

SUMMER 2010

DOMESTIC RESOURCE MOBILIZATION IN AFRICA ETHIOPIA

The project: The North-South Institute has been working with African, UK and Canadian partners on case studies exploring the potential for domestic resource mobilization (DRM) in five Sub-Saharan countries: Burundi, Cameroon, Ethiopia, Tanzania and Uganda. DRM refers to savings and investments that are generated by both the public sector (primarily through taxation) and the private sector (as a channel for private savings by households and domestic firms). Interest in DRM as a means to support sustainable growth and reduce dependence on external aid has been growing: in 2002, the Monterrey Consensus made improved DRM the first of its leading recommended actions; and, the current global economic crisis has only drawn more attention to DRM's potential, due to declining flows in external assistance and global remittances. This summary sets out our key project findings for Ethiopia.

Context: With an improved business climate, Ethiopia's GDP has grown by more than 10% a year on average since 2004, up sharply from earlier years. Agriculture, the largest contributor to GDP, employs about 80% of the population. Exports of flowers, sesame and coffee are especially important. GDP per capita was US\$802 in 2008 (PPP), far below the Sub-Saharan average of US\$2,056 (PPP). Ethiopia is one of the poorest countries in the world and in recent years has suffered famine and repeated food crises. Despite rapid growth recently (well above the African average), government revenue has lagged behind spending, and grants have only partially filled the gap.

Key constraints to DRM: Tax evasion has become entrenched, helping to explain why the **ratio of tax revenues to GDP fell as economic growth accelerated**. It is now consistently under 15%, among the lowest in Africa and a major barrier to DRM. Tax exemptions are estimated at a sizeable 4.5% of GDP (2007).

Tax evasion through **trade mispricing** is a serious drain on resources. Ethiopia is estimated to have lost US\$17bn between 1970 and 2004 to capital flight. In an effort to boost tax collection, the government has recently overhauled the system by creating a new agency, paying staff better, bringing in new taxes, making greater use of technology, and introducing a taxpayer identification number.

Revenue, Tax and GDP Growth (% GDP)



Source: Author's compilation of data from the Ministry of Finance and Economic Development, Ethiopia.

Rank in Doing Business Database 2010:	107/183
Tax revenues (% GDP):	9.7*
Savings rate (% GDP):	1.5*
Sub-Saharan average:	16.6 (2000-08)

*latest available figures

Sources: World Bank, Doing Business Database, 2010 and World Development Indicators Database; International Monetary Fund, International Financial Statistics

Despite recent moves toward liberalization, the financial sector is still in its infancy. Ethiopia's single-digit **savings rate** threatens the sustainability of recent investment and growth. Moreover, bank



deposits and treasury bills earn far less than the recent high rate of inflation. Available savings are also under-used, possibly because of earlier problems with non-performing loans, leading to excess liquidity.

State-owned entities still dominate the banking system. Banks are concentrated in cities, but even there coverage is low, with one branch per 20,000 residents. A growing microfinance sector serves the rural population, but comes nowhere close to meeting demand. Many people thus rely on informal arrangements including social networks, known locally as the *iqquab* and *iddir*, as well as moneylenders who charge exorbitant interest rates of 10-15% a month. As in many other low income countries, people prefer to hold savings in non-monetary forms such as livestock.

Pension funds and remittances, which have both grown strongly in recent years, could help finance investment. In fact, remittances were instrumental in fueling a boom in construction investment. However, the **lack of an inter-bank money market and secondary market for stock and trading bonds** remain a serious constraint.

The way forward: Building on measures already taken, government access to **tax resources** can be enhanced by ensuring reform is implemented effectively and can be sustained. This will involve building the capacity of the new tax agency to provide leadership. Success will also depend on improving assessment and auditing capabilities. Further re-design of the system might also look at **reducing tax exemptions** or making them more effective at stimulating productive investment.

For a stronger **financial sector**, the government needs to, first and foremost, bring inflation under control and build the central bank's capacity to oversee the financial sector, including developing a credit information database. It should also **work gradually**

on the infrastructure for capital markets, possibly starting with government bonds. Encouraging innovative instruments to blend the informal networks with formal financial institutions would help rural areas in particular.

The **international community** can be of help in three areas: developing the capacity of the tax collection system, fighting capital flight, and supporting the development of informational infrastructure. Infrastructure, such as credit reference bureaus and land registries, are essential to well-functioning financial markets. Ethiopia would also benefit from assistance in developing secondary bond markets. Supporting these areas could lead to significant payoff in an economy transitioning from a planned to a more open market economy. ☉

*This is a summary of **Domestic Resource Mobilization in Sub-Saharan Africa: The Case of Ethiopia** by Tsegabirhan Weldegiorgis Abay. Mr. Abay is a lecturer at the School of Economics, Addis Ababa University, in Ethiopia. To read the full case study, go to www.nsi-ins.ca and follow the research project links.*



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