# Domestic Resource Mobilization: Case Study of Ethiopia

## Executive Summary

By

Tsegabirhan W.Giorgis Abay[1]

Submitted to

The North-South Institute (NSI)

April, 2010

[1] Lecturer in the Department of Economics, Faculty of Business and Economics, Addis Ababa University, Ethiopia, (htsegawg@yahoo.com, tsega@econ.aau.edu.et, http://www.aau.edu.et/; )

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

There are a number of institutional constrains that have inhibited the country from attaining the achievable potential in mobilizing domestic financial resources.

**Public savings**

The major factor behind low public saving is the fact that the tax effort of the country has been very low. Taking inter period/regime comparison, Ethiopia’s tax effort has been low and infact has been declining in the recent past years. The tax effort was expected to improve given that the post-1992 growth performance is by far greater than the pre-1992 period.

Particularly the performance of direct taxes has been low throughout the study period. Despite the rapidly increasing resource flow to the private sector, in terms of credit and tax exemptions, business profit tax has remained low, which may indicate the fact that there is large tax evasion in the country’s business community.

Moreover, the contribution of the largest sector (agriculture) has remained marginal throughout the study period. It has rather decreased in the recent past. The contribution of the sector should have improved over time for two reasons. Primarily there has been population growth, which would have contributed to proportional increase of agricultural taxes and fees over time. Secondly this sector has been a beneficiary of the recent growth process, which should have contributed to an increasing rate of growth of tax revenue from this taxpayers group.

There has been substantial tax exemption, meant to encourage investment. The government’s attempt to encourage investment is commendable. Though there should be time lag, given the fact that investment has been increasing since 1992, it should have a positive impact on government tax revenue since the late 1990s. This calls for reexamination of the governance system of tax exemption to minimize abuses of the instrument.

Illegal trade has remained a serious problem in the country. In fact there are widely known corridors of illegal trade, the main being the Easter part of the country, mainly the Somali Regional State of Ethiopia. The problem of illegal trade is complex that calls for development intervention to curb illegal trade in that corridor. For significantly large part of the people illegal trade has remained as the single source of livelihood. So curbing this illegal trade requires changing the source of livelihood of these people. In addition, the government should strengthen its institutional capacity to enforce tax compliance.

The principal strategy is to increase tax effort of the country using different instruments. Basically these instruments should deal with upgrading the tax collection system. Tax payer’s identification is one of the first things to be improved. The recent tax identification effort is commendable. This effort should continue to complete the task and keep it updated to accommodate exit and new entry to the tax payment system. This would need to go hand in hand with tax assessment capacity of the country.

Another issue is to reconsider the level of tax rates and duties. If rates are reduced, the incentive to evade may reduce. Though, the net effect of such reduction cannot be predetermined at this stage, it is worth considering as one strategy to decrease tax evasion. Thus ensuring tax compliance should be another capacity building area of the country. The implementation of these strategic directions to improve the tax effort of the country can range from the short – to medium- term periods.

**Private savings**

On the other hand, one of the major factors that have 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. These remained stunted for long period of time. Ethiopia is under-banked with limited outreach. Particularly, the banking sector has been confines to the provision of the traditional banking services only, with no diversification efforts to introduce new financial instruments.

There are tripled features of the sector that attracts policy attention. On the one hand there is a conservative credit management system in the country. On the other hand, despite this conservative credit management system, there have been high non-performing loans. The third feature of the sector has been excess liquidity and bank reserve, which has negative implication on bank's effort to mobilize saving. Indeed, in view of the excess liquidity and reserve of the sector, there cannot be an immediate interest to aggressively mobilize private saving. The banking sector could have been aggressive to boost savings using both traditional and new saving instruments.

The outcome has been a simultaneous excess reserve and liquidity in the Ethiopian banking industry on the one hand and persistent and substantial macro-level short fall of saving on the other. Excessive liquidity implies 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 while there is one on the table and yet you cannot quench yourself.

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

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

The majority of the population lives in rural areas where there is at best very limited access to financial institutions. To complement the recently evolving micro financing institutions, there is a need for institutional innovation to mobilize saving from the majority of the small farmer and urban poor. The financial sector has to develop saving instruments which are effective to reach the poor farmer but with low transaction costs.

In this regard, one avenue to increase private saving is awareness creation to minimize expensive festivals, marriage and mourning ceremonies. Amidst poverty there is extravagant festive culture in the country.

**Institutional capacity and financial sector infrastructure**

Another strategic direction is to develop the institutional capacity of the central bank of the country. There is an urgent need to develop the capacity of the central bank of the country to adequately discharge its responsibilities to develop the sector and ensure its smooth and health operation. One such capacity building area is to develop credit information database.

There is no capital market so far, which could have substantially contributed to attract savings and ensure efficient allocation of investment. However, such market development requires financial, human, regulatory and related other resources. Thus one needs to be pragmatic and innovative to gradually develop the different infrastructures for capital market, which may start from government bonds. The government may contribute a lot in developing bond market over the medium- and long-terms.

**Pension fund**

One of the non-banking sectors that could have benefitted a lot from the development of the capital market is the pension funds. The recent initiative to administer the fund as an autonomous entity is a modest beginning. Yet, there are concerns that the present pension rate of the civil servants of 10% is not adequate to ensure social security of the elderly. Moreover, much remains to be done to ensure compulsory pension system for every employee, in the private sector and non-governmental organizations. So far there are narrow opportunities for investment of pension funds due to the absence of capital market in the country.

There are large Ethiopian migrants living in different parts of the world. So remittance remains one source of financial resource, which can and should be tapped. Developing different saving instruments could increase saving and investment out of remitted money. The fact that the NBE(central bank of the country) has allowed for opening up of foreign account at this time is commendable to motivate the Diaspora to invest and remit money to the country.

There are studies that show the fact that SSA, among which Ethiopia is one, is indeed, net creditor owing to high capital flight. The first thing to do is to understand the very incentive to save and invest abroad and the mechanisms of capital flight.

In a nutshell, despite the different types of structural impediments, there is wide opportunity to enhance domestic saving. Indeed, there are a number of institutional constrains that has been inhibiting the country from attaining the achievable in mobilizing domestic financial resources.

However, these institutional constraints are amenable to change, if there is will and commitment to develop the necessary institutional and organizational capacity of both tax collection and financial institutions.

The priority areas may be summarized as given in the following policy and strategy matrix.

Figure1. Policy and Strategy Matrix of Domestic Financial Resource Mobilization

| DRM policy areas | DRM specific intervention areas | Prospects | Time framework |
|---|---|---|---|
| The economic environment | Structural constraints | Recent growth episodes and poverty reduction from about 44% to 39% are lights of hope | Long term prospect |
| Public saving: Enhance tax effort | Tax payer's identification | Much is done to identify tax payers | Short term |
| | Developing the tax assessment capacity of different categories of tax payers | Continuous effort is required to keep up with recent initiatives to develop such capacity of different taxpayers categories | Short term extending to the long term |
| | Consider revising tax rates | It is possible to increase tax compliance and increase tax revenue. | Medium term |
| | Strengthen the organizational capacity and governance of the tax collection organizations | Recent restructuring that has empowered the tax authority<br>Business process reengineering (BPR) and studies to introduce business score card<br>Recent higher salary scale is a modest start but it has to aim to introduce and develop performance based management system<br>Enhance tax exemption governance to minimize abuses of this instrument | Short and medium term |
| | Strengthen tax compliance system | There is well established justice system but that requires a lot to go to ensure tax compliance | Short to medium term measures |
| Private saving: financial sector development | Low out reach of financial services | Sector is evolving but much has to be done to expand the outreach and diversify the financial services | Medium to long term |
| | Low saving effort | Excess liquidity and reserve ratios have been one weakness of the sector. The central bank has take measures to stimulate credit<br>Develop new saving instruments | Short to medium term |
| | Strengthen existing and develop innovative instruments to capture the informal sector | Large informal financial sector, it is not difficult to capture the legally operating informal sector | medium term |
| | Strengthen the capacity of the central bank | An ongoing credit register database, strengthening payment services of the sector | Short to medium term |
| | Develop capital market | An ongoing Studies by NBE to establish capital markets | Medium to long term |
| Pension | Room for improvement on pension rates, and its coverage, to ensure universal coverage. | After long period of procrastinations, independently organized,<br><br>Initiations to establish capital market, facilitates the smooth operation of pension funds | Short to medium terms |
| Remittance | Harness it to increasing saving and investment of remitted money | Increasing flow of remittances,<br>Large size of Diaspora, | Short to medium term |

| | | | |
|---|---|---|---|
| Capital flight | Sources and mechanisms of capital flight less known<br>Preliminary indicators it is a serious problem | First measure is to know the underlying factors for capital flight | Sustainable effort over long term |