Financing Ethiopia's Development: Confronting the Gap between Ambition and Means

Derk Bienen, Dan Ciuriak, and Tadele Ferede

Abstract

Ethiopia set out – and in large measure achieved – a very ambitious program of economic and social development under its Growth and Transformation Plan (GTP-I).The scale of public sector involvement was very large: for the five-year Plan period, it called for budgetary government spending and public enterprise off-budget spending of 41% of GDP, more than half of which was to come from budgetary resources. As Ethiopia prepares for the second version of its GTP (GTP-II), it must confront a fiscal numbers problem: Ethiopia's tax share of GDP under GTP-I reached only the12%-13%level, and revenue flows from official international assistance are shrinking. This paper dissects the financing challenge that Ethiopia must meet to achieve its goal of becoming a middle income country. It concludes that only export-led manufacturing in a context of a major expansion of the number of active formal enterprises coupled with best practice performance in all other areas related to revenue generation will square the circle of Ethiopia's development financing challenge.

Keywords: Ethiopia, development financing, resource mobilization, tax, private sector development
JEL Codes: O16, O55

1. Introduction

Ethiopia has set out very ambitious goals to achieve economic, social and environmental transformation. Specific targets include to meet the socioeconomic Millennium Development Goals (MDGs) for 2015, and to achieve middle-income status by 2025. Economic goals include raising productivity in agriculture, improving social services, promoting industrial development, and filling significant remaining gaps in power, transportation (both road and rail) and telecommunications infrastructure.

The main planning instrument is the first generation Growth and Transformation Plan (GTP-I) (MoFED, 2010). Most of the measures mandated under the GTP-I require public sector fiscal resources (either in terms of spending requirements or the foregoing of revenue in the case of incentives).[2]In addition, in response to the growing risk resulting from climate change, the Government of Ethiopia adopted a Climate Resilient Green Economy (CRGE) strategy in 2011 (FDRE, 2011). The goal of the CRGE strategy is to transform the economy from low to middle income status, following a rapid economic growth path that reduces greenhouse gas emissions and improves resilience to climate change. The strategy focuses on improving agricultural productivity, developing the industrial sector, expanding and improving electricity generation and distribution, reforestation, and introduction of clean production technologies. Like the GTP-I, measures under the CRGE require significant Government spending.

[2] Framed in terms of the developmental state model, the GTP-I draws on a wide range of tools requiring Government spending, including: targeted financial support (subsidies, bank loans, and equity participation); tariff exemptions for production inputs; tax incentives, including tax holidays, partial profit exemptions, and free trade zones to attract FDI and to promote priority sectors, particularly those facing handicaps such as inadequate specific infrastructure; strategic government procurement (e.g., assured profit margins for domestic pharmaceutical manufacturers in government health-care procurement); publicly financed infrastructure, particularly power, telecommunications and transportation, both internal expansion of the road and rail network and improving the trade corridors; and the creation of public corporations.

The Government's financing requirements for these two programmes are daunting: for the five-year GTP-I period, budgetary government spending and public enterprise off-budget spending was projected to reach 41% of GDP; this amounted to ETB 1.33 trillion (MoFED, 2010: 40-41), or close to USD 80 billion. Of this, 57% was slated to come from budgetary resources (both domestic and external borrowing) and 43% was to be covered by state-owned enterprises (SOEs).The CRGE was budgeted at around USD 150 billion over its 20-year plan period, of which USD 30 billion was earmarked for the period until 2015 (FDRE, 2011: 38-43).Although the CRGE strategy targets international climate finance for generating some of the financial resources (Bass *et al.*, 2013), domestic resources are also required. Taken together, average domestic resources required for the two programmes were in the range of USD 20 billion per year until 2015, and are unlikely to be lower under GTP-II and the continuation of the CRGE.[3]

To meet the GTP-Iand CRGE goals, the fiscal revenue share of GDP needs to rise–and quite significantly. However, Ethiopia's overall revenue generation performance has been weak. Tax revenue has risen marginally as a share of GDP during the GTP-I period, but this has been offset by declines in other sources of revenue. Aid flows in particular have declined[4] and are likely to remain under pressure as donors continue to address severe budget deficits that emerged as a consequence of the great recession of 2008-2009 and the ensuing slow recovery in the member countries of the Organization for Economic Cooperation and Development (OECD). A surge in private transfers, which have averaged close to 8% of GDP since 2011/12 (IMF, 2014), has been the main source of financing that has helped to ease further deterioration in Ethiopia's balance of payments.

[3] The follow-up to the GTP-I, the GTP-II, is yet to be finalized and therefore resource requirements are not yet known.
[4] Grants as a share of GDP declined from 3.3% in 2010/11 to 1.5% in 2012/13 and are estimated to have remained at about that level in 2013/14 – 2014/15 (IMF, 2014).

In sum, Ethiopia requires a significant boost to its domestic resource mobilization program to maintain the pace of development achieved in recent years, to meet the ambitious GTP and CRGE goals, and to achieve thelonger-term aim ofreaching middle-income status.

The literature has addressed issues related to resource requirements for development in Ethiopia from various angles: policy papers (such as MoFED, 2010 or FDRE, 2011) provide estimates of resource requirements for the specific policies being defined, updated by progress reports (MoFED, 2013; 2014a; 2014b), while macroeconomic reviews (such as the IMF Article IV reports; see IMF, 2012, 2013 and 2014) provide descriptive overviews and projections. Also, considerable research has been undertaken on specific issues related to domestic resource mobilization, such as administrative issues (e.g.,Aizenman/Jinjarak, 2008; Yesegat, 2008; Biber, 2010; African Development Bank Group, 2011a; and Kloeden, 2012); taxationin general (e.g. Bolnick and Haughton, 1998; Bird, 2008; Bräutigam et al., 2008; Lencho, 2012; Fjeldstad, 2013); grants (Mogues *et al*., 2011);and innovative financing mechanisms (e.g., Badu *et al*., 2012). There is as well a body of work on comparative research (e.g., Keen and Mansour, 2010; IMF, 2011). However, only limited research has been undertaken to comprehensively and holisticallyanalyze the factors that contribute to, and the constraints that limit, the mobilization of non-debt creating domestic resources in Ethiopia.[5]

The present paper aims at filling this gap. Its main purpose is to identify reforms to encourage the contributing factors and to address the limiting factors, and to suggest priorities for the sequence of reforms. The methodology applied in the paper is guided by this purpose–it is based on an analysis of descriptive statistics, and a mostly qualitative assessment of regulatory and administrative conditions impacting on the mobilization of domestic resources in Ethiopia.

[5]Abay (2010) and Engida *et al*. (2011) are exceptions to some extent.

The scope of the analysis encompasses the following: First, we analyze the macroeconomic factors that impact on the development financing strategy. Second, we analyze tax performance by tax category and taxpayer groups. Third, we examine the scope to mobilize private sector financial resources by deepening the financial sector.

The paper is organized as follows. Section 2 reviews the macroeconomic context, in particular the scope to reduce the dependence on external debt financing. Section 3 reviews the main instrument of revenue mobilization – taxation. Section 4 reviews the scope to mobilize domestic resources through improved financial depth. Section 5 discusses and draws policy conclusions.

2. Macroeconomic Factors

Ethiopia has been among the top performing economies in Africa – and indeed worldwide – since 2003, with increasingly broad-based growth, a very substantial increase in the volume of two-way international trade, a steady increase in the stock of inward FDI, increased sectoral diversification in its export base (i.e., diversification of exports across product lines), increased regional diversification in the destinations of Ethiopia's exports, and convergence in governance indicators broadly consistent with regional peers (Assefa *et al.*, 2013). However, from a revenue mobilization perspective, the macroeconomic context is problematic in some respects.

2.1 Growth Accounting and Domestic Resource Mobilization

First, there has been some question about the actual level of growth that Ethiopia has achieved during the period of accelerated growth since 2003. This may be important for forensic analysis of domestic resource mobilization since mis-estimation of income growth can compromise effective analysis of revenue generation performance. For example, over-estimation of nominal income growth can create the perception that tax revenues are under-performing, leading to possibly counter-productive

enforcement measures and/or tax rate increases; conversely, under-estimation of inflation (which then results in higher reported real growth for a given amount of price increase) distorts the analysis of the incentives for savings required to finance investment.

The IMF's decomposition of the high measured growth rates during Ethiopia's recent era of double-digit growth indicates that Ethiopia's rate of capital accumulation in the public sector (10.8%) exceeded even the comparable figure for East Asian economies in the 1980s (8.9%).[6]Official sources indicate – not inconsistently –that Ethiopia's growth has been driven by physical capital accumulation, mainly public-led investment in infrastructure (MoFED, 2014b).However, the IMF's growth accounting exercise also concludes that the official statistics imply implausibly high productivity growth between 2006/07 and 2010/11, with productivity growth contributions of 2.6% from labor and 3.2% from the capital, implying total factor productivity (TFP) growth of 5.2%. These figures are high in historical cross-country comparison, especially in view of the fact that a number of factors that normally support high TFP growth were not present in Ethiopia. These factors include favorable initial human and physical capital conditions, favorable terms of trade and a high degree of openness, low inflation, a competitive real exchange rate, low government consumption, high international reserve coverage, and low external debt.[7]Since 2011/12, official growth rates and the IMF's have converged.

If nominal income growth has indeed been over-estimated in Ethiopia in recent years, actual performance on domestic resource mobilization relative to nominal income growth has been stronger than official statistics currently suggest. In turn, this would guide the revenue mobilization effort to give greater weight to factors other than the tax system. If inflation has been higher than officially recorded, real interest rates are deeper under water than currently thought. Accordingly, resolving the issues about macroeconomic

[6] See IMF (2012), Box 1. Ethiopia: Growth Accounting.
[7]Ibid.

performance is important for sound formulation of revenue generation policies.

2.2 The monetary policy framework: Implications for real exchange rates and interest rates

A second key macroeconomic concern is Ethiopia's lack of a credible monetary policy anchor (Durevall and Sjö, 2012).Inflation remains one of the major macroeconomic concerns for Ethiopia. The hopeful assessment by the IMF is that, with appropriate monetary policies (especially maintaining positive real interest rates), Ethiopia is in a position to maintain moderate and stable inflation (IMF, 2012). Ethiopia has managed to keep overall inflation to single digit levels since 2013, notwithstanding negative interest rates; however, this has partly been achieved by an undesirable monetary policy mix.

In the absence of a solid domestic anchor, Ethiopian authorities have relied on the external anchor provided by exchange rate pegs. In a small open economy with a high trade share of GDP, this can be a successful strategy (e.g., the Caribbean islands typically peg their currencies to the US dollar and have generally done quite well with that arrangement both in terms of price stability and growth). In Ethiopia's circumstances–with a low trade share of GDP, heavy reliance on commodities with volatile prices, and fiscal reliance on central bank financing–this approach has resulted in repeated bouts of high inflation. In turn, these bouts of high inflation hinder the establishment of a stable framework for longer-run revenue mobilization in at least two key ways.

First, bouts of high inflation in the context of a pegged nominal exchange rate result in real appreciation of the currency. Ethiopia has had two recent bouts of rapid real appreciation of the Birr; the first, which peaked in 2009, resulted in an overvaluation approaching 30%; the second, since 2012, has

resulted in a more modest degree of overvaluation in the 10-14% range (IMF, 2014:39).

These bouts of real appreciation have undermined the competitiveness of Ethiopian industry and exacerbated Ethiopia's structural savings-investment imbalance. Ethiopia's resource gap (the difference between domestic saving and domestic investment) was17.8% of GDP in 2013/14 (National Bank of Ethiopia); recent IMF estimates suggest a still higher gap in the 18% range in 2014/15 (IMF, 2014). Put another way, Ethiopia has been relying heavily on international savings to finance its investment.

To date, this has been manageable but only because Ethiopia has had access to international assistance. Reliance on international assistance is problematic in a structural sense, since grant revenue comes with its own problems. First, it tends to be fragmented: in addition to fourteen multilateral sources, there are some thirty bilateral programs in Ethiopia, which raises coordination issues and places administrative demands on Ethiopia's public service. Second, it often comes with strings attached (e.g., tied to procurement requirements). And third, it tends to be volatile and pro-cyclical, reflecting cyclical fiscal pressures in donor countries. In any event, grant revenue has been shrinking due to budget constraints in donor countries.

Foreign private capital has also been an important factor in filling the resource gap. However, generally high real effective exchange rates have tended to over-price Ethiopian assets and thus weakened the incentives for foreign direct investment (FDI) inflows. As well, for a number of reasons, FDI is an imperfect substitute for domestic sources of saving:

- a potentially narrow sectoral focus (e.g., on the extractive industries which may have limited spillover benefits in terms of local industrial development);
- a risk of distortion of incentives for government in the recipient country to develop sustainable fiscal structures;

- the requirement for fiscal incentives in the face of locational competition from third countries; and
- in many cases, the need for supporting specific infrastructure which represents a demand on public financing.

Moreover, empirical evidence indicates that sustained success in development is generally accompanied by strong sustained *domestic* resource mobilization. This is consistent with arguments from the political science literature that taxation is a fundamental part of the social contract between a state and its citizens. Taxesenable the provision of public goods, which are an essential part of the mix of a prosperous society.[8]

The bouts of high inflation have also had adverse impacts on domestic savings due to the reality and risk of negative real interest rates. Negative real interest rates remove the incentive to save. Further, for producers (at least those with access to capital), they create incentives to use more capital-intensive methods of production than otherwise would be the case, weakening job creation, which in turn reduces the savings-capable share of the population.

Accordingly, reducing reliance on foreign savings–through all types of instruments, not just those that create debt–should be an important feature of Ethiopia's domestic resource mobilization strategy. In turn, this requires re-engineering the monetary policy framework towards a combination of lower real effective exchange rates and higher real interest rates.As this issue is

[8] See in this regard Bräutigam *et al*. (2008) who argue that "taxation may play the *central* role in building and sustaining the power of states, and shaping their ties to society" (at 1). In addition, Moss et al. (2006) argue that in some instances aid has served as a subsidy that has "discouraged revenue collection, distorted expenditure decision-making, and undermined the incentives to build state capacity" (at 6). A similar reduction of incentives for local revenue generation from grants has been identified in Ghana (see Mogues *et al*., 2011). As well, there is the "aid as source of Dutch Disease" argument: Rajan and Subramanian (2011) find that aid inflows systematically reduce a country's competitiveness, which is reflected in a lower relative growth rate of exportable industries.

well understood and the subject of much commentary (e.g., it has been a consistent theme of IMF Article IV reviews and is agreed by Ethiopian authorities, who see low nominal interest rates as necessary to finance public investment but accept that real interest rates should be positive or at least near zero), we simply mention it here, although it should be emphasized that we consider this an absolutely essential element of a sound framework.

This should support labor-intensive industrial exports, a development that should be encouraged through microeconomic reforms tagetted at expanding the formal production sector and by developing the agricultural sector to trigger sustained development of manufacturing industries that depend on domestic resources, thereby generating a self-reinforcing growth path (AfDB, forthcoming).

2.3 Risks to the Fiscal Framework

A third key concern for Ethiopia in its efforts to mobilize domestic financial resources relates to its overall fiscal situation. While on paper, the budgetary situation appears to be sound, both in terms of the size of the deficit and the debt as a percent of GDP; this in part reflects the fact that spending pressures have been absorbed on the monetary side.

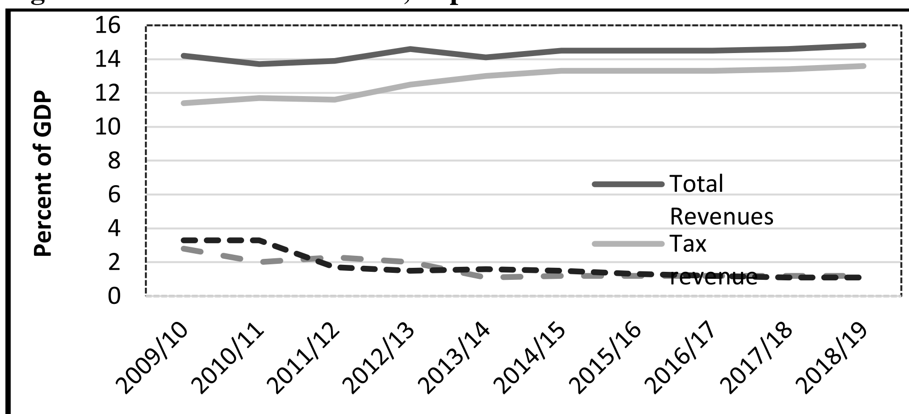
One such escape valve has been National Bank financing; however, as noted, this has led to outbreaks of rapid inflation, which in turn has driven real appreciation of the currency and created problems of maintaining positive real interest rates. Accordingly, Ethiopia has limitedscope to expand Central Bank financing. Moreover, these considerations indicate that supply side constraints must be eased in conjunction with the expansion of fiscal revenue. A self-sustaining domestic resource mobilization (DRM) program necessarily involves spending that has powerful multiplier effects on incomes and thus on income-driven tax revenues.

As well, debt service costs have been held down by the low nominal (and negative real) interest rates; however, these have had negative effects on the mobilization of private savings. Accordingly, moves to more firmly anchor inflation expectations and to restore positive real interest rates in order to incentivize and mobilize private savings would by the same token squeeze back some of these pressures onto fiscal policy, including by substantially increasing debt service costs.

3. Mobilizing Budgetary Resources

Ethiopia's budgetary resources are dominated by tax revenues (which we treat as inclusive of social security contributions, consistent with IMF practice).Ethiopia's tax system has been modestly buoyant, with taxes rising as a share of GDP. Non-tax revenues–the main sources of which are resource rents, profits remitted by state-owned enterprises, and miscellaneous charges such as motor vehicle license fees–constitute a minor and shrinking share of Ethiopian fiscal revenues. As noted, grants have also been declining as a share of GDP and are projected to fall to about 1% of GDP, down from over 3% of GDP at the start of the GTP-I period. As a result of these trends, overall government revenues trended sideways as a share of GDP over the GTP-I period, and are projected by the IMF to continue to do so over the coming GTP-II period under current planning assumptions (Figure 1).

Figure 1: Government revenues, in per cent of GDP



Source: IMF (2013 and 2014), Table 3b.

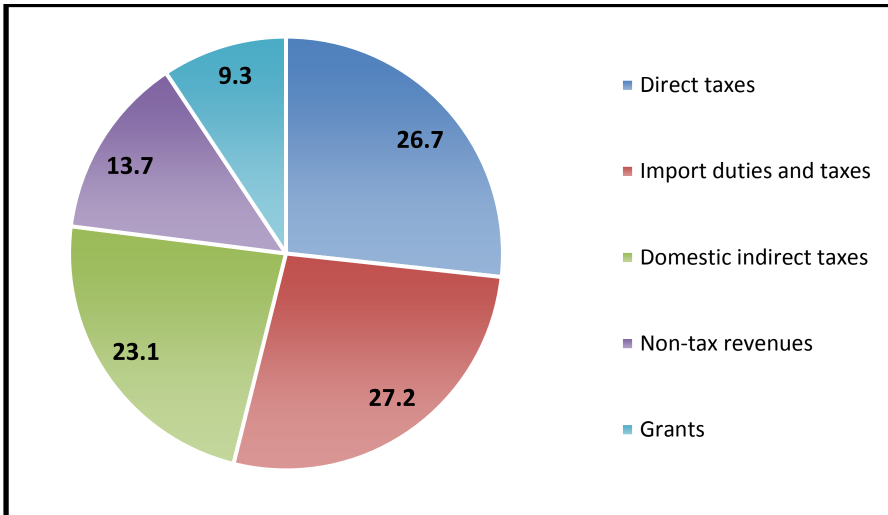
In terms of performance against the GTP-I targets (which set a goal of a total revenue share of GDP of 20.4% by 2014/15, including a tax-to-GDP ratio of 15-17%, approaching the Sub-Saharan Africa average of 17%), Ethiopia has fallen well short, despite the fact that non-tax revenue (which in Ethiopia is predominantly investment income/dividends from state corporate holdings) substantially exceeded planned levels in the first part of the GTP-I period. The main reason for the shortfall was the failure of the tax share of GDP to grow in line with expectations (the aggregate tax elasticity to GDP over the first two years of the GTP-I period was only 1.04).

To put Ethiopia's situation into a broad perspective, given its per-capita GDP, Ethiopia's tax system appears to be about average in terms of overall performance: in a cross-country study based on 2007/08 data, Ethiopia was marginally above a trend line on tax revenue as a percent of GDP (von Haldenwang/Ivanyna, 2010).[9]In a similar study of 43 Sub-Saharan African countries covering the period 1980 to 2010, Ethiopia was also found to have performed in line with trend; in terms of the share of taxes in GDP, however, Ethiopia ranked low, with only eight other countries having lower shares (Mansour, 2014: 19).

In terms of the current revenue structure (Figure 2), Ethiopia derives its revenues from diversified sources. Imports shoulder the single largest tax burden; indirect tax on imports has also been the fastest growing tax source in recent years.

[9] Ethiopia was 0.14 above the trend line, just ahead of Kenya at 0.10. However, Ghana, for example, was 7.28 percentage points above the trend.

Figure 2: Government revenue structure, 2012/2013



Source: Computed based on fiscal data obtained from MoFED

In the following subsections we organize the discussion of Ethiopia's tax performance in terms of type of tax, highlighting particular dimensions. We also comment specifically on tax administration and the general issues of allocative efficiency and fairness. The final subsection comments on non-tax revenues.

3.1 Direct Taxes

Personal income tax (PIT) generally makes a weak contribution to total tax revenue in low income countries. Ethiopia's experience is broadly consistent with this: PIT comprised a little over 11% of total tax revenue in 2012/13 (MoFED, 2014b), which is relatively high for a low income country.[10]

[10] Keen (2012, 10A) summarized as follows: "The personal income tax commonly accounts for less than 10 percent of all tax revenue in low-income countries—compared to an average of more than 25 percent in OECD countries".

As a summary judgment, PIT in lower-income countries is effectively a tax on labor income of those working in the public sector or in large private enterprises. This reflects: (a) the use of wage deductions at source to collect the tax in large and public enterprises; (b) the difficulties of addressing the problem of tax avoidance by high-income individuals and firms through tax planning, an issue that even large, sophisticated tax administrations in the wealthiest countries struggle with; and (c) the efficiency considerations which argue against lowering the threshold to catch small tax filers.

Ethiopia's corporate income tax (CIT) is set at a statutory 30% and accounted for 16.5% of total tax revenue in 2009/10. Since it is typical in developing countries that a small number of firms pay the large bulk of taxes, the main administrative measure to ensure revenue is to create a Large Taxpayer Office (LTO) dedicated to large corporations. Ethiopia already has such an office in place. According to the Ethiopian Customs and Revenue Authority (ERCA), almost 78% of Ethiopia's tax revenue came from fewer than 1,000 filers in 2012.[11]

Since considerations of administrative costs weigh against seeking to expand the direct tax base by lowering thresholds, the main area where there is at least some promise for significant progress is in respect of middle-income taxpayers who are either: (a) not registering for tax (so-called "ghosts"), which points to identification and registration of taxpayers as the required remedy; or (b) underpaying (so-called "icebergs") or not paying (so-called "deadbeats"), which points to increased audit and enforcement as the remedy.[12] While the literature cautions against unrealistic expectations, suggestions to enhance revenue mobilization include the following:

- Reduce the cost of paying taxes; notably Ethiopia went in the opposite direction with its most recent reforms which sharply expanded the time

[11] Reported in "Britain offers Dar, Ethiopia tax scheme," The East African, 11 May 2013, available at http://www.theeastafrican.co.ke/news/Britain-offers-Dar-Ethiopia-tax-scheme-/-/2558/1849510/-/pgbui3/-/index.html (accessed 13 June 2014).
[12] See Keen (2012: 16) and Bird/Wallace (2004).

required for tax compliance according to the World Bank's Doing Business 2013 benchmarking exercise through the introduction of a social security contribution for businesses. Based on the World Bank's Doing Business assessment for 2015, there would be some scope to reduce taxes through consolidation of marginal taxes and reducing frequency of payments (implicitly, this would go hand in hand with the development of treasury bill market to address short-term financing needs for the government);

- Eliminate tax incentives, largely on grounds they are likely to be redundant–firms that are likely to invest would do so in the absence of the incentive (see e.g., Bird, 2008, at 9); this has the added advantage of simplifying compliance monitoring;
- Establish an office dedicated to medium-sized taxpayers, building on the evident successes of LTOs;
- Increase the use of withholding and advance collection schemes; and
- Reduce the cost of entry into the formal sector, thus enabling an expansion of medium-sized taxpayers; while some of this would come at the expense of growth and profit of the more easily taxed large corporations, filling in what has been termed the "missing middle"[13] is an essential start to the process of diversification and expansion of the supply capacity of the economy.

The latter idea may be combined with a simplified presumptive tax for small, informal businesses, in part to drive activity into formal enterprise.[14]

Also, a number of approaches have been suggested to chip away at the problem of tax avoidance by high-income individuals and corporations. These include the following:

[13]Tybout. (2000). The "missing middle" is explained by disincentives to growth to avoid attracting enforcement of taxes.

[14] On presumptive taxation, see Thuronyi (2003). On dynamic effects of such initiatives, see Auriola and Warlters (2005).

- Dedicate units within the tax administration to high-income/wealth individuals; this can provide a focus for enforcement efforts (IMF, 2011);
- Strengthen audit powers, including the possibility to use indirect methods to assess tax liabilities, such as enabling revenue agencies to use third party information, particularly related to assets and flow of investments, to estimate the taxpayer's income (Biber, 2010);
- Participate in multilateral action on tax havens through fora such as the Global Forum on Transparency and Exchange of Information for Tax Purposes; and
- Adopt best practices for addressing abusive transfer pricing.

Experience indicates that there is no single solution to expanding direct taxes. Admittedly, what is indeed feasible in Ethiopia's often sensitive political economy setting would have to be carefully considered.

3.2 Social Security Reforms

Ethiopia instituted social security reforms in 2011 through two regulations governing public service and private organizations' pension and other social security contributions.[15] These provide for contributions from employees and employers. Under both regulations, which were phased in over four years, the employee contribution rose from an initial 5% to 7% of earnings, to be complemented by employer contributions which rose from 7% to 11% (for military and police the employer contribution is greater, rising from 18% to 25%). With the scheme now fully in place, domestic savings should increase and thus help close the overall savings-investment gap. Commentators on the rise of pension funds in Africa note that these are a natural source of funding for infrastructure investment (Pence, 2003).

[15] Private Organizations Employees Social Security Agency Establishment, Council of Ministers Regulation Number 202/2011; and Public Servants Social Security Agency Establishment, Council of Ministers Regulation No. 203/2011.

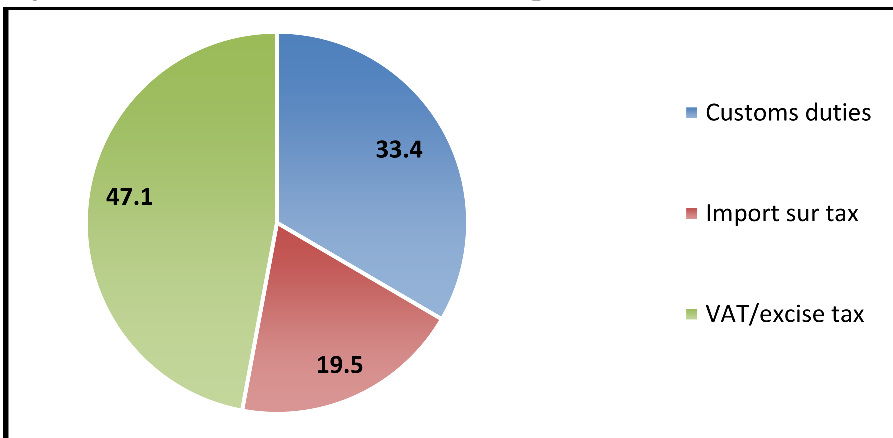
From a standpoint of financing the GTP-I investment requirements, the increase in savings and investment should have a balance sheet effect, expanding government borrowing from the pension funds and increasing government debt service costs which will flow back to the pension funds. This institutional development will support the restoration of positive real interest rates and the expansion of domestic savings. Importantly, this initiative provides a vehicle to lengthen the term-to-maturity of savings and investment instruments in Ethiopia.

From a business cost perspective, the documentation requirements of social security reforms impose compliance costs, a factor which has increased the difficulty of doing business in Ethiopia.

3.3 Indirect Taxes: Tariffs

The most easily collected tariffs in developing countries are typically border taxes. Consistent with this general experience, trade taxes, including duties, excise taxes, VAT and import surtaxes applied to imports represent the strongest and most rapidly growing tax base for Ethiopia (Figure 3).

Figure 3: Structure of Trade Taxes, Ethiopia, 2012/13



Source: Computed based on fiscal data obtained from MoFED

Notably, approximately half the "trade" tax collected in Ethiopia is generated by domestic taxes collected at the border. These are not subject to erosion through trade liberalization. However, reliance on border taxes does raise non-trivial issues in terms of loss of tariff revenue for Ethiopia in advancing its trade agenda:

- accession to the World Trade Organization;[16]
- with extra-regional partners, e.g., the Economic Partnership Agreement (EPA) with the EU; and
- with regional partners, through the Tripartite Free Trade Area (TFTA) talks which combine the members of the Common Market of Eastern and Southern Africa (COMESA), the East African Community (EAC) and the Southern African Development Community (SADC).

One way to minimize the erosion of trade taxes through trade liberalization commitments is to reduce tariff exemptions. For example, Brenton *et al.* (2009) calculated that the revenue cost to Ethiopia of implementing an EPA with the European Union amounted to 32.6% of its tariff revenue when assessed at statutory rates, 17.2% when assessed at applied rates, and only 4.6% if all tariff preferences were eliminated. Abay (2010; Table 6) highlights the very large size of the revenue losses from exemptions.

A second way is to address the issue of "missing trade" between Ethiopia and its immediate neighbors. One estimate suggests that such missing formal trade between Ethiopia, Kenya, Uganda, Sudan, Djibouti and Somalia amounts to about 3.4% of Ethiopia's global two-way trade (Ciuriak, 2010). Some of this trade is undoubtedly taking place but is not being recorded and is thus not subject to duty collection. Much of this trade is however genuine "missing", in the sense that it currently does not take place because of the

[16] Note that WTO accession does not necessarily imply loss of government revenue bound tariff rates are typically substantially higher than the applied rates. However, often at least for some products, such as those covered by sectoral agreements, many acceding countries do commit to reductions of applied tariffs during accession negotiations.

absence of supportive border infrastructure and trade facilitating arrangements. Since the most intensive trade is normally between immediate neighbors,[17] boosting formal trade relations with immediate neighbors would be one way to increase efficiency of taxes that can be collected at the border.

At one point there was much optimism that VAT could be used to replace lost tariff revenues in developing economies. While the actual experience has been inconsistent, the experience in Sub-Saharan Africa has been quite encouraging about the possibilities in this regard. However, Ethiopia already has implemented its VAT and it is unlikely it would realize a further substantial gain sufficient to replace the still-large tariff revenues where the latter to be reduced through trade agreements. However, this option is not entirely to be discounted (see Keen and Mansour, 2010). Options for increased revenue generation through the VAT are discussed below.

3.4 Indirect Taxes: VAT

The total amount of indirect tax collected in Ethiopia amounts to only about 10% of the value of nominal consumption. As a rough comparison, this may be compared to a statutory VAT rate of 15%.[18] Ethiopia's implied 'C-efficiency'[19] is not unreasonably low in international comparison: an IMF estimate places it at 42.9, above the average for low-income countries of 38.0 (IMF, 2011:69). However, the general policy literature warns that VAT effectiveness is likely to be less in economies with large agricultural sectors, low urbanization rates, and large informal sectors, all of which characterize Ethiopia (see Aizenman and Jinjarak, 2008).

[17] Contiguity typically is found to expand trade between two countries by a significant amount, reflecting opportunities for cross-border in goods that are not typically traded across large distances (See, e.g., Shepherd, 2012).
[18] This is a rough comparison since total indirect taxes also include import tariffs and the national accounts definition of consumption is not the definition of consumption for purposes of VAT tax base.
[19] C-efficiency is defined as the level of VAT collected compared to the level implied by the full statutory rate applied to the level of taxable consumption as a ratio to the statutory rate (See, e.g., Aizenman and Jinjarak, 2008).

For analytical purposes, the C-efficiency can be decomposed into a "policy gap", which reflects the extent of zero-rated or exempt products; and a "compliance" gap reflecting imperfect implementation (Keen, 2013).As regards the policy gap, there are important trade-offs between the revenue efficiency of the VAT and the delivery of specific policies (e.g., support for particular social objectives) by applying zero or reduced rates. For example, exempting sensitive items imposes administrative complications on VAT-registered vendors in terms of additional record-keeping and on the tax authorities for verification, not to mention questions related to definitions.[20] An impact analysis study conducted at the time of introduction of the VAT in Ethiopia suggested that, within urban areas, the VAT would be regressive since exempt goods and services were consumed disproportionately by the higher-income groups; these exemptions could not, therefore, be justified on equity grounds. As well, the study concluded that the overall progressivity of the VAT was due to the low incidence of VAT on rural households, but this reflected the high proportion of home-produced goods consumption which shielded these households from VAT (Muñoz and Cho, 2003). Accordingly, there appear to be grounds on which to review Ethiopia's VAT from the perspective of reducing the number of zero-rated or reduced-rate items, thereby boosting VAT revenues, without compromising social policy objectives.

There are also trade-offs in VAT implementation in terms of the sales threshold for mandatory registration of vendors. Generally, a relatively small number of large firms will typically account for a large proportion of potential VAT revenue. Accordingly, setting a high threshold in terms of turnover for registration of vendors can be effective in terms of revenue generation, while minimizing demands for administrative resources and compliance costs on a large number of small vendors. At the same time, a

[20] This does not appear at first blush to be a major problem in Ethiopia's system since the list of exempt goods and services is quite narrow. However, it is an empirical question to be addressed regarding the complications this poses for Ethiopian VAT-registered vendors.

sometimes overlooked benefit of incurring the costs of compliance is the promotion of a culture of record-keeping, which is part and parcel of the transition towards an economy based on formal enterprise.[21]

Related issues concern the use of techniques to enhance compliance. We note, for example, that Ethiopia, which was an early user of VAT withholding for state enterprises to improve compliance, has also established a Large Taxpayers Office and introduced reforms (such as enforcing use of sales registers) to the administrative system in 2008 to improve compliance. Accordingly, there is now established experience to allow Ethiopia's performance to be evaluated against best practice elsewhere.

The effect of varying tax rates also raises complex questions. On the one hand, raising a tax rate tends to elicit a response that reduces the tax base, while providing tax incentives also provides room for tax planning – indeed, it has been the experience of many countries that the revenues lost in this fashion outweighed the benefits garnered from the incentives. Conversely, Keen (2013: 5) reports that "the trend increase in average VAT revenues in sub-Saharan Africa—and even more strikingly for low income countries as a group—has gone along with a trend reduction in the average standard rate."
In comparing Ethiopia's experience against comparator economies, one has to take into account that fiscal systems tend to be quite idiosyncratic across economies: what works as regards approaches to taxation varies by country due to unevenness in many dimensions, including: institutional strengths and weaknesses; availability of skilled workers; the extent of the supporting infrastructure to enable widespread use of electronic systems; socioeconomic conditions; and the unique features of each country's overall division of powers across levels of government.

The division of powers across levels of government is of particular importance in Ethiopia's case, given the effort to decentralize fiscal revenue generation and service delivery. While there are significant benefits from

[21] See in this regard, the International Tax Dialogue (2005: 12).

success in such an endeavor, bottom-line performance depends on the efficiency of local governments (Kiwanuka, 2012), the effectiveness of tax sharing arrangements (which in Ethiopia are critical given that the constitution assigns the more buoyant forms of tax to the federal level, resulting in the need for block grants to balance revenue with spending obligations (Yilmaz and Venugopal, 2008)), and the effectiveness of public expenditure management to ensure that decentralized service delivery ultimately generates coherent national structures (see Tanzi, 1996). In previous benchmarking exercises it has been noted that Ethiopia's regional governments, which in principle are responsible for supporting the local-level *woreda* governments, are themselves heavily dependent on federal government grant support and thus have a limited ability to support the *woredas*, notwithstanding their Constitutional responsibility for this (see Oyugi, 2008: iv). The dependence on the central government has thus worked to limit effective delegation of authority and responsibility. The importance of including civil society engagement as part of private sector development strategies has been emphasized by the African Development Bank (2012:3).

3.5 Turnover Tax

For enterprises below the registration threshold for VAT, Ethiopia applies a turnover tax of 2% payable on revenues from supplying goods to the local market as well as on a range of services, namely construction contractors, grain mills, and tractor and combines harvesters. A 10% turnover tax is payable on other sectors. The turnover tax base is gross receipts in respect of goods supplied or services rendered. Vendors collect and remit the tax. The exempt list of goods and services follows the VAT list. Vendors are classified into three categories. "A" category vendors, with turnover above 500,000 birr must register for VAT, keep records and remit on a monthly basis; "B" category vendors, with turnover above 100,000 birr must keep records, apply the turnover tax, and remit on a quarterly basis; and "C" category vendors with sales of less than 100,000 birr annually are not

required to keep records and apply and remit turnover tax on an annual basis. In respect of the latter group, the tax is formally a presumptive tax. The tax is administered and collected by the regional governments.

The effectiveness of the turnover tax administration in Ethiopia is unclear. The thresholds have been subject to rapid "bracket creep" due to the high rates of inflation, which tends to induce tax resistance. At the same time, the construction of the system (e.g., VAT is shared by the regional authorities with the federal government on a 50-50 basis, whereas turnover tax flows 100% to regional coffers) may result in differing levels of effort at enforcement, given the extent of discretion in application by regional authorities. There may accordingly be room to improve overall tax system performance based on audits such as have been conducted in connection with funded aid programs.[22]

3.6 Excise Taxes

Excise taxes are sales taxes applied to specific goods and services for specific reasons, including simple revenue generation (when applied to price inelastic goods or services), income redistribution (when applied to luxuries, with revenues generated spent on basic services for the poor), to address negative externalities (taxes on ozone-depleting substances), to impose the user-pay principle (e.g., linking gasoline taxes to road maintenance), or to discourage consumption (e.g., "sin" taxes, including alcohol and tobacco). Excise taxes contribute about 12% of total government revenues in OECD countries (Hines, 2009). Ethiopia currently levies excise tax on nineteen products, with rates ranging from 10% to 100%.

From a revenue generation perspective, there are two main issues: setting the level, and preventing leakage across borders through smuggling. Generally

[22]See, e.g., the various Public Expenditure and Financial Accountability (PEFA) Reports undertaken in Ethiopia – e.g., the Southern Nations & Nationalities Peoples' (SNNPRG) Regional Government PEFA Assessment Report, 17 October 2010.

speaking, the wide variation from country to country as regards the level of excise taxes suggests that there is room to consider varying rates to achieve optimal revenue flows (see Bolnick and Haughton, 1998). This is one area where there appears to have been little attention paid[23]and which merits closer examination, including considering the optimality of current rates. As well, the application of excise tax to cell phones has raised issues (see GSM Association, 2007).

3.7 Tax Administration

There is extensive experience with tax administration reform for resource mobilization in Sub-Saharan Africa in general and in Ethiopia, with both the multilateral institutions[24] and donors such as the United Kingdom providing extensive support. A capacity building program for Ethiopian Revenues and Customs Authority (ERCA) funded by the UK government has been underway since 2010.[25]

Consistent with reforms aimed at creating Autonomous Revenue Authorities (ARAs) elsewhere in the region (Kloeden, 2012; Fjeldstadt, 2013), ERCA came into being on 14 July 2008 through an amalgamation of the Ministry of Revenues, the Ethiopian Customs Authority, and the Federal Inland Revenues Department.

The establishment of ERCA was based on a prior "business process re-engineering" study; performance reviews suggest that ERCA's efficiency has increased. Consistent with practice in a number of other donor-assisted tax administration reforms stimulated by research on determinants of tax

[23] A recent exception is Bird and Wallace (2010). This study examines revenue-maximizing excise tax rates on alcoholic beverages in a number of African countries.
[24] For a good summary of this experience, see IMF (2011) and, for East Africa, African Development Bank Group (2011a).
[25] See African Development Bank Group (2011); see also "UK government to assist Tanzania and Ethiopia in tax collection." *News Story*. UK Government, 7 May 2013.

compliance, ERCA has implemented a number of service features to make tax compliance more user-friendly and, in its public communications, has linked paying taxes with the benefits of the public goods and services that taxes support such as clean water and roads. ERCA has largely automated the administration of domestic taxes through a Standard Integrated Government Tax Administration System (SIGTAS), including registration, assessment, remittance, and auditing. The system is presently operational both at the head office and branch offices level.

At the same time, some problem areas have been identified in Ethiopia's tax administration:

- The African Development Bank's Strategy for Ethiopia identifies tax administration as a point of friction with the business community, which considers Ethiopia's tax administration and enforcement procedures as burdensome–and more burdensome on private enterprise than on public and politically-affiliated enterprises.
- Other sources also identify a lack of community trust towards administrators (Yesegat, 2008:161), especially as these work on behalf of unrepresentative administrative agencies, with blanket exemption powers and under little oversight as to how their powers are executed (Lencho, 2012: 379).
- The lack of public tax awareness and accessibility of legislation to taxpayers seems also to be an issue: some of Ethiopia's tax laws are not available in official publications and, though many are online, there is still a vast portion of the population that does not have access to the Internet (Lencho, 2012: 379).
- The proliferation of tax directives has made it difficult to stay abreast of tax law.

Also of note is the recent extensive report on addressing corruption in Ethiopia developed by the World Bank (Plummer, 2012), which reviews various issues related to tax administration, and a second corruption probe by the Ethiopian authorities, which identified 47.9 million birr lost to ERCA

due to tax fraud.[26] There is accordingly some scope to improve tax revenues by tightening controls.

Areas identified in benchmarking exercises where there are possibilities to improve the efficiency of tax administration include the following:

- Simplifying tax procedure codes and regulations;
- Improving public communication of tax rules;
- Simplifying taxpayer registration, filing, and payment, e.g., integrating commercial and tax registration, since both use the same TIN (Ciuriak *et al*., 2012);
- Restructuring basic processes and automation of routine tasks;
- Improving coordination between tax and customs, including by improving information technology applications;
- Improving ex post controls (audit, enforcement, appeals), including systematic random audits, which have proved to be effective elsewhere;
- Reviewing the nominal thresholds for application of particular taxes, such as the VAT and Turnover Tax, to address bracket creep in the context of Ethiopia's still significant level of inflation; and
- Increasing efficiency of the regional tax administration authorities.

Improvements in this area would have some immediate benefit in raising revenue but, more importantly, would have a positive longer-term impact in building social acceptance of taxation.

Finally, the issues of allocative efficiency and fairness need to be considered when undertaking tax reforms. A true evaluation of efficiency and fairness requires a netting out of all taxes *and* subsidies; this is impractical even in the most informationally rich economy. Accordingly, these objectives can only be pursued by applying broad principles, subject to the major constraints of practicality and, in an increasingly globalized world, the tax

[26] See, "Corruption prone areas: What the numbers reveal," *The Reporter*, 18 May 2013.

levels applied abroad. Reforms should be evaluated in terms of the extent to which they move in the following directions:

- Fewer rather than more taxes;
- As broad a base, as few exceptions, and as low a rate as feasible;
- Horizontal equity across comparable groups (e.g., rural vs. urban poor);
- Increasing the overall progressivity in the sharing of burdens; and
- A demonstrable reduction in favoritism in application (e.g., less discretion).

4. Mobilizing Private Sector Resources

Mobilizing private sector resources is a critical complement to improved public sector revenue generation. The main instrument for mobilizing private sector financial resources is a well-functioning financial system: mobilizing financial resources is, after all, what financial systems do. Ethiopia's financial system is still relatively under-developed. At present, nineteen banks are registered to do business in Ethiopia. The banks are complemented by seventeen insurance companies, which also have a limited number of branches, and thirty-one microfinance institutions (National Bank of Ethiopia, 2014). Capital markets are in a nascent stage.

4.1 Banks

Altogether the commercial banking system has a total of 2,015 branches in December 2013, which implies about one branch per 42,978 population (National Bank of Ethiopia, 2014); given that banks are clustered in urban centers, this works out to about one bank outlet per 7,820 urban population.[27] By comparison, in the United States in 1910, there was one bank per 3,000 population (Ciuriak, 2013). That being said, the degree of coverage has improved considerably in Ethiopia since 2008.

[27] CSA's medium variant population projection has been used; in 2012/13, total urban population was 15.2 million, accounting for about 18.2% of total population.

One possible way to increase financial intermediation capacity is to reduce restrictions on foreign bank entry. However, the evidence in this area suggests that foreign banks tend to lend mainly to large firms (domestic or multinationals) and to the government rather than to smaller firms, for which local knowledge is required to evaluate risk. Detragiache *et al*. (2008) conclude that foreign bank entry can even be detrimental by "skimming" the quality clients and thus constraining the expansion of local banks that serve "informationally opaque" clients, such as smaller local firms.

Given policy efforts to promote financial deepening, the thinness of Ethiopia's banking sector suggests structural issues constraining demand for banking services. For example, Allen *et al*. (2012) argue that the minimum viable bank scale is most likely to be achieved only in major cities where there is sufficient population density. They also comment that "most established commercial banks view the sectors targeted by [microfinance institutions] as 'unbankable'."

At the same time, Allen *et al*. (2012) conclude, based on a study of the growth of banking in Kenya using a new dataset on bank branch penetration at the district-level matched with household surveys of financial usage, that significant gains can be made with suitable bank strategies and that technological advances, such as mobile telephone banking, could facilitate Ethiopia's financial development on the savings side.

4.2 Insurance Sector

Insurance companies have longer-term liabilities than banks and thus can safely invest in longer-term instruments and projects. Accordingly, in addition to providing risk mitigation for clients, they fill an important niche in a financial system.

Ethiopia's insurance industry, like its banking sector, features relatively few companies with a very small number of branches given the size of the population. At the end of 2013, seventeen insurance companies existed with 293 branches, more than half of which were in Addis Ababa.

Some recent analysis on the determinants of insurance sector performance may shed light on how policy may be adjusted to promote more extensive financial deepening in this sector. In particular, Mehari and Aemiro (2013) report that large, highly-leveraged, low-risk and high-fixed-asset insurance companies perform better financially, while firm age, liquidity and growth in written premiums have no statistically significant relationship with performance. Again, this points to structural factors which may explain the overall low level of penetration of insurance services in Ethiopia.

4.3 Microfinance Institutions (MFIs)

The story with MFIs in Ethiopia is similar to that of banks and insurance companies: rapid growth from a small base that still leaves large parts of Ethiopia's economy under-served. Deribie *et al*. (2013) provide a relatively up-to-date perspective on the growth of the industry (which reached 2.5 million borrowers and 6.9 billion birr in loans in 2011).

Doocy *et al*. (2005) provide an in-depth report on the impact of a successful MFI project and comment on the role of microfinance in building both human and productive capacity. Certain MFIs also run projects aimed at women, who tend to be at a higher economic disadvantage than men, especially in the informal economy. However, Bekele and Worku (2008) show that micro, small, and medium enterprises (MSMEs) run by women had a higher likelihood of failure than those run by men (Deribie *et al*., 2013).

MFIs have great potential to deepen the financial sector in Ethiopia. In contrast to banks and insurance companies, which might be constrained by the structural factors in Ethiopia, it would appear that Ethiopia is ideally suited for MFI expansion. Accordingly, it may be that regulatory factors are important constraints.

4.4 Capital Markets

Ethiopia has successfully established a commodities exchange but does not have a securities exchange. The lack of an organized secondary market means that securities may be traded openly, but investors face problems of liquidation when the need arises. Nonetheless, the government bond market has expanded significantly as a share of GDP and its depth is in line with a number of comparator economies. Ethiopia's nascent corporate bond market is also advanced beyond the Sub-Saharan African average, although not as much as Ghana, for example (Table 1). Accordingly, Ethiopia has in place the base for an expanded role for capital markets to mediate the flow of savings to investments.

Table 6: Market Capitalization of bond markets in Ethiopia and selected SSA countries

	Government Securities Market Capitalization (% of GDP)		Corporate Bond Market Capitalization (% of GDP)	
	1990–2000	**2001–2010**	**1990–2000**	**2001–2010**
Ethiopia	21.78	28.42	0.00	1.71
Gambia	26.78	29.84	0.00	0.00
Ghana	13.74	28.17	0.04	3.47
Kenya	15.02	20.84	0.03	0.46
Mauritius	22.76	32.39	0.23	0.20
Uganda	39.99	40.30	0.04	0.20
Sub-Saharan Africa average	17.30	18.83	0.65	1.12

Source: Yibin et al. (2013: Table 6).

One constraining factor for rapid development of Ethiopia's capital markets is the lack of suitable investment opportunities domestically. This structural factor tends to lead to what is generically described as "capital flight". In this regard, compliance with record-keeping requirements from enforcement of tax payment may have a positive side-effect of increasing financial

sophistication of private enterprises. This would not only pave their access to capital markets, but it would provide domestic investment opportunities.

5. Conclusion and Recommendations

We reach a mixed verdict in our review of Ethiopia's progress to date in mobilizing financial resources to underwrite its ambitious program of economic and social development under the GTP-I and its likely successor in GTP-II.

Ethiopia has made significant progress in developing its economy and in meeting its social policy objectives as set out in its MDG commitments. It has done so despite confronting numerous complicating factors in addressing its revenue generation problem. These include large and complex challenges in the following areas: establishing a stable macroeconomic framework; relaxing microeconomic structural constraints flowing from the under-developed private sector and the country's reliance on rain-fed agriculture; and nuturing a transformation of the socio-economic fabric of the nation, which is characterized by shallow financial depth, a high degree of informality of economic activity, and a weak social contract between state and individual taxpayers.

Moreover, Ethiopia managed to realize these economic and social gains despite relatively slow progress in improving the basic conditions for a private sector economy – at least if we take at face value the persistently low rankings on international benchmarks such as the World Bank's *Doing Business* and *Logistics Performance Index*. Focusing more narrowly on revenue generation, Ethiopia achieved this progress in the faceof challenges in terms investment capacity and policy implementation effectiveness (Badu et al., 2012).

In terms of policy reforms, Ethiopia has formally played by the book in the two basic areas of taxation and financial sector regulation, but the recommended reforms in these areas these have not come together to

generate the domestic savings needed to support the investment required going forward. Notably, Ethiopia, although growing faster than many of its Sub-Saharan African peers, has failed to substantially raise the fiscal revenue share of GDP, whereas other comparator economies have.

There are of course ways in which governments can address economic development objectives without directly tapping budgetary resources. For example, states can establish state-owned enterprises (SOEs), which benefit from the implicit or explicit guarantee of the state in their access to capital markets. SOEs can be assigned developmental objectives, to be financed from revenues generated by the commercial activity undertaken. The SOE route is likely to face headwinds in the future however.

Where there are significant positive externalities associated with the mandated activity, profit may not be the most important consideration from an economic welfare perspective and private sector engagement therefore may be lacking or even result in inferior outcomes. Accordingly, establishing SOEs can make sense on economic theory grounds. East Asian development which featured financial suppression engineered by the state through state-directed lending of private sector banks had much the same effect–albeit with different financial "wiring". Moreover, the formerly highly polarized debate on SOEs is giving way to a discussion of the conditions under which they can help address development objectives (e.g., see Musacchio and Lazzarini, 2012).

Ethiopia received its first sovereign debt credit ratings in May 2014 from Moody's, Standard & Poor's and Fitch (B to B+ in each case, below investment grade[28]); accordingly, its capacity to contemplate some initiatives in this direction has improved.

At the same time, the SOE route would not be a general solution to the development puzzle for Ethiopia. Moreover, it would carry distinct dangers.

[28] "Ethiopia receives first sovereign rating," *Financial Times*, 12 May 2014.

First, while investors hungry for yield pickup in the era of quantitative easing may very well snap up high yield bond issues (African bonds have been over-subscribed in the recent “bond rush”[29]), the debt created would place Ethiopia at great risk in the not too distant future when Western Central Banks restore positive real interest rates. Second, the WTO+ rules framework for international commerce that is under discussion in the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) negotiations is likely to constrain the role of SOEs in the future. The focus of this paper on the development of long-term sustainable domestic resources to finance Ethiopia’s development ambitions is thus relevant for policy.

With its newfound international credit rating, Ethiopia could also conceivably fill a greater share of its financing needs by tapping into the demand for higher-yielding bonds from investors in advanced countries. However, debt-generating financing carries significant risks as bouts of emerging market crises following monetary corrections in the advanced countries have shown.

All considerations lead, accordingly, to the conclusion that Ethiopia needs to mobilize significant additional amounts of domestic resources, on a sustainable basis, to sustain its nascent economic miracle. Our review does not identify a simple solution, but it does identify a significant number of areas that should be explored– these are summarized in the table below. Ethiopia has followed convention in basic areas of taxation and private sector resource mobilization; in these areas, the scope to improve is at the margin. The basic principles that should guide reforms are as follows:

- Fewer rather than more taxes;
- As broad a base, as few exceptions, and as low a rate as feasible;
- Horizontal equity across comparable groups (e.g., rural vs. urban poor);
- Increasing the overall progressivity in the sharing of burdens; and

[29] For a description and discussion of the bond rush in Africa, see Sulaiman (2014).

- A demonstrable reduction in favoritism in application (e.g., less discretion).

Ethiopia has also eclectically adopted the developmental state model in its industrial policy; and it has muddled through using conventionally inappropriate macroeconomic policies (e.g., negative real interest rates and central bank financing of government expenditures). These worked to sustain Ethiopia's high growth through the GTP-I period. However, there is scant evidence that Ethiopia can move to the next level of development, which we anticipate will be the stated goal of GTP-II, without formally resolving the basic contradictions in its current policy approach that impact on productivity and savings:

- raising domestic savings while maintaining negative real interest rates;
- achieving sustained growth without a large and growing formal business sector; and
- achieving rapid growth based on convergence to the international technology frontier without a highly open trade and investment policy.

In conclusion, Ethiopia faces a "chicken and egg" situation: financing drives development and development generates financing. Supportive macroeconomic and structural economic reforms will endogenously drive revenue mobilization through the revenue-generating institutions that Ethiopia has already put in place. Optimizing the efficiency of these institutions will allow Ethiopia to make the most of the new opportunities for revenue mobilization. Only export-led manufacturing, in part driving off the agricultural base, in a context of a major expansion of formal enterprises, coupled with best practice performance in revenue generation will square the circle of Ethiopia's development financing challenge. GTP-I generally succeeded in the absence of these conditions; GTT-II will not likely be able to follow the same recipes and will have to progressively move Ethiopia through structural change to resemble in its institutional makeup the middle income economy that it seeks to become.

Summary of measures/reforms to improve domestic resource mobilization in Ethiopia

Macroeconomic	
1.	Reform the monetary policy mix to correct the exchange rate misalignment and restore positive real interest rates
2.	Deepen institutional savings by developing social security; use social security revenues to fund longer-term investments and to provide debt finance to government, at positive real yields, to replace central bank financing
Microeconomic and Trade	
1.	Develop the formal private sector by reducing the cost of business start-ups to generate industrial exports to expand resources available for domestic investment
2.	Prioritize institutional savings by developing social security funds which support infrastructure investments and public finance at positive real rates of return
3.	Reduce the administrative cost of filing social security returns
4.	Improve border administration with neighbors to increase formal trade and generate trade tax revenue
Taxation and Tax Administration	
1.	Reduce the cost of paying taxes by consolidating marginal taxes and reducing the frequency of payments
2.	Reduce the use of tax incentives
3.	Establish an office dedicated to medium-sized taxpayers, building on the evident successes of LTOs
4.	Increase the use of withholding and advance collection schemes as the formal business sector expands
5.	Review the administration of the presumptive tax on small business
6.	Dedicate units within the tax administration to high-income/wealth individuals
7.	Strengthen audit powers, including the possibility to use indirect methods to assess tax liabilities and systematic random audits, risk-based audits, to reduce incidence of tax fraud
8.	Participate in multilateral action on tax havens
9.	Adopt best practices for addressing abusive transfer pricing
10.	Reduce the number of zero-rated and reduced-rate items under the VAT, to reduce regressive characteristics

11.	Continue to expand the use of cash registers and to inculcate a culture of record-keeping in private sector business
12.	Review the thresholds for transition from VAT to Turnover Tax and within the Turnover Tax structure to ensure efficient administration in the face of bracket creep due to rapid inflation in the past
13.	Review federal-regional sharing of VAT/Turnover Tax revenues and the use of block grants to ensure that the system is not creating disincentives to effective administration of the tax system as a whole
14.	Review the excise tax structure to optimize rates, taking into account both price elasticities of consumption and the incentives for smuggling due to differentials with neighboring countries
15.	Review the administration of ERCA to address points of friction that have emerged with the business community
16.	Ensure appeal procedures are robust to promote fairness and willingness to comply with tax obligations
17.	Ensure public (including especially online) information on taxes and tax compliance obligations is comprehensive and consolidated to facilitate compliance
18.	Simplify taxpayer registration, filing, and payment, including by integrating commercial and tax registration, since both use the same TIN
19.	Review the tax procedure codes and regulations with a view to simplification
20.	Improve coordination between tax and customs, including by use of information technology applications
21.	Review basic processes with a view to automating routine tasks to increase efficiency and reduce compliance costs for private business and individuals
Private Sector Resource Mobilization	
1.	Support the development of mobile telephone banking to deepen Ethiopia's financial sector in the face of constraints to growth in banking due to low initial scale of operations outside of major urban centres
2.	Review structural factors that may be inhibiting the growth of the insurance sector
3.	Expand resources for promotion of microfinance institutions to exploit under-utilized potential
4.	Accelerate plans to develop government and private sector bond/bill exchanges and an equity exchange

References

Abay, TsegabirhanWeldegiorigis. (2010). “Domestic Resource Mobilization in Sub-Saharan Africa: The Case of Ethiopia,” North-South Institute, Summer 2010.

African Development Bank Group. (2011). “Federal Democratic Republic of Ethiopia Country Strategy Paper 2011-2015, April 2011.

_______. (2011a). Domestic Resource Mobilisation for Poverty Reduction in East Africa: Lessons for Tax Policy and Administration, Tunis.

_______. (2012). Supporting the Transformation of the Private Sector in Africa: Private Sector Development Strategy, 2013-2017.

_______. Forthcoming. Eastern Africa’s Manufacturing Sector: Promoting Technology, Innovation, Productivity and Linkages.

African Development Fund. (2010). Appraisal Report: Promoting Basic Services (PBS - III), Federal Republic of Ethiopia, July 2012.

Aizenman, Joshua and Yothin Jinjarak. (2008). “The collection efficiency of the value added tax: theory and international evidence,” in: *Journal of International Trade & Economic Development: An International and Comparative Review*, 17(3): 391-410.

Allen, Franklin, Elena Carletti, Robert Cull, Jun Qian, Lemma Senbet and Patricio Valenzuela. (2012). “Resolving the African Financial Development Gap: Cross-Country Comparisons and a Within-Country Study of Kenya,” European University Institute EUI Working Papers ECO 2012/15.

Assefa, Henok, Derk Bienen and Dan Ciuriak. (2013). “Ethiopia Investment Prospects: A Sectoral Overview,” *African Review of Economics and Finance* 4(2), June 2013: 203-246.

Auriola, Emmanuelle and Michael Warlters. (2005). “Taxation base in developing countries,” *Journal of Public Economics* 89: 625–646.

Badu, E., D.J. Edwards, D. Owusu-Manu, and D. M. Brown. (2012). “Barriers to the implementation of innovative financing (IF) of infrastructure,” *Journal of Financial Management of Property and Construction* 17(3): 253-273.

Bass, Steve, Shannon Wang, Tadele Ferede and Daniel Fikreyesus. (2013). “Making Growth Green and Inclusive: The Case of Ethiopia”, OECD Green Growth Papers, 2013-07, OECD Publishing, Paris. doi: 10.1787/5k46dbzhrkhl-en

Bekele, Eshetu and Zeleke Worku. 2008. "Women Entrepreneurship in Micro, Small and Medium Enterprises: The Case of Ethiopia," *Journal of International Women's Studies* 10.2: 3-19.

Biber, Edmund. (2010). "Revenue Administration: Taxpayer Audit—Use of Indirect Methods," IMF Fiscal Affairs Department, April 2010.

Bird, Richard M. and Sally Wallace. (2004). "Is It Really so Hard to tax the Hard-to-Tax? The Context and Role of Presumptive Taxes," in J. Alm, J. Martinez-Vazquez and S. Wallace (eds.), *Taxing the Hard-to-Tax: Lessons from Theory and Practice,* Amsterdam: North-Holland.

_______. (2010). "Taxing Alcohol in Africa: Reflections and Updates," Andrew Young School of Policy Studies, Georgia State University, International Studies Program Working Paper 10-31, October 2010.

Bird, Richard M. (2008). "Tax Challenges Facing Developing Countries," Rotman School of Management, Institute for International Business, Working Paper Series IIB Paper No. 12, March 2008.

Bolnick, Bruce and Jonathan Haughton. (1998). "Tax Policy in Sub-Saharan Africa: Examining The Role of Excise Taxation," African Economic Policy Discussion Paper Number 2, July 1998.

Bräutigam, Deborah, Odd-Helge Fjeldstad, and Mick Moore (eds.). (2008). *Taxation and State-Building in Developing Countries: Capacity and Consent*, Cambridge etc.: Cambridge University Press.

Brenton, Paul, Christian Saborowski, Cornelia Staritz, and Erik von Uexkull. (2009). "Assessing the Adjustment Implications of Trade Policy Changes Using TRIST (Tariff Reform Impact Simulation Tool)", World Bank, Policy Research Working Paper 5045.

Ciuriak, Dan. (2010). "Supply and Demand Side Constraints as Barriers for Ethiopian Exports - Policy Options," BKP Development, Trade and Development Discussion Paper No. 02-2010.

_______ . (2013). "Canadian and US Financial Sector Stability Differences over Long History: Is There a Unifying Explanation?" Ciuriak Consulting Working Paper.

Ciuriak, Dan, Derk Bienen, and Mamo Mihretu. (2012). "Unlocking Competitiveness Problem Obliges More Competition," Op-Ed, *Addis Fortune* 12(620), 12 March 2012.

Deribie, Ebisa, Getachew Nigussie and Fikadu Mitiku. (2013). "Filling the breach: Microfinance," *Journal of Business and Economic Management* 1(1): January: 010-017.

Detragiache, Enrica, Poonam Gupta, and Thierry Tressel. (2008). "Foreign Banks in Poor Countries: Theory and Evidence," *Journal of Finance* 63(5), October: 2123–2160.

Doocy, Shannon, Dan Norell, Shimeles Teffera, and Gilbert Burnham. (2005). "Outcomes of an Ethiopian Microfinance Program and Management Actions to Improve Services." *Journal of Microfinance* 7.1: 79-95.

Durevall, Dick and Bo Sjö. (2012). "The Dynamics of Inflation in Ethiopia and Kenya," African Development Bank Group, Office of the Chief Economist, Working Paper No. 151, August 2012.

Engida, Ermias, Seneshaw Tamru, Eyasu Tsehaye, Dario Debowicz, Paul Dorosh, and Sherman Robinson. (2011). "Ethiopia's Growth and Transformation Plan: A Computable General Equilibrium Analysis of Alternative Financing Options," Ethiopia Strategy Support Program II (ESSP II), ESSP II Working Paper 30, November 2011.

FDRE. (2011). Ethiopia's Climate-Resilient Green Economy: Green Economy Strategy.

Fjeldstad, Odd-Helge. (2013). "Taxation and development: A review of donor support to strengthen tax systems in developing countries," WIDER Working Paper No. 2013/010, February 2013.

Global System for Mobile Communications (GSM) Association. (2008). Taxation: the growth of mobile in East Africa." Cited in Wanyenda Leonard Chilimo. (2008). "Information and Communication Technologies and Sustainable Livelihoods: A Case of Selected Rural Areas of Tanzania," PhD Thesis, University Of Kwazulu-Natal, South Africa.

Hines, Roy. (2009). Excise Taxes, University of Michigan Working Paper.

IMF. (2011). Revenue Mobilization in Developing Countries, Fiscal Affairs Department, Approved by Carlo Cottarelli, 8 March 2011.

_______. (2012). The Federal Democratic Republic of Ethiopia: Staff Report for the 2012 Article IV Consultation, 27 August 2012, IMF Country Report No. 12/287.

_______. (2013). The Federal Democratic Republic of Ethiopia: Staff Report for the 2013 Article IV Consultation, 29 August 2013, IMF Country Report No. 13/308.

International Tax Dialogue. (2005). "The Value Added Tax: Experiences and Issues," Background Paper prepared for the International Tax Dialogue Conference on the VAT, Rome, March 15–16, 2005.

Keen, Michael. (2012). "Taxation and Development—Again," IMF Working Paper WP/12/220.

_______. (2013). "The Anatomy of the VAT," IMF Working Paper, WP/13/111.

Keen, Michael and Mario Mansour. (2010). "Revenue Mobilization in sub-Saharan Africa: Challenges from Globalization I—Trade Reform," in: *Development Policy Review* 28, 552–571.

Kiwanuka, Michael. (2012). "Decentralization and Good Governance in Africa: Institutional Challenges to Uganda's Local Governments," Uganda Management Institute, Kampala, Uganda.

Kloeden, David. (2012). "Revenue Administration Reforms in Anglophone Africa since the Early 1990s," IMF Working Paper WP/11/162.

Lencho, Taddese. (2012). "The Ethiopian Tax System: Excesses and Gaps," in: *Michigan State International Law Review* 20(2): 327-380.

Mansour, Mario. (2014). A Tax Revenue Dataset for Sub-Saharan Africa: 1980-2010, "FERDI Working Paper I19, July 2014.

Mehari, Daniel and Tilahun Aemiro. (2013). "Firm Specific Factors That Determine Insurance Companies' Performance In Ethiopia," *European Scientific Journal* 9(10), April: 245-255.

MoFED. (2010). Federal Democratic Republic of Ethiopia. Growth and Transformation Plan 2010/11 – 2014/15, 2 Volumes. Addis Ababa: Government of Ethiopia.

_______. (2013). Growth and Transformation Plan: Annual Progress Report for F.Y. 2011/12, Addis Ababa, Ethiopia, March 2013.

_______. (2014a). Growth and Transformation Plan: Annual Progress Report for F.Y. 2012/13, Addis Ababa, Ethiopia.

_______. (2014b). Ethiopia: An Assessment of Macroeconomic Developments (1992-2012), (Amharic report), Addis Ababa, Ethiopia.

Mogues, Tewodaj, Samuel Benin, and Godsway Cudjoe. (2011). "Do External Grants to District Governments Discourage own Revenue Generation? A Look at Local Public Finance Dynamics in Ghana," IFPRI Discussion Paper 00934.

Moss, Todd, Gunilla Pettersson, and Nicolas van de Walle. (2006). "An Aid-Institutions Paradox? A Review Essay on Aid Dependency and State

Building in Sub-Saharan Africa," Working Paper Number 74, Centre for Global Development, January 2006.

Mu, Yibin, Peter Phelps, and Janet G. Stotsky. (2013). "Bond Markets in Africa," IMF Working Paper WP/13/12, January 2013.

Muñoz, Sònia and Stanley Sang-Wook Cho. (2003). "Social Impact of a Tax Reform: The Case of Ethiopia," IMF Working Paper WP/03/232, November 2003.

Musacchio, Aldo and Sergio G. Lazzarini. (2012). "Leviathan in Business: Varieties of State Capitalism and their Implications for Economic Performance," Working Paper.

National Bank of Ethiopia. (2014). "Quarterly Bulletin", Vol 29 Quarter 2, 30 April 2014.

Oyugi, Walter J. (2008). "Editorial Introduction," *Regional Development Dialogue* 29(2), Autumn, World Bank.

Pence, Eliot. (2003). "The Rise of Africa's Savers – Pension Funds Key Drivers of Growth," 8 March 2013, Africa Globe.

Plummer, Janelle (ed.). (2012). *Diagnosing Corruption in Ethiopia: Perceptions, Realities, and the Way Forward for Key Sectors*. Washington DC: World Bank.

Rajan, Raghuram G. and Arvind Subramanian. (2011). "Aid, Dutch Disease, and Manufacturing Growth," *Journal of Development Economics* 94(1), January: 106-118.

Shepherd, Ben. (2012). "The Gravity Model of International Trade: A User Guide," ARTNeT Gravity Modeling Initiative, United Nations.

Sulaiman, Tosin. (2014). "Analysis: Decade after debt relief, Africa's rush to borrow stirs concern," Reuters, 18 March 2014.

Tanzi, Vito. (1996). "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects," Annual World Bank Conference on Development Economics 1995, Washington DC: The World Bank.

Thuronyi, Victor. (2003). "Presumptive Taxation of the Hard to Tax", paper presented at the conference "The Hard to Tax: An International Perspective", 14-16 May 2003, Atlanta, Georgia.

Tybout, James R. (2000). "Manufacturing Firms in Developing Countries: How Well Do They Do, and Why?" *Journal of Economic Literature* Vol. XXXVIII, March: 11–44.

von Haldenwang, Christian and Maksym Ivanyna. (2010). "Assessing the tax performance of developing countries," Discussion Paper, Deutsches Institut für Entwicklungspolitik, May 2010.

Yesegat, Wollela Abehodie. (2008). "Value Added Tax Administration in Ethiopia: A Reflection of Problems," in: *eJournal of Tax Research* 6(2), 145-168.

Yilmaz, Serdar and VarshaVenugopal. (2008). "Local Government Discretion and Accountability in Ethiopia," Local Government Discretion and Accountability in Ethiopia," International Center for Public Policy Working Paper No. 08-38, December 2008, Andrew Young School of Policy Studies, Georgia State University.