

Stretching out to Approach the Potential to Mobilize Domestic Financial Resources of African Low Income Economies: Case Study of Ethiopia

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The problem: Severe Resource Gap

Ethiopia's Saving-Investment Gap in % of GDP									
	1997- 2002	2003	2004	2005	2006	2007	2008	2009	2010
Ethiopia: Investment	17.1	21.6	25.5	23.0	24.2	25.0	21.8	19.1	16.4
Ethiopia Domestic Saving	6.6	3.6	5.0	3.0	3.7	5.6	0.6	2.1	0.3
Low income SSA saving	7.1	9.2	8.9	9.5	10.4	9.6	7.3	7.8	8.6
Middle income SSA saving	19.0	19.0	19.0	18.3	18.8	19.4	19.4	17.9	18.4
Fragile SSA saving	15.1	14.6	13.2	10.7	12.1	10.3	10.0	8.0	9.6

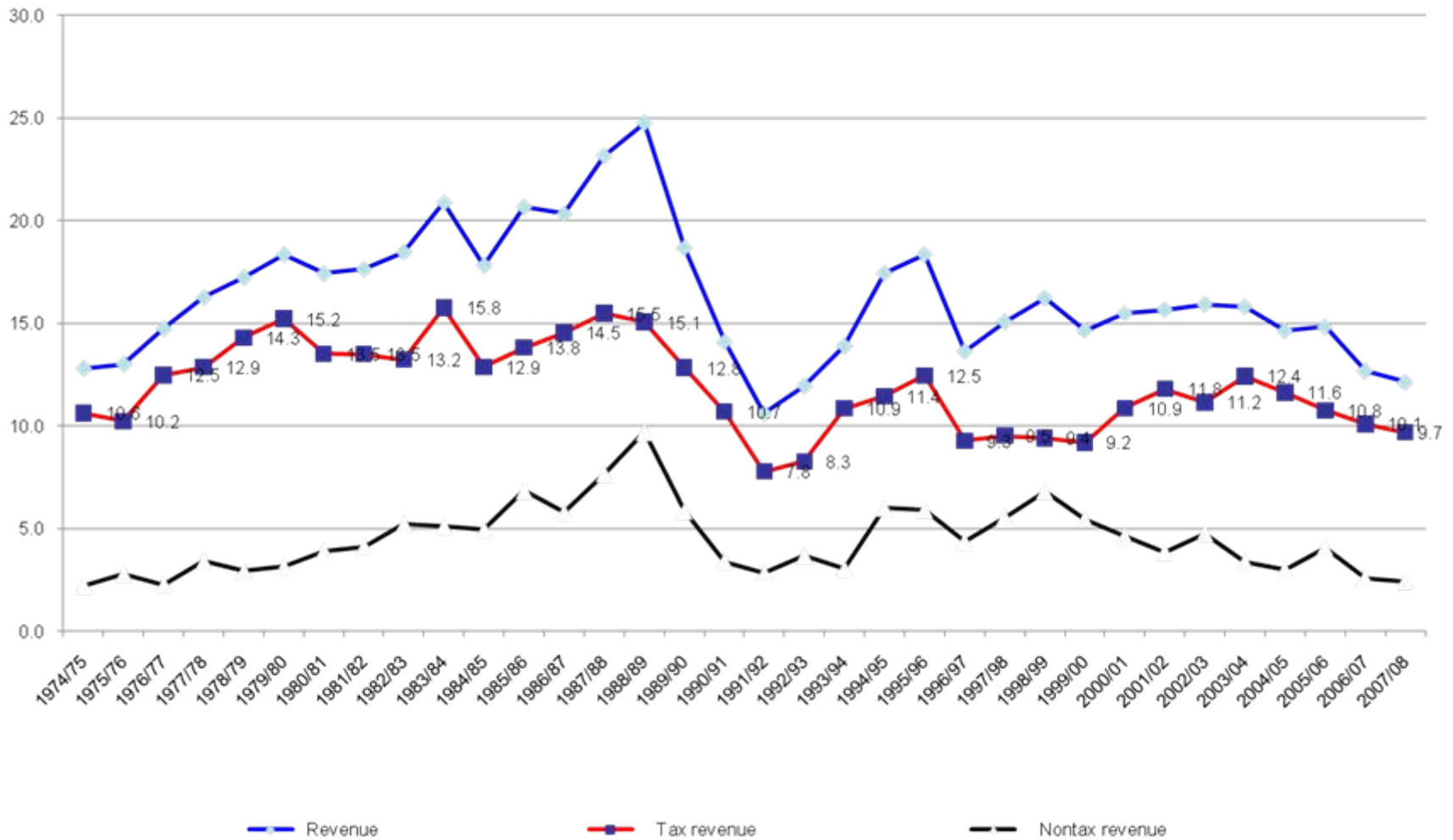
Resource gap (ctd)

1. Both saving and investment have been low, investment consistently lower than 25%, declining recently, to less than 20%
- 2. Persistent & increasing Saving-Investment gap,**
3. Domestic saving ratio is even lower than the low income SSA countries and fragile states

Low Tax Effort: Low Public Saving

- Tax effort consistently small and even declining over recent years, despite the expectation to increase

Percentage share of revenue, tax and non tax revenue of nominal GDP,



Major reasons for low tax effort

1. High tax evasion and fraud, in all tax types, due to low tax compliance owing to **low organizational capacity**,
2. High **tax exemptions**, mainly to the private sector, & a mechanism for fraud,
3. **Lacking commitment to develop organizational capacity of tax collection system**,
 - No meaningful tax reform till the last five years

Revenue Structure

Revenue Items	1979/80- 2007/08	1979/80- 1991/92	1992/93- 2007/08
Share of tax revenue of total revenue	71.73	72.42	71.2
Share of Direct taxes of total tax rev.	37.04	40.28	34.4
•Share of personal income of direct taxes	27.71	27.75	27.7
•Share of Corporate Income Tax (CIT) direct taxes	54.46	56.92	52.5
•Share of agriculture tax of total direct tax	10.79	13.73	8.4
Share of Indirect taxes & Duties from total tax revenue	62.96	59.72	65.6
Share of domestic indirect taxes from tax revenue	26.36	30.75	22.8
Share of external indirect taxes of total indirect taxes	57.61	48.22	65.2

Tax evasion: a major problem

- Average share of direct taxes has decreased
- Share of corporate income tax decreased

Yet large resource flow to the private sector

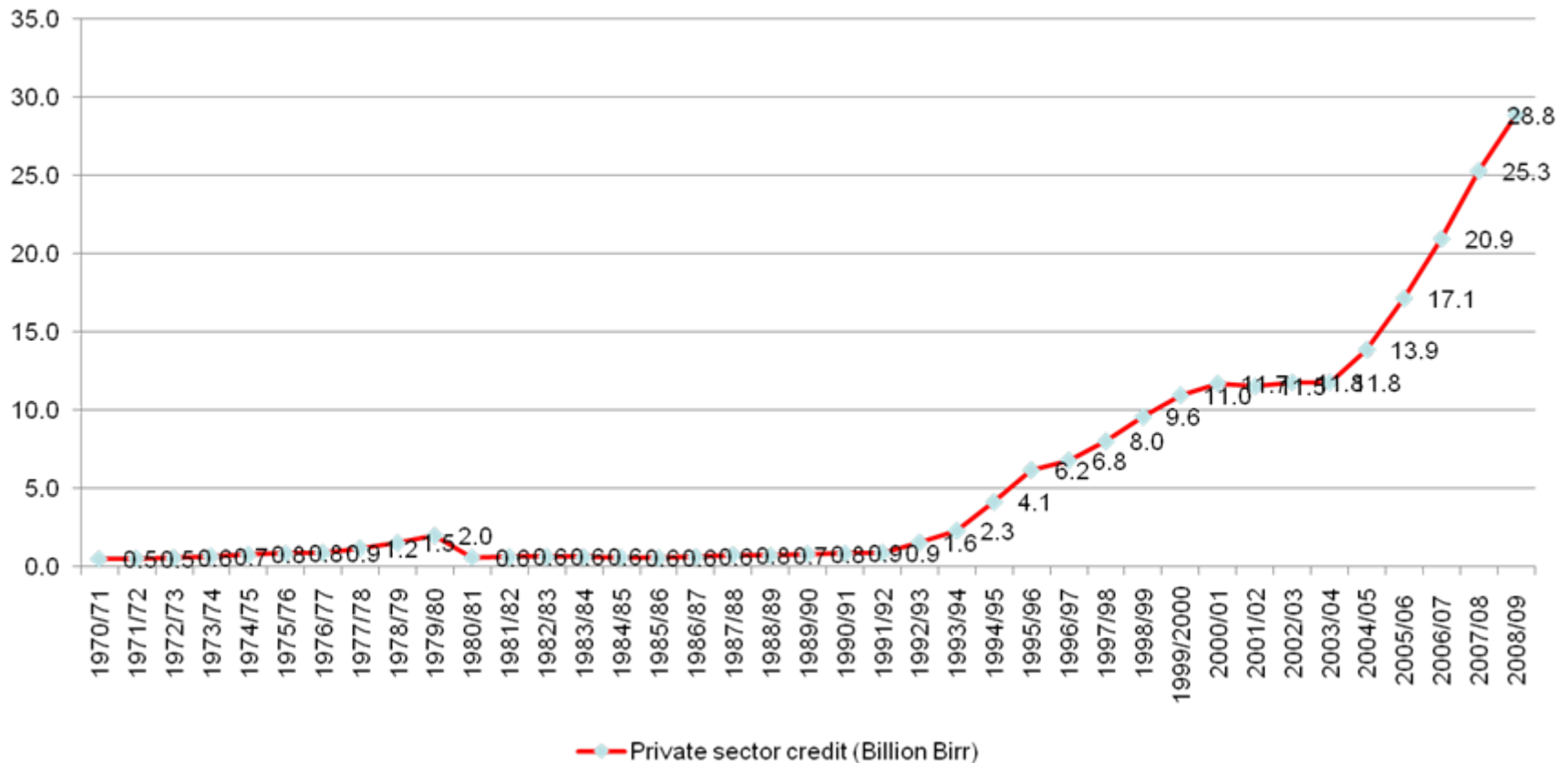
- High tax exemptions
- Private credit
- So it appears that tax evasion stands a major problem

Tax exemption(in millions Birr & %)

Exemption items	2005		2006		2007	
	value	%	value	%	Value	%
Total revenue foregone	3,940.5	100	4,641.2	100	7,719.1	100
% share of GDP	3.7		3.52		4.51	
Share of private sector (<u>at least</u>)	1914.5	48.8	2757.2	59.7	3966.5	51.6

Private Sector Credit for the period 1970/71-2008/09

Private sector credit (Billion Birr)



Manifestations of high tax evasion & fraud

- **Re-export instrument** abused by many foreign contractors, importing free of taxes
- **Abuse of import tax exemptions instrument:**
- **Contraband trade**, profound, through all borders
- **Under- & over- invoicing in Exports & imports**
- **Under reporting of business tax payers**
- **Avoidance of large no. of formally registered business tax payers**

Financial Sector Development & Its implication to Private Saving

Infant sector with limited outreach

- Bank outreach 1 branch for >130,000
- 28 MFIs with 1.8 billion in savings and about 2.2 million active clients in 2008, for 80 million population
- Financial deepening (ratio of broad money(M2) to GDP) is low even by SSA standard
- Low diversification of services, limited to traditional commercial banking services.

Excess Liquidity & Reserve(in %)

Year	2001	2002	2003	2004	2005	2006	2007	2008	(3qrts) 2009-
Excess Liquidity Ratio	19	33	51	53	50	45	42	20	19
Excess Reserve Ratio	6	7	10	18	29	15	14	9	11

Tripled Features of the Banking sector

1. **Credit a reported problem of business community, conservative credit management**
2. **Excess liquidity, excess reserve, while the economy is craving for credit**
3. **In spite of conservative credit management, NPLs were recognized problem of the banking sector, though now a managed problem owing to aggressive measures of the central bank**

Three important strategies to enhance DRM

DRM sector	Strategy
Government saving	<ul style="list-style-type: none"><li data-bbox="548 401 1812 682">a. Increase tax compliance capacity through creating capacity<li data-bbox="548 704 1812 1086">b. Political commitment to fully implement & sustain existing tax reform & create a learning organization<li data-bbox="548 1108 1812 1288">c. Consider to reduce tax rates (30-35%)

Three important strategies to enhance DRM

DRM sector	Strategy
<u>Private saving</u>	a. Strengthen the corporate & supervisory governance of the financial sector to improve credit management
	b. Aggressive saving effort: Strengthen existing & Introduce new saving instruments
	c. Develop capital market

Thank you