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# Aid and Taxation in Ethiopia

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**ABSTRACT** *The relation between aid and taxation is largely contested in the literature. On the one hand, aid may act as a substitute for tax revenue and thus have a crowding-out effect. It can also have a detrimental effect on domestic tax institutions. On the other hand, it can promote and support tax mobilisation through policy advice, technical assistance, and conditionality, in addition to more indirect channels. The case of Ethiopia supports the existence of a positive relation between aid and tax, which occurs mainly through policy advice and technical assistance rather than conditionality. This finding is grounded in both quantitative and qualitative analysis.*

## 1. Introduction

The relation between aid and taxation sits at the core of the sustainability of development efforts and is crucial to ensure independence from foreign aid in the long run. Taxation is the main source of development finance in most countries. In Ethiopia domestic revenues were more than three times as large as total budget aid in 2010, making it the only real candidate for sustainable development financing in a long-term exit strategy from aid dependency. If aid does not support tax mobilisation or, even worse, crowds out taxation, its sustainability and effectiveness can be seriously undermined. Importantly, taxation is also a key arena for government-citizen relations, whereby the latter pay taxes and expect the government to provide goods and services in return. This social contract is at the core of the development of democratic institutions and inclusive states.

The aid-tax relation can be located in the broader debate on aid effectiveness, although it is only one component of it. Interestingly, aid effectiveness remains one of the areas of research most central to the policy debate on developing countries, yet it is still far from providing clear-cut answers.<sup>1</sup> One of the reasons for this lack of consistency in empirical results is that the focus has often been on aid's effects on economic growth, although the link between aid and final outcomes is likely to be indirect and thus possibly weak. In this context, the focus on the fiscal effects of aid is a way to identify more direct linkages from foreign assistance to policy. Since a substantial portion of aid flows to governments' budgets, and decisions on the budget are the core of fiscal policy, a direct link between aid and fiscal outcomes seems plausible. In particular, one of the potentially adverse fiscal effects of aid is to crowd out tax revenues. This concern was already expressed in 1963 by Nicholas Kaldor, who argued that 'foreign aid is likely to be fruitful only when it is a complement to domestic effort, not when it is treated as a substitute for it' (Kaldor, 1963). There are various channels through which aid can influence taxation in African countries, which can potentially result in a negative or a positive relation.

On the one hand, a negative relation could be the result of a crowding out, or substitution, effect of aid on tax. Such an effect may occur for various reasons, chiefly because aid can be considered a less politically costly source of revenue than taxation. The basic argument is that tax revenues need to be *earned* by the government by bargaining with citizens and engaging in a relation of reciprocity,

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whereby the government provides services in exchange for tax revenues. Instead aid can be seen as an *unearned* source of revenue since it does not require the same level of popular engagement and reciprocity. Therefore, by relying more heavily on foreign resources than domestic ones, governments could partly bypass democratic dialogue and bargaining over revenues. However, it must be noted that aid often comes with policy influence and conditionality, which may represent political and administrative costs for the recipient government. A related argument in the literature<sup>2</sup> is that aid can have detrimental effects on domestic institutions and accountability, thus implying an overall negative effect both on the level of tax revenue and on the quality of institutions involved in tax policy.

On the other hand, aid can have a positive impact on tax revenues by imposing conditions related to tax policy or by offering financial and technical support for ministries and tax administrations.<sup>3</sup> This support may provide the necessary capacity, expertise and political legitimacy for engaging in tax reform, thus potentially resulting in higher revenues and better tax administration. Technical assistance and policy advice on tax are particularly relevant in Africa, as donors are widely recognised as one of the main drivers of reform there. Fjeldstad and Moore (2008) argue that tax reform in many African countries has largely followed a global agenda promoted by an epistemic community composed of international tax practitioners, experts, and donors. The remarkable international agreement over this agenda and the cohesiveness of this epistemic community, have contributed to its widespread implementation in many African countries. Not only is it widely accepted that tax reform in Africa has largely been driven by a global agenda; but also that the main actor behind that agenda is the International Monetary Fund (IMF), although other bilateral and multilateral donors are becoming increasingly influential.<sup>4</sup>

Therefore, the relation between aid and tax at the country level is likely to be influenced by a complexity of factors, which push towards a negative or a positive association between the two. An econometric analysis of country level data can clarify whether it is the positive or negative effects that prevail at an aggregate level and on average. However, such analysis alone cannot explain the way in which donors can influence taxation in the local political context. In other words, it cannot fully explain *why* and *how* such a relation occurs. It is therefore necessary to complement these findings with a more detailed historical and political analysis, which fully takes into account the specific country context. Although the literature has recognised the importance of the local context in understanding the political effects of tax reform and the role of donors,<sup>5</sup> country level evidence on the political economy of aid and taxation is very scarce.<sup>6</sup> This article aims to fill this gap by unpacking the aid-tax relation in the political and historical context of Ethiopia.

The remainder of the article is structured around two simple yet non-trivial research questions. Firstly, does aid crowd out tax revenue? By using macroeconomic time series from Ethiopia, [Section 2](#) shows that aid is far from having a crowding out effect on tax revenue, but instead it seems to have a positive relation with it. This finding is partly in line particularly with the most recent literature on aid and taxation. Secondly, and using the econometric results as a starting point, what are the reasons that explain this positive relation in Ethiopia? This second question is the heart of this article. The answer is based on key economic, political and historical elements that characterise the Ethiopian context, as well as an analysis of the role of donors in recent tax reforms.

## 2. Is There a Crowding Out Effect? The Quantitative Evidence

### 2.1 Overview of Existing Debates and Literature

While the theoretical arguments in favour of a positive or negative aid-tax relation are both conceptually plausible, the practical validity of the conflicting hypotheses of revenue displacement and revenue encouragement is an empirical question. These hypotheses have been tested in the literature particularly through tax effort studies. They estimate the effect of aid on the ratio of tax to GDP, once other aspects of the economy are taken into account, such as the level of income, the size of the agriculture and manufacturing sectors, and trade openness. This literature is largely dominated by cross-country studies that are useful in identifying broad trends, but that also suffer from problems related to country heterogeneity. Cross-country studies do not provide fully conclusive evidence on whether the effect of aid on tax is positive or negative. For example, Ghura (1998), Bräutigam and

Knack (2004), and Mahdavi (2008) find evidence of a negative relation between aid and tax, by using different specifications of the basic tax effort model. Looking more specifically at aid heterogeneity, Gupta, Clemens, Pivovarsky, and Tiongson (2004) argue that loans have a positive effect on tax effort because of the need for repayment while grants crowd out domestic revenue, therefore having a negative effect. While this finding is echoed in other studies, and particularly in a recent IMF paper (Benedek, Crivelli, Gupta, & Muthoora, 2012), it is not considered robust by other authors such as Morrissey, Islei, and M'Amanja (2006) and Morrissey, Prichard, and Torrance (2014). The latter study particularly argues that there is no support for the claim that aid discourages tax effort: the aid-tax relation does not seem to be consistently significant although, when it is, it has a positive sign. Clist and Morrissey (2011) argue that more evidence of a positive effect is available after the 1980s, when donors started focussing more on structural adjustment and conditional lending. Support for a positive relation, or at least no evidence of a crowding-out effect, is also provided in Morrissey et al. (2006), Gupta (2007), Mkandawire (2011), and Carter (2013). Even Benedek et al. (2012) show that the negative effect that they find for grants seems to be weakening over time, thus supporting a trend towards a more positive, although generally weakly significant, relation.

This cross-country literature suffers from limitations due to the heterogeneity in the effect of aid amongst countries. Carter (2013) argues that this results in estimates of averaged effects that are unstable and of limited policy interest. As a possible way forward, he suggests an increased reliance on country case studies that can also include interviews with government officials to gain a deeper understanding. Country studies are rare in the tax effort literature, but they are more common in the fiscal response<sup>7</sup> tradition, which tends to find beneficial fiscal effects of aid in African countries. For example, Osei, Morrissey, and Lloyd (2005), Bwire (2013), and Mascagni and Timmis (2014) find a significant positive relation between aid and tax revenues, while Martins (2010) does not find any support for a displacement effect. Importantly, the latter two studies focus on Ethiopia and set the stage for the results presented in what follows.

To start shedding light on the validity of the conflicting hypotheses of revenue displacement or encouragement, I apply the tax effort model to time series data from Ethiopia. This approach is in line with the direction suggested by Carter (2013) to improve the robustness of results in this literature. Moreover the results from the econometric analysis are complemented and strengthened by the qualitative analysis presented in Section 3, which aims at unpacking the aggregate result by explaining how and why it occurs.

## *2.2 Econometric Evidence of a Positive Aid-Tax Relation in Ethiopia*

Ethiopia is a particularly relevant case for the analysis of the aid-tax relation. Since the mid-1980s it has received more aid as a share of GDP than the average of other sub-Saharan African countries, although aid per capita has historically been lower than other African countries. Perhaps more importantly, aid flows to the country are projected to increase.<sup>8</sup> At the same time tax revenue, as a share of GDP, is still lower than the average of both other sub-Saharan African countries and low-income countries more generally. It may be tempting to use the high-aid and low-tax situation as a preliminary indication of a negative relation, or presence of crowding out. However, tax revenue is growing substantially, showing high government commitment in this area. The Growth and Transformation Plan (GTP, the 5-yearly development plan for the period 2010–2015) foresaw an increase in tax revenue of about 25 per cent a year in nominal terms, to reach a tax share of GDP of 15 per cent by 2015. Given that Ethiopia's tax share stood at about 11 per cent of GDP at the beginning of the GTP period, this objective is certainly ambitious.

In addition to this situation of high aid and low tax revenue, Ethiopia lends itself to this analysis because of data availability and quality. The data used here is macroeconomic time series compiled by the Ministry of Finance and Economic Development and it has at least four advantages over data used in similar studies. First, by using exclusively national sources, it avoids the discrepancies that can arise from mixing different databases. Secondly, it captures the component of aid that actually flows to the country and particularly through the national budget. This is the closest substitute to tax revenue and it

is therefore the component of aid that is most likely to have a substitution effect. Thirdly, with 50 annual observations in the period 1961–2010, it is a longer annual series than any other study in this literature. Finally, the data is likely to be of higher quality than most other studies on African countries, as Ethiopia established its Central Statistical Office relatively early, in 1961, and today has the highest Statistical Capacity Rating in Africa.<sup>9</sup>

Table 1 summarises the econometric results from a tax effort model that includes aid data disaggregated into foreign grants and loans, to allow the identification of heterogeneous effects. In addition, the model includes the following explanatory variables: non-tax revenue, agriculture, manufacturing, trade openness, GDP per capita, and two dummies to capture differences in political regimes. The dependent variable is always the tax ratio and all variables are expressed as a ratio of GDP, except GDP per capita (log). The table reports the full set of results, for completeness, although the following discussion focuses particularly on the findings on the aid variables. A full discussion of the econometric results is available in Mascagni (2014), which also reports stationarity and cointegration tests, further specifications of the tax effort equation, robustness checks, and disaggregated results by tax types. While the discussion here abstracts from many important econometric issues, the interested reader can find a greater degree of detail in the working paper version of this work (Mascagni, 2014). The main objective of this section is to provide quantitative evidence on the aid-tax relation as a starting point for further discussion, rather than to discuss the econometrics in detail.

Using Ethiopian data, the tax effort model is estimated using the two-step procedure suggested by Engle and Granger (1987). By exploiting the property of cointegration in the time series data, this technique allows the separation of long-run (LR) equilibrium and short-run (SR) relations. In particular, the first step of the procedure identifies LR relations between the variables of interest, the results

**Table 1.** Summary of econometric results

Variables	(1)	(2)	(3)	(4)
	LR	SR – OLS	SR – IV	SR – IV
Grants	0.325* (1.78)	0.434*** (3.32)	0.378 (1.56)	0.545*** (3.28)
Loans	0.413*** (4.31)	0.254*** 2.98	-0.035 (-0.12)	0.274*** (3.55)
Non-tax	0.163 (1.26)	-0.043 (-0.34)	-0.090 (-0.66)	-0.052 (-0.45)
Agriculture	0.052 (0.87)	0.066 (0.60)	0.131 (1.04)	0.068 (0.69)
Manufacturing	0.736** (2.31)	0.838 (1.61)	1.306* (1.88)	0.810* (1.73)
Trade openness	0.144*** (4.34)	0.207 (4.71)	0.180*** (2.84)	0.226*** (5.30)
GDP pc	-0.007 (-0.39)	-0.005 (-0.16)	-0.018 (-0.55)	-0.004 (-0.17)
Derg	0.017*** (3.61)	0.001 (0.45)	0.001 (0.19)	0.001 (0.20)
EPRDF	-0.003 (-0.42)	-0.002 (-0.86)	-0.002 (-0.56)	-0.004 (-1.35)
ECT		-0.955*** (-5.56)	-0.848*** (-3.54)	-1.019*** (-6.32)
Constant	0.012 (0.08)	0.000 (0.06)	0.001 (0.46)	0.001 (0.42)
Obs.	50	49	47	47
R <sup>2</sup>	0.91	0.61	0.49	0.61

Notes: number in parenthesis are t-values; \* indicates  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ ; all variables are expressed as a percentage of GDP except GDP per capita (log), the Derg and EPRDF dummy variables, and the error correction term (ECT). Variables are included in levels in column 1 and in first difference in the others.

of which are reported in the first column of Table 1. The second step identifies SR effects and it includes an error correction term (ECT) that indicates adjustment to the LR equilibrium. While the long-run results are *superconsistent*,<sup>10</sup> and thus not affected by endogeneity, the short run results are. For this reason Table 1 reports three specifications (columns 2 to 4) for the short-run equation. Column 2 reports the OLS results without any correction for endogeneity. The specifications of columns 3 and 4 partly tackle endogeneity by adopting an instrumental variable approach (2SLS) where two lags of grants and loans are used as instruments. Although far from being fully adequate, this is the most common<sup>11</sup> way to deal with endogeneity in the literature, given the difficulty of finding other appropriate instruments. In column 3 both grants and loans are instrumented, but Mascagni (2014) shows that this IV strategy is not valid in the case of loans. Therefore, column 4 reports an alternative specification where only the grants variable is instrumented using lags.

The main result emerging from Table 1 is a strong rejection of the claim that aid crowds out tax revenue. In Ethiopia both grants and loans seem to be positively associated with tax revenues, and this relation is statistically significant in most specifications. The idea developed in the literature that loans may stimulate tax mobilisation more than grants because of repayment, is partly confirmed in the long run. As shown in column 1, in the first step (LR) the coefficient on loans is strongly significant, at the 1 per cent level of statistical significance, while grants are only weakly significant<sup>12</sup> at the 10 per cent level. Despite this, no evidence can be provided for a detrimental effect of grants on tax effort in the long run. The LR coefficients suggest that a percentage point increase in the share of grants to GDP is associated with a 0.3 percentage points increase in the tax ratio, and the corresponding figure for loans is 0.4.

The short-run results are largely in line with the long run, with both aid variables displaying positive coefficients. In the OLS estimation (column 2) both aid variables are statistically significant at the 1 per cent level and positive, with grants having a larger coefficient than loans. This may suggest that grants are used mainly to release short run constraints in the administration, thus allowing a contemporaneous increase in tax revenue. The IV estimation typically results in less satisfactory t-statistics, which explains the lower level of significance in column 3. However, the coefficient on grants in particular is robust taking into account endogeneity with IV estimation, while a valid instrument could not be found for loans. While the latter displays a small negative coefficient in column 3, this is largely non-significant with a standard error (0.3) almost 10 times larger than the coefficient itself. Despite the efforts in tackling endogeneity, it may still be that the short-run results are biased. However, confidence in the fundamental conclusion of a positive association between aid and tax is strengthened by the set of robustness tests available in Mascagni (2014) and by a parallel exercise carried out with the same data by Mascagni and Timmis (2014). By using the cointegrated VAR methodology, which may be more suitable in tackling the specific issue of endogeneity, the authors confirm that the results on the aid-tax relation is positive and significant in the case of Ethiopia.

Therefore, this econometric evidence shows that Ethiopia is in line with the literature arguing for the lack of a crowding-out effect, and it goes further by showing evidence of a positive relation. In this sense, the case of Ethiopia may represent an anomaly not only with respect to studies showing a negative relation, but also as compared to those finding no association between the two variables. Instead the Ethiopian results strongly suggest that aid and tax are positively associated. The remaining puzzle therefore is to explain why such a relation occurs. The remainder of this article tackles this question by complementing the quantitative results with a qualitative analysis of historical and political factors.

### 3. Making Sense of a Positive Aid-Tax Relation: Historical, Political and Economic Factors

The econometric results in Section 2 strongly reject the presence of a crowding out effect and suggest that a positive relation exists between aid and tax in Ethiopia. The objective of this section then is to unpack this relation and to explain how and why it occurs in the context of Ethiopia. To do this, a mix of primary and secondary sources is used. A wealth<sup>13</sup> of published and unpublished documents was reviewed to identify underlying political and historical elements that influence the Ethiopian culture of government and its relation with foreign donors. This analysis is then deepened and validated through

the use of primary data collected in Ethiopia during 16 months of work in the field. In-depth interviews<sup>14</sup> were carried out with 20 key actors amongst government officials, development partners and independent experts. The main themes covered in the interviews related to the political process of tax reform, the relation between the government and donors, and the channels that may link aid to taxation.

### *3.1 The Aid-Tax Relation in Historical Perspective*

The history of Ethiopia is unique in Africa due to its long tradition of statehood, dating back several centuries, and to its independence from colonial powers. This history is at the core of the Ethiopian culture and distinctiveness. It translates in fiscal terms with a high importance attached to self-reliance and thus to domestic revenues as a source of development financing. For a full account of the fiscal history of Ethiopia, see Mascagni (2016). More generally the historical path of Ethiopia can explain a lot of the politics of the aid-tax relation today, also thanks to the high persistence that typically characterises tax institutions.

Ethiopia always interacted with Western countries as a peer. When it entered the international arena it did so as a sovereign country. It was a member of the League of Nations from 1923, it is a founding member of the United Nations, and it received the first World Bank loan to Africa in 1950. Independence was a central feature of Ethiopian governments during the Imperial regime and continued to be so under Mengistu Haile Mariam, who took power after the 1974 coup as the leader of the socialist regime known as the Derg. Since 1991 the country has been led by the Ethiopian People's Revolutionary Democratic Party (EPRDF), a coalition of ethnic-based parties whose creation was initially promoted by the TPLF (Tigray People Liberation Front). The TPLF has its origins as a Marxist-oriented guerrilla movement that conducted a 16 year long armed struggle against the Derg, eventually leading to its defeat in 1991. For the EPRDF, as for previous regimes, foreign influence quickly emerged as a matter of national political legitimacy. However, in the early stages since taking power, the EPRDF's reconstruction efforts were influenced and supported particularly by the World Bank (WB) and the International Monetary Fund (IMF), with a strong focus on liberalisation and privatisation. This has been attributed to a 'strategic ideological softening' of the EPRDF (See Dereje Fejissa, 2011), in a bid to mark a clear difference with the Derg regime and to stimulate economic recovery. Despite its need for financing and for new international allies, the EPRDF was still able to draw a clear line for what it was willing to accept in terms of foreign policy influence. For example, donors did not succeed in persuading the government to liberalise the financial sector and telecommunications, and to introduce private land ownership. Notably, these are still 'no-go' areas today. More recently, at a time when the idea of a developmental state was already fully embedded within the EPRDF's economic policy, the same sentiment was expressed<sup>15</sup> (cited in Gill, 2010) by the late Prime Minister Meles Zenawi: 'we in Ethiopia very nicely and politely have rejected a number of neoliberal prescriptions given to us, and we have lived to tell the story' (p. 81).

Foreign influence was at the centre of one of the most critical moments of the recent political history of Ethiopia, corresponding to the end of the war with Eritrea. On this occasion the leadership of the time was challenged, amongst other things, for being too lenient on donors' requests to withdraw troops from the Eritrean frontline, which eventually happened in 2001. That year was a turning point<sup>16</sup> for Ethiopian leadership, which saw a stronger focus on centralism and on economic development as a basis for political legitimacy. While in the 1990s the government based its rhetoric on the idea of ethnic federalism, in the 2000s the focus shifted more towards national unity. Starting from the early 2000s, and particularly after the elections in 2005, the EPRDF's political legitimacy has been largely based on its strong role in development in the name of the people of Ethiopia. In this context, and in line with the developmental state approach, the government scaled up massively its efforts in infrastructure development. An example is the Great Ethiopian Renaissance dam on the Blue Nile River, which is set to be the biggest of its kind in Africa. Notably this dam is fully funded with domestic resources, since many donors did not want to get involved due to the dispute with other countries on the Nile waters. This dam emerged in many interviews as a symbol of Ethiopian independence and pride.



Therefore, political legitimacy in Ethiopia has historically been based on a strong sense of independence of the leadership from foreign influence and, particularly in the last decade, on its ability to deliver on development goals. In this context, an observer pointed out that ‘aid is a bitter medicine, not sweet candy’. This is because aid necessarily implies a loss of independence; it implies that the country is weak and is not able to care for its population. This idea of a ‘with’ is well captured in Meles Zenawi’s Millennium speech of 2007<sup>17</sup> :

While we can justly be proud of the fact that every generation of Ethiopians during those centuries have paid in blood to maintain our independence, we cannot but feel deeply insulted that at the dawn of the new millennium ours is one of the poorest countries in the world. Over the course of our second millennium we have gone from being one of the most advanced nations on earth to that of being one of the poorest. Throughout this process we have not been colonized by any foreign nations and hence we have always been the authors of our destiny, both our successes and failures.

This view was echoed in many interviews, particularly those with Ethiopians or with foreigners with a long experience in the country. A well-positioned observer noted that Ethiopia’s historical independence and ability to stand on its own feet is still a central part of the government’s rhetoric today.

Indeed, not only does Ethiopia value independence, including the fiscal aspects of it, but it also has the institutional capacity to potentially live up to its ambition. While capacity constraints are certainly present in today’s Ethiopia, it is important to recognise that, thanks to independence, the administrative apparatus of the Ethiopian government has been in place for several centuries and over time has become a well-consolidated machine. Bahru Zewde, a Professor of history at Addis Ababa University, holds<sup>18</sup> that transitions in Ethiopia were always characterised by administrative continuity and that during the transition of 1991 Ethiopia remained without a government for only one week. The thesis of continuity is developed by Clapham (1988) and supported by Abbink (2011). Alex deWaal (2012) reports that the EPRDF was able to pay salaries to civil servants and take control of police forces within days of taking Addis on 28 May 1991. This was the result of two factors. Firstly, during the armed struggle, the guerrilla movements developed strong organisational skills that were crucial when they eventually stepped up to govern one of the biggest countries in Africa. Young (1997) reports that in 1980–1982, the TPLF controlled and governed about 80 per cent of the territory in the northern region of Tigray where 90 per cent of the people lived. Secondly, the EPRDF inherited the large administrative apparatus of the Derg, which in turn was inherited from the Emperor. It is not rare today to find government officials who were originally hired under the Derg or even under the Emperor.

The discussion so far allows us to draw a first conclusion in support of the econometric results: in the Ethiopian context it seems particularly implausible that aid and tax are treated as substitutes. The reasons for this are both economic and political. On the economic side, the ambitious development plans of the Ethiopian government generate huge financing needs. As an interviewee pointed out: ‘I don’t see why aid should be a deterrent for collecting taxes, because the government is still operating in a financing gap situation’. In other words, Ethiopia cannot afford to substitute aid for taxes if the current development plan and the longer-term vision are to be taken seriously. A top government official noted that:

We want to increase the revenue as much as possible. Then if we get foreign aid, we can add it [to domestic revenue] and it will give us the room to expand our project. [...] If you don’t have any vision, then maybe substitution will work, [but not] if you have a vision, as we do, to reach middle-income level.

On the political side, it is crucial to remember that these plans are the basis of the government’s political legitimacy. Given their importance, they should rely on stable and predictable sources of finance; and aid is not perceived to have these characteristics. While the higher volatility of aid with respect to tax is reflected in the Ethiopian data and in the broader literature (see Bulir and Hamann, 2008 and Mascagni, 2014), this perception is also of political nature:

Aid has its own objectives and it may not align with our [the government's] own objectives so our preference is domestic resource mobilisation. In the short run we have no alternative than to utilise what we get from external sources as much as possible, but in the long run the direction is really to depend on our resources.

Therefore, aid is a particularly risky source of revenue for the government's ambitious development project. Even if raising taxes may be politically costly, it is a cost worth bearing to allow the development project to rely on a steady stream of revenue that is independent from foreign influence. In the words of one interviewee:

Here you almost don't have a political cost [of raising tax]. What is more important for the government is to be able to put in place a plan that they have now promised everyone that they will put in place. So the cost of not doing some of those projects may be higher than the cost of collecting more taxes, in particular if you come from a very low level [of tax].

Importantly, government officials confirmed the perception that increasing tax collections carries a very low political cost. In their view, the EPRDF's tax mobilisation efforts have been focused on broadening the base by bringing more people into the tax net, which is largely seen as fair, while decreasing tax rates. This strategy is rather easy to justify politically, as well as being economically sound. Indeed Prichard (2010, p. 90) notes that 'overt political conflict over taxation is virtually non-existent', with very limited engagement of society, political opposition movements and business organisations in the area of taxation.

Far from having a substitution effect, a few interviewees suggested that in the Ethiopian context aid might even have an incentive effect to mobilise more tax. This could happen because of the loss of independence and 'shame' coming with aid, which provide an incentive to raise more tax to eventually get out of such a situation of dependency. It could also happen because it makes the government's ambitious development project happen, as emerged in two interviews with a government official and with a close observer. Domestic revenues alone would not allow Ethiopia to implement its plans and vision, as they are still too low. However, the fact that aid is available makes the development project realistic and feasible, thus giving momentum to domestic revenue mobilisation efforts. In other words, the government can match foreign resources with domestic ones to allow the plan to be implemented. So aid seems to complement tax, rather than substituting for it.

### *3.2 The Role of Donors in Tax Policy and Reform*

In practice, there are two main channels through which donors can positively influence tax policy and reform: conditionality and policy advice. However, the historical background discussed in the previous section suggests that foreign influence in Ethiopia is limited and conditionality is relatively weak. This is not only due to strong leadership on the Ethiopian side, but also to the fact that foreign aid in the country is largely driven by political and strategic reasons. Furtado and Smith (2007) put it very clearly: 'Changes in the level of donor assistance to Ethiopia have been driven overwhelmingly by political and geopolitical considerations.' This view was echoed in many interviews and development partners fully recognised it, as illustrated by the following quote:

There is a clear intention by certain governments to provide substantial amount of support to Ethiopia, and if there is no conditionality or if the government does not achieve certain things on policy and so on, it does not really matter. What matters is just to get the money there and be assuring that that creates some stability.

In recent years the strategic importance of Ethiopia was largely due to the emergence of terrorist threats, with the bombings of US embassies in neighbouring Tanzania and Kenya in 1998, as well as the 11 September 2001 terrorist attacks in the United States. Ethiopia is a crucial ally of the United

States and Europe, as it is seen as the only stable country in a region, the Horn of Africa, that faces huge political and security challenges. This has clear implications in terms of conditionality: since donors want to support Ethiopia for political reasons, they have limited bargaining power when negotiating and enforcing conditionality.

A good example of how this situation translated practically in the aid arena is the aftermath of the elections in 2005. On this occasion donors condemned the post-election violence and withdrew untied budget support, which by that time was planned to be scaled up from US\$375 to US\$500 million (Furtado & Smith, 2007). However strategic factors quickly came to play. As noted by a close observer: 'this was exactly the dilemma in 2005, if donors would actually want to leave the country or not'. In a climate of increasing tension and distrust, donors rather quickly came up with a solution in the form of a project, called Protection of Basic Services (PBS). The largest component of PBS provides for service delivery at the regional level through the government's financial management system. While PBS was initially intended as a 'punishment' for the government, by taking away the 'free' money under budget support, things turned out to be very different. An official from one of the key development organisations put it rather clearly:

Because donors did not like not to give money to Ethiopia, they created a new monster that they called PBS which in some sense is the same as budget support but it is really a project. It is a budget support in disguise in many ways.

A source close to the government also noted that PBS is 'almost budget support'.

However, the big difference between PBS and budget support is exactly on conditionality. While with the latter there was a dialogue on macroeconomic policies, with PBS the focus shifted entirely to service delivery at the local level, thus largely wiping off the discussion table broader policy dialogues. An interviewee captured the position of donors with PBS as follows:

They have some influence in terms of where the money is going but in terms of the whole macro policy by the government they don't have any influence, there is no conditionality, there is no discussion.

An observer described the new situation under PBS as follows:

Everybody is able to get out of this fairly pleased. The government is pleased because they get a substantial amount of money without much conditionality, and donors and development partners can see that they have big programs here addressing the needs of the poor.

In the area of taxation PBS includes some 'soft' conditionality in the form of a requirement for additionality, whereby the government needs to follow a trend of increasing domestic revenues to contribute to financing local service delivery. However, there is no specific target, making it technically difficult to enforce this requirement, in addition to the potential political constraints. In the words of a top government official: 'it is not necessary to have a target [on tax] because it is actually more important to us [than to donors]; we *want* to increase revenue'. In fact, there has not been any case in which donors questioned the government's efforts on tax mobilisation; while instead that happened in other areas, for example on monetary policy when inflation reached very high levels, making them worried about its impact on PBS objectives. This suggests that the driver for tax mobilisation is not donors' requests but rather a strong domestic drive to collect more taxes. So even if projects have some requirements on taxation, they may not be strictly enforceable and the government seem to over-perform anyway. Therefore, conditionality must be excluded as a key explanation for the positive aid-tax relation.

However a top official from one of the major development partners noted that even without conditionality 'we are still able to provide advice on policies that would adapt to the general model that the government is having'. In the case of taxation donors and the government are fully aligned on

the objective to increase tax revenues, and can therefore build a collaborative partnership towards a common goal. In this sense, this is an exceptional case in the context of otherwise often conflicting points of view. Therefore, in this area of policy, donors can play an important role through both technical assistance and policy advice.

Various donors are involved in the area of taxation in Ethiopia, some of the most active being the WB, the UK's DFID (Department for International Development) and USAID. For example, the Americans were highly involved in the civil service reform, started in the 1990s, which included tax-related elements. Moreover, the Public Sector Capacity Building Programme (PSCAP) is a large multi-donor programme launched in 2004 and one of its six sub-programmes focussed on taxation. PSCAP thus entailed a reinforced collaboration with donors on tax reform, including substantial long-term advisory and technical assistance. In addition, the UK has supported technical assistance programmes through the HM Revenue and Customs (HMRC), which included a twinning programme and study visits of staff from the Ethiopian Revenue and Customs Authority (ERCA) to the UK. More recently the PBS funded a project aimed at increasing transparency and accountability on tax matters at the sub-national level.

While it is true that a variety of donors have been involved in taxation in Ethiopia, there is little doubt that the most influential actor is the International Monetary Fund (IMF). The IMF's role as the main driver of tax reform in Africa is widely recognised. However, the case of Ethiopia is particularly interesting because the IMF there is not technically a donor, since the country is not part of its lending programme. Therefore, it has purely an advisory role without any leverage related to conditionality. Policy advice is delivered through its resident representative's office and several missions of experts from the headquarters in Washington or the East Africa technical assistance centre (East AFRITAC).

The reform pattern of Ethiopia in the past two decades clearly reflects this donor influence, particularly that of the IMF, and a strong alignment of objectives. In the 1990s the government largely focussed on the reduction of trade taxes that culminated in the abolishment of export taxes in the early 2000s. This was in line with the international push towards liberalisation promoted by WB and IMF at that time. In 2001 the tax administration, previously managed by a Revenue Board, was upgraded to Ministry of Revenue, which allowed it to have direct access to donors' support. However, the major reform of the past two decades happened in 2002, encouraged and supported by development partners. The reform concerned domestic taxes, both direct (Proclamation 286/2002) and indirect (Proclamation 285/2002). Reforms on direct taxation reduced the corporate income tax rate from 35 per cent to 30 per cent, which is in line with the IMF's 'conventional wisdom' (see International Monetary Fund, 2013) of keeping tax rates low and widening the base, rather than having relatively high rates applied to fewer taxpayers. Moreover the new laws introduced taxpayer identification numbers (TIN), deductions for the calculation of business profits, and loss carry forwards, amongst others.<sup>19</sup> The main innovation on indirect taxation was surely the introduction of the value added tax (VAT) from January 2003 with a rate of 15 per cent. Again, the focus on domestic taxation of the 2002 reform is fully in line with the more recent concern of donors on the need to recover potential losses in trade taxes with an increase in domestic indirect taxes particularly. Therefore the international community, and particularly the IMF, strongly supported the introduction of VAT as a way to broaden the tax base, improve efficiency and compliance, and generate additional revenue, amongst other<sup>20</sup> potential advantages.

Whether these advantages actually materialised in practice is still unclear<sup>21</sup> and certainly the VAT encountered some implementation problems in Ethiopia. In the first few years following the reform indirect tax remained relatively low, except for an initial increase. The main issue was compliance in urban areas, as new taxpayers in the 'modern sector' did not have the same history of taxpaying that had developed in rural areas. A top government official noted that:

Levies on farmers have always been there. Refusing to pay was seen as insubordination and nobody would dare to do that. Paying tax was culturally accepted.

However, in the cities, where the bulk of economic activity occurs, the situation was much different. Taxpayers were not complying and the government lacked the administrative tools to enforce the law, which were eventually introduced in 2008. The disengagement of the EPRDF from the private sector, that for many years was seen as rent-seeking<sup>22</sup> rather than a partner in the development process, might have contributed to reinforcing low compliance. The reform not only found the resistance of taxpayers. Also, tax administrators did not collaborate on the implementation of improved systems of collection that would undermine the unofficial benefits that they were able to extract from a mismanaged system.

These implementation problems and the stagnation of tax revenue were certainly a trigger for the 2008 reform of tax administration. The most important innovation was the establishment of the Ethiopian Revenue and Customs Authority (ERCA). This greatly improved the status and efficiency of revenue administration that was now managed under a single and independent authority. Furthermore, the implementation of VAT was complemented with the introduction of electronic sales registration machines. These would record all firms' transactions and report them directly to the newly established ERCA, in a bid to push for broader adoption of IT systems throughout the authority. Finally, a campaign against tax evasion included the imprisonment of evaders and a policy of 'naming and shaming' them in the media. Well-known business people and prominent individuals were prosecuted and often jailed over tax matters, with extensive public coverage of such news. These innovations were accompanied by technical assistance (TA) by donors, which are seen as a major driver of capacity development. For example, the digitalisation of tax records and the adoption of new IT systems to manage this data was supported by foreign technical assistance through a Canadian consultancy firm; while recently HMRC has supported the development of the audit and risk management function. Generally, the 2008 administrative reform succeeded in increasing tax revenues, with the nominal growth rate just slightly falling short of 50 per cent in 2009.

In addition to technical assistance, substantial policy advice from the IMF also played a central role both in the two main reforms of 2002 and 2008, as well as in proposing additional measures. An example of the latter is the recommendation of an IMF Fiscal Affairs Department mission in 2009 to integrate the tax operations of Addis Ababa City with ERCA's federal administration. This was mostly motivated by the underperformance of the City in revenue collections, despite being home to most of the business activity in the country. In particular, the Merkato business area was estimated to involve a large proportion of the country's cash transactions, but it contributed only a small percentage to total tax collections. The IMF therefore recommended the integration of the city's administration into ERCA to increase capacity, efficiency and compliance, as well as stimulating cooperation and coordination between the federal and other sub-national governments. The government received this recommendation well and in 2010 started the process of integration. In the context of the federal structure of Ethiopia, this required careful planning and cooperation between the federal government and the city administration, to clearly define the respective responsibilities and to make sure all laws and constitutional provisions were respected. The integration was eventually implemented from January 2011. Talking about this case, a donor official expressed surprise by saying: 'we thought it would have been impossible and actually the government did it in the span of six months.' At the time of the fieldwork, sufficient data was not yet available to allow an evaluation of the success of this operation in terms of revenue generation. However, this is certainly a good example of the positive change that can be triggered on the initiative of donors, when there is strong alignment and cooperation with the government. It also illustrates the key advisory role of the IMF, which is also documented in the following quote from a government official.

The IMF gives us good advice on fiscal policy. Actually that is one of the areas where there is little divergence.

Despite not being a donor, the IMF had a privileged and influential dialogue on fiscal policy with the government. This can partly be due to its role of lender of last resort, even if it is not currently a donor. However, this good dialogue between the government and the IMF on fiscal policy can be regarded as exceptional. While other donors provide technical assistance and contribute to improving tax administration in particular, the dialogue on policy is often limited. In the context of broader macroeconomic policies, several divergences persist between the government and development partners. However, on

fiscal policy a productive dialogue could be established with the IMF, for three reasons in particular. Firstly, the fact that the IMF is not a donor and it therefore does not have the power to impose any conditionality, allows the establishment of a peer-to-peer relation. This is particularly important in light of the spirit of independence and nationalism described in [Section 3](#). The second reason is a strong alignment of objectives between these two bureaucracies on taxation. This may seem an anomaly since the ideology of the Ethiopian government, originally linked to Marxist ideals and more recently to the concept of a developmental state, is clearly at odds with the more liberal approach generally embraced by the IMF. This divergence of views appears clearly, for example, in the case of liberalisations in key sectors of the economy, on which the two institutions are still at odds. However the IMF's stance on fiscal policy is certainly in favour of strong states, including the increase of the tax to GDP ratio.<sup>23</sup> By supporting tax mobilisation, and implicitly a stronger state, the IMF's view is therefore consistent with government's objectives and it allows for a collaborative partnership on tax reform. Thirdly, the IMF is able to provide a very high level of technical experience and professionalism on taxation, given its long engagement in this area of policy throughout the world. These factors are particularly important for a government that has shown a large degree of professionalism and commitment itself, by directly engaging in the international debate on economic development and on the role of the state in this process. While the economic ideas of the EPRDF leadership did not always find wide agreement, they have certainly been influential and they benefited from the support of prominent economists.<sup>24</sup> The fact that the IMF is probably the most experienced international institution in the area of fiscal policy has certainly influenced the consideration that the government has for its advice.

#### **4. Conclusions**

This article shows evidence of a positive relation between aid and tax in Ethiopia ([Section 2](#)), and it argues that this is largely due to policy advice and technical assistance rather than conditionality ([Section 3](#)). By doing this, it contributes to the broader debate on aid effectiveness and more specifically to the literature exploring the aid-tax relation. This is still an unsettled issue in the literature. While the recent cross-country tax effort literature and fiscal response studies reject the presence of a crowding out effect, or even in some cases support the existence of a positive relation; some authors still argue that aid negatively affects taxes. The econometric evidence presented in this article supports the former camp. It suggests that aid, far from being a disincentive to tax mobilisation, is positively associated with tax revenues.

The qualitative evidence complements this result by exploring the role of historical, political and economic factors in explaining this positive relation. It shows that the historical and political background of Ethiopia is an important factor in understanding the relation between donors and the government in general, and particularly in the area of tax. Independence is a source of national pride and political legitimacy in the country, therefore making a substitution effect particularly ill-grounded in this case. While this sentiment certainly stems from the unique history of independence of Ethiopia, such history becomes less and less distinctive as the colonial legacy loses its influence over time; and as African countries become more willing and able to be independent from foreign aid. Therefore, this finding may be relevant to the broader group of low-income and aid dependent countries, rather than being specific to Ethiopia. However, it must be noted that the evidence presented in this article applies directly to Ethiopia, while considerations on its external validity in other countries can only be speculative.

This article argues that aid in Ethiopia positively affects tax revenues particularly through technical assistance and policy advice, rather than conditionality. Importantly the two, TA and policy advice, are related but distinct factors, as illustrated by the case of the IMF that is highly influential while not currently being a donor. In the context of Ethiopia, this can be regarded as an exceptionally good relation with the IMF and three elements are discussed to explain it. More generally, the case of the IMF shows that under certain circumstances, including most notably a strong political commitment and alignment of objectives, the establishment of collaborative relations with development partners can be an important catalyst for tax revenue mobilisation. This finding not only supports the

effectiveness of foreign aid in the short run, as there is no evidence of a crowding-out effect; but it also suggests its importance in building the foundations to sustainable development in the longer term.

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## Notes

1. See for example Arndt, Jones, and Tarp (2010); Rajan and Subramanian (2008); and Bourguignon and Sundberg (2007).
2. For example, see Bräutigam and Knack (2004), Knack (2009), and Moss, Pettersson, and van de Walle (2006).
3. Aid may also affect tax revenues more indirectly through trade and income.
4. See Fjeldstad and Moore (2008); Prichard, Brun, and Morrissey (2012); Moore (2013).
5. See Carter (2013); Fjeldstad (2013); Moore (2013).
6. An exception to this is, for example, Eubank (2012).
7. For an overview, see Lloyd, McGillivray, Morrissey, and Opoku-Afari (2009).
8. Amongst others, DFID has identified Ethiopia as one of its focus countries in its bilateral aid review (Department for International Development, 2011).
9. Ethiopia is rated highest together with South Africa (OECD and African Development Bank Group, 2010).
10. See Engle and Granger (1987).
11. See for example Gupta et al. (2004), Morrissey et al. (2006), Clist and Morrissey (2011), and Mkandawire (2011).
12. In other specifications reported in Mascagni (2014), grants are not statistically significant in the long run.
13. A full bibliography is available on request from the author.
14. In-depth interviews were carried out between 21 October and 10 November 2012 in Ethiopia under the condition of anonymity of interviewees. All quotes reported in this section are from these interviews, for which I have detailed records. They are kept anonymous throughout to guarantee confidentiality.
15. From a two hour question session in 2008 following the presentation of Meles Zenawi's thesis on the developmental state.
16. For a full account of the events in 2001, see Medhane Tadesse and Young (2003).
17. Meles Zenawi's Millennium speech of 2007 is available on [www.nazret.com](http://www.nazret.com).
18. From Professor Bahru Zewde's keynote lecture on the 'Dynamics of political succession in Ethiopia' at the 18th International Conference of Ethiopian Studies on November 1st 2012 in Dire Dawa, Ethiopia.
19. For more details see Alemayehu Geda and Abebe Shimeles (2005).
20. See Keen and Lighthart (2002); Keen and Simone (2004); Keen and Syed (2006); International Monetary Fund (2011).
21. See Baunsgaard and Keen (2010).
22. See Markakis (2011).
23. See International Monetary Fund (2011).
24. For example Joseph Stiglitz, as reported in Gill (2010) and Dereje Feyissa (2011).

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