businesses was also examined for those information sources they used. Figure 3.51 shows the percentage of businesses for which the information source is available for possible use in relation to taxation. Website of tax authorities, e-mails and SMS/text message were the least frequently reported sources of information that are available. The availability of each of these three sources was mentioned only by about 7 percent of the businesses or less. Television/cable, radio and family and friends were the three most frequently mentioned sources available to obtain information on taxation.

Although the direct ERCA sources of information were not perceived as readily available to most respondents, among those who could use them, they were considered “preferred” sources by large majorities: about three quarters of such businesses (for the Bulletin boards and the website) and over 85 percent for the Circulars and Publications.

3.3.7 Computer and Bank Account Usage and Other Issues

The survey data show low penetration of computers in the business firms in the country, (and given that the survey tended to ignore businesses in smaller towns, the overall figures for businesses in the country are likely to be even lower). As shown in panel (a) of Figure 3.52,

FIGURE 3.51: Percentage of Businesses Who Stated Availability of Information Source on Taxation

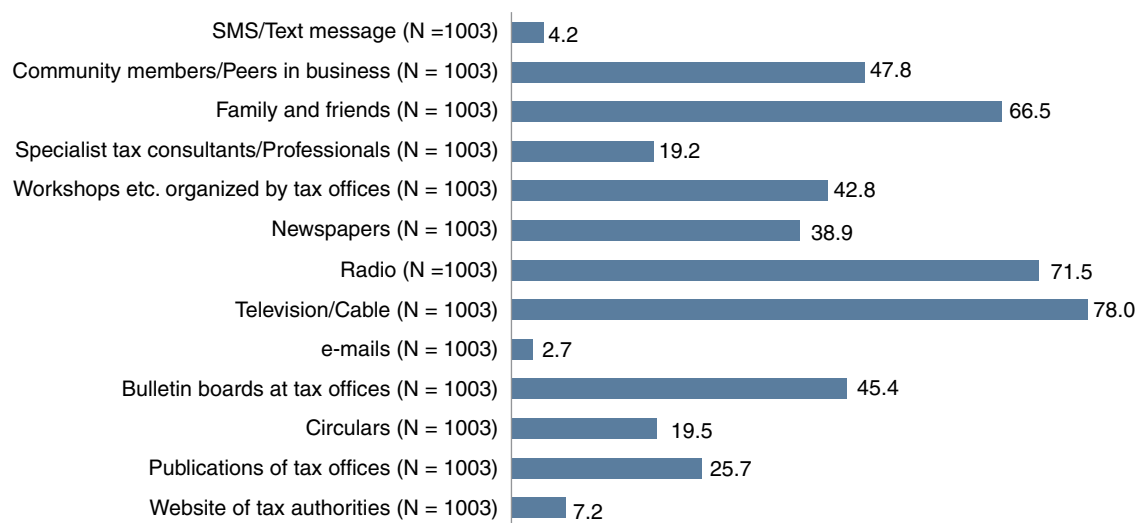


FIGURE 3.52: Firms' Use of Computers (percent)

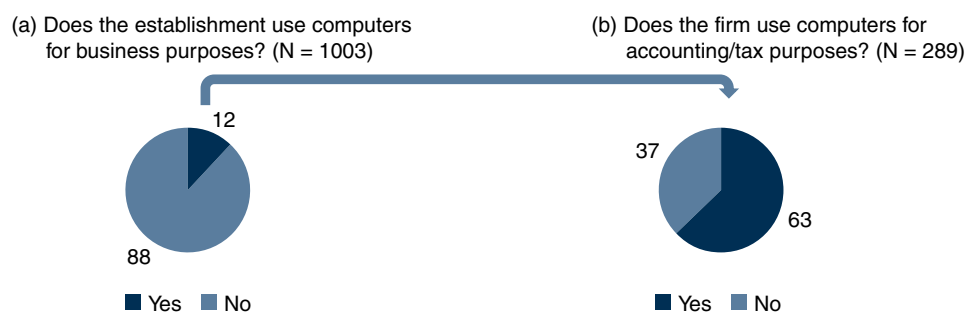
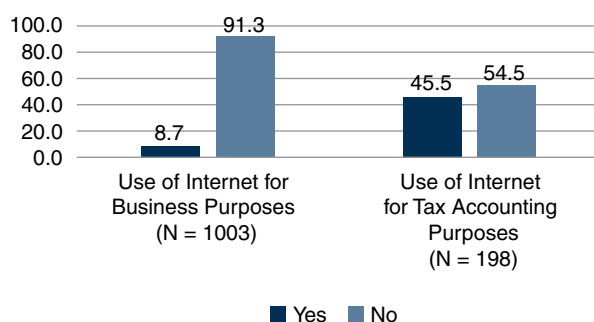


FIGURE 3.53: Firms' Use of Internet



the largest proportion of firms in the sample (more than 88 percent) reported that they do not use computers for business related activities and only about 12 percent responded favorably. Of the sample firms that responded positively to the question of whether the firm uses computers for business purposes or not (i.e., less than 12 percent of the total sample), 63 percent reported that they use computers for accounting and/or tax purposes while the remaining 37 percent reported that they do not use them for such purposes (see panel (b) of Figure 3.52).

Similar to that of computer use, only a very small number of firms responded positively to the question

of whether the firm uses internet for business purposes. As reported in panel (a) of Figure 3.53, only about 9 percent of total firms in the sample reported that they use internet for business purposes. Those who responded that they use internet for business purposes were asked if they use it to obtain and process information for tax purposes. Only 45.5 percent of these firms reported that they use internet for reasons associated with tax (see panel (b) of Figure 3.53).

The majority of informal respondents do not use computers including laptops for business purposes. They do not use internet either. Only 0.80 percent of the respondents used computers and internet for business purposes.

The data on firms' use of bank accounts also show that the number of firms that use bank accounts for their operations is low. As reported in panel (a) of Figure 3.54, only about 45 percent of the firms in the sample reported that they use bank account for their transactions. This number seems low given that the firms are formal firms and they are all situated in the biggest urban areas of the country. Of the sample firms that responded using bank accounts in their operations,

FIGURE 3.54: Firms' Use of Bank Account

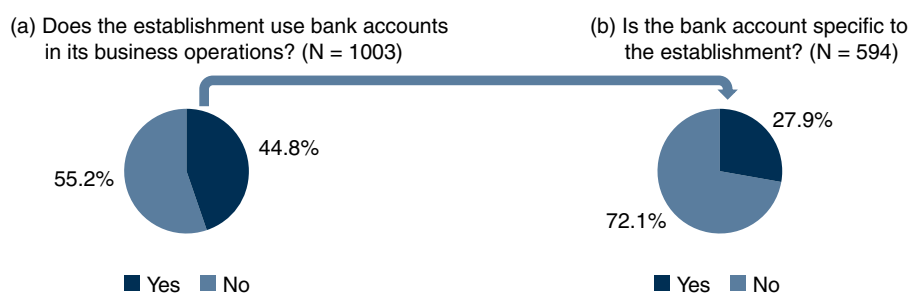
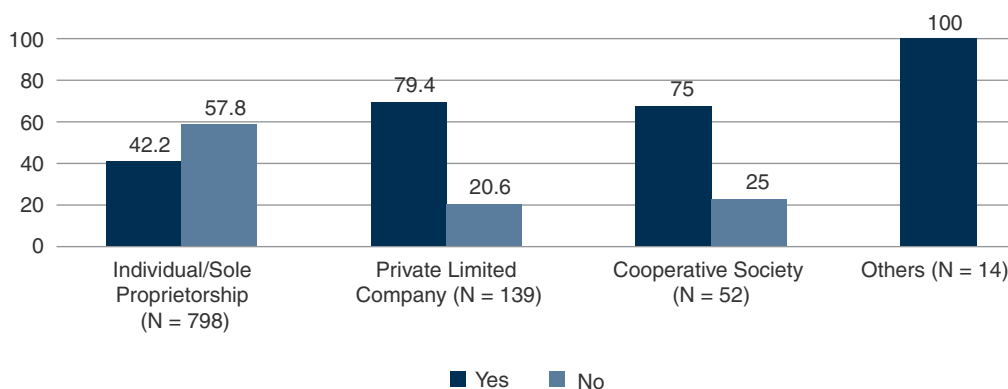


FIGURE 3.55: Use of Bank Account for Business Operations (by legal status)



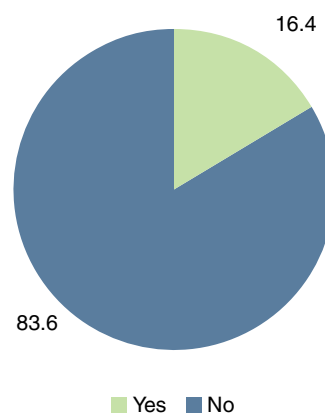
only about 28 percent of them indicated that the bank account is specific to the business establishment (see panel (b) of Figure 3.54). This is not surprising since most of the firms in the sample (about 93 percent of the total sample) are sole-proprietorships where the distinction between the transactions of the business and the owner are mixed.

Use of bank account for business operations in terms of legal status shows that not surprisingly sole-proprietorship businesses turn out to be those using bank account the least. As can be seen from Figure 3.55, about 58 percent of sole-proprietorship firms indicated that they do not use bank account for business operations. The proportion of firms that use bank account is larger in the Private Limited Company ownership structure.

In the case of informal businesses, about 16.4 percent of respondents used a bank account for business activities. However, only 1.2 percent of them had a separate bank account for business operations, indicating that the majority of respondents used a private bank account for business operations (Figure 3.56).

In line with the discussion above, on the use of bank account by the business firms in the sample, only about 26 percent of transaction turnover of the whole firms in the sample is through bank. The magnitude of these transactions are about 40 percent for firms in category A, about 29 percent for firms in category B, and about 10 percent for category C firms. The results are, again, consistent with the size and characteristic features of the firms in the three tax payers' categories. That is, as discussed earlier most of the firms are

FIGURE 3.56: Use of Bank Account (informal) (percent) (N = 499)



sole-proprietorship, small in size, and make their transactions by cash than through bank account.

In general, the survey data show the limited use of computer, internet and bank accounts by businesses (both formal and informal).

In addition to the above, when asked about whether or not firms or any of their employees made any business-related visits to tax offices, a large proportion of category A and half of B taxpayers made visits to tax offices. However, about 41 percent of category C taxpayers reported such visits. Although businesses are required to make business-related visits to tax offices, outsourcing tax-related functions could be a reason for some businesses, especially for category A and B taxpayers not visiting tax offices. On average, a business firm made about 5 visits in the previous tax year (Table 3.14).

In addition, informal business survey respondents were asked to rate general statements related to knowledge

TABLE 3.14: Business-Related Visits to Tax Offices—Formal

	Total	Category		
		A	B	C
N	1003	342	253	408
Yes	43.2	58.6	50.0	40.8
No	56.8	41.4	50.0	59.2

of tax regulations and requirements. About 33 percent indicated that they were knowledgeable or very knowledgeable about tax regulations and requirements while the rest were either not knowledgeable, not sure or somewhat knowledgeable. The results by location also reveal that only 14 percent of respondents in Bahir Dar, were found to be knowledgeable or very knowledgeable while the remaining 86 percent were either not knowledgeable, not sure or somewhat knowledgeable (Figure 4.57).

In addition to the knowledge about tax laws and regulations informal business survey respondents were asked about various tasks of business operations such as keeping accounting records and books for the business. Only 11 percent reported that keeping accounting records would not be a problem while the remaining (89 percent) indicated a little problematic, quite a problem, extremely problematic and not sure whether it is a problem or not (Figure 4.58).

Similar to the above picture, in all locations considered less than 10 percent of respondents indicated that keeping accounting records is not a problem at all. Specifically, in Hawassa, there were not respondents who said “not a problem at all”. These results in relation to the perceptions of keeping accounting records and knowledge about tax laws indicate the need for the tax administration, the government at large, to work on awareness creation not only about tax laws but also record keeping.

FIGURE 3.57: Knowledge about Tax Information and Requirements by Location—Informal

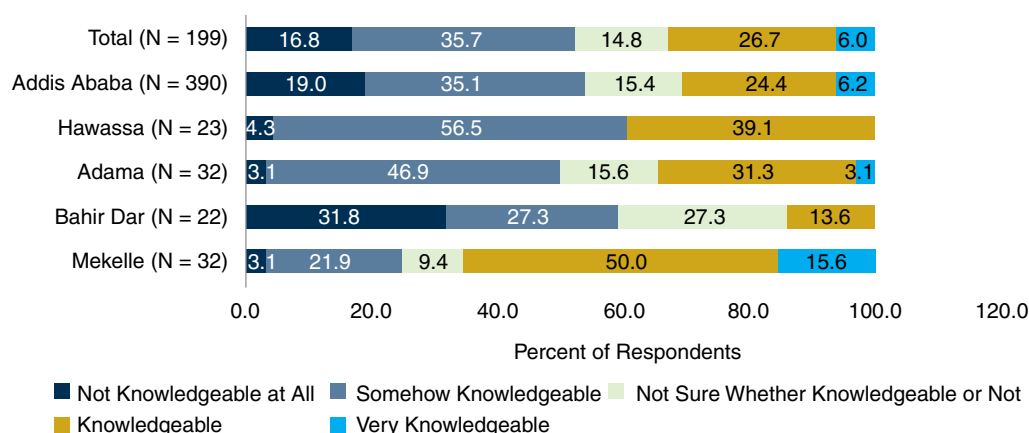
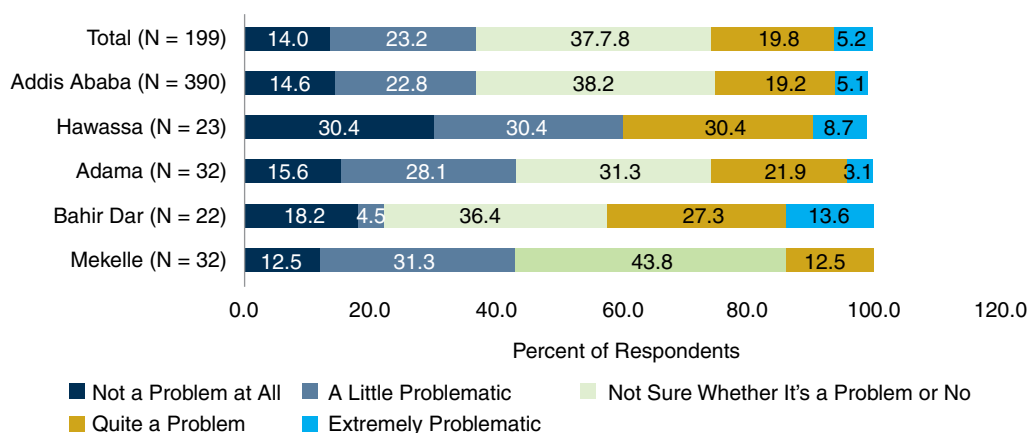


FIGURE 3.58: Perception about Keeping Accounting Records and Books for the Businesses—Informal



4 | Conclusions and Recommendations

Using the survey data the study attempted to estimate and analyze tax compliance costs in Ethiopia for the year 2012/13. The average tax compliance costs per business were estimated to be ETB 6,753 (USD 360) (including the acquisition and maintenance costs) and ETB 5,520 (USD 297) (excluding the acquisition and maintenance costs). The total compliance costs of taxes in Ethiopia in the year 2012/13 were estimated to be ETB 6.7 billion (about USD 360 million). This is between 4.5 and 6 percent of Ethiopia's total government revenue collected in 2012/13 (depending on whether tax compliance costs include acquisition and maintenance cost of software and hardware) and about 1 percent of its GDP during the same year.

Examining tax compliance costs estimates as a share of turnover shows that it was an average of 5.3 percent in the year under consideration. The tax compliance costs (in absolute terms) were found to be larger for category "A" businesses than that of category "C" businesses. The results presented earlier showed that the TCCs/turnover ratio for smaller businesses is high compared to that of larger businesses, providing evidence that tax compliance costs in Ethiopia are regressive. That is, small businesses bore disproportionately higher compliance costs burden compared to large businesses. Survey respondents (especially smaller ones) also perceived the burden of tax compliance as being higher than the amount of tax payable.

Such findings are not unusual internationally. On the other hand, it is often critical to take steps to reduce the compliance burden on small businesses as much as possible. When tax compliance costs are 5 percent of turnover, it is the equivalent of an additional 5 percent turnover tax (which, even assuming a generous profit margin of 20 percent, would be equivalent to a 25 percent profit tax on top of all other taxes being paid by a small business). Such a burden reduces the competitiveness of businesses, especially, small domestic businesses.

In addition, the study revealed the tax compliance cost burden by tax type and by sector. As results showed the compliance costs of business profit tax is much higher than that of other types of taxes for all business categories. Following business profit tax, VAT and TOT compliance costs were found to be significant. This high burden of tax compliance costs on relatively smaller businesses is likely to deter them from fulfilling the requirements imposed on them. The burden of compliance costs increases the cost of doing business. Analyzing the burden of tax compliance costs by business sector also revealed that the trade sector (both wholesale and retail trades) bore a heavier tax compliance cost burden than others.

In addition to the estimation of tax compliance costs for formal businesses, the study assessed taxpayers'

perceptions on the advantages and disadvantages of registering for taxes and the business environment in general (by both formal and informal businesses), as well as experiences and perceptions about VAT and refund process, SRM usage, inspections and audits, penalties and appeals, and communications with ERCA (for formal businesses). High tax rates/ burden and complicated procedures were found to be the biggest disadvantages of registering for taxes by both formal and informal businesses. High price of goods and services compared to VAT unregistered businesses was perceived to be the biggest disadvantage of registering for VAT while “correction of errors” was found to be the biggest difficulty in using SRM.

Recommendations

In addition to the relatively high estimated compliance costs, the perception of high tax burden/ tax rates and complicated tax procedures were mentioned as “disadvantages of registering for taxes” by both formal and informal business survey respondents. Simplifying the tax system and reducing the burden of tax compliance is critical for encouraging formalization of businesses and fostering a positive perception towards the entire tax system.

Specifically, in order to reduce the tax compliance burden on smaller businesses and also encourage formalization, simplification of the tax regime for micro and small enterprises is worth considering. As can be seen from the tax compliance costs burden, the perception of taxpayers and also from a review of the micro and small business taxation legal framework, the regime is complex, time-consuming and costly. For category C taxpayers, there are over 80 categories of sectors and nearly 20 turnover bands. In the implementation of the legal framework, the tax administration relies on daily sales estimates of each and every taxpayer under that regime. The estimation uses mostly such subjective criteria as location and nature of the business, the volume of transactions, expenditures for business and non-business purposes.

The practice of taxing micro businesses coupled with the tax compliance burden as revealed by the relatively high tax compliance costs of smaller businesses

and also the burden of tax audits and inspections necessitated the review of the system in light of the international experience and the reality in the country and replacement of the regime by a more simplified and more objective system similar to the practice in other developing countries.

Many other countries have greatly simplified taxes for micro-enterprises, taking into account both their very low earnings and their relatively lack of capacity for detailed bookkeeping. While the desire to improve “fairness” (vertical/horizontal equity) is usually the motivation for large matrices of sectors and business sizes, these systems sacrifice simplicity for the hope of fairness, but are usually ineffective in achieving fairness. Many studies of micro-enterprises show that their sales are highly variable from year to year and their profit margins range from substantial losses to quite high profit margins, which also vary widely over the years and across locations. Thus many countries have opted for much simpler fixed-tax systems (often administered at the regional or local level, as is already the case in Ethiopia), along with encouragement to keep proper books (see IFC (2007), pp 60–72). Such a system could offer a simple lump-sum (with very limited cells in a matrix, e.g., city versus town/village; services versus trade and manufacturing) that would substitute for both income tax and VAT. However, ERCA would also have to take steps to mitigate abuse of the system (which often becomes a problem, as seen in other countries) by under-declaring turnover.

The trade sector (both wholesale and retail trades) accounted for a large proportion of the business environment in Ethiopia. Heavier tax compliance costs burden on this segment implies that this sector is likely to be deterred from fulfilling tax requirements.

In respect of the disadvantages of registering for taxes both formal and informal businesses showed that high tax burden/ tax rates as the biggest and the second biggest disadvantages of registering for taxes. Especially, in the case of smaller businesses this was found to be the biggest concern apart from complicated procedures. Informal operators further indicated that financial burden of being formal (including taxes and fees) and

lack of clarity of tax laws and regulations as major reasons for not applying for tax registration. Following this, informal businesses indicated that reduction in tax burden/tax rates as one of the factors that would encourage them to register for taxes and operate in the formal sector. The very low income tax exempt threshold (ETB 1800 per annum, which is only about US\$100) might be one of the reasons for such a view especially by smaller businesses. Reviewing the tax rate structure (along with the tax exempt threshold) in addition to simplification of the entire tax system is important in reducing the burden of taxes and changing the attitudes of taxpayers and also encouraging formalization of businesses.

The income tax exempt threshold should be set at approximately the poverty level, and adjusted regularly over time to account for inflation and other relevant factors. The VAT threshold also needs to be adjusted periodically for inflation, and is usually set at the lower turnover level for a “medium” size business (taking into account also the capacity for the necessary bookkeeping for VAT compliance). The current threshold, at about the equivalent of US\$25,000 is quite low by international standards. The fact that about half of businesses that are registered for VAT are outsourcing at least some of the compliance burden suggests that the complexity is more than many Ethiopian businesses can currently handle on their own. The relatively high compliance costs associated with VAT also suggest that the burden is onerous for the smaller businesses. By comparison, the VAT threshold in South Africa is currently about US\$85,000; Kenya’s is about US\$55,000 (see Appendix 2).

In between poverty-level micro-enterprises paying a fixed tax and medium-large businesses paying regular profit tax and VAT, it is often helpful to offer an intermediate regime for “small” businesses that can pay a turnover tax in lieu of both profit tax and VAT (with an option for any business to register for regular profit tax and VAT voluntarily). While some countries offer more than one rate (e.g., a lower TOT rate for trade and a higher rate for services), the structure should be kept simple, and the revenue administration should offer training to encourage proper bookkeeping. In addition to this,

adjusting business categorization thresholds which have been eroded by inflation is worth considering.

Steps should also be taken to simplify category A taxation. For example, it might be helpful to eliminate sector selected registration requirements for VAT. It might also be beneficial to reduce the number of goods subject to excise (e.g., eliminating excise taxes for salt, sugar and soft-drinks). Another important measure should be to consider reviewing the withholding tax (on payments and imports) against the profit tax of suppliers, which tends to discourage use of domestic, small business suppliers.

With regard to the disadvantages of registering for VAT, most formal businesses noted higher prices of goods and services compared to others (i.e., non-VAT competitors) as the biggest disadvantage. Such a result is consistent with what taxpayers usually raise as a concern at various forums. Such a problem could be because businesses that were required to register for VAT have not been registered; and/or after registration if there are businesses that do not issue invoices, such a complaint is likely to arise. In the case of the latter, the survey revealed sales without invoices as the most common ways that businesses use in reducing their tax liability. Under-declaration of sales is always a problem when most transactions are in cash. However, as a growing proportion of transactions take place electronically or through the banking system (including mobile-phone payments such as M-PESA in Kenya and M-declaration in Rwanda), documentation of sales will become increasingly more comprehensive.

Another way to help increase the culture of requesting for receipt by consumers could be useful. One instrument that could be considered in this regard is consumers’ receipt “award” as used in other countries including Rwanda.

Furthermore, the study found the average time taken by the tax office for processing VAT refund to be about 24.5 days. Although this study doesn’t attempt to see the nature of VAT refund requests, this result appears to be applicable to those businesses whose refund requests are allowed to be processed within a short period of time. These businesses are mostly engaged

in export; there are, however, others engaged in non-export business and have refund claims due to the existence of VAT excess credit (for over 5 months)¹² and or the operation of VAT withholding scheme. For such taxpayers, the average time to process VAT refund is likely to be more than the above mentioned period. As the data maintained by ERCA shows the number and volume of VAT refund requests is increasing; this is creating delays in processing refund requests and is imposing burden on not only taxpayers but also the tax administration. In this context and given the base is quite low, the above mentioned result has to be examined with caution.

ERCA should try to expedite payment of refunds to taxpayers to help businesses avoid unnecessary cash flow difficulties. In particular, adoption of risk based refund processing and also accepting bank bonds as a security for VAT refund payment (risky businesses) could be considered as suggested at Ethiopian Chamber of Commerce and Sectoral Association's (ECCSA) forum (ECCSA 2014).

The compliance cost is high for VAT. It is recommend to reduce the frequency of VAT filing (e.g., make it quarterly), for relatively smaller businesses.

The other finding is that a substantial proportion of respondents did not apply for VAT refund; this was due to the view that, among others, refund amount was small (35.1 percent), belief they would not get the refund (15 percent), and complicated formalities for refund (15.3 percent). Although the percentage of respondents who were in view of not getting the refund and complicated procedures is not big, these issues need to be addressed (through awareness creation and making payments for genuine refund requests) in order to maintain a healthy VAT system that has less impact on business environment.

In terms of SRM usage, although respondents noted the existence of advantages, the difficulty of correcting errors was found to be the biggest disadvantage of using the machine. Other studies such as Yesegat and Fjelstad

(2013) also noted correction of errors as one of the difficulties in using SRM; this is because correction of errors is not automatic and needs some paper work and repeated visit to the tax office. Further investigation of the practice of correcting errors in using SRM and identifying possible ways addressing this concern of taxpayers is crucial. Further, it is important to create awareness among taxpayers about the benefits of using SRM.

As reported earlier in the results section, the inefficiency in the appeal process and also the length of time the procedures take were considered to be issues in the dispute resolution system. These perceptions of business taxpayers are likely to make the dispute settlement system not being seen as a useful method of resolving tax disputes and might force them to use an illegal means of resolving tax issues (like by bribing officers and other mechanisms). In addition to the above, examination of the views pertaining to appeal decisions reveals that relatively a small proportion of appeal cases were resolved in favor of the tax authority. Although this result needs to be substantiated through examination of the actual appeal decisions, it sends the message that there is a need to investigate why a large number of appeal decisions were not in favor of the tax authority and what causes them. It is, therefore, important to investigate the entire dispute resolution system and address the issues in the system.

The other interesting finding is that only 36 percent of inspections and audits were considered to be for legitimate reasons, leaving the largest share to other reasons. These other reasons include tax inspections and tax audits happen as mechanisms of seeking informal payments by tax officials, officials inspect and audit taxpayers only to justify their jobs, and someone's interest to create obstacles to others. From the above discussion, it can be noted that only a small percentage of audits and inspections perceived to be legitimate.

In terms of actual audit and inspections, about 30 percent of smaller business showed that they faced audit and inspections. This result evidences the burden on relatively smaller businesses due to tax authorities' audit and inspections. With regard to the frequency of audits and inspections, the average was found to be 4.5 times; it should be noted that this

¹² Non-export businesses are required to carry over their VAT credits to the next five accounting period (five months) before applying for VAT refund.

4.5 average frequency of audits includes all types of inspections (desk audit, inspection of purchases and sales, SRM usage etc) and other visits of tax officials. The frequency of audits and inspections shows the extent of frequent contact between taxpayers and tax officials which might create room for corruption (which in turn might account for the fact that businesses perceived about 20% of inspections to be motivated by “inspection officers looking for informal payments”). In addition, this result might have some link to the view of respondents that only about 36% of the audits and inspection happen for “legitimate reasons.”

The above mentioned issues pertaining to audit and inspection might be due to the fact that the tax administration’s failure to discuss with businesses (to explain why the business has been selected for an audit and also the audit results to convince the taxpayer that the audit finding is justified). Furthermore, the audit compliance burden on relatively smaller businesses signals two things: the compliance burden on smaller businesses, and the pressure in using the scarce tax administration resources. Therefore, to address these issues in relation to audit and inspection, as part of building a modern tax administration, improving the risk based audit system is an important consideration in addition to holding discussions with businesses about tax audits and their outcomes.

With regard to others’ compliance behavior, a large majority of businesses perceive the existence of misstatement of both sales and expenditures for the purpose of reducing taxes. Such a perception of others’ noncompliance is expected to have impact on their own compliance decision. As preliminary findings of a study by Yesegat and Fjelstad (2014) revealed there is a statistically significant relationship between taxpayers’ perception of others’ compliance and their own attitudes towards compliance; the latter is expected to affect taxpayers actual compliance behavior, as the literature shows. It is, hence, important for the tax authority to work towards not only improving compliance behavior but also highlighting positive evidence of good compliance behavior (e.g., annual award ceremonies in each region for “good taxpayers”).

In terms of bank account usage, as the results showed, of those that used bank accounts only a small proportion had bank account specific to the business establishment. This result evidences the limited use of banking by businesses and also mixing personal and business accounts. Overall, the survey results suggest about 75% of all transactions take place in cash, including about 90% for category C taxpayers and 60% for category A taxpayers. This signals the need to exercise caution by the tax administration in imposing income tax on bank deposits as that would increase taxpayers’ mistrust on the tax authority and reduce the incentive to use banking in business operations.

Businesses typically visit tax offices, and this is more so for category A and B tax payers. Furthermore, the in-house cost of compliance for filing taxes is higher than that of pre-filing and post-filing activities. It is, therefore, recommended that electronic filing (efiling) of tax reports and payments, and mobile phone payments should make it possible to considerably reduce the time costs and the overall tax compliance costs for businesses. It is known that the tax authority has launched using efilng for larger businesses (medium business to some extent) in Addis Ababa. Extending the efilng system to those taxpayers who are able to use the system is worth considering. Furthermore, for the efilng system to be effective in reducing the compliance costs of taxpayers, it has to be supplemented by epayment or payment through the banking system. Payment using mobile phone is also recommended to be considered as one option in reducing the compliance costs burden, especially, on smaller businesses.

The fact that 20 percent of category A and 49 percent of category B tax payers do not use sales register machine calls for the need for awareness creation and education on the advantages of using of sales register machine for business activities.

Both for outsourcing and in-house tax accounting, compliance cost is the highest for business profit tax. Turnover tax and value added tax also contribute a lot to compliance cost depending on the business category considered. We also find that the total

compliance cost as a share of turnover is generally high for Ethiopia. Thus, total compliance cost could be reduced if a comprehensive capacity building measures are taken such as to identify factors that contribute to high compliance cost in general and outsourcing in particular.

As shown earlier in section 3, only a very small proportion informal business survey respondents indicated that they are very knowledgeable or knowledgeable while the majority were not or were unsure. In addition, the majority of respondents

viewed the task of bookkeeping as problematic.

These issues call for the government, in particular, tax administration's efforts in creating awareness among informal traders.

The fact that about half of respondents indicated that they are likely or very likely to register for tax in the coming two years and about 24 percent have not decided means that more education and awareness creation is required for informal operators and in particular providing support and assistance is critical in the formalization process.

References

- Blažić, H. (2004), Tax Compliance Costs of Small Business in Croatia. Institute of Public Finance.
- Coolidge, J. (2012), “Findings of tax compliance cost surveys in developing countries,” *eJournal of tax research*, 10(2): 250–287.
- FDRE (1995), The Constitution of the Federal Democratic Republic of Ethiopia of 1995. Articles 95–99, *Negarit Gazeta*, Year 1, No. 1.
- FDRE (2002), Value Added Tax Proclamation, Proclamation No. 285/2002, *Negarit Gazeta*, Year 8, No. 33.
- FDRE (2005), Reorganization of the Executive Organs of the Federal Democratic Republic of Ethiopia of 2001, Proclamation No. 256, *Negarit Gazeta*, Year 8, No. 2 (repealed and replaced by Proclamation No. 471/2005).
- FDRE (2008), Ethiopian Revenues and Customs Authority (ERCA) Establishment of 2008, Article 9, Proclamation No. 587, *Negarit Gazeta*, Year 14, No. 44.
- International Finance Corporation (IFC) (2007), *Designing a Tax System for Micro and Small Businesses: Guide for Practitioners*.
- International Finance Corporation (IFC) (2010), *Tax compliance cost surveys: using data to design targeted reforms*, practice Note No. 8.
- International Finance Corporation (IFC) (2011), *Tax Perception and Compliance Cost Surveys: A Tool for Tax Reform*.
- Klun, M. (2004), Compliance Costs for Personal Income Tax in a Transition Country: The Case of Slovenia. *Fiscal Studies* 25 (1).
- MoFED (2013), *Macroeconomic performance assessment of Ethiopia: achievements, challenges and the foundations for sustainable and inclusive growth and transformation (1991/92–2011/12)*, Addis Ababa, Ethiopia.
- Sandford, C. (1995), *Taxation Compliance Costs: Measurement and Policy*, Fiscal Publications, Bath.
- SEDF (2012), *Nepal tax compliance cost survey report-2012*, International Finance Corporation (IFC), World Bank Group, IFC Advisory Services in SouthAsia.
- Susila, B. and Pope, J. (2012), The magnitude and the features of tax compliance costs of large companies in Indonesia”, *Australian Tax Forum* Volume 27 No. 4.
- Yesegat, W. (2009), *Value added tax in Ethiopia: A study of operating costs and compliance*, PhD thesis, Faculty of Law of the University of New South Wales, Australia.
- Yesegat, W. and Fjellstad, Odd-Helge (2013), *view of paying taxes in Ethiopia: preliminary qualitative results*, a paper presented at the International Center for tax and Development (ICTD) annual conference held from December 11–13, 2013, Lome, Togo.
- Yesegat, W. and Fjellstad, Odd-Helge (2014), *Views of paying taxes in Ethiopia: Preliminary survey results*, paper presented at the ICTD’s annual conference held from Dec 07–09, Arusha, Tanzania.

Annex Tax Compliance Costs— 1 | International Comparisons for Ethiopia¹³

1. INTRODUCTION

The Investment Climate Department of the World Bank Group (WBG) has undertaken over a dozen “tax compliance cost surveys” (TCCS) in developing and transition countries over the past several years, and has amassed a wealth of empirical data documenting the severity of the compliance burden for micro, small and medium enterprises, and perceptions about tax compliance from both formal and informal businesses.

Although the various TCCS are difficult to compare, due to the fact that each was tailored to the particular conditions and priorities in each country, they allow at least for direct comparison of the time required for specific tax compliance tasks in terms of person-hours per year.

The findings of the surveys can not necessarily be taken as typical for developing countries, as the majority of client governments only requested a tax compliance cost survey if there was a reason to believe that it was a problem for business taxpayers (with the exception of South Africa, where we piloted the first such survey, and where tax compliance costs appear to be manageable for the majority of businesses).

The core questions of interest are about the time and cost of basic tax compliance tasks, including primarily in-house staff time (in person-hours per year X gross wage rates) plus (when relevant) costs for hiring external tax preparers or advisors, tax forms, sales registers, or other out-of-pocket expenses. We took care to separate the costs of tax compliance from those of general bookkeeping, asking specifically about both.

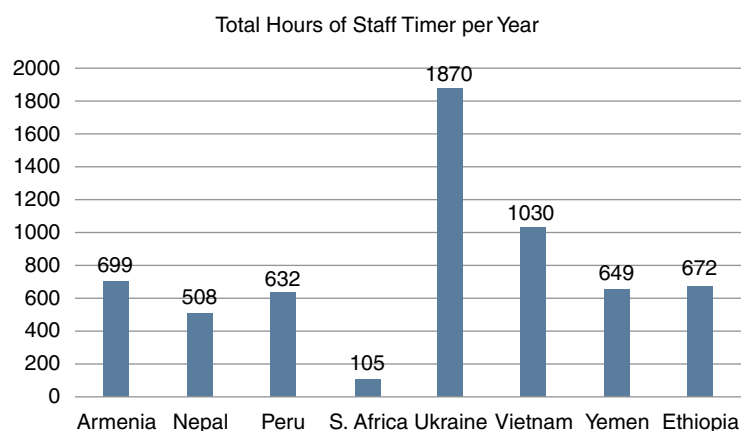
For example, in Armenia, the average business spent a total of about 400 person-hours per year on tax compliance, which was valued at just over \$1000. In other countries, the range has extended from less than 100 hours (or even 50 hours for sole proprietors using simplified tax regimes) to well over 1000 hours (e.g., in Ukraine before recent reforms). Table below illustrates the range for “medium” sized businesses, focusing on time required for Income tax, VAT and payroll taxes in several of the countries in the database.¹⁴

Complexity of tax regimes (e.g., multiple taxes, several different bases, requirements for multiple filings per year, etc.) appear to drive up tax compliance costs, as do requirements to submit detailed accounting records

¹³ This section is extracted from Coolidge, Jacqueline, 2012: “Findings of Tax Compliance Cost Surveys in Developing Countries”, eJournal of Taxation, Vol 10, No. 2, Oct. 2012, pp 250-287. Available at: http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Documents/paper3_v10n2_Coolidge.pdf

¹⁴ Source for all countries other than Ethiopia is Coolidge (2012); for Ethiopia it is mean hours per year of staff time (for a business doing all its tax compliance work in-house) for Business Profit Tax, VAT, Employment and other Withholding taxes for a business in the ETB 500,000—10 million turnover band. A “medium size” business is defined following the Doing Business Paying Taxes indicator, specifically a business with turnover equal to 1050 x per capita GNI (World Bank Atlas method).

FIGURE 1: Average Hours per Year for Tax Compliance (medium size business)



along with tax returns (as in Peru and Armenia), especially if tax accounting differs significantly from financial accounting. Substantial changes to tax legislation and regulations, even if they are designed to simplify the tax regime, require time for taxpayers to learn about them.

Of course, there are several caveats regarding the survey data. Many small business taxpayers find it conceptually difficult to separate tax compliance costs from general bookkeeping, as they tend to carry out bookkeeping only to the extent required for tax compliance. Even knowledgeable tax experts may disagree with one another about where to draw the line, known as the “disentanglement problem.”¹⁵ In fact, Sandford and others have pointed out that there are benefits to tax compliance to the extent that small business management is improved by the financial knowledge gained from tax compliance that wouldn’t have happened otherwise. In such an analysis, gross tax compliance costs minus benefits of tax compliance equal net tax compliance costs.¹⁶ This Annex focuses on gross TCC.

For businesses that outsource some or all of their tax compliance work, the owners are usually unaware of the time spent by their accountant, while the accountant

usually doesn’t know how much time the business spent internally on such tasks. In countries where almost all tax compliance work is done in-house (including Nepal and Ethiopia), we would interview businesses directly; in countries where most such work is outsourced, we would interview the tax preparers (e.g., Peru). In countries where there is a broad mix of the two practices (e.g., in South Africa) it was necessary to interview both groups in order to get a comprehensive picture of the issue.

2. REGRESSIVITY IN TAX COMPLIANCE COSTS

A very common pattern seen across all countries where TCC have been studied is a striking degree of regressivity: they are much heavier, as a percent of turnover, for smaller businesses than for larger ones.¹⁷ While medium and large businesses usually spent less than 1/10th of 1% of their turnover in TCC, small businesses often face TCC of 5% or more of turnover, which can be compared to an extra tax burden.¹⁸

Studies undertaken on TCC in developed countries before the year 2000 typically show burdens of one

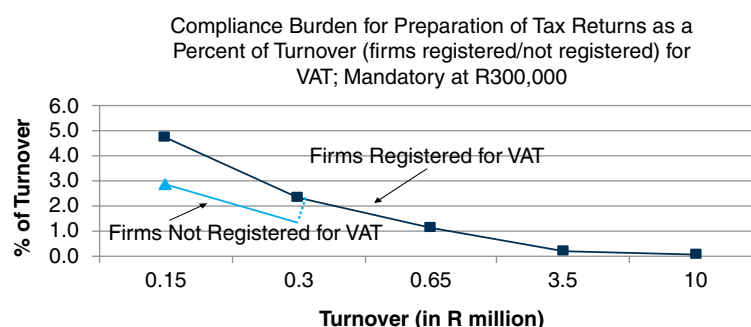
¹⁵ See Turner, Smith and Gurd (2008).

¹⁶ See Sandford, Godwin and Hardwick (1989), Tran-Nam, Evan, Walpole and Ritchie (2000); and Lignier (2006 and 2009).

¹⁷ See, for example, OECD (2012)

¹⁸ It should be noted that in addition to the problems of the valuation of the time of small business-owners, such estimates can also be affected by under-reporting of turnover by business respondents.

FIGURE 2: South Africa Tax Compliance Cost Survey



Source: FIAS 2007.

tenth of one percent of turnover or less for businesses over about \$200,000. However, a more detailed study in New Zealand documented TCC of up to 20% for businesses with turnover under \$20,000 (Colmar Brunton, 2005; although most of these businesses may have been start-ups with both low turnover and relatively high costs in “learning the ropes” of business tax compliance). One key question which could be addressed by regression analysis would be the relative importance of the TCC burden of “start-ups” versus “smallness” in this pattern, given that most startups are also small.

The WBG’s first TCCS was undertaken in 2006 in South Africa, where we estimated TCC of about 5% of turnover for businesses with turnover below \$50,000 and that were registered voluntarily for VAT. Those of similar size not registered for VAT had TCC/turnover of less than 3%.¹⁹

Other countries showed even more extreme TCC burdens for small businesses, although some of the differences may be exaggerated due to relatively higher estimates of the imputed wages of owner/managers or possibly due to under-reporting of turnover by survey respondents (see Figure 3 on next page).

¹⁹ Here it should be noted that businesses voluntarily registered for VAT were probably different from similar-sized businesses in other respects, such as numbers of employees and consequent implications for payroll and other taxes, so the difference can not necessarily be ascribed to VAT alone.

The OECD provides a number of international comparisons for thresholds for Income tax, presumptive tax and VAT. As seen from the table in Annex 1 below, many countries have increased their thresholds to reduce the administrative burden from their taxpayers. Setting a high threshold seems attractive given that the contribution of small business to revenues collected is small,²⁰ though for businesses under the threshold, they may be encouraged to underreport turnover to take advantage of reduced rates that come with the lower thresholds and this would create distortion of competitive neutrality between businesses.²¹

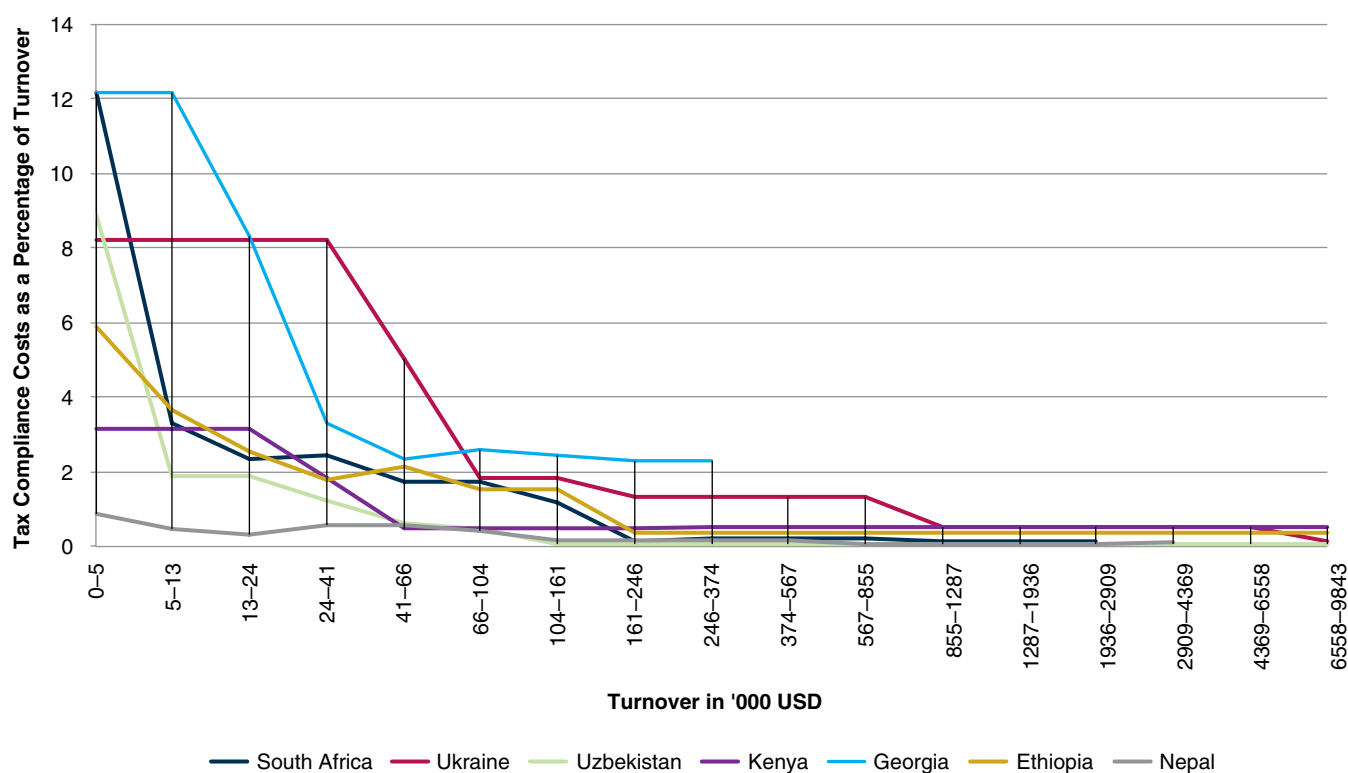
3. DIFFERENCE BETWEEN THOSE WHO OUTSOURCE TAX COMPLIANCE WORK AND THOSE WHO DO IT IN HOUSE

As described above, countries differ substantially in their habits of outsourcing tax compliance. While most of the former Soviet countries involved in TCCS seem to prefer (or need) accountants on staff, those in Latin America are almost opposite: in Peru, for example, tax filings are legally required to be prepared by a certified accountant, most of whom service multiple clients (although large businesses mostly have them on staff).

²⁰ IFC (Engelschalk) “Designing a Tax System for Micro and Small Businesses” page 47.

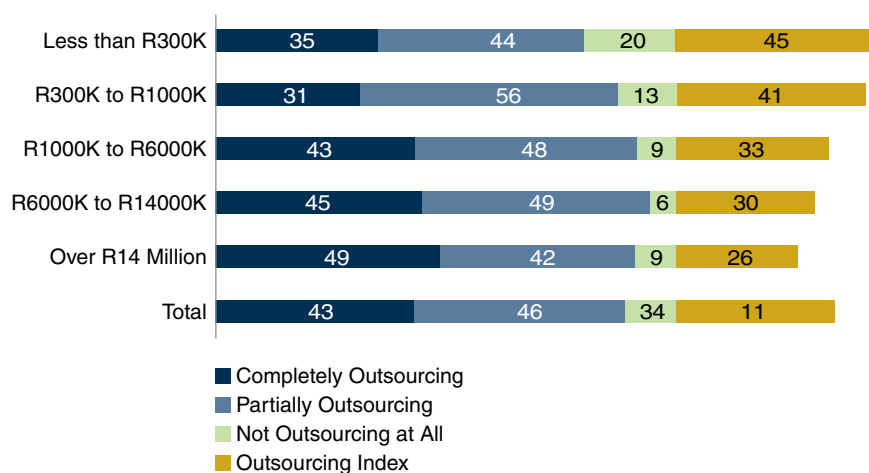
²¹ IFC (Engelschalk) “Designing a Tax System for Micro and Small Businesses” page 46.

FIGURE 3: Tax Compliance Cost as Percentage of Turnover



Source: Compilation from TCCS for countries cited.

FIGURE 4: Outsourcing Practices among Small Business Taxpayers in South Africa, by Turnover Band



Source: Coolidge, et. al, 2009.

In South Africa, the pattern is more mixed: some businesses do all their tax compliance work in-house, some outsource it entirely, and some use a mix of in-house work and outsourcing. (See Figure 4).

Ethiopian businesses do more of their tax compliance work completely in-house, with over two-third doing

all their business profit tax compliance work in-house, over half of VAT payers doing it all in-house, 85% of TOT payers, and 70% of employment tax payers. (See Figure 5).

For the most part, small businesses in South Africa base their decisions on the availability of the necessary skills.

FIGURE 5: Outsourcing Practices among Business Taxpayers in Ethiopia, by Type of Tax

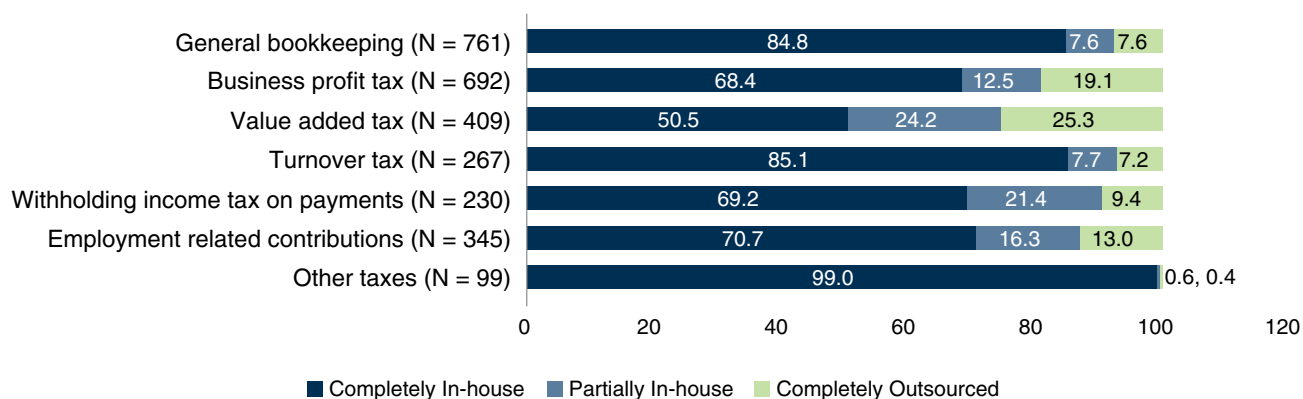
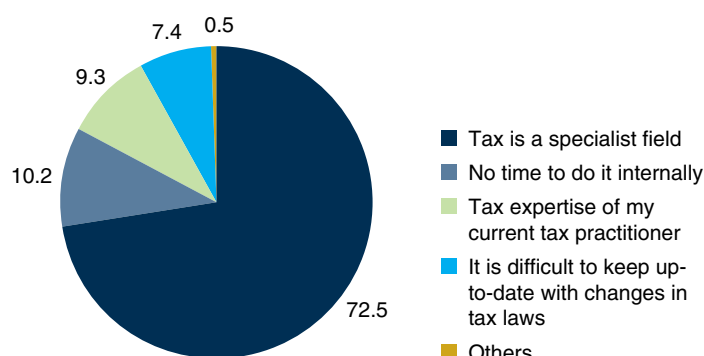


FIGURE 6: Reasons for Decisions to Outsource or Not in South Africa



Among those who do most of their tax compliance work in-house, most say they have sufficient expertise. Among those who outsource, most say they do it because “tax is a specialist field” that they lack. Only about 10% of those who do not outsource say it is because it costs too much, although among the smallest businesses, 25% say that is their reason (Figure 6).

Examining the data in South Africa more deeply, it appeared that the mix of in-house and out-sourced tax compliance was significantly more expensive than either doing all the work in-house or out-sourcing all the work. Apparently, when part of the work is done in-house (e.g., basic bookkeeping, VAT accounting etc) and some tax compliance work is outsourced, the outside tax practitioner needs to review the in-house work before he/she can proceed to the tax compliance work, in order to check for mistakes and correct them if necessary.²²

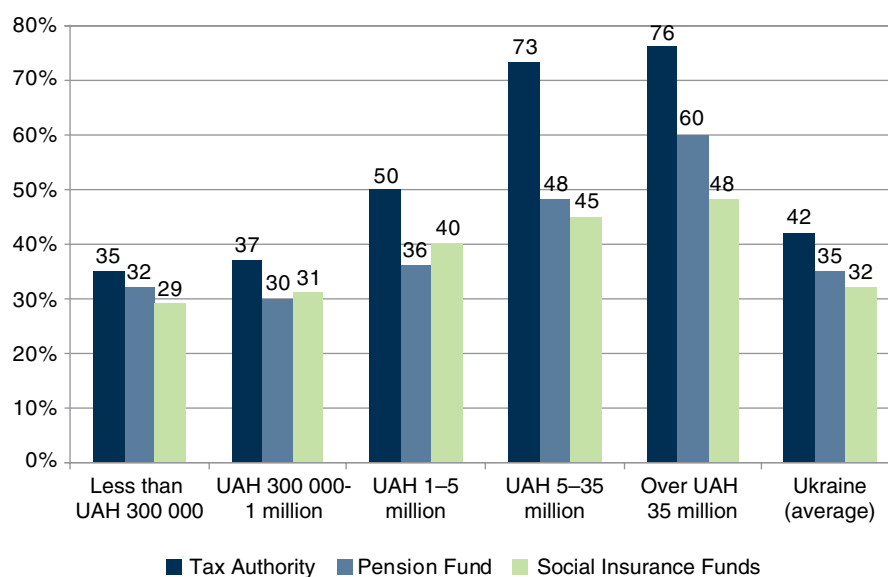
²² Coolidge, et. al, 2009.

4. TAX INSPECTIONS AND AUDITS

Tax inspections and audits are usually a much more important concern for businesses in developing and transition countries than they are in developed countries, and add significantly to tax compliance costs. Most revenue authorities in developing and transition countries do not have a well-functioning system of “risk based audit”, nor of reliable “self assessment” on the part of taxpayers that they feel they can trust. Compounding the problem, many individual tax officials in such countries are alleged to unofficially “negotiate” with taxpayers to reduce their tax payments in return for a bribe. The latter practice may reduce overall costs (tax payments plus bribes) to the taxpayer at the expense of the Treasury.²³

²³ It is also possible that some tax officials threaten taxpayers with a higher tax bill than their legal liability; taxpayers may rather pay a bribe to the tax official to pay the “right” amount of tax than go through the uncertain (and usually lengthy and expensive) process of trying to appeal.

FIGURE 7: Incidence of Inspections among Business Taxpayers in Ukraine



Source: Coolidge, et. al, 2009. Source: IFC (2009).

A well-designed and well-implemented system of risk-based audit, alongside self-assessment of tax liabilities by business taxpayers, should both improve the efficiency of the tax regime and reduce opportunities for bribery inherent in face-to-face contacts between tax officials and taxpayers. It also reduces wasted time for taxpayers and thereby reduces tax compliance costs.

In Ukraine in 2007, for example, even small businesses faced about a one-third chance of inspection not only by the tax authority but also by the pension fund and social insurance fund (see Figure 7).

Ethiopia's figures look similar to Ukraine's figures, with just under one third of businesses experiencing an inspection or audit within the previous two years (Figure 8).

In most countries where the World Bank Group has done a TCCS, the revenue authorities state that their official figures show a much lower rate of inspection. In the case of Ukraine, after discussions with the State Tax Committee and focus groups of business accountants, we concluded that the majority of "inspections" were in fact brief checks of cash registers. In the case of Kenya,

FIGURE 8: Inspections and Audits among Business Taxpayers in Ethiopia

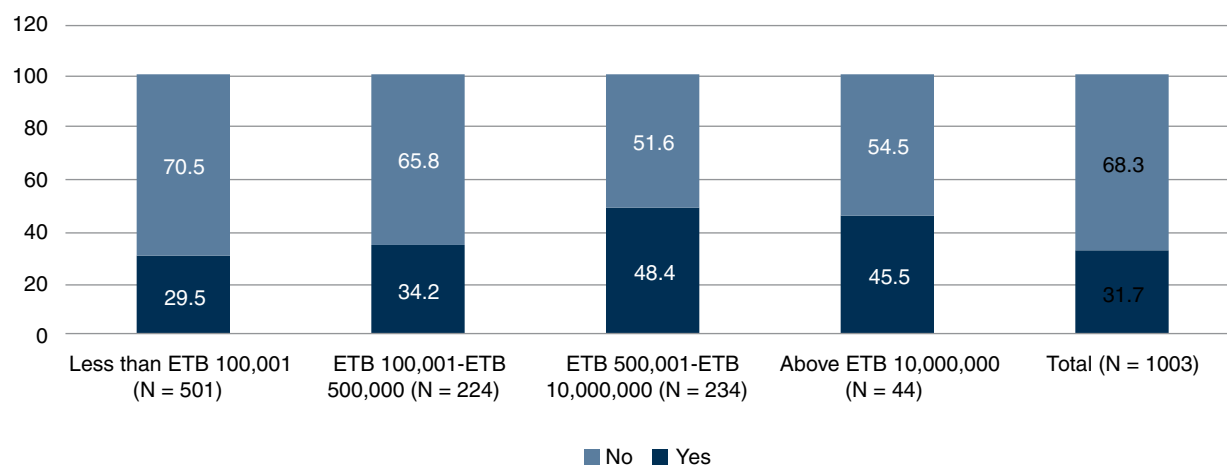
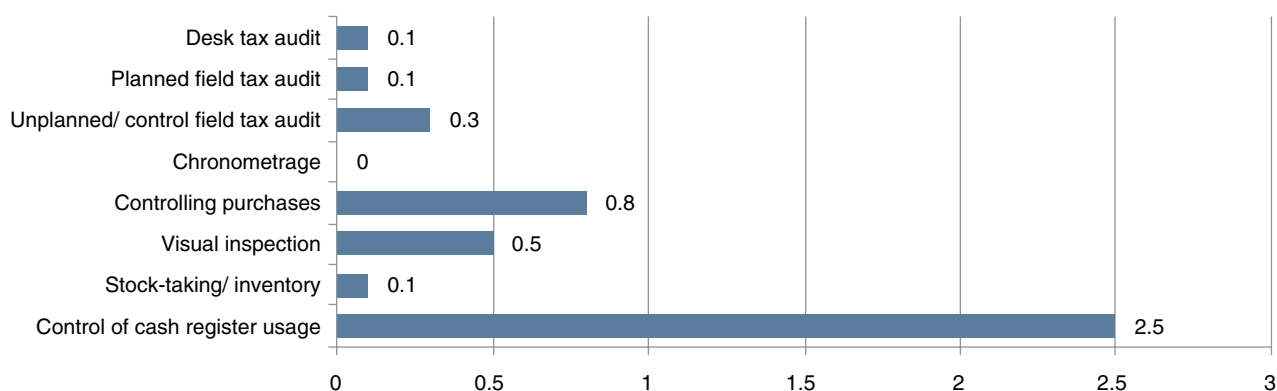


FIGURE 9: Different Types of Tax Inspections in Georgia



Source: IFC (2011) [Georgia].

officials from the Kenya Revenue Authority (KRA) said that many of the short visits were likely “informational visits” by tax officials, which were not inspections at all. However, they also speculated that there may be some “unofficial visits” or even fraud—i.e., people claiming to be tax inspectors who are not.

The TCCS in Georgia included a breakdown of types of inspections (see Figure 9):

Definitions of some of the more technical terms in the chart above are as follows:

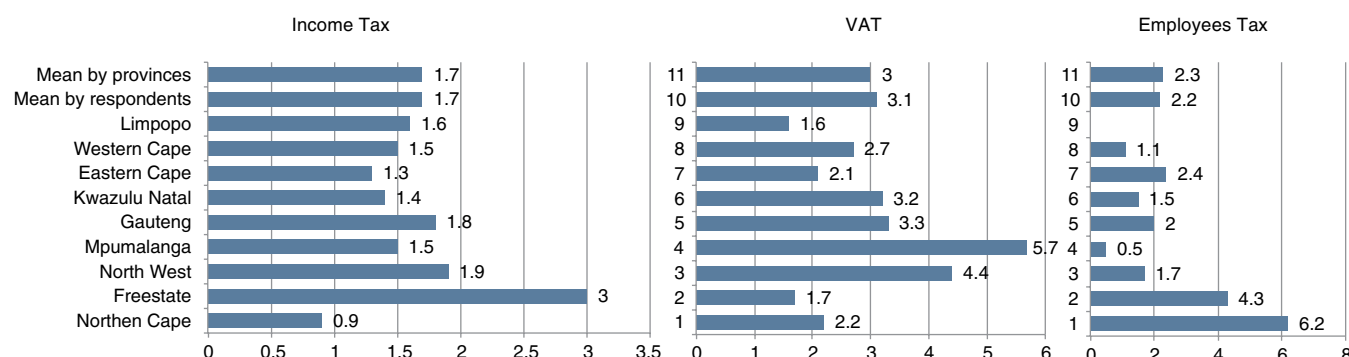
- control of cash register: Check that cash register is in compliance with set standards.
- visual inspection: A visual inspection of premises without checking accounting documents, stock, etc.
- controlling purchases: Tax inspectors buy goods from a store and check if salesperson registers the transaction in cash register and gives them receipt. If not, business is penalized. This is the most frequent

form of tax inspection (usage of cash registers is a legal requirement).

- chronometrage/invigilation: Tax inspectors monitor sales (of a restaurant or a hotel) for a certain period of time, usually for at least one week. If sales during this period exceed sales from previous period as reported by business, then the business gets penalized. Such penalties existed during the survey but have since been abolished.

By way of comparison, we have used the case of South Africa as an example of a country with a well-functioning system of Risk Based Audit (RBA). Overall, small and medium businesses in South Africa in 2006 (those with turnover under about \$2 million) faced only about a 2% chance of inspection for Income Tax and Employees taxes and about 3% for VAT. Some of the less populous provinces showed a slightly higher likelihood of inspection (see Figure 10).

FIGURE 10: Incidence of Tax Inspections by Type of Tax and by Region—South Africa (2006)



Source: FIAS, (2008).

FIGURE 11: Perceptions of Tax Inspections in Georgia

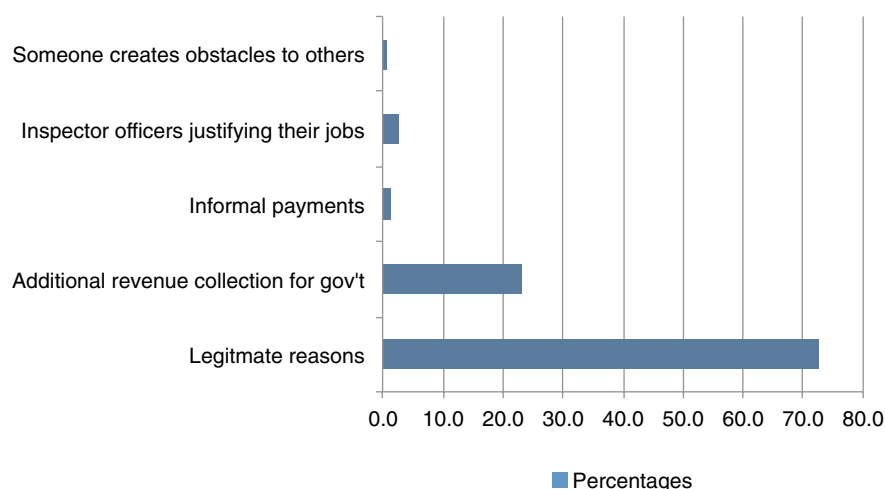
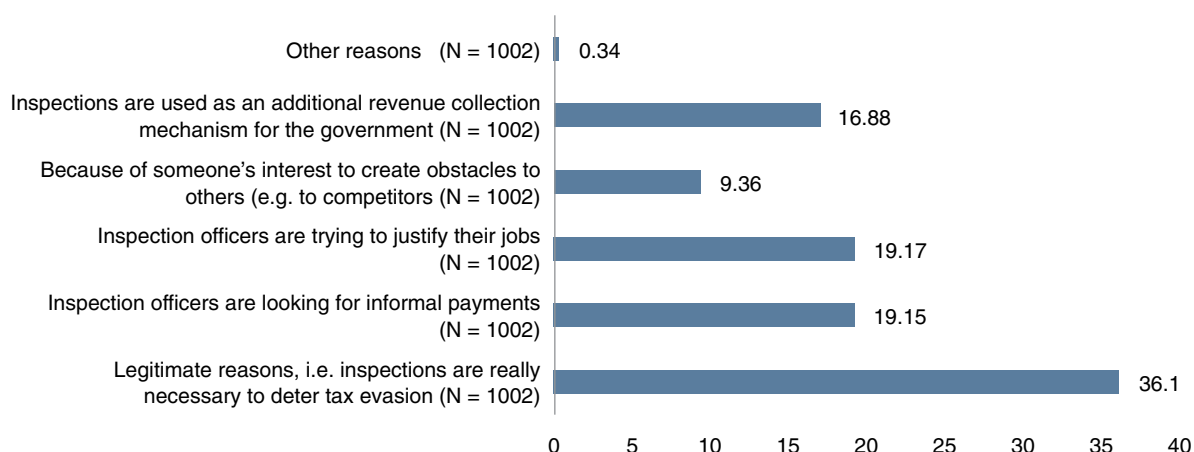


FIGURE 12: Perceptions of Tax Inspections in Ethiopia (percent of inspections)



Of course, businesses also understand the need for at least some inspections to catch and deter evasion. They perceive, however, that many inspections are motivated by a need to achieve revenue targets, to extract bribes, or in some cases to harass “opposition figures” or competitors to “cronies” of politicians.

A very striking difference between Georgia and Ethiopia is evident in the perceptions of business taxpayers about the “legitimacy” of most inspections. In Georgia, the great majority of business taxpayer perceive that tax inspections are carried out primarily for legitimate reasons, e.g., to deter under-reporting of sales and income (see Figure 11).

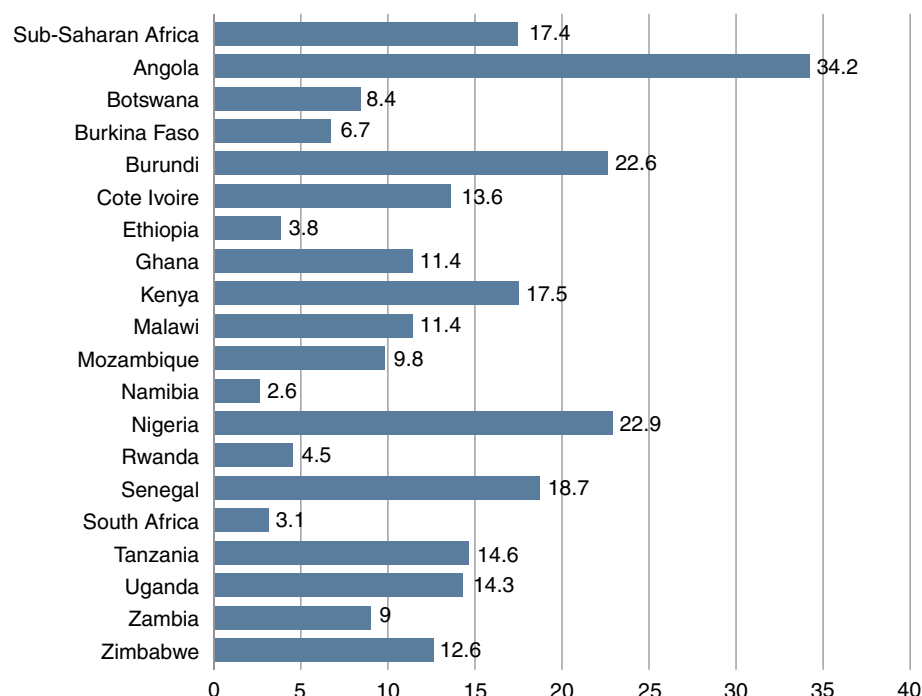
By contrast, in Ethiopia, only a minority perceive tax inspections as legitimate, and much higher percentages than in Georgia perceive bureaucratic motivations

(e.g., “tax officers are trying to justify their jobs” or “used as an additional revenue collection mechanism by government”) or even corruption (“inspection officers are looking for informal payments”). See Figure 12.

The World Bank’s Enterprise Surveys, carried out in almost all developing and transition countries, provides cross-country data on the perception of corruption in the tax administration. Ethiopia compares quite well within Sub-Saharan Africa, similar to South Africa and Namibia. See Figure 13.²⁴

²⁴ In order to compare the estimates above, it is important to multiply the “percent of inspections [where] inspection officers are looking for informal payments” by the “percent of businesses experiencing an inspection in the previous two years” divided by 2: $19.2\% \times 31.7\% / 2 = 3\%$, which is well within the margin of error for the Enterprise Survey estimate for Ethiopia of “Percent of Firms expected to give gifts in meetings with tax officials” = 3.8%

FIGURE 13: Percent of Firms Expected to Give Gifts in Meetings with Tax Officials

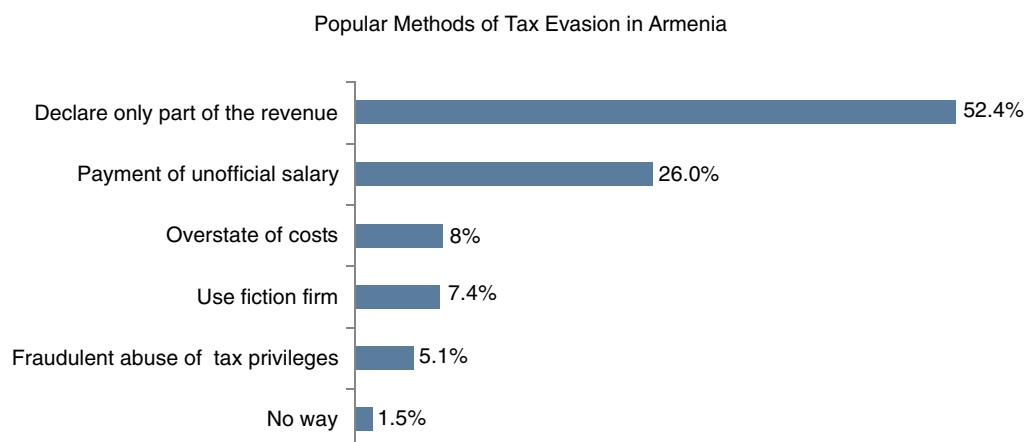


Source: <http://www.enterprisesurveys.org/Data/ExploreTopics/corruption>.

Evasion is another critical problem in developing and transition countries, and although it is very difficult to make cross-country comparisons, Ethiopia seems to have similar problems to other countries, such as Armenia. While businesses in both countries are most likely to evade taxes by under-declaring sales revenue, the second most common evasion tactic in Armenia is “payment of unofficial salary” to workers (Figure 14), while in Ethiopia, the second most

common evasion tactic is the use of fake invoices (Figure 15; but essentially the same as “overstatement of costs”). However, it should be noted that the form of the question was different in the two countries. In Armenia, the data are about the percent of respondents mentioning a particular type of evasion practice, while in Ethiopia, the data are about the subjective responses about statements of the practices among businesses.

FIGURE 14: Perceptions of Tax Evasion in Armenia (percent of respondents who reported at least one method of tax evasion as “popular”)*



*Among businesses who cited at least one method of evasion

FIGURE 15: Perceptions of Tax Evasion in Ethiopia (average ranking of agreement)

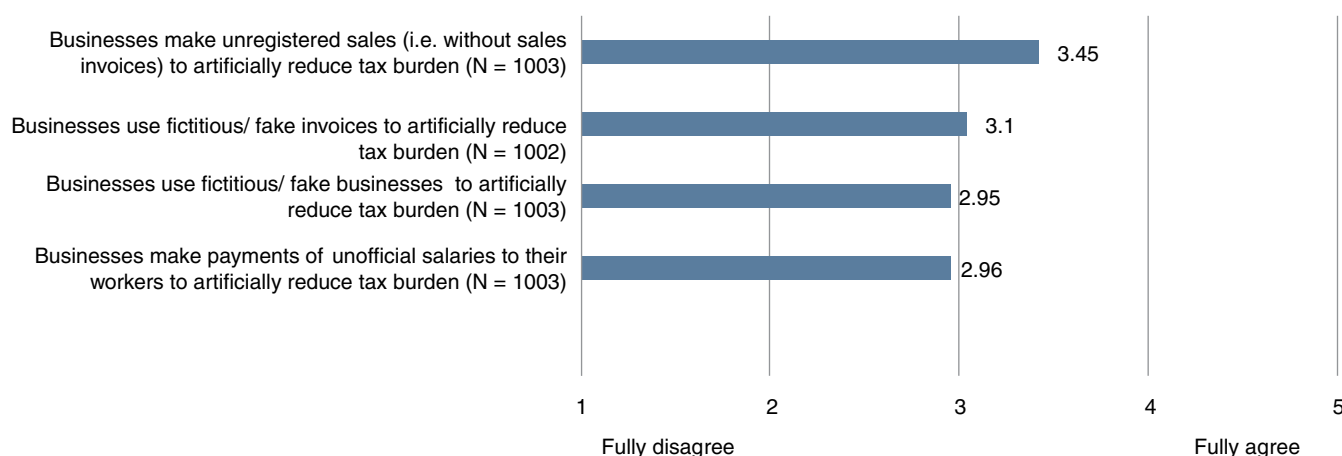
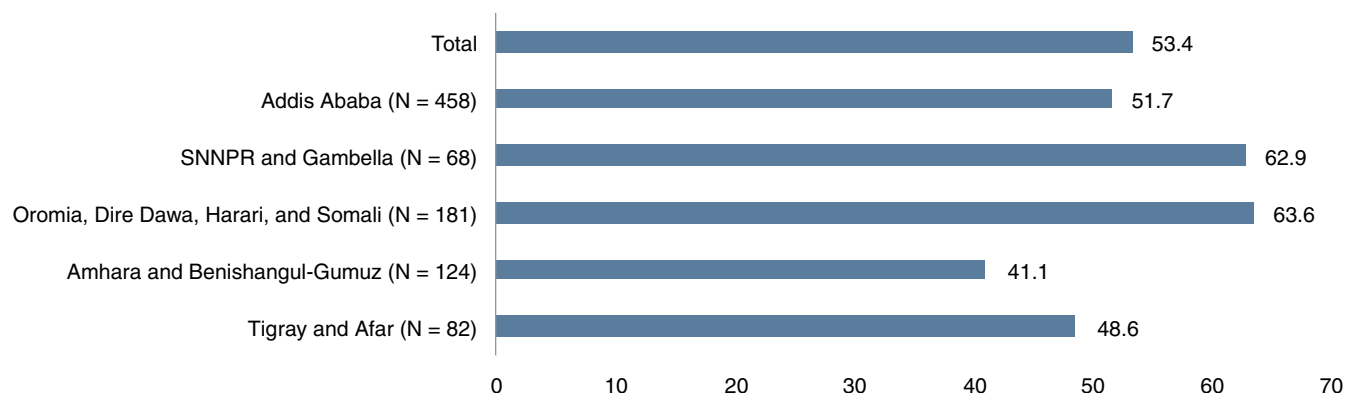


FIGURE 16: Percent of Total Annual Sales Declared for Tax Purposes by Region in Ethiopia (excluding those who said 100% or “don’t know”) (N = 921)



More specifically, the survey interviews asked, regarding “businesses like yours”, what proportion of income was typically reported officially for tax purposes. In the case of Armenia, the share of income reported for tax purposes was about two-thirds, while in Ethiopia it is just over half (Figure 16).

Finally, it is important to repeat and stress the point that international comparisons in tax compliance cost and perception surveys should be considered carefully, taking into account differences across countries in tax regimes (both laws and regulations), the wording of questions, and cultural/national differences in the frankness of survey respondents.

REFERENCES

- Colmar Brunton Social Research Agency, New Zealand, (2005) “Measuring the tax compliance costs of small and medium-sized businesses—a benchmark survey” <http://www.taxpolicy.ird.govt.nz/news/archive.php?year=2005&view=383>
- Coolidge, Jacqueline, 2012: “Findings of Tax Compliance Cost Surveys in Developing Countries”, *eJournal of Taxation*, Vol 10, No. 2, Oct. 2012, pp 250-287. Available at: http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Documents/paper3_v10n2_Coolidge.pdf
- Coolidge, Jacqueline “Tax Compliance Cost Surveys: Using Data to Design Targeted Reforms” World

- Bank Group, Investment Climate In Practice Note no. 8, Feb. 2010. Available at: http://www-wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/2010/04/19/000334955_20100419043011/Rendered/PDF/540860BRI0T axC10Box345636B01PUBLIC1.pdf
- Coolidge, J., Kisunko, G. and Ilic, D. (2009), "Small Businesses in South Africa: Who outsources tax compliance work and why" World Bank Policy Research Working Paper No. 4873. World Bank, Washington DC. Available at: <http://econ.worldbank.org/external/default/main?searchTxt=WPS4873&detailMenuPK=64264748&docTY=620265&menuPK=64264748&pagePK=64166018&piPK=64165415&siteName=EXTDEC&theSitePK=469372>
- European Commission (2004) European Tax Survey. Working paper n 3/2004.
- Evans, Chris (2003) "Studying the Studies: An overview of recent research into taxation operation costs," eJournal of Tax Research, Vol. 1, No. 1
- FIAS (2007) "SME Taxation: A Toolkit for Practitioners"
- FIAS (2007) "South Africa: Tax Compliance Burden for Small Businesses: A Survey of Tax Practitioners," available at: [http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/South_Africa_Tax_Practitioners_Report/\\$FILE/SouthAfrica_FIAS_Tax_Practitioners_Report.pdf](http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/South_Africa_Tax_Practitioners_Report/$FILE/SouthAfrica_FIAS_Tax_Practitioners_Report.pdf)
- FIAS (2008) "Yemen Tax Cost of Compliance Survey" (unpublished manuscript)
- FIAS (2009) "Yemen: Designing a new SME regime: Analysis of compliance cost survey data" (unpublished manuscript)
- Godwin, M. (1995) "The compliance costs of the United Kingdom tax system" In: *Tax Compliance Costs—Measurement and Policy*. Bath: Fiscal Publications in association with The Institute for Fiscal Studies.
- Hasseldine, J; C T Sandford; Jeff Pope; Chris Evans (2001) "Taxation Compliance Costs: A Festschrift for Cedric Sandford," St. Leonards, N.S.W.: Prospect Media
- IFC (2009) *The Costs of Tax Compliance in Ukraine*. Available at: [http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/PublicationCR_CostofTaxCompliance/\\$FILE/CostofTaxCompliance_Ukraine.pdf](http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/PublicationCR_CostofTaxCompliance/$FILE/CostofTaxCompliance_Ukraine.pdf)
- IFC (2011) IFC Tax Perception and Compliance Cost Surveys: A Tool for Tax Reform, World Bank Group, March 2011. Available at: https://www.wbginvestmentclimate.org/uploads/TPCCS_Consolidated_Web.pdf
- IFC (2011) *The Costs of Tax Compliance in Armenia*. Available at: <https://www.wbginvestmentclimate.org/advisory-services/regulatory-simplification/business-regulation/business-operations/upload/Armenia-Report-Cost-of-tax-compliance.pdf>
- IFC (2011) "Georgia Tax Compliance Cost Survey 2010" Power-point presentation
- OECD (2012) "Reducing the Tax Compliance Burden"
- Sandford, C. (1994), "International Comparisons of Administrative and Compliance Costs of Taxation," Australian Tax Forum
- USAID (2008), "Formal SMME Tax compliance Survey Report: Prepared for National Treasury Republic of South Africa", available at: http://www.fias.net/ifcext/fias.nsf/Content/Pubs_BusinessTaxation
- USAID (2008), "Informal SMME Tax Survey Report: Prepared for National Treasury Republic of South Africa", available at: http://www.fias.net/ifcext/fias.nsf/Content/Pubs_BusinessTaxation

Annex 2 | Examples of Thresholds Applied to Reduce the Compliance Burden of Small Businesses

Area of Tax Law	Country	Examples of Thresholds for Small Businesses ²⁵
To pay employee withholdings of presumptive tax tax	Australia	Quarterly payments where annual liabilities < \$25,000 (\$US 22,000)
	Canada ²⁶	From 2008, employers whose average monthly liability is < \$C3,000 (previously < \$C1,000 will be eligible to remit source deductions quarterly instead of monthly.
	Germany	Quarterly payments where prior year wages tax (PYWT) < 3,000; annual payments where PYWT < 800; otherwise monthly
	Ireland	Quarterly payments where total PAYE and PRSI payments for year are < 30,000 (from April 2006); otherwise monthly
	NZ	Monthly payments where annual PAYE liability < \$NZ100,000; otherwise twice monthly
To make advance payments of corporation Income tax	Australia	Annually if not registered for GST and notional tax < \$8,000 (\$US 7,000); otherwise quarterly unless defined as large taxpayer.
	Czech Rep.	Quarterly payments where prior year liability was between CZK30,000–150,000 (approx. \$US 2–10,000); monthly for larger taxpayers
	Ireland	New small companies with first year tax liability < 150,000 not required to make advance payments; other small companies can make advance payments based on prior year liability.
	Slovak Rep.	Quarterly payments where prior year liability was between SVK50,000–500,000 (approx. \$US 3–30,000); monthly for larger taxpayers
	Canada	Increase the threshold (from 2008) below which corporations are eligible to pay federal corporate taxes annually from \$1000 to \$C3000 z
To register for VAT	Austria	Must register if annual turnover > 30,000 (approx. \$US 42,500)
	Canada	Generally, must register if annual taxable sales => \$C30,000)
	Ireland	Must register if annual turnover > 35,000 (services) or 70,000 (goods)
	Japan	Must register if annual turnover > JPY10 mill. (approx. \$US 75,000)
	Singapore	Must register if annual turnover > \$S 1 mill. (approx. \$US 690,000)
	Slovak	Must register if annual turnover > SKK 1.5 mill. (approx. \$US87,000)
	South Africa	Must register if annual turnover > R1,000,000 (approx. \$US85,000)
	UK	Must register if annual turnover > £58,000 (approx. \$US87,000)

(continues)

²⁵ The currency conversions shown in this table were calculated at various times during preparation of the report. Given the recent volatility in currency markets, readers may wish to make their own just-in-time calculations.

²⁶ All the examples for Canada in Table 6 include legislative amendments that have been announced, but are not law as of October 30, 2007. They are expected to be passed into the law by the time this report is released.

Continued

Area of Tax Law	Country	Examples of Thresholds for Small Businesses
To file returns and pay VAT	Australia	Annual for voluntary registration; quarterly where turnover < \$A2 million (\$US 1.64 million); otherwise monthly.
	Austria	Quarterly returns if prior year turnover < 22,000; otherwise monthly.
	Canada	Starting in 2008, annual return and quarterly payment if annual taxable sales < \$C1.5 million (previously \$C500,000). Annual payment if net tax < \$C3,000 (previously \$C1,500)
	Czech Rep	Quarterly payments if annual turnover < CZK 10 mill. (approx. \$US 65,000); otherwise monthly
	Germany	Quarterly payments if prior year tax < 6,136 (approx.\$US8,000); annual payments if prior year tax < 512; otherwise monthly
Use of cash accounting or simplified calculation basis for VAT liability determination	Australia	Optional use where annual turnover < \$A2 mill. (approx. \$US 1.7 million)
	Austria	Optional use for professionals and other businesses if turnover of last two years < 110,000
	Canada	Optional use for prescribed traders where turnover < \$C200,000. Also, optional simplified input credit calculation where annual sales < \$C500,000 and annual purchases < \$C2 million
	Germany	Optional use where turnover < 250,000 (approx. \$US370,000)
	Ireland	Optional use where turnover < 1m (approx. \$US1.35 mill.)
	South Africa	Optional use where turnover < R2.5 mill. (approx. \$US370,000)
	UK	Optional use where turnover < £660,000 (approx. \$US1.3 mill.)
VAT invoices	Austria	Use of simplified invoices (threshold 150).
	Germany	Use of simplified invoices (threshold increased from 100 to 150).
To pay employee withholdings of presumptive tax tax	Australia	Quarterly payments where annual liabilities < \$ 25,000 (\$US 22,000)
	Canada ²⁷	From 2008, employers whose average monthly liability is < \$C3,000 (previously \$C1,000 will be eligible to remit source deductions quarterly instead of monthly.
	Germany	Quarterly payments where prior year wages tax (PYWT) < 3,000; annual payments where PYWT < 800; otherwise monthly
	Ireland	Quarterly payments where total PAYE and PRSI payments for year are < 30,000 (from April 2006); otherwise monthly
	NZ	Monthly payments where annual PAYE liability < \$NZ100,000; otherwise twice monthly
To make advance payments of corporation Income tax	Australia	Annually if not registered for GST and notional tax < \$8,000 (\$US 7,000); otherwise quarterly unless defined as large taxpayer.
	Czech Rep.	Quarterly payments where prior year liability was between CZK30,000–150,000 (approx. \$US 2–10,000); monthly for larger taxpayers
	Ireland	New small companies with first year tax liability < 150,000 not required to make advance payments; other small companies can make advance payments based on prior year liability.
	Slovak Rep.	Quarterly payments where prior year liability was between SVK50,000–500,000 (approx. \$US 3–30,000); monthly for larger taxpayers
	Canada	Increase the threshold (from 2008) below which corporations are eligible to pay federal corporate taxes annually from \$1000 to \$C3000
Turnover tax	Germany	Mandatory accounting threshold set at 0.5 mill. (Previously 0.35 mill).

²⁷ All the examples for Canada in Table 6 include legislative amendments that have been announced, but are not law as of October 30, 2007. They are expected to be passed into the law by the time this report is released.

Area of Tax Law	Country	Examples of Thresholds for Small Businesses
Employment tax	USA	Annual filing and payment (previously on a quarterly basis) where liability < \$1,000 per year.
Turnover tax	Germany	Mandatory accounting threshold set at 0.5 mill. (Previously 0.35 mill).
Employment tax	USA	Annual filing and payment (previously on a quarterly basis) where liability < \$1,000 per year.

Sources: Revenue body web portals; IBFD; OECD Consumption Tax Trends (2006), Tax Administration in OECD Countries: Comparative Information Series (2006)

