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Tax and financial sector policy: The state as an enabler of private sector development in Ethiopia

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- Ethiopia's private sector struggles to grow and create sufficient jobs. As the country enters a new phase of economic reform, questions remain about the technical and political aspects of policymaking and implementation, particularly in key areas for private sector development such as tax and financial sector policies.
- We use secondary data analysis, key informant interviews, and policy document analysis to identify critical constraints in private sector development and assess the capabilities in tax and financial sector policy formulation and monitoring.
- The research finds that tax policies lack dynamism, resulting in inadequate analysis and evaluation. Tax and duty incentives have led to stakeholder conflicts, while reactive financial sector policy changes hinder private sector functioning.
- The research suggests that streamlining and coordinating economic policies, anticipating unintended consequences, establishing proactive policy monitoring, institutionalising private sector engagement, and enhancing coordination among government ministries and agencies could be beneficial to private sector development.

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Policy motivation for research

There is an increasing realisation on the part of policymakers that economic transformation cannot be achieved without the active participation of the private sector. However, Ethiopia's economy continues to struggle to develop a vibrant private sector capable of meeting the changing needs of society and creating enough decent jobs. As the country enters a new phase of economic reform, the need for a carefully balanced role of the state and private sector becomes particularly vital. However, there are still several unanswered questions regarding the technical and political economy underpinnings of the policymaking and implementation processes in critical areas for private sector development.

Overview of the research

The current study focuses on the realms of tax and financial sector policies. The study examines secondary data on sectoral performance and identifies critical constraints holding private sector development. The policy formulation and monitoring capabilities in tax and financial sector policy domains were studied using a qualitative approach. The principal method of data collection is a semi-structured key informant interview. The key informant interviews are complemented with an analysis of relevant policy documents published between 2015 and 2022.

Key findings

The significant effort in modernising 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. The extensive use of tax and duty incentives to achieve sectoral objectives seems to have created friction between various parties regarding who has the mandate to administer such incentives. The execution of special tax and duty incentives also strains existing capacity. Although there are recent efforts to increase the capabilities of the Ministry of Finance for tax policy monitoring, personnel capacity remains a binding constraint.

In the realm of financial sector policy, the frequent and reactive policy changes enacted by the National Bank of Ethiopia have impacted the functioning of the private sector. Although the NBE has recently introduced new measures that signal further opening 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 policy 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 prioritises compliance over broader impact.

Policy implications

To help address current limitations in policymaking, policy coherence, and practical implementation, we outline policy implications that would be likely relevant beyond the realms of the tax system and financial sector.

- 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 the misallocation of rents.

- Unintended consequences of policies that may set off complex behavioural responses from the private sector merit attention from policymakers. 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.

- 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 utilised by supervising authorities and other stakeholders. The application of technology can help in routinising the collection of monitoring data.

- There is a need for authorities to take further steps to institutionalise the involvement of the private sector in the policy formulation process. The confrontational approach that has often characterised 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.

- It is crucial to establish clarity in the mandates of government ministries and agencies and enhance coordination of activities. 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, Revenue, and Customs Commission is required for effective policymaking and administration in the taxation domain from taking root as the private sector development space expands.

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