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Domestic Resource Mobilization in Sub-Saharan Africa: The Case of Ethiopia#

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Acronyms and Abbreviations

DRM	domestic resource mobilization
ERCA	Ethiopian Revenue and Customs Authority
ETB	Ethiopian birr
GDP	gross domestic product
IMF	International Monetary Fund
MFI	micro-financing Institution
MoFED	Ministry of Finance and Economic Development
NBE	National Bank of Ethiopia
BFI	non-bank financial institutions
NSI	North-South Institute
NGO	nongovernmental organization
UNCTAD	United Nations Conference on Trade and Development
VAT	value-added tax

Executive Summary

The level of domestic saving in Ethiopia has been quite low, making sustainability of the recent encouraging growth episodes vulnerable to the availability, access and conditionalties of external resources.

Understandably, structural constraints have constrained the bases for domestic saving; but the domestic resource mobilization (DRM) is substantially below its potential owing to institutional weaknesses.

Public Saving

The major reason for low public saving is the fact that the tax effort is low and declining. Tax effort was expected to improve given the fact that the growth performance has improved substantially since 1992.

The level of direct taxes has been low throughout the study period. Despite the rapid increase in resource flow to the private sector, business taxes have remained low, which may indicate tax evasion and avoidance.

The contribution of the largest sector (agriculture) has remained marginal throughout the study period and, in fact, decreased in recent years. This sector has benefitted from the recent growth and a number of large commercial farms have evolved over the last two decades, which should have resulted in increased tax revenues from this sector. The horticulture industry in general and flower farming in particular have attracted large number of commercial farmers.

Foregone tax revenues have been substantial due to tax incentives meant to encourage investment. Although the government's attempt to encourage investment is commendable, these tax incentives have been a fertile ground for tax evasion and avoidance.

Thus, the Ethiopian government has two options. The first is to maintain the status quo, continue with these tax incentives, and forgo substantial tax revenues — both formal and informal. If the government pursues the tax incentives, it must, at least, take aggressive measures to ensure reliable governance in their application.

The other option is to give up the tax incentives entirely. But, simultaneously, the government must consider reducing tax rates and tariffs to create a competitive business climate and, hence, attract investment and promote export. Reducing tax rates will reduce the strong incentive for tax evasion, avoidance, and fraud and, thus, increase tax revenues, which may compensate for the reduction in rates. In addition, the government has to unconditionally strengthen tax enforcement to ensure voluntary and involuntary tax compliance. If successful, these measures will enhance the tax effort of the country.

Illegal trade has remained a serious problem in Ethiopia. In fact, there are well known corridors of illegal trade, the main one in the eastern part of the country, mainly in the Somali Regional State. The problem of illegal trade is complex and calls for development intervention. For a significantly large number of people, illegal trade is their single source of livelihood; curbing this trade means changing the source of livelihood of these people. However, much can be done to mitigate the problem by strengthening institutional capacity for tax administration. The existence of porous borders can be attributed to structural problems in the Ethiopian economy.

Thus, the principal strategy should be to increase tax effort using different instruments, which should deal with upgrading the tax collection system. Ongoing tax reform is indeed comprehensive enough to address all relevant areas of the tax collection system, but it must be effectively implemented and sustainable.

The prime strategic direction for the future should be to create a learning organization to ensure sustainability of the reforms. The Ethiopian Revenue and Customs Authority (ERCA) should take responsibility, acquire autonomy, and develop the capacity to initiate, design, plan, implement, learn from experience, and adjust its plans. Such a learning organization can sustain the tax reform and achieve the core objectives of developing a fair, efficient, and effective tax collection system.

The critical resource is unwavering political will and commitment to developing a learning organization, in terms of budget allocation and strengthening of the real autonomy of the ERCA. The danger is undue political interference in the reform process and tax enforcement.

In this regard, the donor community could be of help in developing institutional capacity of the tax collection system, the focal being the ERCA.

Private Saving

One of the major factors that has been hindering full mobilization of domestic saving in general and private saving in particular is the embryonic stage of the financial sector, both the banking and non-banking sectors.

The Ethiopian financial sector is at best nascent, despite its long history. It remained stunted for a long period, but has experienced recent rapid growth in private banking. The country is under-banked and banks have limited outreach. The banking sector has been limited to the provision of traditional banking services only, with no effort to introduce new financial instruments. So far, there is no capital market, which could have substantially contributed to the mobilization of savings and their allocation to different investment areas.

There are apparent paradoxes in the sector. The Ethiopian economy in general and the business community in particular are credit starved. Indeed, one of the prime constraints on the business community is the lack of access to credit and poor management, which involves delays and lack of transparency. Yet, although the economy craves credit, there has been persistent over-liquidity in the banking sector. Thus, the already small savings are idle. The economy desperately needs investment and yet there is idle money in the banks.

Moreover, despite, the conservative credit policy, the level of nonperforming loans has been high for a long period, except in recent years. This may be attributable to weak corporate governance of individual banks and the central bank.

One grave outcome of the performance of the financial sector is a low rate of saving in the country. Indeed, in view of the excess liquidity and reserves, commercial banks are not interested in making an effort to mobilize savings. No attempt has been made to diversify savings instruments. Banks must aggressively strengthen existing saving instruments and introduce innovative ones to increase the level of savings.

There is also a need to develop innovative instruments to blend informal with formal financial institutions. Although there are large financial markets, operating legally and illegally and involving quite large volumes of credit, the formal sector has been oblivious to the informal sector so far.

Furthermore, the financial sector should develop savings instruments with low transaction costs to reach poor farmers. This may mean ensuring the sustainability of micro-financing institutions or introducing new saving instruments to reach both rural and urban poor.

One way to increase private savings is to encourage restraint when it comes to festivals and marriage and mourning ceremonies. Amid poverty, there is an extravagant festive culture in Ethiopia. Transforming this culture could contribute substantially to increasing private saving.

There is an urgent need to develop the institutional capacity of the central bank to discharge its responsibilities adequately, develop the sector, and ensure its smooth and healthly operation. For example, developing a credit information database would be an enormous asset to the credit market and reduce the loan default rate.

Currently, there is no capital market that could have substantially contribute to attracting savings and ensuring efficient allocation of investment. Development of such a market requires financial, human, regulatory, and other resources. Pragmatism and innovation are needed to gradually develop the infrastructure for a capital market, which may start with government bonds. The government may contribute considerably by developing a bond market over the medium and long term.

Pension funds could benefit significantly from the development of a capital market. The recent initiative to administer these funds as an autonomous entity is a modest beginning. Yet, there are concerns that the current pension rate for civil servants (10 per cent) is not adequate to ensure social security for retirees. Moreover, much remains to be done to ensure compulsory pension plans for every employee in the private sector and non-governmental organizations. There are few opportunities for investing pension funds due to the absence of a capital market.

Many Ethiopians have emigrated to other parts of the world and remittances remain a significant resource, which can and should be tapped. Developing saving instruments could increase saving and investment of remitted money. The fact that the National Bank of Ethiopia has allowed the establishment of foreign accounts is commendable and will encourage the diaspora to invest and remit money to the country.

Studies show that sub-Saharan Africa, including Ethiopia, is indeed a net creditor owing to high levels of capital flight. First, it is important to understand the incentive to save and invest abroad and the mechanisms of capital flight. The second step is to strengthen or develop the necessary institutional capacity to curb it. In this regard, both local institutions and the donor community should contribute to developing and strengthening the necessary institutions. The donor community is on the receiving end of the illegal capital outflow. If they have the will, donor countries have well-developed institutional capacity to at least mitigate the illegal outflow of resources from low-income countries like Ethiopia.

Briefly, despite the various types of structural impediments, there are many opportunities to enhance domestic saving. Indeed, a number of institutional constraints have been keeping the country from achieving its potential in mobilizing domestic financial resources. These institutional constraints are amenable to change, if there is will and commitment to develop the necessary capacity of both tax collection and financial institutions. The priority areas are summarized in the following matrix.

Policies and strategies for mobilizing domestic financial resources

Strategy	Expected output	Major stakeholders	Critical risks and assumptions	Time frame
Public saving elements: taxation				
Create a learning organization that has the responsibility, authority, and capacity to initiate, plan, design, and implement tax reforms continually	A learning organization with competent and motivated staff, a new working culture, and instruments to create a dynamic organization that sustains change	Government ERCA Workforce of the ERCA Taxpayers Donors supporting capacity building efforts	Political will and commitment: delegation of power, budget allocation, strong accountability. The critical risk is political interference in the daily activities of the ERCA	Continual effort in the short, medium, and long term
Build capacity in tax administration				
• Identify taxpayers	Reliable and complete database, updated in a timely manner	Taxpayers Workforce of the ERCA	Resistance from taxpayers, lower commitment of management and workforce of the ERCA	Short term, as much has already been done
• Assess capacity of various categories of taxpayers	Reduced tax evasion, increased tax revenue	As above	As above	Medium to long term
• Automate	As above	Management and employees of the ERCA	As above	Short- to medium runs
• Develop tax auditing capacity	As above	As above	As above	As above
Enhance tax compliance, both voluntary and involuntary	As above			
• Reduce tax and tariff rate	Reduced evasion & avoidance, & eventually increased tax revenue	Government ERCA Business community	Threat of reduction of tax revenue leading to reluctance to consider the option	Short- to medium terms
• Avoid the existing tax incentives or at least take radical measures to improve its governance	Increases tax revenue, narrows down the chance for tax evasion and avoidance, corruption	Government ERCA Workforce Investors Operational business enterprises	Danger of reduced FDI, even capital flight, resistance from business community, Vested interest in the bureaucracy,	Short- to medium run
• Strengthen tax enforcement capacity, audit, closure	Immediate and effective measures against defaulters	ERCA Workforce Taxpayers Legal system	Major risk is unduly political interference	As above
Private saving: financial sector development				
Address excess liquidity and reserve	Increased credit,	Banks	Default rate may	Short to

ratios: credit starvation, conservative credit policy and management, high excess liquidity and reserve ratios, and high nonperforming loans are incompatible factors that have been contributing to low savings effort	investment, profitable banks	Central bank Borrowers	increase unless commensurate measures taken to develop credit information and a system of accountability	medium term
Undertake an aggressive saving effort • Strengthen existing saving instruments • Develop new saving instruments • Make the real savings rate positive	Increase saving mobilization	Banks and the central bank and other financial institutions involved in saving mobilization	Danger of over liquidity if commensurate measures not taken to address the underlying cause of over liquidity	Short to medium term
Blend the formal and informal financial sectors of the country. The formal sector should develop innovative instruments to capture the informal financial sector	Increase the size and scope of the formal sector and diminish role of the informal sector	Formal financial institutions Central bank Informal institutions	Lack of creativity in establishing institutional mechanism to accommodate the informal sector, lack of policy attention	Short to medium term
Industry capacity building • Strengthen the capacity of the central bank • Effective and immediate implementation of a credit register database, strengthening of payment services	Contributes to reduce information asymmetry, moral hazard and hence default rate of borrowers	All financial institutions Central bank	Lack of commitment of all stakeholders	Short to medium term
Develop capital market	Financial deepening and development	Financial institutions Business community Government	Low participation, illiquidity, mere copying, and failure to tailor it to local situation, low government commitment	Medium to long term
Other related DRM instruments				
Pension: Improve pension rates and ensure universal coverage	Increased pension through improved rate and coverage	Government Business community Trade unions Labour force	The fact that there is no capital market, narrows the scope of business of pension funds	Short to medium term
Remittance: Large size of diaspora	More remittance inflow to the country	The diaspora Central bank Informal channels of remittance	Second generation diaspora may lose attachment	Short to medium term
Capital flight: A serious problem according to some indicators, although detailed study is lacking	Reduce capital flight, more tax revenue	Importers and exporters are the principal agents	Vested interest of the bureaucracy, lack of information, etc.	Sustainable effort over long term

Note: DRM = domestic resource mobilization, FDI = foreign direct investment.

1. Introduction

Ethiopia is the second-most populated country in Africa with more than 80 million people. It is among the low-income sub-Sahara African countries and has been an exemplary of poverty for a number of decades. With a grave development deficit in every sector of the economy, Ethiopia is in need of huge financial resources. To achieve the millennium development goals, “it is reckoned that African and other low-income countries must, on the average, grow at 8% per annum [which requires an investment]... to the tune of 25% of GDP [gross domestic product]” (UNCTAD 2000).

However, Ethiopia is experiencing a severe resource gap. Since 1960, domestic savings have been low: from FY 1961–62 to 2008–09, average domestic savings and investment as a percentage of nominal GDP were 12.8 per cent and 19 per cent, respectively (Table 1). Between 1961 and 74, average domestic savings were about 22 per cent of GDP, while the investment ratio was slightly lower at 20 per cent. With the severe and profound development deficit, the country was not in a position to invest even as much as its average saving rate. From 1975 to 1992, under a centrally controlled economic management system, both average savings and investment ratios declined. Although the average investment ratio has increased substantially since 1992 reaching a peak of 25 per cent in FY 2003–04, savings have declined considerably. Most recently, both savings and investment ratios have fallen to about 4 per cent and 20 per cent, respectively, probably due to double-digit inflation in 2006–09 and the impact of the current global crisis.

Table 1. Domestic savings and investment as a percentage of nominal GDP under three political regimes (1961–2009)

Period	Average domestic savings (% GDP)	Average investment (% GDP)	Policy regime
1961–2009	12.76	18.98	Average over 48 years
1961–74	21.9	20.0	13 years: peaceful period, apparently free-market system under a feudal regime, the first instance of development effort
1975–92	11.6	16.3	17 years: central command economy, less stable period, frequent war and conflict
1993–2009	6.9	21.1	16 years: existing regime, free-market system, private sector encouraged

Source: Ministry of Finance and Economic Development, Addis Ababa, Ethiopia.

Even by sub-Saharan Africa standards, Ethiopia's rate of domestic saving has been very low. From 1997 to 2010, the average saving rate in low-income countries of the region was about 9 per cent, while it was about 19 per cent for middle-income countries. In the same period, the average saving rate of "fragile" sub-Saharan African states was 11.5 per cent, still significantly higher than Ethiopia's rate of 4 per cent (IMF 2009a: 72 and 2009b: 216).

Yet, these various averages for sub-Saharan Africa are not the desired performances to emulate. Rather, countries like Ethiopia should learn from successful Asian countries. The average saving ratio in the newly industrialized Asian economies has remained greater than 30 per cent, except during the recent crisis years when it decreased to about 29 per cent. According to the International Monetary Fund (IMF 2009b), savings as a percentage of GDP was 34 per cent for 1987–94, 32 per cent for 1995–2008, and higher than 29 per cent in 2009–10. Similarly, investment rates have remained above 25 per cent for the period except for the last two years, when they declined to about 23 per cent. Average investment as a percentage of GDP was 30 per cent for 1995–2002, declining to about 25 per cent or more for 2003–08 (IMF 2009a: 72 and 2009b: 216). Compared with the newly industrialized Asian economies, Ethiopia has a long way to go to boost its saving and investment rates, achieve the millennium development goals, and transform the lives of its people.

In view of the severe development deficit in the country, in general, the rate of investment in Ethiopia has remained very low. Investment should and could have increased persistently and substantially had it not been for the short supply of finances. Throughout the last four decades, irrespective of differences in policy regimes, the critical bottleneck on the investment rate has been the severe shortfall in savings. Even the low investment rate may not be sustainable, as it hinges on external resources.

Given the resource deficit and vulnerability of the current low investment rate, the pertinent question is how can the required resources be mobilized? Possibilites include enhancing domestic resource mobilization (DRM),[1] increasing external resource mobilization (including official development assistance, foreign borrowing, and foreign direct investment [FDI]), efficient resource utilization, and a blend of these three strategies.

For Ethiopia, at least in the short and medium term, the three directions are not options to choose from. Rather, the country will have to exploit every potential source. Given the initial situation, domestic and external finance cannot be substitutes for each other, as little has been achieved to date in terms of mobilizing domestic resources. In both the short and medium terms, Ethiopia will have to depend on external finance to narrow the resource gap it has been facing for so long. However, in view of the short supply, volatility, and unbearable conditions attached to external sources, the strategic direction should be to enhance DRM and minimize dependence on external financing.

If DRM and hence domestic saving are critically important but low, the next logical question is what are the underlying reasons for this? Because domestic saving is determined by a number of factors, there could be two sets of reasons. One has to do with the structural determinants of domestic saving, which may include the level of development, level of income and its growth, structure of the economy, population growth and its dependency ratio, development of the private sector, trade openness, the structure of exports, the degree of monetization, urbanization, and the size of the informal sector. The culture of a country and political stability are also important determinants of saving. In general, these structural constraints require long-term development effort. In the short and medium term, they will remain binding constraints, narrowing the very frontier for resource mobilization for low-income countries like Ethiopia.

The other set of determinants are sector-specific institutional constraints that have contributed to low saving and tax effort; these may be amenable to transformation, and these factors are the focus of this study.

The objective of this research is to analyze the major institutional constraints that have been hampering DRM in low-income countries, focusing on Ethiopia as an example. The study examines the prospects for and constraints preventing mobilization of non-debt-creating domestic savings, both public and private.

The research has relied extensively on secondary data sources, the main ones being the Ministry of Finance and Economic Development (MoFED), the National Bank of Ethiopia, and the Ethiopian Revenue and Customs Authority (ERCA). Other sources were used to complement these: for example, published reports of the International Monetary Fund and the World Bank.

The second section of this report focuses on tax revenues, pensions, and remittances. In addition, it provides a cursory overview of capital flight. The third section discusses the deepening of the financial sector and the implications for private savings.

What Can We Learn from the Miraculous Growth of East Asian Countries?

One explanation for East Asia's miraculous growth is the very high rate of savings over an extended period. According to the IMF (2009b) it amounted to 34 per cent of GDP in 1987–94, 32 per cent in 1995–2008, and above 29 per cent in 2009–10. Why was the savings rate so high in these countries (Stiglitz 1996, p. 152; 2001, p. 510).

There was considerable government intervention to develop the financial sector and improve its performance. Specifically these governments worked to create and regulate financial markets and institutions with the prime objective of mobilizing savings to enhance domestic investment (Stiglitz and Uy 1996, pp. 249–250).

In some East Asian countries (Singapore and Taiwan), public-sector savings were already high while in others private savings were high. For instance, "Malaysia and Singapore guaranteed high minimum private saving rates through mandatory provident fund contributions" (World Bank 1993, p. 22). Governments used a variety of strategies to increase savings (for details, see World Bank 1993, p. 22 and Stiglitz and Uy 1996, p. 251).

They promoted savings education by various means including saving mobilization campaigns.

- They created postal savings plans with low transaction costs and risk. The postal savings instrument opened up wide access to large parts of the population, covering the entire postal branch network including rural areas and attracting large numbers of small savers. Some countries encouraged postal savings by providing a tax exemption for interest earned on such deposits. Some also introduced saving bonds, youth saving schemes, and other related savings instruments.
- Some governments introduced a universal, compulsory pension system.
- Another strategy to encourage savings was regulation of the financial sector to encourage its development and healthy operation.
- Many of these governments actively encouraged saving and discouraged credit for consumer items. They imposed stiff taxes on luxury items.

- Most governments of these economies adopted a policy of moderate financial restraint. They maintained deposit and lending rates below market levels to encourage saving and investment in the economy. In pursuing macroeconomic stability, these governments were running small fiscal deficits or even surpluses.
- Maximum effort was made to reach small and rural savers.

Obviously, these methods cannot and should not be taken as a formula for encouraging savings. Low-income countries like Ethiopia must be innovative in adopting these and other instruments. They must consider their domestic realities, informal financial institutions, the adequacy and capacity of their supervisory government organizations in strengthening existing savings instruments and introducing new ones.

2. The State of Ethiopia's Domestic Revenue and the Implications for DRM

A basic premise of this report is that capable and responsible states are key actors in overcoming the structural bottlenecks to development. To discharge their responsibility, domestic revenue (and hence tax) mobilization is a key strategy (Pretoria Communiqué 2008).

A major feature of the Ethiopian macroeconomic situation is the fact that there has been persistent fiscal deficit (Table 3). From 1997 to 2002, even including grants, the country has been facing a fiscal deficit of about −6 per cent of GDP; since 2006, this has started to decline to less than −4 per cent of GDP. When grants are excluded, the fiscal deficit situation is graver: about −14 per cent in 2003, declining to less than −8 per cent since 2007. The IMF forecast that fiscal deficit will decrease during 2009 and 2010, probably in anticipation of the government following a tight fiscal policy, reducing expenditures and local borrowing.

Table 2. Ethiopia's fiscal balance, including and excluding grants (% GDP)

	1997 – 2002	2003	2004	2005	2006	2007	2008	2009	2010
Fiscal balance including grants – Ethiopia	−5.9	−7.0	−3.0	−4.4	−3.9	−3.6	−3.0	−1.5	−1.1
Fiscal balance	−9.0	−13.6	−7.6	−8.7	−7.4	−8.1	−7.2	−5.4	−4.3

excluding grants- Ethiopia									
Fiscal balance excluding grants Low-income sub-Saharan Africa	−7.2	−7.9	−7.5	−7.6	−7.8	−7.9	−7.9	−8.6	−7.9

Source: IMF 2009, p. 74.

Ethiopia's fiscal deficit was higher than the average for low-income sub-Saharan Africa in 1997–2005. Since 2006, the deficit as a percentage of GDP has been slightly lower than the African average.

To address this problem, one may consider both the revenue and expenditure sides of the coin. For countries like Ethiopia with severe development deficit, the direction to follow is to increase government revenue to ensure both stability and growth of the country. This leads us to examine the state and its prospects for mobilizing domestic financial resources.

Apart from the structural constraints that limit the tax base, overall institutional capacity and the system of governance of the fiscal institutions determine public savings in general and the tax effort of the country in particular.

Tax Revenues

The effectiveness and strength of a state is determined by its capacity to mobilize the necessary resources to finance its functions. One performance indicator of such capability is tax effort.

The State of Ethiopia's Tax Effort

The structure of tax revenues and performance over time is one of the determinant factors of tax effort. The Ethiopian tax system involves different types of direct and indirect taxes, including various income taxes: employment (0–35 per cent), profit and rental (30 per cent), interest income (5 per cent). Moreover, a value added tax (VAT) of 15 per cent was introduced in 2003 in lieu of a sales tax. Various tariffs are also levied, mainly on import items.

As can be seen from Table 4 and Figure 2, in the period FY 1979–80 to 2007–08, domestic revenue constituted on average about 84 per cent of total government revenue, which includes domestic revenue and external grants. For the same period, grants averaged about 16 per cent of the total, although this varied with the two policy regimes that prevailed in the country in the last three decades or so. From 1979–80 to 1991–92, the average share of grants was less than 14 per cent; that increased to about 18 per cent during the period 1992–93 to 2007–08. Obviously, Ethiopia's development performance and external relationships have improved substantially during the present regime and, hence, it is not surprising to see this increase in grants.

The wide fluctuations (10–26 per cent) in the share of grants show the unpredictability of this source of revenue. Thus, the strategy should be to fully exploit the potential to mobilize domestic resources.

Table 3. The structure of Ethiopia's public revenue for 1979–80 to 2007–08

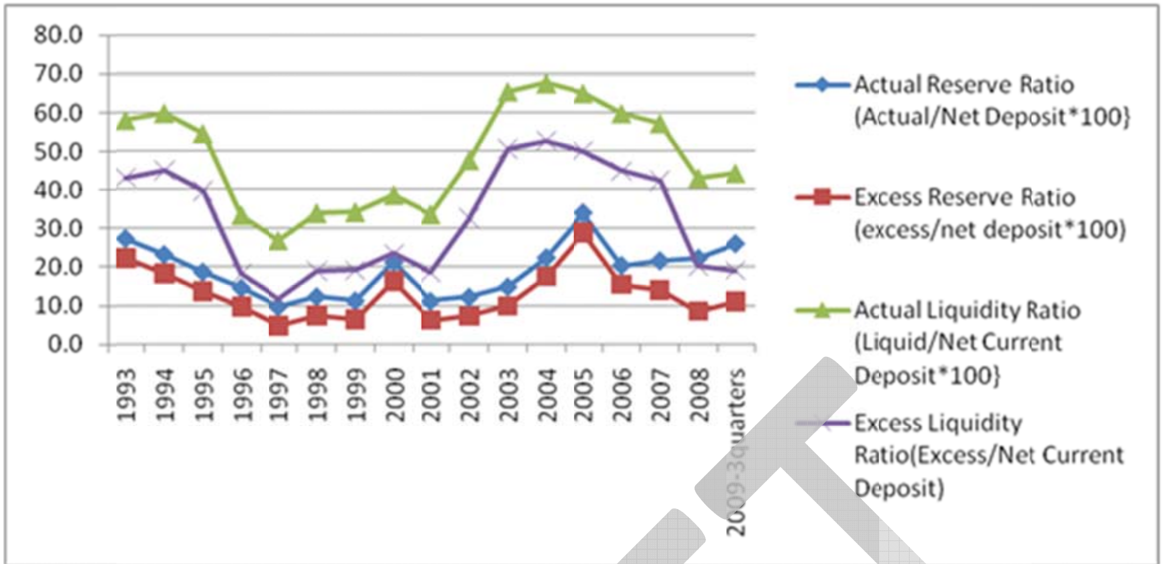
Revenue source	1979–80 to 2007–08	1979–80 to 1991–92	1992–93 to 2007–08	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
Domestic revenue (% total revenue)	84.3	86.5	82.4	84.2	77.4	77.4	84.0	74.2	75.1
External grants (% total revenue)	15.7	13.5	17.6	15.8	22.6	22.6	16.0	25.8	24.9
Tax revenue (% domestic revenue)	71.7	72.4	71.2	70.0	78.6	79.5	72.5	79.6	79.9
Direct taxes (% total tax revenue)	37.0	40.3	34.4	35.0	34.2	31.8	31.5	29.9	29.6
Personal income tax (% direct tax)	27.7	27.8	27.7	30.3	26.0	28.7	31.7	35.2	37.9
Corporate income tax (% direct tax)	54.5	56.9	52.5	51.5	40.2	43.4	39.0	44.3	43.2
Agriculture tax (% direct tax)	10.8	13.7	8.4	8.0	7.4	7.4	4.6	4.4	4.0
Indirect taxes and duties (% total tax revenue)	63.0	59.7	65.6	65.0	65.8	68.2	68.5	70.1	70.4
Domestic indirect taxes (% total indirect taxes)	42.4	51.8	34.8	31.7	25.8	32.1	32.1	32.8	30.3
External indirect taxes (% total indirect taxes)	57.6	48.2	65.2	68.3	74.2	67.9	67.9	67.2	69.7
Non-tax revenue	28.3	27.6	28.8	30.0	21.4	20.5	27.5	20.4	20.1

Source: Ministry of Finance and Economic Development.

Understandably, domestic revenue is composed of tax and non-tax revenue. Between 1979–80 and 2007–08, tax revenue constituted about 72 per cent of domestic revenue with very small inter-regime differences. Although, the average share for 1992–93 to 2007–08 appears to be slightly lower than in the preceding period, it appears to have been increasing to about 80 per cent in 2007–08. The remaining percentage comes from non-tax reform, which averaged about 28 per cent.

However, as may be seen from Figure 2, although non-tax revenues are an important source of revenue, their percentage of total revenue appears to decline in recent years.

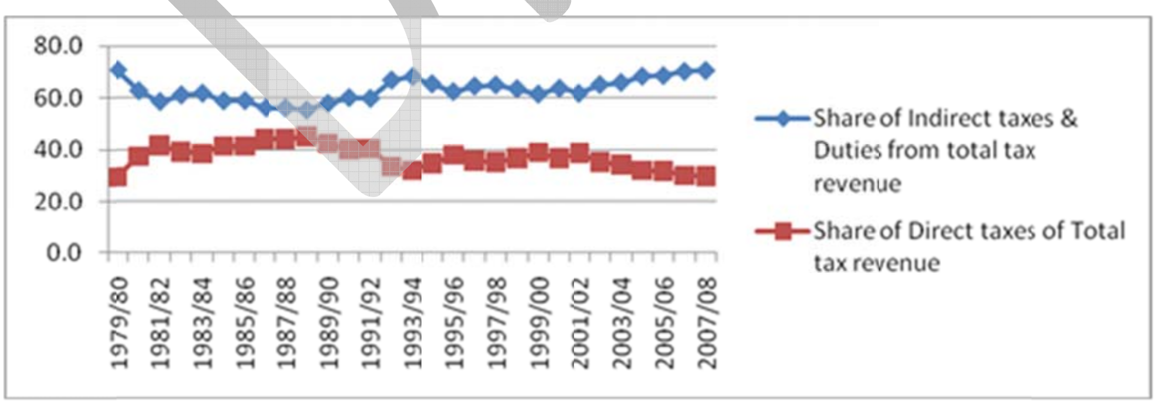
Figure 1. Structure of Ethiopian revenues and trends, 1979–2008 (%)



Source: Ministry of Finance and Economic Development.

A common feature of the tax structure of low-income countries like Ethiopia is the fact that indirect taxes constitute the lion's share. Throughout the study period of about 30 years, the relative importance of direct taxes has remained low: averaging 37 per cent of total tax revenues. In fact, despite expectations of improvement, the share of direct taxes has declined from about 40 per cent in the period 1979–80 to 1991–92 to about 34 per cent during 1992–93 to 2007–08. As shown in Figure 3, it is continuing to decline, despite the expectation that it would increase following changes in policy in the early 1990s.

Figure 2. Direct and indirect taxes and trends, 1979–2008 (% of total tax revenue)



The period since 1992 has been favourable to the private sector. Policy reforms were completed in the early 1990s and one of the pillars of the current government has been to develop the private sector. An investment incentive system is in place and the flow of credit to the private sector has shown a rapid increase. Moreover, the average rate of growth of the GDP for 1995–2003 was about 3%, slightly higher than the population growth rate and significantly higher than the average for pre-1992, which was negative (−0.7%). Since 2004, growth rate has been in the double digit range. With such developments, the share of business profit taxes should have shown a significant increase, the tax base was expected to expand, and the share of direct taxes, particularly the share of business profit tax, should have increased.

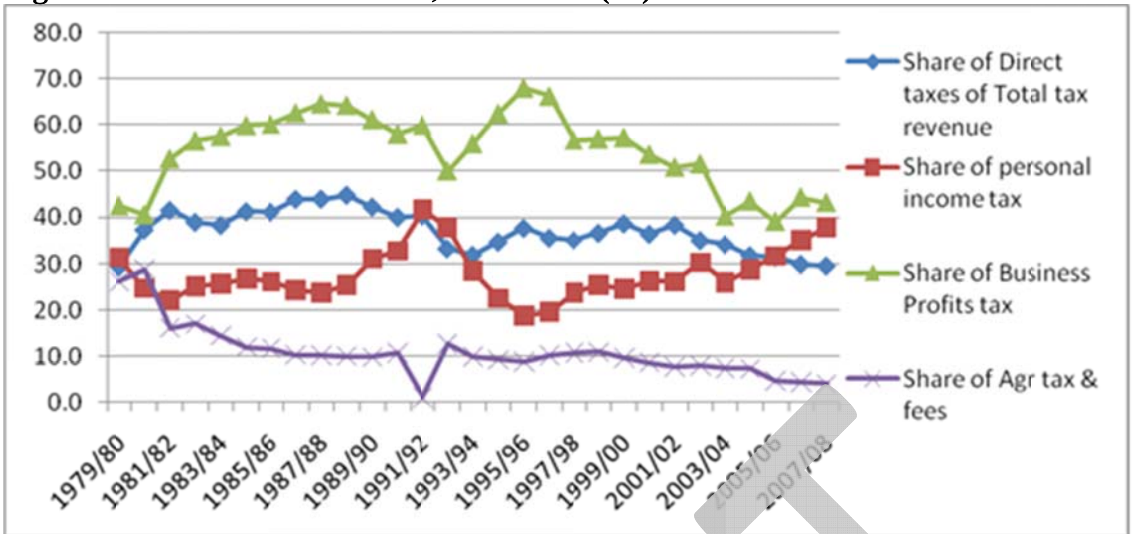
The persistently low share and, in fact, decline in direct taxes can be attributed to the performance of each type of direct taxes.

In 1979–2008, personal income tax constituted nearly 28 per cent of direct taxes under both policy regimes. The high tax rate (up to 85 per cent) of the previous policy regime was reduced to 0–35 per cent. However, with the reorganization of government and district level decentralization, the bureaucracy increased substantially to maintain the relative share of personal income tax. Moreover, there has been an increase in the private sector and NGOs, which must also have contributed to an increase in personal income taxes.

In Ethiopia, personal income tax is the type of tax least associated with tax evasion. With government being the largest employer, there is little or no room for tax evasion. Thus, despite the sharp decrease in the tax rate, personal income tax has shown an increasing trend.

On the other hand, the average share of business profit tax has remained low, at about 55 per cent. As can be seen from Table 4, the average share of business profit has declined from about 57 per cent (1979–92) to less than 53 per cent (1992–2008). From the same table, the share of business tax has declined to 39 per cent and 43 per cent in 2005–06 and 2007–08, respectively. The share of business profit tax has been persistently declining since the second half of the 1990s

Figure 3. Trends in direct taxes, 1979–2008 (%)



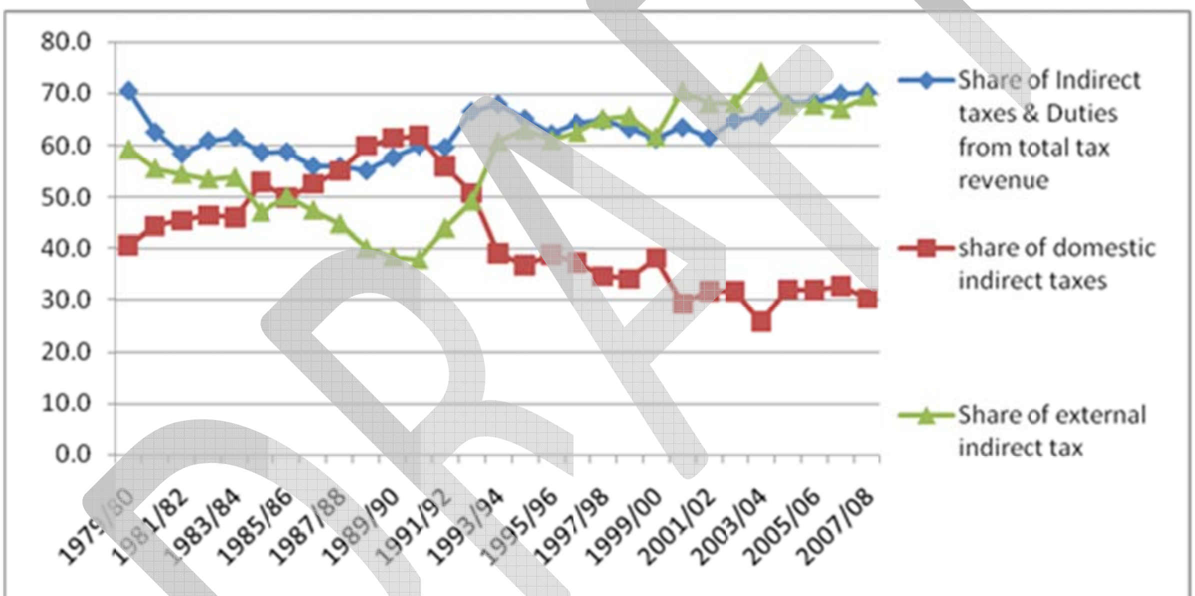
In view of the low level of development of the economy and, specifically, the predominance of rainfed subsistence agriculture, the business sector is still in an embryonic stage. In addition, the country has emerged from a state-run economy with very gloomy growth performance. Following the policy shift in 1992, the situation has been more favourable, and the business share of direct taxes should have substantially increased. Thus, one possible explanation for the decline of business profit tax could be tax evasion and avoidance.

Another important structural weakness of the Ethiopian tax system is the poor contribution of the agricultural sector, which is the source of livelihood of about 80 per cent of the Ethiopian population and the largest contributor to both GDP and exports. As can be seen from Table 4, the share of agriculture-based taxes and fees averaged only about 11 per cent over the entire period 1979–2008 and declined since FY 1991–92 to about 8 per cent. Even during the last six years of consecutive growth of the sector, its tax contribution declined to only 4 per cent of direct taxes, indicating that this type of tax has not been responsive to the growth in the sector.

The declining contribution of the agriculture sector cannot be attributed entirely to the low level of development and its vulnerability to droughts and famines. The sector has been contributing significantly to growth rates experienced since 2004. Moreover, the agriculture sector is no longer a homogenous collection of subsistence farms. Significant investment in commercial farming has occurred over the last decade; the flower industry, for exmple, is growing at an increasing rate and sesame has emerged as an important export crop. There are a number of corporate investors in the sector. Thus, the fact that the tax contribution declined rather than increasing may be attributed to weakness of the tax administration system.

The dominant contributor to tax revenue in Ethiopia has been indirect taxes, i.e., taxes levied on goods and services. As seen from Table 4, the share of indirect taxes was about 63 per cent, 60 per cent, and 66 per cent in 1979–2008, 1979–92, 1992–2008, respectively. Taxes on imports and exports amount to about 58 per cent of indirect taxes over this period and their share of total indirect taxes has been increasing over time. However, this tax is vulnerable to the vagaries of international markets and shocks, such as the 2007–09 global economic crisis. Already scarce foreign exchange has become scarcer, forcing the central bank to allocate foreign exchange administratively. Lack of foreign exchange leads to a decrease in imports. Thus, one of the effects of the global crisis on low-income sub-Saharan Africa countries like Ethiopia has been to reduce both exports and imports, which results in a decline in tax revenues from trade.

Figure 4: Structure and trends in Ethiopia's indirect taxes (%)



The other component of indirect tax is domestic indirect taxes, mainly sales tax and, since 2003, VAT. The share of this tax has declined from 31 per cent to about 23 per cent in the latter period. The recent growth in the country was expected to increase the base for these taxes. With expansion of domestic production, the share of domestic indirect taxes should have improved instead of declining, possibly due to tax evasion.

A more direct indicator of the tax effort of the country is the ratio of tax revenue to GDP. Ethiopia's tax effort has been low throughout the last four decades. Moreover, it appears to have declined instead of increasing.

There has been no significant change in revenues (including grants) as a percentage of GDP throughout the period, 1974–2008: it remained at 19.2 per cent with a decline in the latter years (Table 5).

Table 4. Average government revenue as % of nominal GDP

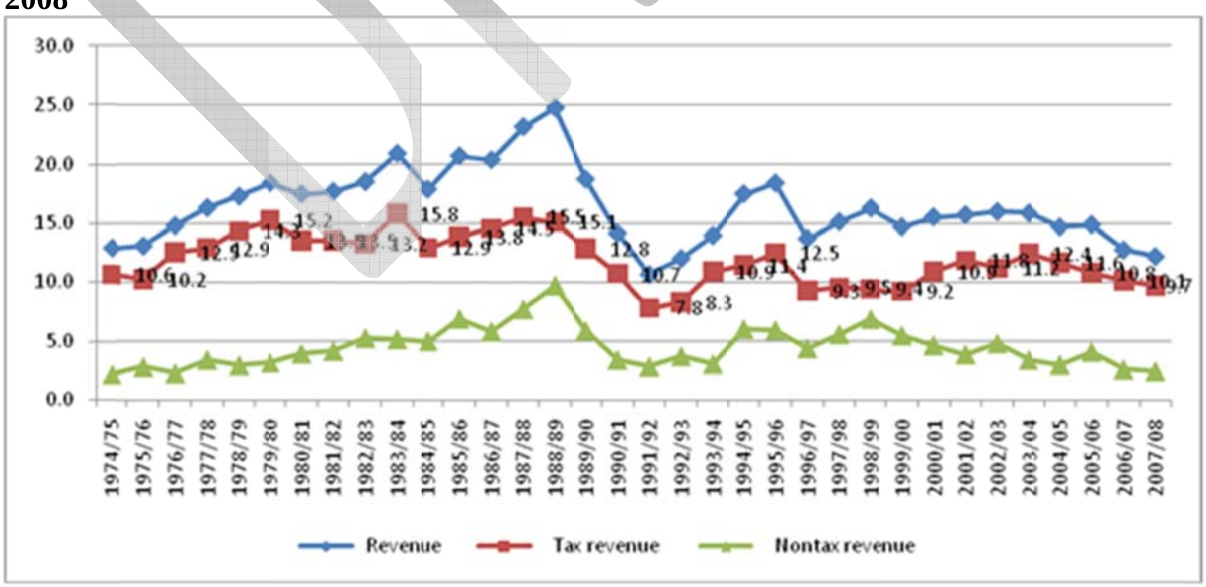
	1974–2008	1974–92	1992–2008	2003–04	2004–05	2005–06	2006–07	2007–08
Total revenue and grants	19.2	20.2	18.1	20.4	18.9	17.7	17.1	16.2
Domestic revenue	16.4	17.7	15.0	15.8	14.6	14.9	12.7	12.1
Tax revenue	11.9	13.1	10.6	12.4	11.6	10.8	10.1	9.7
Non-tax revenue	4.5	4.6	4.4	3.4	3.0	4.1	2.6	2.4
Grants	2.9	2.5	3.2	4.6	4.3	2.8	4.4	4.0

Source: Ministry of Finance and Economic Development.

Domestic revenue exhibits the same trend. The major component of the domestic revenue is tax revenue. The tax-to-GDP ratio has declined from 13.1 per cent in 1974–92 to 10.6 per cent in 1992–2008. Over recent years, the share of tax revenue has declined from 12.4 per cent in 2003–04 to 9.7 per cent in 2007–08.

Although the range of the of tax-to-GDP ration for 1974–91 was 10–16 per cent, it declined to a range of 9–12 per during 1994–2008 (Fig. 6). This figure shows that the tax effort of the current policy regime at its best and worst levels was below than that of the previous policy regime.

Figure 5: Ethiopia's total revenue, tax, and non-tax revenue as % of nominal GDP, 1974–2008



Source: Ministry of Finance and Economic Development.

Apparently, the tax rates of the previous regime were on the high side. As mentioned above, income tax rates were reduced from 89 per cent to 30 per cent for private limited companies and from 85 per cent to 35 per cent for individual income tax. This downward adjustment may partly explain the reduction of the tax ratio. It would bring an immediate decline in the first five years or so, but the tax effort should have gradually increased following the periodic growth of the Ethiopian GDP and related expansion of the private sector. Instead, it has shown a declining trend.

Moreover, tax effort reached its lowest level during the years of political takeover. The share of tax to GDP was particularly low during 1974–75 and 1991–92, which can be attributed to poor tax collection during the years of institutional discontinuity, when power was transferred in a non-peaceful manner.

Another way of looking at the same issue is to make an inter-country comparison. Using a different but related data set, the tax effort of Ethiopia is low even by sub-Saharan African standards.

Table 5. Government revenue of sub-Sahara African countries 1997–2010 (% of GDP).

Country	1997–2002	2003	2004	2005	2006	2007	2008	2009*	2010*
Ethiopia	**15.1**	**16.2**	**16.1**	**14.6**	**14.8**	**12.8**	**12.5**	**12.5**	**12.5**
Low-income sub-Saharan Africa average	14.1	15.3	16.0	16.1	16.5	17.1	17.1	16.4	16.6
Fragile sub-Saharan Africa average	13.5	13.8	14.6	15.2	16.1	16.8	17.7	17.3	17.6
Middle income sub-Saharan Africa countries	24.5	24.2	24.8	26.2	27.2	27.6	27.0	26.6	26.5
sub-Saharan Africa	21.1	20.8	22.3	24.1	24.7	24.0	24.7	20.8	21.6
Kenya	20.2	19.7	21.4	21.2	21.1	22.2	22.0	21.5	21.1
Ghana	15.4	20.2	22.4	21.8	21.9	22.7	22.8	22.4	22.3

* Figures for 2009 and 2010 are estimates.

Source: IMF 2009, p. 75.

In recent years (2005–10), Ethiopia's tax and non-tax revenues as a percentage of GDP have been consistently lower than the average of low-income sub-Saharan African countries. Similarly, they have been consistently lower than the sub-Saharan Africa average, which has been consistently above 21 per cent since 1997. Comparing Ethiopia with Ghana and Kenya, both of which are low-income sub-Saharan African countries, Ethiopia's revenues have been consistently lower.

Ethiopia is one of the nine sub-Saharan African countries that collect in the range of 10–14 per cent of their GDP (Table X). Of the 49 countries listed here, 40 collect revenues greater than 15 per cent of their GDP.
Moreover, the tax-to-GDP ratio for high-, middle-, and low-income countries is about 40 per cent, 25 per cent, and 18 per cent, respectively (Gallagher 2005, p. 130). Thus, Ethiopia ranks below the average of African low income-countries.

Table X. Government revenues of African countries as % of GDP (average 2007–08)

Revenues 10–14% of GDP	Revenues 15–19% of GDP	Revenues 20–24% of GDP	Revenues >25% of GDP
1. Burkina Faso	1. Benin	1. Cape Verde	1. Algeria
2. Central Africa Republic	2. Burundi	2. Chad	2. Angola
3. Comoros	3. Cameroon	3. Eritrea	3. Botswana
4. Ethiopia	4. Congo, Democratic Republic of	4. Ghana	4. Congo, Republic of
5. Guinea	5. Cote d'Ivoire	5. Kenya	5. Egypt
6. Madagascar	6. Gambia, The	6. Liberia	6. Equatorial Guinea
7. Rwanda	7. Guinea Bissau	7. Mauritius	7. Gabon
8. Sierra Leone	8. Mali	8. Seychelles	8. Lesotho
9. Uganda	9. Malawi	9. Sudan	9. Libya
-------------	10. Mozambique		10. Mauritania
10. Zimbabwe (<10%)	11. Níger		11. Namibia
	12. Nigeria		12. Sao Tomé and Príncipe
	13. Senegal		13. South Africa
	14. Tanzania		14. Swaziland
	15. Togo		15. Tunisia
	16. Zambia		

Source: Africa Partnership Forum (2009, p. 7).

Major Reasons for Low Tax Effort in Ethiopia

A number of structural factors have decreased the tax base of the country: the dominance of subsistence agriculture, the dismal growth history, massive poverty, the mono-commodity export sector, the low level of monetization of the economy, and the size of the informal sector.

Nevertheless, despite these structural constraints, there is room to increase tax effort in the existing formal sector in the short and medium terms. There is high tax potential that could be tapped. The major hindrances are institutional factors, which are amenable to change.

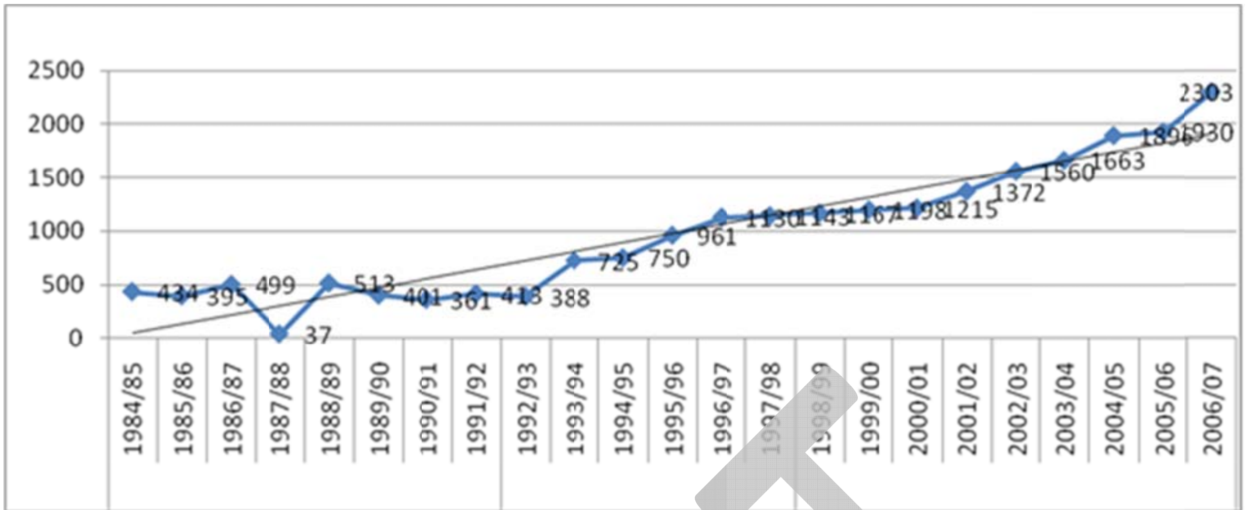
Tax evasion and avoidance have been significant. Low voluntary compliance and weak enforcement mechanisms reflect the institutional weakness of the tax collection system in terms of identification of taxpayers, assessment capacity, administration, law enforcement, and taxpayer culture. Fortunately, these weaknesses can be rectified if there is will, commitment, and a strong system of accountability on the part of the government and its bureaucracy.

It is not easy to measure the extent of tax evasion and avoidance; however, there are strong indicators of the gravity of the problem. As discussed above, tax effort has remained low and declining in a period when it was expected to increase. In particular, the contribution of direct taxes has stagnated during a period when there was a favourable macroeconomic environment (since 1991) and double-digit growth in the country (since 2004). In 1992, there was a clear policy shift in favour of the private sector, which has been nurtured since then.

Private credit increased by nearly 25 per cent during 1992–2009 to about 13 per cent of GDP. As a result, investment increased during the same period: from 16 per cent during the period of controlled economy to more than 21 per cent in 1992–2008 (Table 1 and Fig. 2). Increased investment expands the bases for both direct and indirect taxes; thus, the fact that the share of revenue from direct taxes has been declining is not compatible with such an increase. Although there may be a lag time, after five years direct taxes in general and business profit tax in particular should have increased by the second half of the 1990s. The dismal performance of business profit tax can then be attributed to tax evasion and avoidance.

A related indicator is the number of businesses. Figure 8 shows the steady increase in the number of industrial establishments for 1984–2007 (it does not include construction, agriculture, financial, and service sectors). Although the number of establishments does not directly indicate taxable profit, it does show that the number of taxpayers indeed increase substantially, from as few as 400 firms in the early 1980s to more than 2300 in 2006–07. These firms cannot have failed to earn a profit for nearly two decades.

Figure 6. Number of large and medium industrial establishments in Ethiopia, 1984–2007



Source: CSA, manufacturing surveys.

A related but stronger indicator of the magnitude of tax evasion is the large gap between registered and actual investment. Although I know of no formal study in this area, some officials and experts indicate that actual investment amount to only 20–30 per cent of registered investments. Why is there such a gap? Are there constraints that hinder actual investment, such as access to finance, delays in credit administration, access to infrastructural services, etc.? If so, such constraints should have been mitigated over time, increasing the investment rate substantially. But that does not appear to have occurred. Another explanation for the gap is fraud and corruption in the management of the tax exemption for investment goods (discussed further below under "Tax evasion mechanisms").

Tax exemptions: One of the reasons for low tax effort in Ethiopia is the large number and size of tax exemptions,[2] which appear to be highly abused. Some data show that tax foregone due to exemptions is substantial and increasing over time (Table 7). For 2005, 2006, and 2007, the total foregone tax revenue was ETB 3.9, 4.6, and 7.7 billion, respectively, or 3.7, 3.5, and 4.5 per cent of GDP. In FY 2008–09, total exemptions amounted to ETB 14.9 billion (4.2 per cent of GDP). And these figures do not include foregone taxes due to tax holidays of five to seven years.

Table 6: Revenue lost to customs exemptions

Exempted items	2005		2006		2007	
	Value (ETB millions)	%	Value (ETB millions)	%	Value (ETB millions)	%
Capital goods imported by:						
Private sector	1171.7	29.74	1610.9	34.71	2572.1	33.3
Public sector	984.2	24.98	730.9	15.75	2207.6	28.6
NGOs	95.7	2.43	110.4	2.38	112.4	1.5
Imports by private enterprises	240.5	6.10	289.9	6.25	297.7	3.9
Personal effects	502.3	12.75	856.4	18.45	1096.7	14.2
Diplomatic community	334.2	8.48	368.2	7.93	476.1	6.2
Professional trade	20.3	0.52	16.7	0.36	21.9	0.3
Raw materials for pharmaceuticals	8.7	0.22	11.9	0.26	13.8	0.2
Imports by public enterprises	68.8	1.75	62	1.34	82.6	1.1
Industry-specific exemptions	49.7	1.26	47.9	1.03	76.6	1.0
Others	464.4	11.79	536	11.55	761.6	9.9
Total revenue	3940.5	100.0	4641.2	100.0	7719.1	100.0
% of GDP	3.7		3.52		4.51	

Note: ETB = Ethiopian birr, GDP = gross domestic product, NGO = nongovernmental organization.

Source: Ministry of Revenue (2008).

Understandably, the largest beneficiary of exemptions is the private sector, as it is the target of this incentive system. Tax incentives are a sacrifice the government has been willing to pay to promote investment in the country.

However, it is timely to reconsider the effectiveness of such tax incentives in attracting investment and boosting global competitiveness of commodities and services. There are strong arguments against tax incentives. If they are adopted by every country that wants to be globally competitive, then countries will end up competing in tax incentives, which may lead to zero taxation. Thus, these tax incentives should be used sparingly as a short- or medium-term measure.

A related argument is based on an understanding of the drivers of global competitiveness. There are both price and non-price factors determining competitiveness: prices, quality, product differentiation, delivery time, meeting predetermined standards, for example. Tax exemptions and holidays are expected to reduce investment and operating costs and, hence, render businesses price-competitive in the global markets. However, the fundamental determinant of price competitiveness is not tax incentives but continuous improvement in productivity. Thus, incentives should focus on improving productivity, which has a long-lasting effect and on improving the investment climate, which has a significant impact on business costs and risks.

Moreover, tax incentives as an instrument to attract FDI are a secondary variable. More fundamental factors include peace, stability, political predictability, good governance, adequacy and efficiency of basic infrastructure, market size, access to raw materials, and availability of skilled labour (UNCTAD 2000, p. 11). It is only after these factors are assured that tax incentives and policy are considered in investment decisions.

Given these points, the decision options for the Ethiopian government are two. The first is to maintain the status quo, continue with these tax incentives, and substantially improve administration of the investment and export incentives. In general, administrative measures against evasion and avoidance may be ineffective, given the history of low tax compliance in the country and the strong incentive of taxpayers to evade and avoid their tax obligations. The other option for the Ethiopian government is to give up the tax incentives and consider reducing tax rates and strengthening the tax collection and compliance system. A reduction in tax rates and tariffs would encourage investment and create a competitive environment. Further, it would reduce the strong incentive to evade or avoid taxes and commit fraud and, thereby, increase tax revenues. If the government simultaneously strengthened its tax collection system, there would be both voluntary and non-voluntary compliance and enhanced tax effort. The government would have greater financial capacity and, hence, the policy space to invest in basic infrastructure to enhance the competitiveness of the value chains of many export commodities.

Tax evasion mechanisms: According to customs officials and officers, the manifestations of tax fraud and evasion are manifold. The import tax exemption is highly abused. Many investors take advantage of their investment ventures to illegally import goods for which they have obtained tax exemption. The quantity of goods imported is far greater than what is actually required for investment. For instance, according to officials and officers from the ERCA, many investors in real estate and hotels have abused this process and ended up in trading in construction materials and furniture, selling at prices below those for legally imported goods. Although the ERCA has been able to bring charges and win a number of cases in the courts, there are many cases of which the ERCA is unaware or is not able to take to court. In general, the authorities, which have the power to give permission, do not have a mechanism for checking the final destination of tax-exempt goods to determine whether serious fraud or corruption has occurred.

Business people take advantage of the system. They register to invest in priority sectors, such as textiles, garments, leather, and others, proceeing to the point where they get government support, including tax exemptions, to import capital goods, then abuse this privilege and shift to other business ventures. The requirements for obtaining exemptions, which include submission of an investment license and a feasibility study, are cheap to comply with. The necessary documents are rudimentary and prepared at a very low cost. The investment licensing process does not involve a large cost in terms of time or money as it is meant to encourage investment. Thus, many business people meet the official requirements at a small expense, enjoy the privileges by importing expensive items, such as cars, that may not be part of the intended investment, then abandon the investment venture. This explains the very large gap between registered and actual investment.

In one case, a businessperson, who registered for the garment industry, ended up in advertisement. Others failed to respond to my enquiries, probably to avoid any risk of being identified by government authorities. There are even cases of expatriates who benefited from tax exemptions while importing finished goods and trading them in the local market — a clear abuse of the investment incentives. These people also bribe customs officers and officials and import non-exemption items without paying import taxes and duties.

Another mechanism for avoiding taxes is the exemption of imports meant for export. Many foreign contracting companies involved in construction work, including hydroelectric power stations and road construction, have taken advantage of this system to import a huge amount of machinery and equipment and their spare parts, which were supposed to be exported at the end of the contract period. However, because the tax collection system fails to trace these imports, they have ended up remaining in the country for decades and have likely been sold in the domestic market, competing with local business people who have been paying taxes and duties on the same goods. Understandably, the size of such imports should be large. Officials from the relevant tax authority cite, for example, one foreign construction company, which owes an accumulated tax of ETB half a billion (about USD 40 million), a substantial amount for poor countries like Ethiopia. This company is currently working on a large project, financed bilaterally through external sources, and it has implicit protection from its government. Thus, there is a serious problem enforcing Ethiopian laws when the tax-defaulting company is foreign.

One area that has been eroding the taxation system is contraband export trade. Although the problem has not been quantified, it is understood that illegal trade is rampant and claiming considerable tax revenue. All ERCA officials interviewed concede that illegal trade has created a significant leakage of tax revenue from the Ethiopian government.

This illegal trade involves various routes and mechanisms involving both imports and exports. Literarily, every border and port seems porous to illegal trade, which takes place through Somalia, Djibouti, Kenya and the Sudan. Illegal imports and exports even pass through the Bole Airport, the only international airport.

This illegal trade involves various mechanisms. Almost all types of exports, which include coffee (the major export item), other crops, and live animals, are illegally exported through the Somalia, Kenya, and Sudan borders. A feasible option for tackling this problem may be correcting the incentive system and putting in place a marketing structure that captures the needs of the people operating in such illegal exports of goods.

The other route is through Bole Airport where exporters manage to ship goods deceitfully, mainly perishable items like flowers and fruit. The government took measures to facilitate export of such perishable products by allowing exporters to bypass the checking system at the airport. Normally customs officers verify the type and quantity of goods and check documents, which may take several hours and the delay could affect the quality of perishable goods. However, some exporters are abusing the government's good will gesture. Customs officials complain that the declared quantity of exports is substantially less than the actual volume. The banking system does not capture the difference, leading to capital flight.

The other side of illegal trade is the import of goods, mainly electronics and medicines, through various corridors, mainly in the eastern part of the country bordering Somalia and Djibouti. In these border areas, it has been very difficult to control contraband trade as many people depend on it and regional governments recognize this. Thus, administrative control would not be effective. Rather diversifying the sources of livelihood of the people should be the strategic approach to curbing illegal trade and increasing government revenue in these contraband corridors.

These contraband goods are transported hundreds of kilometres, through different customs checking points and sold in the capital and other cities. This is only possible through fraud and corruption, which is the worst manifestation of institutional decadence.

Through the single international airport that accepts cargo, there is illicit import of various goods, usually electronics. Importers buy foreign exchange from both official and parallel markets and import more than indicated in their documentation. They pay taxes on the declared quantity and move it past customs through bribery or deceit. In some cases declared type of good is different from the actual imports. Business people declare goods with a low tax rate, but actually bring in high-value goods.

The extent of tax evasion problem is such that many business people have never submitted sales tax or VAT, which they collect from consumers on behalf of the government. In response to such practices, the tax administration introduced cash registers, although this in still in the trial stage, with low coverage.

In addition, many limited liability companies underreport taxable income to evade taxes on profits.

Weak organizational capacity of the tax administration: One fundamental reason for the high degree of tax evasion is the low organizational capacity of the tax collecting system. For example, until recently the administration did not have a database of taxpayers and the actual number of taxpayers was unknown.

A major issue, however, is the poor assessment capacity. Large numbers of taxpayers, who are sole proprietors — many family-managed enterprises with a small amount of capital — do not have accounting records of their business. Imposing taxes on such groups remains a daunting task, as it is difficult to determine their taxable income. Underestimating and overestimating taxable income are equally undesirable. Underestimates will reduce tax revenues, but overestimating taxable income may cause the business to fail. A regular comprehensive profitability study across the various sectors of the economy is needed, as the findings could be used to determine taxable income.

Even limited liability companies, which are expected to have a system of accounts and are required to present audited financial reports, have not developed this capacity. Tax officers and accountants say that these companies fabricate accounts to understate their taxable income. Despite the legal implications of liquidation, a number of businesses have been reporting losses for a number of years.

Moreover, the regulatory body has been oblivious to the fact that limited liability companies do not have standard accounting records. At the same time, auditing is also at an embryonic stage in terms of preparing financial reports for even large taxpayers.

In addition to these core weaknesses, tax administration has been operating as an office in the civil service with no autonomy on many fronts. Tax administration is characterized by low pay, low human resource development, low motivation, and, hence, high prevalence of corruption and little automation despite advances in information technology. With such weak tax administrative capacity, tax evasion is the rule rather than the exception, and foregone tax revenues are huge.

However, the damage to the Ethiopian economy extends beyond the huge financial loss to the government. There have been rewards or penalties for taxpayers and defaulters, respectively. Lawful and responsible taxpayers were outcompeted by non-taxpayers. Thus, survival instinct drives almost everyone in business to fraud and corruption, and unlawful, fraudulent, and corrupt practices have become self-reinforcing, crowding out legal business over time. These weaknesses have prevailed for a number of decades, and tax evasion and avoidance have been the culture in the country.

Scope of the ongoing Ethiopian tax reform: Transforming this culture of evasion and avoidance requires comprehensive and sustainable tax reform **to** ensure efficient and effective tax collection. Since 1992, Ethiopia has experienced several major economic reforms involving liberalization and privatization policies that included major changes in the tax rates, from highly progressive toward a moderate level that aimed at boosting investment in the country.

Apart from revising the tax rates downward in the early 1990s, various efforts have been made to increase the tax effort of the country. Pronounced changes have taken place since the early years of the 21st century. Following the Public Sector Reform Program (PSCAP) of 2005, tax reform has been undertaken throughout the country and is an ongoing project.

The thrust of the reform has been to create an efficient and effective tax collection system. It includes raising public awareness, identifying potential taxpayers, developing assessment capacity, enhancing the tax compliance system, business reengineering to improve administration, minimizing tax evasion and thereby increasing collection.

In 2008, the Ministry of Revenue, the Federal Inland Revenue Authority, and the Ethiopian Customs Authority were merged into the ERCA on July 2008. The ERCA is outside the civil service system and has the autonomy to discharge its major functions including the right to fire and hire its own employees. Moreover, it has introduced higher salaries to attract competent staff and to serve as a motivation not to become involved in corrupt behaviour. Every employee is expected to register his or her personal property as a precondition of employment — a further step to prevent corruption.

The assignment of tax identification numbers to every taxpayer over the last five years or so has been a major achievement for a country that had no knowledge of the number and nature of its taxpayers. To strengthen the identification system, biometric database on taxpayers is under development.

The ERCA is developing a computerized integrated taxation system to replace the age-old manual, inefficient, and unorganized tax accounting practices. This measure will enhance the tax assessment capacity of the ERCA — a critical institutional weaknesses. Specifically, the automation effort involves the development of a Standard Integrated Government Tax Administration System, which is tailored to process and store information about taxpayers, tax liability, and performance of taxpayers in terms of identifying filers, later filers and non-filers. This database is expected to make the tax collection system effective and efficient as well as fair. The other technological intervention is the development of an automated System for Customs Data Administration, meant to process customs data and services.

Moreover, the authority has started to introduce sales register machines on business firms. This initiative is meant to increase the effectiveness of the VAT. The machines transmit records of sales to the tax authority through a wireless connection. The integrated computerized tax system is critical in the areas of registration, assessment, accounting, debt management, auditing, and enforcement as well as tax monitoring and reporting.

To enhance tax revenues, a number of new taxes were introduced recently. For instance, taxes on service sales, rental income, and capital gains were introduced in 1990, 1993, and 1994, respectively. In 2003, the sales tax was replaced by the VAT to broaden the tax base.

Since 2002, the enforcement power of the ERCA has increased considerably. It has introduced a mechanism for voluntary compliance by taxpayers. Moreover, it has introduced a withholding tax to encourage voluntary compliance and gather information for compulsory compliance. The ERCA has acquired the legal power to foreclose on the property of defaulting taxpayers without having to seek an order from the courts. It has also strengthened its investigative and prosecutorial powers.

On the other hand, the ERCA has also been taking measures to improve taxpayer services, including opening a Large Taxpayers' Office, dedicated to providing services to large taxpayers.

For those who do not have account books, the ERCA is developing a standard assessment for various types of taxpayers. This requires continuous efforts to create and update the assessment database.

What should be done to increase the tax effort?

Creating a learning organization: The major challenge of the civil service system in general and the newly established ERCA in particular is how to develop a learning organization that has inherent capacity to create momentum for change. Institutional reform cannot be effectively implemented as a campaign-style change in a given period. Rather the organization must develop the autonomy and capacity to nurture a culture of initiative taking.

In sub-Saharan Africa, many tax reforms have been initiated from outside. For example, the Monterrey Consensus of 2002 recognized the importance of different sources of development finance, one of which was DRM. The Doha Declaration highlighted the need to make further progress in mobilizing all sources of development finance including domestic savings (Africa Partnership Forum 2009, p. 1). International financial institutions (IMF and the World Bank) have strongly advised many sub-Saharan African countries, including Ethiopia, to carry out tax reform.

Whether the impetus came from above or below, why did it take so long to initiate tax reform? The current government has ruled the country for nearly two decades; why did it not act sooner? The fact that the Ethiopian government, specifically the tax administration, did not take the initiative is a sign of institutional weakness that should be rectified. Clearly there has been institutional inertia for a long time. This must be recognized and measures must be taken to develop dynamic institutions in the country.

To ensure sustainable changes in tax administration, it is necessary to create a learning organization — an organization that has an inherent culture of sustaining change and the capacity to initiate, design, and implement changes. It is time to end the dichotomy between planning and implementation of reforms, where higher bodies plan and impose reform from above while the tax administration and its employees act as passive implementers. Rather, the authority and its employees should own the reform. Ownership should involve the freedom and capacity to initiate, design, plan, implement, and make adjustments to tax reform measures.

The ongoing tax reform process should be sustainable. This involves the creation of an organization that includes every stakeholder. The ERCA should develop the institutional capacity to understand and respond to the interests, problems, and concerns of its major stakeholders, including the government, taxpayers, and tax officers. Such capacity can lead to a system that meets the basic needs of all stakeholders and creates a culture of voluntary compliance.

The surest way to sustainable development of the tax collection system is for the ERCA to take the responsibility, acquire the authority, and develop the capacity to initiate, design, plan, implement, and adjust changes over time. Tax reform is not a fix-all formula that can be applied to eradicate all problems for all time. Once the current reform measures are successfully implemented, other problems will crop up in due course. The ERCA should be able to deal with new problems and cope with developments in and outside the country. Thus, tax reform is nothing but a learning process that is highly participatory and uses a well-established institutional mechanism to accommodate the interests, constraints, and concerns of all stakeholders. The ideals of developing a tax system that is fair, efficient, and effective and with a broader tax base, diversified tax mix, capturing the informal sector are basically the objectives of such a learning organization.

In the global experiences of tax reform, there have been both success and failures. The main factor that determines success is will and commitment of policymakers. Failure also occurs when reforms aim at certain tasks, without regard to sustainability. Another factor is the relative strength of vested interest groups, who prefer to maintain the status quo, manifested by undue interference by higher officials in the affairs of the tax administration and defence of tax defaulters.

A dynamic institution may be able to eradicate or at least substantially reduce tax evasion and avoidance in Ethiopia. It can create a voluntary tax compliance culture, where paying taxes is a matter of national pride.

Enhancing tax compliance: Tax compliance hinges on the rules that define the incentives and motivations of all those involved in the system: taxpayers, tax and customs officers, and the government. The critical elements that define the rules of the game include the motivation and competence of the workforce of the tax authority, the motivation, incentives, and organizational capacity of the taxpayer, as well as the system of accountability in the tax collection system.

Taxpayers' prime interests hinge on tax rates, service delivery by the administration, and the culture of compliance in the country. The first thing to do is sustain and strengthen the existing system to promote voluntary compliance, through education, improving the bureaucracy process reengineering and have administrative facilities to encourage voluntary compliance.

The Ethiopian government should consider reducing the high prevailing tax and tariff rates. This would substantially reduce tax evasion and avoidance, which would increase tax revenues. Simultaneous development of an effective enforcement mechanism might create a strong incentive to pay taxes and the increase would likely make up for the reduction in rates. The authority may also need to revise the list of dedutible business expenses.

If tariffs and tax rates are sufficiently reduced, there will be no strong reason for the Ethiopian government to continue with the existing tax incentives, which have resulted in huge forgone tax revenues and encouraged tax evasion, corruption, and fraud.

Another element that affects taxpayer compliance is the tax administration system with its hurdles, red tape, and bribery. Reengineering must make tax payment easier.

However, prompt and efficient service is critically dependent on the motivation and competence of the workforce. At the centre of creating a learning organization is the competence and motivation of the ERCA's workforce. This requires understanding and appreciating the fact that the employees of the ERCA are indeed one of the major direct stakeholders. In this regard the fact that the authority has become autonomous to fire and hire its employees is commendable. It is a big achievement the fact that the authority has acquired higher salary scale, which could attract more competent professionals. One agent of corruption, inefficiency, and hence tax evasion is the workforce of the tax administration of the country. One of the main drivers of tax corruption includes low pay, and the quick get-rich ambitions. If remunerations are comparable to the wages for a similar job in the private sector, tax officers may not take the risk of engaging in corruption. On the other hand, if their salaries and wages of tax and customs officers are too low to support themselves and their dependents, the incentives for corruption arise.

However, a fixed salary increment might not take the authority too far. There are good arguments for developing performance-based management system. That is more likely to be inherently dynamic. This, however, is easier said than done. It requires strong performance data, which can help to measure the contributions of each organizational unit and individual employees of the organization. Moreover, non-monetary motivation instruments may be considered to transform the attitude towards public service. Public service requires its own culture, one that respects and rewards the profession. The non-monetary motivation instruments may include giving national awards to tax heroes, tax and customs officers who provided public services without any involvement in corrupted practices.

Moreover, the authority has to develop its own human resource to ensure the availability of the required competence in different disciplines. In a country, where there has not been a dedicated higher learning institution (except the recent commencement by the Ethiopian Civil Service College) the supply of tax officers is quite limited. In such a situation, the authority has to develop its own people.

Thus, competent and motivated staff with a culture of creativity and initiative-taking will serve as a critical resource for the development of a learning organization.

Due to evasive and corrupted culture in the country, involuntary compliance should remain a critical strategy in the short- and medium runs. Tax evasion and avoidance, corruption and fraud have remained the culture in the country for long period.

Transforming such a culture is challenging. It requires changing the motivations, incentives and mindset of all agents in the system. Such transformation is time taking and challenging, calling for unwavering commitment of the government. The major risk area that may compromise the sustainability of the ongoing tax reform is unduly political intervention in the daily operation of the authority.

The tax enforcing capacity may include strengthening of the tax assessment, auditing, and implementation capacity, as well as controlling contraband of the authority.

Thus, the system of accountability of the country in general and the authority in particular, should be further strengthened to ensure complete tax compliance. Both the institutionalized stick and the carrot determine the motivation to default and evade the tax system of the country.

From the present section, one observes the fact that the tax effort of the country is low and declining. Understandably, there are structural constraints that have constrained the tax base of the country. Yet, within such constraints, the country is collecting substantially below its potential, because of high tax evasion and avoidance, which are essentially institutional.

There is an ongoing tax reform in the country, which aims at addressing the major institutional capacity problems of the tax collection system of the country. The first direction into the future is to create a learning organization to ensure sustainability of the reform. The authority should take the responsibility, acquire the autonomy and develop the capacity to initiate, design, plan, implement, learn and adjust its plans. Such a learning organization can sustain the tax reform and achieve the core objectives of developing a fair, efficient and effective tax collection system.

The other strategy is to ensure tax compliance in the country, which involves both voluntary and involuntary institutional mechanisms. There are direct and principal stakeholders to low tax compliance and hence evasion and avoidance. These are the taxpayer and the workforce of the authority. The direction should then be to develop an institutional mechanism that entertains the concerns and interests of all stakeholders. In case of conflict of interests, there is wider space for reaching a negotiated settlement, within the premises of the legal system of the country.

Promoting voluntary compliance involves a number of factors. The prime factor is to decrease the existing tax and tariff rates such that it minimizes the incentive to evade and avoid. If tax and tariff rates are sufficiently reduced then there will not be a need to have tax incentives. The extent of the formally foregone tax is substantial to attract policy attention. Moreover, these incentives have become fertile grounds for evasion, fraud and corruption in the country.

The other element is the competence and motivation of the workforce of the authority. Improved salary scale and the autonomy of the authority to hire and fire its own employees is an encouraging development. However, much remains to be done to develop the competence of its staff and introduce performance-based remuneration system in the country, which is a critical resource for creating a learning organization and the success of the ongoing business process reengineering.

The other side of the coin is to strengthen the tax enforcement system of the country to strengthen the incentive to voluntary compliance and hold accountable of everyone involved in violating the tax law of the country in whatever form.

The critical resource is unwavering political will and commitment to develop a learning organization, which may be expressed in terms of budget allocation and guarantee and strengthen the real autonomy of the authority. The danger is unduly political interference in the reform process.

In this regard, the donor community could be of help in developing institutional capacity of the tax collection system, the focal being the ERCA.

Pensions

Pensions constitute one of the nontax revenue in the country, which accounts about one third of the domestic revenue of the country. So giving due attention to such source of revenue is advisable in enhancing DRM of the country. Pensions are one of the nontax revenues that have been showing visible growth in Ethiopia. Moreover, there is quite large potential to develop pensions as one element of public saving.

The basic question is how to enhance it and ensure its efficient allocation to boost investment.

With developments over time, the proportion of the aged population is more likely to increase into the future. Unless social security is established, what will happen to those who are disabled to work and hence earn income? Inability to work and earn income to support oneself is and should be a social problem that calls for policy attention.

Different countries have adopted different pension systems.[3] Those East Asian countries, who have taken off the development ladder, have treated pension contribution as instruments of national saving in their respective economies. As a result these countries have set high contribution rates (up to 50 percent of salaries in Singapore and 28 percent in Malaysia) and the fact that the savings covered not just retirement but other purposes as well, such as providing the down payment for housing (Stiglitz and Uy, 1996: 251).

For Ethiopia there are concerns and possibilities for an increase of pension funds. One concern is the fact that the Ethiopian pension system has partial coverage. It does not cover the private sector, which has not yet introduced it as a system. So the suggestion is for introducing mandatory pension system in the private and NGO sectors.

The current civil service's pension is based on employee contribution of 4 per cent and government contribution of 6 per cent. One direction is to improve the pension rate from this low rate of 10 per cent.

Despite the lower pension rate and partial coverage, pension has increased from the order of about ETB 11 million during 1979–80 to about 1.6 billion in 2007–08. The annual average growth rate for the period 1979–80-2007–08 was about 23 per cent. For the period 1979–80-1991–92 the average annual growth rate was about 8 per cent while for the period 1992–93-2007–08 the average growth rate was about 35 per cent.

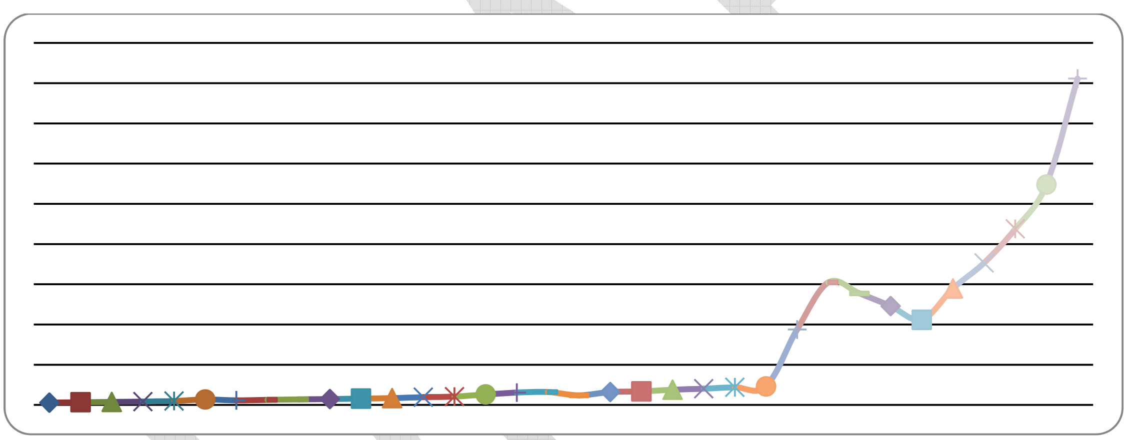
Table 7: Average growth rates of pensions for different periods

	1979–80-2007–08	1979–80-1991–92	1992–93-2007–08
Average growth rate of pensions	23.15	8.29	35.22

Source: MoFED

The contribution rates of 10 per cent remained unchanged for the last four decades or so. The rapid growth after 1992 and particularly the recent jump may be attributed to an increase in the size of the civil servants of the country. The federal arrangement has created regional government structures, which have more or less the same government structure like the federal government. Following this, district level decentralization has taken place in the country. These developments should have contributed to an increase of the size of the civil servants of the country.

Figure 7: Pension contributions (ETB millions, 1974–75-2007–08)



Source: MoFED

Another reason for the jump of pension funds during the period 1998–99 and 2002–03 is an increment in salary of the civil servant. Moreover, the contribution of the government of 6 per cent was not reported as pension funds in the past. So when the contribution of government started to be reported, the pension curve has shown sharp shot.

Another area of concern is the management of pension funds. Whatever pension fund is collected, it has to be properly managed so as to earn and contribute to the national pension fund. In Ethiopia, up to the recent five or so years, pension funds were being held idle in the hands of the government. At best the government was using it to supplement its recurrent expenditures.

Since the last five years or so, pension funds are being autonomously managed by a government agency, which can invest it in sectors believed to be safe and paying. So far the only feasible option available to invest the pension funds is government treasury bills, which however, are secured but low-paying options. The government has been issuing treasury bills to supplement its recurrent budget deficit at very cheaper price. The fact that there are no well developed bonds, stocks and secondary markets has constrained the utilization of pension funds.

Remittances

In this period of globalization, labor mobility is increasing. This may indicate the fact that international immigration will further increase into the future.

The literature recognizes both push and pull factors as the underlying causes for international immigration. Countries have different immigration policies to attract different types of labor, skilled and unskilled labor. There are wider opportunities for immigration from low-income countries like Ethiopia to different high- and medium-income countries. On the other side of the labor mobility, there are a number of push factors on the part of low-income countries, including Ethiopia. Looking for better life, quite large Ethiopians have been migrating to different countries. Massive poverty, narrow employment opportunities, low payment, frequent famines, civil and inter-border conflicts, political problems, search for better services (education, health) have been the major reasons for immigration of many Ethiopians to the rest of the world. The relative importance of each causal factor may change over time. For instance, during the dictatorial military regime that ruled the country for the period 1974-1991, political immigrants were one of the largest numbers of African refugees (Regt de Marina 2007, p. 6). The immigration of recent years is largely explained by economic factors.

Different segments of the Ethiopian society have been targeting different destinations. The educated have been targeting to North America, Europe and Australia. On the other hand, less-skilled Ethiopian young females were trafficking to the Middle East, Saudi Arabia, Gulf States, Lebanon and Yemen, most often taking low-pay domestic employments.

Though there is paucity of data, international immigration is largely a recent experience for Ethiopians. Large Ethiopians were forced to leave the country since the end o the 1970s owing to massive killings under the officially declared red terror, when large numbers of young scholars were murdered without due process of law.

Table 8: International immigration

Country/region	Stock of Immigrants (000)			
	1960	**1990**	**2005**	**2010**
Ethiopia	393.3	1155.4	554	548
Africa	9,176	15,958	17,679	19,191
Low human development(HD) countries	4,266	8,928	8,468	8,812
World	77,115	155,518	195,245	213,944
Ethiopia share of Africa in %	4.29	7.24	3.13	2.86
Ethiopia's share of Low HD countries in %	9.22	12.94	6.54	6.22

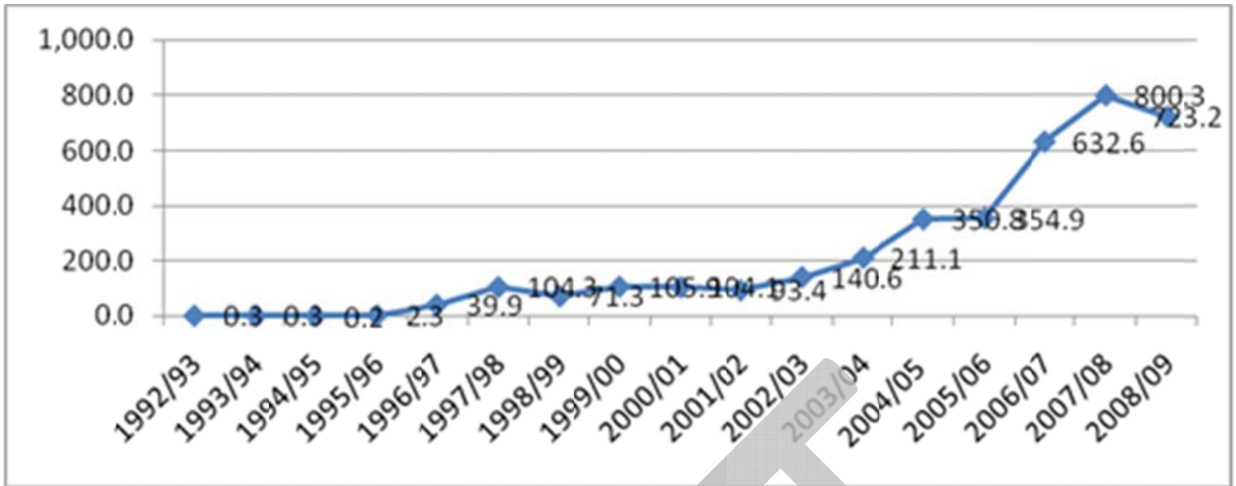
Source: HDR 2009, p. 146.

In the 1960s, the size of Ethiopian immigrants was less than 400,000, which has increased to about 1.1 million in the 1990s. The figure reduced to nearly half a million in 2005 and remained stable at that level on 2010. The share of Ethiopian immigrants from the total African immigrants was about 4 per cent in the 1960s, which increased to more than 7 per cent. From then, the share of Ethiopian immigrants has declined to less than 3 per cent in 2010.

The Ethiopian Diaspora is largely a first generation immigrant. This has implication on the flow of remittances. First generation immigrants retain fresh memory of their home country. There is intimate relationship with family members, relatives, friends etc. This social attachment with the people at home and the childhood memory will remain natural inclination to support families and invest in birth-country Ethiopia. So utmost effort should be done to facilitate and effectively mobilize this source of finance as one source for financial resources.

As can be seen from the following figure, remittance has been growing from the order of US$ 0.3 million in 1992–93 to about US$ 800 million in 2007–08, which has declined to $723 million in 2008–09, probably due to the global economic crisis.

Figure 8: Amount of Remittance Inflow to Ethiopia (In Millions USD)



Source: NBE

If remittance is such an important source of resources to the Ethiopian economy, what should be done to enhance its inflow and utilization?

It is commendable that the Ethiopian investment code provides equal treatment of the Ethiopian Diaspora as resident citizens of the country. This is believed to stimulate the Diaspora to invest at their birth country.

Moreover, the central bank of the country (NBE) has permitted for remittance accounts in foreign currency in Ethiopia. This facilitates holding and saving remittance in foreign currency.

The fact that the financial sector is nascent may narrow down the scope for investing in different sectors of the economy. Strengthening the financial sector infrastructure may further encourage more remittance inflows and their efficient allocation. The infancy of the financial sector may remain a serious limitation in the near future in ensuring efficient allocation of remittances in Ethiopia. The financial sector should make continual endeavor to improve the relevance and quality of its services to attract more inflow of remittance to the country. Moreover, utmost effort should be exerted to encourage investment of the remitted funds.

The overall direction should be towards positively managing immigration and ensuring quite responsive financial and investment system that adjusts with time to address timely problems of the Diaspora.

Capital Flight

Another potential source of mobilizing domestic resource, which can enhance domestic saving is stemming and reversing capital flight. Economic development is nothing but a process of investing, generating surplus and reinvesting that surplus for further improvement, expansion or new investment. If for whatever reason there is capital leakage, such a leakage is a complete loss with severe repercussions on a given economy.

But, what is the significance of capital flight as a problem of low-income countries like Ethiopia? A recent study has come up with new evidence that shows the fact that Africa is a "net creditor" to the rest of the world. For the period 1970-2004, the study has estimated the size of capital flight for a sample of 40 sub-Saharan African countries of which Ethiopia is one. The finding of the study shows the fact that "real capital flight amounted to $420 Billion (in 2004 dollars). Including imputed interest, the stock of capital flight for this group of countries reached a staggering $607 Billion dollars in 2004. The size of capital flight of these countries exceeds their combined external debt by $398 Billion. This excess capital outflow makes Africa a "net creditor" to the rest of the world" (Ndikumana and Boyce 2008, p. 35).

Specifically, for Ethiopia, the study has estimated the fact that the real capital flight for Ethiopia was about 17 Billion USA dollars, while the stock of capital flight as of 2004 was about 23 Billion dollars. The net foreign assets, which is the difference between outflow and inflow for the year 2004 was about 16 Billion dollars. Taking the capital/GDP ratio, it constitutes 175 per cent (Ndikumana and Boyce, 2008:41).

Indeed, African leaders have recognized the very severity of the problem. The Joint Conference of African Ministers of Finance and Economic Development and Planning, in its twenty-fourth meeting on, 6 - 8 May 1999, convened in Addis Ababa, Ethiopia, has acknowledged the fact that capital flight is one of the major development bottlenecks of Africa. The meeting recognized the fact that stemming and reversal of capital flight could significantly contribute to DRM for sustainable socio-economic development of the continent.

The largest channel for capital flight is trade faking, which involves different forms of over- or under-invoicing of exports and/or imports of a country, use of fake transactions and other transfer mechanisms. Many Ethiopian and non-Ethiopian wealthy individuals take advantage of institutional loopholes, to evade the legal system and misappropriate the scarce financial resources of the country.

One mechanism, which has been leading to capital flight, is the fact that there have been under invoicing practices by exporters. The declared prices (prices indicated in the Letter of Credit (L/C) are lower than the actual market prices of goods. Moreover, the declared quantity is less than the actual exported quantity, evading the legal system. Customs officials believe that this is a significant problem in the export of horticulture products, though there has not been figurative data to verify these claims.

The underlying causes could be overvalued exchange rate or high import duties or otherwise. In addition to addressing these underlying causes, governments should establish or strengthen required organizational capacity to minimize capital flight.

One manifestation of capital flight is corruption, which has earned an official recognition in the country. Yet beyond establishing anti-corruption organization, it requires more commitment in addressing the underlying factors for corruption, which are related with weak institutional capacity to ensure accountability of every citizen including officials.

Policy implications of the review on capital flight suggest that one of the preconditions for controlling or minimizing the capital flight is establishing stable macroeconomic environment. This may involve avoiding an overvalued exchange rate, and free access to foreign exchange. This is easier said than done, for countries like Ethiopia, which have severe foreign exchange constraint that has made rationing compulsory.

One of the factors believed to contribute to capital flight is the weak financial sector. Repressive financial system is believed to contribute to capital flight. The development of financial sector, facilitation of investment in the country will contribute to minimize capital flight.

Yet, establishing or strengthening the required institutions of surveillance, monitoring and system of accountability comes as priority intervention area to manage and minimize capital flight.

In this regard, donors can play a critical role to mitigate or avoid capital flight. Usually capital flies to or through the financial institutions of developed countries. If there is will and real commitment on the part of the donor's community, they have the necessary institutional capacity to identify, mitigate or avoid illegal outflow of resources from low-income countries like Ethiopia.

3. Depth and Structure of the Ethiopian Financial Sector and the Implications for DRM

One venue of improving DRM is private saving, which is channelled through the financial sector. The development of the financial sector plays a critical role in the mobilization and allocation of private saving.

Sustainable socio-economic development requires the development of an efficient and well-developed financial sector.[4] The major functions of the financial sector include a number of services. In order to facilitate the exchange of goods and services, the sector serves as a payment mechanism. It further mobilizes saving and channel them to investment, providing such an intermediary role between lenders and borrowers. A full-fledged financial sector is one of the core market institutions that ensure the supply of long-term capital to the economy. Furthermore, in allocating financial resources, it diversifies risks of investment.

In fact, a well-matured financial sector provides a variety of financial instruments. On the one hand, it offers different rates of return, risk, and maturities to savers and on the other, it provides alternative sources of finance at varying interest rates and maturities to investors. Financial sector development is, therefore, the development of different financial institutions including commercial banks, development banks, saving and loan associations, credit unions, insurance companies, mutual funds, pension funds, which intermediate between lenders(savers) and borrowers (investors) with well nurtured financial markets including loans, bonds, equity, asset-backed primary markets and secondary derivative markets (Chami et al. 2009, p. 4).

The purpose of the present section is to assess the development of the financial sector in view of its capacity to provide the major financial services to the Ethiopian economy. Specifically, this section analyses the nascent Ethiopian financial sector in terms of the range, depth and outreach of services being provided to the national economy. The focus of the analysis is on the depository banking sector of the country with the sole purpose to understand the effort to mobilize and allocate private saving in the Ethiopian economy.

Outreach of the Ethiopian Financial Sector and Its Structure

Given the above background, the present subsection assesses the level of outreach of the sector in the Ethiopian economy and society, focusing on the development of the formal financial sector, which covers the banking, non-banking and related others. At present, the major financial institutions operating in Ethiopia are banks, insurance companies and microfinance institutions (MFIs). In addition, there will be a brief review of the informal financial sector of the Ethiopia economy.

The Banking Sector

Despite a long history of money use in Ethiopia, and a history of a century of modern banking, the financial sector in general and the banking industry in particular remain nascent. While, the history of modern money dates back to more than 2000 years, the first modern bank was established in 1905. Apart from the banks that were short lived during the Italian five year invasion, a number of banks and the Central Bank of the country were established during the 1960s[5] (Gedey 1990). Before the 1974 military takeover of power, there were domestic, foreign and jointly owned banks in the country.

In 1975, all financial institutions, the banks and insurance companies, were nationalized, following the socialist ideology of the then military government. In addition, the major means of production of the country, land, all manufacturing enterprises were nationalized. In fact, the role and significance of the private sector, the type and extent of private involvement, were delimited. It put a ceiling of ETB 200,000 (USD 96,000 at the time) for retail establishments, ETB 300,000 for wholesale establishments and ETB 500,000 (raised to one million in 1985) for industry. During this period of military rule (1975-1991), all formal financial institutions were state owned, and the investment and hence new entry and operations were state-controlled. Moreover, financial prices were controlled by the state (Gebrehiwot 1997, p. 55).

After 1992, Ethiopia has undertaken financial reforms, which include elimination of credit discrimination, interest rate liberalization, reduction of government control and introduction of market-based business operation management (Gebrehiwot, 1997:64).

Currently, the Ethiopian banking sector involves, the central bank, both state and privately owned commercial banks, one development bank (of course state owned) and another mortgage bank, entirely locally owned companies. So far there are no foreign owned banks in the country.

One of the outcomes of the financial reform is its opening up to the private sector. Following, the Monetary and Banking Proclamation No. 83/1994 and the Licensing and Supervision of Banking Business No. 84/1994, a number of commercial banks and insurance companies were established since 1994. In fact, nearly after four decades or so, the first private commercial bank was established in 1995. Since then ten private commercial banks are established. As of 2009, there are three state-owned and ten private banks in the country, all of which are locally owned. There are few more under establishment. There are predictions that the number of commercial banks could reach about 20 in the next 3-5 years.

One of the state owned banks is the Development Bank of Ethiopia with the primary objective of financing investment in different sectors of the economy. The mission of this bank is to excel in project financing, which involves mobilization of resources from different sources and channel them to medium and long-term investment credits. The major sources of funds are deposits (time and demand) contributing to about 25 per cent, inter-bank loans holding another 25 per cent and equity is represented by 50 per cent. In addition, the bank looks for donor support to promote its ideals.

In total, for all the 13 banks there are 596 branches in different parts of the country. Out of these branches, 232 of them, constituting about 39 per cent are located in the capital city of the country, which is also the largest economic and business center in the country. The rest 364 branches (constituting about 61 per cent) are established in different parts of the country, concentrating in major urban centers. For a population of nearly 75 million, there are less than 600 branches, which is about 1 branch for about 125,000 persons. These branches are concentrated in major urban centers, mainly regional cities and some relatively bigger towns. Taking the urban population of about 12 million (as of 2007), one branch serves about 20,000 persons in urban centers. So far there has not been any branch operating in the rural side of the country. This shows the fact that Ethiopia indeed, is under-banked country with limited outreach.

Table 9: Number of Bank Branches and Capital as of the 2nd quarter of 2008–09

Banks/insurance	No. of banks/ insurance	No. of branches				Capital	
		Regional urban centres	Addis Ababa	Total no. of branches	% share from total	(ETB million)	Share of capital from total
State owned commercial and development and mortgage bank	3	206	62	268	44.97	6,699	63.8
Private commercial banks	10	158	170	328	55.03	3,803	36.2
Grand banking sector	13	364	232	596	100	10,502	100
Public insurance	1	27	11	38	21.5	238.8	39.1
Private insurance	10	59	80	139	78.5	371.5	60.9
Total insurance	11	86	91	177	100	610.3	100

Source: NBE 2009.

One may observe that the Ethiopian banking industry is underfinanced itself with a total capital of ETB 10.5 billion (<USD 800 million at the time). This constrains the size of credit available to the Ethiopian economy. It can only finance very few large investment worth of hundreds of millions. The banking sector cannot finance major physical infrastructural works, like hydroelectric power stations and other infrastructural works that require multi-million investment costs. In fact, the researcher is aware of the fact that before ten years or so, one of the challenges of an already established cement project was the fact that there was no bank, which had the capacity to finance the project. So the few banks, specifically the largest state owned commercial bank and the development bank had to create a consortium to finance a cement project worth of about US$ one Billion.

Moreover, it is highly concentrated in one state owned commercial bank, which owns 43.4 per cent of the total capital. In general, the three government banks hold about 64 per cent of the total capital. The size of capital of the remaining ten private commercial banks is about ETB 3.8 billion (USD 285 million), with an average of ETB 380 million (about USD 28 million). As of this year, the size of capital of the private banks ranges from ETB 95 million to 676 million (USD 7–50 million). The share of the largest bank (in terms of capital ownership) is only 6.4 per cent of the total. This implies that none of the private banks has the capacity to finance large investment worth of a Billion dollars.

In terms of number of branches, similar market structure is observed. Out of the total bank branches of 596, the state owned and largest commercial bank owns 209 branches across the country, which is about 35 per cent of the total. The state owned banks as a group own about 45 per cent of the branches. The private sector owns the remaining 55 per cent of the branches in the country. The highest share of branches from the privately owned banks is only about 10 per cent with 58 branches, followed by the next largest number of branches of 51 branches. A newly established bank has started with only branch in the capital city recently during 2008–09.

Non-bank Financial Institutions: Insurance and MFIs

Often significant saving and financing through non-bank forms are indicators of financial diversity because bank deposits and loans constitute the traditional forms of savings and credit in many countries.

Non-bank financial institutions (NBFIs) directly or indirectly enhance the mobilization of savings. They directly provide alternative saving and investment options. Moreover, the synergy effect of all banking and NBFIs is believed to be larger than the isolated development of each financial market.

The NBFIs include different financial institutions including insurance and finance companies, investment banks, pension and mutual funds.

In Ethiopia, the NBFIs include insurance companies and MFIs. The lack of diversification of the NBFIs is another indicator of the infancy of the financial sector of the country.

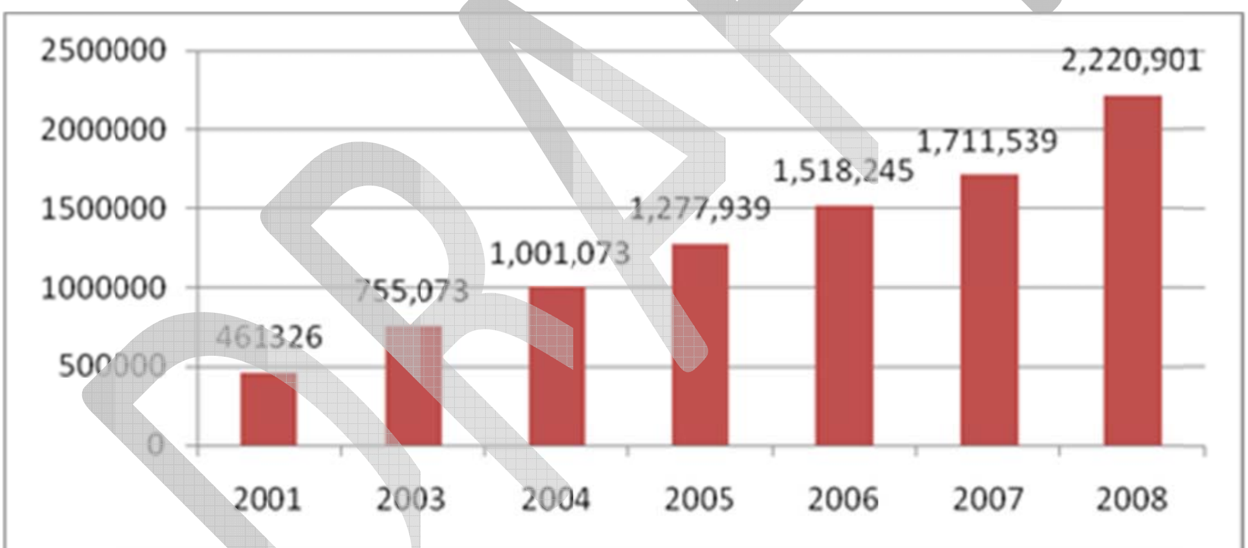
Similar to the banking sector, the insurance industry too is nascent with only 11 locally owned companies having 177 branches across the country, with a total capital of ETB 610.3 million. Private insurance companies accounted for the lion's share (78.5 percent) of the total branches. Of the total branches of insurance companies, 51.4 percent were situated in Addis Ababa. During the central command economic management system, there was only one state-owned insurance company. After the financial reform of the early 1990s, 10 privately owned insurance companies have emerged in the Ethiopian financial market. In terms of outreach, one branch insurance company in the country serves almost 441,807 people, showing the extent of infancy of the industry in Ethiopia. (NBE 2009, p. 28).

The other type of NBFI is MFIs. One of the structural challenges of the financial system of low-income countries like Ethiopia is the fact that the rural societies has remained out of the reach of financial system. Specifically, rural Ethiopia, which employees more than 80 per cent of the population has remained for long unbanked. To alleviate this problem, MFIs are being promoted in many countries, with mixed performance stories.

In a relatively short period, since 1994–95, the number of MFIs has reached 28. For all the MFIs, as of the second quarter of 2008–09 (December 2008), the size of savings and disbursed loans were ETB 1.8 and 8.3 billion, respectively. The average size of savings and disbursed loan size were less than USD 40 and USD 400, respectively. The total asset of the industry was ETB 5.5 billion, which is composed of ETB 4.06 billion liability and ETB 1.401 billion capital (NBE 2009).

The size of outreach has been increasing rapidly from year to year, since 2001. It was less than half of a million in 2001, and exceeded a million in 2004 and reached nearly 2.3 million in 2008.

Figure 9: Number of loan clients of MFIs in Ethiopia



Source: NBE, and Wolday 2006, p. 29

Though the growth of the number of MFIs and their number of clients could be impressive, the outreach remains marginal in terms of the magnitude of the needy population.

Similar to the banking and insurance industries, the top five large MFIs, which are directly or indirectly affiliated to regional governments, accounted for 84.7 percent of the total capital, 93.0 percent of the savings, 90.7 percent of credit, and 90.9 percent of the total assets of the MFIs operating in the country. Obviously, the rest MFIs are either small or medium size. Seven of these 28 MFIs may be categorized as medium, while the rest are classified as small (NBE 2009, p. 28).

The nominal lending interest in Ethiopia falls in the range of 9 per cent to 24 per cent per annum, which is claimed to be one of the lowest rates in sub-Saharan Africa (Wolday 2006, p. 29), but definitely higher than the lending rate of commercial banking in the country. The major justification for high lending rate is the very significant transaction cost of the financial transactions of MFIs in the country. However, whatever the underlying cause, the lending rate seems to defeat the purpose of contributing to poverty alleviation. The poor is paying quite high interest rate, which indicates the gravity of the problem of lack of access to finance of the poor. The question is, what sort of business is there for both the rural and urban Ethiopian poor that makes such lending rate feasible for the poor.

The critical problems of the sector are its limited outreach and sustainability. An institution to be self-sustaining should be able to generate sufficient finance from its operation. At least, it should be able to finance its operation, which implies that the MFIs should be profitable. Information asymmetry (hence moral hazard and default rate), indebtedness of the borrower, high cost of operation (attributed to high transaction cost), low-income and hence low saving, and vulnerability of the borrower to different shocks all contribute negatively to the sustainability of MFIs in Ethiopia.

In general, the financial sector is at its infancy, with low institutional capacity. For instance, one of the bottlenecks of the Ethiopian financial market is lack of credit information system, where banks could consult in deciding to whom to lend.

Genesis of the Capital Market in Ethiopia

One of the indicators of the maturity of the financial sector could be the state of development of the capital market. Capital market has a critical role in mobilizing and channeling long-term capital to the economy.

So far there has not been any capital market[6] in the country. Thus, essentially, it is the task into the future. According to the IMF classification, Ethiopia is one of the 31 financially developing countries in sub-Saharan Africa, with only treasury bills. Unlike many others, Ethiopia has not yet developed treasury bond market, corporate bond and equity markets and their secondary markets.

Figure 10: Level of development of capital markets in sub-Saharan Africa and Ethiopia's position

Degree of Development of Capital Market in sub-Saharan Africa	No. of sub-Saharan African countries	Financially developing countries	Frontier market countries	Emerging market countries
1. no capital markets at all	13	13	0	0
1. Treasury bill market only	9	9	0	0
2. Treasury bill and treasury bond markets	5	4	1	
3. treasury bill and bond markets, and corporate bond or equity markets	7	4	3	0
4. All four markets,	10	1	8	1

Source: IMF 2009a, p. 59.

As can be read from the table above, there are 22 sub-Saharan African countries, which have developed/at least introduced some or all of the treasury bill, treasury bond, bond, corporate (equity) markets, while Ethiopia is among the 9 countries, which has introduced only treasury bill market.

For Ethiopia, therefore, the only experience which might be considered as an element in the capital market is the treasury bills auction by the government. This is essentially a money market meant to siphon of money from the economy, which is a short-term investment. The Government issues treasury bills for its money market operations. "A Treasury bills market, in which bills are auctioned fortnightly, is the only regular market where securities are transacted. Government bonds are occasionally issued to finance government expenditures and/or to absorb excess liquidity in the banking system". (NBE 2007, p. 44) There is no secondary market for these treasury bills, limiting their impact, which has constrained the significance and impact of these financial instruments.

Table 10: Results of Treasury Bills Auction

Particulars	2007–08	2008–09	
	Qtr II	Qtr I	Qtr II
Number of bidders	52	71	74
Public	38	49	54
Private	14	22	20
Number of bids accepted	60	81	84
Public	38	55	60
Private	22	26	24
Amount Supplied (ETB million)	18,087.00	7,622.00	7,657.00
28-day bill	6,500.00	1,305.00	960.00
91-day bill	6,774.00	3,885.00	4,031.00
182-day bill	4,813.00	2,432.00	2,666.00

Source: NBE quarterly report, 2008–09

As can be observed from the table above, it has been a primary market involving only small players, not exceeding 75 in the second quarter of 2008–09. Since there are no secondary markets, the impact of treasury bills was limited to the size and structure of the treasury bills. The treasury bills involve short-term transactions involving 28-day, 91-day and 182-day bills.

One of the major reasons for low participation rate in the market for treasury bills was the low interest earning. Since 2004–05, the nominal average yield rate was less than 1 per cent. In fact, it was 0.133, 0.039, 0.495 and 0.673, in the years since 2004–05, respectively. For the period before 2004, the yield rate was in the range of 1-2 per cent. Thus, the market for treasury bills remained thin throughout.

Another indicator of the low level of development of the Ethiopian banking industry and which may be promoted to contribute to the development of a capital market is inter-bank money market, which has remained at quite low level for long period. The number of inter-bank transactions has been very few in number involving only small size of money. For instance, during 2006–07 only five inter-bank transactions were effected in the entire year.

In a decade, up to June 2007, and since the introduction of the inter-bank money market in September 1998, merely seventeen transactions worth of ETB 259 million (USD 19.3 million) were transacted with interest rates ranging between 7 and 8 percent. This means less than two transactions per year, involving about ETB 25 million (USD 1.9 million) per year only. Subsequently, "during the year 2007–08, only four inter-bank money market transactions were undertaken involving less than ETB 200,000**.** No inter-bank money market transaction was conducted in the first and second quarters of 2008–09. The maturity period of these loans widely spanned from overnight to 5 years. Persistent excess reserves in the banking system and lack of collateral in the case of private banks have mainly contributed to the poor performance of the inter-bank money market in Ethiopia" (NBE 2007, p. 46).

The genesis of stock market appears to evolve over the recent years, though not officially decreed. A number of individual initiatives are going on to raise capital to finance certain investments in the country by issuing stock certificates. A number of promoters are indeed selling shares to invest on different industries, such as cement, sugar, agriculture based-projects, real estate, transport and others. Thus, primary stock markets appear to evolve in the country.

One of the missing market agents is the "liquidity providers", which provides secondary markets for the government bonds and the evolving stock markets. It seems that the number of lenders and borrowers is increasing over time. The agents and brokers, who are known in the literature as "liquidity providers" are lagging behind the bond and stock markets. As a result, the evolving bond and stock markets are simple "buy and hold" markets. There is no trading in the bonds and stocks and there are no such intermediary agents to facilitate the trading of such financial instruments (Chami et al. 2009, p. 10).

The Informal Financial Sector

Markets have evolved from personal exchanges to impersonal exchanges. It appears that the Ethiopian financial sector has not finished its evolution from personal to impersonal exchanges. There are large segment of the economy, which relies on informal financial institutions. These financial markets address the demand and needs of a specific community, specializing in small but with short-term transactions (Nissanke and Aryeetey 2006, p. 7).

For Ethiopia, there has not been formal research (at least to the knowledge of the author) that could help to determine the relative significance of the informal financial sector. Yet, there are studies and observations that indicate the fact that the informal sector may exceed the formal sector in terms of coverage, influence and even the total value of transactions (Nissanke and Aryeetey 2006, p. 7).

In this regard, the United Nations Conference on Trade and Development states:

> *"Officially recorded rates of savings do not measure the full extent of potential resources that could be mobilized in African countries. Indeed, savings in the formal*

> *financial sector represent only a small fraction of the total. Most savings are held either in non-financial assets or in the informal financial sector. Indeed, studies suggest that non-financial assets represent around 80 per cent of all household assets in rural areas. These modes of saving outside the formal financial system are much less amenable to accurate capture by national statistics."* (UNCTAD 2008, p. 7)

The demand for credit is complex involving different economic agents. These heterogeneous economic agents have different capacity and access to different types of credit. There is a sector, which relies on the formal sector. This sector is legible for formal credit, because it can afford to present acceptable collateral to the formal financial sector.

On the other hand, there is good size of the financial market that is being served by the informal financial sector, which covers the financing need that is not met by the modern banking industry and micro financing industry.

Typical income group that has remained marginalized from the formal financial sector is the poor, both rural and urban poor. Let alone for the rural poor, the rural rich does not have physical access to formal banks and non-banking institutions. In Ethiopia, the formal financial sector has been confined to major urban centers. To address the financing needs of these inaccessible groups, MFIs have emerged since 1994, but definitely remotely distant to satisfy the needs of the Ethiopian rural poor.

Quite large number of the Ethiopian population, who do not have access to formal institutions, save their money in terms of precious metals, like gold and silver. They buy golden ornaments, partly believing that they resalable, at a latter period of their life. There has not been a research to quantify the magnitude of such saving. But the present researcher is of the opinion, that this type of saving involves quite significant magnitude of saving. If the society has an access to secured and attractive alternative, and upon a good deal of marketing effort, large saving could have been mobilized. In addition, a large part of the pastoralists, hold their wealth in terms of having large stock of livestock. If there were good access to market and an option to saving and invest in alternative investment areas, large resource could have been mobilized. Thus, there is a good deal of opportunity to mobilize large resource, which has been saved in kind due to lack of diversification of and access to formal financial institutions.

Moreover, parallel to the formal finance institutions, a number of informal institutions operate in the Ethiopian financial market.

One such informal, in fact illegal financial market is the private moneylenders, which lends to both low-income group and middle income earners, at exorbitantly high interest rate. For instance, in cash cropping localities, large private commercial farmers face severe shortage of working capital during the harvest period.

Under the existing banking arrangement, neither land nor agricultural produce on the farm can serve as collateral in the formal banks. So at times of need, usually during the peak harvest period, both small and large commercial farmers are obliged to borrow at 10-15 per cent per month from moneylenders. In general, though there has not been a formal research to determine the size of this market, different business people recognize that there is huge market. The challenge is to come up with institutional innovativeness to formalize this market, which could boost the intermediary functions of the financial sector.

The other informal but quasi-legal financial institutions are social forums of saving and collective insurance. Since Ethiopia is a very heterogeneous society, involving different religions and ethnic groups with different cultural set up, it is difficult to come up with exhaustive list of the informal financial institutions. Yet, there are some informal institutions that are commonly known and operate side by side with the formal financial market. Such informal institutions include Iqquab and Iddir. These are group-based informal financial institutions, which provide financial services including saving and collective insurance. Iqquab is basically a saving institution, where members would contribute some agreed amount per agreed period, which could be a day, week or a month. The saving rate and the time interval of saving are initially negotiated. Once these are agreed upon, they will remain in force up until the saving cycle is completed. Every member contributes the agreed amount, every period. In each collection, a member draws a lottery to take the mobilized money. This way, Iqquab has been serving as an informal saving institution in large parts of the country. These informal financial institutions are usually a social forum among persons of acquaintance. Thus, this informal but quasi legal saving institution operates on personal relationship, instead of impersonal market system, indicating its inherent limitation in the financial intermediation process.

The other quasi legal informal institution, Iddir, is a collective insurance, where group of people negotiate and establish such forum in order to support each other at times of need. Members contribute and regularly pay some fee/contribution/ and they will be entitled to certain financial and social support at bad times. Essentially, these are mutual assistance associations.

The major service provided by the informal finance is saving and provision of credit to members, both in cash and kind. Because of their informality, the transaction costs of such financial services are low, since there is no overhead cost, at all. The social relationship of members and the society is the enforcing mechanism.

The challenge is to come up with institutional innovation that could graduate the informal institutions to formal one and hence develop a mechanism whereby the formal financial institutions could develop instruments that can effectively serve these informal but effective institutions that are believed to mobilize significant volume of saving in the country. The coexistence of the formal and informal financial institutions has strong policy implications. If they coexist, would there be mechanism that enables them to work together, is a researchable issue.

Financial deepening and intermediation in the Ethiopian Economy

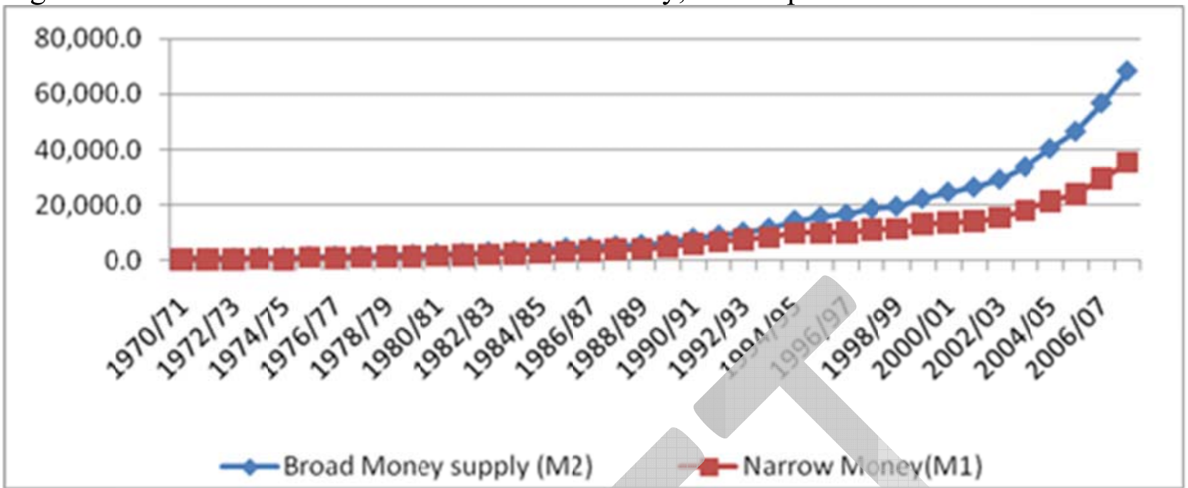
This subsection discusses the degree of deepening of the Ethiopian financial sector. It reviews the degree of monetization (taking the ratio of broad money to GDP), the performance of deposit mobilization and the allocation of credit to the private sector.

The degree of monetization of the Ethiopian economy

One of the indicators of financial development of an economy is the ratio of broad money (M_2) to GDP. Provided the subsistence agriculture dominated economy, low urbanization rate, low-income and high absolute poverty, the level of monetization of the economy should be low. Indeed, the ratio of broad money (M2) to GDP is low. As the level of monetization of the economy increases, the share of broad money to GDP is expected to rise.

As can be seen from the following figure, a data set since 1970–71, shows the fact that both M_1 and M_2 were sluggish during the pre-reform reform (1992–93) and have been increasing fast since then. The data set shows the fact that broad money has been increasing, after 1992, indicating the fact that the monetization of the Ethiopian economy has been increasing in the last two decades or so.

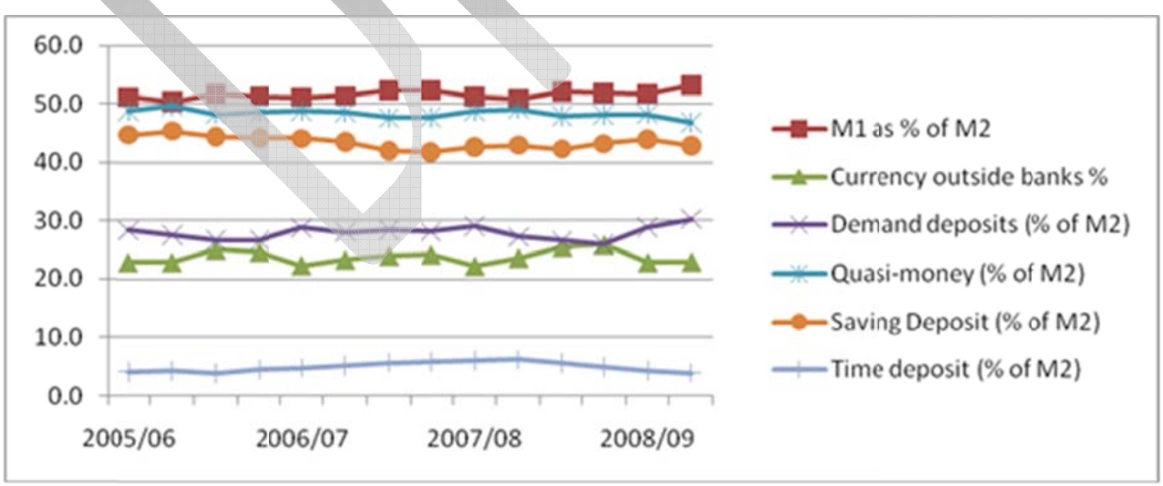
Figure 11: Growth trend of narrow and broad money, for the period 1970–71 to 2006–07



Source: MoFED and NBE,

Obviously, the relative contribution of each element of broad money matters in taking broad money as an indicator of financial development. The share of quasi money (deposits) and specifically saving deposits constitutes the highest percentage of broad money (M_2) in the given period. The second largest contributor is demand deposit.

Figure 12: Percentage Share of Broad Money (M_2) Elements (Quarterly 2005–06-2nd quarter of 2008–09)



Source: NBE

Therefore, currency outside the banks constitutes the smaller percentage compared with both demand and saving deposits. The average percentage share of narrow money (M_1) out of the broad money supply for the period 2005–06 (second quarter) to 2008–09 was about 52 per cent. The share of quasi-money for the same period was 48 per cent. Therefore, the largest contributor to total money supply has been saving deposits with an average percentage share of about 44 per cent, followed by the second largest contributor of demand deposits that accounted for about 28 per cent. Hence, the growth rate of M_2 can be attributed to saving and demand deposits, which together constitute for about 72 per cent in the given period.

For the recent decade, however, a related but different data set on sub-Saharan Africa shows the fact that the percentage share of broad money to GDP has been consistently declining from the order of 36 per cent in the period 1997-2002 to 23 per cent in 2009 and is predicted to slightly reduce to 22 per cent in 2010.

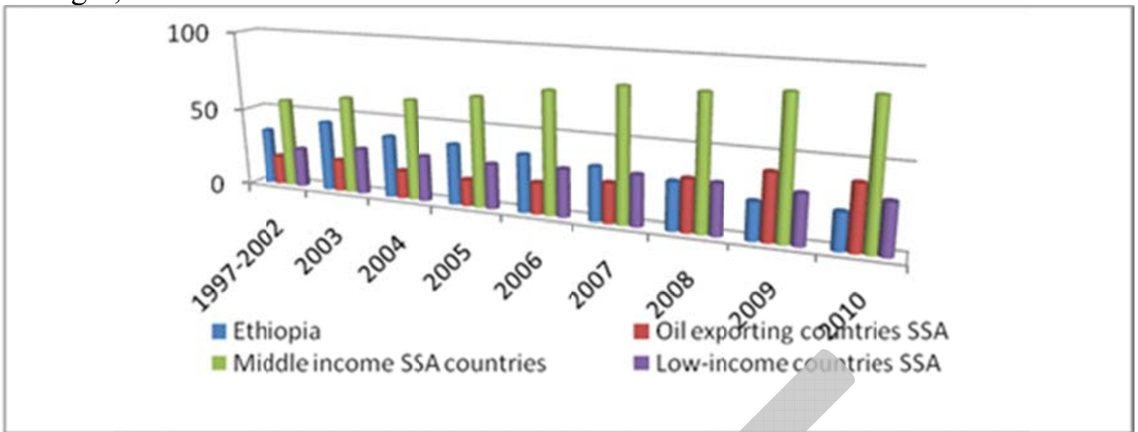
Table 11: Broad money (percent of GDP)

Country, regional averages	1997-2002	2003	2004	2005	2006	2007	2008	2009	2010
Ethiopia	**35.5**	**44.3**	**39.0**	**38.0**	**36.1**	**33.3**	**29.2**	**22.7**	**22.1**
Oil exporting countries sub-Saharan Africa	18.6	20.1	17.7	16.6	19.6	24.4	31.8	40.4	39.1
Middle income sub-Saharan African **countries**	**56.5**	**61.4**	**63.6**	**69.0**	**76.0**	**81.9**	**81.7**	**85.0**	**86.6**
Low-income countries sub-Saharan Africa	24.8	29.0	28.6	28.1	29.7	31.0	30.9	30.1	30.7

Source: IMF 2009, p. 74

Since 1997-2002, while the share of broad money to GDP has been increasing for all sub-Saharan Africa groups, oil exporting, middle income and low-income sub-Saharan African countries, it has been falling for Ethiopia. For the low-income sub-Saharan African countries, the ratio has increased from the order of 25 per cent to about 30 per cent in the same period.

Figure 13: The Percentage share of Ethiopia's Broad money to GDP and sub-Saharan Africa averages, 1997-2002 to 2010



Source: IMF 2009, p. 74

For the middle-income countries, the increase of the ratio appears to be dramatic. It has increased from a high rate of about 56 per cent in 1997-2002 to about 87 per cent in 2010. Compared to all sub-Saharan Africa income groups, Ethiopia's percentage share of broad money to GDP has been low in the given period.

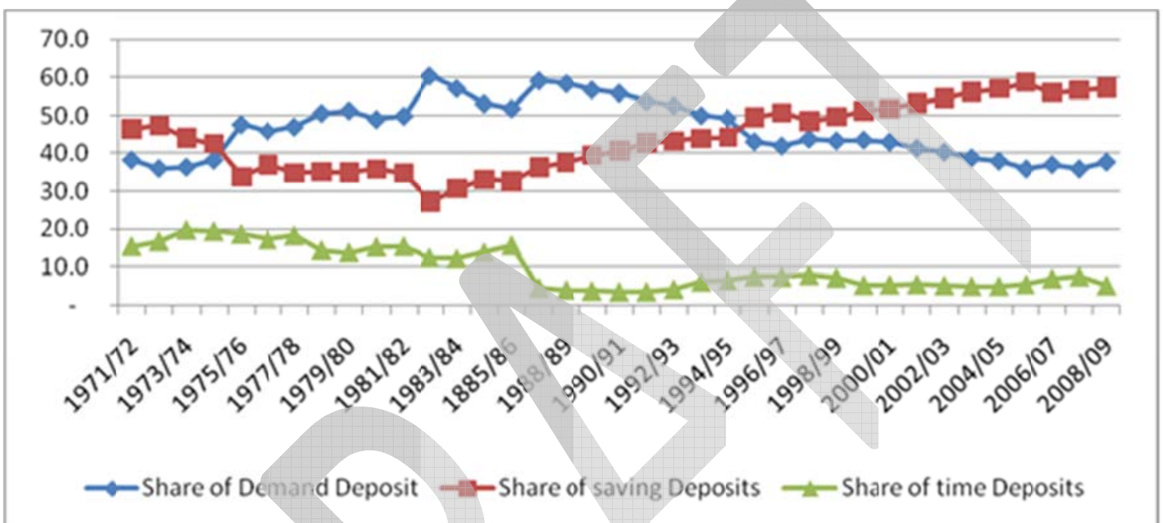
Deposit Mobilization: Savings, Time, and Demand Deposits

One of the major functions of the financial sector is to intermediate between lenders and borrowers. Apart from providing other services, financial institutions mobilize funds using different saving instruments and then lend it to different segments of the economy. Therefore, one performance indicator of the financial sector is the extent of saving deposits over time.

The other function of the financial sector is to serve as payment media, where different economic agents use the bank to conduct their payments. With development, the bank remains the safest and largest mechanisms of payment. Thus, the performance of demand deposits can be taken as an indicator of the development of such service of the bank.

During the entire period from FY 1971–72 to 2008–09, saving constituted on average 44 per cent of the total deposits while the average share of demand deposits was about 46 per cent. The share of time deposits has been consistently low, with an average of 9.8 per cent in the given period. However, there have been inter-policy regime differences in the relative share of each deposit type. During the 1974–75-1991–92 period while the share of demand deposits was 53 per cent, the share of saving deposits (SD) was 35 per cent, probably indicating that saving was highly suppressed during the command economy. In the subsequent policy regime, since 1992–93, the relative position of saving and demand deposits (DD) has shifted in favor of the former. While the share of DD has declined to 42 per cent, the share of SD has increased to 52 per cent. In fact, since 1994–95, saving deposits has been greater than demand deposits and the gap between the two has been increasing. This can be vividly seen in the figure just below, where the curve for saving deposits was increasing, while that of the demand deposits is showing a declining trend. The share of time deposit remained consistently low at less than 10 per cent.

Figure 14: Percentage share of different types of Deposits over 1971–72-2008–09



Source: NBE

If one considers the periodic growth rates of total deposits, one can see that the growth rate of total deposits has been about 16 per cent with small inter-regime difference. The average growth rate of saving deposits over the period 1971–72-2008–09 was about 17 per cent. For the period 1974–75-1991–92, the average growth rate of saving deposits was about 17 per cent. For the subsequent period, since 1992–93, the average growth rate was about 19 per cent, for the recent years the average growth rate exceeded 20 per cent, in fact reaching about 25 per cent for the year 2008–09. During the recent three to four years, there has been double digit inflation in the country, bringing down the real interest to negative values. Yet, despite this inflationary situation, saving has been increasing. The main reason for such an increase of saving during inflationary situation is the fact that there has not been any alternative investment/saving that savers could consider as an option, which can be taken as an indicator of the embryonic stage of the financial sector despite the rate of growth of total deposits and its elements.

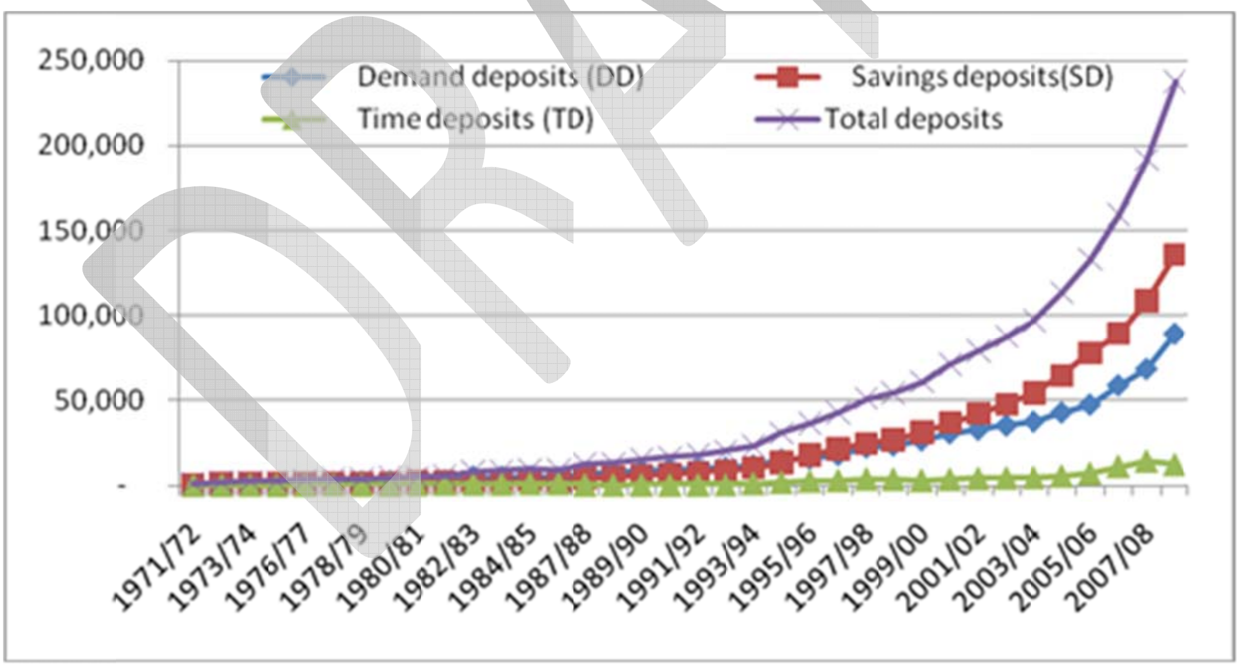
The average growth rates of demand deposits for the entire period 1971–72-2008–09, 1971–72-1974–75, 1975–76/1991–92, and 1992–93-2008–09 were about 17 per cent, 9 per cent, 21 per cent and 14 per cent, respectively. For the years since 2001–02, the annual growth of demand deposits was less than 10 per cent but picking up for the recent years.

Table 12: Percentage Distribution of Deposits & their annual growth rates (1971–72-2008–09)

Deposit Item	1971 –72-2008 –09	1971 –72-1974 –75	1975–76–1991–92	1992–93-2008–09	2001–02	2002 –03	2003 –04	2004 –05	2005 –06	2006 –07	2007 –08	2008 –09
Share of DD of TD	46.3	37.2	53.0	42.0	41.4	40.3	38.8	37.9	35.9	37.0	35.9	37.7
Share of SD of TD	44.0	45.0	35.4	51.9	53.2	54.5	56.2	57.0	58.7	56.0	56.7	57.1
Share of Time D of TD	9.8	17.8	11.7	6.1	5.5	5.2	5.0	5.0	5.5	7.0	7.4	5.2
Growth rate of TD	16.0	17.8	16.7	16.5	11.2	10.3	10.7	17.0	17.2	20.0	20.1	24.0
Growth rate of DD	16.6	8.7	20.6	14.3	7.1	7.5	6.4	14.4	10.8	23.9	16.5	30.2
Growth rate of SD	16.8	6.3	16.8	18.6	14.5	13.0	14.1	18.7	20.6	14.5	21.6	25.1
Growth rate of Time D	14.8	20.3	7.4	20.9	13.4	4.8	7.8	16.9	27.2	54.0	27.5	-14.0

Source: NBE, TD= Time deposits, DD= demand deposits, SD= saving deposits.

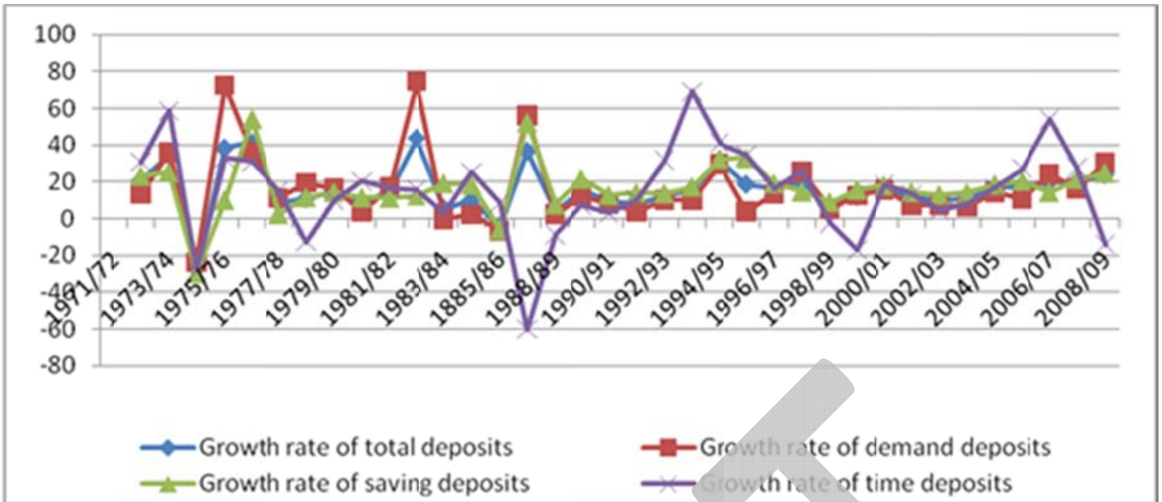
Figure 15: Trends of Different Types of Deposits, Demand, Saving and Time Deposits 1971–72-2008–09



Source: NBE

Thus, one may note the fact that except a decrease of time deposits for one year, saving and time deposits have been increasing even during inflationary periods, 2007–09.[7]

Figure 16: Annual Growth Rates of Different Types of Deposits, 1971–72-2008–09



Any individual can save any amount, with no discrimination. It is very accessible and easier to save and withdraw.

On the other hand, reflecting on the experience of the East Asian successful countries, one does not observe any change in the deposit structure in Ethiopia. Throughout banks has never been pursuing aggressive and innovative saving instruments. In the entire period, the same saving and payment instruments have been used in the banking sector, without any change.

Credit Flow to the Private Sector

As a complement to the M2/GDP ratio as an indicator of financial deepening, one may take the ratio of credit to the private sector to GDP as an indicator of financial development. It is a preferred indicator, because it measures the extent of reliance of the private sector on banks to finance their needs for finance, for both investment and working capital requirement.

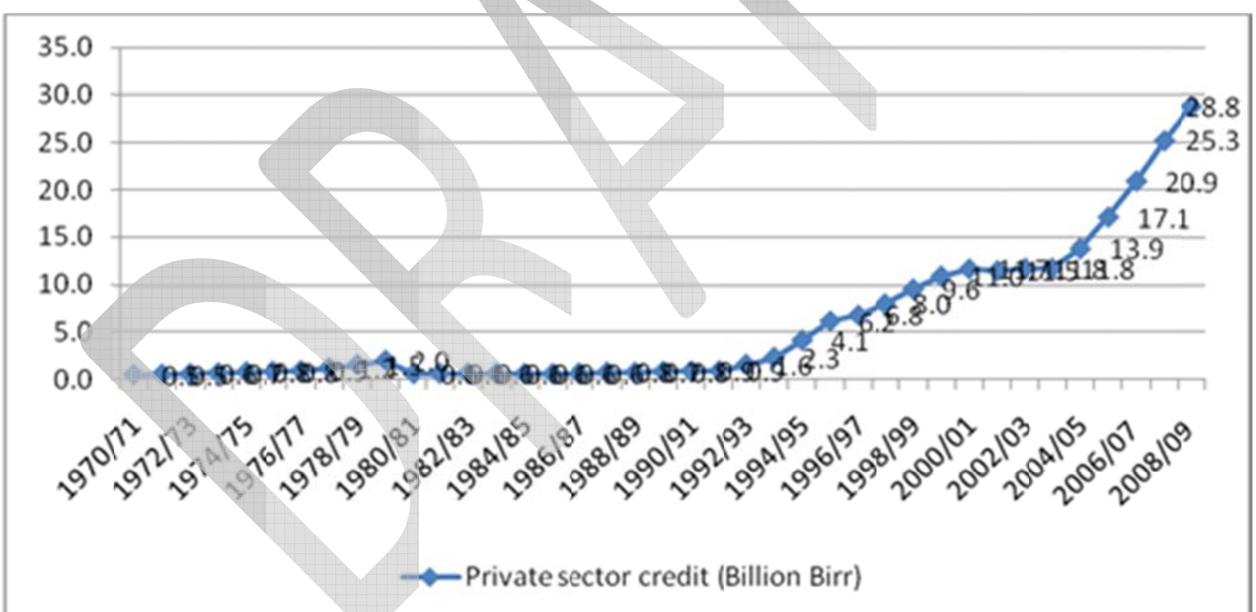
One of the basic functions of the financial sector is to provide intermediary services, channelling saving into loans for investment. Ultimately credit channelled to the private sector, represents the actual service of financial sector to the economy in general and the private sector in particular. "The supply of credit to the private sector is ultimately responsible for the quantity and quality of investment and, in turn, for economic growth, this variable may be expected to exert a causal influence on real GDP per capita" (Demetriades and Hussein, 1996:395).

Thus, it is appropriate to consider the magnitude of credit as one indicator of financial deepening of a given country. The larger and growing trend of disbursed loans, the larger the financial sector.

Private credit grew from the order of ETB 500 million in 1970–71 to nearly ETB 30 billion in 2008–09. In this entire period of nearly four decades, the average growth rate of private credit was about 14 per cent. During same period, the average ratio of private credit to GDP was 9.8 per cent.

Yet, there have been significant inter period differences in the magnitude and share of private credit in Ethiopia. As can be seen from the following figure, private sector credit remained low for the period 1970–71-1991–92 and then it has dramatically picked up in the subsequent period of 1992–93-2008–09. The two clear periodic differences show the credit history of the country involving three policy regimes.

Figure 17. Private sector credit, 1970–2009 (ETB billion)



Source: MoFED and NBE

The first five years, 1970–71 -1974–75, represent the state of credit allocation to the private sector, under apparently free market system, but essentially feudal regime, dominantly agricultural economy, with less development endeavors. Yet, compared with the subsequent period, the average share of private credit from GDP was 8.6 per cent with average of annual growth rate of about 11.8 per cent.

The subsequent period of 1975–76-1991–92 is a period of a policy regime that has discriminated the private sector at a policy level. Credit priority was setup in favor of publicly owned enterprises and cooperatives but against the private sector. Indeed, the average share of private credit from the GDP of the same period was the lowest average of the entire period, which is about 6.9 per cent. The average growth rate of private credit of the same period was still the lowest, 4.8 per cent, compared to the previous and subsequent periods of different policy regimes.

Table 13: Average percentage share of private credit from GDP and its Growth rate

Period	Average Share of Private Credit from GDP	Average Annual Growth Rate of Private Credit
1970–71-2008–09	9.8	14.4
1970–71-1991–92	7.2	6.1
1970–71-1974–75	8.6	11.8
1975–76-1991–92	6.9	4.8
1992–93-2008–09	13.2	24.6

Source: MoFED.

The magnitude of private credit has shot up following the change in policy regime from central command to free market system, and specifically after the financial reform following the 1991 takeover of political power of the existing EPRDF regime. Following financial reform, which abolished credit discrimination against the private sector, private credit has been growing on average at nearly 25 per cent for the period 1992–93-2008–09. During the same period, the average share of private credit to GDP has increased to about 13 per cent. The expansion of private credit since 1992–93 can be attributed to changes in the policy regime, which avoided discrimination against the private sector and in fact has been encouraging the private sector using different policy instruments, like favorable lending interest rate (NBE 2007, p. 2).

However, despite the fact that the magnitude of private credit has been increasing at an increasing rate since the 1992 reform, still lack of access to credit stands one of the prime constraints that the business community is facing in Ethiopia.

Owing to restrictive credit policy and governance of banks, firms rely on their internal source of financing to finance their activities. This is more glaring problem, during investment phase, especially when the investor is a new one, without any credit history.

Table 14. Sources of finance for initial investment in various activities

	Credit from formal institutions (banks)	Own finance	Others
Food	31.09*	64.05	7.0
Beverage	44.66	55.71	0.0
Textile	16.72	72.6	18.1
Garment	31.57	66.78	0.3
Leather and leather products	41.87	73	0.0
Tannery	38.25	66.23	7.9
Flower	45.71	51.69	4.5

* The number of observations is not the same for the various sources; thus, the total does not add up to 100%.

Source: Tsegabirhan et al. 2010, p. 115.

As can be seen from the table, substantial numbers of firms rely on own or other sources of finance to meet their financial requirements. The percentage of firms, which relied on the formal institutions (specifically banks) were in the range of 17 per cent in textile to 46 per cent in the flower industry. One possible reason for this low access to bank credit is the stringent and conservative credit policies of the Ethiopian banks.

Related problem of the sector is the high collateral requirement, which has become a discouraging factor in the credit market.

Low Saving Effort: Excess Liquidity in an Economy that Craves Credit

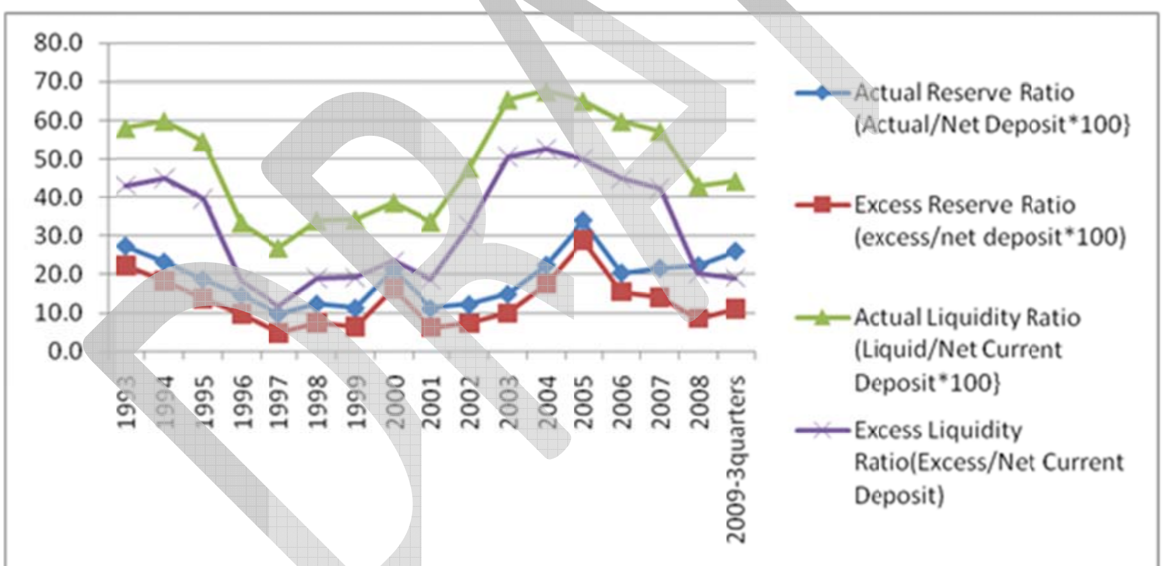
Obviously, one of the prime functions of a central bank is to ensure the healthy and transparent operation of financial institutions of a given country. One performance indicator of the healthy operation of the financial sector is the liquidity position of each financial institution at a given time. In Ethiopia too, the NBE (the central bank of the country), has been legislating different legislations and directions on reserve and liquidity requirements so as to ensure smooth and health operation of the banking sector and other financial institutions. There is an inherent dilemma between maintaining liquidity and profit maximization. Though banks do appreciate their liquidity, normally, they should prefer to hold smaller amount of their deposit as reserve and lend or invest the rest to maximize their profit. Benefits of the sector are generated from credit and/or investment deposit money. Since, the lower the reserve requirement, the higher the chances for banks to earn larger interest income, banks are normally expected to have no excess reserve or at least lower and declining excess reserve ratio. In view of such tendency of financial institutions to maximize their profit, there is a danger of illiquidity. The repercussions of an illiquidity of financial institutions could lead to financial crisis. To avoid or minimize such danger, normally, central banks do set minimum reserve and liquidity ratios.

This section discusses the state of liquidity and reserve as well as nonperforming loans.

Excess Liquidity and Reserve

However, as can be seen from the following figure and table, there have been persistent and high excess reserve and liquidity in the Ethiopian banking sector. As the figure below shows, the excess liquidity and reserve ratio curves are consistently higher, though there has been fluctuation over some time. The difference between the actual reserve/liquidity ratio curves and excess/liquidity/ ratio curves shows the officially required reserve/liquidity ratios.

Figure 18: Excess Reserve and Liquidity Position of Ethiopian Commercial Banks, 1993-2009



Source: National Bank of Ethiopia.

For the period 1993-2009, the average ratios for actual and excess reserve were 19 per cent and 13 per cent, respectively. For long period of time the official reserve ratio remained at 10 per cent which after April 2008, was then raised to 15 per cent, to 20 per cent and then to 25 per cent recently to control money supply in view of the recent experience of high inflation in the country. Despite the fact that the official reserve requirements were high, there has been an excess reserve ratio of about 13 per cent. Banks do complain about the fact that the official reserve requirement is too high and yet, paradoxically one observes persistent excess reserve.

Table 15: Excess reserves and liquidity of the Ethiopian banking sector

Reserve/Liquidity ratios	**Average (1993-2009)**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009-3quarters**
Actual Reserve Ratio (Actual/Net Deposit*100}	19.1	12.2	14.9	22.5	33.9	20.4	21.7	22.3	26.1
Excess Reserve Ratio (excess/net deposit*100)	12.8	7.2	9.9	17.5	28.9	15.4	14.0	8.5	11.1
Actual Liquidity Ratio (Liquid/Net Current Deposit*100}	48.4	47.5	65.5	67.6	65.0	59.7	57.2	42.9	44.1
Excess Liquidity Ratio(Excess/Net Current Deposit)	32.3	32.5	50.5	52.6	50.0	44.7	42.2	20.2	19.1
Liquidity Requirement Ratio (Liquidity Requirement/Net Current Deposit*100	16.0	15.0	15.0	15.0	15.0	15.0	15.0	22.7	25.0

Source: National Bank of Ethiopia.

Similarly, for the period 1993-2009, one observes persistent excess liquidity that ranges between 19 per cent and 53 per cent, and with an average of 32 per cent. Taking the recent years, excess liquidity reached about 53 per cent in 2004 and seems to decline to about 20 per cent in 2008. This indicates the fact that the banking sector has been persistently holding idle money while the Ethiopian economy has not been in a position to quench its thirsty for credit.

Thus, there is an inherent paradox in the Ethiopian banking sector. The banking sector has been over liquid for long period and at the same time the business community is starved for credit.

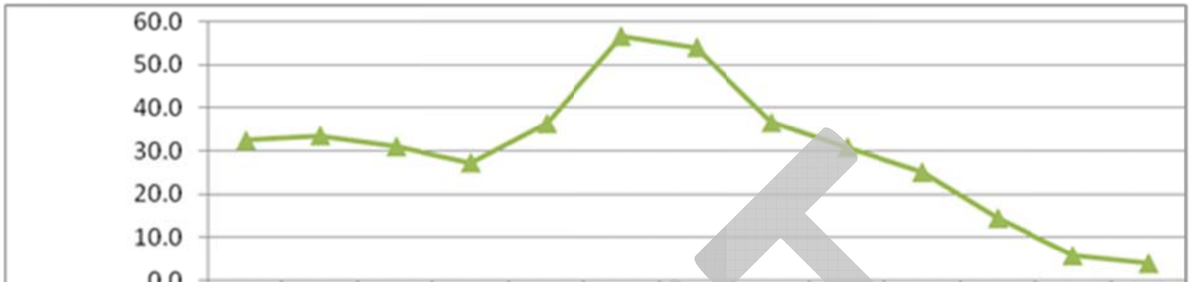
High Nonperforming Loans Ratios

One of the problems of the Ethiopian banking industry, at least until the recent past has been high nonperforming loans (NPLs). The problem was so significant to capture the attention of the central bank of the country.

Data on NPLs was not accessible to the researcher. But, according to officials from the NBE, this was a significant problem of the sector for some time, to the extent of 25 per cent. Since the recent years, the NBE took strict measures to reduce NPLs, which appears successful to reduce from the order of 25 per cent some years back to less than 10 per cent at the time of interview, December, 2009.

The data of the largest commercial bank may be indicative of the trend of NPLs of the banking sector of the country.

Figure 19: Non-performing loan ratios of the largest commercial bank in Ethiopia (1997-2009)



	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
NPL - RATIOS	32.5	33.6	31.1	27.3	36.4	56.7	54.1	36.6	30.9	25.2	14.5	5.8	4.0

Source: Commercial bank of Ethiopia,

Throughout the nonperforming loans (NPLs) has been high for long period except the recent years. In the years 2001 and 2003, the ratio of NPLs reached more than 50 per cent and then started to decline to the extent of reaching less than 10 per cent since 2007. The performance of the largest commercial bank matters because this bank holds lion's share of the banking industry in terms of capital, disbursed loan, assets, number of branches. So the magnitude of NPL ratios, indeed indicate the typical behavior of the banking industry. According to officials, the government (municipality of the capital city and related other government organizations) have borrowed too much from this state bank, that there are concerns of illiquidity in the recent year, of 2009–2010, which is another side of the story of excessive government interference, which eroded the liquidity position of the bank.

These high NPLs have been experienced in a situation, where there is quite a conservative credit policy. The Ethiopian banking sector has a conservative credit policy involving stringent assessment of credit worthiness of the client and against asset collateral. Moreover, business people have been complaining of the highly bureaucratic credit administration, which is expressed in terms of long delays in processing credit requests and disbursement of approved loans.

Excess liquidity with liberal credit policy could lead to high NPLs, as the risk of default rate increases with loose credit policy. The Ethiopian case is the reverse of such a situation. With excess liquidity, the banking sector remained with its conservative credit policy. Yet, with such conservative credit policy, high NPLs was a significant problem of the sector, that has attracted the attention of policy makers of the country.

In understanding the underlying causes for such dilemmas of the sector, the agents of the industry obviously are the borrowers, the banks, the central bank of the country and the credit environment, which includes the functioning of the judicial and legal system of the country and the development of an information system in the sector. Each body of the relationship is supposed to have its own share in explaining the state of default rate in the country.

From the side of the borrowers, there are intentional and unintentional factors. Unplanned investment, weak financial management, bankruptcy, and external shocks (price decline) are some of the unintentional factors that have been contributing for high default rate. Most of business firms, including limited liability companies have weak organizational capacity such that many of them do not have conventional accounting system. In the absence of reliable system of accounts, it is difficult for banks to follow the performance record of a borrower. The quality of credit assessment of loan application is affected by the absence of well-established system of accounts. The other factor is the moral hazard on the part of borrowers, which have been contributing to high NPLs and even to the conservative credit policy of the country. There is serious information asymmetry between the lender and the borrower, which leaves the lender in a disadvantageous position.

The problem of moral hazard is compounded by governance problems in the banking industry itself. Delays in disbursements and related managerial weaknesses, over- and under- financing, duplication of credit facilities, over estimation of collateral, etc have been contributing to high NPLs. These weaknesses could be attributed to institutional weakness of the industry, for instance lack of database could contribute to duplication of credit lines. Weak corporate governance reflected in terms of corrupted behavior in overestimation of collateral is another manifestation of weak corporate governance. Illicit agreements and corrupted behavior of bank officials adulterates the quality of credit assessment, its follow up and its repayment, exasperating the problem of moral hazard in credit management. Lack of responsiveness for long period of time is another weakness of the institutional setup. The problem of high NPLs, excess liquidity and excess reserve remained a typical feature of the Ethiopian banking industry for long period of time. Yet, neither the banks nor the central bank of the country were responsive to deal each of the fundamental problems of the sector. Such irresponsiveness basically is an indicator of the weak governance and managerial capacity in the industry.

The problem of moral hazard is further aggravated by the weak organizational capacity of the banking industry of the country. Weak institutional capacity of the supervisory body (the central bank) and the institutions of accountability have been contributing to high NPLs in the industry. For one thing, the initial situation was quite unfavorable. The financial institutions in general and the banking sector in particular emerged from a situation where the state-owned banks, which were "operating on a soft budget, failed to develop the capacity for risk assessment and monitoring of their loan portfolio (Nissanke and Aryeetey 2006, p. 6).

Evolving from this legacy, the private sector has emerged in a local market situation where there has been low competition and low supply of banking services. In this regard, Nissanke and Earnest were categorical to assess the performance of African banking sector, which appears strongly relevant to the Ethiopian banking industry.

> There was neither active liquidity and liability management nor any incentive to increase efficiency, often resulting in increased costs of financial intermediation. The regime of financial repression discouraged banks from investing in information capital, crucial for the development of financial systems. Institutions have typically been burdened with severe agency problems in dealing with idiosyncratic risks, that is, the problems caused by costly and imperfect information such as adverse selection, moral hazard, and contract enforcement. (Nissanke and Aryeetey 2006, p. 6)

Moreover, there has not been a database on credit information in the industry. So far there has not been credit information that could have critically served the industry to manage their outstanding credits and entertaining potential customers. Hence, every bank operates in a state of information asymmetry at to the credit history of their potential credit client. Once credit is proceed and disbursed there has been weak monitoring capacity of the banks to oversee the performance of the credit. The interesting question is that though the initial situation was such unfavorable, why is that the sector failed to develop the requisite organizational capacity to address the major problem of the sector?

One of the manifestations of the weak organizational capacity is the weakness of the supervisory capacity of the central bank of the country, reflected in terms of staffing, the experience, motivation and commitment and limited access to relevant information.

One outcome of the legacy of the sector and its infancy is the fact that there has not been serious competitive pressure. As a result, this nascent financial sector has been shouldering such an inefficient banking sector. If the banks can make easy profit with such excess reserves and liquidity, there does not seem adequate incentive and pressure to reduce excess liquidity aggressively.

Excess liquidity and reserve coupled with conservative credit policy, which in turn is attributed to high risk, suggest that there cannot be aggressive effort to mobilize saving in the country.

This means the fact that the existing banks have not been aggressive to in their intermediation services. There has not been any innovative introduction of new saving instruments.

Conclusions and policy implications on financial development and private saving mobilization

By way of summary, one may note down the salient features of the Ethiopian banking industry.

The Ethiopian financial sector is at its best nascent, despite its long history. It remained stunted for long except for the recent fast growth rate of private banks. The country is under-banked with limited outreach. There is no capital market so far, which could have substantially contributed to the mobilization of savings and its allocation to different investment areas. The low level of development of the sector implies the fact that the institutional capacity of the sector is very low, with its widespread implications on the magnitude of private saving in the economy.

There are apparent paradoxes in the sector. There is huge resource gap in the economy. Moreover, one of the prime constraints of the business community in the country is the lack of access to credit and its excessively procrastinated management. With such an economy that craves for credit, there have been persistent over liquidity of the banking sector of the country. Yet, with a conservative credit policy, there have been quite high nonperforming loans for long period, except for the recent years.

One grave outcome of such state of performance of the financial sector is the fact that there has been very low saving effort in the country. Excess liquidity, low nominal saving rate and negative real deposit rate all contribute negatively to saving. Moreover, there has not been any attempt to diversify the saving instruments. Banks should be aggressive to strengthen existing saving instruments and to introduce innovative saving instruments to increase saving. They should consider and learn from other countries and intimately understand the problems and behaviors of different economic agents of the Ethiopian economy to mobilize private saving.

The implication of excessive liquidity is the fact that the already small saving is being held idle. The economy desperately needs investment and yet there is idle money in the banks. It is like you are thirsty for water and there is some on the table and yet you cannot quench yourself.

The strategic directions should therefore be to promote aggressive saving using existing and new saving instruments on the one hand and reduce over liquidity of the banking sector.

Moreover, the financial sector should develop alternative markets and instruments that can enhance saving and investment. Gradual introduction of capital market, which may start from government bond appears timely move. Development of a capital market requires will and commitment of the government. Fostering capital market is a complex process that requires intimate understanding of how capital markets operate and what can be learned from the rest of the world. In addition to learning from the rest of the world, one needs to be institutionally innovative to understand the capacity, problems and prospects of the Ethiopian institutional setup. That may help to design a capital market that is tailored to the realities of the country. Offhand, nurturing capital markets requires systemic transformation and capacity development of the macroeconomic system, government behavior and commitment including strong legal and regulatory system.

In such an attempt to develop the financial sector, there is a need for developing innovative instruments to blend the formal with the informal financial institutions. There are quite important informal financial institutions that have to be integrated with the formal sector, which could be a win-win scenario for both the formal and informal financial sectors.

On the other hand, the central bank of the country should identify the underlying causes for over liquidity in the banking sector and promote credit and investment in the country.
One direction could to investment on relevant capacity building areas to mitigate the bottlenecks that hinder smooth operation of the credit market, credit information, ensuring rule of law and minimize the chances for default.

In addition, the Ethiopian government should work on awareness creation to minimize expensive festival, marriage and mourning ceremonies. The government may bring about different non-government forces mainly religious organizations to enhance saving consciousness.

Notes

1. Although domestic resources may be broadly understood to mean "anything and everything from domestic financial capital, to human capital, to social capital to natural resources (Culpeper and Bhushan 2008, p. 6), in this study, it is defined as non-debt bearing "fiscal and financial resources accruing within the domestic economy" (Culpeper and Bhushan 2008, p. 6) including remittances. The focus here is on domestic saving, which includes both public and private saving.

2. One of the core objectives of the tax policy was to promote investment in the country. One incentive for this is tax exemption on the import of capital goods, for both initial and replacement/rehabilitation investments. Moreover, there is a tax holiday for the first five or so years of operation. These exemptions are intended to attract both local and foreign direct investment and encourage global competitiveness of local firms.

3. There are two broad options. One is the universal non-contributory social security/pension/ system to all elderly and other related segments of the society. This could be effective to address the problem as the government is bearing the burden of financing this service. The problem for Ethiopia is the capacity of governments to bear the fiscal burden of such pension system. The alternative is to go for contributory pension targeted to certain groups of elderly. This reduces the fiscal burden to the government but at the expense of ensuring universal coverage of problems of the elderly.

4. For some time, there has been an outstanding debate on the causal relationship between financial development and economic growth. There are quite number of studies with different conclusions and concerns over the direction of causality between economic growth and financial development. The performance of countries and hence their research results, could be different due to different reasons. For some countries, investment could be financed from cash inflows, FDI, grants, foreign loans etc. In such a situation, domestic credit channeled to the private sector could be small to come up distinctly as a strong

variable to explain growth. The purpose of the present study does not intend to contribute to resolve this debate on causal relationship between saving and growth. In view of persistent high saving-investment gap, the inadequacy of external resources and inherent less desired conditionalities of external resources, low income countries like Ethiopia should give due attention to develop the institutions for domestic resource mobilization, including developing the financial sector.

5. For instance, the National Bank of Ethiopia and the largest commercial bank in Ethiopia, the Commercial Bank of Ethiopia, were established in 1963. The Development Bank of Ethiopia was established in 1969.

6. The capital market is the market for securities, where governments and companies can raise long-term funds for investment by issuing different types of securities. Thus, it is the market for mobilization of savings and channeling same into long-term productive investments. It is a complex market involving different markets, stock, bond and other markets involving both primary and secondary markets. In these diverse markets, different agents and operators operate and they require different resources and institutional capacity. Establishment of an effective and efficient capital market requires holistic approach involving the development of many institutions, supporting infrastructure and strong regulatory system. (For detailed discussion, see Chami et al. 2009, Torre and Schmukler 2007.)

7. Ethiopia has experienced inflationary situation since 2005/06. During the 2006, the monthly average growth rate of the general price index was in the range of 10–13 per cent. During 2007, the range picked up from 13 to 18 per cent. In 2008 the index was in the range of 18–44 per cent, which further increased to reach 46 per cent in January 2009. The same trend was experienced during the first six months of 2009.

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