



## FUNDING DEVELOPMENT: ETHIOPIA TRIES TO STRENGTHEN ITS TAX SYSTEM, 2007–2018 (SHORT VERSION)

*This summary draws on an ISS case study with the same title can be found on the [ISS website](#). Leon Schreiber drafted the full case based on interviews conducted in Addis Ababa, Ethiopia in October 2018. Case published December 2018. Summary published in May 2019.*

### BACKGROUND

Following a decade of political and economic turbulence, Ethiopian Prime Minister Meles Zenawi entered the 2000s determined to ignite economic development in his country, Africa's second-most-populous nation. But financing the government's double-digit growth ambitions and planned infrastructure projects would require significantly more tax revenue, and Ethiopia tax collections were far below the 18% average GDP for sub-Saharan Africa.

Efforts to improve tax collection and stimulate investment included a modernized legal framework, more-favorable terms for businesses, the issuance of taxpayer identification numbers (TINs) to all businesses and individual taxpayers in urban areas, the establishment of a value-added tax (VAT) to replace the existing sales tax, the collection of new excise duties on luxury imports, the introduction of mandatory income tax withholding by employers, and the establishment of a self-assessment system to enable taxpayers to complete their own declarations rather than having all payments calculated by tax officials.

By 2006, however, the country's tax-to-GDP ratio not only had failed to grow but also had declined to 10.7% from 11.8% in 2002 despite three years of GDP growth in excess of 10% annually. In November 2007, the civil service ministry and minister of revenue Melaku Fenta appointed two dozen of the country's foremost tax experts to review procedures and propose improvements in order to overhaul the country's underperforming tax administration system.

## KEY ISSUES

- Despite a series of reforms, Ethiopia's tax-to-GDP ratio had declined.
- Tax policies and tax rules were deeply fragmented in a country where the federal political system comprised nine ethnically based regions and two chartered cities, which collected and kept for themselves more than a fifth of all government tax revenues.
- At the national level, the federal inland revenue authority and the customs authority each had tax collection authority, but their systems were not coordinated, which resulted in complications for both taxpayers and officials.
- The lack of a centralized digital database aggravated the information management and coordination problems.
- Employee capacity and morale at the tax agencies were low, and corruption flourished, contributing to the problems with the VAT.
- A system of generous tax exemptions, motivated partly by the government's desire to attract foreign investment, led to substantial losses in tax collections from large companies.
- Despite Ethiopia's economic growth, more than a third of economic activity still took place in the informal sector—beyond the view of government tax officials.

## REFORM STRATEGY

In late 2007, Fenta's team of tax experts began to revamp tax administration in Ethiopia, building on the government's September 2006 adoption of the national Plan for Accelerated and Sustained Development to End Poverty. The framework included an ambitious call for the government to increase the country's tax-to-GDP ratio to 17% by 2010 from 10.7% in 2006. It further stipulated that "vigorous efforts will be made to further improve tax collection, and to combat fiscal fraud," and it pledged to accelerate the pace of tax reforms.

After more than a year of research, the team produced a set of proposals to reengineer tax administration. At the federal level, the team called for the merger of three separate revenue institutions into a single entity—the Ethiopian Revenues and Customs Authority (ERCA)—and for its director general to be a member of the cabinet. The team further proposed that the new agency be organized along functional lines rather than tax categories, that it should develop standardized and clear policies and procedures, and that it should be exempt from certain public service rules so that it could set competitive salary scales and easily fire underperforming or corrupt employees.

In a reflection of Prime Minister Meles's firm support for the reform effort, the cabinet approved the team's proposals in only a few months. Meles appointed Fenta, the incumbent minister of revenue, as the first director general of ERCA. To ensure that the new organizational structure

translated into improved tax administration, ERCA had to simplify its tax procedures, enhance staff capacity, and combat corruption. Other urgent priorities included expanding the use of IT and raising public awareness to boost voluntary compliance. Finally, ERCA also had to find ways of collaborating and coordinating effectively with the country's 11 regional revenue authorities.

## ACTIONS TAKEN

With more autonomy over hiring decisions than its predecessor agencies had, ERCA launched a wholesale reevaluation of its existing staff based on skills and integrity. Fenta assembled a human resources placement committee to screen and propose staff for ERCA, and with Meles's support, the agency laid off hundreds of workers—especially those suspected of corruption. Salaries rose to help ERCA attract skilled workers, and technical training for staff became mandatory.

To combat graft, ERCA created a dedicated directorate that introduced a code of ethics and provided all staff members with training and a copy of the code. The new tax office also received authorization to create its own intelligence and investigations team. The measure authorized the office to prosecute both officials and taxpayers implicated in fraud or corruption—without having to rely on external agencies.

Replacing the tax system's manual, paper-based information management system with a modern digital database was a pressing priority both to reduce the time required to pay taxes and to limit opportunities for corruption. The government in 2006 decided to extend the use of its three-year-old, computerized Standard Integrated Government Tax Administration System (SIGTAS)—which it had adopted to administer the VAT—to all other tax types and across all branch offices. Next, to create an integrated central database that would cover the entire country and include taxes from all levels of government, ERCA's IT team in 2008 launched a project to install SIGTAS in the offices of Ethiopia's 10 regional revenue authorities.

Alongside the rollout of information technology, ERCA worked to overcome difficulties with the issuance of TINs. Ethiopia lacked a uniform national identity system, and regional governments issued their own ID cards in local languages. That made it difficult to base the issuance of TINs on identity documents. In response, the IT team proposed using biometrics and added a module to SIGTAS that enabled the tax authorities to capture fingerprints and link them to TINs.

In 2010, with the back-end systems in place, ERCA built an electronic tax-filing module on SIGTAS and rolled out e-filing to selected large taxpayers on a pilot basis. It extended the program to all large taxpayers during the following tax season and in 2013 expanded it to cover medium-size taxpayers in urban areas where power supply and internet connections were adequate.

Though extending SIGTAS to the regional tax authorities was a major step, it was obvious the authorities would require ongoing capacity building and support. As a result, ERCA established a directorate dedicated to regional cooperation. The new directorate assembled a team of officials who traveled the country to build relationships with the regions and harmonize tax policies.

The federal tax office in 2010 also began playing a more proactive role to ensure that microenterprises—which were informal businesses, often run by households, that were unincorporated and had turnovers of less than 100,000 birr (about US\$7,400 in 2010)—were registered and paid their fair shares of taxes. A long-standing lump-sum turnover tax, administered by the regional governments, was the main tool for promoting compliance by microenterprises, but the regional authorities sometimes lacked the ability to visit and accurately assess all of their jurisdictions’ registered microenterprises. The problem was especially acute in the capital, Addis Ababa, which accounted for the vast majority of the country’s small businesses.

To generate greater tax compliance in the country’s strongest economic region, ERCA in 2010 assumed administrative control of the Addis Ababa regional revenue authority. Teams of officials crisscrossed the city to visit business premises and calculate dues. In 2012, ERCA also opened two dedicated offices at the capital city’s vast open-air market. The offices divided the market into blocks, and officials visited each individual trader.

Reaching out to all taxpayers was also on ERCA’s reform agenda. As part of its organizational restructuring in 2008, ERCA established a taxpayer service division and introduced a service-standards charter that outlined what customers could expect when visiting an ERCA office. To answer taxpayer questions, the authority also created a call center to provide information during business hours. In addition, the agency launched television and radio programs to showcase the link between paying taxes and development. And during annual tax-week events, federal officials hosted promotional events across the country.

## RESULTS

Throughout the tax reform process, Meles’s support had been a critical factor. When he died in office in August 2012, the reform began to unspool, and in May 2013, a team of police officers arrested Fenta on corruption charges. Fenta insisted that the allegations were “trumped up and based on hearsay” and were responses to his refusal to allow powerful people, including cabinet ministers, to evade customs duties on luxury imports. Fenta’s arrest, along with arrests of some of his deputies, sent shockwaves throughout ERCA and triggered an exodus of skilled officials. Fenta was ultimately released in 2018, having spent five years in jail awaiting the outcome of a trial that never concluded.

Amid the upheaval and insecurity, ERCA did not renew its contract with the IT consultants who had helped install SIGTAS. With insufficient technical support and with officials weary of taking initiative lest they cross powerful people, the IT system rapidly decayed. And although emergency measures begun in 2015 helped stabilize ERCA, many problems remained. The World Bank's 2018 Doing Business index revealed that by 2018, Ethiopia ranked 133rd in the world—compared with 29th in 2008—in ease of paying taxes. Still, the initial phase of reforms from 2007 to 2013 produced measurable gains: Total taxes collected nearly tripled to US\$3.8 billion from US\$1.3 billion, reaching US\$7.8 billion by 2017. And the share of total government revenues financed by taxes grew to 82% in 2016 from 48% in 2007.

Even though tax revenues rose strongly in absolute terms, Ethiopia fell well short of its initial aim to lift the country's tax-to-GDP ratio to 17%. The ratio increased to 12.3% in 2013 from 10.7% in 2007 but stagnated at about 12.4% from 2013 to 2017 because growth in revenue collection failed to keep up with the country's rapidly expanding economy. It remained to be seen whether the elevation of ERCA to ministry-level status under a new, reform-minded prime minister in 2018 would make a difference.

## LESSONS LEARNED

- ERCA's experience demonstrated a weakness inherent in two aspects of the reform process that normally might be considered advantages: strong support at the top level of government and the concentration of authority in one highly skilled individual: Fenta. In this case, both made the institution vulnerable to interference after Meles's death.
- Elevating ERCA to cabinet-level status injected a political element that added to the agency's vulnerabilities.
- The top-down measures of Fenta's ERCA, together with unaddressed controversies over how ERCA divided revenues with subnational governments, caused friction with the regional tax authorities.

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