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The state as an enabler of private sector development in Ethiopia

The cases of tax and financial sector policy

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1. Introduction

Despite increasing realization on the part of policymakers that economic transformation cannot be achieved without an active participation of the private sector, Ethiopia's economy continues to struggle to develop a vibrant private sector capable of meeting the changing needs of the society and creating enough decent jobs. The past few decades have seen a great deal of debate as well as gradual shift in the official position on the role of the state in the economy. Regardless of the disparities in normative positions with respect to the broader implications of the state's participation in the economy, there is little disagreement about the core functions of the state as a policymaking and service delivery apparatus facilitating the operations of the private sector.

In recent years, there has been some effort to understand better the government's bureaucratic capacity for policymaking and service delivery. For instance, Araya (2019) studies civil service management practices across federal, regional, and local government institutions in selected sectors. Bedasso et al. (2018) analyse the policymaking process and bureaucratic capacity in the domain of industrial policy. However, as the country enters a new phase of economic reform that requires careful balancing of the roles of the state and private sector, there are still a number of unanswered questions regarding the technical and political economy underpinnings of the policymaking and implementation processes in areas that are critical for private sector development.

Against this backdrop, the current study attempts to answer the following questions:

1. What are the factors affecting policy coherence in key economic policy domains such as taxation and financial regulation?
2. Who are the key actors involved in economic policy making in domains relevant for private sector development?
3. How is implementation feedback incorporated in policy revision and new policy design?

The choice of tax and financial sector policies as two examples of policy domains relevant to the private sector is motivated by both theoretical and empirical reasons. Theoretically, taxation is the most basic function of the state that is necessary for financing essential public goods. However, optimal taxation and efficient administration of taxation that enable the state to finance public goods without discouraging economic activity have remained elusive for many economies. Similarly, finance is a key ingredient of economic activity, the supply of which often requires effective regulation by the state even in the context of a modern free market economy. Empirically, anecdotal evidence and our own background analysis of the landscape of private sector development in Ethiopia show that access to finance and issues related to taxation are two of the most critical bottlenecks of private sector development.

The discussion on tax and financial sector policymaking is set in the context of the overall evolution of private sector development policy and the current state of the private sector. As such, the paper highlights the strikingly small role the formal private sector plays in generating employment. We also put in the spotlight the sluggish growth in manufacturing output and export performance, underscoring the urgent need to improve the business environment. The analysis of secondary data on sectoral performance and key constraints informs the design and interpretation of the primary data collection on tax and financial sector policymaking.

We conducted semi-structured interviews with 15 officials from 10 government and private sector organizations to explore institutional practices, policy coherence and policy networks in the making, monitoring and evaluation of tax and financial sector policies. The key findings can be summarized as follows. The significant effort in modernizing the tax administration over the past several years has not been matched by comparable dynamism in the tax policy framework. This is manifested in the dearth of systematic tax analysis and evaluation of the effect of tax policy change on key development outcomes. Although the MoF has lately created a dedicated tax policy directorate, the personnel capacity of the unit leaves a lot to be desired. The extensive use of tax and duty incentives to achieve sectoral objectives seems to have created frictions between various parties as to who has the mandate to administer such incentives. The execution of special tax and duty incentives also places a heavy demand on existing capacity.

In the realm of financial sector policy, the frequent and reactive policy changes enacted by the NBE are reported to have impacted the functioning of the private sector and line ministries responsible for affected sectors. Although the NBE has recently introduced new measures that signal further opening up of the financial sector, the changes seem to have emanated from a shift in political impetus rather than a technocratic process based on analytical feedback and learning. The need for timely monitoring and evaluation of policy changes implemented through financial institutions appears to be subordinated to the traditional function of supervision of financial institutions, which prioritizes compliance over broader impact.

The rest of the paper is organized as follows: Section 2 presents an overview of the evolution of private sector development policy in Ethiopia, section 3 documents the trends and patterns of private sector development over the past decade, and section 4 sets the context with a summary of the tax and financial sector polices introduced over the past few years. Section 5 presents the main findings of the qualitative analysis on tax and financial sector policy capabilities. Finally, section 6 concludes and highlights policy implications.

2. Brief overview of the evolution of private sector development policy in the post-1991 period

After the end of the socialist regime in 1991, Ethiopia introduced reforms for recovery, which included lifting restrictions on the private sector, reinstating market forces, reducing tariffs, and devaluing the currency. These economic policies and strategies were guided by an overarching Agricultural Development Led Industrialization (ADLI) strategy (Gebreeyesus, 2013). These decade-long reforms created an environment for rapid economic growth and poverty reduction after the turn of the century (Manyazewal and Shiferaw, 2019). Hence, Ethiopia embarked on a rapid economic growth trajectory in the next two decades after 2000. Five-year national development plans were prepared to guide development policies and strategies, accompanied by sector development plans for education, health, roads, and other areas in the last two decades.

The first decade (2000-2010) focused on poverty reduction principally through economic growth under the Sustainable Development and Poverty Reduction Program (SDPRP) for the period 2002-2005 (MoFED, 2002) and a Plan for Accelerated and Sustained Development to End Poverty (PASDEP) for the period 2005/6-2009/10 (MoFED, 2005). ADLI remained an overarching policy umbrella for both the SDPRP and PASDEP. While active industrial policies were not introduced until after the 2010s, the Industrial Development Strategy (IDS) was prepared in 2002.

The IDS strategy emphasized enhancing the role of the private sector as an engine for industrialization. Some of the policy priorities of the IDS included creating a conducive business environment for the private sector and providing direct support to strategically selected sectors such as textile and apparel, meat, leather and leather products, other agro-processing industries, construction, and micro and small enterprises (FDRE/Mo Info, 2003; EDRI, 2016; Gebreeyesus, 2019). However, the focus on industrial private sector development was not prominent in the SDPRP document. While there is more emphasis on industrial development in the subsequent PASDEP document, there was still no clear strategy for bolstering the private sector.

The SDPRP and PASDEP periods saw significant economic growth averaging 6% and 10%, respectively. However, it is fair to say that economic transformation was not achieved. Hence, the Government of Ethiopia showed a clear change of direction by envisaging a policy of economic transformation since 2010. The preparation of the first Growth and Transformation Plan (GTP-I) spanning 2010 to 2015 and the second GTP-II (2015-2020) witnessed a more active industrial policy. The two GTPs emphasized transforming the structure of the economy from agriculture to industry and a higher-value service sector (MoFED, 2010; NPC, 2016).

During the first GTP, in addition to macroeconomic stability and improvement of the business environment, various support schemes were directed towards selected export-oriented and import-substitution sectors such as textiles, leather goods, cement, and pharmaceuticals. The interventions included direct capacity-building support and fiscal incentives such as tax holidays, reduction of indirect taxes on capital goods, and preferential credit to selected sectors. Heavy government investment in infrastructure was also expected to enhance the competitiveness of the private sector (Gebreeyesus, 2013). Similarly, additional support programmes such as twinning, benchmarking, Kaizen, industrial input supply, and skill development programmes were introduced to enhance the international competitiveness of the private manufacturing industry. Several sector-based development institutes for leather, textile, food, metal sectors were set up to strengthen support for the private sector. Moreover, to ensure environmental sustainability, Ethiopia prepared a green growth strategy known as the Climate Resilient Green Economy (CRGE) in 2011 (FDRE, 2011).

At the end of the first GTP I period, the industrial sector's share stood at 15%, which is significantly lower than the target of 19%, indicating achievements in structural transformation have been poor. Specifically, the share of the manufacturing sector in GDP during the plan period was less than 5%, which is below target and lower than the 10% average in Sub-Saharan African countries. The poor performance of the micro and small manufacturing enterprises and the low level of promotion of entrepreneurship, particularly among the youth, are some of the key contributors to the poor performance of the manufacturing sector (NPC, 2016).

The focus on growth and transformation continued in the second GTP (2015-2020), underscoring the attraction of FDI and improving manufacturing performance via expansion and development of industrial parks and integrated agro-processing. The development of industrial parks is seen as crucial to addressing the production and logistics constraints that impede productivity and competitiveness for both domestic and foreign investors. Real GDP growth continued during the second GTP period annually averaging at 8%. However, the structure of the economy has not changed as the service and construction sectors continued to be the main growth drivers despite the government's policy of focusing on agriculture and industry.

Economic policies and strategies over the last decades have brought fast economic growth and substantial poverty reduction. However, these achievements were driven mainly by public investment in social and economic infrastructure. Throughout the post-socialist era, the private sector has not succeeded in being the leading driver of growth and decent jobs.

The increasing debt burden, particularly foreign debt, due to stagnating exports, shortage of foreign exchange, low tax to GDP ratio raised questions about Ethiopia’s economic growth sustainability. Hence, the Homegrown Economic Reform Agenda was prepared in 2019 to conduct macroeconomic, sectoral, and structural reforms to pave the way for the next national development plan, namely the Ten-Year Perspective Plan (2020-2030).

There are two key constraints to private sector development in terms of policies, strategies, and their implementation (IFC, 2019). The first relates to policies and regulations which are subject to frequent changes, especially those related to taxes, creating uncertainty. Implementing policy through internal circulars that are often not public also creates additional confusion among enterprises. Related to this is the uneven implementation of regulations to private versus state-owned enterprises creating unfair competition. The second constraint relates to low technical capacity in ministries and agencies mandated with supporting the private sector and weak horizontal coordination among agencies and institutions leading to misalignment of goals and inefficient bureaucracies. This is particularly true in the case of taxes and customs where inconsistent rules are being applied across sectors leading to informal transactions as the 'one-stop shop' is hardly implemented.

3. Private sector development in Ethiopia

As indicated in previous sections, the private sector remains nascent in Ethiopia. There has been an expansion of infrastructure by the government presumed to improve the competitiveness of the private sector. There has also been a support system in place. However, actual success in terms of revitalizing the private sector has been limited. In this section, we discuss the role of the private sector in the Ethiopian economy, its characteristics, and main binding constraints.

3.1. The role of the private sector in the Ethiopian economy

The role of the formal private sector in employment creation remains limited: Based on national labour force surveys for 2013 and 2021, shown in Table 1, the share of employment by private organizations nationwide remains small at 3.8% in 2013 and 3.9% in 2021 respectively. For urban areas, private sector employment declined from 18% in 2013 to 15% in 2021. Hence, overall, the role of the private sector in absorbing the labour force remains limited. Both at the national level and in urban areas, the government employs slightly more than the private sector.

Hence, the share of employment in the private sector is small and hasn't shown significant change from 2013 to 2021. The only major development in terms of employment distribution is that the share of unpaid family workers declined from about 54% in 2013 to 39% in 2021. A significant number of people transitioned from unpaid family work into self-employment in agriculture and non-agriculture sectors nationwide. The share of unpaid family workers and those self-employed in urban areas did not show a significant change between 2013 and 2021. However, most self-employment remains in the informal sector with low earnings.

In summary, despite the government's focus on creating a vibrant private sector that absorbs a significant number of the increasingly youthful workforce, the sector remains a small employer. There is considerable room for improvement in creating a vibrant private sector that can absorb a high proportion of the workforce, potentially increasing the share of middle-income households in the country.

Table 1: Employment Types

Job Type (%)	2013		2021	
	Nationwide	Urban	Nationwide	Urban
Private Organizations	3.8	18.2	3.9	15.0
Government	3.9	20.1	5.5	22.1
NGOs	0.2	1.0	0.2	0.8
Members of Coop	0.2	0.8	0.1	0.2
Self Employed (agri and non-agri)	36.0	38.6	47.6	38.9
Employer	0.4	0.7	0.1	0.4
Domestic workers	0.9	4.1	1.7	5.7
Unpaid Family workers	53.9	14.7	39.4	13.1
Others	0.8	1.7	1.5	3.8
Total	100	100	100	100

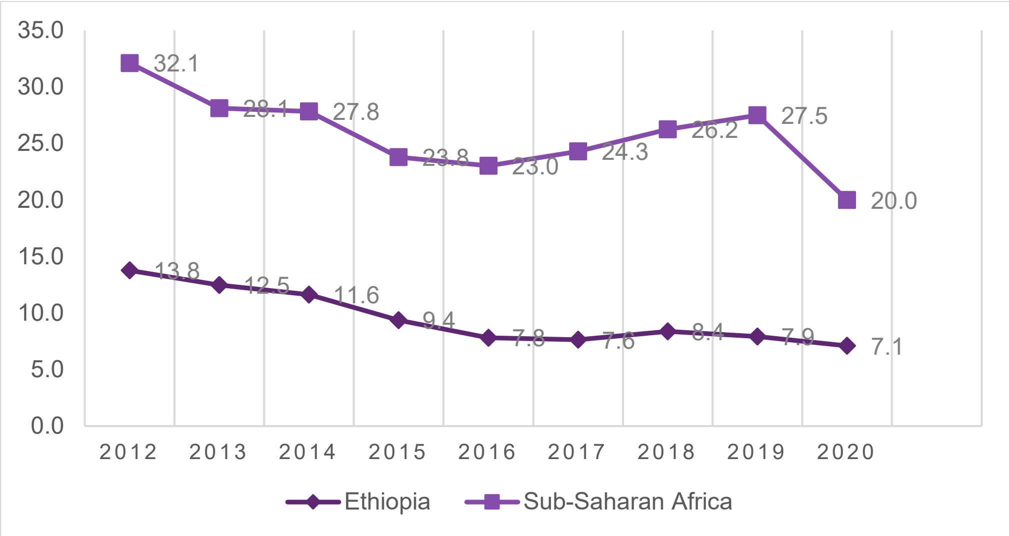
Source: Authors computation based on the 2013 and 2021 national labour forces surveys

Stagnant, import-dependent, and geographically concentrated manufacturing sector: Based on the CSA survey data on large and medium manufacturing enterprises (LMMEs) for 2016/17, there are more than 3,600 LMMEs in the country, more than 96% of which are private. The employment created by LMMEs in Ethiopia has remained stagnant and hovered around 300,000 from 2013 to 2018. Manufacturing of food and beverages and textile and garment are the largest employers among the large and medium manufacturing enterprises. Moreover, there is a geographic concentration of large and medium manufacturing firms in Addis Ababa. Based on the LMMEs survey, about 40% of all medium and large manufacturing establishments were located in Addis Ababa in 2018. The LMMEs remain highly import- dependent as about half of their input costs are imported. Textile and garment, machinery and equipment, and basic iron manufacturing are particularly import dependent. Manufacturing of food and beverages and non-metallic minerals are the sub-sector with relatively lower import dependence with about 30% and 20% import cost of inputs, respectively.

Low and declining exports as a share of GDP: In the last decade, export as a share of GDP remains low and has been declining as the share decreased from about 14% in 2012 to 7% in 2020 (Figure 1). Hence, export hasn't matched the GDP growth witnessed in the country. The export share in GDP is about a third of the Sub-Sahara Africa average. In 2019, while it was close to 8% (down from about 17% in 2011), the average for sub-Saharan

African countries was 27.5%. The agricultural sector remains by far the main export earner for the country with more than 80% of all exports, notably coffee, oil seeds, pulses, khat, and flowers. The lack of diversification in exports and dependence on a few low-value primary products exposes the country to the effects of global price shocks.

Figure 1: Exports as a percentage of GDP



Source: WDI

A steady flow of FDI and high private gross capital formation: Ethiopia attracted a steady flow of foreign direct investment since 2015, which ranged between 3 and 4 billion USD making it one of the largest receipts in Africa except before it declined in 2019/20 to 2.4 billion USD. The National Bank of Ethiopia (NBE, 2021) preliminary estimates for 2020/21 show FDI would bounce back to close to 4 billion. With gross capital formation (investment) consistently above 30% and averaging 35% for 2011 – 2020 (about two-thirds of which is private for most years), Ethiopia has a relatively high investment rate among countries in Sub-Sahara Africa. Hence, Ethiopia's growth in the last decade came more from capital deepening rather than improvement in total factor productivity (See, for example, Tekleselassie, 2021).

3.2. Characteristics of the private sector

Formal sector dominated by male workforce and managers: Based on the 2015 Enterprise Survey for Ethiopia conducted by the World Banks covering the non-agriculture formal sector (services and manufacturing) employing five or more people, about 28% of the workforce are female, which is comparable to the Sub-Sahara Africa average (29%) and slightly lower than the average for low-income countries (32%). The share of top female managers is particularly meagre in Ethiopia which stood at 5% compared to 14% and 20%

in SSA and low-income countries, respectively. Female participation in ownership remains low in Ethiopia at 36% but is slightly higher than the 20% corresponding figures for both SSA and low-income economies[1].

Workforce internal training by firms remains low: among non-agricultural formal firms, only 21% of firms provide training to their workforce internally compared to 28% and 27% in SSA and low-income economies. The intensity of training measured by the proportion of workers who got training internally is particularly low among enterprises in Ethiopia, only 27% compared to 44% and 40% in SSA and low-income economies, respectively.

Financing tools remain limited, with internal finance being the primary source of investment financing: The proportion of firms with checking or saving bank accounts in Ethiopia is close to 93% compared to SSA (83) and low-income economies (72). However, the share of investment financed by banks remains low at less than 8% for Ethiopia, 9% for SSA and 6% for low-income economies. Internal financing by firms covers 83.3% in Ethiopia, 71.1% in SSA, and 83.8% in low-income economies. Investment by supplier credit and equity (or stock sales) cover less than 1% in Ethiopia, lower than averages for SSA (3.3% and 7% respectively) and low-income economies (1.8% and 4.4% respectively).

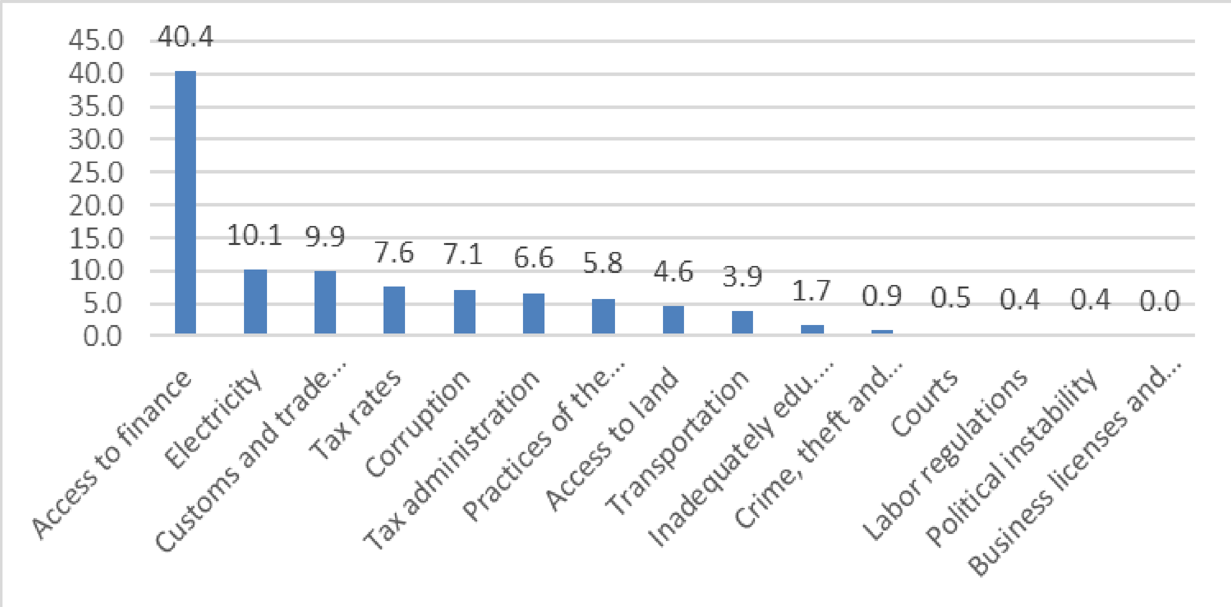
A large number of micro and small enterprises exist but manufacturing value-added is dominated by few large firms: Shiferaw and Söderbom (2019) show that the industrial sector in Ethiopia is characterized by a large number of very small, typically informal, enterprises and a small number of large firms. However, large firms account for the bulk of manufacturing output and employment. The micro and small enterprises tend to register low value-added, low wages, little exports, and limited technological progress.

3.3. Private sector development bottlenecks

Access to finance remains the most significant constraint for the private sector: Figure 2 shows the top ten business environment obstacles according to the 2015 Enterprise Survey. As shown in Figure 2, access to finance is the biggest obstacle for 40% of the firms. Figure 3 provides a summary of business environment obstacles by the size of firms. Access to finance is reported to be the biggest challenge by the majority of firms of all sizes.

[1] The relatively higher share of female ownership in Ethiopia compared to SSA and low-income economies is likely to be a reflection of Ethiopia's family law which automatically accords joint ownership between spouses unless specifically stated for individual ownership by a court.

Figure 2: Main Business Environment Obstacles



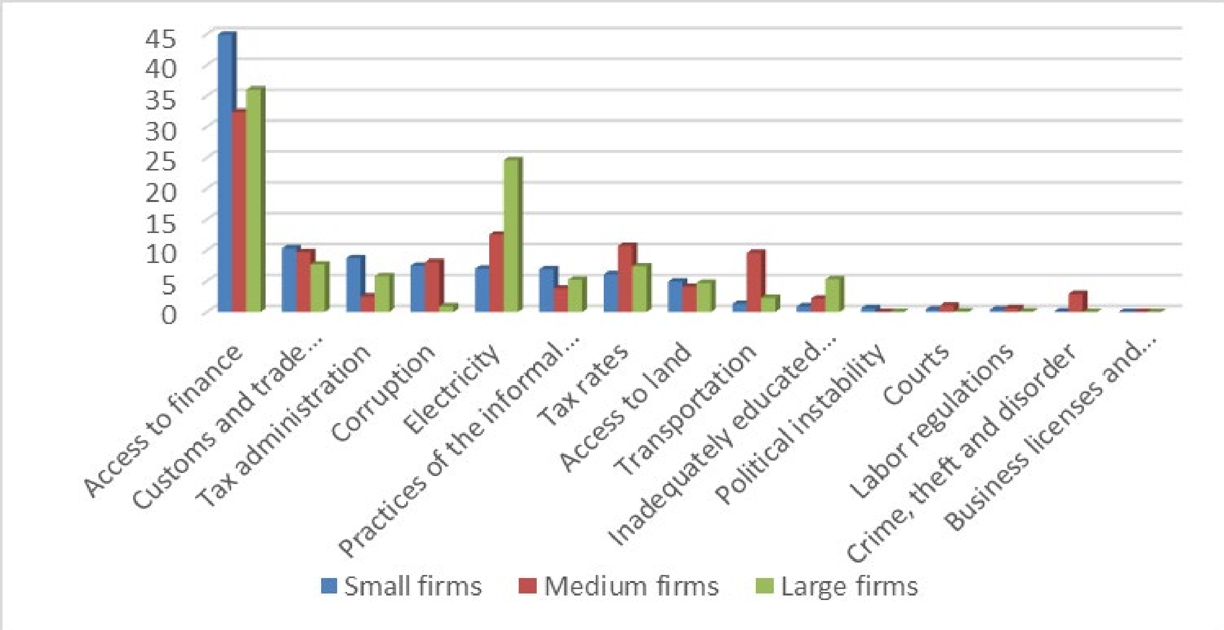
Source: World Bank Enterprise Surveys, http://www.enterprisesurveys.org

Electricity, customs and trade regulations, and tax rates remain critical binding constraints for the private sector: Unreliable electricity, bureaucracy in customs and trade regulations, and tax rates follow access to finance as the most significant constraints to the private sector in Ethiopia.

Electricity is the second biggest challenge for medium and large firms, followed by tax rates for medium-sized firms and customs and trade regulations for large firms. For small firms, access to finance is followed by customs and trade regulations and tax administration as the top three obstacles.

Access to finance is not only a binding constraint to existing firms but also aspiring entrepreneurs**:** Based on the 2021 Labor Force and Migration Survey, access to finance is by far the biggest constraint for individuals who aspire to start their businesses. About 64% of respondents list access to finance as their major constraint to starting a business, followed by 13% who cited a lack of working premise and finance and 8% who cited a lack of working premise.

Figure 3: Main Business Environment Obstacles by firm size



Source: World Bank Enterprise Surveys, http://www.enterprisesurveys.org

Lack of working premises is also mentioned as a leading constraint for micro and small manufacturing enterprises: A nationwide survey of micro and small manufacturing enterprises by the Ethiopian Development Research Institute in 2016 similarly revealed that the key challenges for the operation and growth of enterprises to be lack of adequate working premises, lack of access to credit and shortage of power supply (Gebreeyesus et al., 2018).

Lack of inputs at the desired quality and quantity remains a challenge for large and medium manufacturing enterprise: Based on the Large and Medium Manufacturing Enterprises Survey (CSA, 2018), for large and medium manufacturing enterprises, the main bottlenecks for operating at full capacity and growth is a shortage of inputs with the desired quality followed by unreliable electricity and weak market demand.

Weak private sector support system: The Growth and Transformation Plans (I and II) envisaged the private sector to be the bedrock of development in Ethiopia, and hence a support system was put in place. The support system includes interventions such as direct capacity-building support and fiscal incentives such as tax holidays, reduction of indirect taxes on capital goods and preferential credit to selected sectors in addition to the heavy public investment in infrastructure such as roads, power, and telecom (Gebreeyesus, 2013). However, implementation of the various support systems was below par due to weak civil service, lengthy bureaucracy, and weak coordination among the multiple stakeholders and government agencies.

Other constraints: Inefficiencies in trade logistics, expensive transportation for inputs and outputs, tax administration, and lack of educated and trained workforce are other constraints affecting the performance of the private sector (see, for example, various chapters in Cheru, Cramer, Oqubay, 2019).

4. An overview of recent tax and financial sector policies in Ethiopia

4.1. Tax policies

Tax reforms in Ethiopia have been undertaken since the 1940s. However, the reforms became comprehensive and intensive since the 2000s. Some reforms included income tax reforms, the introduction of Value Added Tax (VAT), excise taxes, and foreign trade tariffs (see Harris and Seid, 2021 for a list of tax reforms in Ethiopia in recent years).

Income tax reform reduced the maximum marginal tax rate from 85 percent to 50 percent in 1992, 40 percent in 1999, and 35 percent in 2002 (NBE, 2017). Similarly, income tax thresholds and related progressive tax rates were reformed in 2002 (Proclamation No. 286/2002) and 2016 (Proclamation No.983/2016). Similarly, the top rate of business profit tax was reduced repeatedly. It was slashed down from 89 percent before the reform to 45 percent in 1992, and then to 40 percent in 1999 and in 2002 to the present rate of 35 percent.

Value Added Tax (VAT) replaced sales tax in 2003 and was revised in 2019 (Value Added Tax Amendment Proclamation No. 1157/2019). The amendment in 2019 focused on the administration of VAT. A VAT of 15 percent is levied on legally registered businesses having a total turnover exceeding or equal to 1 million Birr per annum, which was 500,000 per annum before the VAT amendment.

Excise reforms were undertaken under Excise Tax Proclamations. No.307/2002, 570/2008 and 610/2008, and mostly recently 1186/2020. Foreign trade tariffs were brought down from a maximum of 230% to a maximum of 35% by the reform in 2003 (See, for example, Woldeyes et al., 2019).

Harris and Seid (2021) document that the tax reforms in the last two decades were motivated by the need to update tax thresholds to account for inflation (income tax and VAT thresholds), broadening the tax base to raise revenue, and pursuing wider policy objectives (e.g., tackling pollution via increases in excise duties on older cars with large engines, supporting agricultural modernization using import and other tax exemptions, and helping businesses).

The fundamental authority to tax is derived from the Constitution of 1995, which, following the federal structure, shares tax powers between the Federal Government and the Regional States. Except for customs duties, which are the exclusive preserve of the Federal

Government, most other taxes are sliced into pieces by the Ethiopian Constitution and shared between the Federal Government and the Regional States based on specific formulas (Lencho, 2013).

Although tax reform process is usually initiated by the Ministry of Finance, there are cases where tax policy reform requests come from other ministries with specific interests. In 2019, for instance, MoF granted duty-free importation of various agricultural equipment based on a request from the Ministry of Agriculture and the Agricultural Transformation Agency, which had conducted a study on the implications of such incentives for the modernization of the agricultural sector (Harris and Seid, 2021). The tax reform process under the ministry of finance engages different stakeholders. Sometimes, it is done by a committee of experts, especially when the reform request comes from other organizations.

There is little rigorous research on the impact of the recent tax policy and administration reforms on the Ethiopian economy. The indirect impact assessment on the effect of the various tax reforms suggests that the impact is mixed. According to NBE (2017), the tax revenue to GDP ratio during 1993-2016, on average, improved marginally to 10.5 percent compared to the average of 9.1 percent in the 1975-1991. A study by African Development Bank on the effect of the recent tax reforms in Ethiopia shows that the reforms have increased revenue collection AfDP (2019). In terms of specific taxes, the new excise tax proclamation resulted in a decline in the import of old cars by 10-fold and earnings from excise tax increased by 65% in 2019/20 (Addis Fortune (2021). On the other hand, a study by Woldeyes et al. (2019) showed a substantial loss in government revenue due to second the schedule tariff scheme. As far distributional impact is concerned, replacing sales tax with VAT was also found to have adversely impacted the poorest 40 percent of the population (Muñoz and Cho, 2003).

The review of studies on tax policy and reforms reveals some key gaps. Firstly, the tax policy reforms in Ethiopia have not been consistently costed, making it challenging to conclude concretely if the reforms have increased revenue (Harris and Seid, 2021). Second, considerable discrepancies exist between existing laws and directives making effective tax administration daunting. Similarly, several ambiguities appear in the proclamations, regulations, and directives (Abdella and Clifford, 2010). Thirdly, there is often considerable time lag between the issuance of tax proclamations and regulations, and the associated implementation directives, which increases risk and uncertainty for businesses (Abdella and Clifford, 2010).

4.2. Financial sector policies

The National Bank of Ethiopia (NBE) is legally an "autonomous institution" as stated in both the 1994 and the 2008 NBE establishment proclamations which is authorized to initiate new financial policies or review existing policies. In recent years, the NBE has issued several proclamations and directives in relation to monetary policy and supervision of financial institutions. There is a claim on the part of private financial institutions that many of the directives tend to favor state banks. The recently repealed 27% deposit retention rule which applied to private banks and used to extend credit to the DBE to finance projects in priority sectors like agriculture and manufacturing, and to purchase Government T-Bills is often mentioned as a case in point. Furthermore, the National Bank usually lacks the enforcement authority on the state-owned banks.

The NBE has introduced several recent directives which can potentially transform the retail payment system in Ethiopia (Haile et al., 2022 for details on NBE directives since 2019). For instance, the *Licensing and Authorization of Payment Instrument Issuer Directive No. ONPS/01/2020* provides a broader definition of financial institutions beyond banks and microfinance institutions. The new definition includes services of fintech companies such as mobile money, wallet, and related digital financial services.

A related directive is *Licensing and Authorization of Payment System Operators Directive No. ONPS/02/2020* which allows non-financial institutions, including fintech companies, to provide payment related services in Ethiopia under a payment system operator license issued by the NBE. Payment processing, personalization of payment cards, acquiring payment transactions, point of sale machine operation, payment aggregation and payment applications or solutions are the specific activities covered by this directive. Another recent directive related to the protection of financial consumers, is the *Financial Consumers Protection Directive No. FCP/01/2020*. The NBE issued this directive to protect consumer data as well as set a framework for compliance and dispute resolution procedures.

The NBE has issued several foreign exchange directives in recent years. We only mention a few examples here. The Foreign Currency Intermediation by Banks Directive No. SBB/77/2020 authorizes local banks to borrow from external lenders in foreign currency and extend foreign currency denominated loans to local entities engaged in foreign exchange generating business. The Retention and Utilization of Forex Earnings Directive No. FXD/70/2021 (amending Directives No. FXD/66/2020) provides incentives to exporters of goods and services in importing and repaying external debts. Recipients of foreign exchange and exporters can hold 45% of their export earnings and remittances indefinitely in a

Retention Account. Exporters and recipients of foreign exchange must surrender the remaining 55% at the prevailing exchange rate on the day of receipt to the recipient's bank, and the latter must pay the equivalent in Birr.

5. Assessing policy formulation and monitoring capabilities: the cases of tax and financial sector policies

Given the prominence of taxation and access to finance as factors determining the business environment, this section zooms in on the state's capabilities for formulating tax and financial sector policy as well as monitoring and evaluation of policy implementation.

5.1. Methodology

The study of the policy formulation and monitoring capabilities in tax and financial sector policy domains was conducted using a qualitative approach. The principal method of data collection is a semi-structured key informant interview. The key informant interviews are complemented with analysis of relevant policy documents published between 2015 and 2022. The selection of key informants proceeded in two stages. First, the primary key informants were selected from the ministries of finance and revenue for tax policy and the National Bank of Ethiopia for financial sector policy. Second, a secondary set of key informants were interviewed from associated government agencies and private sector organizations to collect further information and triangulate information provided by the primary key informants. The government organizations selected for triangulation were included because they are responsible for a sector significantly affected by tax or financial sector policies. Table 2 presents the full list of organizations and the number of officials interviewed.

Table 2: Selection of key informants

Organization	Number of key informants	Policy role
Ministry of Finance	2	Primary - tax policy
Ministry of Revenue	3	Primary – tax policy
National Bank of Ethiopia	3	Primary – financial sector
Ethiopia Chamber of Commerce and Sectoral Associations	1	Secondary- tax and finance
Addis Ababa Chamber of Commerce and Sectoral Associations	1	Secondary- tax and finance
Ministry of Industry	1	Secondary- tax and finance
Ministry of Trade and Regional Integration	1	Secondary- tax and finance
Ethiopia Investment Commission	1	Secondary- tax and finance
Ministry of Labor and Skills	1	Secondary- tax and finance
Ministry of Planning and Development	1	Secondary- tax and finance

A generic list of 16 questions was prepared to guide the interview with primary key informants representing the tax and financial sector policy domains. The questions cover two broad categories: a) policy formulation and coherence and b) monitoring and evaluation. The interviews with the secondary key informants were less structured than the ones with primary key informants as the focus varies with how the respective organization is affected by tax and financial sector policies. In addition to the key informant interviews, policy documents were obtained either directly from the organization in charge of the policy or their website and reviewed.

5.2. Tax policy

a. Policy formulation

The mandate of formulating tax policy belongs to the Ministry of Finance. There has been considerable stability in the organizational structure behind tax policy compared to multiple changes that have taken place on the administration side over the past few years. This is indicative of the complexity of revenue administration challenges compared to policy formulation. Although organizational stability is desirable, it appears that there has also been a lack of dynamism in the formulation of tax policy.[2] This is manifested in the relative stagnancy of tax policy in the decade between 2010 and 2020. This assessment is shared by tax policy officials and private sector representatives. The last two growth and transformation plans had little use for tax policy reform as an instrument to achieve development objectives. The key informants claim that this is attributed to a belief among policymakers that tax-related problems mainly emanate from tax administration instead of policy gaps. This belief might have led to a disproportionately larger share of reform effort having been directed towards modernizing tax administration than adapting the policy framework to changing economic circumstances. The remarkable efforts in improving tax administration notwithstanding, there has been a dearth of evidence-based policy making in the realm of tax policy. Most of the incremental changes that were made over the past decades were carried out with limited research and empirical evidence.

The lack of dynamism in tax policy is not limited to the internal revenue system as the custom duties on imports are also characterized by considerable rigidity. One of the main gaps in the past was that the customs' tariff book had not been considered when the country's strategic plans were formulated. One of the key informants contended that this is likely to have impacted the growth of the manufacturing sector. Such effect is likely to have

[2] One key informant remarked that the Ministry of Finance has strong capabilities in its traditional role of expenditure management, whereas its tax policy capabilities are still developing.

occurred due to perverse incentives created by the existing tariff schedule, which might not necessarily align with the policy ambition to transform the structure of the economy.

Another potential explanation for the lack of dynamism in tax policy is linked to the internal structure of the Ministry of Finance which was dominated by the expenditure side of public finance. Until 2017, the legal department managed the tax policymaking process as there was no tax unit or directorate in the Ministry of Finance. That means there was no formal structure to follow up on tax policy issues. Moreover, the economic dimensions of tax policy have been eclipsed by the legal aspects of the policy.

As to the policy process, a new policy or a revision to existing policy can be initiated as a result of official reviews or external feedback. The current process requires detailed and systematic studies when the ideas are initiated. Then, the findings of the study will be presented to the minister. Although draft laws are discussed with stakeholders before the conclusion of the approval process, the findings of the initial assessment and recommendations are not usually shared with the public in time to receive proper feedback. This, according to officials, is because the policy reform will be less effective or have distortionary impacts if economic agents are informed before full implementation. This is viewed as problematic by private sector representatives who argue that stakeholder consultation should not be limited to commenting on a near-final draft but must include more intensive engagement from scratch.

b. Policy coherence

Although there do not seem to be many glaring incoherencies at the policy level, the key informants contend that there are some inconsistencies in the use of tax policy to promote manufacturing growth. One example in this context is the treatment of industries such as tobacco and alcoholic beverages that qualify for tax incentives as manufacturing activities on the one hand and are subject to a significant excise tax on the other hand. The extensive use of exemptions and tax incentives that often benefit the rich is inconsistent with the purportedly pro-poor orientation of economic policy in other domains.

Apart from the few apparent inconsistencies, the key informants from both government and private sector observed that the lack of dynamism in tax policy, particularly in the GTP periods, might have prevented the tax system from being more coherent with the overall development strategy. There are instances of tax policy incoherence with overall development policy. For example, the country follows mainly export-oriented industrial policy focusing on labour-intensive light manufacturing such as textile, garment, shoe and leather. To that end, various incentive mechanisms have been implemented to promote export. Moreover, to protect enterprises in these selected sectors, a 35% import duty is levied on imports of such products. However, the high protection of these industries has resulted in higher prices of such commodities in the domestic market and hence manufacturers prefer to sell their products in the domestic market rather than exporting (See, for example, Gebreeyesus and Kebede, 2017). Additionally, it was pointed out that the equity implications and relevance of tax policy in the immediate future will depend on how it will adapt to emerging dynamics in the economy, including taxing e-commerce, other digital services, and externalities.

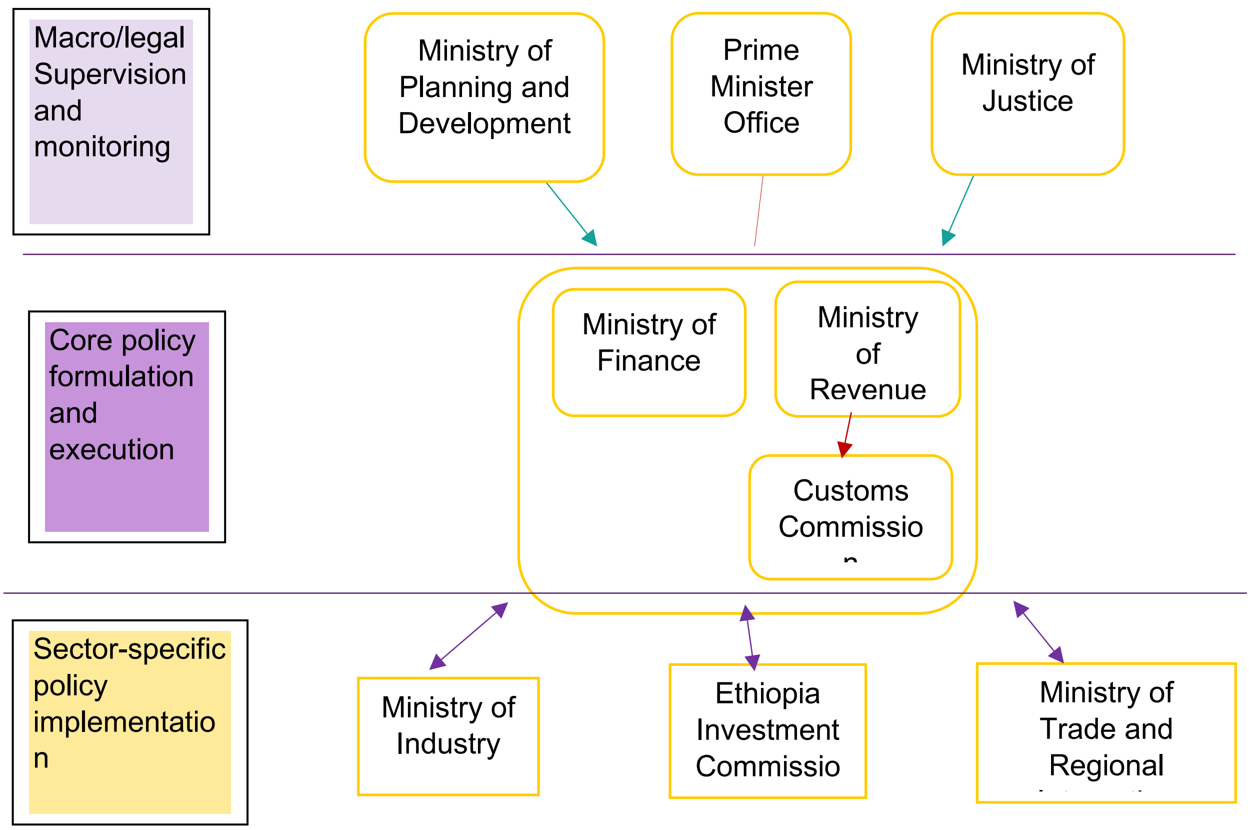
Most of the inconsistencies and frictions emerge at the stage of tax administration. Due to presumed overlaps in responsibilities, the management of tax and duty benefits is usually a source of friction. For instance, the Ministry of Revenue sometimes falls into disagreement with the Ethiopian Investment Commission when the latter attempts to take charge of facilitating tax and duty benefits instead of the Ministry of Industry which is mandated by the proclamation to play that role. But this apparent overreach is not limited to the EIC. Several ministries and agencies are constantly trying to claim a share of the tax incentives management role by directly approaching the Ministry of Revenue with requests. In contrast, a key informant from the EIC commented that revenue authorities tend to exercise too much discretion in managing tax incentives which sometimes can contradict the spirit of the law. In addition, this has led to the application of inconsistent tax and duty rules across sectors contributing to proliferation of informal transactions as attested by IFC (2019).

The federal structure could also be a source of tax policy differences that must be managed carefully in order to avoid distortions. Regions can promulgate their own tax proclamations, regulations, and directives. Though they cannot change the tax rates, they have other powers such as defining tax exemptions. For instance, the Addis Ababa city administration considers only large enterprises for tax holidays, while the Ethiopian investment commission believes micro and small enterprises should also be included in tax holidays. It was also pointed out that some regions had not yet started implementing the revised excise tax rates.

c. Policy network

As the previous sections show, tax policy is mainly controlled by the Ministry of Finance. However, as a policy instrument with significant economy-wide implications, the overall policy process is expected to be supported by a network of key stakeholders that play various roles in formulating, executing, monitoring and evaluating of the policy. Figure 4 lays out a simplified version of the policy network that characterizes the tax policy domain. At the center of the policy network, the Ministry of Revenue is the second key pillar of the policy network, with responsibility to administer tax revenue collection based on the policy framework formulated by the Ministry of Finance. This also makes it a critical counterpart in the policy monitoring and evaluation process as it usually collects the required data for adaptation. The Ministry of Revenue is mandated to oversee both internal and customs revenue administration with the Customs Commission subordinated to it. However, key informants from the private sector commented that, in practice, some of the actions of the Customs Commission give the impression that it has a horizontal relationship with the Ministry of Revenue.

Figure 4: Tax policy network



The Ministry of Industry (MOI) is arguably the most critical line ministry in the tax policy network. This is due to the more complex application and non-trivial implications of tax policy in the case of the industry sector. It should also be noted that the MOI is in charge of the nation’s industrial strategy, which is supposed to have tax policy as one of its key instruments. The central role of tax policy and administration for the operation of manufacturing firms is highlighted in a study based on network data collected from firms (Bedasso et al., 2016). However, it appears that the role of the MOI is more pronounced in tax administration than in policy formulation, as expert-level engagement with the tax policy directorate at Ministry of Finance is reported to be very limited. On the tax administration front, MOI is responsible for managing the various tax incentive schemes targeted at the manufacturing sector.

The other key agency in the tax policy network is the Ethiopia Investment Commission (EIC). As the linchpin of investment facilitation across all sectors of the economy, it plays a critical role in the earlier stages of investment operations, particularly FDI. However, there is sometimes ambiguity about the role of EIC both in the industrial policy and tax policy. It is not always clear which aspects of investment promotion EIC can execute on its own and which ones it should defer to other ministries and agencies. For example, the one-stop investment facilitation service at EIC used to include duty-free services. However, the Ministry of Finance has relocated the duty-free function back to its premises which, according to a key informant from EIC, has reduced the efficiency of the investment registration process.

The tax policy feedback process is not limited to government ministries responsible for trade and investment facilitation. A key informant from the Ministry of Labor and Skills pointed to several instances where they proposed tax policy issues pertinent to their mandate of promoting ease of doing business and attained considerable success. For instance, Ministry of Finance accepted their request to revise the income tax rate for sole proprietorships and cooperatives to promote job creation in 2017.

d. Monitoring and evaluation

As in most other government functions, the monitoring capabilities in the tax system are relatively more robust than the evaluation capabilities. At the Ministry of Revenue, monitoring activities are undertaken through reporting, field visits, and weekly review meetings with each core process. However, there is no specific technology employed by the ministry to collect and analyse monitoring data. Data is still collected manually. As for Ministry of Finance, after the establishment of the tax unit in the ministry, there is tax follow up and evaluation team under the directorate. There is also an effort to setup an electronic system to collect repots from enterprises by the tax directorate. But the key informant remarked that there are significant personnel capacity constraints. There is significant staff turnover often triggered by low salaries in the public sector which makes it difficult to build specialized human capital in relatively more technical areas such as tax policy analysis.

Monitoring is often rendered difficult because the responsibility to manage tax incentives is diffused. The Ministry of Revenue discovered around 35 government organizations tasked with managing tariff and tax incentives. But none of them were following up on the implementation thereof. The administrative burden of monitoring compliance to tax incentive schemes can be overwhelming. For example, the Ministry of Industry appears to exercise significant discretion that at least requires a large amount of data. Due to poor monitoring and supervision, the performance audit of incentive package beneficiaries is not carried out until they visit the office to renew their license.

As far as evaluation is concerned, the key informants acknowledged that impact evaluation of policies is virtually non-existent. Let alone ex-post impact evaluation, the key informants emphasized, little attention is placed on the ex-ante impact assessment of policies at the drafting stage. They further stated that the focus is more on the administration and revenue it can generate. The extensive use of tax exemptions was also reported to have made it difficult to assess the tax potential of the economy due to the lack of proper analysis of tax expenditures.

The absence of an impact evaluation system of tax policies can result in the continuation of policies with significant unintended negative impacts. For example, in 2008 and 2012, 150% of export tariffs were levied on raw hides and skins and crust leather to encourage value-addition in the leather sector (Abebe and Schaefer, 2013). However, due to poor capacity of tanneries to process raw hides and skins, the price of raw hides and skins plummeted and the market for them collapsed. Hence leather manufacturers had to import raw hides and skins as they could not find quality raw hides and skins locally. Overall, the performance of the leather industry in Ethiopia in the last decade was poor, with declining productivity, value-added share, and employment share among the sub-sectors of the manufacturing sector (see, for example, Hailu et al., 2020). The revision to lift part of the 150% tariff on export of raw hides and skins and crust leather did not come until 2020.

5.3. Financial sector policy

a. Policy formulation

As it has been practiced over the past few decades, financial sector policy mainly concerns the regulation of financial institutions and the allocation of foreign exchange. As such, it is primarily conducted in the form of directives issued by the National Bank of Ethiopia (NBE) to regulate the formation of financial institutions (banks, insurance companies, and microfinance institutions) and the conduct of financial transactions undertaken by those institutions. This typically includes both domestic and foreign transactions.

The relative lack of complexity in Ethiopia's financial sector arising from the political choice to restrict the pace of liberalization has so far rendered the role of NBE relatively straightforward. Multiple pathways that lead to a new policy or revision in the financial sector ranging from NBE's own monitoring of the economy to private sector feedback to recommendations from International Financial Institutions. As an institution that is ultimately accountable to the head of the executive branch, the NBE formulates policy in line with the broader strategic objectives and normative orientations of the governing party.

Typically, the policy formulation process begins with a study on the respective policy issue. There is a practice of considering the experiences of developed countries as part of the benchmarking exercise. Lately, stakeholder participation has become one of the requirements by Ministry of Justice to provide a green light for the policy formulation process to go ahead (except in the presence of confidential issues that cannot be revealed to the public).[3] It remains to be seen how much this regulation will remediate the common complaint by private financial institutions regarding the lack of timely consultation on critical policy changes.

As an example of a policy change that originated from an external source, the key informants highlighted the process followed in the case of policies enacted on the recommendations of the IMF. In such cases, the relevant directors check the initial studies before they are sent to vice governors, followed by the board. Once the board approves, the draft is presented to the macro committee. Generally, the macro committees serve as the primary vehicle for policy coordination, including fiscal and monetary policy coordination.

A review of the most recent policy changes implemented by NBE - including capital markets proclamation, the establishment of a moveable collateral registry and the permission for commercial banks to borrow in foreign currency from foreign banks – shows the NBE responds to long-standing bottlenecks and market failures only when the reform becomes politically tenable. The slow pace of financial deepening in the economy demonstrates the overly cautious approach that has dominated financial sector policymaking in Ethiopia since the end of the socialist era in 1991.

b. Policy coherence

Financial sector policies are drawn from the ten-year perspective plan governing the nation's economy. Generally, financial sector policy is one of the most prominent domains in which the normative orientations of the governing coalition are reflected. As such, the highly restrictive requirement on commercial banks to commit 27% of their deposits to government bonds that was in place between 2011-2019 was emblematic of the state-led development ideology espoused by the EPRDF-led regime. On the contrary, the recent changes including capital market proclamation and movable property registry signal the shift towards a more private-sector-driven approach since 2018.

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[3] There is a risk that such exceptions could result in undue discretion by NBE officials to restrict the degree of stakeholder engagement.

There is increasing attention to financial inclusion consistent with the broad-based poverty reduction objectives of economic policy. The NBE has formulated a financial inclusion policy framework and formed a directorate to oversee the implementation. The key informants reported that NBE engaged key ministries such as agriculture to ensure alignment with sectoral strategies when formulating the financial inclusion policy. The focus on inclusion is also manifested in the establishment of a dedicated unit at the Development Bank of Ethiopia headed by the vice president.

However, coherence and alignment in high-stakes policy domains such as foreign exchange management seem fraught with difficulty, unlike policies in more novel areas such as financial inclusion. Key informants mentioned that there are multiple government bodies with a strong interest in foreign currency allocation, which sometimes have attempted to enact their policies concerning foreign exchange management.

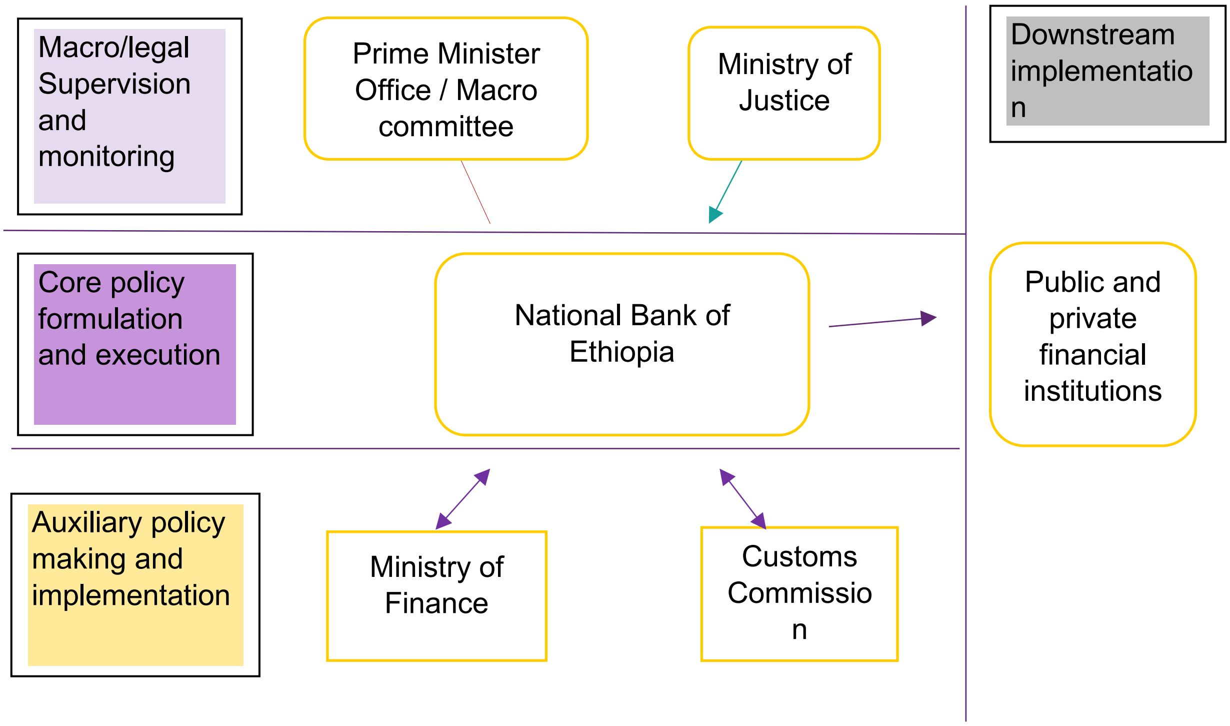
The frequent change of policy, particularly in relation to foreign exchange management, appears to have caused significant uncertainty on the part of other government agencies and the private sector in a way that may undermine policy coherence. A key informant representing the private sector also indicated that the policies were not comprehensive which adds to the uncertainty and creates loopholes to be exploited.

c. Policy network

As the previous sections indicated, the NBE has relative autonomy and insulation in financial sector policymaking. As such, it occupies a significant portion of the policy space while a few other institutions play the role of oversight, implementation, and information coordination as part of the policy network as shown in Figure 5. Given the absence of “central bank independence” as a principle guiding financial and monetary policy in Ethiopia, the NBE is tightly linked to the executive branch through the macro committee and its board of directors. However, as a policy body whose mandate also includes growth promotion, the NBE is expected to coordinate its actions more closely with other bodies in charge of macroeconomic policy, such as MoF. In practice, there appears to be relatively weak coordination in policy formulation as well as monitoring and evaluation between institutions responsible for fiscal and monetary policy.

The relative insulation and concentration of financial policymaking in the hands of NBE might pose a challenge from the point of view of ensuring sufficient checks and balances that is often achieved by distributing different functions across multiple financial regulatory bodies. This challenge could become more pronounced as the sophistication of the financial sector increases. Even though financial sector policy is usually the domain of organizations instead of policy networks, the policy’s effectiveness depends on the efficiency of the feedback loop between other organizations affected by the policies and the financial regulator. In this context, key informants from organizations such as the Ministry of Trade and Regional Integration revealed that the consultation and feedback process between their organizations and the NBE in relation to the effects of finance/monetary policy on the sectors they oversee leaves a lot to be desired.

Figure 5: Financial sector policy network



d. Monitoring and evaluation

The monitoring of financial sector policy often overlaps with the supervision function of the NBE, which requires the bank to obtain regular reports from financial institutions and conduct on-site supervision. In this context, there is a long-standing data collection and compilation system the NBE deploys to monitor the performance of the sector. The fact that the private sector counterparts are usually well-structured financial institutions with sufficient capabilities makes monitoring relatively straightforward.

But this creates the risk of rigidity by limiting the monitoring functions of the NBE to traditional supervision responsibilities, which might exclude the monitoring of emerging trends in a manner that will facilitate timeous policy responses. The NBE's follows a Risk-based Supervision (RBS) approach and employs a CAMEL-rating system to summarize and score performance of individual banks. A significant part of the supervisory approach is compliance-based which appears to have little effect in terms of bringing about the desired change in behaviour. The NBE lacks significant leverage because the private rents some of the rules bestow on financial institutions mean the banks have an incentive to violate them and pay comparatively modest fines. It was also noted that the lack of enforcement authority over state banks leaves a significant gap in the effective implementation of financial sector policy.

When it comes to evaluation, there seems to be little effort to conduct a systematic evaluation of the impacts of financial sector policy on various aspects of the economy. Admittedly, it is not always easy to conduct impact evaluation of economy-wide macroeconomic and financial policies such as the ones implemented by NBE. However, given the high stakes involved in the performance of those policies, the absence of processes and mechanisms to obtain evaluation feedback is concerning.

Some form of structured evaluation is necessary to understand the unintended consequences of financial sector policy. In this regard, even other government agencies relayed concerns about the impacts of some of the recent policy changes. For instance, a key informant from MoTRI revealed that their inspections uncovered more than 287,000 quintals of exportable items hoarded in warehouses. They argue that such hoarding occurs due to the recent increase in the share of foreign currency earnings from export that has to be surrendered to NBE. The NBE would have no systematic way of identifying such impacts of policy changes on a timely basis unless it puts in place an evaluation mechanism.

6. Conclusion

Over the past few years, the orientation of economic policy in Ethiopia has shifted from a statist approach to a largely private sector-driven model. This is predicated on the assumption that the public sector will continue to play a critical role in creating a conducive environment for private sector development. But it is not entirely clear whether the existing policy formulation and implementation processes can deliver the desired change. This study attempts to zero in on the institutional practices and capabilities in tax and financial policymaking and implementation from the point of view of their contributions to private sector development.

Economic policymaking over the past few decades has benefited from a significant degree of institutional continuity combined with gradual reform. But that also meant a critical re-examination of consequential policies has often been lacking. There has been greater emphasis on logistical solutions and a band-aid approach to recurrent problems instead of thorough policy reviews. Apart from the political inertia that has prevented meaningful changes, the weakness of the monitoring and evaluation systems has contributed to the lack of dynamism in domains such as tax policy. The gaps in systematic evaluation and timely course correction can also be linked to the lack of political accountability manifested in the legislature's role being limited to rubberstamping the executive's proposals. This deprives the process of important political checks and balances.

The empirical findings presented in the previous sections have the following policy implications that are likely to be relevant for domains beyond tax and financial sector policies:

1. It is essential to streamline and efficiently coordinate the implementation of key economic policies affecting private sector operations. This is particularly important when there is a high chance that incoherence and the resulting loopholes can generate uncertainty and lead to misallocation of rents.
2. Serious attention should be paid to the unintended consequences of policies that may set off complex behavioural responses from the private sector. One way of understanding potential unintended consequences is properly simulating policy decisions and conducting ex-ante evaluations. Increasing the capacity of the tax unit at the Ministry of Finance can help improve the analytical inputs to tax policy formulation and execution.
3. The policy monitoring process needs to be more proactive than reactive. Implementing agencies are likely to have more incentives to collect and compile

monitoring data regularly if the expectations are set at the design stage and the information is utilized by supervising authorities and other stakeholders. The application of technology can help in routinizing the collection of monitoring data.

4. Authorities should take further steps to institutionalize the involvement of the private sector in the policy formulation process. The confrontational approach that has often characterized the government's engagement with the private sector should give way to a partnership-oriented model. Establishing broad-based engagement mechanisms will help to prevent the emergence of pernicious and less equitable patronage-driven approaches from taking root as the private sector development space expands.
5. It is crucial to establish clarity in the mandates of government ministries and agencies and enhance coordination of activities. Currently, a lack of transparency in mandates and responsibilities results in poor implementation of a support system for the private sector. Coordination among ministries such as the Ministry of Trade and Economic Integration, the Ministry of Industry, and the Ethiopian Investment Commission is essential for the effective implementation of the support system for the private sector. Similar coordination between the Ministry of Finance and the National Bank of Ethiopia helps implement effective fiscal and monetary policy mixes. Moreover, coordination among the Ministry of Finance, Ministry of Revenue, and Customs Commission is required for effective policymaking and administration in the domain of taxation.

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